The McGraw-Hill Companies

Financial Services

Dr S GURUSAMY

Ph.D., in Financial Services
Reader, Department of Commerce
DG Vaishnav College
Chennai

Vijay Nicole Imprints Private Limited
CHENNAI

The McGraw-Hill Companies

Vijay Nicole Imprints Private Limited

No. 2/43, Valayapathy Street, J.J. Nagar
Mogappair East, Chennai - 600 037
Email: iipvni@vsnl.net, vijaynicole@eth.net
Website: www.vijaynicole.com

ISBN: 81-8209-073-3

Laser typeset at: Windom Publishing Private Limited, Chennai

Printed at: Chennai Microprint Private Limited, Chennai

Preface

Financial Services is a current topic of interest to people from all walks of life. The financial services sector is the nucleus of the growth model designed for the economic development of a country.

This book is a spin-off of my books *Financial Services and Systems* and *Financial Institutions and Markets*. It is designed to meet the undergraduate requirements of students of commerce.

This book is in 20 chapters and covers topics of current interest including merchant banking, public issue management, new issues and underwriting of securities, leasing, hire purchase, factoring, consumer finance, venture capital, insurance and pension funds.

Student-friendly, crisp and tailor-made for undergraduate students, the book has the following salient features:

1. Emphasis on clarity of concepts
2. Simple language for ease of understanding
3. Complete coverage of the undergraduate curriculum of various universities
4. Examination oriented with summary and numerous review questions
5. Up-to-date material, current information on hot topics like insurance, consumer finance, credit rating, pension fund, and so on

My deep sense of gratitude goes to my mentor and research guide late Dr N Vinayakam, who was the source of inspiration for the ultimate materialization of this work. I am indeed indebted to my beloved parents whose blessings are the source of my strength always. I thank my wife and children for their excellent cooperation. I acknowledge Mr D Sathyamurthy, Managing Director, Saravana Stocks Private Limited, Chennai for his valuable suggestions.

I take this opportunity to express my sincere thanks to Mr P K Madhavan and his colleagues at Vijay Nicole Imprints for timely publication of this book.

I would be grateful for feedback and suggestions from readers.

Dr S Gurusamy

This work is dedicated

To

The most esteemed members of
'Shri Vallabhacharya Vidyasabha,'
Chennai

Contents

Chapter 1

Financial Services—An Overview

Financial services constitute an important component of the financial system. Financial services, through the network of elements such as financial institutions, financial markets and financial instruments, serve the needs of individuals, institutions, and corporates. It is through these elements that the functioning of the financial system is facilitated. Considering its nature and importance, financial services are regarded as the fourth element of the financial system. In fact, an orderly functioning of the financial system depends, to a great deal, on the range and the quality of financial services extended by a host of participants.

FINANCIAL SERVICES—CONCEPT

Services offered by banking and financial companies are called 'financial services'. Banking and financial companies include both Asset Management Companies and Liability Management Companies. Asset Management Companies include leasing companies, mutual funds, merchant bankers, and issue/portfolio managers. Liability Management Companies comprise of the bill discounting and acceptance houses.

FINANCIAL SERVICES—OBJECTIVES/FUNCTIONS

Following are the objectives of financial services that are generally offered by banking financial companies:

1. ***Fund raising*** Financial services help to raise the required funds from a host of investors, individuals, institutions and corporates. For this purpose, various instruments of finance are used. The funds are demanded by corporates houses, individuals, etc.
2. ***Funds deployment*** An array of financial services are available in the financial markets which help the players to ensure an profitable deployment of the funds raised. Financial services assist in the decision making regarding the financing mix. Services such as bill discounting, factoring of debtors, parking of short-term funds in the money market, credit rating, e-commerce, and securitization of debts are provided by

banking financial services firms in order to ensure efficient management of funds.

3. ***Specialized services*** The financial services sector provides specialized services such as credit rating, venture capital financing, lease financing, factoring, mutual funds, merchant banking, stock lending, depository, credit cards, housing finance, book-building, etc. besides banking and insurance. Institutions and agencies such as stock exchanges, specialized, and general financial institutions, nonbanking finance companies, subsidiaries of financial institutions, banks, and insurance companies also provide these services.
4. ***Regulation*** There are agencies that are involved in the regulation of the financial services activities. In India, agencies such as the Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) and the Department of Banking and Insurance, Government of India, through a plethora of legislative measures, regulate the functioning of the financial service institutions. The objective is to ensure an orderly functioning of the financial markets.
5. ***Economic growth*** Financial services contribute, in good measure, to speeding up the process of economic growth and development. This takes place through the mobilization of the savings of a cross section of people, for the purpose of channeling them into productive investments. In this connection, it is to be noted that a number of developed and developing countries which have a highly efficient financial market, have witnessed a greater rate of savings and investments.

FINANCIAL SERVICES—CHARACTERISTICS

Like any other service, financial services too are characterized by the following:

1. ***Intangibility*** The basic characteristics of financial services are that they are intangible in nature. For financial services to be successfully created and marketed, the institutions providing them must have a good image and enjoy the confidence of their clients. Quality and innovativeness of services are the focal points for building credibility and gaining the trust of the clients.
2. ***Customer orientation*** The institutions providing financial services study the needs of the customers in detail. Based on the results of the study, they come out with innovative financial strategies that give due regard to costs, liquidity, and maturity considerations for various financial products and services. This way, financial services are customer-oriented.

3. ***Inseparability*** The functions of production and supply of financial services have to be carried out simultaneously. This calls for a perfect understanding between the financial services firms and their clients.
4. ***Perishability*** Financial services have to be created and delivered to the target clients instantaneously. They cannot be stored. They have to be supplied according to the requirements of customers. Hence, it is imperative that the providers of financial services ensure a match between demand and supply.
5. ***Dynamism*** Financial services must be dynamic. They have to be constantly redefined and refined on the basis of socio-economic changes occurring in the economy, such as disposable income, standard of living, level of education, etc. Financial service institutions must be proactive in nature, and constantly evolve new services by visualizing the expectations of the market.

FINANCIAL SERVICES MARKET—CONCEPT

The market for the exchange of financial services products and instruments through a wide variety of players, each one offering a unique type of service, may be designated as the 'financial services market'.

FINANCIAL SERVICES MARKET—CONSTITUENTS

The financial services market comprises of four major constituents as stated below:

1. ***Market players*** Financial services are offered by a host of institutions and agencies that understand and meet the requirements of a wide spectrum of customers. The players include banks, financial institutions, mutual funds, merchant bankers, stockbrokers, consultants, underwriters, market makers, corporate bodies, FIIs, custodians, vendute capital funds, etc.
2. ***Instruments*** Financial instruments constitute an important part of the financial services market. The instruments include equity instruments, debt instruments, hybrid, and exotic instruments. It is characteristic of a financial services market that a number of innovative instruments such as zero-coupons bonds, etc. are floated, on a continuous basis. The purpose is to keep the financial markets vibrant.
3. ***Specialized institutions*** A financial services market is characterized by the dynamic presence of specialized institutions. These include acceptance houses, discount houses, factors, depositories, credit rating agencies, venture capital institutions, etc.

4. ***Regulatory bodies*** The financial services market is regulated by a host of institutions and agencies. The regulatory bodies include the Department of Banking and Insurance of the Central Government, Reserve Bank of India, Securities and the Exchange Board of India, Board for Industrial and Financial Reconstruction, etc.

GROWTH OF FINANCIAL SERVICES IN INDIA

The growth of financial services in India has taken place under the various stages. It is outlined below:

Merchant Banking Era

The period between 1960 and 1980 may be called the 'merchant banking era'. During this period, financial services such as merchant banking, insurance, and leasing services began to grow. During this period, merchant bankers carried out the following functions:

1. Identifying projects, preparing feasibility reports, and developing detailed project reports
2. Conducting marketing, managerial, financial and technical analysis on behalf of their clients
3. Assist in designing an appropriate capital structure
4. Acting as a bridge between the capital market and the fund-seeking institutions
5. Carrying out underwriting functions
6. Assisting enterprises in getting their issues listed on the stock exchange
7. Offering legal advice relating to mergers and acquisitions
8. Providing technical advice on leveraged buyouts and takeovers
9. Extending syndication facility as part of arranging project finance
10. Arranging working capital loans

Investment Companies Era

This era marked the setting up of a variety of investment institutions and banks. The investment companies include the Unit Trust of India, which is the largest public sector mutual fund in the world, the Life Insurance Corporation of India that initiated the life insurance business and the general insurance corporations. The Life Insurance Corporation of India has grown as a public monopoly. In 1970, insurance which until then was in the private sector, was nationalized. On nationalization, an insurance corporation was set up as a holding company with four subsidiaries to handle the general insurance business in the public sector. The leasing business started emerging at the close of the 1970s. Although such companies were initially engaged in equipment lease financing, later they undertook leasing operations of different kinds, such as financial, operating and wet leasing.

Modern Services Era

This stage marked the launch of a variety financial products and services during the eighties. These financial services included over-the-counter services, share transfers, pledging of shares, mutual funds, factoring, discounting, venture capital, and credit rating. The mutual fund industry introduced innovative schemes for savings mobilization in order to encourage the savings habit among the people. With their transparent asset and liability management, mutual funds offer attractive and stable returns on the investors' money.

An important financial service that was introduced in the Indian financial sector during this period was 'credit rating'. The system of credit rating was designed to boost investors' confidence, and encourage their active participation in the capital market operations, besides promoting sound discipline in the financial system. The constitution of venture capital funds was another landmark development in the Indian financial services sector. Factoring became a popular mode of short-term financing, both in domestic as well as international trade transactions. The entry of commercial banks in the above services changed the entire profile of the financial system in India.

Depository Era

In order to integrate the Indian financial sector with the global financial services industry, depositories were set up. The depository system was introduced with a view to promoting the concept of paperless trading through the dematerialization of shares and bonds. The stocklending scheme approved by the Central Government in the 1997-98 budget conceived the idea of setting up a separate corporation to deal with the trading of "Gilts". The introduction and popularization of book-building was also another step forward in the direction of building a strong financial services sector in India. This step is likely to benefit both the investors and fund users. Similarly, the 'on-line trading' interface introduced by the Bombay Stock Exchange, the Delhi Stock Exchange, and the computerization of the National Stock Exchange, are all acting as the fulcrum for the development of a strong financial services market in India. Such a measure is expected to give a fillip to paperless trading, save the investors from the onslaught of jobbers and brokers, and ensure better tax compliance too. In order to protect investor interest and to pave the way for regulation, growth and development of financial services, the SEBI comes out with periodical guidelines relating to the capital adequacy ratio for merchant bankers and other players in the financial system.

Legislative Era

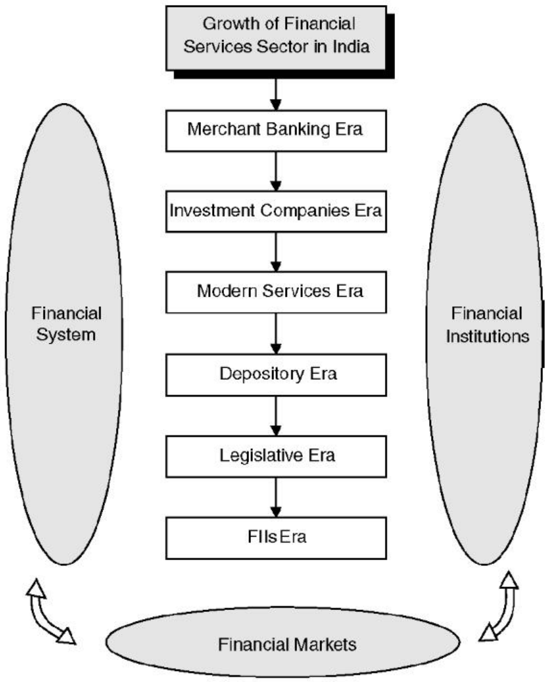
Several legislations were introduced in order to allow for broad-based development in the financial services sector. The FERA has been replaced by FEMA. Far-reaching amendments were made in the Indian Companies Act, Income Tax Act, etc. to facilitate safe and orderly trading, and settlement of transactions. A landmark development that took place in the legislative era was the enactment of a separate law to regulate the 'Internet Trading' of securities.

Foreign Institutional Investors (FIIs)

This era marks the latest stage in the growth of the Indian Financial markets. The economic reform measures initiated by the government necessitated greater free play for various participants. As part of it, divestment guidelines have been issued by the SEBI in recent times, whereby FIIs are permitted to operate in the Indian capital market. Such a step is aimed at infusing vibrancy to the Indian capital market so as to contribute to its growth and development.

Financial services firms in India are increasingly looking for ways and means by which the Indian corporate sector could mop up capital from the international financial markets such as London, Luxembourg, New York, etc. GDR and ADRs are the usual route through which these portfolio investments have flowed to India. The Indian financial services institutions work in fandum with world-level financial services institutions, such as Lehman Brothers, Arthur Anderson and Goldman Sachs as part of their efforts to upgrade to world standards in the matter of management of financial services. The various stages involved in the growth of Indian financial services industry is depicted in Exhibit 1.

Exhibit 1 Stages of Growth of Financial Services Sector in India



FINANCIAL SERVICES SECTOR—PROBLEMS

The Indian financial services industry has been making rapid progress in in various spheres of financial services. In fact it is preparing itself to face competition, especially from its global counterparts. With the gradual opening up of the economy, this sector is fast integrating with global financial markets, besides effectively tackling the competition from foreign financial firms in India. However, this sector faces many problems. A brief description of some of these problems is presented below:

1. ***Lack of expertise*** To be able to understand and implement many of the financial services schemes, experts are required. Despite the presence of a number of institutions and professional bodies, there has been noticed a dearth of personnel with expert knowledge to manage the firms engaged in financial services sector in India. The public sector financial services industry, for instance, is constrained by restrictions imposed on salaries, etc. and the private sector firms too cannot match the offers made by the foreign financial firms.

2. ***Inadequate accommodation*** Financial services firms require accommodation at central locations in order to be able to effectively cater to the needs of a wide variety of clients. Finding a suitable place in the financial capital of India, Mumbai, has become a serious problem due to skyrocketing real estate prices.
3. ***Inadequate technology*** One of the basic problems faced by the Indian financial services firms is that they lack adequate and time-tested technology to efficiently create and deliver the financial products to the clients. For instance, relative tardy growth of computer and telecommunication technology has constrained the growth of the financial services industry in India considerably in the initial period. Further, institutions and banks lack sufficient networking facility needed for undertaking the transfer of various instruments.
4. ***Inadequate quality service*** Rendering financial service efficiently is the cornerstone of a successful financial services market. In fact, the key to survival is to deliver quality services and products at the right price, at the right place and at the right time. This calls for the application of appropriate technology to process a large flow of information to their clients. Indian financial services firms need to improve the quality of their services to the satisfaction of their clients. Very often, there is complaint of high fees and poor quality service. The work of credit rating agencies also comes under attack, as the grading furnished by them is often unreliable.
5. ***Captive organizations*** The practice in India is that most financial service institutions have been set up as subsidiary organizations of large commercial banks and financial institutions. The subsidiary institutions, thus, depend on their parent institutions for funds. This obligates the parent firms to lend at rates of interest lower than that of the market rates, despite situations where the parent institutions are hard-pressed to raise funds at a higher cost. Although such a practice helps the subsidiaries to operate economically with adequate margin, it deprives the parent institutions of making efficient use of their funds. This results in increased cost of funds being allocated to the financial services subsidiaries. Moreover, the practice has failed to provide a level-playing field to the financial service enterprises, thus eroding their competitive advantage.
6. ***Restricted scope of operations*** The scope of operations relating to financial services is currently restricted to certain segments. For instance, the scope of venture capital operations in India is restricted to providing finance for start-up, high-tech projects and to converting

R&D efforts into commercial production. Venture capital funds in India are shy of entering the services sector. The scope therefore needs to be widened to include a variety of services such as supply of seed capital for expansion and growth, buyouts, turnarounds, mergers, and acquisitions, etc. In the same way, lease financing should not be restricted to operating and financial leases.

7. ***Limited innovation*** The growth and development of the financial system is measured in terms of the width and depth of the range of products offered by it. There has been limited innovation in the realm of financial services products. It is imperative therefore that the financial services sector works to achieve growth and development, by innovating and introducing a wide range of financial products tailor-made to suit the needs of varying entrepreneurs. For instance, a number of tailor-made and imaginatively designed financial packages may be offered by the venture capital funds to satisfy the needs of entrepreneurs.

   Similarly, leasing firms should be encouraged to provide leasing facilities for a variety of capital equipment, besides ensuring that leasing companies are not created merely to trade in tax shields at government cost.
8. ***Lack of sound institutional mechanism*** An immediate requirement for a healthy financial services sector is the existence of a sound institutional mechanism. This is important for a broad based and a strong financial system. Moreover, there must be a wide range of financial services available too. The establishment of a sound institutional mechanism, whereby the existing financial institutions, banks and insurance companies are allowed to open full-fledged subsidiaries, is therefore, called for.
9. ***Other problems*** In addition to the above, the following are some of the problems faced by the financial services sector in India:
   1. Lack of core-competence and resultant insufficient competitive advantage.
   2. Lack of reliable benchmarking, thus depriving them of the benefit of cost-control, cost-reduction, and review of processes and procedures governing their activities.
   3. Indulgence by certain firms in unfair practices including imparting unethical advice to their clients, etc.

REVIEW QUESTIONS

Section A

1. What are 'financial services'? Name them.
2. What is a financial services market?
3. State the significance of 'depository era' in the development of Indian financial services market?
4. State the significance of 'FIIs era' in the development of Indian financial services market?

Section B

1. What are the objectives of financial services?
2. What are the characteristic features of financial services?
3. What are the constituents of a financial services market?
4. Identify the problems faced by the financial services market in India.

Section C

1. Discuss the different stages in the growth and development of financial services market in India over the ages.

Chapter 2

Financial Services Environment

Financial Services Environment (FSE) connotes forces that drive the contemporary evolution in the structure of financial services and markets of a national economy. These forces include policies of money, growth, financial markets etc. formulated by the government.

THE FORCES

The forces that influence the financial services are as follows:

1. Employment and unemployment
2. Inflation and deflation
3. Trade cycles
4. Stagflation
5. Economic growth
6. The exchange rate and balance of payments
7. Deregulatory measures
8. Technological changes
9. Enhanced competition
10. Global portfolio preferences

The forces that influences the financial services environment are depicted in Exhibit 2.

Exhibit 2 Financial Services Environment

A brief description of the various forces that influence the dynamics of a financial services market is presented below:

Employment and Unemployment

Full employment ensures better utilization of resources of a nation. It also enhances the country's Gross National Product(GNP). Unemployment refers to involuntary idleness of resources including manpower. Persistence of this problem leads to a situation where the actual output GNP is less than the country's potential output.

Inflation and Deflation

Inflation represents a situation of constantly rising prices of commodities and factors of production. Inflation, is the persistent upward movement in the general price level which results in a decline in the purchasing power of the monetary unit. Inflation affects different segments of people in different ways. Inflation brings about a change in the pattern of income distribution. The situation of falling prices is called deflation. Both inflation and deflation are fraught with consequences, good and bad. It therefore becomes the task of the government to mitigate the ill-effects of inflation and deflation.

Trade Cycles

Trade cycles are periodic fluctuations in the levels of economic or business activity which is reflected in the variation in GNP. The fluctuations occur on production and employment fronts over time. Periods of good trade alternate with periods of bad trade. In other words, boom periods of high output and high employment alternate with slump periods of low employment rate. In periods of recession, unemployment is high and the rate of inflation is moderate. The causes of business cycles are to be studied so as to undertake remedial measures.

Stagflation

Stagflation represents the coexistence of inflation and unemployment in a stagnant economy. Most modern economies suffer from this malady.

Economic Growth

The trend in the nation's total output over a certain period is known as economic growth. It refers to an expansion of society's production capacity such as bringing new land under cultivation or setting up new factories etc. Growth is measured by the annual rate of increase in per capita income. There are three major sources of growth viz., labor force, capital formation, and technological progress. A country seeks to achieve economic growth mainly for improving the living standards of its people. If the rate of economic growth exceeds the rate of population growth, there will be an improvement in the standard of living of the people.

Exchange Rate and Balance of Payments

The balance of payments is a systematic record of all economic transactions of a country with the rest of the world in an accounting year. These transactions are largely influenced by the exchange rate. The rate at which the currency of a country is exchanged for the currency of another country is called rate of exchange.

Deregulatory Measures

The need for joining the drive towards deregulation of domestic financial markets and their eventual integration with the world financial markets also acts as a force for innovations in the financial services market. The worldwide reduction of structural rigidities and other barriers to competition stimulate a greater competitiveness between the national and financial positions and assure an equality of competitive conditions between all financial intermediaries. This helps decreased costs of intermediation thus making markets more efficient.

Technological Changes

The worldwide revolution happening in the realm of information technology is another fundamental force underlying change and innovation in financial markets. This revolution has come about through the development of increasingly more sophisticated computers and their widespread application for efficient hand ling of information. This has strongly influenced the progress towards greater perfection in goods and financial markets alike and has led to much higher trading activity.

Lowcost, instantaneous telecommunications have been vital in bringing together financial market participants worldwide to create truly global financial markets with the possibility of round-the-clock trading. One of the most important results of this growth in technology has been the significant increase in the efficiency with which information is disseminated and interpreted in both cash and futures sectors of world financial markets. This brings greater breadth and depth to trading. Further, it encourages financial institutions to make and market new instruments, since providers of innovations are enabled to match up directly or indirectly with end users who have previously only enjoyed isolated markets.

Enhanced Competition

Growing competition in international financial markets is another factor which has increased the pressure for innovation and structural change. Competition results from technology changes and from shift in savings and investment patterns. The increased competition happens between different national financial systems, and between banks and nonbank financial institutions within a national financial system. Technological advancement has given rise to the birth of the concept of 'financial supermarkets', which mark a clear departure from the traditional versions of financial services viz., loans, deposits, credit cards, and insurance, to offering customized new products and services.

Global Portfolio Preferences

The shifting global portfolio preferences have a strong impact on the nature of developments to take place in the realm of financial markets around the globe. For instance, the 'second oil shock' shifted wealth from the oil-consuming countries to the oil producers and then, in the wake of economic adjustments, back to Europe, Japan, and a few small Asian countries. The OPEC portfolio holders were more attracted into short-term bank deposits, but today's Japanese investors prefer treasury bonds. These differing portfolio preferences among investors and corresponding differences among debtors have fostered such innovations as swaps and options, securitization, etc.

PLAYERS IN FINANCIAL MARKETS

Households

Households are the people that include wage earners, individuals, housewives, and others. The demand for funds arises for meeting the needs of investment in housing, education, and consumer durables. The supply of funds arises as a result of savings, savings for a retired life, savings for meeting precautionary motive, etc. The demand for and the supply of funds from these players are largely influenced by demographic factors such as age, sex, income level, marital status, personal taxes, etc.

Business Firms

The demand for funds arises owing to their engagement in two types of investments, viz., working capital and fixed capital investments. Firms meet their funding requirements either though borrowings or though their own accumulated savings. The demand for and the supply of funds depends upon such factors as the state of the economy, whether the economy is in the state of boom, or recession, technological progress, taxes, etc.

Financial Firms

These are the institutions and agencies involved in the provision of financial services. Financial firms include brokers, merchant bankers, underwriters, custodians, banks, financial institution, investment bankers, etc.

Governments

Governments such as central, state, and local bodies take part in financial markets, both as borrowers and as lenders of funds. Their primary role is confined to borrowing of funds. In fact, one of the methods of government financing is popularly called 'deficit financing'. Deficit financing requires borrowing to bridge the deficit. Where surplus is yielded on account of excess of revenue over the expenditure, government becomes a lender. Hence, factors such as tax revenues and expenditures predominantly determine the demand for and the supply of funds.

External Agencies

Apart from the domestic agencies such as households, governments, and firms, external agencies such as foreigners also cause demand and supply of funds. This is called 'international borrowing and lending'. Factors such as information, transaction costs, determine the demand for and the supply of loanable funds. Foreign exchange market is concerned with borrowing and lending of foreign currencies.

INTEREST RATE DETERMINATION

Meaning

The rate of exchange between present and future resources is called 'market interest rate'. An interest rate refers to the price of a loan. Interest rate represents terms at which short-term funds are loaned and borrowed.

Features

a. Shifting resources Interest rate helps those who wish to bring future resources to the present by borrowing and those who wish to shift present resources to future by lending

b. Future expectation The exchange of resources takes place through the mechanism of market rate of interest. It tells participants as to how much money is to be expected in future for the money lent now

c. Rate determination The relative demand for and supply of funds determine the market rate of interest. The market rate of interest is always positive because lenders have the alternative of keeping the funds idle and therefore there is no question of getting anything less in future than what they give up now.

d. Different rates There are many market rates depending on the length of time and the extent of risk of funds. The rate as applicable to a risky company will be higher than that paid by the government because lenders are risk-averse and require greater compensation in future resources from risky borrowers.

Determining the Rate of Interest

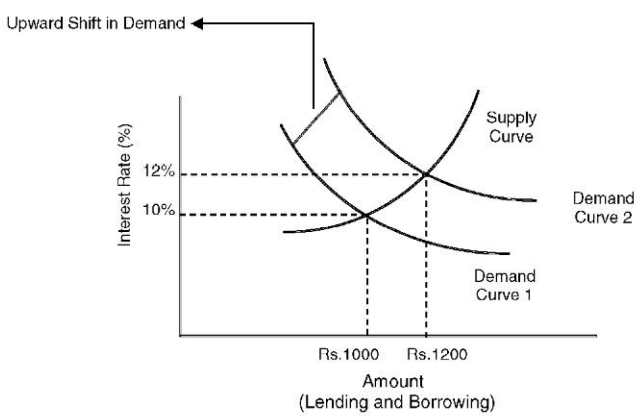
The rate of interest for funds is determined by the demand for and the supply of funds.

a. Demand for funds Demand for funds is indicated by the 'demand curve'. The function of a demand curve is to show different rates of interest at which borrowers would be willing to borrow. Demand curve always slopes downwards. This is because; high interest rate would result in less borrowing and vice versa. Further, higher rate of interest fuels the necessity for a promise of higher amount in future for a given amount at present. This makes borrowings less attractive. Moreover, demand curve represents the behavior of borrowers.

b. Supply of funds Supply of funds is indicated by the 'supply curve'. The function of a supply curve is to show the different rates of interest at which lender would be willing to lend. Supply curve always slopes upwards. This is because; high interest rate would result in more lending by lenders and vice versa. Supply curve represents the behavior of lenders.

As shown in Exhibit 3, the rate of interest of 10 percent is determined by the interplay of the forces of demand for and supply of funds of Rs. 1,000. If demand for funds increases from Rs. 1,000 to Rs. 1,200, the rate of interest increases from 10 percent to 12 percent. This is of course based on the assumption that the supply of funds remains constant at Rs. 1,000.

Exhibit 3 Supply Curve—Behavior of Lenders



MACROECONOMIC AGGREGATES IN INDIA

Macro economic aggregates constitute a set of policies and programs that are formulated and implemented by the national Government in tandum with the central monetary authority as part of management of the economy.

Government policies for macroeconomic management are geared to initiating and nurturing industrial activity and exports. The objective is to overcome sluggishness in the industrial sector and the deepening of the synchronized slowdown in the global economy. In the recent past, a robust recovery in agricultural performance, comfortable food stocks, record lows in inflation, and a strong improvement in the balance of payments, have helped bring about a large accretion to the foreign exchange reserves and, provided a favourable environment for the macroeconomic policy stance of the government. Significant macroeconomic aggregates and their features of India are discussed below:

Real Sector Policies

Real sector policies are guided by the objective of boosting domestic investment demand by expanding the participation of private enterprise and by promoting foreign investment. For instance, trade policies focus on an aggressive medium-term export strategy, both product and market specific, within the overall goal of raising India's share in world exports. The process of removal of Quantitative Restrictions (QRs) and the reduction/rationalization of tariffs is carried forward. Foreign investment policy extends the liberalization of extant ceilings on Foreign Direct Investment (FDI) in various sectors. Liberalization is also effected in respect of the participation of FIIs in Indian corporate entities. Norms for overseas issuances by Indian companies and Indian direct investment abroad are eased significantly alongwith procedural simplifications.

Fiscal Policies

Fiscal policies renew commitment to consolidation and rectitude alongside a six-pronged strategy to reinvigorate the economy and return to a growth path consistent with its potential. Monetary policy aims at ensuring adequate liquidity to meet credit demand, and pursues the objective of softening of interest rates consistent with a vigil on price stability. The refined channels of credit delivery, and the operational effectiveness of monetary policy are sought to be improved as an integral part of building the institutional infrastructure and augmented for an efficient and vibrant financial system. Banking and financial sector reforms are aimed at deregulating the policy environment so as to enhance the operational efficiency of financial intermediaries, thus strengthening these institutions by benchmarking prudential standards against international best practices, improving the regulatory and supervisory function, and enhanced transparency, accountability, and market discipline.

Agriculture Policy

Agricultural policy aims at initiating measures for the development of the agriculture sector. A number of steps have been undertaken in this regard. For instance, measures have been taken to reduce foodgrain stocks that are posing problems of storage and disposal. QRs on export of several food items including wheat and wheat products, coarse grains and pulses have been dismantled. The Central Issue Price (CIP) of wheat and rice was lowered for the Above Poverty Line (APL) consumers so as to increase the off-take under the Targeted Public Distribution System (TPDS). The policy of dividing the country into five zones for selling subsidized wheat in the open market was also removed. Each State is now treated as a separate zone and the actual freight cost incurred by the FCI in transporting wheat to that State is charged.

Several new initiatives under the "save grain campaign scheme" to reduce losses of foodgrains during the post-harvest period have been initiated, including creation of additional storage capacities, additional capacity for bulk handling, storage and transportation facilities and creation of conventional godowns through private sector participation. Grain banks are proposed to be established in various locations of the country.

Forward trading is being allowed in sugar. A package of policy measures aimed at boosting sugar exports and forward trading has been announced. Three exchanges were given 'in-principle' approval to carry out futures trading in sugar. A consortium was given an 'in-principle' approval to set up a multi-commodity exchange to undertake futures and spot trading in 30 commodities.

A key objective of fiscal policy is the acceleration of agricultural reforms, the removal of regulatory and procedural rigidities and an improved infrastructure in the agricultural sector. Assistance from Rural Infrastructure Development Fund (RIDF) is linked to reforms in the agriculture and rural sectors and funds for RIDF-VIII have been enhanced. The allocation for the Accelerated Irrigation Benefit Programme (AIBP) was also stepped up.

Policy on Manufacturing, Infrastructure and Services

Policy initiatives are continued to be taken under the gamut of 'economic liberalization', to support and promote manufacturing, infrastructure and services sector. For instance, FDI up to 100 percent is permitted in a wide range of manufacturing activity and commerce, in Special Economic Zones (SEZs) and in telecommunications, airports, courier services, drugs and pharmaceuticals, and hotel and tourism sectors. The defence sector has been opened up for private participation. The Union government has put in place a tourism development package consisting of development of six tourism circuits to international standards and permission for Special Purpose Vehicles (SPVs) to raise resources from both public and private sectors for infrastructure development in these circuits. Steps are also taken to address infrastructural constraints through the implementation of the National Highway Development Project, expansion in the ambit of National Telecommunication Policy through opening up of Domestic Long Distance Telephony, etc. An Infrastructure Equity Fund of Rs. 1000 crores has been set up for providing equity investment for infrastructure projects.

The policy for the automobile industry allows foreign equity investment up to 100 percent in this sector without any minimum capitalization norms. It aims to promote the Indian automotive industry as globally competitive, with a balanced transition to open trade at minimal risk to the Indian economy and local industry. The Government has also removed the outstanding export obligation of auto companies, given the imperatives of the World Trade Organization (WTO).

The Plan outlay on power, roads and national highways and railways is enhanced substantially to step up public investment in infrastructure. Measures are undertaken to address the issue of appropriate user-charges necessary to provide adequate returns on investment. The Accelerated Power Development Programme (APDP) has been redesigned as the Accelerated Power Development and Reform Programme (APDRP) with enhanced plan allocation. Access of the States to the fund under the programme will be on the basis of agreed reform programmes.

Trade Policies

The Medium-Term Export Strategy (MTES) sets out a road map for the export sector, which is coterminus with the Tenth Five-Year Plan period. The MTES aims at increasing India's share in world trade. The MTES includes product (220 commodities) and market identification for exports and indicative sector wise strategies for identified potential sectors. Export market diversification is also a major objective of the Export and Import

(EXIM) Policy with special focus on sub-Saharan Africa and the Commonwealth of Independent States (CIS).

Export and Import (EXIM) Policy

The Five-Year EXIM policy for the period 2002–2007 includes, *inter alia,* removal of all QRs on exports (except a few sensitive items reserved for exports through State Trading Enterprises), a farm-to-port approach for exports of agricultural products, special focus on cottage sector and handicrafts, and Assistance to States for Infrastructural Development for Exports (ASIDE).

28 Agri Export Zones (AEZs) have been sanctioned in 14 States to promote the export of agro products and agro-based processed products. Export capabilities of the small scale sector, which accounts for about 50 percent of India's exports, has been strengthened through a programme for "Special Focus on Cottage Sector and Handicrafts" including promotion of cottage sector exports under Khadi and Village Industries Commission (KVIC), access to funds from Market Access Initiative (MAI) for units in the handicrafts sector, exemption from maintenance of average level of exports under Export Promotion Capital Goods (EPCG) Scheme, duty-free imports of specified items up to three percent of the Free-on-Board (FoB) value of exports and benefit of export house status at a lower average export performance (Rs. 5 crore). Similar incentives are extended to industrial cluster-towns with export potential like Tirupur (hosiery), Panipat (woollen blankets) and Ludhiana (woollen knitwear).

Several measures including reduction in customs duty on imports of rough diamonds to zero and abolition of licensing regime for rough diamonds were undertaken to enable India to emerge as a major international centre for diamonds. Important measures have also been taken to give a fillip to jewellery exports, including reduction in value addition norms for export of plain jewellery from 10 percent to 7 percent and allowing mechanized unstudded jewellery exports at a value addition of only 3 percent.

Policies for External Capital Flows

Various policy initiatives as mentioned below have been undertaken to further liberalize the movement of cross-border capital flows especially in the area of outward foreign direct investment, inward direct and portfolio investment, non-resident deposits, and external commercial borrowings.

a. Foreign direct investment The policy framework governing inward Foreign Direct Investment (FDI) has been substantially liberalized under the automatic route. FDI up to 100 percent is permitted under the automatic route for manufacture of drugs and pharmaceuticals, in the hotel and tourism sector and for mass rapid transport systems in all metropolitan cities (including associated commercial development of real estate). Similarly, airports, development of integrated townships, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, manufacture of building materials, and courier services (subject to exclusion of activity relating to distribution of letters) are being permitted 100 percent FDI under the automatic route. FDI up to 49 percent from all sources was permitted in the private sector banks under the automatic route.

b. Portfolio investment Indian companies are permitted to raise the 24 percent limit on FIIs investment to the sectoral cap/statutory ceiling as applicable. As regards FIIs port folio investment, they are Union Government, subject to sectoral limits for FDI except in specified sectors. FIIs are also allowed by the Reserve Bank to trade in exchange traded derivative contracts subject to limits prescribed by the Securities and Exchange Board of India.

c. Nonresident deposits Continuing with the policy of progressive liberalization of the capital account, the nonresident nonrepatriable (NRNR) account and nonresident special rupee (NRSR) account schemes have been discontinued. Existing accounts under the schemes would continue upto the date of maturity after which the amount would be credited to nonresident (external) accounts/nonresident (ordinary) accounts.

Ongoing liberalization of current external transactions encompass repatriation of current income like rent, dividend, interest and pension of nonresident Indians (NRIs) based on an appropriate certification. Indian corporates with proven track record are allowed to contribute funds from their foreign exchange earnings for setting up Chairs in educational institutions abroad, and for similar such purposes.

d. Indian direct and portfolio investment overseas Existing limits for Indian direct investment outside India under the automatic route have been raised to U.S. $ 100 million. Two-way fungibility of American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) has become operational with the issue of guidelines by the RBI. The transactions is be demand-driven and the custodian is responsible for monitoring the re-issuance of ADRs/GDRs. Foreign Currency Convertible Bonds (FCCB) up to U.S. $ 50 million was brought under the automatic route.

e. External commercial borrowings and EEFC accounts The Reserve Bank allow corporates on a case-by-case basis to credit even higher proportions of export proceeds to their EEFC accounts than 50/70 percent allowed hitherto with a view to enabling them to take advantage of lower interest rates and prepay their external commercial borrowings.

Fiscal Policy

The Union government, adopts a six-pronged strategy, *inter alia,* emphasising continuation of agricultural and food economy reforms, enhancement of public and private investment in infrastructure, strengthening the financial sector and capital markets, deepening structural reforms and regenerating industrial growth. The strategy for fiscal correction continues to rest on control of nonplan expenditure, tax reforms, larger disinvestment proceeds, and maintaining a higher growth in revenue relative to aggregate expenditure.

Tax Measures

The Union Budgetary measures aim at providing a modern tax regime with a view to reviving demand, promoting investment, accelerating economic growth and enhancing productivity. On the direct tax front, measures are aimed at seeking further progress towards widening the tax base, rationalization and simplification of tax structure and encouraging voluntary compliance. Tax on distribution of dividend by domestic companies and mutual funds are abolished. However, the ultimate recipients of the income would be taxed as per the rate applicable to them.

Investment in bonds issued by Small Industries Development Bank of India (SIDBI) and National Housing Bank (NHB) were exempted from capital gains tax under 54EC. The indirect taxes have been further simplified by reducing the number of items attracting special duty of 16 percent. The tax base was expanded by including specified services provided by the corporate sector similar to services provided by banks and nonbanking financial institutions. The peak rate of customs duty was reduced while rationalization and simplification of the rate structure was carried further alongwith concessions for specified equipment for ports and airports and the civil aviation sector, the steel industry, IT hardware, and units in special economic zones.

Structural Reforms

The Union Budgetary measures provide momentum to the consolidation of structural reforms. A key policy change has been envisaged for dismantling the Administered Price Mechanism (APM) and Oil Pool Account. The market forces are expected to increasingly determine the pricing of petroleum products. Private companies will be permitted to undertake distribution, subject to specified guidelines to be overseen by a Petroleum Regulatory Board. The subsidy on Liquefied Petroleum Gas (LPG) and kerosene oil is contemplated to be reduced and then to be phased out fully.

REVIEW QUESTIONS

Section A

1. What is 'financial services environment'?
2. Name the players in the financial services market.
3. Define 'interest rate'.

Section B

1. What are the features of 'interest rate'?
2. How is interest rate determined? Illustrate.
3. Outline the policy initiatives as regards 'external capital flows'.

Section C

1. Describe the forces that influence the dynamics of a financial services sector of a country.
2. Discuss the various macroeconomic aggregates that affect the financial sector policy initiatives in India.

Chapter 3

Merchant Banking

Merchant banking, although a nonbanking financial activity, resembles a banking function. The function of merchant banking which originated, and grew in Europe, was enriched by the American patronage, and these services are now being provided throughout the world by both banking and nonbanking institutions. The word "Merchant Banking" originated among the Dutch and the Scottish traders, and was later on developed and professionalised in Britain.

DEFINITION

1. According to ***Random House Dictionary,*** "Merchant bank is an organization that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures. These organizations are sometimes banks which are not merchants and sometimes merchants who are not banks and sometimes houses which are neither merchants nor banks."
2. According to ***Charles P. Kindleberger***, "Merchant banking is the development of banking from commerce which frequently encountered a prolonged intermediate stage known in England originally as merchant banking."
3. According to the ***Securities and Exchange Board of India*** (Merchant Bankers) Rules, 1992. "A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management."

Merchant Bankers

A set of financial institutions that are engaged in providing specialist services, which generally include the acceptance of bills of exchange, corporate finance, portfolio management and other banking services, are known as 'merchant bankers'. It is not necessary for a merchant banker to carry out all the above mentioned activities. A merchant banker may specialize in any one activity, and take up other activities, which may be complementary or supportive to the specialized activity.

FUNCTIONS

Merchant banking, being a service-oriented industry, renders the same services in India as merchant banks in UK and other European countries. In the U.S, investment bankers cater to the needs of business enterprises by undertaking merchant banking functions. Merchant banks in India carry out the following functions and services:

1. Corporate Counselling
2. Project Counselling
3. Pre-investment Studies
4. Capital Restructuring
5. Credit Syndication and Project Finance
6. Issue Management and Underwriting
7. Portfolio Management
8. Working Capital Finance
9. Acceptance Credit and Bill Discounting
10. Mergers, Amalgamations and Takeovers
11. Venture Capital
12. Lease Financing
13. Foreign Currency Finance
14. Fixed Deposit Broking
15. Mutual Funds
16. Relief to Sick Industries
17. Project Appraisal

A brief description of these functions is presented below:

Corporate Counselling

Corporate counselling refers to a set of activities undertaken to ensure efficient running of a corporate enterprise at its maximum potential through effective management of finance. It aims at rejuvenating old-line companies and ailing units, and guiding the existing units in locating areas/activities of growth and diversification.

Following are the activities which form part of corporate counselling:

1. Providing guidance in areas of diversification based on the Government's economic and licensing policies.
2. Undertaking appraisal of product lines, analyzing their growth and profitability and forecasting future trends.

3. Rejuvenating old-line companies and ailing sick units by appraising their technology and process, assessing their requirements and restructuring their capital base.
4. Commissioning of diagnostic studies.
5. Assessment of the revival prospects and planning for rehabilitation through modernization and diversification and revamping of the financial and organizational structure.
6. Arranging for the approval of the financial institutions/banks for the schemes of rehabilitation involving financial relief, etc.
7. Providing assistance in getting soft loans from financial institutions for capital expenditure, and the requisite credit facilities from the bank.
8. Monitoring of rehabilitation schemes.
9. Exploring possibilities for takeover of sick units and providing assistance in making consequential arrangements and negotiations with financial institutions/banks and other interests/authorities involved.

Project Counselling

Project counselling is a part of corporate counselling, and relates to project financing. It broadly covers the study of the project. It offers advisory assistance on the viability and procedural steps for its implementation.

Following are the activities forming part of the Project counselling:

1. Undertaking the general review of the project ideas/project profile.
2. Providing advice on procedural aspects of project implementation.
3. Conducting review of technical feasibility of the project on the basis of the report prepared by own experts or by outside consultants.
4. Assisting in the selection of a Technical Consultancy Organization (TCO) for preparing project reports and market surveys, or review of the project reports or market survey reports prepared by TCO.
5. Assisting in the preparation of project report from a financial angle, and advising and acting on various procedural steps including obtaining government consent for implementation of the project.
6. Assisting in obtaining approvals/licenses/permissions/grants, etc from government agencies in the form of letter of intent,

industrial licence, DGTD registration, and government approval for foreign collaboration.

7. Providing guidance to Indian entrepreneurs for making investment in Indian projects in India and in Indian joint ventures overseas.
8. Identification of potential investment avenues.
9. Carrying out precise capital structuring and shaping the pattern of financing.
10. Arranging and negotiating foreign collaborations, amalgamations, mergers, and takeovers.
11. Undertaking financial study of the project and preparation of viability reports to advise on the framework of institutional guidelines and laws governing corporate finance.
12. Providing assistance in the preparation of project profiles and feasibility studies based on preliminary project ideas, covering the technical, financial and economic aspects of the project from the point of view of their acceptance by financial institutions and banks.
13. Advising and assisting clients in preparing applications for financial assistance to various national financial institutions, state level institutions, banks, etc.
14. Assisting clients in making applications for obtaining letters of intent, industrial licence, DGTD registrations, etc.
15. Providing assistance in seeking approvals from the Government of India for foreign technical and financial collaboration agreements, guidance on investment opportunities for entrepreneurs coming to India.

Preinvestment Studies

Activities that are connected with making a detailed feasibility exploration to evaluate alternative avenues of capital investment in terms of growth and profit prospects are called 'pre-investment studies'. Some of these activities are as follows:

1. Carrying out an in-depth investigation of environment and regulatory factors, location of raw material supplies, demand projections, and financial requirements in order to assess the financial and economic viability of a project.
2. Helping the client in identifying and short-listing those projects which are built upon the client's inherent strength with a view to accentuate corporate profitability and growth in the long run.

3. Conducting such studies as may be required for foreign companies wishing to participate in joint ventures in India.
4. Offering a package of services, including advice on the extent of participation, government regulatory factors and an environmental scan of certain industries in India.

Capital Restructuring Services

Activities that are carried out to assist projects in achieving their maximum potential through effective capital structuring and to suggest various strategies to widen and restructure the capital base, diversify operations and implement schemes for amalgamations, merger or change in business status are collectively known as 'Capital Restructuring Services'.

Under the gamut of capital restructuring services, merchant bankers provide advice to companies governed by FERA on disinvestments to their maximum advantage, and restructuring the capital for ailing or sick units. Capital restructuring is undertaken by analyzing the capital structure ratios, asset restructuring ratios and the debt service coverage, with overall impact on fund-generating capacity of the clients corporate unit.

Following are the services covered:

1. Examining the capital structure of the client company to determine the extent of capitalization required.
2. Preparing a comprehensive memorandum for the Controller of Capital Issues, and securing consent where the capitalization takes place through issue of bonus shares.
3. Suggesting an alternative capital structure conforming to legal requirements, viz., extent of capitalization of reserve and quantum of disinvestments by 'offer for sale' and/or fresh issues of corporate securities such as equity share, and preference share in the case of FERA companies.
4. Preparing a memorandum covering valuation of shares and justifying the level of premium applied for.
5. Critically examining tax implications where the proposal involves offer for sale.
6. Suggesting the ideal capital restructuring for sick units and advising the client companies on the 'extent and means of bringing fresh capital into business'.
7. Capital restructuring may cover mergers, takeovers and amalgamations, involving modernization or diversification of the existing production systems and the units.

Credit Syndication

Activities connected with joint credit procurement and project financing, aimed at raising Indian and foreign currency loans from banks and financial institutions, are collectively known as 'credit syndication'.

Activities covered under credit syndication are as follows:

1. Estimating the total cost of the project to be undertaken.
2. Drawing up a financing plan for the total project cost which conforms to the requirements of the promoters and their collaborators, financial institutions and banks, government agencies and underwriters.
3. Preparing loan application for financial assistance from term lenders/financial institutions/banks, and monitoring their progress, including pre-sanction negotiations.
4. Selecting institutions and banks for participation in financing.
5. Follow-up of term loan application with the financial institutions and banks, and obtaining the approval for their respective share of participation.
6. Arranging bridge finance.
7. Assisting in completion of formalities for drawing of term finance sanctioned by institutions by expediting legal documentation formalities, drawing up agreements etc as prescribed by the participating financial institutions and banks.
8. Assessing working capital requirements.

Issue Management and Underwriting

Issue management and underwriting are the activities connected with the management of the public issues of corporate securities, viz., equity shares, preference shares, and debentures or bonds, and are aimed at mobilization of money from the capital market.

Following are some of the popular services provided by merchant bankers in this regard:

1. Preparation of an action plan
2. Preparation of budget for the total expenses for the issues
3. Preparation of CCI application and assisting in obtaining consent/acknowledgement
4. Drafting of prospectus
5. Selection of institutional and broker underwriters for syndicating/ underwriting arrangements
6. Selection of Issue Houses and advertizing agencies for undertaking pre and post-issue publicity

7. Obtaining the approval of institutional underwriters and stock exchanges for publication of the prospectus
8. Making arrangements for designing and printing of prospectus and application forms, as well as their dispatch, if necessary
9. Providing assistance in launching the issue in the form of advertisement campaigns by holding press, brokers' and investors' conferences, etc.
10. Coordination with the underwriters, brokers and bankers to the issue, and the Stock Exchanges
11. Providing advice on the design of a sound capital structure, acceptable to financial institutions
12. Determining the quantum, terms and timing of the public issue of different forms of securities, the extent and sources, loan finance, and deployment of internal resources etc in compliance with the requirements of the Companies Act/Stock Exchanges, etc.
13. Arranging for stock exchange clearances and listing of securities
14. Liaisoning and coordination with various constituents of the public issue to make the function of issue management successful

Portfolio Management

Making decisions relating to the investment of the cash resources of a corporate enterprise in marketable securities by deciding the quantum, timing and the type of security to be bought, is known as 'Portfolio Management'. It involves making the right choice of investment, aimed at obtaining an optimum investment mix, taking into account factors such as the objectives of the investment, tax bracket of the investor, need for maximizing yield and capital appreciation, etc.

Merchant bankers provide the following portfolio management services:

1. Undertaking investment in securities
2. Undertaking investment for nonresident Indians, on both repatriation and nonrepatriation basis
3. Undertaking review of Provident Fund investment, Trust investment, etc.
4. Safe custody of securities in India and overseas
5. Collection of return on investment and reinvestment of the same in profitable avenues, investment advisory services to the investors and other related services
6. Providing advice on selection of investments

7. Carrying out a critical evaluation of investment portfolio
8. Securing approval from RBI for the purchase/sale of securities (for NRI clients)
9. Maintaining investment records and complying with ceiling requirements
10. Collecting and remitting interest and dividend on investment
11. Providing tax counselling and filing tax returns through tax consultants

Working Capital Finance

The finance required for meeting the day-to-day expenses of an enterprize is known as 'Working Capital Finance'. Merchant bankers undertake the following activities as part of providing this type finance:

1. Assessment of working capital requirements
2. Preparing the necessary application to negotiations for the sanction of appropriate credit facilities
3. Providing assistance in negotiations with all banks, and suggesting a sharing pattern of credit limits amongst participating banks, where more than one bank is involved
4. Assisting, coordinating and expediting documentation and other formalities for disbursement
5. Advising on the issue of debentures for augmenting long-term requirements of working capital

Acceptance Credit and Bill Discounting

Activities relating to the acceptance and the discounting of bills of exchange, besides the advancement of loans to business concerns on the strength of such instruments, are collectively known as 'Acceptance Credit and Bill discounting'. Bill accepting and discounting are an integral part of a developed money market.

In order that the bill accepting and discounting takes place on sound lines, it is imperative that the firms involved command a good reputation and financial standing. Further, collecting credit information and rating the credit-worthiness of the parties concerned are very much a part of this function. In developed money markets like London and New York, there are specialized agencies, such as discount houses and acceptance houses, that play an active role in the promotion of this function. In India, RBI takes special care in developing the bill market.

Merger and Acquisition

This is a specialized service provided by the merchant banker who arranges for negotiating acquisitions and mergers by offering expert valuation regarding the quantum and the nature of consideration, and other related matters.

The various functions that form part of this activity are as follows:

1. Undertaking management audits to identify areas of corporate strength and weaknesses in order to help formulate guidelines and directions for future growth.
2. Conducting exploratory studies on a global basis to locate overseas markets, foreign collaborations, and prospective joint venture associates.
3. Examining the pros and cons of proposals and formulating schemes for financial reconstruction, merger, and acquisition.
4. Obtaining approvals from shareholders, depositors, creditors, government, and other authorities.
5. Monitoring the implementation of merger and amalgamation schemes.
6. Identifying organizations with matching characteristics.
7. Assisting in the compliance of legal requirements, obtaining consent from various authorities, etc. by coordinating with solicitors, accountants, valuators, and other professional experts involved in the task.
8. Advising on capital reorganization of business enterprises.

Merchant bankers provide advice on acquisition propositions after careful examination of all aspects, viz., financial statements, articles of associations, provisions of companies act, rules and guidance of trade chambers, the issuing house associations, etc.

Venture Financing

A specially designed capital, as a form of equity financing for funding high risk and high reward projects, is known as 'Venture Capital'. The concept of venture capital originated in the USA in the 1950s, when business magnates like Rockefeller financed new technology companies. The concept became more popular during the sixties and seventies, when several private enterprises undertook the financing of high-risk and high reward projects. In India, venture capital companies have largely contributed to the technological and industrial revolution.

A large number of Indian and international companies are engaged in venture capital funding for high technology and high-risk projects. A number of leading national development financial institutions such as IFCI, IDBI and ICICI are engaged in venture capital financing, and have developed a number of special schemes for this purpose.

Lease Financing

A merchant banking activity whereby financial facilities are provided to companies that undertake leasing, is known as 'Lease Financing'. Leasing involves letting out assets on lease for a particular time period for use by the lessee. Leasing provides an important alternative source of financing capital outlay. Lease financing benefits both the lessor and the lessee.

Following are the important services provided with regard to leasing:

1. Providing advice on the viability of leasing as an alternative source for financing capital investment projects.
2. Providing advice on the choice of a favourable rental structure.
3. Providing assistance in establishing lines of lease for acquiring capital equipment, including preparation of proposals, documentations, etc.

In India, leasing is a nonbanking financial activity, undertaken by leading development financial institutions like ICICI, IDBI and IFCI. Commercial banks also provide lease financing by forming subsidiaries under the amended Banking Regulations Act of 1949.

Foreign Currency Financing

The finance provided to fund foreign trade transactions is called 'Foreign Currency Finance'. The provision of foreign currency finance takes the form of export-import trade finance, euro currency loans, Indian joint ventures abroad, and foreign collaborations. The main areas that are covered in this type of merchant activity are as follows:

1. Providing assistance for carrying out the study of turnkey and construction contract projects.
2. Providing assistance in applications to working groups, liaison with RBI, ECGD, and other institutions.
3. Arranging for the syndication of various types of guarantees, letters of credit, preshipment credit, deferred postshipment credit, bridge loans, and other credit facilities.
4. Providing assistance in opening and operating banks accounts abroad.
5. Arranging foreign currency loans under buyer's credit scheme for importing goods.

6. Arranging deferred payment guarantees under suppliers credit scheme for importing capital goods.
7. Providing assistance in obtaining export credit facilities from the EXIM bank for export of capital goods, and arranging for the necessary government approvals and clearance.
8. Undertaking negotiations for deferred payment, export finance, buyers credits, documentary credits, and other foreign exchange services like packing credit, etc.
9. Providing guidance on forward cover for exchange risk.
10. Assisting in arranging foreign currency guarantees and performance bonds for exporters.

Brokering Fixed Deposits

Following are the services rendered by merchant bankers in this regard:

1. Computation of the amount that could be raised by a company in the form of deposits from the public and loans from shareholders
2. Drafting of advertisement for inviting deposits
3. Filing a copy of advertisement with the Registrar of Companies for registration
4. Arranging for the issue of advertisement in newspapers, as required by the Companies Act
5. Drafting and printing of application forms
6. Making arrangements for the collection of deposits at the banks' branches
7. Submission of periodical statements to companies concerned
8. Making arrangement for payment of interest amounts
9. Providing advice to the company on the terms and conditions of fixed deposits, and deciding on the appropriate rate of interest, keeping in view the prevailing capital and money market conditions
10. Helping the company to observe all the rules and regulations in this connection
11. Assisting in maintenance of records and registers for the purpose.

Assistance is provided under Section 58(A) of the Companies Act, 1956 and the rules there under.

Mutual Funds

Institutions and agencies that are engaged in the mobilization of the savings of innumerable small investors for the purpose of channeling them into productive investments of a wide variety of corporate and other securities, are called 'Mutual Funds'. UTI is the first and the largest mutual fund in the country. The mutual funds industry has a large number of players, both in the public as well as in the private sector. Commercial banks are also making rapid strides in the realm of mutual funds business.

Some of the services rendered by mutual funds are as follows:

1. Mopping up public savings
2. Investing the funds in a diversified portfolio of shares and debentures belonging to well-managed and growing companies
3. Earning investors a steady return on investments with an assurance of capital appreciation
4. Engaging in the business of acquisition, holding or disposal of securities
5. Making investment in any commercial paper floated by the Central Government, RBI, any local authority, any foreign Government, foreign bank or any other authority outside India and approved by RBI

Relief to Sick Industries

Merchant bankers extend the following services as part of providing relief to sick industries:

1. Rejuvenating old-lines and ailing units by appraising their technology and process, assessing their requirements, and restructuring their capital base
2. Evolving rehabilitation packages which are acceptable to financial institutions and banks
3. Exploring the possibilities of mergers/amalgamations, wherever called for
4. Assisting in obtaining approvals from the Board for Industrial and Financial Reconstruction (BIFR) and other authorities under the Sick Industrial Companies (Special Provisions) Act, 1985
5. Monitoring the implementation of rehabilitation schemes, mergers and/or amalgamations

Project Appraisal

The evaluation of industrial projects in terms of alternative variants in technology, raw materials, production capacity, and location of plant is known as 'Project Appraisal'. Project evaluation is indispensable because resources are scarce, and alternative opportunities exist in terms of projects for commitment of resources. Project selection can be rational only if it is superior to others commercially (net financial benefit accruing to owners of project) or important to the nation as a whole. The various components of project appraisal are financial appraisal, technical appraisal and economic appraisal.

MERCHANT BANKERS' CODE OF CONDUCT

Merchant Bankers have to abide by the following Code of Conduct as prescribed by the SEBI:

1. ***Integrity*** Observance of high standards of integrity and fairness in all dealings with clients and other merchant bankers.
2. ***Quality service*** Rendering high standards of service, exercising due diligence, ensuring proper care and exercising independent professional judgment, disclosing to the clients, wherever necessary, possible sources of conflict of duties and interests, while providing unbiased services.
3. ***Fair practice*** Refraining from making any statement or becoming privy to any act, practice or unfair competition, which is likely to be harmful to the interests of other merchant bankers, or is likely to place other merchant bankers in a disadvantageous position in relation to the merchant banker, while competing for or executing any assignment.
4. ***Responsible statement*** Not to indulge in making any exaggerated statement, oral or written, to the client, either about the qualification or the capability to render certain services, or achievements in regard to services rendered to other clients.
5. ***Best advice*** Endeavoring to render the best possible advice to the clients keeping in mind the client's needs, and the merchant banker's own professional skill in order to ensure that all professional dealings are effected in a prompt, efficient, and cost effective manner.
6. ***Secrecy*** Not to divulge to other clients, press or any other party, any confidential information about the client and deal in the securities of any client without disclosing to the Board, as required under the regulations.
7. ***Information*** Making constant efforts to ensure that the investors are provided with true and adequate information, without making any misguided or exaggerated claims, in order to make them aware of the attendant risks before they undertake any investment decision.
8. ***Prospectus*** Making available copies of the prospectus, memorandum and related literature to investors.
9. ***Allotment*** Initiating adequate steps to ensure the fair allotment of securities, and refund of application money without delay.

10. ***True market*** Not to be a party to the creation of false market, price rigging or manipulation, passing on price sensitive information to brokers, members of the stock exchanges and other players in the capital market, or take any other action which is unethical or unfair to the investors.
11. ***Compliance*** Abiding by the provisions of the Act, rules and regulations which may be applicable and relevant to the activities carried out by the merchant bankers.

REVEIW QUESTIONS

Section A

1. Define the term 'merchant banking'.
2. Who are merchant bankers?
3. What is 'corporate counselling'?
4. What is 'project counselling'?
5. What are 'preinvestment studies'?
6. What is 'credit syndication'?
7. What is 'issue management'?
8. What is 'portfolio management'?
9. What is 'acceptance credit'?
10. What is 'bill discounting'?
11. What is foreign currency financing?
12. What are 'mutual funds'?
13. What is 'project appraisal'?
14. Name the various components of project appraisal.

Section B

1. List the activities forming part of corporate counseling.
2. List the activities forming part of project counseling.
3. What are the components of preinvestment studies?
4. What are 'capital restructuring services' offered by a merchant banker?
5. What are the activities undertaken by a merchant banker as part of credit syndication?
6. What are the activities performed by merchant bankers as part of working capital financing?
7. What are the activities performed by merchant bankers as part of mergers and acquisitions?

8. What is venture financing? How is it different from lease financing?
9. Identify the main areas covered under the foreign currency financing
10. What are the services rendered by mutual funds in India?
11. What are the measures of relief provided by merchant bankers?
12. Mention the codes of conduct outlined by the SEBI for merchant bankers.

Section C

1. Discuss in detail the various functions performed by merchant bankers in India.
2. What are the services rendered by merchant bankers as regards 'brokering of fixed deposits'?
3. What are the issue management services rendered by merchant bankers? Explain.
4. What are the portfolio management services rendered by merchant bankers? Explain.

Chapter 4

Public Issue Management

CONCEPT

The management of securities of the corporate sector offered to the public on a regular basis, and existing shareholders on a rights basis, is known as 'public issue management'. Issue management is an important function of merchant bankers and lead managers.

The function of capital issues management in India is carried out by merchant bankers who have the requisite professional skill and competence. One of their major functions, in fact, is issue management. Factors such as the tremendous growth in the number and size of public listed companies, and the complexity arising due to the ever-increasing SEBI requirements have all attributed to the increasingly significant role played by merchant bankers in the recent past.

FUNCTIONS

The general functions that form part of the capital issues management of merchant bankers are as follows:

1. Obtaining approval for the securities issue from SEBI
2. Arranging for underwriting of the proposed issue
3. Preparation of draft and finalization of the prospectus and obtaining its clearance from the various agencies concerned
4. Preparation of draft and finalization of other documents such as application forms, newspaper advertisements, and other statutory requirements
5. Making a choice regarding registrar to the issue, printing press, advertising agencies, brokers and bankers to the issue, and finalization of the fees to be paid to them
6. Arranging for press conferences and the investors' conferences
7. Coordinating printing, publicity and other work in order to get everything ready at the time of the public issue
8. Complying with SEBI guidelines after the issue is over by sending various reports as required by the authorities

CATEGORIES OF SECURITIES ISSUE

Corporate enterprises use several modes for raising funds from the capital market. Issue of securities constitutes an important mode of raising such finances. Security issue takes the following forms:

1. Public Issue
2. Right Issue
3. Private Placement

Public Issue of Securities

When capital funds are raised through the issue of a prospectus, it is called 'public issue of securities'. It is the most common method of raising funds in the capital market. A security issue may take place either at par, or at a premium or at a discount. The prospectus issued for this purpose, should disclose all the essential facts about the company to the prospective purchasers of security. Further, the prospectus must conform to the format set out in Schedule II of the Companies Act, 1956, besides taking into the account SEBI guidelines. SEBI insists on the adequacy of disclosure of information that should serve as the basis for investors to make a decision about the investment of their money.

Rights Issue

When shares are issued to the existing shareholders of a company on a privileged basis, it is called 'Rights Issue'. The existing shareholders have a preemptive right to subscribe to the new issue of shares. Right shares are offered as additional issue by corporates to mop up further capital funds. Such shares are offered in proportion to the capital paid-up on the shares held by them at the time of the offer.

It is to be noted that the shareholders, although privileged to be offered the issue, are under no legal obligation to accept the offer. Right shares are usually offered on terms advantageous to the shareholders. For instance, shares of market value Rs. 150 may be offered at par.

Private Placement

When the issuing company sells securities directly to investors, especially the institutional investors, it takes the form of private placement. In this case, no prospectus is issued, since it is presumed that the investors have sufficient knowledge and experience and are capable of evaluating the risks of the investment. Private placement covers shares, preference shares and debentures. The role of the financial intermediary, such as the merchant bankers and lead managers, assumes greater significance in private placement. They involve themselves in the task of preparing an offer memorandum and negotiating with investors.

Private placement obviously commands an advantage over the public issue on the following grounds:

1. Speed and confidentiality of issue
2. Access to capital market more quickly than a public issue which may take 6 months to one year. Time taken by private placement is just 2 to 3 months
3. Less expensive method of raising capital because of fewer compliance procedures
4. Advantageous to small companies which cannot afford a public issue because of the expense involved
5. Ideally suited to companies which need only a relatively limited amount of capital funds
6. Not influenced by the prevailing bull or bear phases of the stock market
7. More stable attitude of institutional investors towards the regular issue of securities in private placement market

MECHANICS OF PUBLIC ISSUE MANAGEMENT

The mechanism connected with the management of public issue is depicted in Exhibit 4.

Exhibit 4 Mechanics of Public Issue Management

ISSUE MANAGER

Any financial institution/intermediary which carries out the activities connected with issue management, is registered with SEBI, and follows its regulations and guidelines, is capable of venturing into issue management. Issue management is an important activity for merchant bankers.

Requirements

The Issue Manager needs to satisfy the following requirements before being allowed by the SEBI to carry out various issue management activities:

1. Adequate and necessary infrastructure such as adequate office space, equipments and manpower to effectively discharge activities.
2. Minimum number of two persons needed, who are professionally qualified in Law, Finance or Business Management and have the experience to conduct the business of the merchant banker.
3. Fulfilling the capital adequacy requirements, i.e. a minimum net worth of Rs. 5 crores.

Categories of Issue Managers

SEBI has classified Issue Managers into four categories as follows:

1. Category I: Merchant banker who is authorized to act as issue manager, advisor, consultant, underwriter and portfolio manager
2. Category II: Merchant banker who is authorized to act only as advisor, consultant, underwriter and portfolio manager
3. Category III: Merchant banker who is authorized to act as underwriter, advisor and consultant to an issue
4. Category IV: Merchant banker who is authorized to act only as advisor or consultant to an issue

The registration requirements for the respective categories are progressively less stringent. However, with a view to facilitating only high net worth companies to operate as merchant bankers, so as to ensure the provision of quality service and to have a screening effect, merchant bankers of categories II, III and IV were abolished through an amendment, dated December 9, 1997 to the SEBI Merchant Bankers Regulations, 1992. Similarly, only body corporates, and not proprietorship or partnership firms will be registered with SEBI as merchant bankers. The objective was to enhance corporate discipline and professionalism in the sphere of issue management.

Restrictions on Issue Managers

SEBI regulations have prescribed restrictions on the number of issue managers who can be associated with an issue. This is presented below:

Issue Size	Permissible Number of Lead Managers
Less than Rs. 50 crores	2
Rs. 50 crores but less than Rs. 100 crores	3
Rs. 100 crores but less than Rs. 200 crores	4
Rs. 200 crores but less than Rs. 400 crores	5
Rs. 400 crores and above	5 or more

Source: SEBI (Merchant Bankers) Rules & Regulations, 1992

ROLE OF ISSUE MANAGER

The merchant banker as an issue manager is helpful in the following ways:

1. ***Easy floatation*** An issue manager acts as an indispensable pilot facilitating a public/rights issue. This is made possible with the help of a repository of special skills possessed by him to execute the management of issues.
2. ***Financial consultant*** An issue manager essentially acts as a financial architect, by providing advice relating to capital structuring, capital gearing and financial planning for the company.
3. ***Underwriting*** An issue manager allows for underwriting the issues of securities made by corporate enterprises. This ensures due subscription of the issue.
4. ***Market makers*** Merchant bankers, as issue managers often act as the market makers for the issues lead-managed by them. They invest, continue to hold and provide, buy and sell quotes for the listed scrips of the company.
5. ***Due diligence*** The issue manager has to comply with SEBI guidelines. The merchant banker will carry out activities with due diligence and furnish a Due Diligence Certificate to SEBI. The detailed diligence guidelines that are prescribed by the Association of Merchant Bankers of India (AMBI) have to be strictly observed. SEBI has also prescribed a code of conduct for merchant bankers.
6. ***Coordination*** The issue manager is required to coordinate with a large number of institutions and agencies while managing an issue in order to make it successful.

7. ***Liaison with SEBI*** The issue manager, as a part of merchant banking activities, should register with SEBI. While managing issues, constant interaction with the SEBI is required by way of filing of offer documents, etc. In addition, they should file a number of reports relating to the issues being managed.

ACTIVITIES INVOLVED IN PUBLIC ISSUE MANAGEMENT

There are several activities that have to be performed by the issue manager in order to raise money from the capital market. Adequate planning needs to be done while chalking out an appropriate marketing strategy. An analytical study of various sources, the quantum, the appropriate time, the cost of raising capital, and the possible impact of such resources on the overall capital structure will greatly help this task. The various activities involved in raising funds from the capital markets are described below:

Preissue Activities

a. Signing of MoU Signing of MoU between the client company and the merchant banker-issue management activities, marks the award of the contract. The role and responsibility of the merchant banker as against the issuing company are clearly spelt out in the MoU.

b. Obtaining appraisal note An appraisal note containing the details of the proposed capital outlay of the project and the sources of funding is either prepared in-house or is obtained from external appraising agencies, viz., financial institutions/banks, etc. A project may be funded either by borrowing money from outside agencies or by injecting capital.

c. Optimum capital structure The level of capital that would maximize the shareholders value and minimize the overall cost of capital has to be determined. This has to be done considering the nature and size of the project. Equity funding is preferable especially when the project is capital intensive.

d. Convening meeting A meeting of the Board of Directors of the issuing company is convened. This is followed by an EGM of its members. The purpose of these meetings is to decide the various aspects related to the issue of securities. An application to RBI, seeking its permission is made, where capital issue of shares is to be offered to NRIs/OCBs or FIIs.

e. Appointment of financial intermediary Financial intermediaries such as Underwriters, Registrars, etc. have to be appointed. Necessary contracts need to be made with the underwriter to ensure due subscription to the offer. Similar contracts, when entered into with the Registrars to an issue, will help in share allotment related work, appointment of bankers to an issue for handling the collection of applications at various centres, printers for bulk printing of issue related stationery, legal advisors, and advertising agency. Simultaneously, consents from various experts such as auditors, solicitors, legal advisors, etc. has to be obtained under Section 58 of the Companies Act, 1956.

f. Preparing documents As part of the issue management procedure, the documents to be prepared are 'initial listing application' for submission to those stock exchanges where the issuing company intends to get its securities listed, 'MoU with the Registrar', bankers, advisors, and comanagers to the issue, agreement for purchase of properties, etc. This will have to be sent for inclusion in the prospectus.

g. Due diligence certificate The lead manager issues a 'due diligence certificate' which certifies that the company has scrupulously followed all legal requirements, has exercised utmost care while preparing the offer document and has made a true, fair and adequate disclosure in the draft offer document.

h. Submission of offer document The draft offer document along with the due diligence certificate is filed with SEBI. The SEBI, in turn, makes necessary corrections in the offer document and returns the same with relevant observations, if any, within 21 days from the receipt of the offer document.

i. Finalization of collection centres In order to collect the issue-application forms from the prospective investors, the lead manager finalizes the collection centers.

j. Filing with RoC The offer document, completed in all respects, after incorporating SEBI observations, is filed with Registrar of Companies (RoC) to obtain acknowledgement.

k. Launching the issue The process of marketing the issue starts once the legal formalities are completed and statutory permission for issue of capital is obtained. The lead manager has to arrange for the distribution of public issue stationery to various collecting banks, brokers, investors, etc. The issue is opened for public immediately after obtaining the observation letter from SEBI, which is valid for a period of 365 days from the date of issue.

Conducting press conferences, brokers' meets, issuing advertisements in various newspapers and mobilizing brokers and sub-brokers marks the launching of a public issue. The announcement regarding opening of issue is also required to be made through advertising in newspapers, 10 days before the opening of the public issue.

l. Promoters' contribution A certificate to the effect that the required contribution of the promoters has been raised before opening of the issue, has to be obtained from a Chartered Accountant, and duly filed with SEBI.

m. Issue closure An announcement regarding the closure of the issue should be made in the newspapers.

Postissue Activities

These activities are undertaken immediately after the closure of the issue. The lead manager has to manage the postissue activities. Certificates such as Certificate of 90 percent subscription from the Registrar, and Final Collection Certificate from bankers are to be obtained. The major activities covered are:

a. Finalization of basis of allotment If the public issue is oversubscribed to the extent of greater than five times, a SEBI-nominated public representative is required to participate in the finalization of Basis of Allotment (BoA). In case of rights issue that is oversubscribed greater than two times, a SEBI-nominated public representative is required to participate in the finalization of BoA. If it is under-subscribed, information regarding accepted applications is formalized, and Regional Stock Exchanges are approached for finalization of BoA.

b. Despatch of share certificates Immediately after finalizing the BoA, share certificates are despatched to the eligible allotees, and refund orders made to unsuccessful applicants. In addition, a 78 days report is to be filed with SEBI. Permission for listing of securities is also obtained from the stock exchange.

c. Advertisement An announcement in the newspaper has to be made regarding the basis of allotment, the number of applications received and the date of despatch of share certificates and refund orders, etc.

MARKETING OF ISSUE

Need

In the case of a public issue, the company is required to take certain steps by which the potential investing community is appraised of the features of the forthcoming issue. The need for marketing the public issue arises because of the highly competitive nature of the capital market. Moreover, there is a plethora of companies, which knock at the doors of investors seeking to sell their securities. Added to this, the media bombards the modern investors with eye-catching advertisement to sell their concepts to prospective investors.

Steps

Following are the steps involved in the marketing of the issue of securities to be undertaken by the lead manager:

1. ***Identifying target market*** The first step towards the successful marketing of securities is the identification of a target market segment where the securities can be offered for sale. This ensures smooth marketing of the issue. Further, it is possible to identify whether the market comprises of retail investors, wholesale investors or institutional investors.
2. ***Estimating subscriptions*** After having chosen the target market for selling the securities, steps are taken to assess the maximum number of subscriptions that can be expected from the market. It would work to the advantage of the company if it concentrates on the regions where it is popular among prospective investors.
3. ***Determining price*** After assessing market expectations, the kind and level of price to be charged for the security is decided. Pricing of the issue also influences the design of capital structure. The offer has to be made more attractive by including some unique features such as safety net, multiple options for conversion, attaching warrants, etc.
4. ***Mobilizing intermediaries*** For successful marketing of public issues, it is important that efforts are made to enter into contracts with financial intermediaries such as an underwriter, broker/sub-broker, fund arranger, etc.
5. ***Preparing offer document*** Every effort is made to ensure that the offer document for issue is educative and contains maximum relevant information. Institutional investors and high net worth investors should also be provided with detailed research on the project, specifying its uniqueness and its advantage over other existing or upcoming projects in a similar field.
6. ***Launching advertisement campaign*** In order to push the public issue, the lead manager should undertake a high voltage advertisement campaign. The advertising agency must be carefully selected for this purpose. The task of advertising the issue shall be entrusted to those agencies that specialize in launching capital offerings. The theme of the advertisement should be finalized keeping in view SEBI guidelines. An ideal mix of different advertisement vehicles such as the press, the radio and the television, the hoarding, etc. should be used.

   Press meets, brokers and investors conference, etc. shall be arranged by the lead manager at targeted regions. It would be appropriate to make use of the services of Market Research organizations that specialize in carrying out opinion polls. These services would be useful in collecting data on investors' opinion and reactions relating to the public issue of the company. Such a task would help develop an appropriate marketing strategy. This is because, there are vast numbers of potential investors in semi-urban and rural areas. This calls for sustained efforts on the part of the company to educate them about the various avenues available for investment.

7. ***Holding Brokers' and investors' conferences*** As part of the issue campaign, the lead manager should arrange for brokers' and investors' conferences in the metropolitan cities and other important centres which have sufficient investor population. In order to make such endeavors more successful, advance planning is required. It is important that conference materials such as banners, brochures, application forms, posters, etc. reach the conference venue in time. In addition, invitation to all the important people, underwriters, bankers at the respective places, investors' associations should also be sent.
8. ***Determining timing of the issue*** A critical factor that could make or break the proposed public issue is its timing. The market conditions should be favorable. Otherwise, even issues from a company with an excellent track record, and whose shares are highly priced, might flop. Similarly, the number and frequency of issues should also be kept to a minimum to ensure success of the public issue.

PUBLIC ISSUE PROPOSAL—FACTORS

Following factors shall be considered by the lead manager before making the choice of an appropriate public issue proposal:

1. ***Promoters profile*** The basic factor that must be considered by the lead manager is the background of the promoters and the management viz., their education, business/technical expertise, financial strength, and reputation, etc. The success of a company is greatly dependent on this factor. The issue will be well received in the market if it is from a company with a successful track record. Equally important are the success profiles of the group/ associate concerns or the holding company. If the group/associate concerns are financially strong enough, they can also lend support to the public offering. The merchant banker must investigate whether there is any pending litigation, defaults and disputes of the promoters for the company with any person, bank or institution before picking a public issue proposal.

2. ***Company profile*** The track record of the company and the quality of its management, the industry in which it operates, the product mix of the company and business prospects of the product proposed to be manufactured must be considered by the merchant banker. The financial health of the company can be gauged by probing the existing capital structure, debt equity ratio, level of gearing, nature and extent of various resources/provisions, etc.
3. ***Project profile*** Aspects such as whether an outside financial institution appraises the project, whether there is participation of institutions in the financing of the project and the level of financial participation are looked into by the lead manager. The fact that the project is appraised and funded by an institution certifies the viability of the project to a greater extent.
4. ***Capital market profile*** The lead manager should consider the conditions that are prevailing in the capital market. The share price movement of the group/associate concerns whose shares are already listed on stock exchanges should be analyzed. It would be beneficial to make a comparison of such price movements with that of other similar companies.
5. ***Other factors***
    1. Investor outlook towards other companies operating in similar industries, which are already listed
    2. Investors' response to previous public issues of similar companies
    3. Dividend payment schedule of the company and its associate concerns
    4. Cost benefit analysis of the issue

PRICING OF ISSUES

While fixing an appropriate price, the relevant guidelines for capital issues given by SEBI from time to time must be considered. Companies, themselves in consultation with the merchant bankers, do the pricing of issues. While fixing a price for the security issue, the following factors should be considered:

1. **Qualitative factors**, which include the prospects of the industry, track record of the promoters, the competitive advantage the company has in making the best use of the business opportunities, and growth of the company as compared to the industry, etc.

2. **Quantitative factors**, which include the earnings per share, book value, the average market price for 2 or 3 years, dividend payment record, the profit margins, the composite industry price earnings ratio and the future prospects of the company, etc.

With the abolition of the office of the Controller of Capital Issues, companies can adopt free pricing.

CCI Model

Although the CCI was abolished long ago, it would be interesting to discuss the mode of fixing the price for the issues. The fair value of the share is calculated on the basis of the NAV of the share, Profit Earning Capacity Value and Average Market Price.

1. **Net Asset Value**

   NAV = Total Net Worth ÷ Total number of shares outstanding

   where

   Total Net Worth = [Equity Capital + Free Reserves – Contingent Liability] + Fresh capital

2. **Profit Earning Capacity Value (PECV)**

$$\text{Share price} = \frac{\text{EPS} \times 100}{\text{Capitalization rate}}$$

   where

   EPS = [Average Profit before tax – Provision for taxation + Contribution to profits by fresh issue] ÷ Total number of shares outstanding

3. **Average Market Price**

   In this method, the fair price of the share is determined as an average of the NAV and PECV. The average market price is kept in the background, as a relevant factor while settling the fair value.

Safety Net Scheme

This is the most popular method of pricing public issue used by a number of companies in India. The method aims at affording a measure of protection while fixing the price. Some companies, while making public issues at a premium, use this scheme. Under this scheme, the merchant bankers provide a 'buy back facility' to the individual investor, in case the price of the share goes below the issue price after listing. This arrangement is of great help to the investors as it reduces losses. In this connection, SEBI has laid down guidelines for the safety net scheme.

LAW RELATING TO ISSUE MANAGEMENT

It is important that the lead managers take into account the regulations of the capital issue as prescribed by the various enactments mentioned below:

1. Provisions of the Companies Act, 1956
    - Prospectus (Sec. 55 to 68A)
    - Allotment (Sec. 69 to 75)
    - Commissions and discounts (Sec. 76 & 77)
    - Issue of shares at premium and at discount (Sec. 78 & 79)
    - Issue and redemption of preference shares (Sec. 80 & 80A)
    - Further issues of capital (Sec. 81)
    - Nature, numbering and certificate of shares (Sec. 82 to 84)
    - Kinds of share capital and prohibition on issue of any other kind of shares (Sec. 85 & 86)
    - Matters to be specified in prospectus and reports to be set out therein (Schedule II)
2. The Securities Contracts (Regulations) Act, 1957 regarding transactions in securities
3. The Securities Contracts (Regulation) Rules, 1957
4. SEBI Guidelines and Clarification

SEBI Rules and Regulations

SEBI, as a leader of the Indian capital market regulatory framework, often comes out with a series of guidelines, clarificatory notes, rules and regulations for the purpose of adequate disclosure in the prospectus and investor protection. Merchant bankers have to ensure strict adherence to these norms. The guidelines cover the following key aspects :

1. Promoters contribution and lock in period for shares
2. Pricing of issues
3. Issue of convertible debentures and credit rating
4. Proportionate allotment of shares
5. Firm allotment to mutual funds, Foreign Institutional Investors and Financial Institutions
6. Disclosures to be made in the prospectus

REVIEW QUESTIONS

Section A

1. What does 'public issue management' mean?
2. What does 'public issue of securities' mean?
3. What is 'rights issue' of securities?
4. What is 'private placement'?
5. Who is 'issue manager'?
6. Name the different categories of merchant bankers as per the SEBI guidelines.
7. State the number of issue managers who can be associated with an issue.
8. What is the need for undertaking the marketing of public issue of securities?
9. What is 'Profit earning Capacity Value'?
10. What is 'average market price'?
11. What is 'safety net scheme'?

Section B

1. What are the functions forming part of public issue management?
2. Explain the mechanics of public issue management.
3. What are the advantages of private placement of securities?
4. State the requirements to be fulfilled by the issue manager to carry on the issue management activities.
5. Elaborate on the role of issue manager in the realm of public issue management.
6. What are the steps involved in the marketing of the issue of securities?
7. Mention the factors to be considered in pricing the issue of securities.
8. Explain how the issue price is determined under the 'CCI Model'.
9. What are the laws regulating the public issue management?

Section C

1. Discuss the different categories of public issue of securities.
2. Discuss the preissue activities relating to public issue management.
3. Discuss potsissue activities of public issue management.
4. Explain the factors to be considered in the choice of an appropriate public issue proposal.

Chapter 5

New Issues Market (NIM)

NIM also known as 'primary market' is a market, which is characterized by the presence of a set of all institutions, structures, people, procedures, services, and practices involved in raising of fresh capital funds by both new and existing companies.

NIM AND SECONDARY MARKETS—AN INTERFACE

Both the primary and secondary markets are closely interrelated. This is clear from the following:

1. ***Securities trading*** For the purpose of securities to be traded in the secondary market, it is important that they are first issued in the primary market.
2. ***Securities listing*** In order that a corporate entity makes a successful issue of security in the primary market, it is incumbent that the terms of the issue carry a stipulation that the issues are to be listed in a recognized stock exchange and that an application for this purpose has been made already to the stock exchange concerned.
3. ***Regulation*** The activities in the primary market such as the new issues, etc. are greatly influenced by the regulatory norms prescribed by the SEBI and stock exchanges. The objective is to bring about orderliness in the new issues market.
4. ***Marketability*** The advantage of marketability provided by the secondary market greatly helps the subscribers in the primary market. For instance, the positive trends prevailing in the secondary market immensely help the investors to off-load their existing holdings so as to subscribe for fresh issues in the NIM. This liquidity advantage helps in expansion of the NIM.
5. ***Prevailing conditions*** The conditions prevailing in the secondary market affect to a very great extent the successfulness or otherwise of the issue being made in the NIM. Accordingly, where the conditions are so favorable in the secondary market that high market prices prevail,

the issues made in the primary market will turn out to be encouraging and successful. In such a case issues would fetch good premiums.

6. ***Survival*** The existence and the survival of the secondary market is dependent on efficacy of the NIM as an avenue for fund raising. There could be no stock exchanges if there is no NIM. In the same manner there will be no NIM in the absence of an efficiently functioning stock exchange. An efficient secondary market is therefore, a *sine-qua-non* for a growing primary market.

SERVICES OF NIM

A brief description of the various services rendered by the new issues market is made below:

Transfer Function

An important function rendered by NIM is to allow the transfer of resources from savers to entrepreneurs who establish new companies. It is also called the function of 'origination'. The transfer function is facilitated by specialist agencies that are engaged in the provision of investigative and advisory services as specified below:

a. Investigative services The merchant bankers and other agencies provide the investigative services. These include technical analysis, economic analysis, financial analysis and analysis of legal and environmental aspects of the proposed business. Merchant bankers provide the above information to investors so as to enable the investors in making a choice as to the type, quality and quantity of the issue.

b. Advisory services Various advisory services are made available with a view to improving the quality of capital issues. The relevant services include determining the type, the mix, the price, the timing, the size, the selling strategies, the methods of floatation, and the terms and conditions of issue of securities.

c. Guarantee function It is the function of 'underwriting'. Underwriting aims at guaranteeing the subscription of public issue. Underwriters ensure successful subscription of the issue by undertaking to take up the securities in the event of the public failing to subscribe the same. It benefits the issuing company, the investing public and capital market in general. The function of underwriting is undertaken for a fee.

d. Distribution function The function that facilitates the sale of securities to ultimate investors is called 'distribution'. The function of distribution is rendered by the specialized agencies like brokers and dealers in securities.

They maintain a constant and a close link with the issuers and the ultimate investors on the one hand, and issuers and other agencies of capital market on the other.

NIM VS. SECONDARY MARKET

NIM is different from the secondary market in the following respects:

Sl. No.	Feature	NIM	Secondary Market
1.	Issue of securities	NIM deals only with new or fresh issue of securities. Issues are considered fresh or new provided such issues are made for the first time either by the existing company or by the new company	Deals in existing securities
2.	Location	No fixed geographical location needed	Needs a fixed place to house the secondary market activities, viz., trading
3.	Transfer of securities	Securities are created and transferred from corporates to investors for the first time	Securities are transferred from one investor to another through the stock exchange mechanism
4.	Entry	All companies can enter NIM and make fresh issue of securities	For the securities to enter the portals of stock exchanges for the purpose of trading, listing is mandatory
5.	Administr-ation	Has no tangible form of administrative set-up	Has a definite administrative set-up that facilitates trading in securities
6.	Regulation	Subject to regulations mostly from outside the company—SEBI, Stock Exchanges, Companies Act, etc.	Subject to regulation both from within and outside the stock exchange framework

Sl. No.	Feature	NIM	Secondary Market
7.	Aim	Creating long-term instruments for borrowings	Providing liquidity through marketability of those instruments.
8.	Price Movement	Stock price movement in secondary market influences pricing of new issues	Both macro and micro factors influence the stock price movement
9.	Depth	Depends on number and the volume of issue	Depth depends upon the activities of the primary market as it brings into the fore more corporate entities and more instruments to raise funds

METHODS OF MARKETING SECURITIES#

Following are the various methods being adopted by corporate entities for marketing the securities in the New Issues Market:

Pure Prospectus Method

Meaning

A method of marketing securities whereby an existing corporate enterprise mops up capital funds from the general public by means of an issue of a prospectus, is called 'Pure Prospectus Method'. It is the most popular method of making public issue of securities by corporate enterprises.

Features

1. ***Exclusive subscription*** Under this method, the new issues of a company are offered for exclusive subscription of the general public. According to the SEBI norms, a minimum of 49 percent of the total issue at a time is to be offered to public.
2. ***Issue price*** Direct offer is made by the issuing company to the general public to subscribe to the securities at a stated price. The securities may be issued either at par, of at a discount or at a premium.
3. ***Underwriting*** Public issue through the 'pure prospectus method' is usually underwritten. This is to safeguard the interest of the issuer in the event of an unsatisfactory response from the public.

Information sourced from the official website of SEBI, http://www.sebi.gov.in/

4. ***Prospectus*** A document that contains information relating to the various aspects of the issuing company, besides other details of the issue is called a 'Prospectus'. The document is circulated to the public. The general details include the company's name and address of its registered office, the names and addresses of the company's promoters, manager, managing director, directors, company secretary, legal adviser, auditors, bankers, brokers, etc the date of opening and closing of subscription list, contents of articles, the names and addresses of underwriters, the amount underwritten and the underwriting commission, material details regarding the project, i.e., location, plant and machinery, technology, collaboration, performance guarantee, infrastructure facilities, etc. nature of products, marketing set-up, export potentials and obligations, past performance and future prospects, management's perception regarding risk factor, credit rating obtained from any other recognized rating agency, a statement regarding the fact that the company will make an application to specified stock exchange(s) for listing its securities and so on.

Advantages

The pure prospectus method offers the following advantages to the issuer and the investors alike:

1. ***Benefits to investors*** The pure prospectus method of marketing the securities serves as an excellent mode of disclosure of all the information pertaining to the issue. Besides, it also facilitates satisfactory compliance with the legal requirements of transparency, etc. It also allows for good publicity for the issue. The method promotes confidence of investors through transparency and non discriminatory basis of allotment. It prevents artificial jacking up of prices as the issue is made public.
2. ***Benefits to issuers*** The pure prospectus method is the most popular method among the large issuers. In addition, it provides for wide diffusion of ownership of securities contributing to reduction in the concentration of economic and social power.

Drawbacks

The raising of capital through the pure prospectus method is fraught with a number of drawbacks as specified below:

1. ***High issue costs*** A major drawback of this method is that it is an expensive mode of raising funds from the capital market. Costs of various hues are incurred in mobilizing capital. Such costs as underwriting expenses, brokerage, administrative costs, publicity

costs, legal costs, and other costs are incurred for raising funds. Due to the high cost structure, this type of marketing of securities is followed only for large issues.

2. ***Time consuming*** The issue of securities through prospectus takes more time, as it requires the due compliance with various formalities before an issue could take place. For instance, a lot of work such as underwriting, etc. should be formalized before the printing and the issue of a prospectus.

Offer for Sale Method

Meaning

Where the marketing of securities takes place in bulk quality to intermediaries, such as issue houses, stockbrokers and others, it is a case of 'Offer for Sale Method'.

Features

Under this method, the sale of securities takes place in two stages. In the first stage, the issuer company makes an enblock sale of securities to intermediaries such as the issue houses and share brokers at an agreed price. Under the second stage, the securities are resold to ultimate investors at a market-related price. The difference between the purchase price and the issue price constitutes 'profit' for the intermediaries. The intermediaries are responsible for meeting various expenses such as underwriting commission, prospectus cost, advertisement expenses, etc.

The issue is also underwritten to ensure total subscription of the issue. The biggest advantage of this method is that it saves the issuing company the hassles involved in selling the shares to the public directly through prospectus. This method is, however, expensive for the investor as it involves the offer of securities by issue houses at very high prices.

Private Placement Method

Meaning

A method of marketing of securities whereby the issuer makes the offer of sale to individuals and institutions privately without the issue of a prospectus is known as 'Private Placement Method'. This is the most popular method gaining momentum in recent times among the corporate enterprises.

Features

Under this method, securities are offered directly to large buyers with the help of share brokers. This method works in a manner similar to the 'Offer for Sale Method' whereby securities are first sold to intermediaries such as issues houses, etc. They are in turn placed at higher prices to individuals and institutions. Institutional investors play a significant role in the realm of private placing. The expenses relating to placement are borne by such investors.

Advantages

Private placement of securities offers the following advantages:

1. Less expensive as various types of costs associated with the issue are borne by the issue houses and other intermediaries themselves
2. Less troublesome for the issuer as there is not much of stock exchange requirements concerning contents of prospectus and its publicity, etc. to be complied with
3. Placement of securities suits the requirements of small companies.
4. The method is also resorted to when the stock market is dull and the public response to the issue is doubtful

Disadvantages

The major weaknesses of the private placement of securities are as follows:

1. Concentration of securities in a few hands
2. Creating artificial scarcity for the securities thus jacking up the prices temporarily and misleading general public
3. Depriving the common investors of an opportunity to subscribe to the issue, thus affecting their confidence levels

Initial Public Offer (IPO) Method

The public issue made by a corporate entity for the first time in its life is called 'Initial Public Offer' (IPO). Under this method of marketing, securities are issued to successful applicants on the basis of the orders placed by them, through their brokers.

When a company whose stock is not publicly traded wants to offer that stock to the general public, it takes the form of 'Initial Public Offer'. The job of selling the stock is entrusted to a popular intermediary, the underwriter. An underwriter is invariably an investment banking company. He agrees to pay the issuer a certain price for a minimum number of shares, and then resells those shares to buyers, who are often the clients of the underwriting firm. The underwriters charge a fee for their services.

Stocks are issued to the underwriter after the issue of prospectus which provides details of financial and business information as regards the issuer. Stocks are then released to the underwriter and the underwriter releases the stock to the public.

The issuer and the underwriting syndicate jointly determine the price of a new issue. The approximate price listed in the red herring (the preliminary prospectus often with words in red letters which say this is preliminary and the price is not yet set) may or may not be close to the final issue price. IPO stock at the release price is usually not available to most of the public. Good relationship between the broker and the investor is a prerequisite for the stock being acquired.

Full disclosure of all material information in connection with the offering of new securities must be made as part of the new offerings. A statement and preliminary prospectus (also known as a red herring) containing the following information is to be filed with the Registrar of Companies:

1. A description of the issuer's business
2. The names and addresses of the key company officers, with salary and a 5 year business history on each
3. The amount of ownership of the key officers
4. The company's capitalization and description of how the proceeds from the offering will be utilized, and
5. Any legal proceedings that the company is involved in

Applications are made by the investors on the advice of their brokers who are intimated of the share allocation by the issuer. The amount becomes payable to the issuer through the broker only on final allocation. The allotment is credited and share certificates delivered to the depository account of the successful investor.

The essential steps involved in this method of marketing of securities are as follows:

1. ***Order*** Broker receives order from the client and places orders on behalf of the client with the issuer.
2. ***Share allocation*** The issuer finalizes share allocation and informs the broker regarding the same.
3. ***The client*** The broker advises the successful clients of the share allocation. Clients then submit the application forms for shares and make payment to the issuer through the broker.
4. ***Primary issue account*** The issuer opens a separate escrow account (primary issue account) for the primary market issue. The clearing house of the exchange debits the primary issue account of the broker and credits the issuer's account.
5. ***Certificates*** Certificates are then delivered to investors. Otherwise depository account may be credited.

The biggest advantage of this method of marketing of securities is that there is no need for the investors to part with the money even before the shares are allotted in his favor. Further, the method allows for elimination of unnecessary hassles involved in making a public issue. Under the regulations of the SEBI, IPOs can be carried out through the secondary market and the existing infrastructure of stock exchanges can be used for this purpose.

Rights Issue Method

Where the shares of an existing company are offered to its existing shareholders, it takes the form of 'rights issue'. Under this method, the existing company issues shares to its existing shareholders in proportion to the number of shares already held by them.

The relevant guidelines issued by the SEBI in this regard are as follows:

1. Rights Issue shall be issued only by listed companies
2. Announcement regarding rights issue once made, shall not be withdrawn and where withdrawn, no security shall be eligible for listing upto 12 months
3. Underwriting as to rights issue is optional and appointment of Registrar is compulsory
4. Appointment of category I Merchant Bankers holding a certificate of registration issued by SEBI shall be compulsory
5. Rights shares shall be issued only in respect of fully paid shares
6. Letter of Offer shall contain disclosures as per SEBI requirements
7. Agreement shall be entered into with the depository for materialization of securities to be issued
8. Issue shall be kept open for a minimum period of 30 days and for a maximum period of 60 days
9. A minimum subscription of 90 percent of the issue shall be received
10. No reservation is allowed for rights issue as regards FCDs and PCDs
11. A 'No Complaints Certificate' is to be filed by the 'Lead Merchant Banker' with the SEBI after 21 days from the date of issue of offer document
12. Obligatory for a company where increase in subscribed capital is necessary after two years of its formation or after one year of its first issue of shares, whichever is earlier (this requirement may be dispensed with by a special resolution)

Advantages

Rights issue offers the following advantages:

1. ***Economy method*** Rights issue constitutes the most economical method of raising fresh capital, as it involves no underwriting and brokerage costs. Further, the expenses by way of advertisement and administration, etc. are less.
2. ***Easy method*** The issue management procedures connected with the rights issue are easier as only a limited number of applications are to be handled.
3. ***Choice to shareholders*** Issue of rights shares does not involve any dilution of ownership of existing shareholders. Further, it offers freedom to shareholders to subscribe or not to subscribe the issue.

Drawbacks

The method suffers from the following limitations:

1. ***Restrictive method*** The facility of rights issue is available only to existing companies and not to new companies.
2. ***Works against society*** The issue of rights shares runs counter to the overall societal considerations of diffusion of share ownership for promoting dispersal of wealth and economic power.

Bonus Issue Method

A method of marketing the securities of a company by converting its accumulated reserves and surplus profits, it takes the form of 'bonus issue method".

Bonus issue merely implies capitalization of existing reserves and surplus of a company. The issue of bonus shares is subject to certain rules and regulations. The issue does not in any way affect the resources base of the enterprise. It saves the company enormously of the hassles of capital issue.

SEBI Guidelines

Issued under Section 205 (3) of the Companies Act, bonus shares are governed by the guidelines issued by the SEBI (applicable to listed companies only) as follows:

1. ***Reservation of shares*** In respect of FCDs and PCDs, bonus shares must be reserved in proportion to such convertible part of FCDs and PCDs. The shares so reserved may be issued at the time of conversion(s) of such debentures on the same terms on which the bonus issues were made.

2. ***Issued out of reserves*** The bonus issue shall be made out of free reserves built out of the genuine profits or share premium collected in cash only. Reserves created by revaluation of fixed assets are not capitalized.
3. ***Not in lieu of dividends*** The declaration of bonus issue, in lieu of dividend, is not to be made.
4. ***Fully paid shares*** The bonus issue is not made unless the partly paid shares, if any are made fully paid-up.
5. ***Track record*** The company has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption thereof and has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus, etc.
6. ***Implementation*** A company that announces its bonus issue after the approval of the Board of Directors must implement the proposal within a period of 6 months from the date of such approval and shall not have the option of changing the decision.
7. ***The articles*** The Articles of Association of the company shall contain a provision for capitalization of reserves, etc. If there is no such provision in the Articles, the company shall pass a resolution at its general body meeting making provisions in the Articles of Association for capitalization.
8. ***Resolution*** Consequent to the issue of bonus shares if the subscribed and paid-up capital exceeds the authorized share capital, the company at its general body meeting for increasing the authorized capital shall pass a resolution.

Rights Issue Vs. Bonus Issue

Bonus issue is different from rights issue in the following respects:

Sl. No.	Feature	Rights Issue	Bonus Issue
1.	Payment	The issue is to be paid for	The issue is free
2.	Privilege	Confers a privilege on the existing members	Not a privilege issue
3.	Paid-up shares	Shares may be partly paid-up also	Shares are necessarily to be fully-paid up

Sl. No.	Feature	Rights Issue	Bonus Issue
4.	Minimum Subscription	Minimum subscription is required	Minimum subscription is not required
5.	Separate Account	Money is to be kept in a separate bank account	No such requirement
6.	Right to Renounce	Rights issue may be renounced by a member in favour of a nominee	No such facility is available
7.	Regulation	Regulated by the provisions of the Companies Act and SEBI guidelines	Regulated by the provisions of the company's Articles and SEBI guidelines

Book-building Method

A method of marketing the shares of a company whereby the quantum and the price of the securities to be issued will be decided on the basis of the 'bids' received from the prospective shareholders by the lead merchant bankers, is known as 'book-building method'. Under the book-building method, share prices are determined on the basis of real demand for the shares at various price levels in the market. For discovering the price at which issue should be made, bids are invited from prospective investors from which the demand at various price levels is noted. The merchant bankers undertake full responsibility for the issue.

The option of book-building is available to all body corporates, which are otherwise eligible to make an issue of capital to the public. The initial minimum size of issue through book-building route was fixed at Rs. 100 crores. However, beginning from December 9, 1996 issues of any size will be allowed through the book-building route.

Book-building facility is available as an alternative to firm allotment. Accordingly, a company can opt for book-building route for the sale of shares to the extent of the percentage of the issue that can be reserved for firm allotment as per the prevailing SEBI guidelines. It is therefore possible either to reserve securities for firm allotment or issue them through the book-building process.

Advantages of Book-building

Book-building process is of immense use in the following ways:

1. Reduction in the duration between allotment and listing
2. Reliable allotment procedure

3. Quick listing in stock exchanges possible
4. No price manipulation as the price is determined on the basis of the bids received

Stock Option or Employees Stock Option Scheme (ESOP)

A method of marketing the securities of a company whereby its employees are encouraged to take up shares and subscribe to it is known as 'stock option'. It is a voluntary scheme on the part of the company to encourage employees' participation in the company. The scheme also offers an incentive to the employees to stay in the company. The scheme is particularly useful in the case of companies whose business activity is dominantly based on the talent of the employees, as in the case of software industry. The scheme helps retain the most productive employees in an industry, which is known for its constant churning of personnel.

Bought-out Deals

Meaning

A method of marketing of securities of a body corporate whereby the promoters of an unlisted company make an outright sale of a chunk of equity shares to a single sponsor or the lead sponsor, is known as 'bought-out deals'.

Features

1. ***Parties to the deal*** There are three parties involved in the bought-out deals. They are promoters of the company, sponsors and cosponsors who are generally merchant bankers and investors.
2. ***Outright sale*** Under this arrangement, there is an outright sale of a chunk of equity shares to a single sponsor or the lead sponsor.
3. ***Syndicate*** Sponsor forms a syndicate with other merchant bankers for meeting the resource requirements and for distributing the risk.
4. ***Sale price*** Sale price is finalized through negotiations between the issuing company and the purchaser, the sale being influenced by such factors as project evaluation, promoters image and reputation, current market sentiments, prospects of off-loading these shares at a future date, etc.
5. ***Fund-based activity*** Bought-out deals are in the nature of fund-based activity where the funds of the merchant bankers get locked in for at least the prescribed minimum period.
6. ***Listing*** The investor-sponsor makes a profit, when at a future date, the shares get listed and higher prices prevail in the market. Listing

generally takes place at a time when the company is performing well in terms of higher profits and larger cash generations from projects.

7. ***OTCEI*** Sale of these shares at Over-the-Counter Exchange of India (OTCEI) or at a recognized stock exchanges, the time of listing these securities and off-loading them simultaneously are being generally decided in advance.

Bought-out Deals Vs. Private Placements

Following are the differences between bought-out deals and private placements:

Sl. No.	Feature	Private Placement	Bought-out Deal
1.	Trading Scrips	Listed securities	Unlisted securities
2.	Creating Securities	Results in the creation of additional securities for the buying institutions	Securities are simply transferred from promoters to sponsors who in turn off-load them to the public
3.	Lock-in Period	Five years	18 months

Benefits

Bought-out deals offer the following benefits:

1. ***Speedy sale*** Bought-out deals offer a mechanism for a speedier sale of securities at lower costs relating to the issue.
2. ***Freedom in price setting*** Bought-out deals offer freedom for promoters to set a realistic price and convince the sponsor about the same.
3. ***Investor protection*** Bought-out deals facilitate better investor protection as sponsors are rigorously evaluated and appraised by the promoters before off-loading the issue.
4. ***Quality offer*** Bought-out deals help enhance the quality of capital floatation and primary market offerings.

Limitations

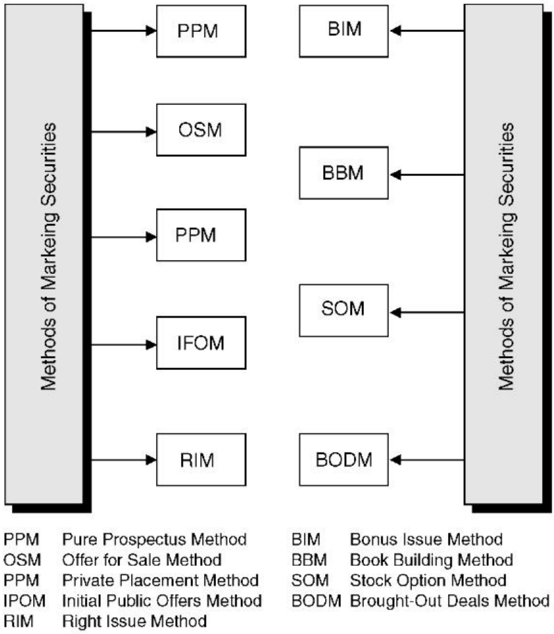
Bought-out deals pose the following difficulties for the promoters, sponsors and investors:

1. ***Loss of control*** The apprehensions in the minds of promoters, particularly of the private or the closely held companies that the sponsors may usurp control of the company as they own large chunk of the shares of the company.

2. ***Loss of sales*** Bought-out deals pose considerable difficulties in off-loading the shares in times of unfavorable market conditions. This results in locking up of investments and entailing losses to sponsors.
3. ***Wrong appraisal*** Bought-out deals cause loss to sponsors on account of wrong appraisal of the project and overestimation of the potential price of the share.
4. ***Manipulation*** Bought-out deals give great scope for manipulation at the hands of the sponsor through insider trading and rigging.
5. ***No accountability*** Bought-out deals pose difficulty of penalizing the sponsor as there are no SEBI guidelines to regulate offerings by sponsors.
6. ***Windfall profits*** Bought-out deals offer the advantage of windfall profits by sponsors at the cost of small investors.
7. ***Loss to investors*** Where the shares taken up by issue brokers and a coterie of select clients are being bought back by the promoters at a pre-fixed higher price after allotment causing loss to investors of the company.

The different methods used for marketing securities in a new issues market is shown in Exhibit 5.

Exhibit 5 NIM—Methods of Marketing Securities



OTCEI Guidelines

The OTCEI allows for the off-loading of the shares acquired by sponsors in bought-out deals. The following conditions have been prescribed in this regard:

1. Minimum post-issue holding of promoters shall be 25 percent with a lock-in period of five years
2. Sponsor to act as a market-maker for 18 months who has to identify an additional market maker for such compulsory market-making. The two market-markers should, between them, hold upto 5 percent of the equity offered to the public
3. Sponsors to offer two-way quotes based on minimum and maximum trading prices
4. Freedom to members and dealers to decide the ratio of holdings between the members, and dealers and the nonmembers/nondealers in a bought-out deal where the members and dealers participate in the bought-out deal by taking up a minimum 10 percent of the total value of securities for which the deal is done
5. Initial offer of the bought-out deals should be made on the OTCEI members and dealers and where the participation from them is not forthcoming, only then it may be offered to nonmembers/nondealers
6. Offer of a minimum 25 percent of the post-issue paid-up capital of the company to the public

REVIEW QUESTIONS

Section A

1. What is 'New Issues Market' (NIM)?
2. What is meant by the 'pure prospectus method' of marketing securities?
3. What is 'offer for sale' method of marketing securities?
4. What is 'private placement'?
5. What is 'IPO'?
6. What is 'red herring prospectus'? When is it filed?
7. What is 'rights issue'?
8. What is 'bonus issue'?
9. What is 'book building method'?
10. What is 'ESOP'?

Section B

1. Explain the interface between the new issues market and the secondary market.
2. Describe the services rendered by the NIM.
3. Bring out the points of distinction between the NIM and the secondary market.
4. What are the features of the 'pure prospectus method' of marketing securities?
5. What are the advantages of pure prospectus method of marketing securities?
6. State the features of 'offer for sale' method of marketing securities.
7. What are the advantages and disadvantages of 'private placement' method of marketing securities?
8. State the information to be provided in the 'red herring prospectus'.
9. Enumerate the steps involved in the marketing of securities in the case of 'IPO' method.
10. State the relevant guidelines pertaining to rights issue of securities under the SEBI.
11. How is rights issue of securities useful?
12. State the SEBI guidelines relating to the issue of bonus shares by a corporate enterprise.
13. How is rights issue different from the bonus issue?
14. Bring out the advantages of 'book building method' of marketing of securities.
15. What are the benefits and limitations of bought-out deals?
16. Specify the SEBI guidelines relating to bought-out deals.

Section C

1. Discuss the different methods of marketing the issue of securities by a corporate enterprise.
2. What are 'bought-out deals'? What are their features? How are they different from private placements?

Chapter 6

Underwriting of Securities

DEFINITION

Underwriting is a guarantee given by 'underwriters', the financial market intermediary to take up a whole or a part of the issue of securities not subscribed by the public. It is a marketing technique whereby corporate enterprises are able to sell their securities to the public and thereby achieve success in the public issue. The service is utilized by corporates in order to procure the necessary funds. The agreement between the issuing company and the underwriter, whereby sale of a certain quantum of securities is guaranteed for the issuing company, is known as underwriting agreement. The underwriter works for a commission called 'underwriting commission'.

According to **Gerstenberg**, "Underwriting is an agreement entered into before the shares are brought by the public that in the event of the public not taking up the whole of them the underwriter will take an allotment of such part of the shares as the public has not applied for."

TYPES

A brief description of different types of underwriting is outlined below:

Firm Underwriting

It is an underwriting agreement whereby, the underwriter agrees to take up a specified number of securities, irrespective of the securities being offered to the public. It is an agreement for outright purchase of securities, the underwriter being given a preference in allotment over the general public in respect of the commitment given by the company issuing the securities. This is in addition to the shares not taken up by the public. Such an agreement is designed to create confidence in the minds of investing public.

Subunderwriting

When a large issue of securities is made and the underwriting of securities is contracted out by the main underwriter to other underwriting intermediaries for a commission, it is known as 'subunderwriting'. This type of underwriting helps the main underwriter minimize the risk of loss of investment in the event of the issue being unpopular.

Joint Underwriting

When an issue of securities by a company is underwritten by two or more underwriting intermediaries jointly, it is called 'joint underwriting'. The objective is to minimize the risk and share the benefit arising from the capital issue. Besides, this also helps underwriters with limited resources to pool them and successfully take up the issue.

Syndicate Underwriting

When a syndicate of underwriters, by means of an agreement, underwrites the issue of securities collectively, it is known as 'syndicate underwriting'. Such an arrangement is worked out in the case of issues that are considered potentially risky. There will be two types of agreements which will form part of the syndicate underwriting. They are—agreement between the issuing company and underwriter, and agreement among the underwriters themselves stating the terms and conditions.

UNDERWRITER

The financial services intermediary who arranges for the subscription of the issue of securities, in the event of the issue not being taken up by the public, or who firmly guarantees a capital issue, is called 'the underwriter'.

National financial institutions, commercial banks, merchant bankers, and members of stock exchanges function as underwriters. The lead manager, in consultation with the company, arranges the underwriting service. Several factors are taken into consideration while making the selection of an underwriter for an issue. The factors include financial strength, experience in the primary market, past underwriting performance and defaults, if any, underlying underwriting commitments, the network of investor clientele of the underwriter and overall reputation of the underwriter. If any part of the issue is underwritten, the prospectus shall contain a statement that the underwriters have sufficient resources to discharge their obligations.

Before accepting the underwriting obligation, the underwriter takes into consideration factors such as the company's standing and record, competence of the management, objectives of the issue, project details, offer price, other terms of the issue, and off-balance sheet liabilities.

UNDERWRITING AGREEMENT

A contract between an underwriter and the company issuing capital with regard to the commitment for subscription of securities is known as 'underwriting agreement'. The underwriter agrees to subscribe or procure subscription to a portion of the capital to be issued, in case the issue is not fully subscribed, the maximum liability of the underwriter being restricted to the amount underwritten. The underwriters usually include merchant bankers or financial institutions such as UTI, and other mutual funds, LIC or ICICI.

In finalizing underwriting arrangements, both the resources of the underwriters and the marketing aspects of the issue are kept in mind. The participation of brokers in underwriting helps in marketing the issue to the individual investor. Financial institutions consider underwriting proposals on the basis of the viability of the project for which public issue is being made.

BENEFITS/FUNCTIONS

The financial service of 'underwriting' is advantageous to the issuers and the public alike. The function and the role of underwriting firms are explained below:

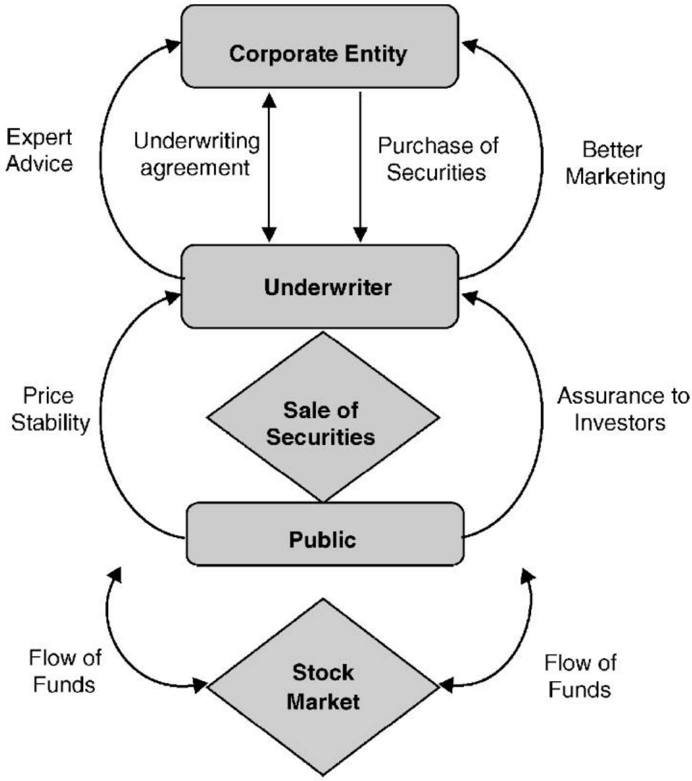
1. ***Adequate funds*** Underwriting, being a kind of a guarantee for subscription of a public issue of securities enables a company to raise the necessary capital funds. By undertaking to take up the whole issue, or the remaining shares not subscribed by the public, it helps a company to undertake project investments with the assurance of adequate capital funds. Further, underwriting agreement assures the company of the required funds within a reasonable or agreed time.
2. ***Expert advice*** Underwriters of repute often help the company by providing advice on matters pertaining to the soundness of the proposed plan etc, thus enabling the company to avoid certain pitfalls connected with the securities issue. It is therefore, possible for an issuing company to obtain the benefit of expert advice through underwriting by entering into an agreement. Further, underwriters also supply important information to the issuing company with regard to investor's attitude, market conditions etc. and suggest changes in their financial plans too, wherever necessary.

3. ***Enhanced goodwill*** The fact that the issue of securities of a firm are underwritten, would help the firm achieve a successful subscription of securities by the public. This is because, intermediaries, of financial integrity and established reputation usually do the underwriting. Such an activity, helps enhance the goodwill of the issuing company. By purchasing securities, either directly from the company or from the market, they vouchsafe the financial soundness of the company.
4. ***Assurance to investors*** Underwriters, before underwriting the issue, satisfy themselves with the financial integrity of the issuer-company and viability of the plan. The underwriting firms assure this way, the soundness of the company. The investors are, therefore, assured of having low risk when they buy shares or debentures which have been underwritten by them. Their firm commitment towards fulfilling their underwriting obligations helps create confidence in the minds of the investing public about the company.
5. ***Better marketing*** Underwriters ensure efficient and successful marketing of the securities of a firm through their network arrangements with other underwriters and brokers at national and global level. This promotes a wide geographical dispersion of securities and facilitates tapping of financial resources for the company.
6. ***Benefits to buyers*** Underwriters are very useful to the buyers of securities due to their ability to give expert advice regarding the safety of the investment and the soundness of companies. The information and the expert opinion published by them in various newspapers and journals are also helpful.
7. ***Benefits to stock market*** Underwriters provide stability to the price of securities by purchasing and selling various securities. This ultimately benefits the stock market.

MECHANICS OF UNDERWRITING

The working mechanism connected with the underwriting of securities is depicted in Exhibit 6.

Exhibit 6 Mechanics of Underwriting



INDIAN SCENARIO

Underwriting, as an important type of financial service, became popular in the Indian capital market only recently. It made its beginning in 1912 when M/s.Batliwala and Karni underwrote the shares of the Central India Spinning and Weaving Co. Ltd. Underwriting, on a substantial scale, started in the Indian capital market only after World War I. The Tatas started the first underwriting business in India in 1937, with the setting up of the 'Investment Corporation of India Ltd'. Not only were there few underwriting firms operating in India, but the quantum of underwriting done was also less.

Underwriting gained momentum and popularity after January 1955, with the setting up of the Industrial Credit and Investment Corporation of India (ICICI). Later, other development financial institutions such as the Life Insurance Corporation of India, Industrial Development Bank of India

(IDBI) and Unit Trust of India (UTI) also started taking an active part in the underwriting of new issues, with IDBI being one of the largest.

UNDERWRITING AGENCIES

The Indian capital market is dominated by several underwriting agencies such as private firms, banks, financial institutions, etc.

Private Agencies

Some of the important private firms that are involved in underwriting business are M/s.Place, Siddons and Gough, M/s.Baltiwala and Karni, M/s.Dalal and Co., M/s.Kothari and Co. and M/s.Wright and Co.

Investment Companies

In addition to private agencies, a number of investment companies and trusts are also engaged in the underwriting business. These include Industrial Investment Trusts of Bombay, Birds Investment Ltd., Calcutta, Devkaran Nanji Investment Co., and Investment Trust of India Ltd.

Commercial Banks

After the nationalization of commercial banks, and with the initiation of reform measures in the beginning of the nineties, banks started taking a active part in the underwriting business.

Development Finance Institutions (DFIs)

A number of development finance institutions were established all over the country in order to spur development and growth in the industrial, export and agricultural sectors. These institutions provide both direct and indirect, financial and other type of assistance. Among the indirect assistance of finance, underwriting constitutes an important segment. These institutions include the Life Insurance Corporations (LIC), the Industrial Finance Corporation of India (IFCI), ICICI, IDBI, UTI and State Financial Corporations (SFCs). These institutions account for a major share of the underwriting business in India.

OBSTACLES

Underwriters in India face several debilitating conditions that constitute obstacle to their progress. Some of the hardships faced by them are as follows:

1. ***Chaotic capital market*** An essential prerequisite for the development and the promotion of underwriting is the existence of a well -developed capital market. Unfortunately, the capital market in India

is of recent origin. With the progress taking place very slowly, even after the implementation of economic reforms in the beginning of the nineties, a lot of uncertainties persist. Moreover, the kind of equity culture existing in the capital market is sluggish, dormant and chaotic. All these factors resulted in the slow progress of underwriting activity.

2. ***Slow industrialization*** Thanks to many obstacles in the Indian economy, industrial development has been relatively slow and tardy. There were many legislative and other measures of control and regulation that were so archaic that they caused heavy hardship to industrial development. On account of these reasons, the Indian capital market remained underdeveloped especially with regard to underwriting agencies for a long time.
3. ***Managing agency system*** The managing agency system, prevalent in the corporate world, was also responsible for the slow growth of the underwriting business in India. Managing agents who performed the underwriting activity indulged in the sale of securities of managed companies to their friends.
4. ***Bashful investors*** The bashful nature of Indian investors was responsible for the slow progress of underwriting. Indian investors lack the inclination to make smart investment in securities. The backward nature of the Indian industry is responsible for not contributing anything towards the development of underwriting business.
5. ***Lack of specialized institutions*** For the underwriting service to take place and flourish, it requires the presence of specialized financial institutions similar to the investment bankers of USA, or the issue houses of UK. Such specialized institutions were not available in the Indian capital market, although the banks and institutions started the underwriting business in a big way very late.
6. ***Unsuccessful corporates*** The inability of the Indian corporates to emerge successful after the public issue of securities made potential investors lose faith in the activities of the capital market. This also resulted in inadequate capital formation. The underwriting business thus, did not take off well, since this made the investments more risky.

SEBI GUIDELINES

SEBI has issued detailed guidelines regulating underwriting as a financial service. Following are the important guidelines:

1. ***Optional*** Underwriting has been made optional by the SEBI, for issues since October 1994. Accordingly, if an issue has not been underwritten and the firm is not able to collect 90 percent of the

amount offered to the public, the entire amount collected would be refunded to the investors. However, the requirement of a minimum of 90 percent subscription will not be applicable to the exclusive debt issues, provided the issuer makes adequate disclosures about the alternative sources of finance that have been tied-up.

2. ***Number of underwriters*** The issuers will decide on the number of underwriters. For this purpose, the lead managers must satisfy themselves about the net worth of the underwriters, and the outstanding commitments, and disclose the same to SEBI. The underwriting arrangement should be filed with the stock exchange.
3. ***Registration*** An important regulation announced by SEBI was the requirement for underwriting firms to get themselves registered with SEBI. The registration requires the underwriters to have a minimum net worth of Rs. 20 lakhs.
4. ***Obligations*** Underwriters are required to follow scrupulously the general obligations and responsibilities, procedures for inspection and disciplinary proceedings in case of default. The underwriting obligations, at any point of time, should not exceed 20 times an underwriters net worth.
5. ***Subunderwriting*** As a step towards diversifying the risk, the underwriter can off-load a portion of the obligations to other underwriters. For this purpose, underwriters can arrange for subunderwriting on their own. In order to ensure transparency in the operations of underwriters, an agreement is entered into with each body corporate on whose behalf the underwriting is undertaken. The agreement stipulates details such as the period within which the underwriter shall subscribe to the issue after being asked, the precise commission payable and details of arrangements made by the underwriter for fulfilling the underwriting obligations.
6. ***Underwriting commission*** The payment of underwriting commission depends on the amount of obligation devolving on the underwriter. Underwriting commission is payable by the issuer-corporation on the basis of the commission rates prescribed by SEBI. They are the maximum ceiling rates and are negotiable. No underwriting commission is payable on amounts taken up by promoters, employees, directors and their friends, and business associates. Underwriting commission is to be paid within 15 days of finalization of allotment. However, it is payable only when the entire portion has been subscribed.

The relevant rates of underwriting commission are as follows:

1. In respect of equity shares, the commission is 2.5 percent on both the amount devolving on underwriter, and on the amount subscribed by the public.
2. In respect of preference, convertible and nonconvertible debentures.
   - For underwriting upto Rs. 5 lakhs, the commission is 2.5 percent for the amount devolving on underwriter and 1.5 percent on the amount subscribed by the public.
   - For underwriting exceeding Rs. 5 lakhs, the commission is 2 percent for the amount devolving on underwriter and 1 percent on the amount subscribed by the public.

VARIANTS OF UNDERWRITING

There are variants of the underwriting business, which have recently evolved owing to the series of changes that have taken place in the control and regulatory ambience of the Indian capital market.

Offer for Sale

Offer for sale takes place when a company arranges to obtain money from private sources, by making the issue of securities fully to them. The private sources include issue houses and merchant bankers. Issue is generally made below the par value, which is then sold to the public. In such an eventuality, the company issues a 'statement in lieu of prospectus' instead of a regular prospectus. A statement in lieu of prospectus with information to be disclosed according to Schedule III of the Companies Act (Sec. 70(1)) should be filed with ROC three days before allotment of shares or debentures.

Bought-out Deals (BODs)

Meaning An arrangement, whereby the entire equity or related security is bought in full or in lots, with the intention of off-loading it later in the market is called 'bought-out deal'.

Features

1. ***Arrangement*** The arrangement takes place between the merchant banker/sponsor and the company, the shares being held by the sponsor until they are ready for public participation.
2. ***No retailing*** BODs eliminate retailing, thereby saving time and cost. They are the cheapest and quickest source of finance for small and medium companies.

3. ***Fund-based activity*** BODs convert a fee-based activity into a fund-based activity for merchant bankers.
4. ***Wholesale activity*** The capital raised from public, which is a retail activity, is rendered into a wholesale activity by the guidelines issued by SEBI in 1994, for reservation of issues without lock-in periods.
5. ***Reserved portions*** From the reserved category for institutional investors, lead managers can take a stake upto 5 percent of the post-issue equity. The reserved portion of the issue need not be underwritten. The public offer is 25 percent of the issue and underwriting is optional.

Advantages

1. Efficient appraisal of the project by the merchant bankers before the funds are invested.
2. Appropriate avenue to price the securities of companies.
3. Helpful in raising funds upfront and thus saving the cost of raising funds through a public issue.
4. Helpful to entrepreneurs who are not confident enough of tapping the capital market directly.
5. Measure of assurance and safety to the investor since the project is appraised by a merchant banker.
6. Benefits of larger participation of FIs, merchant bankers and FIIs and consequent higher credibility.
7. Handsome gains for the merchant banker if proper issue and prices are selected.

Private Placement

Definition The direct sale of securities by a company to institutional investors is called ’private placement’. It is another variant of underwriting. Private placement assumes that the offerees are limited and few, and have sufficient knowledge and experience to evaluate the merits and risk of investment.

Private placement facility is available for both listed and unlisted companies with a good track record of sales and profit. In the case of listed companies, private placements take into account their trading volumes, the level of floating stock and the purpose for which additional funds are being raised.

Features

1. ***No prospectus*** In private placement no prospectus is issued.
2. ***Instrument covered*** Private placement covers shares, preference shares and debentures.
3. ***Issuers*** The issuers could be public limited companies or private limited companies.
4. ***Investors*** Investors include Unit Trust of India, Life Insurance Corporation, General Insurance Corporation, State Finance Corporations, and Pension and Insurance Funds. Investors have sufficient knowledge and experience to be capable of evaluating the merits and risks of the investment.
5. ***Intermediaries*** The intermediaries are credit rating agencies, trustees (e.g. ICICI) and financial advisors such as merchant banks. The financial intermediary plays a vital role in preparing an offer memorandum, and negotiating with investors.
6. ***Negotiation*** By dealing with a limited number of institutional investors, the credit rating agents or trustees like ICICI can negotiate a loan directly tailored to suit the issuer's needs
7. ***Popular instrument*** The most widely used instrument in private placement is nonconvertible debenture, which is preferred by institutional investors because it gives stable and assured yield. The debentures are generally held until maturity.
8. ***Market size*** The private placement market is as big as the market for public issue through prospectus and rights combined.

Rationale Many factors contributed to the need for the development of opportunities for privately placing the securities. Some of these factors are as follows:

1. ***Capital market conditions*** The conditions that were prevailing in the Indian capital market with regard to pricing, listing and trading conditions made it difficult for corporates to raise capital for new projects. The cost of raising capital in terms of publicity and brokerage, which has always been prohibitive, along with uncertainties, has prompted companies to look for private placement opportunities for public subscription. Activity in the institutionalized private placement market has been quite intense, with most public sector enterprises, financial institutions, and corporations meeting their requirement through private equity funding

2. ***FIs resources*** A huge pool of savings with Financial Institutions (FIs) such as banks, including rural banks, insurance companies, provident funds, trusts, and foreign private equity funds, made it possible for the growth of private placements
3. ***Preferences*** The preferences of institutional investors, details of the company, promoters, management, project to be undertaken, pricing norms, and projections also played an important part in the development of the private placement market

Advantages

1. ***Popular mode*** Private placement has obvious advantages of speed, low cost, confidentiality, and accommodates smaller debt financing than is possible in a public issue.
2. ***Quick access*** Private placement offers access to capital more quickly than the public issue.
3. ***Secrecy*** Confidentiality is ensured in private placement, especially for private limited companies and closely held public limited companies, which do not want to make public issues for fear of takeover, wealth tax hassles and institutional interference.
4. ***Influence*** Private placement is not influenced by the prevailing bull or bear phases in the stock markets.

Grey Market

When securities are not sold through prospectus, it is a case of 'grey market placement'. In the grey market, trading takes place in securities much before official listing. The modus operandi in grey market is soliciting through post or print media, or door-to-door, and interested parties to purchase shares in private placement. While shares of new companies are sold at par or at nominal premium, in the case of shares of existing and profit making companies, premium could be very high. The brochure that normally accompanies the application presents a rosy picture and does not convey the gestation period or risks involved. The grey market exists with the active connivance of promoters. They sell shares out of their quota and profit from any premium collected.

REVIEW QUESTIONS

Section A

1. What is 'underwriting of securities'?
2. What is 'firm underwriting'?
3. What is 'subunderwriting'?
4. What is 'joint underwriting'?
5. What is 'syndicate underwriting'?
6. Who is an underwriter'?
7. What is an underwriting agreement'?
8. What are 'bought-out deals'?
9. What is 'private placement'?
10. Mention any three benefits of 'private placement'.
11. What is 'grey market'?

Section B

1. Explain the mechanics of underwriting of securities.
2. What are the benefits of underwriting of securities?
3. What is the Indian scenario as regards underwriting of securities?
4. Who are underwriting agencies? Explain them.
5. What are the obstacles faced by the underwriters in India?
6. What are the features of 'bought-out deals'?
7. Bring out the advantages of 'bought-out deals'.
8. Bring out the rationale behind the private placement as a method of marketing of securities undertaken by firms in India.

Section C

1. Explain the different types of 'underwriting of securities'.
2. Detail the SEBI guidelines regarding underwriting as an emerging business financial service.
3. Discuss the different variants of underwriting.

Chapter 7

Capital Market

DEFINITION

Capital market may be defined as a market for borrowing and lending long-term capital funds required by business enterprises. Capital market is the market for financial assets that have long or indefinite maturity. Capital market offers an ideal source of external finance. Capital market forms an important core of a country's financial systems too.

It refers to all the facilities and the institutional arrangements for borrowing and lending medium-term and long-term funds. Like any market, the capital market is also composed of those who demand funds (borrowers) and those who supply funds (lenders).

MONEY MARKET

According to the Reserve Bank of India, a money market is a 'centre for dealings, mainly of a short-term character, in monetary assets; it meets the short-term requirements of the borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus investible funds at the disposal of the financial and other institutions, and individuals are bid by borrowers, again comprising institutions and individuals and also by the Government'.

CHARACTERISTICS

Following are the characteristic features of a capital market:

1. ***Securities market*** The dealings in a capital market are done through the securities like shares, debentures, etc. The capital market is thus called securities market.
2. ***Security prices*** The price of securities that are dealt with in the capital market is determined through the general laws of demand and supply. The equilibrium in demand and supply of securities is brought

about by the prices. The price depends upon a large number of factors such as the following:

a. Yield on securities
b. Extent of funds available from public savings
c. Level of demand for funds
d. Flow of funds from the banking system
e. Price situation in general
f. Attitude towards liquidity on the part of investors

3. ***Participants*** There are many players in the capital market. The participants constitute a plethora of institutions, which provide a wide variety of services of access to capital. The capital is either directly supplied or arranged through financial intermediaries. These intermediaries form the basic edifice of a capital market. The participants in the capital market include the following:

   a. Block exchanges
   b. Brokers
   c. FIIs
   d. IIIs
   e. Postfolio manager
   f. Custodians
   g. Depositories
   h. Merchant bankers
   i. Share Transfer Agents
   j. Underwriters
   k. Venture capital funds
   l. Mutual funds
   m. Regulators, etc.

4. ***Location*** It is interesting to note that the capital market is not confined to certain specific locations, although it is true that parts of the market are concentrated in certain well-known centres known as Stock Exchanges. It exists all over the economy, wherever suppliers and users of capital get together and do business.

FUNCTIONS

The functions performed by the capital market are detailed below:

Allocation Function

Capital market allows for the channelization of the savings of innumerable investors into various productive avenues of investments. Accordingly, the current savings for a period are allocated amongst the various users and uses. The market attracts new investors who are willing to make new funds available to business. It also allocates and rations funds by a system of incentives and penalties.

Liquidity Function

Capital market provides a means whereby buyers and sellers can exchange securities at mutually satisfactory prices. This allows better liquidity for the securities that are traded.

Other Functions

In addition to the functions of funds allocation and liquidity, capital market also renders the following functions:

a. Indicative function A capital market acts as a barometer showing not only the progress of a company, but also of the economy as a whole through share price movements.

b. Savings and Investment function Capital market provides a means of quickly converting long-term investment into liquid funds, thereby generating confidence among investors and speeding up the process of saving and investment.

c. Transfer function Capital market facilitates the transfer of existing assets—tangible and intangible—among individual economic units or groups.

d. Merger function Capital market encourages voluntary or coercive take-over mechanism to put the management of inefficient companies into more competent hands.

INDIAN CAPITAL MARKET—EVOLUTION AND GROWTH

Standing the test of time, the Indian capital market has undergone phenomenal changes. Since the mid-eighties, a metamorphic transformation involving multidimensional growth has taken place in an otherwise dormant Indian financial system. The magnitude of growth could be gauged in terms of massive jumps in funds mobilization, the turnover on the stock exchanges, the amount of market capitalization, and the expansion of investor population. The regulatory framework has been strengthened and streamlined in order to tackle effectively the problems associated with the massive growth of the market.

The evolution in the realm of capital market in India could be broadly discussed as follows:

Infrastructure Stage

The period between 1947 and 1973 mark the period of the development of infrastructure for capital market. The stage saw the process of strengthening of capital market through the establishment of a network of development financial institutions such as IFCI (1948), ICICI (1955), IDBI and UTI (1964), SFCs (during the fifties and sixties) and SIDCs (during the sixties and early seventies). A number of important enactments covering the functioning of different segments of capital market were legislated during this period. These include: Capital Issues (Control) Act, 1947, Securities Contracts (Regulation) Act, 1956 and Companies Act, 1956.

Development of an organized indigenous capital market was inhibited in the initial years that followed independence owing to a variety of factors as stated below:

1. Insignificant demand for long-term funds owing to weak industrial base and low savings rate
2. Dependence of many foreign companies upon the London capital market for raising funds rather than on the Indian capital market
3. Adverse consequences of the managing agency systems, which performed different functions of promotion, management and underwriting of new capital issues
4. Lukewarm interest shown by Indian corporates for mobilizing capital through the instruments of shares and debentures from capital market.
5. More reliance of the industry on the bank credit which offered credit at relatively lower (often subsidized) rates of interest; and
6. Hazards of administered interest rate structure

New Issues Stage

This stage heralded the enactment of the Foreign Exchange Regulation Act (FERA) between the period 1973 and 1980. Under this Act, shareholding of foreign firms in joint ventures was restricted to 40 percent if the companies wanted to be recognized as Indian companies. This period saw many well-managed multinational companies offering their equities to the public at relatively low prices. This encouraged a large number of domestic public limited companies to come out with the offer of new capital issues for public subscription. All these culminated in the stock market exhibiting an upward trend with share prices displaying a high level of buoyancy.

This also created, for the first time, an awareness among the common investors about the potential of equity investments as a hedge against inflation and a source of higher earnings compared to the other forms of investments.

The SEBI Stage

This stage of development during the period between 1980 and 1992 brought about rapid changes in the Indian capital market. This marked a period of change, signifying the widening and deepening of the market. 'Debenture' emerged as a powerful instrument of resource mobilization in the primary market. The public sector bonds, which came to be introduced since 1985-86, imparted an additional dimension to the market. The impressive growth witnessed in this stage was responsible for bringing into existence a number of stock exchanges, phenomenal increase in the listed companies with a quantum jump in their paid-up capital and market capitalization. This signified a momentous growth in the secondary market.

a. New financial services An important part of development under this stage was the emergence of SEBI as an effective regulatory body to set right many ailments afflicting the secondary and the primary markets so as to afford a measure of protection to small investors. New financial services such as credit rating, etc came to be introduced. Several credit rating institutions such as CRISIL, CARE and ICRA were set up in order to help investors make a right choice of investment. Similarly, Stock Holding Corporation of India was set up to provide custodial services; IL&FS was set up to offer infrastructure financing and leasing services; and TDICI, RCTC and TFCI were also constituted as specialized financial institutions. The OTCEI was established to provide screenbased stock exchange facility to investors. Similarly, mutual funds and venture capital fund/companies were also set up.

b. Committees/Working groups An important part of growth during this period was the constitution of a number of committees in order to suggest measures to revamp and restructure the working of the secondary market and cause buoyancy in the primary market so as to instil confidence in the investing community. These included the following:

(i) A Committee on Organization and Management of Stock Exchange, 1986 under the chairmanship of Mr. G.S. Patel

(ii) A Working group on the Development of the Capital Market, 1989 under the chairmanship of Dr. Abid Hussain

(iii) A Study Group for Guidelines Relating to Valuation and New Instruments, 1991 under the chairmanship of Mr. M.J. Pherwani

(iv) A High Powered Study Group on Establishment of New Stock Exchanges, 1991 under the chairmanship Mr. M.J. Pherwani

(v) A Committee on Trading in Public Sector Bonds and Units of Mutual Funds, 1992 under the chairmanship of Mr. S.S. Nadkarni

A number of recommendations of the above committees were implemented to help streamline the operations of the capital market. However, this period witnessed one of the worst crises in the Indian capital market with a major scam in securities market breaking out. Large-scale irregularities in securities transactions that took place in 1992 exposed the loopholes in the existing systems and procedures of stock trading. This necessitated the overhauling of the regulatory framework of the capital market for preventing recurrence of such irregularities in the future. The Securities and Exchange Board of India (SEBI) which was set up as a regulatory body of the Indian securities market in 1988 was vested with statutory powers for regulating capital market only in 1992 after the enactment of the SEBI Act, 1992. Ever since its inception, SEBI has been focusing its attention on policy-making, based on wider consultations through the mechanism of a number of committees to examine the various aspects/segments of the capital market.

Structural Transformation

The structural transformation started taking place since 1992. Many technological innovations on par with the developed countries of the world began to be introduced in the realm of trading operations in the Indian stock market. Some of the significant forces/happenings that were responsible for the structural transformations were:

1. ***Financial liberalization, adoption of market oriented approach*** and opening up of areas to private sector hitherto reserved for the public sector.
2. ***Computerized on-line trading and setting up of clearing houses/ corporations*** by most of the stock exchanges.
3. ***Constitution of a depository*** to facilitate scripless trading.
4. ***Overhauling and strengthening of regulatory structure*** of stock exchanges with the establishment of SEBI.
5. ***Permission to Indian companies to raise resources*** abroad through the issue of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs) after obtaining specific approval from the government of India, since May 1992.

6. ***Disinvestments*** by government of its holding in public sector undertakings commencing from 1992-93.
7. ***Opening up of the market for portfolio investment*** by foreign institutional investors and encouraging foreign private participation in financial services including stock-broking.
8. ***Restructuring of the corporate sector*** and increasing resort to mergers and takeovers.
9. ***Abolition of the capital issues control*** along with setting up of norms for information disclosure requirements, establishment of regulations for various market intermediaries, prohibition of insider trading and fraudulent practices and modernization of stock exchanges.
10. ***Global recessionary trend and portfolio diversification*** by the international fund managers.
11. ***Entry of new institutions*** like merchant banks, leasing and hire purchase companies, venture capital funds/companies, etc and greater participation of banks and financial institutions in capital market related activities.
12. ***Growth in saving of households*** backed by changing attitudes and investing habits towards investment in shares.
13. ***Introduction of innovative financial instruments*** such as warrants, cumulative convertible preference shares and a host of hybrid bonds/ debentures.
14. ***Measures initiated by the government***, SEBI and stock exchange authorities for protecting the interests of investors, i.e. setting up of investor protection funds at the stock exchanges, restructuring of various committees on the stock exchanges with larger participation of public nominees of clearing corporations/houses on the stock exchanges, making merchant bankers responsible for the contents of offer documents and laying down the code of conduct for market intermediaries including brokers/sub-brokers.

SEBI issued separate set of guidelines for different categories of intermediaries such as brokers/sub-brokers, merchant bankers, registrars to issue, portfolio managers, under writers to issue, mutual funds, bankers to issue, debenture trustees and venture capital funds/companies. Detailed guidelines were issued by the SEBI for disclosure and investor protection in respect of new issues and for regulation of insider trading and prohibition of fraudulent and unfair trade practices.

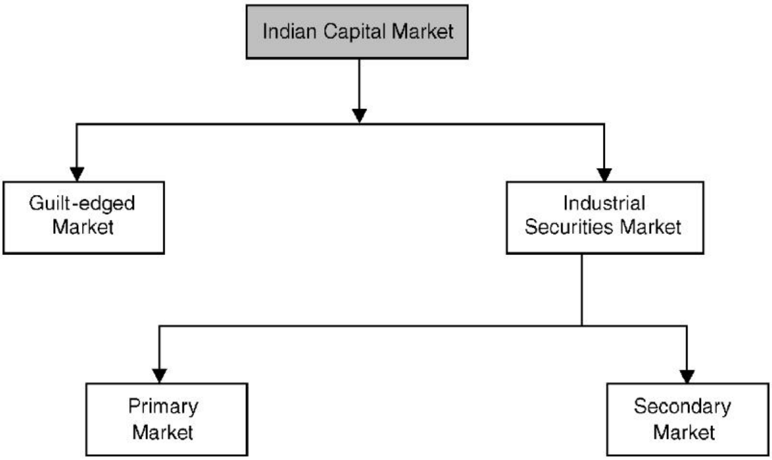
CONSTITUENTS OF INDIAN CAPITAL MARKET

The Indian capital market is composed of the following:

1. The gilt-edged market
2. The industrial securities market

The constituents of the Indian Captial Market are shown in Exhibit 7.

Exhibit 7 Constituents of Indian Capital Market



Gilt-edged Market

'Gilt-edged Market' also known as 'Government Securities Market', is the market for government and semigovernment securities. An important feature of the securities traded in this market is that they are stable in value and are much sought after by banks (as banks are obligated under the Banking Regulations Act to maintain a proportion of total deposits in Government securities as part of SLR requirements).

Some of the special features of the gilt-edged market are as follows:

1. Guaranteed return on investments
2. No speculation in securities
3. Institutional based investors which are compelled by law to invest a portion of their funds in these securities
4. Predominated by such institutions as LIC, GIC, the provident funds and the commercial banks
5. Heavy volume of transactions necessitating negotiation of each transaction

Industrial Securities Market

The market for industrial securities is known as 'Industrial Securities Market'. It offers an ideal market for corporate securities such as bonds and equities. Industrial securities market comprises of the following segments:

1. Primary market
2. Secondary market

Primary Market

Meaning

Primary market also known as New Issues Market (NIM) is a market for raising fresh capital in the form of shares and debentures. Corporate enterprises, which are desirous of raising capital funds through the issue of securities, approach the primary market. Issuers exchange financial securities for long-term funds. The primary market allows for the formation of capital in the country and the accelerated industrial and economic development.

Modes of Raising Capital

Following are the popular ways by which capital funds are raised in the primary market:

1. ***Public issue*** Where the securities are issued to the members of the general public, it takes the form of 'public issue'. It is the most popular method of raising long-term funds.
2. ***Rights issue*** Where the issue of equity shares of a body corporate is made to the existing shareholders as a preemptive right, it takes the form of 'rights issue'. Under this method, additional securities are offered for subscription to the existing shareholders.
3. ***Private placement*** Where the shares of a body corporate are sold to a group of small investors, it takes the form of 'private placement'.

Secondary Market

Meaning

A market, which deals in securities that have been already issued by companies, is known as 'the secondary market'. It is also called the stock exchange or the share market. The market provides a platform for buying and selling of securities.

Importance

The importance of the secondary market springs from the fact that it is the base upon which rests the edifice of the primary market. In other words, for the efficient growth of the primary market, a sound secondary market is an essential requirement. This is because the secondary market offers the important facility of trading of securities.

Stock Exchanges

The activities of buying and selling of securities in a secondary market are carried out through the mechanism of stock exchanges. Stock exchanges form an integral part of the secondary market in India. There are at present 24 stock exchanges in India recognized by the government. They are located at Mumbai, Calcutta, Delhi, Chennai, Ahmedabad, Bangalore, Hyderabad, Indore, Pune, Kanpur, Cochin, Ludhiana, Mangalore, Patna, Guwahati, Bhuwaneshwar, Jaipur, Saurashtra, Surat, Baroda, Coimbatore, Rajkot and Meerut, and OTC Exchange of India and NSE at Mumbai.

In addition, there is also a ringless and automated stock market operating at the national level known as 'Over-the-Counter Exchange of India' (OTCEI) which was established to give a major fillip to the capital market. The exchange operates through a number of electronically linked counters at different locations giving rise to a national trading system. It aims at helping small and start-up companies to overcome the problem of raising capital through a public issue at exorbitant cost. It also helps investors to overcome the problems of illiquidity, inaccessibility, delayed settlement and transfers that are abound with the traditional stock exchanges.

NEW FINANCIAL INSTITUTIONS

A number of institutions of finance have been established to cater to the credit requirements of various segments of industry and needs. A brief outline of these institutions is presented below:

Venture Fund Institutions

An innovative financing scheme of providing funds for high risk and high reward projects is called 'Venture capital financing'. It is a form of equity financing designed specially for funding new and innovative project ideas. Venture capital funds are instrumental in bringing into force the hitechnology projects by assisting the research and development projects, which are eventually converted into commercial production. Many specialized financial institutions have promoted their own venture capital funds. They include Risk Capital Foundation of IFCI, Venture Fund of IDBI, SIDBI, Technology Development and Infrastructure Corporation of India (TDICI), and others.

Mutual Funds

Financial institutions that provide facilities for channeling savings of a vast number of small investors into avenues of productive investments are called 'Mutual Funds'. Mutual funds are essentially collective investment vehicles that invest the funds pooled from numerous investors and thus gives them the benefit of diversified investment portfolio and a reasonable return.

Through institutionalized mechanism, they offer the benefit of diversified portfolio and expert investment advice and management to a large number of investors. Specialized financial institutions like LIC, UTI, etc besides commercial banks such as SBI, Canara Bank etc are carrying out the business of mutual funds. A wide range of benefits such as high return, easy liquidity, safety and tax benefits are offered by mutual funds to the investors.

Factoring Institutions

Financial institutions that provide financial accommodation on the basis of assignment/sale of accounts receivables are called 'factoring institutions'. Under the factoring arrangement, the factoring institution undertakes the task of collecting the book debts for and on behalf of its clients. The concept of rendering financial services through factoring has gained strong momentum in the advanced countries, like USA, UK, etc. Based on the recommendations of the Vaghul Committee and Shri Kalyanasundaram Committee, the RBI has initiated several measures to develop factoring service. Accordingly, RBI along with government of India, has notified factoring as an eligible banking activity. Some of the factoring institutions operating in India are SBI Factors and Commercial Services Private Limited, a subsidiary of State Bank of India and CanBank Factors Limited, a subsidiary of Canara Bank.

Credit Rating Institutions

There has been a long-felt need in India for those institutions which would provide services of evaluating the credit-worthiness of traders and securities and on the basis of which issue rating grades indicative of the quality and soundness of credit. The main purpose of credit rating is to provide guidance to investors/creditors in determining the credit risk associated with a debt instrument/credit obligation by an independent, professional and impartial institution. The credit rating institutions presently operating in the country include Credit Rating Information and Services India Limited (CRISIL), Investment Information and Credit Rating

Agency of India Limited (ICRA), Onida Information and Credit Rating Agency of India Limited (ONICRA), Credit Analysis and Research Limited (CARE), etc.

Over-The-Counter Exchange of India (OTCEI)

The OTCEI was set up by a premier financial institution to allow the trading of securities across the electronic counters throughout the country. It addresses some specific problems of both investors and medium sized companies. Some of the greatest strengths of OTCEI are transparency of transactions, quick deals, faster settlements and better liquidity.

National Stock Exchange of India Limited (NSEI)

NSEI was established under the Companies Act, 1956 on November 27, 1992 to function as a model stock exchange. The exchange aims at providing the advantage of nationwide electronic screen based "scripless" and "floorless" trading system in securities. The institution allows for an efficient and transparent system of securities trading.

National Clearance and Depository System (NCDS)

Under the scripless trading system, settlement of transactions relating to securities takes place through a book entry as against the physical exchange of securities under the traditional system. The need for scripless trading was felt on account of the anticipated unprecedented growth on the stock market, contributing to a steep rise in the number of investors and the growth of equity cult among the masses. Moreover, the present system of physical transfer of securities and the registration is slowly becoming an outdated practice. The entire scripless trading system comprises the following three segments:

1. ***National Trade Comparison and Reporting System*** which prescribes the terms and conditions of contract for the securities market
2. ***National Clearing System*** which aims at determining the net cash and stock liability of each broker on a settlement date
3. ***National Depository System*** which arranges to provide for the transfer of ownership of securities in exchange on payment by book entry on electronic ledgers without any physical movement of transfer deed

National Securities Depositories Limited (NSDL)

The NSDL was set up in the year 1996 for achieving a time bound dematerialization as well as rematerialization of shares in accordance with the Depositories Act, 1996. The establishment of NSDL is expected to alleviate the problems of post-trade transactions in the secondary market.

Stock Holding Corporation of India Limited (SHCIL)

Set up on the basis of the recommendations of the Pherwani Committee, the corporation aims at serving as a central securities depository in respect of transactions on stock exchanges. The corporation also takes up the administration of clearing functions at a national level.

NEW FINANCIAL INSTRUMENTS

Indian capital market also witnessed a phenomenal growth in the launching of a variety of new financial instruments. A brief description of some of the newly introduced financial instruments is presented below:

Commercial Paper (CP)

A form of usance promissory note, which is negotiable by endorsement and delivery, is known as Commercial Paper.

Certificate of Deposit (CD)

The CD is a document of title, similar to the deposit receipt issued by a bank. There is no prescribed interest rate on such funds and therefore banks have the freedom to issue it at a discount or at face value. Being a bearer document, it is readily negotiable. It is beneficial both to the banker and the investor.

Secured Premium Notes (SPN) with Attached Warrant

These are the bonds issued with a detachable warrant and are redeemable after a notified period, say, 4 to 7 years. In the case of fully paid SPNs, the warrants attached to them facilitate the holder, the right to apply and get allotted equity shares.

Nonconvertible Debenture (NCD) with Detachable Equity Warrants

The equity warrants attached to this instrument allows its holder to buy a specific number of shares from the company at a predetermined price within a definite framework. Warrants are issued where full payment of NCDs value has been made. Where the option to apply for equities is not exercised, the company will be at its liberty to dispose off the unapplied portion of shares.

Zero Coupon Bonds

These are the bonds which bear no interest. In order to compensate the loss of interest, they are issued at substantial discount from their eventual maturity values.

Zero Interest Fully Convertible Debentures (FCD)

These instruments carry no interest. They are automatically and compulsorily converted into shares after the expiry of a specified time period as may be notified in the terms of issue.

Deep Discount Bonds

The bonds that are issued by corporates at very high discount and matured at par value are 'Deep Discount Bonds'.

Stockinvest

An arrangement whereby it is possible for an investor to apply for the shares without having to pay for them and where the investor could make payment for shares when allotted to him, through his banker, is known as 'stockinvest'. Under this mechanism, there is only a guarantee of subscription and a banker makes payment only on the allotment of shares.

Equity Shares with Detachable Warrants

The holders of these shares are eligible to apply for a specified number of shares at a predetermined price in future. Detachable warrants are separately registered with the stock exchanges and traded separately.

'Equipref' Shares

These instruments are issued in two parts, part A and part B. Part A is convertible into equity shares automatically and compulsorily on the date of allotment without any further act or application by the allottee. Part B will be redeemed at par/converted into equity shares after a lock-in-period at the option of the investors.

Preference Shares with Warrants Attached

The holders of these shares are eligible to apply for equity shares for cash at 'premium' at any time in one or more stages between the third and fifth year from the date of allotment.

Euro Issues

The securities that are issued by Indian companies and are traded in European stock exchange are called 'Euro Issues'. This has become an important source of raising finance by Indian companies. Foreign investors and NRIs are the main subscribers to these securities. The instruments used as part of Euro Issue include Foreign Currency Convertible Bonds, European Deposit Receipts, and Global Depository Receipts.

Nonvoting Right Shares

These are the shares issued by companies having good track record, under the relevant provisions of the amended Companies Act.

Other Innovative Instruments

In addition to the above financial instruments that are issued by companies in India, some of the other major innovative financial instruments floated by the corporate entities include Money Market Mutual funds, Specialized Mutual Funds, Nonvoting Shares, Floating Rate and Rating-sensitive Notes, Commodity Linked bonds, Stripped debt securities, High yield (junk) bonds, Exchange-traded options, Interest rate futures, Options or futures contracts, foreign currency futures, Stock index futures, shelf registration, Discount brokerage, Electronic funds transfer, Leveraged buyouts, project finance, Secured zero interest Partly Convertible Debentures (PCDs) with detachable and separately tradable warrants, Fully Convertible Debentures (FCDs) with interest (optional), etc.

Specialized savings and investment institutions cater to the needs of a growing market. The proliferation of financial institutions and instruments provides the saver with a wider choice of assets depending upon the perception of risk, liquidity and yield, and has begun to impart a measure of competition in the field of financial services.

MEASURES OF REACTIVATION

In the interest of the investing public and to pave way for the healthy development of the capital market, following measures have been taken by the SEBI to streamline and to reactivate the stock market in India. These steps aimed at achieving improved practices and greater transparency in the capital market:

1. ***Periodical inspection*** of stock exchanges
2. ***Registration of intermediaries*** (registration being based on certain eligibility norms such as capital adequacy, infrastructure, etc) such as the stockbrokers and sub-brokers under the provisions of the Securities and Exchange Board Act, 1992.
3. ***Guidelines and regulatory measures*** for capital issues for the purpose of ensuring a healthy and efficient functioning of the market.
4. Compulsory requirement for companies to make ***material disclosures*** about the risk factors in their offer document.
5. ***Mandatory rating*** of debt instruments.

6. ***Vetting of offer document*** to ensure due compliance of the requirements of listing that all disclosures have been made by the company in the offer document when the application for listing of securities is made to the stock exchange.
7. ***Advertisement code*** for public issues so as to ensure fair and truthful disclosures.
8. ***Regulating registrars*** to new issues and share transfer agents on matters concerning capital adequacy requirements, general obligations and responsibilities, procedures for inspection and action in case of default.
9. ***Constitution of a panel in 1998*** to suggest measures to revive the secondary market with focus of attention on the need for strong regulations, surveillance and investor education and the need to have adequate insurance cover for the members of the exchange. The committee made many suggestions to revive the secondary market. For instance, the panel recommended that Pension and Provident Funds should be allowed to invest in the secondary market. For this purpose, some of the institutions such as mutual funds, etc must be permitted to float dedicated schemes in which the pension funds and provident funds could be invested. It was expected that when these schemes invested the money in the securities market, it would pave way for the development in the secondary market. Moreover, pension funds could derive the benefit of the fund management expertise and experience of the institutions.
10. ***Expansion of the list of scrips eligible for compulsory dematerialized trading*** by institutional investors.
11. Implementation of the recommendations by the Government to allow companies to ***buyback their shares*** through an amendment of the Companies Act, 1956.
12. ***Market-making*** to help simulate liquidity in a larger number of scrips on the B2 group on the BSE.
13. ***Granting permission to the stock exchanges to expand their terminals,*** allowing for an efficient automated and integrated system of functioning of stock exchanges throughout India.
14. ***Constituting a Committee on Corporate Governance (CCG*** under Kumar Mangalam Birla) with a view to focus attention on enhancing shareholder value, while ensuring sufficient protection to stakeholders like creditors and suppliers.

15. Introducing a new system of dealing called ***'rolling settlement'*** and convincing the institutional investors about the benefits of moving to this mode of settlement.
16. Introduction of new and innovative instruments of trade such as ***'derivatives'.***

MEASURES OF INVESTOR PROTECTION

The SEBI has initiated a number of measures in order to protect the interest of investors. These include: computerization of stock exchanges, expanding the realm of dematerialization of shares, prescribing the capital adequacy for brokers, application of the circuit breaker in stock exchanges in case of wide fluctuations in prices, introducing and fine tuning the format of quarterly results and other stringent measures. These measures are expected to produce positive results in terms of transaction cost, transparency, and investor confidence.

Towards enhancing and deepening the transparency of operations in the capital market, SEBI has taken a host of measures. These included: introduction of net trading, implementation of the recommendations of the Kumar Mangalam Birla report on corporate governance, K.B.Chandrasekhar report on venture capital funds,etc permitting high net worth foreign individuals and corporates to invest in stock markets under the FII route, allowing domestic mutual funds to manage foreign portfolios and a new framework for accounting standards so as to accomplish universal accounting practices.

SCRA

Stock exchanges are subject to Government supervision and control. The regulation of the functions and working of stock exchanges in India have been brought under the purview of the Securities Contracts (Regulation) Act, which was passed in 1956. The regulations require that only those stock exchanges which have been recognized by the Central Government, are permitted to function in any notified State or area.

RECENT INITIATIVES IN THE INDIAN CAPITAL MARKET

During 2001-02, several changes were introduced in the settlement practices in the capital markets, including extension of the rolling settlement on T+5 basis to all scrips. This has been changed to T+2 rolling settlement system. The risk management system for the stock exchanges was strengthened in the aftermath of the irregularities in the securities market. The year also witnessed major institutional changes for improving corporate governance practices. The norms for issuance of shares in the primary market were eased further in order to encourage companies to come out with public issues. In the derivatives segment, the range of products was extended further to include index options, stock options, stock futures, and index futures.

Primary Market

The Securities and Exchange Board of India amended the SEBI (Disclosure and Investor Protection) Guidelines, 2000 to provide for the inclusion of Foreign Venture Capital Investors (FVCIs) and State Industrial Development Corporations (SIDCs) as Qualified Institutional Buyers (QIBs) for participating in the book-building process. It also abolished the lock-in period for the preissue share capital of an unlisted company held by Venture Capital Funds (VCFs) and FVCIs, and removed the restriction of a minimum issue size of Rs. 25 crores in case of an Initial Public Offer (IPO) through book-building. The option to allocate the unsubscribed portion of the fixed price portion in a book-building issue to any category or lapse altogether was allowed. Buyback norms were relaxed by the Government and the cooling-off period for a fresh issue of a security after buyback was reduced to 6 months from 2 years.

Secondary Market

The SEBI extended compulsory rolling settlement on T+5 basis to 414 scrips w.e.f. July 2, 2001 and advised the stock exchanges to introduce uniform settlement cycle (Monday to Friday) in respect of remaining securities. Rolling settlement on T+5 basis was extended to all scrips with effect from January 2, 2002. The settlement cycle was shortened to T+2 effective April 1, 2002. This brought the securities settlement system in India at par with international standards, in line with the recommendations of the Report of the Joint Task Force of the Committee on Payments and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) on securities settlement systems.

Other reforms initiated by the SEBI included banning of all deferral products, including *badla*; introduction of a market-wide circuit breaker system applicable at three stages of the index movements and introduction of 99 percent value-at-risk (VaR) based margin system for all scrips in the compulsory rolling settlement with effect from July 2, 2001; and shifting of the margining system from net basis to gross basis (sales and purchases) with effect from September 3, 2001. In order to widen the equity derivatives market, the SEBI permitted introduction of new derivative products. The stock exchanges, accordingly commenced trading in index options in June

2001, followed by options on select securities in July 2001 and futures on select securities in November 2001. The FIIs were also permitted to trade in all exchange-traded derivative contracts subject to position limits effective February 2002.

Major initiatives were also taken to improve standards of corporate governance, including amendment to listing agreements requiring the companies to furnish segment-wise details of revenues, results and capital employed along with quarterly unaudited results, etc. The SEBI issued norms for speedy redressal of investors' grievances and prescribed Model Rules for stock exchanges to be implemented in phases. The SEBI advised the stock exchanges to amend listing agreements requiring companies to furnish statements and reports on their Electronic Data Information Filing and Retrieval (EDIFAR) system.

The disclosure norms for mutual funds were tightened to help investors take more informed investment decisions. SEBI required the mutual funds to disclose the performance of benchmarks in the case of various types of equity-oriented, debt-oriented and balanced fund schemes while publishing half-yearly results. Detailed investment and disclosure norms for employees of Asset Management Companies (AMCs) and Trustee Companies were laid down in order to avoid any actual or potential conflict of interests. The SEBI prescribed that all mutual funds should enter into transactions in Government securities only in dematerialized form. Mutual funds were allowed to invest in the listed or unlisted securities or units of VCFs within the overall ceiling for such investments. To bring about uniformity in the calculation of the Net Asset Value (NAV) of mutual fund schemes, the SEBI issued guidelines for valuation of unlisted equity shares. With a view to improving the professional standards, certification by the Association of Mutual Funds of India (AMFI) was made mandatory for the appointment of agents/ distributors by all mutual funds.

REBOUND IN INDIAN CAPITAL MARKET

Although Indian forces suffered bruises in the last part of the nineties owing to the manipulative trade practices of unscrupulous brokers and other participants, it has been witnessing fine times in the recent past, thanks to many favorable conditions contributing to it. Some of the factors that are responsible for this phenomenon are as follows:

1. Strong macroeconomic aggregates
2. Active participation of retail investors with renewed vigor
3. Active FII buying

4. Active III (Indian Institutional Investor) buying
5. Favorable sovereign rating by leading credit rating agencies like S & P, Moody's, etc.
6. Strong foreign exchange reserve position
7. Strong fundamentals of basic and other industrial sectors such as steel, FMCGs, etc.
8. Favorable monsoons fuelling adequate demand for goods and services in the economy
9. Favorable political conditions
10. Forecasts of better growth prospects in future

REVIEW QUESTIONS

Section A

1. What is money market?
2. What is capital market?
3. Name the committees that were constituted for revamping the Indian capital market.
4. What is 'gilt-edged market'?
5. State the segments of the industrial securities market.
6. What is 'primary market'?
7. What is 'secondary market'?
8. What are the different modes of raising funds in a capital market?
9. State the importance of secondary capital market.
10. What is a 'stock exchange'?
11. What are factoring institutions?
12. What is the purpose of credit rating agencies?
13. What is 'OTCEI'?
14. What is 'NSE'?
15. What is 'National Clearance and Depository System' (NCDS)?
16. What is a 'commercial paper'?
17. What is a 'Certificate of Deposit'?
18. What is 'SPN'?
19. What are 'zero-coupon bonds'?
20. What are 'deep-discount bonds'?
21. What is 'stock-invest'?
22. What are 'equipref' shares'?
23. What are 'Euro issues'?
24. What are nonvoting rights shares?

Section B

1. Distinguish between money market and capital market.
2. Sketch the characteristic features of a capital market.
3. What are the factors, which inhibited the development of an indigenous capital market in India?
4. What are the special features of gilt-edged market?
5. What are the venture capital institutions functioning in India?
6. Write a note on the new financial institutions set up in the Indian capital market.
7. Identify the factors that are responsible for the recent rebound in the Indian bourses?

Section C

1. Discuss the various functions performed by the capital market in the context of the economic development of a country.
2. Trace the growth and development of the Indian capital market over the years.
3. Outline the various measures of structural transformation undertaken with regard to the development of capital market in India.
4. Discuss the working of the constituents of the Indian capital market.
5. Elaborate on the new financial instruments launched by the corporates in India.
6. Discuss the measures initiated by the Indian Government for the reactivation of Indian capital market.
7. Discuss the recent initiatives in the Indian capital market.

Chapter 8

Stock Exchange

HISTORY OF STOCK EXCHANGES

The first organized stock exchange in India is the Bombay Stock Exchange (BSE), which was established in 1875. But trading in securities used to take place much earlier in the 18th century, and share quotations were published in contemporary newspapers. However, dealings were not regulated by any code of rules, nor any hours of business prescribed nor was there any committee to supervise the conduct of members. Dealers congregated under some tree in open fields for the purpose of transacting business.

The advent of western-styled business practices in India in the early **18th century** commenced with the establishment of the East India Company's office in India. Towards the close of the 18th century, the East India Company naturally dominated business in securities and loan transactions. Evidence of the existence of trading in stocks of banks of certain companies is available in price quotations in contemporary newspapers. By the 1830s, there was a perceptible rise in the volume of business in loans of corporate stocks and shares. In 1836, the "Englishman" of Calcutta reported quotations of 4 percent, 5 percent and 6 percent loans of the East India Company as well as shares of Bank of Bengal. Shares of banks like the "Corporation Bank", the "Chartered Mercantile Bank", the "Chartered Bank", the "Oriental Bank", and the old "Bank of Bombay" were traded. In 1839, the trading list was broader in Calcutta, where newspapers gave quotations of banks like "Union Bank", the "Agra Bank" and business ventures like "Bengal Bonded Warehouse", the "Docking Company" and "Steam Tug Company". Between 1840–50, banks recognized about half-a-dozen brokers and merchants in Bombay. In 1850, the Companies Act introducing limited liability was enacted and the era of joint stock enterprises began in India.

By the **mid-19th century**, railways were extended, telegraph was introduced, and hence communication expanded. Consequently, the country witnessed rapid development of commercial activity. Internal trade and commerce gradually improved and broadened. This was followed by a growth in corresponding demand for Indian goods in Europe. Eventually, the brokers participated in this general progress and prosperity.

The American Civil War of 1860–65 had a widespread impact on the fledgling Indian share market. The supply of cotton to Europe was totally stopped, and India, especially Bombay, the cotton belt, became the major supplier. There was an unlimited demand for Indian cotton. Exports doubled in 1861–65. The price of cotton shot up as the Civil War progressed. The bulk of these exports was paid in bullion. The largest flow was in 1864-65, the last year of the war. The flush of gold bullion spawned numerous ventures in a wave of speculation. Companies—banks, financial association, land reclamation, trading, cotton cleaning, pressing, hotels, shipping, and steamer companies, etc. were floated for every imaginable purpose. Every company that was floated commanded a premium.

Brokerage business became attractive, and in 1860 there were 60 brokers. Their acknowledged leader was Premchand Roychand who was the first broker to read and speak English. He was a genius and a brilliant financial strategist. He was called the 'Napoleon of Finance'. But the bubble burst on 1st of July 1865. Like the South Sea Bubble and Tulip Mania in Europe, the crash had a disastrous effect on Bombay and its environs. Innumerable companies failed; only a few were left solvent in Bombay. The Share Mania left desolation in its wake. Nevertheless, it was responsible for initiating the process of establishing the Stock Exchange in Bombay.

MEANING

1. A specialized marketplace that facilitates the exchange of securities that already exist, is known as a Stock Exchange or the stock market. It is also called a 'secondary market' for securities. It is considered to be *sine-quo-non* for the primary market. In fact, the success of the issues taking place in the primary market depends much on the soundness and the depth of the secondary market; it provides the investor, the facility of disposing off their holdings as and when the need for it arises.
2. A Stock Exchange constitutes any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. It serves as a specialist marketplace for facilitating transactions in existing corporate securities at prices that are "fair

and equitable”. A stock exchange contributes to enhancing the investment opportunities available to investors, thus enlarging the aggregate amount of funds available to finance, the production of goods and rendering of services, so as to promote a desirable allocation of the funds among various sectors of the economy.

3. A market where securities are bought and sold, under a code of rules and regulations, is known as a ‘stock exchange’. Its chief aim is to facilitate the provision of capital funds to trade, industry and commerce. In addition, it also provides finances to the government. It is considered to be the nerve center of national finances. It is the financial barometer and structure that reflect the prosperity or adversity of an economy. It is the fulcrum on which the whole financial structure of a country stands.

DEFINITION

1. According to ***Hastings,*** “Stock exchange or securities market comprises all the places where buyers and sellers of stocks and bonds or their representatives undertake transactions involving the sale of securities”.
2. According to ***Husband and Dockeray,*** “Securities or stock exchanges are privately organized markets which are used to facilitate trading in securities”.
3. According to ***Derek Honeygold,*** “Stock exchange can be described as the place where a marriage of convenience is enacted between those who wish to raise capital, such as companies, governments and local authorities, and those who wish to invest—largely households through the medium of institutions acting upon their behalf”.
4. According to Section 2 (3) of the ***Securities Contract Regulation Act 1956,*** “The stock exchange has been defined as any body of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities”.

   Under the said Act, the following securities can be traded at the stock exchange:

   a. Shares, scrips, stocks, bonds, debentures, debenture stocks or other marketable securities of a like nature in or of any incorporated company or other body corporate
   b. Government securities; and
   c. Rights or interests in securities

FUNCTIONS/ SERVICES/ FEATURES/ ROLE

Stock exchanges have come to occupy an important place in the economy of a country. Stock exchanges are very sensitive to the political and economic changes. They are appropriately called the "barometers of the state of economy" or "the mart of the world" or "business of business" and so on.

The growth in the number and size of companies has increased the significance and the role of stock exchanges. As the citadel of capital market through which the bulk of investment activities are conducted by individuals and institutional operators, stock exchanges facilitate the transfer of existing flow of savings into the profitable channels of investment.

Stock exchanges play an important role in the capital formation of an economy paving way for the industrial and economic development of the country. It induces the public to save and invest in the corporate sector that is profitable to them. Companies depend upon stock exchanges for raising finance. Stock exchanges render many important services to the investors and the corporations alike.

Following are some of the functions and services rendered by a stock exchange:

1. ***Common, trading platform*** A stock exchange provides an ideal and convenient meeting place and a common platform for sellers and buyers of securities. It is the nerve center where open offers and bids are made under free competition.
2. ***Mobilization of savings*** Stock exchanges help in the mobilization of savings and surplus funds of individuals, firms and other institutions. In other words, the stock market provides ample opportunity to all the investors, both individuals and institutions to invest their surplus funds (amount saved after meeting the expenses from the earnings) into various financial instruments, and thus, directs its flow towards deficit units (which are short of funds to meet their productive requirements). In this way, stock markets assist in capital formation process in the economy. Further, in the case of prosperous and growing industries, where the stock prices show a rising trend more flow of funds will take place and vice versa.
3. ***Safety to investors*** One of the fundamental functions of a stock exchange is to provide adequate safety to the genuine investors and save them from fraud and manipulation caused due to activities of speculators, For this purpose, adequate rules and regulations have

been provided under the Securities Contract (Regulation) Act, 1956. In this regard, the Central Government has been given wide powers to regulate and control the activities of the members and stock exchanges. Further, there are well defined byelaws, rules and regulations given in the SCRA relating to the listing of securities, admission of the members, trading mechanism, disclosure of material information, transparency, delivery, penalties, etc. The SEBI also regulates the working of stock exchanges with a view providing safety to investors by periodically issuing guidelines on matters connected with securities trading.

4. ***Distribution of new securities*** Stock exchanges also help in the distribution of new securities. Existing companies, which wish to raise additional capital, may sell securities through stock exchange.
5. ***Ready market*** An important function of a stock exchange is to provide a continuous, ready, open and a broad-based market for securities. This way maximum liquidity, marketability and price uniformity for securities is ensured. It is possible for the investors to sell their securities at the best-quoted price and thus, convert their investments into cash, almost immediately and without much effort. The liquidity advantage of the stock exchange enables people to sell and purchase the securities at their own convenience. The advantage of ready market encourages investment of funds in industrial enterprises besides enhancing the value of the investment as a collateral security for obtaining loans. The price quotations of securities in the stock exchanges enable suppliers of capital to know the real worth of the security from time to time.
6. ***Liquidity*** Liquidity is an important indicator for judging the efficiency of an exchange as it concerns with sale and purchase of securities, quickly, easily and at reasonable prices, which is nearer to the previous one. In fact, liquidity is related with depth, breadth and resiliency of the market. Depth relates to buy and sell orders around the price at which a share is transacted. Breadth refers to the adequate volume of orders and response of orders to price changes in a scrip is called resiliency. The broad indicators of market liquidity are frequency of sales, narrow spread between bids and offers, and prompt execution of orders and minimum price changes between transactions as they occur. The benefits of a continuous market are that, it creates marketable liquid investments and facilitates collateral lending.
7. ***Capital formation*** As an essential adjunct of joint stock enterprise, stock exchanges allow for quick capital formation to take place. This in turn contributes to the development and promotion of the economy

through accelerated industrial development. Stock exchanges enable people to know the current market prices of securities. People could invest in those securities that yield higher returns. Thus, stock exchange facilitates the capital formation in the country by inducing the public to save and invest.

A stock exchange is responsible for inculcating savings habits in the people by providing them wide opportunities of profitable investments in a wide ranging securities of industrial and other concerns. Moreover, a stock exchange acts as a showpiece of securities issued by corporate enterprises and government agencies. Thus, a stock exchange acts as an agency for capital formation so as to engineer industrial and economic development on the right lines.

8. ***Speculative trading*** An efficient functioning of stock market motivates investors to save more and invest in high yielding securities, and thus, promotes those industrial units that show best productive and financial performance. Speculation also plays a dominant role in mobilization of savings in an economy. For instance, healthy speculation on the stock exchanges, based on scientific analysis and expert opinion, not only estimates fair price of the stock but also provides adequate liquidity. No stock exchange can operate efficiently merely on the basis of genuine investment, i.e. investment based on actual (physical) delivery of the scrips. In fact, such investments cannot provide the requisite volume of business, either to the stock exchange or to the company. Therefore, the liquidity and the price continuity in the stock market are possible only if there is a reasonable opportunity for speculative trading. In order that there is taking place an orderly and efficient growth in a stock exchange, it is imperative that opportunities are provided to shrewd businessmen to speculate and reap profits from fluctuations in security prices. In fact, speculation adds life and agility to the working of a stock exchange by activating price movements, by expecting either rise or fall in prices. This in turn contributes to the accelerated growth of the secondary market.
9. ***Sound price setting*** Stock exchanges, through a plethora of measures of compliance, allow for a sound and a fair price setting to take place. The prices usually reflect the real worth of securities. Factors such as limitless and free competition in open market, enlightened scientific trading based on accurate knowledge of present as well as future prospects of demand and supply, free flow of information, etc contribute for the better price which benefits the investors ultimately. Further, stock exchanges help in determining

current market prices of various securities. The prices at which transactions take place are recorded and made public in the form of market quotations, which help the investors to know the current market prices of securities.

10. ***Economic barometer*** Stock exchanges serve as a barometer of the economy. The price movement of securities on a stock exchange indicates the state of health not only of industrial companies but also of the economy of the nation as a whole. For instance, any impending trends of the business cycles are correctly reflected on the stock exchange. Similarly, any deep-rooted malaise afflicting the economy is also reflected in the stock market operations. In fact, the stock market indices act as precursors for the entrepreneurs to initiate appropriate measures governing the management of their corporate enterprises. They act as a barometer of the business conditions and progress of the business in the country. One can easily find out whether there is a boom or a depression in the economy and it is also possible to easily analyze the causes of these conditions too. Moreover, the fluctuations in the stock prices represent the collective judgment of all the investors and speculators. For example, if the financial performance of a certain company is not satisfactory, then many of the investors would be ready to sell the shares of such a company, which will lead to increase in the supply, and this would ultimately result in fall in the price of that scrip and vice-versa. That is why, it is said that the stock market 'foresees the future' and reflects the public opinion and acts as a barometer of the economy.
11. ***Dissemination of market data*** Stock exchanges serve as information hub of trade and industry of an economy. They disseminate information about share prices, volume of trade, industry-wise, scrip-wise, etc. In addition, information is also provided on the financial aspects of the companies whose shares are traded widely in the stock market. The signals of impending financial or business booms or distress are first indicated in advance by stock exchanges very promptly.
12. ***Perfect market conditions*** Perfect market conditions prevail in the stock exchanges. On account of these reasons, the transaction and the carrying cost are the least. The activities are much standardized. They are well regulated by institutions of government. They facilitate a free and limitless competition among the dealers and the brokers of securities.
13. ***Seasoning of securities*** Stock market players such as underwriters, dealers, brokers, and speculators temporarily hold securities issued

by new companies. This is called ‘seasoning of securities’. The securities are then released gradually at a time when the market is prepared to absorb the new issue. This process ensures a better benchmarking and market for the securities.

14. ***Efficient channeling of savings*** The stock exchange mechanism enables judicious use of national savings by allowing the flow of savings into the profitable and desirable areas of investments. It allows corporates to mobilize capital in a free and equitable manner. For, only those corporate enterprises that satisfy the market tests of efficiency and profitability could possibly approach the market for capital funds. Accordingly, a company with good prospects would be able to raise additional capital, as its share prices would be rising in the market.
15. ***Optimal resource allocation*** Stock exchange serves as an ideal tool of allocating the national savings to promising issues and thereby, ensures most effective and optimum allocation and utilization of scarce financial resources in industry and commerce for maximum social advantage. This is made possible by the price mechanism under the free competition.
16. ***Platform for public debt*** By serving as an organized market for government securities, stock exchanges allow for raising huge resources of finance required by the government for financing its development activities. Stock exchanges act as platforms for mopping up public debt to execute the schemes of planned projects. It works as an over-the-counter market, consisting of dealers and brokers in government securities. Banks, LIC, Provident Fund and Pension Fund institutions are the chief buyers of government securities.
17. ***Clearing house of business information*** The business information supplied by corporate enterprises is allowed to be exchanged between investors and the issuers by the stock exchange. This allows a stock exchange to serve as a clearing house of business information. Besides, the information provided by corporates by way of financial statements, annual reports and other reports, etc. helps ensure maximum publicity of corporate operations and working.
18. ***Evaluation of securities*** Another important function of the stock exchange is to allow for an opportunity to determine a reasonable and fair price of various scrips traded on its floor through the market forces of demand and supply. The prices of the scrips quoted on the stock exchange change continuously on the basis of their real (intrinsic) worth along with fundamental and technical factors. Whereas, the technical factors are concerned with demand and supply

position, market sentiments, rumours, mood, past trend, etc. fundamental factors include the economy, industry and firm variables.

19. ***True market mechanism*** The stock exchange provides liquidity and price continuity only to listed securities. Securities that are listed and allowed to be traded on a particular stock exchange are called listed securities. It is possible that a security may be listed at more than one stock exchange for the purpose of trading. A stock exchange assists in determining the stock prices near to their 'true and fair' market worth and prevents from violent and erratic fluctuations in such prices. It allows for price continuity to prevail in the market which leads to stability in the market. A stock exchange, thus facilities free market mechanism providing for marketability, stability and continuity in prices.
20. ***Investor education*** An important function of a stock exchange is to widen the share ownership base especially in developing countries. Stock exchanges play a significant role in educating the mass through various communication media by providing information relating to principles and advantages of investing in shares, debentures, bonds and other avenues. They also educate the people in selecting the securities and designing their own portfolio. Stock exchanges have a potential to play a significant role in the Indian economy where the saving rate is the highest in the world, and the mass of population is uneducated and living in rural and semi-urban areas. Educating the public at large about the investment management has been popular in developed countries too. For example, the stock exchanges like New York Stock Exchange, London Stock Exchange, Melbourne Stock Exchange, Sydney Stock Exchange, Toronto Stock Exchange, etc. have initiated various methods like 'Own Your Share' 'Own Your Share of Australia' 'Your Brother and You' etc to educate the masses and for widening the share ownership base.
21. ***Fair price determination*** The prices in the stock market are determined by the interplay of the forces of supply and demand. The two-way auction trading taking place in the stock exchange facilitates a fair price determination. There is free trading and free competition in the stock market, which in turn facilitates better bargains so as to arrive at a fairly attractive price.
22. ***Industrial financing*** Stock exchange provides for an ideal ground for the corporate enterprises to mobilize the capital required for undertaking industrial activities such as setting up new ventures, expansion and modernization of existing production units etc at a

reasonable cost. If the enterprise happens to be a company of good standing, then it is possible to obtain an attractive price for the company's shares being issued.

23. ***Company regulation*** The requirements of 'listing' on a stock exchange makes it possible for the stock exchange to rein in on the corporate enterprises. Listing thus allows for the quoting and trading of securities of corporate enterprises on the floor of a stock exchange. Stock exchanges, thus, exercise wholesome influence on the management and working of companies in public interest.

STOCK EXCHANGE AND COMMODITY EXCHANGE DISTINGUISHED

The points difference that exist between a stock exchange and a commodity exchange are furnished below:

Sl. No.	Feature	Stock Exchange	Commodity Exchange
1.	Function	Provides easy marketability	Offers hedging or price insurance services and liquidity to securities
2.	Object	Object is facilitating capital formation an making best use of capital resources	Object is facilitating goods flow through risk reduction
3.	Participants	Inventors and speculators	Producers, dealers, traders and a body of speculators
4.	Period of dealings	Cash, ready delivery and dealings for account for a fortnight	Instant cash dealings and a settlement period of 2 or 3 months for Futures Market dealings
5.	Articles Traded	Industrial securities such as stocks and bonds, and Government securities such as public debt etc.	Only durable, graded and goods having large volume of trade, price uncertainty and uncontrolled supply
6.	Speculation	Speculation ensures saleability of securities affording a broad, ready, liquid and continuous market of securities	Speculation ensures assumption and absorption of price risk

Sl. No.	Feature	Stock Exchange	Commodity Exchange
7.	Forward Contract	Forward dealings are simplified as securities are fully standardized	Standards are to be fixed for deliverable grades to facilitate futures contract
8.	Cornering	As seller has to deliver the agreed securities, cornering is easy	Cornering is difficult as the seller has option to deliver standard or other deliverable goods
9.	Price-Quotation	As regards forward dealings, only one quotation is possible	Cornering is difficult as the seller has option to deliver standard or other deliverable goods for futures dealings, multiple quotations are possible

STOCK EXCHANGE TRADERS

Only the registered members are permitted to carry out trading on the floor of a stock exchange. However, for reasons of convenience some other persons are also permitted to enter the premises and transact business on behalf of the members. They are:

Remisiers

The sub-brokers employed by a member (share-broker) to secure business are called 'Remisiers'. As the share brokers are prohibited to get business by advertisement ,the role of remisiers assumes importance. Remisiers are not permitted to enter the trading floor for exchange dealings. Remisiers are engaged by the full-fledged members of the BSE in order to secure business for them. They act as agents of the members. The members pay them commission on the business procured by them and for this reason remisiers are best known as "half commission men". The remisiers are practically under the same restrictions as their principals.

Authorized Clerks

Authorized clerks are the people who assist a member in transacting business, especially at times where the volume is heavy. The employees of a member of a stock exchange are called 'authorized clerks'. These clerks or assistants are authorized to transact business on behalf of their member-employer, but they cannot make any bargain in their own name. Such persons can sign on behalf of their employers where they are provided with the power of attorney. They also assist the member in conducting the exchange transactions. Besides, they are authorized to enter the trading floors of the stock exchange for carrying out buying and selling of scrips on behalf of their employers. They cannot buy or sell on their own account. The number of authorized clerks permitted for each member varies between exchanges. For instance, in the Bombay Stock Exchange, five authorized clerks are permitted per member; the Calcutta Exchange allows eight authorized clerks or member assistants per member, and the Madras Exchange provides three authorized clerks for a member.

Brokers and Jobbers

In a stock exchange, the actions of brokers and jobbers are interrelated. Both the broker and the jobber perform important functions. A broker acts as an expert agent of the ordinary investors who is hardly competent to deal with skilled jobbers directly. A jobber renders a useful service by executing orders without delay. The immediate execution of orders helps make the price fluctuations smooth. He uses his experience and specialized knowledge to name the price at which a security should pass from one investor to another. Although there is a clear-cut distinction between brokers and jobbers in the London Stock Exchange, no such difference exists between them in India. For instance, brokers are commission agents who transact business in securities on behalf of nonmembers; they work on a commission basis. A broker's commission on his business is fixed.

A broker serves as a link between the general public and the jobber. Since a broker acts for a larger number of his non-member clients, he deals in a wide variety of securities. Brokers are competent to enter into transactions in an exchange. Brokerage charges are collected for the services rendered by them. Brokers place orders on behalf of their client-shareholders, collect the share certificate from the seller-broker and deliver the same to the buyer-broker. It is the brokers through whom transactions are dealt in by a stock exchange. Brokers trade in their own account, besides placing orders on behalf of their clients. The actions of brokers infuse liquidity in stock exchanges all over the world. Stock broking business in India is a traditional family business. With the initiation of economic reforms, international investors and foreign brokerage houses entered the Indian capital market. A great deal of change has since taken place in the profile of the market participants. Corporate broking houses are now common, which is an international norm.

Tarawaniwalas

Tarawaniwalas are dealers in securities in the BSE who transact business in their own name and on their own behalf as well. Such dealers usually specialize in one or two securities only. They resemble the jobbers of the London Exchange in as far as the method of transacting business is concerned. A typical dealer like the tarawaniwala is not prohibited from acting as a broker although it might prove objectionable from the point of view of the public as it gives him a chance to purchase securities from clients at lower prices or sell his own securities to them at higher prices.

Dealers

Dealers are market-makers. They are important intermediaries in the stock exchange. Dealers buy and sell inventory of stocks. Through this process, they absorb excessive buying or selling pressures, thereby providing liquidity and immediacy in the exchange. Such intermediaries are not very common in the Indian capital market.

WEAKNESSES

Although rapid strides have been made in the Indian stock markets, there are many irritants that continue to afflict the functioning of the stock exchanges. Following are the principal weaknesses of the Indian stock exchanges:

1. ***Raging speculation*** It is highly characteristic of the Indian stock exchanges that there prevails a rampant speculative transaction. The continued spell of unprecedented booms and crashes is a clear testimony for this phenomenon. The Indian stock market witnesses high volatility taking the unwary investors for a ride as they do not reflect a very healthy state of affairs. Over-speculative character and high volatility have made the Indian stock market crises prone.
2. ***Insider trading menace*** The possibility that the insiders in a stock exchange have an access to price-sensitive information about the market movements of certain scrips breaks the ‘Playing field’. This way, equal opportunity of information access is denied to all the participants in the market.
3. ***Neglect of small investors*** The Indian stock market is often highly dominated by large financial institutions, big brokers, and operators. The oligopolistic structure does not leave any advantage to the small investors. The small investor is often meted out a raw deal, despite the much-proclaimed safeguards built into the various regulations issued by the SEBI from time to time.

4. ***Restrictions on forward trading*** The ban imposed on the 'forward trading' in India in 1969, had a deleterious effect on share prices. Further, the restrictions placed on dividend payments by companies as part of the anti-inflationary measures adopted by the government aggravated the dealings in share market. The limited facility allowed for carrying forward the delivery contract beyond 14 days in an informal manner. Under forward trading, the earlier contract is concluded and a new contract is entered into without any actual delivery. Only the balance between the contracted price and market price is paid between the buyer and the seller. This system of forward trading was useful for providing liquidity and avoiding payment crisis. However, rampant speculation gave rise to difficulties in the actual physical transfer of securities resulting in a virtual and inevitably payment crisis.
5. ***Bad trading practice*** There are many obsolete, inefficient and outdated share-trading practices that are ruling roost in the Indian stock exchanges. Major problem areas are settlement periods, margin system and carry forward (badla) system. The *settlement period* is 14 days in most of the Indian stock exchanges, whereas most of the countries are moving towards a rolling 3 days settlement period. The lengthy settlement period encourages the growth of trading shops outside the stock exchange system, besides increasing the risk exposure of market participants due to price movements. Avoidance of *margin payment* under the margin system is another problem area. Under the margin system, the members have to maintain with the clearing house of the stock exchange a deposit, which is a certain percentage of the value of the security being traded by members. Accordingly, if a member buys or sells securities marked for margin above the free limit, a specified amount per share has to be deposited in the clearing house. A major weakness of the system was that the margin was totally discretionary in character, with a variation of zero to sometimes 40 percent depending on nature of shares and timing of trading. This practice often gave rise to runaway booms. Moreover, under the present settlement and margin system, there is a strong incentive to collude for the buyer and seller-brokers for the purpose of avoiding margin payments. *Carry forward* (or badla) system was another obnoxious practice followed in the Indian financial system. The practice caused unprecedented speculation in shares. It allowed a wholly spurious kind of share trading in which neither the buyer has the money to pay for the shares at the time of settlement nor the seller has the

shares to deliver, or at least one of the two is spurious. This obviously constricts the smooth and free functioning of the stock exchanges.

6. ***Lack of integration*** In order that the services of a stock market are made use of by a wide spectrum of investors across the country, close integration among the various stock exchanges becomes an imperative necessity. Such an arrangement will also help enhance the cohesive functioning of the stock exchanges with efficient sharing of information among them. The limited inter-market operations have resulted in increased costs and risks of investors in smaller towns. This problem has been further aggravated by the lack of cohesion among exchanges in terms of legal structure, trading practices, settlement procedures and jobbing spreads.
7. ***Lack of interface*** In India, the kind and the quality of developments taking place in the realm of new issues market are not adequately matched by the developments in the secondary markets. For instance, the recent upsurge of the primary market has created serious problems of interfacing with the secondary market. The stock exchanges are ill-equipped to handle the great volume of transactions in the primary market. It therefore, requires that the secondary market is re-oriented so as to discharge the new responsibilities efficiently and effectively. This would in turn spur all-round growth in the capital market, thus making the Indian stock market a real investor-friendly market.
8. ***Ineffective banking system*** The dilatory and inefficient working of the banking system under which outstation cheques takes very long to be encashed, the difficulty in making necessary payments in reply to calls or in connection with the subscription for issues also affect the system. The restrictions imposed by the FERA on inflow and outflow of foreign exchange and the time consuming procedures are irritants not only to foreign but also to nonresident Indian investors, who have grown substantially in recent years. All this militates against the efficient functioning of the secondary market.
9. ***Inadequacy of investor service*** As regards investor service, it is found to be much wanting especially among the small stock exchanges. They make a limited contribution to the spread of the equity cult in their region.
10. ***Inadequate infrastructure*** The extent of facilities that are available in the stock exchanges are far from satisfactory. This results in lower operational flexibility of stock exchanges and brokers to handle sudden surges in volumes of trading. For instance, the level of computerization across stock exchanges has been inadequate resulting in the absence

of computer linkages between stock exchanges and its members. This has hampered the effective inter-market operations, monitoring of trading and post-trading operations, as well as the free flow of information on an intra and inter-exchange basis. The inadequate infrastructure and ineffective trading settlements/pratices have also resulted in a lack of NRI confidence in the Indian capital markets.

REGULATION OF STOCK EXCHANGES

All stock exchanges were subject to self-regulation till 1956, whereby the regulation emanated from their own management bodies, i.e. Board of Governors. Now, Indian stock exchanges are subject to three-tier regulation. The first level constitutes the authority exercised by the Central Government under the Indian Constitution and through its Ministry of Finance (Stock Exchange Division) over the functioning of the stock exchanges.

The authority, however, is regulated primarily through the Securities Contract (Regulation) Act, 1956 (SCRA). Further, the Securities and Exchange Board of India (SEBI) also regulates the stock exchanges in order to protect the interest of investors and to promote the development of security markets in India. This constitutes the second-level authority. The third-level of authority constitutes self-regulation whereby all stock exchanges have their own separate rules, byelaws and regulations that are exercised through their Governing Board.

Regulatory Structure

a. The stock exchange division The Stock Exchange Division of Ministry of Finance has its Head Office at Delhi and Branch offices at Bombay and Calcutta. The essential functions of the Division are as follows:

(i) Providing linkage between government and stock exchanges
(ii) Monitoring the operations of the stock exchanges
(iii) Providing advice to overcome the untoward developments and crises
(iv) Ensuring the compliance of listing provisions
(v) Ensuring smooth functioning of the stock exchanges and
(vi) Issuing licenses to brokers and dealers in securities and also in areas beyond the jurisdiction of recognized stock exchanges

b. SEBI An apex body called the Securities and Exchange Board of India (SEBI) has also been constituted besides the above. A Chairman heads the SEBI. The first chairman of this Board was Dr. S.A. Dave, former Executive Director of IDBI. Besides, the Central Government is also empowered to nominate four members that comprise the top management team of the SEBI. The SEBI issues from time to time various rules, regulations and guidelines for promoting the development and stabilization of the securities market in India. A few important among them are as follows:

(i) SEBI (Portfolio Managers) Rules and Regulations, 1992
(ii) SEBI (Stock Brokers and Sub-brokers) Rules and Regulations, 1992
(iii) SEBI (Insider Trading) Regulations, 1992
(iv) SEBI (Merchant Bankers) Rules and Regulations, 1992
(v) SEBI (Mutual Fund) Regulations, 1993
(vi) SEBI (Underwriters) Rules and Regulations, 1993
(vii) SEBI (Registrars to Issue and Share Transfer Agents) Rules and Regulations, 1993
(viii) SEBI (Debenture Trustee) Rules and Regulations, 1993
(ix) SEBI (Bankers to an Issue) Rules and Regulations, 1993

Besides the above, SEBI has also issued guidelines regarding the following:

(i) Free pricing of shares
(ii) Disclosures and Investors' protection
(iii) Registration of Foreign Institutional Investors (FII)
(iv) Allotment of shares
(v) New financial instruments
(vi) Credit rating of fixed return bearing securities

c. Departments The major departments of a typical stock exchange in India are as follows:

(i) Listing Department
(ii) Operations Department
(iii) Computer and EDP Department
(iv) Inspection and Audit Department
(v) Monitoring Department
(vi) Investor Service Department

1. ***Listing department*** It is an important department of a stock exchange. Its main function is to list the securities of companies for trading purposes at the stock exchange. The task of this department is to examine the prospectus and project of the company to ensure whether the company fulfills all their requirements as per existing byelaws of the stock exchange and guidelines of the government. It also ensures whether the company has made fair and equitable allotment of shares.

2. ***Operations department*** The basic objective of this department is to keep watch on the daily trading and other operations of the stock exchange. It collects quotations and makes them available to members by publishing in the evening every day. This department also looks after the auction of shares and related matters connected with settlements.
3. ***Computer and EDP department*** The basic function of this department is to collect and compile the various data relating to corporates, quotations of scrips and member-wise and scrip-wise turnover. Financial results of companies like their net profits, dividends, bonus, balance sheets, etc are all recorded on the computer. Further, it builds up a sound management information system, which is useful to members and investors for making their investment decisions.
4. ***Inspection and audit department*** This department is concerned with carrying out routine audit of the stock exchanges for checking the accuracy and validity of the accounting records, balance sheet item, receipts and payments items, and other relevant registers. The department ensures that all the registers and records are duly maintained by the stock exchanges as per guidelines of the SEBI and the Government.
5. ***Monitoring department*** This department aims at supervising the activities of the members in the trading ring. Besides, it also watches the price movements and the trading volume of the members. The department initiates necessary measures to check excessive trading and speculative transactions by imposing ad hoc margin, suspending trading and enquiring into any specific development.
6. ***Investor service department*** The basic objective of this department is to safeguard the interests of investors by rendering expeditious service to them and by attending to their complaints against broker-members and their authorized clerks and the listed companies. The department takes necessary follow-up action with the members and the companies concerned.

STEPS IN STOCK TRADING

Following are the typical steps involved in trading on the National Stock Exchange:

1. ***Client registration*** The buyer approaches the broker and executes a client registration form wherein all details about the buyer are furnished. This forms the basis for trading in the exchange through the broker.

2. ***Agreement*** An agreement between the buyer and the broker as specified by the exchange concerned is entered into. This agreement is called the client member agreement.
3. ***Order placing*** Buyer places the order in writing with the broker for the purchase of certain number of scrips at a certain specified price.
4. ***Order confirmation*** After collecting the order from the client ,the broker places the order in his computer system, which is in turn transmitted to the computer system of the NSE at Mumbai. The order confirmation slip is obtained by the broker from the exchange.
5. ***Trade confirmation*** A trade confirmation slip is generated as soon as the order is matched by the computer against the price generated by the matching algorithm (price-time priority). The trade confirmation slip gives details of the trade executed. The buyer makes payment of necessary margin money to the broker.
6. ***Contract note*** The broker issues a contract note to the buyer in respect of all the orders that are executed during the day. Such a note spells out the obligations of the parties concerned, for the buyer to make payment and the broker to make delivery of scrips. Accordingly, the payment is made and the scrips are taken delivery by the buyer, which thus concludes the contract.

MECHANICS OF SETTLEMENT

The process of fulfillment of the obligations of the trade by the parties to the transactions is known as 'settlement'. This implies payment of funds to the seller and delivery of securities to the buyer. Although in a traditional commodity market, a trade is negotiated and settled instantaneously, i.e. payment is made and goods are taken delivery immediately, settlement of trade is in a stock market, not instantaneous. For instance, payment for the purchase and the delivery of shares takes a certain cycle.

Types

There are two types of settlement of trade in vogue. They are Rolling Settlement and Account Period Settlement.

a. Rolling settlement system Under this system of settlement, the trades executed on a certain day have to be settled after a certain number of days depending on the nature of settlement cycle practised by the exchange concerned. Accordingly, where a settlement cycle specified is T+3, it implies the trades executed on the first day (say a Monday) have to be settled on the fourth day (on Thursday), i.e. after a gap of 3 days.

b. Account period system Under this system of settlement, trading is allowed to continue for a certain agreed period and it is possible for the investor to buy or sell for a certain number of days, and thereby accumulate a certain position during the period. At the end of this period, his obligation in terms of shares purchased or sold and the amount to be paid by him is worked out and communicated to him. The obligations of a broker are worked out after netting the trades. The working of the above system of settlement as practised in the NSE for its equity segment is illustrated below:

Settlement Cycle at NSE

Day 1	Wednesday	Trade cycle commences
Day 7	Tuesday	Trade cycle ends
Day 8	Wednesday	Obligations worked out and communicated to brokers
Day 13	Monday	Sellers deliver shares sold to the clearing house
Day 14	Tuesday	Purchasers pay amounts for purchases made
Day 15	Wednesday	Sellers get amounts due and buyers get their shares

As shown above, it is possible for an investor to freely trade in any pattern that he chooses during a period between a Wednesday and a Tuesday. After the expiry of this period, the obligation of each broker in terms of the shares sold/purchased and the money to be paid/received is worked out and duly communicated to the broker. The broker is expected to deliver the shares that he has sold on Monday next and pay the amounts due on Tuesday next.

Counter Party Default

The default committed by either or both the parties to the trading transaction namely buyer and the seller in honoring their respective commitments at the end of the settlement period, in a bilateral settlement process is referred to as 'counter party default'. In a situation like this, the buying broker might default in making payment although the seller is ready to deliver the shares. Similarly, the selling broker might default to deliver the shares although the buying broker is ready to pay the money. In such a situation because of the default of one party, the other party suffers. The counter party default is deleterious in that it would cause destabilization of the functioning of the stock exchanges thus threatening the safety and integrity of the market. It is therefore imperative to have a safety system in place to deal with such situations.

Settlement Guarantee Mechanism

The system, which is devised to eliminate counter party risks, is known as 'settlement guarantee mechanism'. The National Stock Exchange of India first introduced the system, which is popular in the developed markets. This is being adopted in other exchanges as well. According to the system, settlement of trade is undertaken by a separate legal agency called the 'Clearing Corporation'. Stock exchanges may set up separate Clearing Corporation either singularly or jointly. The NSE has a separate fully owned subsidiary which undertakes this function.

The working of the settlement guarantee mechanism is described below:

The clearing corporation acts as a counter party in respect of every trade. It ensures and verifies that the deliveries of money and shares are made and passes them on to the respective brokers. If one of the brokers defaults, the Clearing Corporation ensures that the trade is carried out unhindered by making payment or making delivery of scrips on behalf of the defaulting broker, who is thereafter dealt with by the Corporation separately. The mechanism thus, helps both the brokers and thereby their investors who are assured of prompt settlement irrespective of the fulfillment of obligations by the other party. Such a function helps minimize the market risk and thus helps save the integrity and safety of the stock exchange. The guarantee also covers transactions involving bad deliveries. In order to perform this function satisfactorily, the clearing corporation resorts to a variety of risk management techniques like margining, exposure limits, etc.

Prerequisites For the successful working of the settlement guarantee system, the following essential requirements are called for:

a. Automated trading and settlement processes
b. Established risk management procedures
c. Well defined settlement schedule
d. All securities to be cleared through the clearing house
e. Multilateral netting (netting across locations, etc.)
f. Funds settlement through clearing banks
g. Clear procedures for post-settlement issues

DEPOSITORY

In the traditional mode of purchase and sale of securities, there is a physical movement of securities, which invariably proved to be a long-drawn ordeal for an investor. Many problems are encountered owing to the physical nature of securities. Common problems encountered in the market by both the individual and the institutional investors are as follows:

1. Time-consuming process of transfer of ownership of shares due to physical movement of securities
2. Involvement of heavy paper work
3. Risks due to transiting through the postal system, resulting in loss of certificates and attendant problems
4. High percentage of bad deliveries due to the vulnerability of physical certificates to forgery, theft, mutilation, etc.

Need

The relatively smaller volume of trading transactions taking place in the realm of stock market could cope with the traditional system of transfer of securities based on physical delivery of paper certificates. However, the unprecedented growth in the number of investors, both individual and institutional, and the volume of transactions, sent the whole settlement system haywire. The system of settlement mechanism encountered the problem of huge volumes of paperwork related to processing of share certificates.

Depository provides an answer to the kind of problems encountered as above by the investors. Depository originated in the USA. Depository provides for an electronic transfer of securities. This process completes transfer of ownership in a day. In fact, the international practice is Delivery versus Payment, implying that once funds are available in the buyer's account, he gets a clean delivery, with ownership transferred to him on the same day.

Depository provides for scripless transfer of ownership thus improving the efficiency of the market and thereby eliminating the problems encountered in dealing with physical securities. A wide range of related services would also be available. Some of the services that are rendered by the depository are as follows:

1. Maintaining beneficial holdings on behalf of individual investors
2. Providing facilities of dematerlization and rematerlization of securities
3. Effecting transfer and settlement of trades
4. Extending pledge and hypothecation facilities and thereby regulating stock lending operations
5. Effecting inter-depository transfers in a multi-depository environment

A depository operates essentially in a manner similar to a bank. In a depository environment no movement of certificates is necessary. They may be immobilized and may be locked up with the depository. However, the certificates can continue to exist in the physical form. A few countries have adopted this model too. Alternatively, certificates may be dematerialized, i.e. they may be physically destroyed. This is the model provided by the Indian Depositories Act. According to the arrangement provided for in the Act, securities once dematerialized can again be rematerialized, i.e. they can be reissued in the physical form, if the investor so desires.

Trade settlement takes place with the advice of the clearing house, which provides details of obligations. The investor instead of delivering physical securities, transfers electronic securities from his account to the depository. The depository transfers the title of the securities and informs the other investor. All these transfers take place electronically. All communications take place through a computer network and movement of physical securities is eliminated. Since communication is fast and is on real time basis, all transactions can be completed on the same day. Such a system can settle trades on the very next day of trading and a buyer can get ownership of securities transferred on the next day of trading.

STOCK TRADING SYSTEM

Trading on a stock exchange takes place either on the basis of the auction system on a trading floor or a broker-dealer market (which is quote-driven or dealer-driven). Every one of the worlds stock markets uses one of the two trading systems or a hybrid of both.

Auction Trading System

This is an order-driven or a custom-driven trading system where customers' buy and sell orders are matched at a central point. The New York Stock Exchange (NYSE) is an order-driven auction market. This system allows the buyer and the seller to find a mutually agreeable price, with no intervention from the broker-dealers.

The buy and sell orders are automatically matched and in case of any imbalances, the specialists take up the job of filling in. The specialist is a single designated market-maker who stands in the market at all times, adding effectiveness and efficiency into the trading mechanism. 90 percent of the trading in the NYSE is done this way.

In Indian stock markets other than the BSE, the trading is mainly order-driven with the buyers and sellers transacting directly with one another. Although this does have the advantage of giving the investors a better price, growth of the markets has been hampered by a relatively high-degree of volatility and liquidity. SEBI has proposed a system of market-makers on the exchanges at Bombay, Calcutta, Delhi and Chennai. Any member of these stock exchanges can, with prior approval of SEBI, take up the charge of becoming a market-maker. Market-makers can make markets for 500 scrips, which are not included under the BSE National Index. Each market-maker will be required to acquire at least 30,000 shares in each of the scrips.

According to Reserve Bank of India guidelines, market- makers would be in a position to impart liquidity to scrips and reduce volatile movements in share prices by permitting banks to finance their operations. Banks have been authorized to determine the amount of working capital requirements, the margin (existing 50 percent margin on loans to individuals against shares is not applicable) and credit limits for margin making requirements. The rate of interest depends on the amount and banks can stipulate an interest rate subject to a minimum of 16 percent on amount over Rs. 2 lakhs. Scrips, other than those for which market making is undertaken may be accepted as collateral.

Dealer Trading System

This is a quote-driven or dealer-driven trading system where dealers compete to give the customers the best price. This type of trading takes place through an electronic media with the help of well-networked computer system. The system runs the trading by trying to find the customer for the best price available. The National Association of Security Dealers Automated Quotation System (NASDAQ) is quote-driven, as it is a computerized network, which serves over the counter.

Dealers who buy and sell a particular security regularly make a market in that security. The market-makers quote both 'bid and ask' prices for the two sides of the market, both buy and sell continuously. There are no restrictions on the number of market-makers in a given share. Competing market-makers are obliged to quote the best and competitive prices through the system. Market-makers offering the best price are assigned orders on a rotating basis. The market-makers for most of the active shares transmit their quotations electronically.

Hybrid Trading

Hybrid trading system is an auction type of trading with bids and offers being made by open out-cry and at the same time it is a quote-driven system too. This type of trading system is prevalent in the Bombay Stock

Exchange (BSE). A jobber, unlike the NYSE specialist, does not have to maintain an orderly and continuous market. Acting on their own behalf and never as agents, their income was mostly derived from the spread between the bid and the offer prices by assuming a position in a particular share. Bombay Stock Exchange has an informal system of jobbers.

Margin Trading

A method of trading on a stock exchange whereby an investor is allowed to buy securities on credit by making a deposit of a certain amount in the concerned stock exchange is known as 'margin trading'. Margin account or margin trading is much in vogue in the USA. An investor can open a cash account or a margin account with a member firm. Whereas in the case of cash account, securities are purchased against cash, the margin account investors have to apply for permission to buy securities on credit besides furnishing more information regarding the financial standing. Margin trading provides a customer with added leverage through the use of borrowed funds. Such accounts can also be used to procure quick and easy loans, for short sales, naked call writing and spreads.

When investors buy securities on margin, they buy some shares against cash payments and borrow from the brokers to pay for additional shares, using the paid shares as collateral. The margin customer has to sign a margin agreement, pledging securities as loan collaterals. Before they lend the clients margined securities, the brokers also ask the customers to sign a stock-loan consent form. Margins are regulated by the Federal Reserve, which stipulates 55 percent of margin.

SPECIALISTS

Specialists are market-makers who focus their attention on the maintenance of prices for the investors to find an appropriate price for their bids. Specialists contribute for the effective functioning of the stock exchange. The Specialists firms are mostly the members of the exchange who act as dealers/brokers in shares. Specialists on the floor of exchange carry out the dual function of representing the customers on the one hand and trading on their own account on the other. They buy and sell shares of one or more companies and thereby, help in maintaining a free and continuous market in the shares of companies for which they act as specialists.

The specialists are expected to maintain a fair and orderly market for the securities. In their capacity as brokers, they execute orders on behalf of other brokers for a commission and as dealers, they trade on their own accounts, profits and risks. They buy from the public, when other public bids for purchase are not available and execute the market orders in the absence of other public offers to sell at or near the last price prior to their order. Their customers constitute the other members of the exchange. As specialists they do not transact business directly with the public.

Functions of Specialists

Specialists operating on a stock exchange make a continuous market in shares assigned to them. Following are the functions of specialists:

1. Acting as brokers on the acceptance of orders for execution from other members of the exchange
2. Providing a conduit of information for electronically quoting and recording current bid and ask prices for the shares of companies assigned to them
3. Acting as dealers and trade on their own accounts when faced with a liquidity imbalance in the market
4. Providing the two-sided market, by quoting a bid indicating the price at which shares will be purchased from a seller and an offer the ask price at which shares will be sold to a buyer

Market-makers

Dealers who are responsible for creating and maintaining a market in a security are called "market-makers". In order to carry out the function of market-making, it is essential that the market-making dealers continuously engage themselves in the purchase and sale of a particular security on their own account, and at their own risk and at prices equivalent to the security's trading unit. The quotations that are used for this purpose by the dealers are of two types. They are 'bid price' and 'ask price'. A bid price is the price at which the dealer will buy a security and an ask price is that at which a dealer is willing to sell a security. The difference between bid and ask prices in any quotation is the 'spread'.

The market-makers are obliged to offer a continuous two-way market in all their registered securities. Transactions are reported within 90 seconds of execution. A dealer may take a position in a security by buying for inventory (long position) or by selling securities that he has not yet purchased. A quotation, at all times, must include both sides of the market even though one side may be non-existent.

Broker-dealer

He is the dealer in the New York Stock Exchange (NSE). The broker-dealers are registered with SEC. They may buy and sell securities on their own risk/account, or as an agent, trade on behalf of others. A broker-dealer can also handle purchase orders and perform the following functions:

1. To sell out of his inventory if he makes a market in a particular share which a customer wants to buy
2. To act as an agent where he gets the order for a share in which he does not make a market and buy the same from another market-maker or from someone else who owns the securities
3. To buy shares on his own account and resell them

   The main advantages of the broker-dealer markets are as follows:

   a. Provision of instance information to the market-makers regarding the bid and ask quotations in a particular share
   b. Assurance to investors about the best possible execution of their orders as the traders check with all the market concerned
   c. Possibility for traders to gauge market quickly
   d. Stimulating market competition
   e. Facilitating easy and convenient trading
   f. Providing an easy access to the information on the volume, the indexes of OTC shares, and individual trades

RECENT DEVELOPMENTS

The structure of stock market in India has undergone a vast change due to the liberalization process initiated by the Government. A number of new structures have come to be added to the existing structure of the Indian stock exchange. A brief description of these structures in the Indian stock market system is presented below:

Over-the-counter Market System

Basically this market is meant for small size companies. The primary objective of this market was to enable the small start-up companies or companies in green field ventures to obtain their capital requirements at the minimum cost. On the basis of the recommendations of the High Powered Committee on Stock Exchange Reforms (G.S. Patel) and Committee (Abid Hussain) on Capital Market Reforms, the Over-The-Counter Exchange of India (OTCEI) was incorporated in October 1990 under the Companies Act, 1956. Granted recognition under section 4 of the Securities Contract (Regulation) Act 1956, the OTCEI was promoted by various public financial institutions like Unit Trust of India (UTI), Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Finance Corporation of India (IFCI), Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), SBI Capital

Market, CanBank Financial Services, etc. Commencing its operations on September 29, 1992 at Bombay, the OTCEI introduced screen-based automatic singular trading system. Although companies enjoy the same status as listed on the other stock exchanges, it is not possible that a company listed at OTCEI can be listed on other stock exchanges.

National Stock Market System (NSMS)

National stock market system was advocated by the "High Powered Group on the Establishment of New Stock Exchanges" headed by Shri.M.J.Pherwani (popularly known as Pherwani Committee). The committee recommended in June 1991, the following three tier-stock market structure:

- *Principal Stock exchanges* comprising 5 major stock exchanges at Bombay, Calcutta, Madras, Delhi and Ahmedabad
- *Regional stock exchanges* like those in major state capitals
- *Additional Trading Floors* (ATFs) sponsored or managed by Principal or Regional stock exchanges

At present the National Stock Market in India comprises the following:

1. National Stock Exchange of India Limited (NSE)
2. Stock Holding Corporation of India Limited (SHCIL)
3. National Clearing and Depository System (NCDS)
4. Securities Trading Corporation of India (STCI)

National Stock Exchange (NSE)

The National Stock Exchange (NSE) was set up for the purpose of providing a nationwide stock trading facility to investors so as to bring the Indian financial market in line with international financial market. It started its operations by the end of 1993. The NSE uses the electronic trading system and computerized settlement system aimed at extending the facility of electronic trading to every corner of the country. The exchange has two separate segments, viz. capital market segment and money market segment. While the capital market segment is concerned with trading in equity shares, convertible debentures and debt instruments as nonconvertible debentures, the money market segment facilitates high value trading in debts, public sector bonds, mutual fund units, treasury bills, government securities, call money instruments, etc. The main participants, in this market are usually banks, financial institutions, and other financial agencies.

Stock Holding Corporation of India Limited (SHIL)

This Corporation was set up in October 1987, under the Companies Act, by 7 All India financial institutions viz. IDBI, IFCI, ICICI, LIC, GIC, UTI and RBI.

The range of services that are made available by this institution includes quick transfer of shares among its member institutions, clearing services, depository services, support services, management information services, and development services. This is a board-managed company and has a whole time Managing Director in charge of the day-to-day management of the corporation. It has set up regional centers at New Delhi, Calcutta and Madras. It is providing facilities in the major market centers in India.

National Clearance and Depository System (NCDS)

This system was created chiefly to help overcome the problem of settlement and clearance of transactions consequent to enormous workload on the clearing agencies and share transfer agencies. The problems mainly arose out of systematic risk like counter party risk, credit risk, bad deliveries, long delayed delivery, counterfeit scrips, and forged scrips.

Securities Trading Corporation of India (STCI)

The Reserve Bank of India set up Securities Trading Corporation of India Limited (STCI) in May 1994, under the provisions of the Indian Companies Act, 1956, jointly with public sector banks and All-India financial institutions. The main objective of establishing the Corporation was to foster the development of an active secondary market for Government securities and bonds issued by public sector undertakings. It had an authorized and paid-up capital of Rs. 500 crores of which, RBI contributed 50.18 percent. The RBI in December 1997 divested part of its equity in STCI in favor of the Bank of India, an existing shareholder of the Company.

Corporitization and Demutualization

Of late, efforts are on by the SEBI to corporatize and demutulize the Indian stock exchanges. For this purpose a Study Group under the Chairmanship of Justice M.H. Kania has been constituted. The object is to put in place a common structural model for the Indian stock market system. Accordingly, stock exchange will have to undergo changes in organizational structure.

Corporitization and Demutualization refer to the process of conversion of a stock exchange from a not-for-profit entity to a for-profit company. The process of transition from 'mutually-owned' association to a company 'owned by shareholders' is called 'demutualization'. Demutualization involves the segregation of members' right into distinct segments, viz. ownership rights and trading rights. It changes the relationship between members and the stock exchange. Members, while retaining their trading rights, acquire ownership rights in the stock exchange, which have a market value, and they also acquire the benefits of limited liability.

REVIEW QUESTIONS

Section A

1. What is a ‘stock exchange’?
2. Define a stock exchange.
3. How many stock exchanges are there in India? Name them.
4. Who are ‘remisiers’?
5. What are the functions of ‘authorized clerks’?
6. Who are ‘brokers’?
7. Who are ‘jobbers’?
8. Who are ‘tarawaniwalas’?
9. Who are share market dealers?
10. What is ‘badla’?
11. What is ‘speculation’?
12. What is ‘insider trading’?
13. What is ‘forward trading’?
14. What is ‘carry forward system’?
15. What is ‘margin payment’?
16. What is ‘rolling settlement’?
17. What is ‘account period system’?
18. What do you know of the settlement cycle at the NSE?
19. What is ‘counter party default in a stock market trading’?
20. What is a ‘depository’?
21. What is the need for a ‘depository’?
22. What is ‘auction trading system’ of stock trading?
23. What is ‘dealer trading system’ of stock trading?
24. What is ‘hybrid trading system’ of stock trading?
25. What is ‘margin trading’?
26. Who are the specialists on a stock exchange? Name them.
27. Who are ‘market makers’?
28. What is ‘over-the-counter market system’?
29. What is ‘National Stock Market System’ (NSMS)?
30. What is ‘demutualization’ and ‘corporitization’ of stock exchanges?

Section B

1. Distinguish between a stock exchange and a commodity exchange.
2. How are brokers different from jobbers?
3. Bring out the weaknesses in the Indian stock exchanges.
4. What are the essential functions of the stock exchange division of the Ministry of Finance?
5. State the some of the important regulations/guidelines brought out by the SEBI.
6. What are the functions of the 'listing department' of a stock exchange?
7. Explain the steps in 'stock trading'.
8. Explain the mechanics of settlement of trade on a stock exchange.
9. Explain the mechanism of settlement guarantee system in a stock exchange
10. What are the prerequisites for the successful working of the 'settlement guarantee system'?
11. What are the functions of specialists on a stock exchange?
12. What are the functions of 'market makers' on a stock exchange?
13. What are the functions of 'broker-dealers' on a stock exchange?

Section C

1. Trace the history and the growth of Indian stock exchanges.
2. Describe and discuss the various functions rendered by stock exchanges.
3. Explain the various stock exchange traders.
4. How are stock exchanges in India regulated? Explain.
5. Identify and explain the functions of major departments of the Indian stock exchanges.
6. Explain the different systems of stock trading.
7. Outline the recent developments in the Indian stock market.

Chapter 9

SEBI—Functions and Working

Presence of an efficient securities market is an important requirement for a country's march towards industrialization. For, the market offers a mechanism for efficient mobilization and channeling of savings of the household sector into productive enterprises. By offering attractive rewards in the form of returns and capital appreciation, the securities market encourages thrift and risk taking. It also helps enterprises to raise money in a cost-effective manner. The emergence of securities market in India dates back to the eighteenth century, when the Bombay Stock Exchange was set up in 1887. It was a vital segment of the Indian financial system.

The securities market came in for a spectacular growth, both in terms of its ability to mobilize resources and to allocate it with some efficiency in the nineteenth century. The market has come to provide all the support needed for the growth and development of the corporate sector by facilitating the raising of long-term capital funds. In fact, the Indian financial system witnessed an unprecedented growth in terms of the number and the variety of players. The number of active investors, institutions and intermediaries increased manifold. The stock exchanges also grew in number. All these factors necessitated the need for creating an awareness and interest among the common investors. Moreover, the burgeoning growth of corporate enterprises ushered in excellent investment opportunities available in the securities market among the lay savers.

The need for setting up a statutory apex body was felt by the government to promote an orderly and healthy growth of the securities market and for investor protection. The body was expected to help sustain the growth momentum and thereby, crystallize the awareness and interest into a committed, discerning and growing pool of investors. This was aimed at protecting investors' rights and curbing trading malpractices and structural inadequacies of the market. In countries like the USA and UK, National Securities Exchange Commission monitors the capital market operations and safeguards the investors' interest. Such an agency helped the healthy growth of the securities market there.

GENESIS

Government of India set up the Securities and Exchange Board of India (SEBI) on April 12, 1988 on the basis of the recommendations of the high powered Committee on Stock Exchange Reforms headed by G.S. Patel. SEBI was given a legal status by the Securities and Exchange Board of India Ordinance, 1992. The members of the Board of Management of the SEBI comprised those drawn from professional brokers, financial consultants, merchant bankers, investors, stock exchange authorities, finance ministry, etc.

FEATURES OF THE SEBI BILL

The SEBI has been entrusted with a wide range of responsibilities in regulating the activities of almost all the players in the capital market. After the abolition of the controller of capital issues, the issuer of capital, which is the promoter, has come under SEBI's jurisdiction. The SEBI laid down certain guidelines for the issuers to ensure investor protection. The SEBI was expected to regulate mutual funds, merchant bankers, registrars to issue, share transfer agents, portfolio managers, underwriters, investment advisors, brokers and sub-brokers. SEBI has also been given certain powers to regulate the functioning of stock exchanges in India.

OBJECTIVES

SEBI was set up with the following objectives of assisting and facilitating the mobilization of adequate resources through the securities market and its efficient allocation, keeping in mind the interests of issuers, investors and the intermediaries:

1. ***Conducive environment*** SEBI aims at creating a proper and conducive environment required for raising money from the capital market through the rules, regulations, trade practices, customs and relations among institutions, brokers, investors and companies. It also aims at endeavoring to restore and safeguard the trust of investors, especially the interest of the small investors. This is to be achieved by meeting the needs of the players connected with the securities market such as the investors, the corporate sector and the intermediaries. SEBI works for creating proper investment climate to enable corporate sector to float industrial securities easily, efficiently and at affordable minimum cost.
2. ***Investor education*** SEBI aims at educating investors so as to make them aware of their rights in clear and specific terms by providing

them with information. This way, SEBI aims at maintaining liquidity, safety and profitability of the securities in the market that are crucial for any investment. A high degree of protection of investor rights and interests is made possible by providing adequate, accurate and authentic information on a continuous basis. This way, the market efficiency is also ensured.

3. ***Infrastructure*** SEBI aims at developing a proper infrastructure for facilitating automatic expansion and growth of business of middlemen like brokers, jobbers, commercial banks, merchant bankers, mutual funds, etc. This is aimed at providing efficient service to their constituents, viz. investors and corporate sector at competitive prices.
4. ***Others*** In addition to the above mentioned objectives, SEBI would also make efforts to bring about necessary enactments for regulating business of intermediaries such as mutual funds, NBFCs and chit funds, etc. SEBI would also work towards creating a framework for more open, orderly and unprejudiced conduct in relation to takeover and mergers in the corporate sector so as to ensure fair and equal treatment to all the security holders.

MANAGEMENT

Under Section 4 of the SEBI Act, the management of SEBI is entrusted with the Board of Members. The Board consists of a Chairman, two members from amongst the officials of the Ministries of the Central Government dealing with Finance and Law, one member from amongst the officials of the Reserve Bank of India constituted under Section 3 of the Reserve Bank of India Act, 1934 and two other members appointed by the Central Government who are professionals having experience or special knowledge relating to securities market. The Chairman and the other members of the Board are chosen from amongst the persons of ability, integrity and standing who have shown capacity in dealing with problems relating to securities market or have special knowledge or experience of law, finance, economics, accountancy, administration or in any other discipline which, in the opinion of the Central Government, shall be useful to the Board.

POWERS AND FUNCTIONS

Under the SEBI Act

Under Section 11 (1) of the SEBI Act, following are the powers and the functions of the SEBI, designed to protect and promote the interests of investors in securities, and thereby allow for the promotion and the development of the securities market in a regulated manner:

a. Stock exchange regulation SEBI is empowered to regulate the business in stock exchanges and any other securities market. It works to prohibit fraudulent and unfair trade practices in securities market. SEBI performs functions like calling for information, undertaking inspection, conducting enquiries and audits of the stock exchanges, intermediaries, and self-regulatory organizations in the securities market.

b. Stock brokers regulation SEBI is empowered to register and regulate the working of stockbrokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities market in any manner.

c. CIS regulation SEBI works to regulate the working of Collective Investment Schemes (CIS), including mutual funds. For this purpose it promotes and regulates self-regulatory organizations.

d. Investor protection SEBI is empowered to initiate all the steps for promoting investor education and training of intermediaries in securities market. For this purpose it would work towards prohibiting insider trading in securities, besides regulating substantial acquisition of shares and take-over of companies.

e. Others

(i) Performing such functions and exercising such powers under the provisions of the capital issues (Control) Act, 1947 (Subsequently repealed) and the Securities Contracts (Regulations) Act. 1956, as may be delegated to it by the Central Government

(ii) Levying fees or other charges for carrying out the purposes of Section 11 of the Act

(iii) Conducting research for the above purpose

(iv) Performing such other functions as may be prescribed by the government

Section 17 of the Act empowers the Central Government to supersede SEBI and exercise all of the above powers under the following circumstances:

1. Where on account of grave emergency SEBI is unable to discharge the functions and duties under any provisions of the Act
2. Where the SEBI persistently defaults in complying with any direction issued by the Central Government under the Act

3. Where in the discharge of its functions and duties under the Act and as a result of such default the financial position of SEBI or its administration has deteriorated
4. Where the public interest is to be served

Under the SCRA

In addition to the powers that have been granted to be exercised by the SEBI under its own law, following are the powers granted to it under the Securities Contracts (Regulation) Act (SCRA):

Information SEBI calls for periodical returns from stock exchanges. It would also prescribe maintenance of certain documents by the exchanges. In addition, SEBI calls upon the exchange/any member(s) to furnish explanation/information relating to the affairs of the exchange/any member(s) and appoint any person to conduct an inquiry into the affairs of the governing body of any exchange/any member of the exchange.

Stock exchange regulation SEBI commands the following powers as relating to the regulation of stock exchanges:

a. ***Approval of byelaws*** of the exchange(s) for regulation and control of contracts
b. ***Licensing of dealers*** in securities in certain areas
c. ***Compel a public company*** to list its shares
d. ***Amendment of rules*** relating to matters specified in Section 3(2) of the Act
e. ***Furnishing of annual report*** by recognized stock exchanges
f. ***Issuing directions*** to stock exchanges in general or a stock exchange in particular to make rules or to amend rules
g. ***Superseding the governing body*** of a recognized stock exchange
h. ***Suspension of business*** of a recognized stock exchange
i. ***Prohibit contracts*** in certain cases
j. ***Submission of applications*** for the recognition of stock exchanges
k. ***Grant of recognition*** to stock exchanges
l. ***Withdrawal of recognition*** of a stock exchange
m. ***Making or amending rules*** or articles of association of a stock exchange regarding voting rights of members of a stock exchange at any meeting
n. ***Issue of notification*** declaring Section 13 to apply to an area, consequent upon which contracts issued in that area, otherwise than between members of a recognized stock exchange or through

or with such members would be illegal

o. ***Regulation and control*** of the business of dealing in spot delivery contracts
p. ***Hearing appeals*** submitted by companies against refusal of a stock exchange to list their securities and
q. ***Issues of a notification*** specifying any class of contracts as contracts to which the SCRA or any provision contained therein would not apply

Registration of Intermediaries

All intermediaries dealing in securities are compulsorily registered with the SEBI in accordance with the regulations made under the SEBI Act. The certificate of registration contains the conditions/rules and regulations for conduct of business by the security market intermediaries. The SEBI prescribes regulations for the application form and the manner of making an application as well as the fee payable. The SEBI can suspend/cancel a certificate of a registration granted to the intermediaries in accordance with the regulations made by it in this behalf. An intermediary/person aggrieved by an order of the SEBI, suspending/canceling registration can prefer an appeal to the Government. By various regulations notified from time to time, the SEBI has prescribed the procedure for registration of various intermediaries associated with the securities market.

Directions from Government

The Government of India can issue directions to the SEBI on questions of policy in writing from time to time. It is bound to follow and observe such directions in the exercise of its powers/the performance of its functions. The Government has absolute discretion to determine whether a question is one of the policy or not. Its inability to discharge its functions/duties, or non-compliance to follow and act upon any direction given by the Government or requirement in the public interest may lead to its supersession by the Government.

Power to Make Rules

The Government is authorized to make rules for carrying out the purposes of the SEBI Act. The important matter for which rules may be framed, include, the additional functions to be performed by it, its constitution, maintenance of its accounts, manner of inquiry to impose penalty for defaults, constitution of the Securities Appellate Tribunal (SAT), the forms of appeal and fee before the SAT, and the form in which reports have to be submitted to the Government. The Government was also empowered to frame rules regarding the conditions for certificate of registration for intermediaries. With effect from 1995, this power was withdrawn from the Government and rests with the SEBI now.

Power to Make Regulations

To carry out its functions, the SEBI is empowered to make regulations. Every regulation made by it must have the prior approval of the Government. All such regulations must be published as notification in the official gazette. The matters for which regulations may be framed include (a) the conditions for registration certificate, fee for registration, cancellation/suspension of registration of intermediaries and (b) matters relating to issue of capital, transfer of securities and so on.

Power to Adjudicate

The SEBI is empowered since 1995, to appoint any of its officers of the rank of a division chief as the adjudicating officer, to hold an enquiry in the prescribed manner for determining the amount of penalty on any intermediary. The quantum of penalty is to be fixed with due regard to (a) the amount of disproportionate gain or unfair advantage made as a result of the default, (b) the amount of loss caused to an investor/group of investors as a result of the default and (c) the repetitive nature of the default.

REGULATORY ROLE

Since its inception in 1992, the SEBI, as a capital market regulator, has been making tremendous efforts towards achieving its twin objectives of investor protection and capital market development as mandated by the SEBI Act. SEBI has initiated a number of policy initiatives. The focus of attention of SEBI's activities is as follows:

1. Increasing market transparency through further improvement of disclosure standards
2. Improving the standards of corporate governance
3. Improving market efficiency by speeding up the process of dematerialization and introducing rolling settlement in a phased manner
4. Reduced transaction costs by refining the margin system
5. Enhancing the market safety through an efficient margin system and stepping up surveillance

ROLE AND RELEVANCE

The role of SEBI in the realm of development and regulation of the securities market in India is discussed below:

Credible Regulatory Structure

SEBI has been responsible for successfully creating a credible regulatory structure for the securities market. It acts as a major catalyst for the development of the securities market in India. For this purpose it brings about far reaching changes in market practices, introduces the internationally acclaimed best practices and procedures in the realm of trading and engages itself in periodical modernization of the market infrastructure by enforcing regulations taking advantage of technology. SEBI introduced a package of measures of liberalization, regulation and development for the healthy promotion of the securities market in India, keeping in mind the necessity of contributing to the industrial and economic growth of the country. Some of these measures include the following:

a. Disclosure Introduction of disclosure norms for issuers so as to ensure the observance of high standards of integrity and fair dealing thus benefiting the investors.

b. Automation Introduction of automated working procedures through the computers in all stock exchanges, thus facilitating trading with the help of terminals of stock exchanges and modernization of market infrastructure.

c. Depository Creation of the facility of depository by the enactment of the Depositories Act, 1996 thus providing for the establishment of depositories in securities with the objective of ensuring free transferability of securities, its speed, accuracy, and security.

d. Trading Introduction of number of systematic measures thus enforcing reliable trading mechanism and preventing market failures and the establishment of settlement guarantee funds in the stock exchanges thus facilitating a smooth and timely settlement of funds.

e. Others Other measures of establishing a credible securities structure include shortening of settlement cycles of stock exchanges, modernizing and strengthening of the surveillance systems in stock exchanges and SEBI, liberalization of FII policy and simplification of the investment procedures by the FIIs, and strengthening of the regulations for takeover to encourage take-over in a fair and transparent manner and to protect the investors.

Market Surveillance

In order to bring about orderliness in the working of the stock exchanges all over India, market surveillance is an important key used by the SEBI. This assumes relevance in the context of the growing incidence of scams taking place in the capital market. SEBI set up a Market Surveillance Division as early as in July 1995, with a view to keep a pro-active surveillance on the activities of the stock exchanges. Following are the focus of attention in this regard:

a. Policy formulation SEBI has the power to formulate relevant policy for introduction of surveillance systems and risk containment measures at the stock exchanges to bring integrity, safety and stability in the Indian securities markets.

b. Surveillance system SEBI commands the power to oversee the surveillance activities of the stock exchanges including monitoring of market movements by them. For this purpose, SEBI establishes independent surveillance cells in stock exchanges. SEBI also assists in the formation of Inter-Exchange Market Surveillance Group for prompt, interactive and effective decision-making on surveillance issues and coordination between stock exchanges. SEBI oversees the implementation of Stock Watch System, an on-line automated surveillance system at stock exchanges. Besides, it also involves in alerting and advising investors through press releases about the need for a cautious trading in scrips in ICE (Information, Communications and Electronics industry) and directing the stock exchanges to closely monitor the trading and other developments in respect of shares of such companies.

c. Inspection SEBI is empowered to carry out the inspection of the surveillance cells of the stock exchanges and initiating investigations. It also carries out the inspection of intermediaries. Inspection is carried out to gather evidence of alleged violations of securities market such as price rigging, creation of artificial market, insider trading, public issue related irregularities and other misconduct.

d. Information SEBI undertakes the preparation of reports and studies on market movements, which SEBI circulates periodically to the Ministry of Finance in the Government of India and to securities markets regulators from other countries. Reporting by stock exchanges through periodic and event driven reports is also done by the SEBI.

e. Risk containment Risk containment measures in the form of elaborate margining system and linking of intra-day trading limits and exposure limits to capital adequacy are also undertaken by the SEBI. Suspension of trading in scrips to prevent market manipulation and tightening entry norms for public/right issues is done by the SEBI.

f. Price bands SEBI arranges for the announcement of daily price bands to curb abnormal price behavior and volatility.

Disclosure Standards

SEBI appointed an expert committee in 1995, under the Chairmanship of Y. H. Malegam to suggest measures for improving the disclosure standards. Another committee was appointed under the chairmanship of C. B. Bhave to recommend measures for improving the continuing disclosure standards by corporates and timely dissemination of price sensitive information to the public. On the basis of the recommendations of the above committees, SEBI initiated such steps as the imposition of a set of entry barriers on new issues specifying the minimum issue size requirements for companies that seek listing. A reinforcing step was initiated by the SEBI by issuing the compendium of SEBI (Disclosure and Investor Protection) Guidelines, 2000 effective from January 27, 2000. This was the consolidation of all the earlier guidelines encompassing entry norms, lock-in-period, promoters' contribution, etc. This was done in order to streamline the current procedure and smoothen out the aberrations in initial public offerings.

Best Governing Practices

Based on the recommendations of the Kumar Mangalam Birla Report, SEBI put into vigorous practice, the code of corporate governance in listed companies for the purpose of affording protection to investors through the mechanism of enhanced standards of corporate management.

To secure corporate governance in companies, the SEBI issued directives to stock exchanges to amend the listing agreement to include a new clause (clause 49) on corporate governance to be adhered to, by the listed companies. The board areas of corporate governance were composition of board of directors, constitution and functioning of audit committees, remuneration of directors, disclosure requirements, compliance report on corporate governance and compliance certificate. Such a measure was designed to instill investor confidence in the capital market through better corporate governance.

Building Investor Confidence

SEBI took a number of steps in order to allow for better investor protection and market development so as to usher in an active primary market. Safety measures introduced by the SEBI for safeguarding the interests of millions of investors and also for building their confidence were as follows:

1. Appointment of Compliance Officer
2. Prudent corporate governance norms for all listed companies to ensure transparency and better disclosure practices
3. Service centers set up by stock exchanges for investors to enable them to have a forum for recording and counselling their grievances as well as access to financial and other information of companies and government policies, rules, regulations, etc
4. Better monitoring and market surveillance systems
5. Directions to stock exchanges to take stern action against companies not complying with listing agreement
6. Standardization of investor complaints lodged with SEBI against companies

GLOBAL OUTLOOK

Rapid developments in the realm of global financial markets has prompted the SEBI to initiate steps for the faster integration of the Indian securities market with the rest of the world. Accordingly, FIIs have been permitted to invest in all types of securities including government securities. Similarly, Indian companies have been permitted to raise resources from abroad through issue of American Depository Receipts, Global Depository Receipts, Foreign Currency Convertible Bonds and External Commercial Borrowings. In the same manner, Indian stock exchanges have been permitted to set up trading terminals abroad and trading platform of Indian exchanges are now accessed through internet from anywhere in the world.

As an active and leading member of the International Organization of Securities Commission (IOSCO), the SEBI has been making all efforts to harmonize SEBI regulations and guidelines with IOSCO's principles of securities' regulations. This was designed to conform to global standards. On the basis of the IOSCO's 30 principles of securities' regulations, the SEBI has devised its own principles aimed at protection of investors, ensuring that markets are fair, efficient and transparent, and reduction of systematic risk. The eight categories of principles formulated by the SEBI are as follows:

1. Principles relating to the regulator
2. Principles of self-regulation
3. Principles for the enforcement of securities regulations

4. Principles for cooperation in regulation
5. Principles of issue
6. Principles for market intermediaries
7. Principles for the secondary market

Improving Operational Efficiency

An important requirement for the efficient functioning of the capital market is the efficient functioning of the market participants. In this regard, SEBI has undertaken a number of measures aimed at improving the operational and informational efficiency in the market. This has helped the participants to carry out transactions in a cost-effective manner by providing full, relevant, accurate and timely information.

A number of checks and balances have been built up to ensure the desired level of investor protection, enhance their confidence and avoid systematic failure of the market. Allowing contestability of the market and imposing entry criteria for issuers and intermediaries have ensured stability of the system as a whole. Prudential controls on intermediaries have facilitated the financial integrity of the market. For instance, code of conduct for the intermediaries as prescribed in the regulations, capital adequacy and other norms, a system of monitoring and inspecting their operations instituted to enforce compliance and initiating disciplinary actions against the delinquent intermediaries are some of the measures aimed at improving the operational efficiency of the market participants in the securities market.

SEBI has been making consistent endeavors to promote a market, which is both efficient and fair, and also protects the interests of investors. Dematerialization and the rolling settlements are the major steps taken by the SEBI for improving and modernizing the markets. The dematerialization system introduced by the SEBI is one of the far-reaching steps. The process aims at eliminating physical paper and thereby helping in the reduction of the work on the clearing houses, the registrar to issue and share transfer agents. It has also helped overcome many of the handicaps faced under the traditional paper-based system, namely hand delivery bargains, negotiated trades without price bands, etc.

The system called for elimination or modification of these practices with a view to improving the market microstructure, provide for increased transparency, efficient price discovery and curb unhealthy market practices so as to improve investor confidence. The efforts taken by the players such as depositories, registrars and share transfer agents in the 'demat' system has greatly helped reducing delays and hardships to the investors.

The Rolling Settlement System was introduced by the SEBI in respect of demat shares in order to enhance the liquidity of the market. This mechanism has greatly helped integrate Indian markets with the best global practices and made them more attractive for foreign investors. In fact, the introduction of rolling settlement proved to be a turning point in the history of Indian capital market. The system provides many benefits to corporate entities such as better price realization, decline in speculative activities leading the share prices to reflect its intrinsic value based on medium-term and long-term prospects of the company, etc. It has also helped the exchanges, brokers, fund managers and FIIs in their transactions in securities.

Screen-based Trading

A landmark development that took place in the history of the SEBI was the initiative taken by it to constitute the OTCEI (Over-The-Counter Exchange of India) in the year 1992 and the National Stock Exchange (NSE) in the year 1994. The Exchange allowed for transparency in the securities dealings made possible through the screen-based trading. Under this mechanism, information regarding quotations for securities, the prices of transactions and volume of those transactions is made publicly available promptly after each transaction or quotation.

This electronic form of trading that has gained acceptance internationally as a highly transparent, cost efficient and faster mode for executing trades has been greatly contributing to the development of the Indian securities market. SEBI initiated steps to ensure that all the stock exchanges in the country introduce electronic trading system and automate their operations. As a result, the open-outcry system of trading which was prevalent in the stock exchanges in the country till a few years ago is being gradually replaced by computerized trading. SEBI has also contributed to further modernization of the trading system by permitting internet trading under order routing system in a limited way through registered stockbrokers on behalf of clients for execution of trades on recognized stock exchanges.

REVIEW QUESTIOINS

Section A

1. What is the need for setting up the SEBI?
2. What is screen based trading?

Section B

1. What are the objectives for which the SEBI was set up?
2. What are the features of SEBI bill?
3. How is SEBI managed?
4. What are the powers commanded by the SEBI as regards the regulation of stock exchanges in India?
5. Comment on the regulatory role of the SEBI.
6. What are the measures of market surveillance adopted by the SEBI for the orderly working of the Indian stock exchanges?
7. What are the measures initiated by the SEBI towards building investor confidence?

Section C

1. Discuss the powers and functions of the SEBI in the realm of investor protection and the efficient management of the Indian stock market.
2. Discuss broadly the role and the relevance of the SEBI in the development and regulation of securities market in India.

Chapter 10

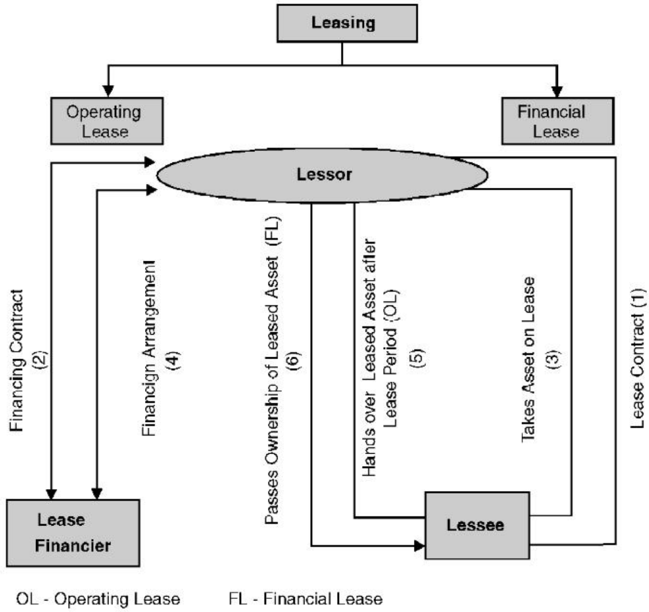
Leasing

DEFINITION

According to the Institute of Chartered Accountants of India, “a lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time. Lessor is a person who conveys to another person (lessee) the right to use an asset in consideration of a payment of periodical rental, under a lease agreement. Lessee is a person who obtains from the lessor, the right to use the asset for a periodical rental payment for an agreed period of time”.

A financing arrangement that provides a firm with the advantage of using an asset without owning it, may be termed as ‘leasing’. The mechanism of lease financing is depicted in Exhibit 8.

Exhibit 8 Mechanics of Lease Finance



CHARACTERISTICS OF LEASE

The following are the characteristics of a lease:

1. ***Parties to lease agreement*** There are two parties to a lease agreement. They are: the lessor and the lessee. Lessor is a person who conveys to another person (lessee) the right to use an asset in consideration of a periodical rental payment, under a lease agreement. Lessee is a person who obtains, the right to use the asset from the lessor for a periodical rental payment for an agreed period of time.
2. ***Lease asset*** Leasing is used for financing the use of fixed assets of high value. The asset is the property to be leased out. It may include an automobile, an aircraft, plant and machinery, a building, etc. However, the ownership of the asset is separated from the use of the asset. During the period of the lease, the ownership of the asset rests with the lessor, while the use is transferred to the lessee.
3. ***Lease term*** The term of the lease is called the lease period. It is the period for which the lease agreement is in operation. It is illegal to have a lease without a specified term. However, in India, perpetual lease is in operation, where the lease period is for an indefinite period of time. On expiry of the lease period, the asset reverts to the lessor mentioned in the 'operating lease'. In the case of a financial lease, the lease period is in consonance with the economic life of the asset, so that the lessee is given the advantage of exclusive use throughout its useful period.

   Sometimes, the lease period may be broken into primary lease period and secondary lease period. A primary lease period is a period during which the lessor wants to get back the investment together with interest. A secondary period comprises the latter part of the lease period, where only nominal rentals are charged in order to keep the lease agreement operational.
4. ***Lease rentals*** Lease rentals constitute the consideration payable by the lessee as specified in the lease transaction. Rentals are determined to cover such costs as interest on the lessor's investment, cost of any repairs and maintenance that are part of the lease package, depreciation on the leased asset and any other service charges in connection with the lease.

TYPES OF LEASE*

Lease is of different types. They are discussed below:

Financial Lease

A financial lease, also called 'capital lease', is a contract involving payment over an obligatory period, of specified sums sufficient in total to amortize the capital outlay, besides giving some profit to the lessor.

According to the International Accounting Standard (IAS) No. 17, "a financial lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred."

According to the Institute of Chartered Accountants of India, "financial lease is a lease under which the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset."

A financial lease is noncancelable in nature. The lessee is responsible for the maintenance of the asset leased. The lease generally provides for the renewal of the lease on expiry of the lease contract.

Variants of financial lease include full payout lease and true lease.

a. Full payout lease In this type of lease, the lessor recovers the full value of the leased asset, within the period of the lease, by way of lease rentals and the residual value. According to the U.S. Controller of Currency, " a full payout lease is one from which the lessor can reasonably expect to realize a return of its full investment in the leased property plus the estimated cost of financing the property over the term of the lease from the sources such as rentals, estimated tax benefits and the estimated residual value of the property at the expiration of the initial term of the lease. It could be considered a typical financial lease, as within the first lease period, the asset leased out fully payoff its value, in addition to yielding the lessor, a desired return on investments."

b. True lease In this type of lease, the typical tax-related benefits, such as investment tax credit, depreciation tax shields, etc. are offered to the lessor.

Operating Lease

An operating lease is any other type of lease whereby the asset is not fully amortized during the noncancelable period of the lease, and where the

---

* Sourced from the book '*Lease Financing and Hire-purchase including consumer credit',* by Sri. Vinod Kothari, Published by Wadhwa and Company Pvt. Ltd, Stadium Suburbs, Dhantoli, Nagpur – 440 012, 1991, pp. 7–44.

lessor does not rely on the lease rentals for profits. It is basically an economic service. It is a short-term lease on a period-to-period basis, the period of lease being less than the useful life of the asset.

The lease is cancelable at short-notice by the lessee. The lessee has the option of renewing the lease after the expiry of the lease period. It is the responsibility of the lessor to ensure maintenance, insurance, etc of the asset, which is chargeable by the lessor. It is a highrisk lease to the lessor, since it could be cancelled at any time.

a. Net lease A variant of operating lease is net lease. A type of lease where the lessor is not concerned with the repairs and maintenance of the leased asset is known as 'net lease'. The only function of the lessor is to provide a financial service. According to the U.S. Controller of Currency, " a net lease is one in which the lessor will not provide, directly or indirectly or be obligated to provide any of the following:

(i) The servicing, repair or maintenance of the lease property during the lease term
(ii) The purchasing of parts and accessories for the lease property
(iii) The loan of a replacement or substitute while the lease property is being serviced
(iv) The purchasing of insurance for the lessee, except where the lessee has failed in its contractual obligation to purchase or maintain the required insurance
(v) The renewal of any license or registration for the property unless such action is clearly necessary to protect the interest of the lessor"

Conveyance-type Lease

It is a very long tenure lease applicable to immovable properties. The intention of the lease is to convey title in property. Such leases are entered into for periods which may be as long as 99 years or 999 years.

Leveraged Lease

When a part or whole of the financial requirement involved in a lease are arranged with the help of a financier, it takes the form of leveraged lease. This type of lease is resorted to in cases where the value of the leased asset is very high. In this type of lease, the lessor, who is also a financier, involves one more financier, who may hold a charge over the leased asset, over and above a part of the lease rentals.

Sale and Leaseback

Under this type of lease, the owner of an asset sells it to the lessor, and gets the asset back under the lease agreement. The ownership of the asset changes hands from the original owner to the lessor, who in turn leases out the asset, back to the original owner. This paper exchange of title has the effect of providing immediate free finance to the selling company, the lessee. This transaction also helps the release of funds tied up in that particular asset.

Partial Payout Lease

It is a type of lease whereby the lessor obtains full payment of the lease in several leases. This broadly falls under the category of operating lease.

Consumer Leasing

Leasing of consumer durables such as televisions, refrigerators, etc. is called consumer leasing. It has assumed popularity with the rapid increase in the quantum of consumer credit. According to the U.S. Controller of Currency, "Consumer lease is a contract in the form of a lease or bailment for the use of personal property by a natural person for a period of time exceeding four months, and for a total contractual obligation not exceeding \$ 25,000, primarily for personal, family, or household purposes, whether or not the lessee has the option to purchase or otherwise become the owner of the property at the expiration of the lease, except that such term shall not include any credit sales."

Balloon Lease

A type of lease, which has zero residual value at the end of the lease period, is called 'balloon lease'. It also means a kind of a lease where the lease rentals are low at the inception, high during the mid years, and low again during the end of the lease.

Close-end Leasing

A leasing arrangement whereby the asset leased out is reverted to the lessor is known as 'close-end leasing'. It is also called 'walk away' lease.

Open-end Leasing

A term commonly used in automobile leasing in the USA, it means a lease agreement where the lessee guarantees that the lessor will realize a minimum value from the sale of the asset at the end of the lease period.

Under this arrangement, if the asset's residual value fetches less price than agreed, the lessee pays the difference to the lessor. In the same manner, where the asset's residual value fetches more than the value agreed, the lessor pays the excess to the lessee. It is so called because the lessee does not know the actual cost of the asset until it is sold at the end of the lease.

Swap Leasing

In swap leasing, the lessee is allowed to exchange equipment leased out whenever the original asset has to be sent to the lessor for some repair or maintenance.

Wrap Leasing

When the lessee further subleases the asset to the enduser, retaining a fee and a share of the residual value, it is called wrap leasing. Normally, the term of the first lease is longer than the second, in order to maximize the first lessor's tax deductions. It is so called because the first lease wraps the second lease.

Import Leasing

The leasing of imported capital goods is known as 'import leasing'. It is beneficial to the lessee because arranging any other source of funding may take a long time, during which the prices of the importable item, as also the rates of exchange, may change. Moreover, lenders don't usually finance the import duty, which forms a sizable part of the acquisition of such items.

Special procedures Following are the special procedures for import leasing under the Export-Import Policy of 1990–93, and the handbook of procedures:

1. ***Permission*** Import leasing is allowed only where specific permission of the authorities is obtained.
2. ***HP forms*** The leasing company may also relinquish its rights in favor of the actual user, the lessee, with the approval of the concerned licensing authority. This means that financing of imports on the basis of hire purchase agreements is also possible. These hire purchase agreements may be worded as lease agreements coupled with an option to buy. Permission of the licensing authority for relinquishing the lessor's right may be obtained while applying for the joint license.
3. ***Conditions*** The conditions to be satisfied by the leasing company are as follows:
    - Provision in the Memorandum of Association, with leasing as one of the objectives

- Minimum issued and paid up capital of the company should be Rs. 1 crore
- The company's shares must be listed in a recognized stock exchange

4. ***Endorsement*** Endorsement of the import license is required, thus making the leasing companies joint holders of the import licence
5. ***Compliance*** Both the lessor and the lessee are jointly liable for compliance of the terms and conditions of the licence.
6. ***FTZs*** If leasing of assets is to be done to units located in free trade zones, necessary permission from the Board of approvals in the concerned zone shall be obtained.
7. ***Consent letter*** Filing a consent letter duly signed both by the lessor and the lessee, accompanied by a copy of the lease agreement must be provided to the regional licensing authorities.

Cross-border Leasing

A type of lease where the lessor in one country leases out assets to a lessee to another country, is known as cross-border leasing. The jurisdictions of lessors and lessees are in two different countries. Cross-border leasing originated in the 1970s in the U.S. Financial institutions in the U.S., leased out big assets, such as airplanes, etc. to the lessees outside USA. The intention was to skim the benefits of income tax and depreciation with a view to reduce financial cost to the lessees.

a. Double-dip According to the concept of double-dip, it is possible to have the advantage of depreciation tax benefits twice, depending on the prevalence of differing tax laws in two different countries. For instance, the lessor in India leases out an asset to a lessee in USA. Assuming that the tax laws of India do not differentiate between true leases and tax-oriented leases, it is considered a financial lease, where risk and rewards are transferred, to the lessee. In this case, capital allowances (depreciation tax benefits) are granted to the Indian lessor. Similarly, the lessee in USA under the said lease, may be considered for granting depreciation tax allowances upon the satisfaction of certain conditions which may be provided for capital lease.

b. Triple-dip Where the benefit of depreciation tax allowances is available in three different jurisdictions for a single asset leased out, it is a case of triple-dip. Accordingly, benefits are available for hire purchase, true lease, and capital lease.

Japanese Cross-border Leasing

The Japanese leasing falls broadly under three categories, namely samurai leasing, shogun leasing and mushashi leasing. A ***'Samurai Lease'*** was encouraged by the government of Japan with the intention of reducing the huge surplus in the balance of payments enjoyed by Japan. Samurai lease was intended for the acquisition of large value items such as aircrafts, etc through cheap foreign currency loans provided by the Export-Import bank of Japan. Exemptions were given from the Foreign Exchange and Trade Laws of Japan for such leases.

In the year 1980 a Yen-dominated ***'Shogun Lease'*** was brought into use with the amendment of the Foreign Exchange and Trade Laws of Japan. Accordingly, Japanese leasing companies were allowed to lease or sell equipment located outside Japan to non-residents. The ***'Mushashi Lease'***, which was basically leasing in foreign currency, was also popular in Japan.

International Leasing

When a leasing company operates in different countries through its branches, it is a case of international leasing. International leasing is active in countries such as U.S., Japan and Hong Kong. 'U.S. Leasing International' started the first international leasing company in the year 1959, in Canada. The single most important problem faced by international leasing companies is that they have to face draconian provisions in foreign exchange laws prevailing in the respective countries.

FINANCIAL LEASE VS. OPERATING LEASE

Financial lease is different from operating lease in the following manner:

Sl. No.	Characteristics	Financial Lease	Operating Lease
1.	Specificity	The asset leased out is use specific for the lessee	The asset leased out may be used commonly by a number of users in sequence
2.	Ownership Risks	The lessee bears the risks and rewards associated with the use of the asset leased; the lessor is simply the legal owner of the asset	The risks and rewards associated with the use of the asset leased is borne by the lessor, and the lessee is simply provided with the use of the asset for a certain period time

Sl. No.	Characteristics	Financial Lease	Operating Lease
3.	Obsolescence Risk	The lessee bears the risks of obsolescence	The lessor bears the risks of obsolescence
4.	Cancelability	The lease cannot be cancelled by either of the parties. The lessor is rather interested in rentals and not in the asset	The lease can be cancelled at the option of the lessee and the lessor does not have the difficulty of leasing the same asset to other willing lessees
5.	Lease Period	The lease period usually coincides with the life of the asset, and may be broken into primary and secondary period	Lease period is generally small, as the lessor intends to lease the same asset several times to various users
6.	Maintenance	The cost of repairs and maintenance are borne by the lessee; the lessor is merely a financier in the deal	The cost of repairs and maintenance are borne by the lessor
7.	Lessor's Service	As the lessor is just a financial institution, it does not render any specialized service in connection with the lease	The lessor is specialized in handling and operating the particular asset and, usually provides specialized services
8.	Payout	It is a full payout lease, where a single lease repays the cost of the asset, together with the interest	It is usually a nonpay out lease, as the lessor is in the business of leasing the asset to various users several times

TEST FOR FINANCIAL LEASE

In order to determine whether or not a lease is a financial lease, the following tests can be employed:

1. ***Substance test*** According to the substance test, to constitute a financial lease, all the benefits and the risks of the lease must be available, to the lessee. The various benefits include the right of use of the asset, right to exclusively enjoy any appreciation in the value of the asset, right to prohibit anybody else from using the asset or

sharing the benefits of appreciation, right to claim damages or any other chargers from the supplier, etc. Similarly, the lessee must be exposed to various risks, such as loss due to idle capacity, technological obsolescence, loss due to damage in transit, liability to pay any taxes attached to ownership of the asset, etc.

2. ***Full payment test*** If the lessor recovers the whole of the asset cost together with interest, the lease is regarded as a financial lease. Similarly, if the minimums lease payments, together with covenanted residual value payback is 90 percent or more of the asset cost, it constitutes a financial lease to the lessee.
3. ***Transfer of title test*** When the lessee has an option to buy or sell the asset leased, it constitutes a financial lease. The lessee is absolved of the duty of returning the asset to the lessor.
4. ***Lease term test*** If the lessee is allowed to exhaust the asset to junk, the lessee shall be considered the beneficial owner of the asset, and this test is sufficient to constitute a financial lease for the lessee. In other words, if the lease term extends to the whole, or substantively the whole of the asset's economic life, i.e. quantitatively 75 percent or more, the lease is taken as a financial lease.

MYTHS ABOUT LEASING

Although leasing is believed to be the most beneficial form of financing, there are several myths surrounding it. They are as follows:

1. ***100 percent financing*** A commonly held opinion is that leasing provides 100 perce nt financing, without having to borrow. Although it is true that leasing enables avoidance of acquisition of the asset, there is an incursion of liability by way of a periodical payment of lease rentals.
2. ***Off-balance sheet financing*** As against borrowing which gets shown as a liability with its resultant effect on the debt-equity ratio, the leasing liability need not be shown in the balance sheet. This is supposed to keep the debt-raising capacity of the firm intact, though this is not quite true. The debt-raising ability of a firm is dependent upon its ability to service its debt, and not on the balance sheet ratios and their interpretations.

   In fact, the contractual obligations under both borrowing and leasing remain in tact through interest and lease rentals. Hence, both the options add to financial risks. Therefore, to say that leasing is a better option, in that it does not require to be shown in the balance sheet is not tenable.

3. ***Better financial performance*** Another commonly held view is that leasing helps improve the financial performance of a firm. This is because; it is possible to enhance the ROI with less asset base. Such ratios, which are the result of accounting adjustments, are illusory in reality. A lease transaction is capable of creating wealth for the firm, only if it yields a positive NPV.
4. ***No evaluation needed*** It is believed that leasing does not require to be included in any capital expenditure evaluation, since there are no capital investments involved. This argument defies logic, because leasing, like a buying decision, needs to be examined carefully of cash flow consequences in order to determine the possible advantages of it. In the absence of any screening, the decision to accept leasing might expose the firm to business fluctuations, and endanger its very survival.

PARTICIPANTS

There are a number of players present in the leasing industry. A brief discussion of these players is presented below:

Lessors

There are different kinds of lessors. They are specialized leasing companies, one-off lessors, manufacturer-lessor, banks-sponsored leasing companies, financial institutions, in-house lessors, etc.

1. ***Specialized leasing companies*** specialize in the business of leasing assets. They target their clients through advertisement, etc. The volume of business transacted by them is huge. They command a massive build-up of capital strength and expand their business operations through grand alliances and tie-ups.
2. ***One-off lessors*** are those companies which come to the leasing business for the purpose of availing the advantage of huge depreciation and tax benefits.
3. ***Manufacturer-lessors*** are those who are in the field of manufacturing capital assets, that are available for leasing. IBM, and United Shoe Machinery Corporation, U.S. are some of the pioneering manufacturing companies which have ventured into the business of leasing.
4. ***Banks-sponsored leasing companies*** are those which operate as subsidiaries of the banks, and have been established for the purpose of undertaking the leasing business. For instance, under the provisions of the Banking Regulations (Amendment) Act, 1984 banks in India have been permitted to set up their own associates for carrying out the leasing business.

5. ***Financial institutions*** constitute another important segment of the leasing business. In India, institutions such as ICICI, etc provide leasing services.

Lessees

The lessees constitute a wide range of companies, from blue chip companies to small units, which avail the financial services from the lessor companies. The considerations for, and the conditions under which, such companies operate vary. A characteristic of the Indian lessees is that most of them belong to the private sector.

Lease Brokers

Lease brokers are the intermediaries between the lessors and lessees who help find a suitable lessor for a prospective lessee and vice versa. Armed with information and rapport, lease brokers help both lessors and lessees with financial advantage through tough negotiations and by providing a wider choice.

Lease Financiers

Lease financiers are banking institutions which provide financial assistance to lessors for the purpose of acquiring the assets that are to be leased. Such assistance is usually secured by the hypothecation of the leased asset, and also by the assignment of lease rentals.

LEASING PROCESS

The process of leasing takes the following steps:

1. ***Lease selection*** The first step in a leasing transaction is the selection of the asset to be taken out on lease basis. The lessee does this by giving due consideration to various requirements such as, lease payments and other factors. The lessee then approaches the leasing company or the lease broking company for the purpose of finalizing the lease deal. A lease agreement is broadly negotiated.
2. ***Order and delivery*** Based on the selection made by the lessee, the lessor goes about placing an order for the manufacture of the asset to be leased. The manufacturer delivers the asset at the site of the lessee who, in turn, gives a notice of acceptance to the lessor.
3. ***Lease contract*** Both the parties sign a lease agreement setting out the details of the terms of the lease contract. Leases will normally be full payout, with varying terms and conditions. The usual lease period ranges from 3 to 5 years.

4. ***Lease period*** During the currency of the lease period, the lessee will make lease payment at regular intervals, as agreed upon between the parties. The lessee will ensure the proper upkeep and maintenance of the asset leased.

   In addition, the lessee will also be entitled to warranties and after-sales services from the lessor. At the end of the lease period, the lessee may either renew the lease or terminate the lease, and retreat the asset to the lessor, or may even acquire the asset from the lessor. However, it is to be noted that there is no possibility of the lessee being given the purchase option in the lease agreement itself.

SERVICES OF LESSOR

The lessor renders the following services to the benefit of the lessee:

1. ***Provision of credit facility*** One of the most important functions of a lessor is granting credit facility to enable the lessee to acquire the use of the asset, by permitting the lessees to avoid paying the full purchase price of the asset. Lessees, instead, amortize this debt by instalments of rental payments. The rentals charged by the lessor include the cost of the asset and interest charges.
2. ***Absorbing obsolescence risks*** In the case of a noncancelable financial lease, the risk of obsolescence arising out of the usage of the asset has to be borne by the lessee. However, in the case of a noncancelable operating lease, the lessor provides the advantage of 30 days time for cancellation of the lease by the lessee, which should enable the lessee to acquire a new asset to cope with the change in technology. In this case, the lessor will collect certain amount of compensation from the lessee by way of premium, which is added to the periodical lease rentals.

Comprehensive Package

The lessor usually undertakes to provide a package of services, or pay for services such as general maintenance, wealth tax and accounting etc to the lessee. This way, the lessor saves the lessee from having to deal with each piecemeal payment.

ADVANTAGES OF LEASING

Leasing as a financial service offers the following potential advantages both to the lessor and lessee:

Advantages to Lessor

a. Stable business Leasing mechanism provides for a continuous and stable manufacturing business for the lessor. The business is supported by the lessee's continued patronage, since there is no necessity for capital investment outlay. It is possible for the lessee to acquire the asset even in times of depression, thus contributing to the growth of the manufacturer's sales, even in times of depression.

b. Wider distribution Leasing allows for capturing a wider distribution network by the lessor. This assumes significance given the fact that the lessees do not have to allocate funds for heavy capital investments.

c. Sale of supplies Depending on the nature of the leasing arrangement, the lessor has to ensure the supply of spare parts and components required for the maintenance of the asset leased. This would augment the sale by the lessor-manufacturer.

d. Secondhand market In the case of operating lease, where the asset leased by the lessee is reverted to the lessor, it is possible for the lessor to either lease out the asset again, or to sell it in the open market. This creates a secondhand market for the used asset.

e. Tax benefits There is relative tax benefit for the receipt of lease rentals. For instance, sales tax payable on lease rentals is lower than the direct tax payable on revenue receipts on the sale of the asset. This enables the manufacturer-lessor to supply products at highly competitive rates. In addition, the lessor-owner of the asset can also claim depreciation tax benefits on assets let out on lease. This provides a better tax planning opportunity to the lessor.

f. Absorbing obsolescence risks In the case of a noncancelable financial lease, the risk of obsolescence arising from the usage of the asset has to be borne by the lessee. In the same way, the cancelable nature of operating lease enables the lessor to cancel the lease and acquire a new asset for further lease. In addition, the lessor charges a premium on the lease rentals.

g. Fillip to capital market Leasing companies, as intermediaries of finance, give an impetus to investment activity, and facilitate the flow of savings into real investments. By reducing the terms on which finance is provided, lessors encourage an accelerated rate of real investment. This way, leasing companies contribute to the growth and development of the capital market.

h. Easy finance The availability of easy and convenient finance has proved to be a great stimulant for the increase in demand for capital equipment. This in turn boosts the manufacture and sales of the leasing companies.

i. Other benefits In addition to the benefits discussed above, the lessor commands some of the following benefits too:

- Advantage of collateral security on the lease payments by the lessee
- Offers a high growth potential, even in times of general depression
- High return on equity because of better leveraging
- Ability to accept public deposits, and contribute to better financial resources

Advantages to Lessee

a. Efficient use of funds Leasing arrangements allow the lessee to acquire the use of the asset without having to own it. This dispenses with the need for capital investment. This also enables the lessee to make efficient use of the available financial resources. This way, more funds are released for working capital purposes. In addition, the conservation of cash outflow also contributes to the profitability of the firm.

b. Cheaper source Leasing, as a mode of financing the use of capital assets, is found to be less expensive, as compared to other modes such as the buying option, etc.

c. Flexible source Leasing of equipment is a highly flexible source of financing, as compared to other methods. The flexible nature of the lease contract allows for promotion of the mutual interest of the parties, especially of the lessee. This is because it is always possible for a leasing plan to be tailor-made to suit the requirements of the lessee. However, the extent of flexibility of the lease depends on its financing structure.

d. Enhanced borrowing capacity Leasing is considered advantageous to the lessee since it helps enhance the ability to borrow in a diversified way. This is possible because the lessor's credit rating of the lessee is less stringent. Besides, owing to the advantage of lower debt-equity ratio, lease financing allows for a mix of financing methods rather than relying on one source.

e. Off-balance sheet financing The biggest advantage claimed by lease financing is that the asset acquired, and the corresponding liability, need not be shown in the balance sheet. This helps keep the debt-equity ratio of the lessee either intact or low, thus contributing to an improved ROI. This is possible because there is an increase in operating income, without any increase in net block.

f. Tax benefits The extent of benefit that would be derived by owning an asset, by way of depreciation tax shield is less than the benefit to the lessee by way of lease rentals. This is because depreciation tax shield is less than lease rentals. Moreover, lease rentals are fully tax-deductible. Further, this will help amortize the cost of the asset in the books of the lessee in a much shorter period. This also enables the lessee to write off more amounts in the initial years, which eventually makes it possible to postpone taxes to the latter years. Similarly, the lease on land permits the lessee to write-off land values against taxable income, which is not otherwise permissible under income tax rules.

g. Favorable terms The terms of financial arrangements with institutions are usually restrictive and disadvantageous to loanees. Lease arrangements allow the use of the asset on favorable terms.

h. Guards against obsolescence In the case of operating lease, the lessee can be protected from the risk of obsolescence of the asset leased, since it is always possible for the lessee to terminate the existing lease arrangement anytime, and to take up another asset under a fresh lease. This becomes all the more significant in the context of rapid technological changes.

i. Avoidance of initial cash outlay Leasing provides 100 percent financing and the benefit of using the finances without having to borrow. The initial investment required is thus avoided in a leasing arrangement.

j. Better liquidity 'Sale and Lease-back' arrangements provide the advantage of better liquidity, since it enables the lessee to make a sale of the asset owned to the prospective lessor, and then take the asset back on lease. This helps a lessee-firm to overcome a liquidity crunch by being in a position to sell and realize cash. This helps overcome working capital crises.

k. Other benefits

(i) Avoidance of applicability of the provisions of FEMA

(ii) Lease rentals are permissible for reimbursement, even under government contracts

(iii) Provision of long-term finance without diluting ownership/control

(iv) Leasing avoids complex decisions relating to capital budgeting exercises, especially in the context of government companies, where capital budgeting is quite cumbersome

(v) No trouble in the disposal of the used asset by the user-lessee, since the asset reverts to the lessor on expiry of the lease contract

(vi) Efficient mode of financing which allows piecemeal acquisition of small equipments

(vii) No disturbance to the normal lines of credit

(viii) Easy and convenient payment of lease rentals, which is unaffected even during the inflation periods

(ix) An ideal mode of asset acquisition, especially for non-profit organizations such as hospitals, which are continuously confronted with the budget constraints

LIMITATIONS OF LEASE FINANCING

Although leasing is claimed to be possessing certain overriding advantages over the traditional buy-and-use mode of financing, it is fraught with various limitations as discussed below:

1. ***Disguised debt financing*** Evidence has been gained through studies that lease financing is another form of debt financing. In fact, it is considered to be a disguised form of debt financing. It essentially involves borrowing of an asset, instead of funds. Moreover, the obligations of leasing are similar to those incurred under debt financing. In a survey conducted in the U.S. in 1959, it has been found that leasing was an intermediate between secured and unsecured debt.
2. ***Costly option*** When the leasing company acts only as a financial intermediary, and borrows from the market at prevailing or even higher interest rates, leasing may prove to be a costlier exercise as compared with a straight borrowing.
3. ***Loss of tax shield*** If depreciation rates are higher, and leasing is preferred over buying, it may result in loss of depreciation tax shield for the lessee.
4. ***Double sales tax*** Depending on the prevailing sales tax laws in various states, there are possibilities of the lease rental revenues attracting sales tax twice, once at the time of the sale and again when the asset is leased out.
5. ***Loss of residual value*** There is a loss of residual value for the lessee, since the leased asset has to be returned to the lessor at the end of the lease period. If the residual value of the leased asset fetches a substantial amount of scrap, it would bring the advantages of cash flow. Moreover, sale of residue sometimes acts as a protective shield against inflationary erosion of money.
6. ***Unfavorable gearing*** Like any other borrowing, leasing also creates fixed obligations. This results in an increase in the capital gearing of the company. This might be disadvantageous to the borrowing capacity of the company.

7. ***No ownership*** Unfortunately leasing does not provide the advantage of ownership to the users. This is not suitable especially for those who would not be satisfied merely with the right of usage, as against the right of ownership, of the asset.
8. ***Risk of default*** If the lessor has borrowed funds in hypothecation in order to acquire the asset for being leased out and if there is a default in the repayment of instalments, the asset may be taken over by the financial institution. This might hamper the interest of the lessee and ultimately affect business.
9. ***No working capital*** Leasing provides a mechanism only for long-term capital requirements. It fails to provide access to much needed working capital finance.
10. ***Indiscriminate finance*** Lease companies provide lease financial assistance to the lessee, sometimes too enthusiastically, without considering their requirements, project feasibility, repayment capability, etc. This attitude of indiscriminate financing defeats the genuine object of leasing.
11. ***Long-term venture*** The lessor is in a relatively disadvantageous position, since funds are required to be invested for a longer term. It naturally takes years to recover the original cost of the assets that are leased out, which in turn exposes the lessor to various types of risks.

REVIEW QUESTIONS

Section A

1. Define 'leasing'
2. What is a leasing contract?
3. Who are the parties to a leasing contract?
4. What is a 'financial lease'?
5. What is an operating lease?
6. What is a full payout lease?
7. What is a 'net lease'?
8. What is a leveraged lease?
9. What is sale and lease back?
10. What is consumer leasing?
11. What is a 'balloon lease'?
12. What is swap leasing?
13. What is a close-end leasing?
14. What is an open-end leasing?

15. What is import leasing?
16. What is cross-border leasing?
17. What is 'double dip' and 'triple dip' in leasing?
18. What is international leasing?
19. What is a 'Samurai lease'?
20. What is a 'Shogun lease'?
21. What is a 'Mushashi lease'?

Section B

1. Explain the mechanism of lease financing.
2. Outline the special procedures relating to import leasing as per the Export-Import policy of 1990-93.
3. Distinguish between financial lease and operating lease.
4. What are the tests applied in a leasing contract to determine whether or not the lease is a financial lease?
5. Explain the leasing process with the help of a chart.
6. What are the services rendered by a lessor?
7. How is a leasing contract beneficial to the lessee?
8. How is a leasing contract beneficial to the lessor?

Section C

1. What are the characteristic features of a lease? Explain.
2. How are leases classified? Explain.
3. Expose the myth about lease financing.
4. Detail the functions of the various participants in a leasing contract.
5. Explain the various advantages of lease financing.
6. What are the limitations of lease financing? Explain.

Chapter 11

Accounting for Lease

LEASE

An agreement whereby the right to use an asset is conveyed by the lessor to the lessee is known as lease.

Financial Lease

A type of lease where the present value of the minimum lease payments at the commencement of the lease exceeds, or is equal to, the fair value of the leased asset is called 'financial lease'. In other words, a lease is classified as financial lease provided it secures for the lessor, the recovery of the capital outlay and a return on the funds invested during the lease period. Minimum lease payments constitute the periodical lease rentals payable by the lessee during the lease period. It also includes the residual value that is expected to be fetched by the leased asset. Fair value of the leased asset means the estimated exchange value of the asset. Residual value is the salvage value of leased asset at the time of expiry of the lease term. Lease period is the noncancelable period for which the lessee has contracted the use of the asset.

Operating Lease

A lease, which is cancelable at the option of the lessee, and which does not secure for the lessor the recovery of the capital outlay and a return on the funds invested during the lease period, is known as 'operating lease'.

ACCOUNTING AND REPORTING FOR FINANCIAL LEASE—BOOKS OF THE LESSOR

Adjustment in Profit and Loss Account

1. ***Receipt of Lease Rental***
   - Debit Cash
   - Credit Lease Rental
2. ***Provision for Depreciation***
   - Debit Statutory Depreciation
   - Credit Leased Asset

3. ***Charging Statutory Depreciation***
   - Debit Profit and Loss Account
   - Credit Statutory Depreciation
4. ***Recording Lease Rental***
   - Debit Lease Rental
   - Credit Profit and Loss Account
5. ***Introducing Lease Equalization Account (LEA)***
   - Debit Lease Equalization Account
   - Credit Lease Adjustment Account
     (Where annual lease charge is more than statutory depreciation)
   - Debit Lease Adjustment Account
   - Credit Lease Equalization Account
     (Where annual lease charge is less than statutory depreciation)
6. ***Transfer of LEA to Profit and Loss Account***
   - Debit Profit and Loss Account
   - Credit Lease Equalization Account
     (Where annual lease charge is more than statutory depreciation)
   - Debit Lease Equalization Account
   - Credit Profit and Loss Account
     (Where annual lease charge is less than statutory depreciation)

Adjustment in Balance Sheet

The carried down balance of Lease Adjustment Account for each year is shown on the assets side of the balance sheet, duly deducted from the cost of leased asset. Alternatively, it may also be shown under the head 'Current Assets', where the balance of the terminal year is shown deducted from the cost of leased asset.

The accumulated statutory depreciation shall be shown to be deducted each year from the cost of the leased asset.

Where,

1. ***Statutory depreciation*** means the minimum depreciation that is required to be charged to the profit and loss account in accordance with the provisions of the Companies Act, 1956

2. ***Lease equalization account*** is the temporary account introduced to provide a cushion to offset the differences between annual lease charge and statutory depreciation. It is transferred each year to the profit and loss account
3. ***Lease adjustment account*** is an account introduced as a corresponding account to the Lease Equalization Account, and is adjusted in the balance sheet as shown above

Important Computations

a. Implicit rate of interest It is the rate of interest at which the total present value of the minimum lease payments is equal to the fair value of the leased asset at the inception of the lease. The rate at which the minimum lease payments are discounted to determine the present value is arrived through trial and error. In, cases where it is not possible to arrive at the exact rate of interest by trial and error, it is determined by the interpolation method as follows:

$$\text{Lower Trial Rate} + \left\{ \frac{D_2}{D_1} \times D_3 \right\}$$

where,

D_2 is the difference of total present values of minimum lease payments at lower trial interest rate and the fair value of the leased asset

D_1 is the difference of total present values of minimum lease payments at lower trial interest rate and at higher trial interest rate

D_3 is difference between higher and lower trial interest rates in absolute terms

b. Net annual lease charge It represents the recovery of the net investment/fair value of the leased asset. The minimum lease payments are normally greater than the financial income.

$$\text{Minimum Lease Payments} > \text{Finance Income}$$

c. Finance income It is determined by using two methods, namely Implicit interest method and Weighted method.

Implicit interest method In this method, the finance income is calculated at the implicit rate of interest on the outstanding net investment each year.

Weighted method Using this method, the finance income is apportioned for each year as given below:

$$\frac{\text{Total Finance Income} \times \text{Outstanding MLP Each Year}}{\text{Total of Outstanding MLP Each Year}}$$

d. Outstanding net investment The outstanding net investment in lease has to be greater than the minimum lease payments.

Net Investment in the lease > Minimum Lease Payments

e. Net investment in lease Each year's Net Investment in Leased Asset is greater than Net Annual Lease Charge for that year.

f. Lease equalization account It is the amount of difference of the annual lease charge and the statutory depreciation.

ACCOUNTING AND REPORTING FOR FINANCIAL LEASE—BOOKS OF THE LESSEE

The leased asset should be disclosed in the balance sheet only as a note, mentioning the future obligations of the lessee as laid out in the lease agreement. Lease rentals should be accounted on an accrual basis over the lease term. This is done to recognize an appropriate charge in the profit and loss account. The appropriate charge should be determined in reference to the lease agreement, type of the asset, proportion of the lease period to the life of the asset as specified by technical/commercial evaluation and other such considerations. The excess of the lease rentals paid over and above the amount accrued in respect thereof should be treated as prepaid lease rental and vice versa.

ACCOUNTING AND REPORTING FOR OPERATING LEASE—BOOKS OF THE LESSOR

Illustration*

Vinayak Ltd. furnishes you the following details relating to their activities of leasing of a Super Computer:

Cost of Super Computer	Rs. 60,000
Estimated Exchange value of Super Computer at the time of its inception, i.e. 1.4.2005	Rs. 60,000
Term of lease	4 years

Lease Rentals payable in advance by Karthik Ltd are:

1.4.2005	Rs. 35,000
1.4.2006	Rs. 16,000
1.4.2007	Rs. 8,000
1.4.2008	Rs. 4,500

* Adapted from the Guidance Note on Accounting for Leases issued by the ICAI, New Delhi, 1995.

The company had the following items of assets and liabilities:

- Equity share capital Rs. 2,60,000
- Other Fixed Assets Rs. 2,00,000

It has estimated that the computer would have a salvage value of 5 percent of the cost of the asset to Vinayak Ltd. It has been provided that the lessee could continue the lease upto the end of the lease term. The relevant statutory rate of depreciation under the Written Down Value method is 40 percent.

You are required to show the following in the books of Vinayak Ltd:

1. Type of the lease activity
2. Implicit rate of interest
3. Gross investment in the lease
4. Unearned finance income
5. Net lease investment
6. Statutory depreciation
7. Distribution of finance income
8. Annual lease charge
9. Amount to be transferred to Lease Equalization Account (LEA) and the Lease Adjustment Account (LAA)
10. Relevant accounting entries for the lease term
11. Following ledger accounts:
    a. Cash Account
    b. Lease Rental Account
    c. Statutory Depreciation Account
    d. Profit and Loss Account
    e. Lease Equalization Account
    f. Lease Adjustment Account
12. Balance sheet of Vinayak Ltd. for the lease term

Solution

The relevant solution for the above illustration is presented below:

Type of Lease Activity

In order to determine the nature of lease activity, the test to be used is, whether the total present values of Minimum Lease Payments (MLP) are either equal to, or greater than, the fair value of the leased asset. To arrive at the present value of MLPs, the appropriate discount rate has to be calculated. This, therefore, entails the computation of the implicit rate of interest.

Implicit Rate of Interest

The implicit rate of interest is determined by the trial and error method. Assuming a trial interest rate of 14 percent, the following calculations can be set up:

Year	MLP Rs.	Trial Rate – 14 %	
		PVF	PV of MLP (Rs)
Beginning of 2005	35,000	1.00	35,000
Beginning of 2006	16,000	0.877	14,032
Beginning of 2007	8,000	0.769	6,152
Beginning of 2008	4,500	0.675	3,038
End of 2008	3,000	0.592	1,776
Total	**66,500**	-	**59,998**

As depicted in the above table, at the trial interest rate of 14 percent, the total of present values of MLPs, Rs. 59,998, are approximately equal to the fair value of the leased asset, Rs. 60,000. Hence, it is concluded that the implicit rate of interest is 14 percent.

As concluded from the above computations, it is a case of financial lease because the total present values of Minimum Lease Payments (MLP) are equal to the fair value of the leased asset.

Gross Investment in the Lease = Total of MLPs + estimated salvage value of the leased asset, i.e.

Rs. 63,500 + Rs. 3,000 = Rs. 66,500

Unearned Finance Income = Gross Investment in the Lease – Total PV of MLPs

Rs. 66,500 – Rs. 60,000 = Rs. 6,500

Statutory Depreciation

BV at the Beginning Rs.	Depreciation @ 40% - WDV Rs.	BV at the End Rs.
60,000	24,000	36,000
36,000	14,400	21,600
21,600	8,640	12,960
12,960	5,184	7,776

Finance Income and other calculations

The calculation of finance income and other items are as follows:

Method I Implicit Interest Method—Computation Table

1	2	3 (3 – 6)	4 (3 – 2)	5 (4 × 14%)	6 (2 – 5)	7 (3 – 6)	8 (6 – Dep)	9	
Year Beginning	MLP	Net Lease Investment	Net Lease Investment	Finance Income @ 14%	Annual Lease Charge	Net Lease Investment at the End	Lease Equalization Account	Lease Adjustment Account	
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
2005	35,000	60,000	25,000	3,500	31,500	28,500	7,500 Dr	7,500 Cr	7,500 Cr
2006	16,000	28,500	12,500	1,750	14,250	14,250	150 Cr	150 Dr	7350 Cr
2007	8,000	14,250	6,250	875	7,125	7,125	1,515 Cr	1,515 Cr	5,835 Cr
2008	4,500	7,125	2,625	368	4,132	2,993	1,941	-	-
End of 2008	3,000*	2,993	-	-	2.993	-	-	1,941 Cr	7,776 Cr

* Salvage value

Method II Weighted Method—Computation Table

1	2	3	4	5 (2 – 4)	6 (5 – Dep)	7	
Year Beginning	MLP	MLP O/S	Finance Income	Annual Lease Charge	Lease Equalization Account	Lease Adjustment Account	
						Actual	Cumulative
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
2005	35,000	31,500	3,561	31,439	7,439 Dr	7,439 Cr	7,499 Cr
2006	16,000	15,500	1,752	14,248	152 Cr	152 Dr	7,287 Cr
2007	8,000	7,500	848	7,152	1,488 Cr	1,488 Dr	5,799 Cr
2008	4,500	3,000	339	4,161	-	-	-
End of 2008	3,000*	-	-	3,000	1,977 Dr	1,977 Cr	7,776 Cr
Total	66,500	-	6,500	60,000	-	-	-

$$* \frac{\text{Rs.}6{,}500 \times \text{MLPo/s}}{57{,}500}$$

Accounting Entries—Under Implicit Interest Method

Particulars	2005 Rs.	2006 Rs.	2007 Rs.	2008 Rs.
Debit Cash A/c	35,000	16,000	8,000	7,500
Credit Lease Rental A/c	35,000	16,000	8,000	4,500
Credit Salvage A/c	-	-	-	3,000
Debit Lease Rental A/c	35,000	16,000	8,000	4,500
Debit Salvage A/c	-	-	-	3,000
Credit P & L A/c	35,000	16,000	8,000	7,500
Debit Profit & Loss A/c	24,000	14,400	8,640	5,184
Credit Statutory Depr.	24,000	14,400	8,640	5,184
Debit Lease Equ. A/c	7,500	-	-	1,941
Credit Lease Adj. A/c	7,500	-	-	1,941
Debit Lease Adj. A/c	-	150	1,515	-
Credit Lease Equ. A/c	-	150	1,515	-
Debit Lease Adj. A/c	-	150	1,515	-
Credit P & L A/c	-	150	1,515	-
Debit P & L A/c	7,500	-	-	1,941
Credit Lease Equ. A/c	7,500	-	-	1,941

Ledger Accounts—Under Implicit Interest Method

Cash Account			
To Lease Rental	35,000	By Balance c/d	35,000
To Balance b/d	35,000	By Balance c/d	51,000
To Lease Rental	16,000		
To Balance b/d	51,000	By Balance c/d	59,000
To Lease Rental	8,000		
To Balance b/d	59,000	By Balance c/d	66,500
To Lease Rental	7,500		

Lease Rental Account

To Profit & Loss A/c	35,000	By Cash	35,000
To Profit & Loss A/c	16,000	By Cash	16,000
To Profit & Loss A/c	8,000	By Cash	8,000
To Profit & Loss A/c	7,500	By Cash	7,500

Profit and Loss Account

To Statutory Depreciation A/c	24,000	By Lease Rental A/c	35,000
To Lease Equalization A/c	7,500		
To Balance c/d	3,500		
To Statutory Depreciation A/c	14,400	By Balance b/d	3,500
To Balance c/d	5,250	By Lease Rental A/c	16,000
		By Lease Equalization A/c	150
To Statutory Depreciation A/c	8,640	By Balance b/d	5,250
To Balance c/d	6,125	By Lease Rental A/c	8,000
		By Lease Equalization A/c	1,515
To Statutory Depreciation A/c	5,181	By Balance b/d	6,125
To Lease Equalization A/c	1,941	By Lease Rental A/c	7,500
To Balance c/d	6,503		

Statutory Depreciation Account

To Computer on Lease A/c	24,000	By Profit & Loss A/c	24,000
To Computer on Lease A/c	14,400	By Profit & Loss A/c	14,400
To Computer on Lease A/c	8,640	By Profit & Loss A/c	8,640
To Computer on Lease A/c	5,184	By Profit & Loss A/c	5,184

Lease Equalization Account

To Lease Adjustment A/c	7,500	By Profit & Loss A/c	7,500
To Profit & Loss A/c	150	By Lease Adjustment A/c	150
To Profit & Loss A/c	1,515	By Lease Adjustment A/c	1,515
To Lease Adjustment A/c	1,941	By Profit & Loss A/c	1,951

Lease Adjustment Account			
To Balance c/d	7,500	By Lease Equalization A/c	7,500
To Lease Equalization A/c	150	By Balance b/d	7,500
To Balance c/d	7,350		
To Lease Equalization A/c	1,515	By Balance b/d	7,350
To Balance c/d	5,835		
To Computer on Lease A/c	7,776	By Balance b/d	5,835
		By Lease Equalization A/c	1,941

Accounting Entries—Under Weighted Method

Particulars	2005 Rs.	2006 Rs.	2007 Rs.	2008 Rs.
Debit Cash A/c	35,000	16,000	8,000	7,500
Credit Lease Rental A/c	35,000	16,000	8,000	4,500
Credit Salvage A/c	-	-	-	3,000
Debit Lease Rental A/c	35,000	16,000	8,000	4,500
Debit Salvage A/c	-	-	-	3,000
Credit P & L A/c	35,000	16,000	8,000	7,500
Debit Profit & Loss A/c	24,000	14,400	8,640	5,184
Credit Statutory Depr.	24,000	14,400	8,640	5,184
Debit Lease Equ. A/c	7,439	-	-	1,977
Credit Lease Adj. A/c	7,439	-	-	1,977
Debit Lease Adj. A/c	-	152	1,488	-
Credit Lease Equ. A/c	-	152	1,488	-
Debit Lease Equ. A/c	-	152	1,488	-
Credit P & L A/c	-	152	1,488	-
Debit P & L A/c	7,439	-	-	1,977
Credit Lease Equ. A/c	7,439	-	-	1,977

Ledger Accounts—Under Weighted Method

Cash Account

To Lease Rental	35,000	By Balance c/d	35,000
To Balance b/d	35,000	By Balance c/d	51,000
To Lease Rental	16,000		
To Balance b/d	51,000	By Balance c/d	59,000
To Lease Rental	8,000		
To Balance b/d	59,000	By Balance c/d	66,500
To Lease Rental	7,500		

Lease Rental Account

To Profit & Loss A/c	35,000	By Cash	35,000
To Profit & Loss A/c	16,000	By Cash	16,000
To Profit & Loss A/c	8,000	By Cash	8,000
To Profit & Loss A/c	7,500	By Cash	7,500

Profit and Loss Account

To Statutory Depreciation A/c	24,000	By Lease Rental A/c	35,000
To Lease Equalization A/c	7,439		
To Balance c/d	**3,561**		
To Statutory Depreciation A/c	14,400	By Balance b/d	3,561
To Balance c/d	**5,313**	By Lease Rental A/c	16,000
		By Lease Equalization A/c	152
To Statutory Depreciation A/c	8,640	By Balance b/d	5,313
To Balance c/d	**6,161**	By Lease Rental A/c	8,000
		By Lease Equalization A/c	1,488
To Statutory Depreciation A/c	5,181	By Balance b/d	6,161
To Lease Equalization A/c	1,977	By Lease Rental A/c	7,500
To Balance c/d	**6,503**		

Statutory Depreciation Account			
To Computer on Lease A/c	24,000	By Profit & Loss A/c	24,000
To Computer on Lease A/c	14,400	By Profit & Loss A/c	14,400
To Computer on Lease A/c	8,640	By Profit & Loss A/c	8,640
To Computer on Lease A/c	5,184	By Profit & Loss A/c	5,184

Lease Equalization Account			
To Lease Adjustment A/c	7,439	By Profit & Loss A/c	7,500
To Profit & Loss A/c	152	By Lease Adjustment A/c	152
To Profit & Loss A/c	1,488	By Lease Adjustment A/c	1,488
To Lease Adjustment A/c	1,977	By Profit & Loss A/c	1,977

Lease Adjustment Account			
To Balance c/d	7,439	By Lease Equalization A/c	7,439
To Lease Equalization A/c To Balance c/d	152 7,287	By Balance b/d	7,439
To Lease Equalization A/c To Balance c/d	1,488 5,799	By Balance b/d	7,287
To Computer on Lease A/c (Balancing figure)	7,776	By Balance b/d By Lease Equalization A/c	5,799 1,977

Balance Sheet—Under Implicit Method–2005

Liabilities	**Rs.**	**Assets**	**Rs.**
Equity Capital	2,60,000	Computer on Lease Less: Depreciation Less: Lease Adj. A/c	60,000 24,000 7,500
Profit & Loss A/c	3,500		**28,500**
		Other Fixed Assets	2,00,000
		Cash	35,000
Total	**2,63,500**		**2,63,500**

Balance Sheet–2006

Liabilities	Rs.	Assets	Rs.
Equity Capital	2,60,000	Computer on Lease	60,000
Profit & Loss A/c	5,250	Less: Accu. Depreciation	38,400
		Less: Lease Adj. A/c	7,350
			14,250
		Other Fixed Assets	2,00,000
		Cash	51,000
Total	**2,65,250**		**2,65,250**

Balance Sheet–2007

Liabilities	Rs.	Assets	Rs.
Equity Capital	2,60,000	Computer on Lease	60,000
Profit & Loss A/c	6,125	Less: Accu. Depreciation	47,040
		Less: Lease Adj. A/c	5,835
			7,125
		Other Fixed Assets	2,00,000
		Cash	59,000
Total	**2,66,125**		**2,66,125**

Balance Sheet–2008

Liabilities	Rs.	Assets	Rs.
Equity Capital	2,60,000	Computer on Lease	60,000
Profit & Loss A/c	6,503	Less: Accu. Depreciation	52,224
		Less: Lease Adj. A/c	7,776
			Nil
		Other Fixed Assets	2,00,000
		Cash	66,500
Total	**2,66,503***		**2,66,500**

* Due to approximations

Balance Sheet—Under Weighted Method–2005

Liabilities	Rs.	Assets	Rs.
Equity Capital	2,60,000	Computer on Lease	60,000
Profit & Loss A/c	3,561	Less: Depreciation	24,000
		Less: Lease Adj. A/c	7,439
			28,561
		Other Fixed Assets	2,00,000
		Cash	35,000
Total	**2,63,561**		**2,63,561**

Balance Sheet–2006

Liabilities	Rs.	Assets	Rs.
Equity Capital	2,60,000	Computer on Lease	60,000
Profit & Loss A/c	5,313	Less: Accu. Depreciation	38,400
		Less: Lease Adj. A/c	7,287
			14,313
		Other Fixed Assets	2,00,000
		Cash	51,000
Total	**2,65,313**		**2,65,313**

Balance Sheet–2007

Liabilities	Rs.	Assets	Rs.
Equity Capital	2,60,000	Computer on Lease	60,000
Profit & Loss A/c	6,161	Less: Accu. Depreciation	47,040
		Less: Lease Adj. A/c	5,799
			7,161
		Other Fixed Assets	2,00,000
		Cash	59,000
Total	**2,66,161**		**2,66,161**

Balance Sheet–2008

Liabilities	Rs.	Assets	Rs.
Equity Capital	2,60,000	Computer on Lease	60,000
Profit & Loss A/c	6,503	Less: Accu. Depreciation	52,224
		Less: Lease Adj. A/c	7,776
			Nil
		Other Fixed Assets	2,00,000
		Cash	66,500
Total	**2,66,503***		**2,66,500**

* Due to approximations

REVIEW QUESTIONS

Section A

1. What is 'implicit rate of interest'?
2. What is net annual lease charge?
3. What is 'finance income'?
4. What is 'lease equalization account'?

Section C

1. Explain and illustrate the accounting and reporting for financial lease.

Chapter 12

Hire Purchase

DEFINITION

A transaction of finance whereby goods are bought and sold as per the terms and conditions specified below is known as 'hire purchase finance'.

1. Payment of periodic instalments
2. Immediate possession of goods by the buyer
3. Ownership of goods remaining with the vendor until the payment of the last instalment
4. Vendor's right to repossess the goods in the event of default committed by the buyer
5. Treatment of each instalment as hire charge till the payment of the last instalment

According to the Hire Purchase Act of 1972, the term 'hire purchase' is defined as, "an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement, and includes an agreement under which:

- Possession of goods is delivered by the owner thereof to a person on the condition that such person pays the agreed amount in periodic payments
- The property of the goods is to pass to such a person on the payment of the last of such instalment
- Such a person has a right to terminate the agreement any time before the property so passes."

RIGHTS OF HIRER

The Hire Purchase Act of 1972, provides the following rights to the hirer:

Right of Protection

It is not possible for the hire vendor to terminate the hire purchase agreement on account of default in payment of hire charges by the hirer, or due to unauthorized act or breach of express conditions, unless the hire vendor gives notice in writing to the hirer in this regard.

Right of Notice

When the hire charges are weekly, or for a period less than that, one week notice is to be given, and in all other cases a two weeks notice is to be given.

Right of Repossession

The right of repossession is not available to the hire vendor, unless sanctioned by the court in the following cases:

1. One half of the price has been paid where the hire purchase price is less than Rs.15,000 (Rs.5,000 in the case of motor vehicles)
2. Three fourth of the price has been paid where the hire purchase price is not less than Rs. 15,000 (Rs.5,000 in the case of motor vehicles)
3. Three fourth or such higher proportion, not exceeding nine-tenth, where the hire purchase price is not less than Rs. 15,000

Right of Statement

The hirer has the right to obtain a statement on payment of Re.1, containing details such as the amount paid by the hirer, the amount and the date upon which the instalment becomes due but has not been paid, the amount of instalment, which will become payable, etc.

Right to Excess Amount

The hirer has the right to obtain any amount in excess of the value of goods repossessed, over and above the amount of instalments payable by the hirer, in the erent of a default.

RATE OF INTEREST

The type of interest rates popularly used in hire purchase financing is as follows:

Add-on Rate of Interest

Add-on rate of interest refers to that rate of interest which is chargeable in hire purchase as a percent of the original cash price of the asset. In other words, the hire purchase agreement will not specify a rate, but will only specify the total quantum of interest.

Flat Rate of Interest

It is the discount rate applied to a figure from which the amount of discount is deducted at the outset.

Effective Rate of Interest

Effective rate of interest, also known as true rate of interest, is the rate of interest, arrived at by trial and error, at which the total present value of the stream of instalments is equal to the cash price of the asset bought on hire purchase.

Effective rate of Interest = Trial rate at which NPV of future HP instalments is zero

LEASE FINANCING VS. HIRE PURCHASE FINANCING

Following points of distinction exist between lease financing and hire purchase financing:

Sl. No.	Characteristics	Lease Financing*	HP Financing
1.	Ownership	Ownership of the property lies with the finance company, the lessor, and it is never transferred to the lessee, the user	Ownership of the property is transferred to the hirer on the payment of the last instalment
2.	Depreciation	Lessor, and not the lessee, is entitled to claim depreciation tax shield	The hirer (owner) is entitled to claim depreciation tax shield
3.	Capitalization	Capitalization of the asset is done in the books of the lessor, the leasing company	Capitalization of the asset is done in the books of the hirer
4.	Payments	The entire lease payments are eligible for tax computation in the books of the lessee	Only the hire-interest is eligible for tax computation in the books of the hirer
5.	Salvage Value	The lessor, and not the lessee, has the right to claim the benefit of salvage value	The hirer can claim benefit of salvage value as the prospective owner of the asset
6.	Magnitude	Leasing is used as a source of finance, usually for acquiring high cost assets such as machinery, ships, airplanes, etc	Hire purchase is used as a source of finance, usually for acquiring relatively low cost assets such as automobiles, office equipments, etc

* With reference to 'operating lease'

7.	Down Payment	No down payment is required for acquiring the use of the leased assets	Down payment is required to be made for acquiring the asset and there is a margin maintained to the extent of 20–25 percent
8.	Reporting	In the books of the lessee, leased assets are disclosed by way of a note only	The asset bought on hire purchase will be shown as an asset, and the amount of instalments payable to the lessor as a liability
9.	Maintenance of Asset	Whereas the lessee has to maintain the leased asset in the case of financial lease, upkeep is the responsibility of the lessor in the case of operating lease	It is the hirer's responsibility to ensure the maintenance of the asset bought
10.	Suitability	It is not suitable for the low-capital enterprises which desire to show a strong asset position in their balance sheets	It is highly suitable for the low-capital enterprises which need to show a strong asset position in their balance sheets
11.	Nature of Asset	An asset given on lease by a leasing company is considered as the fixed asset of the lessor	The hire vendor normally shows the asset let under HP either as stock in trade, or as receivables
12.	Receipts	All receipts from the lessee is taken into the lessor's profit and loss account	Only the interest portion is taken into the hire-vendor's profit and loss account
13.	Income	Lessor's income declines as the investment outstanding in the lease declines	In the case of HP transactions, finance charges are allocated to the HP period equally

ACCOUNTING FOR HIRE PURCHASE

In the comparative evaluation between leasing and hire purchase, calculation of interest and the split of the instalment amount into 'interest and principal' components assume importance, especially where the flat rate of interest only is available in the problem. Interest amount is calculated by applying a rate of interest on the principal amount outstanding at the beginning of each period. The principal amount is determined as the difference between 'instalment amount per period and the interest amount per period.' The mode of interest calculation is discussed below:

METHODS OF INTEREST CALCULATION

(All methods assume annual payment at the end of the year)

1. Effective rate of interest or annual percentage rate method
2. Sum-of-years digits method
3. Straight-line method

Effective Rate of Interest (ERI)

Effective Rate of Interest (ERI) method, also known as Annual Percentage rate Method, is a method of interest calculation where the effective rate of interest is determined by the popular *'IRR'* technique. Accordingly, effective rate of interest is that rate of interest, which equates the PV of all future annual instalment payments, with the HP principal payable at the beginning of the hire purchase contract. The HP principal payable is the excess of the cost of the asset hire purchased, over and above the down payment made. Following are the steps involved in the determination of ERI:

Step 1 Find HP principal = Cost of asset – Down payment

Step 2 Find Total interest amount for the HP period = [HP principal × Flat rate of interest × HP period of years]

Step 3 Find Total HP amount = [Step 1 + Step 2]

Step 4 Find Annual instalment amount = [Step 3 ÷ No. of instalments]

Step 5 Find Effective Rate of Interest (ERI)

Rate of Interest: → PV of Future Annual Instalments = PV of HP principal amount payable

Step 6 Find Annual Interest Amount = Total Principal outstanding at the beginning × ERI

Sum-of-years Digits Method

Under this method, the annual amount of interest is determined as follows:

Annual amount of interest = [Number of years of remaining HP period including the current year ÷ Total of all digits representing the period of HP] × Total amount of interest for HP period where,

Total amount of interest for HP period   Total amount payable

Flat rate of Interest

Straight-line Method

Under this method, the annual amount of interest is determined as an equated annual financial charge as follows:

Annual amount of interest   Total amount of interest for HP period

No. of HP periods

METHOD OF REPORTING

The interest charged and the principal component are to be separately disclosed in the books of the hirer and the hire vendor. The relevant method of reparting for hire purchase finance transactions is presented below:

Disclosure in Hirer Books

1. The annual interest and depreciation charge must be debited to the P and L account every year, until the loan is paid off
2. The principal component of outstanding hire purchase each year must be shown in the balance sheet by way of current liability of hire purchase outstanding within one year, and by way of secured loan of hire purchase outstanding for periods more than one year

Disclosure in Hire Vendor Books

1. Cost of HP deal shall be debited to P and L account
2. The interest received from the hirer each year constitutes finance income, and shall be credited to P and L account

LEASE VS. HIRE PURCHASE EVALUATION

The hirer makes the evaluation of the desirability for lease and HP. Theconsidered hirer makes a decision based on the PV of net cash outflow. The decision for HP is considered favorable where the PV of net cash outflow under HP is less than the PV of net cash outflow under leasing. Following are the steps involved:

Step 1 Calculate annual interest amount

Step 2 FindPrincipal amount outstanding at the beginning of each year

= Total outstanding principal – principal paid in the previous year

Step 3 Find Principal paid in the previous year = Annual instalment amount – Annual Interest

Step 4 Find Annual ITS = Annual Interest × Tax rate

Step 5 Find Annual depreciation

Step 6 Find Annual DTS = Annual depreciation × Tax rate

Step 7 Find Total TS = Step 4 + Step 6

Step 8 Find Annual instalment amount

= Total HP amount + [HP amount × Flat rate of interest] ÷ No. of HP years

Step 9 Find PV of salvage value of asset = SV × PVF

ty = Terminal year K = Cost of capital

Step 10 Find Net cash outflow of HP = Step 8 – Step 7

Step 11 Find PV of net cash outflow of HP at the appropriate discount rate

Step 12 Find Total PV net cash outflow of HP = Step11 – Step 9

Step 13 Find Tax shield on annual lease rentals = Annual Lease rental × Tax rate

Step 14 Find Net cash outflow of Leasing = [Annual lease rental – Step13]

Step 15 Find Total PV of net cash outflow of Leasing at the appropriate discount rate

= Net cash outflow of Leasing × PVAF

n_K = number of lease years at a 'K' interest rate

Step 16 Make a decision: HP is desirable if total PV of net cash outflow of HP is less than that of leasing

Illustration

Following details pertain to a company manufacturing air bags required for the luxury cars:

1. Cost of equipment Rs. 5,00,000
2. Down payment 25% of cost price
3. Number of instalments payable at the end of each year is 4
4. Flat rate of interest 14% p.a.
5. Appropriate discount rate 18%
6. Annual lease rentals Rs. 1,00,000 with a lease period of 5 years
7. Tax rate 50%
8. Depreciation to be charged on SLM, the salvage being Rs. 40,000 at the end of 4 years

The company is examining two financing alternatives, HP and leasing. You are required to give your considered opinion about the choice of financing to be adopted by the firm. Also determine the annual amount of interest under the three methods. Show the disclosure in the financial statements of the hirer for all the years of the finance and capital charge, presuming that the company prefers HP financing.

Solution

I. Calculation of ERI

a. Flat rate of interest = 14%

b. Cost of equipment = Rs.5,00,000

c. Down payment 25% = 0.25 × 5,00,000 = Rs.1,25,000

d. HP principal amount = 5,00,000 – 1,25,000 = Rs.3,75,000

e. HP interest = [3,75,000 × 0.14 × 4] = Rs.2,10,000

f. Total HP amount = 3,75,000 + 2,10,000 = Rs.5,85,000

g. Annual Instalment amount = 5,85,000 ÷ 4 = Rs.1,46,250

h. ERI by trial and error:

Instalment Amount	Trial I – 20%		Trial II – 21%	
	PVF	PV	PVF	PV
1,46,250	0.833	1,21,826	0.826	1,20,803
1,46,250	0.694	1,01,498	0.683	99,889
1,46,250	0.579	84,679	0.564	82,485
1,46,250	0.482	70,493	0.467	68,299
	Total	3,78,496	**Total**	3,71,476

Since the exact required HP principal amount of 3,75,000 could not be reached in the above process, ERI is determined as follows:

$$20\% + [3{,}75{,}000 - 3{,}71{,}476] / 3{,}78{,}496 - 3{,}71{,}476 = 20.50\%$$

Net Cash Out flow

- Under HP = **Rs. 1,42,809**
- Under Leasing = **Rs. 1,56,350**

Decision

Since acquiring the use of the equipment under the HP scheme involves less net cash outflow, which is lower than that under the lease option, the company is well advised to choose the HP option.

II. Annual Interest

Year	O/S Principal ERI	Interest Paid			Principal Paid			Annual Instalment		
		ERI	SOYD	SLM	ERI	SOYD	SLM	ERI	SOYD	SLM
1.	3,75,000	76,875	84,000	52,500	69,375	62,250	93,750	1,46,250	1,46,250	1,46,250
2.	3,05,625	62,653	63,000	52,500	83,597	83,250	93,750	1,46,250	1,46,250	1,46,250
3.	2,22,028	45,516	42,000	52,500	1,00,734	1,04,250	93,750	1,46,250	1,46,250	1,46,250
4.	12,194	24,865	21,000	52,500	1,21,294	1,25,250	93,750	1,46,250	1,46,250	1,46,250

Annual Interest under SOYD

Year 1 = $[(4 \times 2{,}10{,}000) \div (4 \times 5)] \div 2$ = Rs.84,000

Year 2 = $[(3 \times 2{,}10{,}000) \div (4 \times 5)] \div 2$ = Rs.63,000

Year 3 = $[(2 \times 2{,}10{,}000) \div (4 \times 5)] \div 2$ = Rs.42,000

Year 4 = $[(1 \times 2{,}10{,}000) \div (4 \times 5)] \div 2$ = Rs.21,000

Annual Interest under SLM

For all years = $2{,}10{,}000 \div 4$ = Rs. 52,500

III. Analysis Table (Using ERI)

Sl. No.	Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
1.	Annual Instalment	1,46,250	14,6250	1,46,250	1,46,250	-
2.	Annual Interest – 20.5%	76,875	62,653	45,516	24,865	-
3.	Depreciation [1]	1,15,000	1,15,000	1,15,000	1,15,000	-
4.	Cost of HP (2 + 3)	1,91,875	1,77,653	1,60,516	1,39,865	-
5.	Tax Shield of HP (4 × 50%)	95,938	88,827	80,258	69,933	-
6.	Salvage value	-	-	-	40,000	-
7.	Net cost of HP (1 - 5 – 6)	50,312	57,423	65,992	36,317	-
8.	PVF – 18%	0.847	0.718	0.609	0.516	0.437
9.	**PV of Net cost of HP (7 × 8)**	**42,614**	**41,230**	**40,189**	**18,776**	**-**
10.	Annual Lease rental	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000
11.	TS of Lease rental (10 × 50%)	50,000	50,000	50,000	50,000	50,000
12.	Net cost of Leasing (10 – 11)	50,000	50,000	50,000	50,000	50,000
13.	**PV of Net cost of Leasing (12 × 8)**	**42,350**	**35,900**	**30,450**	**25,800**	**21,850**

REVIEW QUESTIONS

Section A

1. What is meant by 'hire purchase financing'?
2. How is the term 'hire purchase' defined under the provisions of the Hire Purchase Act, 1972?
3. What is 'add-on rate of interest'?
4. What is 'flat rate of interest'?
5. What is 'effective rate of interest'?

Section B

1. What are the features of a hire purchase contract?
2. What are the rights of a hirer under the provisions of the Hire Purchase Act, 1972?
3. Explain the different types of interest rates used in hire purchase financing.
4. Explain the steps in the calculation of 'effective rate of interest'?
5. How is interest calculated under the 'sum-of-years digits method'?
6. How are hire purchase transactions reported in the books of account?

Section C

1. Bring out the points of distinction between lease financing and hire purchase financing.
2. Explain the different methods of calculating interest in a hire purchase

Chapter 13

Factoring

The word ‘factor’ has been derived from the Latin word ‘facere’, which means to make or do or to get things done. Factoring originated in countries like USA, UK, France, etc. where specialized financial institutions were established to assist firms in meeting their working capital requirements by purchasing their receivables.

MEANING

A financial service, whereby an institution called the ‘Factor’, undertakes the task of realizing accounts receivables such as book debts, bills receivables, and managing sundry debts and sales registers of commercial and trading firms in the capacity of an agent, for a commission, is known as ‘Factoring’. Factoring, as a fund-based financial service, provides resources to finance receivables, besides facilitating the collection of receivables.

DEFINITION

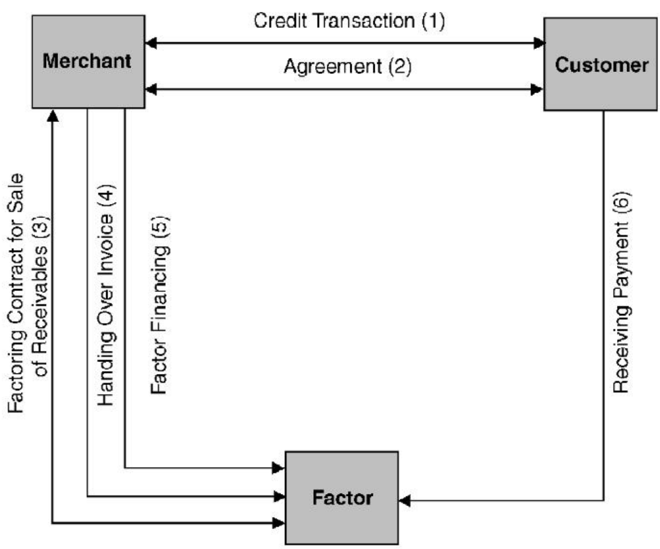
1. ***Peter M. Biscose*** defines the term ‘Factoring’ in his treatise ‘Law and Practice of Credit Factoring’ as “a continuing legal relationship between a financial institution (the factor) and a business concern (the client) selling goods or providing services to trade customers, whereby the factor purchases the clients’ book debts, either with or without recourse to the client, and in relation thereto, controls the credit extended to customers, and administers the sales ledger”.
2. ***C.S. Kalyansundaram,*** in his report (1988) submitted to the RBI defines factoring as, “a continuing arrangement under which a financing institution assumes the credit and collection functions for its client, purchases receivables as they arise (with or without recourse for credit losses, i.e. the customer’s financial inability to pay), maintains the sales ledger, attends to other bookkeeping duties relating to such accounts, and performs other auxiliary functions.”

3. According to the ***Study Group*** appointed by the International Institute for the Unification of Private Law (UNIDROIT), Rome, 1988: "A domestic factoring means an arrangement between a Factor and his client, which includes at least two of the following services to be provided by the Factor:
   - Finance
   - Maintenance of accounts
   - Collection of debts
   - Protection against credit risk
4. Factoring can also be broadly defined as an agreement in which receivables arising out of sale of goods/services are sold by a firm (client) to the "Factor" (a financial intermediary), as a result of which the title to the goods/services represented by the said receivables passes on to the Factor. Henceforth, the Factor becomes responsible for all credit control, sales accounting and debt collection from the credit customers.

MECHANISM

Under the factoring arrangement, the seller does not maintain a credit or collection department. The job, instead is handed over to a specialized agency, called the 'Factor.' After each sale, a copy of the invoice and delivery challan, the agreement and other related papers are handed over to the Factor.

Exhibit 9 Mechanics of Factoring



The Factor, in turn, receives payment from the buyer on the due date as agreed, whereby the buyer is reminded of the due date payment account for collection. The Factor remits the money collected to the seller after deducting and adjusting its own service charges at the agreed rate. Thereafter, the seller closes all transactions with the Factor. The seller passes on the papers to the Factor for recovery of the amount. The mechanics of factoring is depicted in Exhibit 9.

CHARACTERISTICS

The characteristics of Factoring are as follows:

1. ***Bailment contract*** The nature of the Factoring contract is similar to that of a bailment contract. Factoring is a specialized activity whereby a firm converts its receivables into cash by selling them to a factoring organization. The Factor assumes the risk associated with the collection of receivables, and in the event of non-payment by the customers/ debtors, bears the risk of a bad debt loss.
2. ***Form of factoring*** Factoring takes the form of a typical 'Invoice Factoring' since it covers only those receivables which are not supported by negotiable instruments, such as bills of exchange, etc. This is because, the firm resorts to the practice of bill discounting with its bankers, in the event of receivables being backed by bills. Factoring of receivables helps the client do away with the credit department, and the debtors of the firm become the debtors of the Factor.
3. ***Assignment of debt*** Under factoring, there is an assignment of debt in favor of the Factor. This is the basic requirement for the working of a factoring service.
4. ***Fiduciary position of factor*** The position of the Factor is fiduciary in nature, since it arises from the relationship with the client firm. The Factor is mainly responsible for fulfilling the terms of the contract between the parties.
5. ***Professional management*** Factoring firms are professionally competent, with skilled persons to handle credit sales realizations for different clients in different trades, for better credit management.
6. ***Credit realizations*** Factors assist in realization of credit sales. They help in avoiding the risk of bad debt loss, which might arise otherwise.
7. ***Less dependence on bank finance*** Factors help in reducing the dependence on bank finance towards working capital. This greatly relieves the firm of the burden of finding financial facility.

8. ***Recourse factoring*** Factoring may be nonrecourse, in which case the Factor will have no recourse to the supplier on nonpayment from the customer. Factoring may also be with recourse, in which case the Factor will have recourse to the seller in the event of nonpayment by the buyers.
9. ***Compensation*** A Factor works in return for a service charge calculated on the turnover. Factor pays the net amount after deducting the necessary charges, some of which may be special terms to handle the accounts of certain customers.

FACTORING AND OFF-BALANCE SHEET FINANCING

Under factoring arrangements, and while making credit sales, the invoice is made in the name of the Factor. The receivables become the assets of the Factor. The client's debts are purchased by the Factor. Hence, the finance provided by the Factor goes off the balance sheet, and the items appear in the balance sheet only as a contingent liability in the case of recourse factoring. In case of nonrecourse factoring it does not appear in the financial statements of the borrower.

TYPES OF FACTORING

Besides the normal function of collection of receivables and sales ledger administration Factors take different forms, depending upon the type of special features attached to them. Following are the important forms of factoring arrangements that are currently in vogue:

Domestic Factoring

Factoring that arises from transactions relating to domestic sales is known as 'Domestic Factoring'. Domestic Factoring may be of three types, as described below:

a. Disclosed factoring In the case of 'disclosed factoring' the name of the proposed Factor is mentioned on the face of the invoice made out by the seller of goods. In this type of factoring, the payment has to be made by the buyer directly to the Factor named in the invoice. The arrangement for factoring may take the form of 'recourse', whereby the supplier may continue to bear the risk of nonpayment by the buyer without passing it on to the Factor. In the case of nonrecourse factoring, Factor, assumes the risk of bad debt arising from nonpayment.

b. Undisclosed factoring Under 'undisclosed factoring', the name of the proposed Factor finds no mention on the invoice made out by the seller of goods. Although the control of all monies remains with the Factor, the entire realization of the sales transaction is done in the name of the seller. This type of factoring is quite popular in the UK.

c. Discount factoring 'Discount Factoring' is a process where the Factor discounts the invoices of the seller at a pre-agreed credit limit with the institutions providing finance. Book debts and receivables serve as securities for obtaining financial accommodation.

Export Factoring

When the claims of an exporter are assigned to a banker or any financial institution, and financial assistance is obtained on the strength of export documents and guaranteed payments, it is called 'export factoring'. An important feature of this type of factoring is that the Factor-bank is located in the country of the exporter. If the importer does not honor claims, exporter has to make payment to the Factor. The Factor-bank admits a usual advance of 50 to 75 percent of the export claims as advance. Export factoring is offered both as a 'recourse' and as a 'nonrecourse' factoring.

Cross-border Factoring

'Cross-border Factoring' involves the claims of an exporter which are assigned to a banker or any financial institution in the importers' country and financial assistance is obtained on the strength of the export documents and guaranteed payments. International factoring essentially works on a nonrecourse factoring model. They handle exporter's overseas sales on credit terms. Complete protection is provided to the clients (exporters) against bad debt loss on credit-approved sales. The Factors take requisite assistance and avail the facilities provided for export promotion by the exporting country. When once documentation is complete, and goods have been shipped, the Factor becomes the sole debtor to the exporter.

The important features of this type of factoring are as follows:

1. It is similar to Export factoring, where an import Factor is engaged by the export Factor at the debtors end
2. It is also called 'international factoring' or the two-Factor system of factoring
3. The parties involved are the exporter (client), the importer (customer), the export Factor and the import Factor
4. There are two separate inter-linked agreements, between the exporter (client) and the export Factor on the one hand, and the export Factor and the import Factor on the other

5. The export and the import Factors belong to a formal chain of Factors, with well-defined rules governing the conduct of business
6. Services of the import Factor include linkage between export Factor and the importer, resolving international barriers like language, legal formalities, etc. underwriting customer trade credit risk, collecting receivables and transferring funds to the export factor in the currency of the invoice

Modus Operandi

The method of dealing as relating to cross-border factoring is explained below:

1. ***Export factor*** The exporter informs the export Factor about the export of goods to an import client, domiciled in a specified country, regarding goods sold on open-credit.
2. ***Import factor*** The export Factor writes to the import Factor domiciled in the country of the importer, enquiring about the credit-worthiness, reputation etc of the importer.
3. ***Delivery*** The exporter delivers the goods to the importer. He also delivers the relevant documents, such as invoices, bills of lading and other supporting documents, to the export factor, the export receivables being factored on a nonrecourse basis.
4. ***Credit information*** The export Factor works with the import Factor for carrying out activities such as credit checking, sales ledgering and collection for customers located in the importer's country. The import Factor collects and disseminates credit information about the importer (customer), besides making payment to the export Factor in the currency of the invoice, on assignment of documents, on the maturity of credit period, or on collection.
5. ***Payment*** The export Factor makes payment to the exporter upon assignment, maturity or collection of export receivables, depending upon the type of factoring arrangement between them.

Full-service Factoring

Full-service factoring, also known as Old-line factoring, is a type of factoring whereby the Factor has no recourse to the seller in the event of the failure of the buyers to make prompt payment of their dues to the Factor, which might result from financial inability/insolvency/bankruptcy of the buyer. It is a comprehensive form of factoring that combines the features of almost all factoring services, specially those of nonrecourse and advance factoring.

With Recourse Factoring

The salient features of this type of factoring arrangement are as follows:

1. The Factor has recourse to the client firm in the event of the book debts purchased becoming irrecoverable
2. The Factor assumes no credit risks associated with the receivables
3. If the customer defaults in payment, the resulting bad debt loss shall be met by the firm
4. The Factor becomes entitled to recover dues from the amount paid in advance if the customer commits a default on maturity
5. The Factor charges the client for services rendered to the client, such as maintaining sales ledger, collecting customers' debt, etc.

Without Recourse Factoring

The salient features of this type of factoring are as follows:

1. No right with the Factor to have recourse to the client
2. The Factor bears the loss arising out of irrecoverable receivables
3. The Factor charges higher commission called 'del credere commission' as a compensation for the said loss
4. The Factor actively involves in the process of grant of credit and the extension of line of credit to the customers of the client

Advance and Maturity Factoring

The essential features of this type of factoring are as follows:

1. The Factor makes an advance payment in the range of 70 to 80 percent of the receivables factored and approved from the client, the balance amount being payable after collecting from customers
2. The Factor collects interest on the advance payment from the client
3. The Factor considers such conditions as the prevailing short-term rate, the financial standing of the client and the volume of turnover while determining the rate of interest

Bank Participation Factoring

It is variation of advance and maturity factoring. Under this type of factoring, the Factor arranges a part of the advance to the clients through the banker. The net Factor advance will be calculated as follows:

$$[\text{Factor Advance Percent} \times \text{Bank Advance Percent}]$$

Collection/Maturing Factoring

Under this type of factoring, the Factor makes no advancement of finance to the client. The Factor makes payment either on the guaranteed payment date or on the date of collection, the guaranteed payment date being fixed after taking into account the previous ledger experience of the client and the date of collection being reckoned after the due date of the invoice.

ADVANTAGES OF FACTORING

Factoring, as an innovative financial service, commands the following advantages:

1. ***Cost savings*** Factoring allows for the elimination of trade discounts. Besides, it also helps in reduction of administrative cost and burden, facilitating cost savings. There is also overall savings in cost, expenses and efforts as there is no need for the client to maintain a special administrative setup to look after credit control.
2. ***Leverage benefit*** Another advantage of factoring is that it helps improve the scope of operating leverage.
3. ***Enhanced return*** Factoring is considered attractive to users as it helps enhance return.
4. ***Liquidity*** Factoring enhances liquidity of the firm by ensuring efficient working capital management. For instance, it helps avoid increased debts in the case of without recourse factoring. Similarly, efficient management of current assets leads to reduced working capital requirements, besides helping to minimize bad debt losses.
5. ***Credit discipline*** Factoring brings about better credit discipline amongst customers due to regular realization of dues. This is achieved through effective control of the sales journal, reduced credit risk, better working capital management, etc. Factoring indirectly goads the client (seller) to sell only to customers with good credit standing, thus bringing about credit discipline. Further, factoring allows for investigation of market reputation, financial standing, business prospects, etc. of the parties concerned.

6\. ***Accelerated cash flows*** Accelerated cash flows help the client meet liabilities promptly, as and when they arise.

6\. ***Credit certification*** The Factor's acceptance of the client's receivables is tantamount to credit certification by the factoring agency.

7\. ***Prompt payment*** Factoring facilitates prompt payments and credits by providing insurance against bad debts.

8. ***Information flow*** Factoring ensures constant flow of critical information for the purpose of decision-making and follow-up. It therefore helps eliminate delays and wastage of man-hours.
9. ***Infrastructure*** Factoring acts as a stimulant to go in for sophisticated infrastructure towards highlevel specialization in credit control and sales ledger administration.
10. ***Better linkages*** Factoring allows for the promotion of linkages between bankers and Factors. Such an arrangement helps better dealings, debt protection, collection of sales ledgers, etc.
11. ***Boon to SSI sector*** Factoring arrangements work as a boon to the SSI sector, which invariably faces the problem of inadequate working capital. The facilities provided by a Factor would be a great advantage to the SSI units, as it serves as an enriched source of financing.
12. ***Efficient production*** The Factor undertakes the responsibility of credit control, sales ledger administration and debt collection problems. Thus, the client can concentrate on functional areas of the business such as planning, purchase, production, marketing, and finance.
14. ***Reduced risk*** Factoring allows for reduction in the uncertainty and risk associated with the collection cycle, since funds from a Factor are an additional source of finance for the client outside the purview of MPBF.
15. ***Export promotion*** Factoring facilities are designed to help exporters avail of financial assistance on attractive terms, which in turn allows for promotion of exports.

DISADVANTAGES OF FACTORING

Despite the fact that factoring offers an excellent sort of financial services, in that it helps sellers of goods on credit basis to avoid bad debts and at the same time ensure prompt collection from buyers, it is fraught with the following drawbacks:

1. Engaging a factor may be reflective of the inefficiency of the management of the firm's receivables
2. Factoring may be redundant if a firm maintains a nation-wide network of branches
3. Difficulties arising from the financial evaluation of clients
4. A competitive cost of factoring has to be determined before taking a decision about engaging a factor

FACTORING—PLAYERS

Factoring starts with credit sales made by the seller, and is mainly concerned with the realization of credit sales. Factoring starts where credit sales ends. Thus, the Factor works between the seller and buyer, and sometimes together with seller's bank too.

The people who take part in factoring services include the following:

1. Buyer of the goods who has to pay for them on credit terms
2. Seller of goods, who has to realize credit sales from buyer
3. 'Factor', who acts as agent in realizing credit sales from buyer and passes on the realized sum to the seller after deducting a commission

The various activities undertaken by the above parties in a factoring transaction are as follows:

The Buyer

1. Negotiating the terms of purchase of goods and services with the seller
2. Receiving delivery of goods with invoice, and instructions from the seller regarding making payment to the Factor on due dates
3. Making payments to the Factor in time, getting an extension, or in the case of default subjecting to the legal process at the hands of Factor

The Seller

1. Entering into a Memorandum of Understanding (MOU) with the buyer by setting out the terms and conditions of factoring
2. Making a sale of goods to the buyer as per the MOU
3. Delivering copies of invoice, delivery challan, MOU and payment instructions given to the buyer, and to the factor
4. Receiving payment in advance from the factor on the sale of receivables
5. Receiving balance payment from the factor, after deduction of the Factor's services charges, etc.
6. Providing a satisfactory assignment, together with actual invoices and evidence regarding delivery
7. Submitting details of all sales to the factor for credit approval prior to shipping
8. Warranting that each customer has received the merchandise or that it be accepted without any counterclaim or disputes
9. Granting the factor the right to hold any balances standing to its credit as security for any debts owed by the clients to the factor, no matter how it arises

The Factor

1. Entering into an agreement with the seller for rendering factoring services
2. On receipt of copies of the sale documents, making advance payment on the strength of book debts to the seller
3. Receiving payment from buyers on the due date and making remittances of the same to seller after deductions, thus relieving the client of the bother of collection work
4. Advising the client on the credit worthiness of potential customers with the help of extensive information available on the financial standing and credit worthiness of individual customers and their track record of payments
5. Efficient credit administration
6. Purchasing bonafide account receivables previously approved by it
7. Charge interest on sums advanced at a certain agreed interest rate
8. Render a statement of account at periodical intervals
9. Securing compliance with the following terms and conditions:
    - That the invoice, bills or other documents drawn by the seller, and other details of payments arising out of the transaction, are duly factored
    - Confirm that the collectibles are all free of any encumbrances, charge, lien, pledge, hypothecation, mortgage, right of set-off or counterclaim from another, etc
    - That the seller executes a deed of assignment in favor of the Factor to enable the latter to recover payment in case of default
    - That strict compliance with all the terms and conditions is ensured
    - That the seller procures a letter of waiver from the bank in favor of the Factor in the event of the bank having a charge over the assets sold out to buyer, and the safe proceeds are deposited in the account of bank

FUNCTIONS OF A FACTOR

The various functions that are performed by a Factor are described below:

1. Maintenance/administration of sales ledger
2. Collection facility/of accounts receivable
3. Financing facility trade debts
4. Assumption of credit risk/credit control and credit protection
5. Provision of advisory services

Sales Ledger Administration

A Factor performs the following activities as regards the administration of sales ledger:

1. Maintenance of the clients' sales ledgers
2. Sending periodical reports to the client on the current status of receivables, receipts of payments from the customers and other useful information
3. Maintenance of a payment schedule, whereby details of payments spread over a certain period of time are shown, besides the changes that take place in the payment pattern

Provision of Collection Facility

A Factor performs the following activities in connection with the provision of collection facility:

1. Undertaking to collect the receivables on behalf of the client, thus relieving the client of the problems involved in collection, so that the client is free to concentrate on other important functional areas of the business.
2. Helping in cost reduction on matters connected with collection through savings in manpower, time and efforts.
3. Arranging for systematic collection, of receivables with the help of trained manpower and sophisticated infrastructure facilities.
4. Making timely demands on debtors and urging them to make prompt payment.
5. Ensuring a motivated collection keeping in view of the fact that demand for payments emanates from a credit institution.
6. Adopting an independent procedure, as demanded, in order to ensure prompt collection of dues from the clients' customers.
7. Initiating legal action, as may be necessary, on customers to secure payments.

Financing Trade Debts

The activities covered under this head are as follows:

1. Purchasing the book debts of the client at a price and getting the same assigned in the factor's favor.
2. Making advance payments on the strength of book debts to the extent of 80 percent of the assigned debts. In the case of 'with recourse factoring', the advance provided by the Factor would have to be refunded by the client in the event of non-payment by the buyer. In the case of 'without recourse factoring' there would be no question of the advance being returned to the Factor.

Credit Control and Protection

This function assumes significance in the context of 'without recourse factoring'. The relevant activities are as follows:

1. Fixing credit limits for approved customers in consultation with the client.
2. Undertaking to buy all trade debts of the customer within the approved limits.
3. Assuming the risk of default in payments.
4. Determining the extent of the line of credit.

Advisory Services

These services are provided based on the Factor's strength of specialized knowledge and experience in finance and credit dealings, and access to extensive credit information. They essentially emanate from the bond relationship between the Factor and its client. The services include the following:

1. Providing information about the customer's perception of the client's products, changes in marketing strategies, emerging trends, etc.
2. Evaluating the procedures followed for invoicing, delivery and dealing with sales returns
3. Operating the credit department for banks and other institutions which are engaged in leasing, hire-purchase, merchant banking, etc.

FACTORING COST

Factoring charges for the various services extended to clients include:

Commission

This includes the charge for collection and sales ledger administration, calculated on the value of debt purchased, the commission being deducted from the face value of book debts.

Interest Charges

These are the discount charges for the period between the date of advance payment and the date of collection.

LINE OF CREDIT—METHODS

A Factor usually determines the credit limit by considering the financial position, the past payment record and the value of the goods sold by the client to the customer. A Factor may adopt any of the following methods in order to determine the extent of credit granted to clients:

Objective Method

The amount of sales to be granted to customers is determined by taking into consideration the approved limit and the average collection period in the following manner:

$$\frac{\text{Annual sales}}{\text{ACP}}$$

Accordingly, the actual line of credit for an annual sales turnover of Rs. 10,00,000 for a 40 day collection period will be as follows:

$$\frac{\text{Rs. }10{,}00{,}000}{40} = \text{Rs. }25{,}000$$

Subjective Method

The extent of credit limit depends on the credit-worthiness of the customer, which is assessed with the help of credit information. The information is accessed through sources such as credit rating reports, bank reports, trade references, analysis of financial statements using current ratio, quick ratio, net profit margin and Return On Investment (ROI). Besides, prior collection experience and customer visits also form the basis of credit assessment by the Factor.

FACTORING VS. BILLS DISCOUNTING

Facoring differs from bills discounting in the following manner:

Sl. No.	Characteristic	Factoring	Bills Discounting
1.	Recourse	May be with or without recourse	Only with recourse
2.	Collector	Factor is the collector of receivables	Drawer is the collector of receivables
3.	Services	Besides financing facility, many other services are also extended	Only financing facility is available
4.	Refinancing	Receivables once factored cannot be refactored	Bills once discounted can be rediscounted
5.	Bulk Finance	Financing arrangement covers entire quantum of receivables	Financing is bill-based
6.	Mode of Accounting	It is an offbalance sheet financing	No such possibility

RBI GUIDELINES FOR FACTORING

RBI, as a central monetary authority, has been engaged in initiating a number of measures, for the development and promotion of factoring as a viable financial service. In this regard, the RBI has set up working groups for examining the circumstances in which factoring services can be regulated for the overall efficient promotion of the financial market in India. As a follow-up to the recommendations of the Kalyanasundaram Group, the Banking Regulation Act, 1949, was amended to enable commercial banks to undertake factoring business. In 1990, RBI issued the following guidelines aimed at regulating the factoring services provided by banks on the basis of the recommendations of various working groups.

Prior Approval

No business of factoring is to be undertaken by banks directly. However, indirect participation of banks in factoring services with the Reserve Bank's prior approval, will be allowed, whereby banks could invest in shares of other factoring companies within the limits specified.

Subsidiaries

Banks are permitted to set up separate subsidiaries for undertaking the factoring business, either individually or jointly with other banks, with prior approval of RBI. Banks desirous of doing so should apply to the Chief Officer, Department of Banking Operations and Development, Reserve Bank of India, Central office, Mumbai, in the form specified for the purpose.

Exclusive Business

Factoring is to be undertaken by a factoring subsidiary or a joint venture factoring company, and such Factors should not engage in financing other companies who are also engaged in the business of factoring.

Investment Limit

The investment limit of a bank in the shares of factoring companies, inclusive of its subsidiary in the factoring business, shall not exceed in aggregate 10 percent of the paid up capital and reserves of the bank.

RBI Clearance

Prior clearance of the RBI is to be obtained for making application to the Controller of Capital Issues in connection with the setting up of subsidiaries of the joint venture factoring companies.

Reporting

Factor-banker shall submit periodical reports to the RBI regarding the factoring business undertaken by it.

FACTORING—INDIAN SCENARIO

An important development in the Indian factoring services took place with the RBI setting up a 'Study Group' under the chairmanship of Shri C.S. Kalyansundram in January, 1988. The study group aimed at examining the feasibility and mechanism of organizing factoring business in India. The group submitted its report in January 1989. Various functional formalities, implications and the importance of promoting factoring in the country, with the participation of banking and nonbanking financial intermediaries like merchant banks, etc were examined by the group.

MAJOR FACTORING FIRMS

Due to the positive efforts of the RBI, a number of banks and nonbanking companies set up factoring companies. A brief description of some of these firms is given below:

SBI Factors and Commercial Services

SBI Factors and Commercial Services (SBI FACS) was floated by the SBI, as its subsidiary, in March 1991, with a paid up capital of Rs. 25 crores.

Features

1. ***The exporter*** Exporter submits to SBI FACS a detailed list of customers (importers) together with credit line requirements. The Indian exporter applies for a credit limit in respect of the overseas importer. The exporter enters into an export factoring agreement with the SBI FACS, which is the export Factor. The exporter then assigns all the export receivables to export Factor, and subsequent assignment to the respective import Factors. While shipping goods, the exporter ensures that each invoice is payable to a specific Factor in the importer's country.
2. ***The import factor*** The SBI FACS selects an import Factor located in the customers' country. The import Factor rates the importer, and intimates the result to SBI FACS. The import Factor grants the credit line based on the credit worthiness of the overseas importer. The import Factor remits the funds to SBI FACS on receipt of sale proceeds from the buyer on the due date of the invoice. In the event of the importer defaulting to pay the proceeds of the goods exported, the import Factor pays the receivables 100 days after the due date to the export Factor.

3. ***SBI factor*** SBI FACS makes an advance payment to the exporter against the approved export receivables after sending the copies of the invoices and shipping documents to the import Factor. It converts the foreign currency remittances into rupees and transfers the proceeds to the exporter. SBI FACS levies a service fee of 0.5–2 percent of the value of the invoice. It sends statements indicating the above details to RBI at half yearly intervals. It acts only as export Factor, and is not authorized to act as import Factor.

Services

1. Bill-discounting facility
2. Undertaking collection and credit services designed to improve cash flow by timely realization of debts or receivables (A seller can have his invoice converted into instant cash upto 80 percent without having to wait for 30, 60 or 90 days or even longer for payment by the purchaser)
3. Undertaking the responsibility of collection of debts due from clients of customers
4. Undertaking the maintenance of clients' sales ledger
5. Providing monthly sales analysis, overdue invoice analysis and customer payment reports to clients
6. SBI FACS has designed its services based on the models prevalent in countries like Singapore and Indonesia, and adapted them with changes suitable to the domestic business environment
7. All services are provided against recoverable service charges, without guarantee or security being insisted upon. Factoring services are available to all business organizations engaged in manufacturing and trading

Canara Bank Factors

The Canara Bank Factors Ltd. was set up as a subsidiary of Canara Bank Ltd. in August 1991. The paid up capital of Rs. 10 crores was contributed by Canara Bank, Andhra Bank and Small Industries Development Bank of India, in the proportion of 60:20:20. The Factor started its operations initially in the south zone.

Fairgrowth Factors

The first company to be set up in the private sector was Fairgrowth Factors Ltd. It started its functioning in April 1992 with a paid up capital of Rs. 5 crores.

Foremost Factors Limited (FFL)

1. It is the first joint venture private sector factoring company, which commenced export factoring to Indian exporters in 1997
2. It is a joint venture between the Mohan Exports and the Nations Bank Overseas Corporation (USA), 20th Century Finance Corporation and the ICDs Group
3. It provides advance payment to exporters upto 80 percent account receivables, the remaining 20 percent to be paid when full payment is received from the customer/buyer
4. It arranges credit risk protection on mutually agreed terms, and the exporter gets the additional benefit of open account trading without credit risk
5. The FFL is a member of 'Factors Chain International', a group that includes nearly 120 of the world's leading financial institutions in 50 countries
6. Since the FFL uses the standard 'International Electronic Data Interchange Factoring Network', it can provide speedy and reliable reporting on their overseas account

OPERATIONAL PROFILE OF INDIAN FACTORING

Domestic Factoring

1. Factoring is of the recourse factoring type
2. The Factor undertakes collection and credit services
3. Factoring is not available for deferred credit transaction type of credit sales
4. Factoring advance upto 80 percent is available to the seller (client)
5. Factors also undertake maintenance of the sales ledger by using computerized systems, monthly sales analysis and overdue invoice analysis
6. Factors provide customers' payment reports to the clients
7. Availability in cash is directly geared to sales once a line of credit is established
8. Factors charge for factoring receivables by way of service charges/fee without guarantee/security being insisted upon, etc.

Export Factoring

1. Approval by RBI of the scheme evolved by the Export Credit and Guarantee Corporation of India (ECGC) for the exporters for the purpose of providing a non-fund based export-factoring service

2. ECGC providing non-fund based export factoring as an in-house service
3. ECGC granting 100 percent credit protection to bills drawn on approved overseas buyers through endorsement to the policy
4. ECGC enters into a tripartite agreement with the exporter and the authorized dealer which provides for the following:
   - Guarantee for making the bill immediately on the bank's advice after the expiry of 30 days from the date of the bill with regard to nonpayment of any factored bill
   - Discounting by the authorized dealer in consideration of the above unconditional guarantee
   - Authorization to deduct the ECGC's factoring charges (which should be 1 to 1.5 percent) from the proceeds of each bill and remittance of the same to the ECGC
   - ECGC would have recourse to the exporter if non-payment of the bill is the fault of the exporter. The authorized dealer would be paid by the ECGC in accordance with the guarantee contained in the tripartite agreement
   - ECGC would obtain directions from RBI in their turnover, entitling them to recover the amount from the foreign party in the event of the exporter failing to realize the export proceeds in the stipulated time

OPERATIONAL PROBLEMS IN INDIAN FACTORING

1. Lack of access to any authentic common source of information
2. Lack of experience and database to take on jobs such as credit evaluation of clients
3. Expensive system of multiple databases maintained by individual Factors
4. Lack of uniformity in the working of specialized credit information agency/bureau
5. High stamp duty on assignment of debt to Factors
6. High cost of operations and consequent erosion of profitability for the Factors
7. No fool-proof legal framework available which is capable of protecting the interest of the Factor and other parties involved in factoring
8. Lack of access to wider funding sources on the same scales as available to other finance companies
9. Too much dependence on equity funds, forcing them to have a non-viable funding pattern

10. Reluctance on the part of banks in India to issue a disclaimer certificate enabling the purchase of book debts by the Factor
11. Not much headway achieved in export factoring

Considering the fact that the factoring service in India is in its infancy, and that its quantitative growth is relatively limited, its future depends on the removal of a number of genuine operational obstacles, some of which have been outlined above.

REVIEW QUESTIONS

Section A

1. Define the term 'factoring'.
2. Trace the origin of the word 'factoring'.
3. What is 'domestic factoring'?
4. What is 'disclosed factoring'?
5. What is 'undisclosed factoring'?
6. What is 'discount factoring'?
7. What is 'export factoring'?
8. What is 'cross-border factoring'?
9. What is 'full service factoring'?
10. What is 'with recourse factoring'?
11. What is 'without recourse factoring'?
12. What is 'bank participation factoring'?
13. Who are the players in a factoring arrangement?
14. How is sales calculated under the 'objective method' of line of credit?

Section B

1. Explain with a chart the mechanism involved in factoring.
2. Sketch the characteristic features of factoring.
3. How do you distinguish factoring from 'off-balance sheet financing'?
4. Explain the 'modus operandi' as regards cross-border factoring.
5. What are the salient features of 'with recourse factoring'?
6. What are the salient features of 'without recourse factoring'?
7. What are the salient features of 'advance and maturity factoring'?
8. What are the advantages of factoring?
9. What are the disadvantages of factoring?

10. What are the functions of a factor as regards ‘sales ledger administration’?
11. What are the functions of a factor as regards ‘provision of collection facility’?
12. What are the functions of a factor as regards ‘financing of trade debts ’?
13. What are the functions of a factor as regards ‘credit control and protection’?
14. What are the advisory services rendered by a factor?
15. What are the components of cost of factoring?
16. Explain the methods of ‘line of credit’.
17. Bring out the points of distinction between factoring and bills discounting as modes of short-term financing.
18. State the RBI guidelines as regards factoring.
19. What are the services offered by the SBI factor?

Section C

1. Elaborate the different types of factoring.
2. Discuss the functions of various players in a factoring arrangement.
3. Explain the functions of a factor.
4. Give an account of factoring in the Indian context.
5. Discuss the operational profile of the Indian factoring.
6. Discuss the operational problems of the Indian factoring.

Chapter 14

Consumer Finance

DEFINITION

The term consumer finance refers to the activities involved in granting credit to consumers to enable them possess own goods meant for everyday use. It is known by several names such as credit merchandising, deferred payments, instalment buying, hire purchase, pay-out-of income scheme, pay-as-you earn scheme, easy payment, credit buying, instalment credit plan, etc.

1. ***According to E.R.A. Seligman,*** an authority on consumer finance, "the term consumer credit refers to a transfer of wealth, the payment of which is deferred in whole or in part, to future, and is liquidated piecemeal or in successive fractions under a plan agreed upon at the time of the transfer."
2. ***Reavis Cox***, an authority on economics of consumer credit defines consumer credit as "Business procedure through which the consumers purchase semidurables and durables other than real estate, in order to obtain from them a series of payments extending over a period of three months to five years, and obtain possession of them when only a fraction of the total price has been paid."

TYPES

There are several types of credit facility available to consumers. They are briefly discussed below:

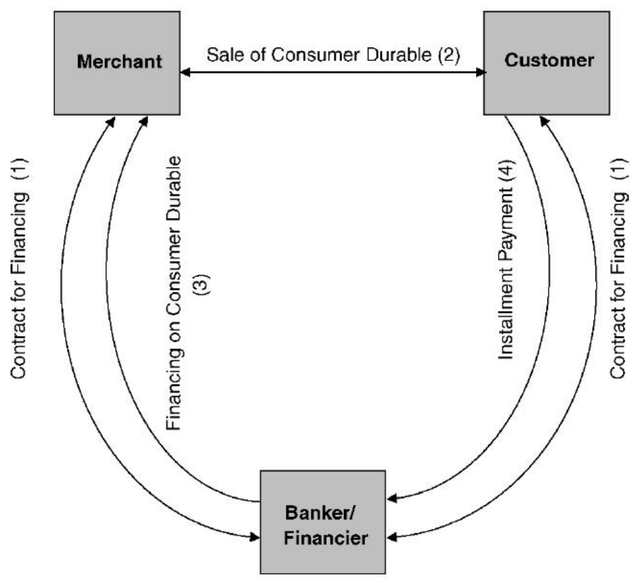
1. ***Revolving credit*** An on going credit arrangement similar to a bank overdraft, whereby the financier, on a revolving basis, grants credit, is called 'revolving credit'. The consumer is entitled to avail credit to the extent sanctioned as the credit limit. An ideal example of revolving credit is credit cards.
2. ***Fixed credit*** It is like a term loan whereby the financier provides loan for a fixed period of time. The credit has to be squared off within a stipulated period. Examples of fixed credit include monthly instalment loan, hire purchase, etc.

3. ***Cash loan*** Under this type of credit, banks and financial institutions provide money with which the consumers buy articles for personal consumption. Here, the lender and the seller are different. The lender does not have the responsibilities of a seller.
4. ***Secured finance*** When the credit granted by a financial institution is secured by a collateral, it takes the form of 'secured finance'. The collateral is taken by the creditor in order to satisfy the debt in the event of default by the borrower. The collateral may be in the form of personal property, real property or liquid assets.
5. ***Unsecured finance*** When there is no security offered by the consumer against which money is granted by financial institutions it takes the form of 'unsecured finance'.

MECHANICS OF CONSUMER FINANCING

The working mechanism of consumer financing is depicted in Exhibit 10.

Exhibit 10 Mechanics of Consumer Financing



SOURCES OF CONSUMER FINANCE

The various sources of consumer finance available to people are discussed below:

Traders

The predominant agencies that are involved in the provision of consumer finance are traders. They include sales finance companies, hire purchase and other such financial (nonbank) institutions.

Commercial Banks

Commercial banks take keen interest in providing, directly or indirectly, the finance for consumer durables. Banks lend large sums of money at 'wholesale' rates to commercial or sales finance companies, Hire purchase concerns and other such financial intermediaries. Recently, banks have also started directly financing consumers through personal loans, which are meant for purchasing consumer durable goods. Personal loans are granted without a security. They are cheaper than hire purchase credit.

Banks a high risk area, commercial banks ventured into the business of consumer credit very late. It was in the year 1978, when the National City Bank of New York in the U.S. opened the first full-fledged consumer credit department. Now, with the advent of consumerism, banks have started participating in the consumer finance in a big way.

Credit Card Institutions

Credit card institutions arrange for credit purchase of consumer articles through the respective banks which issue the credit cards. The credit card system enables a person to buy goods and services on credit. The credit card scheme operates in the following way:

On presentation of the credit card by the buyer, the seller prepares three copies of the sales voucher—the first for the seller, the second for the bank or credit card company and the third for the buyer. The seller gives one copy to the buyer and the other is forwarded to the bank for collection. The seller's bank forwards all such bills to the card issuing bank or company. The bank credits the seller's account and debits the amount to the customer's account. The buyer receives a monthly statement from the card issuing bank or company and the outstanding amount is to be paid within a period of 20 to 45 days without any additional charge. If payment is delayed, bank charges interest per year on the amount outstanding.

Nonbanking Finance Companies (NBFCs)

Nonbanking finance companies constitute another important source of consumer finance. Consumer finance companies, also known as small loan companies, personal finance companies or licensed lenders, are non-savings institutions whose prime assets constitute sale-finance receivables, personal cash loans to consumers, short and intermediate-term business receivables, etc. These finance companies charge substantially higher rates of interest than the market rates. Consumers approach them as a last resort. Such companies run an equal risk of high collection charges too.

Credit Unions

A credit union is an association of people who agree to save their money together and in turn provide loans to each other at relatively lower rates of interest. These are called cooperative credit societies in India. The first credit union was started in Germany in the year 1848. These are nonprofit, deposit-taking and low-cost credit institutions.

Middlemen

Middlemen, such as dealers of consumer articles, also grant credit to consumers as part of their promotion campaign. In many cases, dealers work in unison with banks and finance companies, and direct the consumers to the friendly finance companies. This type of arrangement helps dealers maintain a close and loyal relationship with customers.

Other Sources

1. Savings and loan associations
2. Mutual savings banks

MODES OF CONSUMER FINANCE

Consumer finance is available through several ways as shown below:

1. ***Open accounts*** Open account is a method of consumer financing whereby the retailer allows the customer to make any number of purchases during a month, not exceeding a certain value. There is neither a down payment, nor any interest charged on such credit. It is the most popular form of credit account.
2. ***Credit card*** Credit cards are emerging as the most popular mode of consumer finance and slowly replacing paper money. They have brought about a revolution in individual wealth holding.

   Being a high-risk area, commercial banks ventured into the business of consumer credit very late. It was in the year 1978, when the National

City Bank of New York in the U.S. opened the first full-fledged consumer credit department. Now, with the advent of consumerism, banks have started participating in the consumer finance in a big way.

3. ***Revolving account*** This is a type of account, which allows a customer the facility of making purchases during a month and making payments thereof on a deferred payment basis, by easy monthly instalments. The consumer is allowed to make fresh purchases since the credit is reduced by the monthly instalments. The charge for credit is calculated as a percentage of the purchase price, which is then added to the purchase cost of the article.
4. ***Option plan*** Under this plan, a customer has the option of paying the amount mentioned in the statement of account either in full or in part, and thus having the balance brought forward. A charge for the credit is calculated as a percentage of the balance outstanding at each month-end and, added to the balance.
5. ***Instalment account*** A most popular mode of consumer finance, the instalment credit, is more a sales promotion exercise for dealers. It has become a permanent part of the business structure in many countries. Under this plan, the consumer pays up for the sale of a consumer durable in equal periodical instalments.
6. ***Cash loan*** It takes the form of credit being extended in the form of cash. Consumers resort to this plan in order to consolidate the existing debts into one lump sum, or for the purpose of purchasing merchandise or services. The period of such loans vary depending on finance companies.

DEMAND FOR CONSUMER FINANCE—FACTORS

Several factors work in favor of making consumer finance a popular form of finance. Following are some of the factors that have contributed to the growth of consumer finance:

1. Increase in consumer disposal income
2. Enhancement in the real income of consumers
3. Convenient size of the instalment payments
4. Growth in nuclear families leading to spurt in number of households
5. Lower charges
6. Down payment and credit contract

CONSUMER FINANCING—PRACTICE IN INDIA

A popular form of consumer financing in India is 'instalment credit'. There are various forms of consumer credit granted by finance companies and dealers. In the case of 'over-the-counter', one-to-one or 'walk-in' financing, credit is granted directly to individuals or institutional funding agencies such as cooperatives. Dealers and finance companies are directly involved in this type of financing. When a large number of consumers are financed, institutional funding is involved. In this case, the financier disburses the finance in tranches through the employer or the cooperative societies. The loan instalment is deducted from the salary of the employees.

Products Covered

Consumer financing in India covers a wide range of products, such as cars, TVs, washing machines, refrigerators, geysers, air-conditioners, computers, etc. The products covered possess some distinct features such as the specific identifiability, durability, substantiality, repossessability, saleability, serviceability and repiarability of the products. An important feature of consumer credit in India is the system of sales-tax levied on the sale of products by hire purchase or instalments.

Terms of Finance

The terms and conditions for consumer financing are as follows:

a. Eligibility The basic eligibility for consumer finance is the income of the individual consumer and the nature of employment. The EMIs (Equivated Monthly Instalments) are worked out based on the number of instalments. In addition, the tenure of employment of the consumer is also taken into consideration before granting consumer finance.

b. Guarantee Usually financiers insist on guarantee for the credit availed by the consumer. The guarantors need to have a better income and standing than the consumer. Guarantee is obtained in order to ensure prompt payment of the instalments.

c. Tenure Consumer finance is granted for a short periods of up to five years. This again depends on the extent of competition prevailing in the market. Moreover, the tenure of finance also depends on the value of the asset purchased. Naturally, assets of smaller value are given short-term credit and assets of higher value are given a comparatively longer-term credit. There is therefore a greater flexibility in the tenure of loan.

d. Rate of interest The effective rate of interest for consumer finance is much higher than the rates applicable to business finance. This is because, the loans are granted based simply on the personal integrity of the consumer. Although many countries have fixed the maximum rate of interest on the hire purchase proposals, there is no such limit in India. The effective rate of interest varies between 20 percent and 30 percent, depending on the source of funding. Finance companies use different methods of disclosing the interest rates, such as a flat rate of interest, a yearly declining balances rate, net interest rate, etc.

e. Other charges In addition to the rate of interest, finance companies also charge documentation fees, processing fees, management fees, examination fees, service charges, brokerage, collection costs, etc. A deposit is also taken from the consumer as a precautionary measure to guard against any default in the payment of instalments.

f. Mode of payment In the case of individual loans, payments are usually collected in advance in the form of post-dated cheques. In the case of institutional financing, there is an arrangement for the deduction of instalments from the salary of the employee, which is in turn remitted to the finance company, by the employer.

g. Credit evaluation A verification of the details furnished by the consumer is carried out in order to ascertain the validity of the statement and the credit standing of the consumer. The examination may either be carried out by the financier, or by an independent agency. Details about the age, monthly income, status of employment, previous payment record, marital status, assets owned, borrower's equity in purchase, type of collateral offered, address, etc are verified. In fact, the four Cs, character, capacity, capital, and condition are verified. The financier accesses various sources for collecting these details about the consumer. The sources include personal enquiry with the applicant, with the employer or with any third person. Direct enquiry is also done through local credit rating agencies.

PRICING OF CONSUMER FINANCE

The pricing of consumer credit depends on the extent of facility offered by the financier. The components of the price are: a risk-free rate of interest assuming no probability of default, default-risk premium, administration expenses, etc.

MARKETING CONSUMER FINANCE

The privilege of availing credit from a retail store is often an attraction to consumers to continue buying from the same store. This result in store loyalty, which is advantageous to retailers. In foreign countries, companies go to the extent of advertising in such a manner as to convert cash customers into credit customers. Retailers often mail personal letters to attract customers. In the event of promotion campaigning by finance companies, the demand may come both from existing customers with additional credit needs, and also from new customers.

Care is always taken by companies to adopt a policy of efficient credit collection, without sacrificing the quality of accounts. Of late, the consumer credit industry has started paying attention to new graduates and the newly shifting families. Similarly, finance companies also collect the addresses of new tenants from building societies or real estate agents. As the salaried class constitutes the most reliable credit customers, finance companies exert great efforts to get tie-ups with employers or employee cooperative societies in order to meet their regular credit demands.

CONSUMER FINANCE INSURANCE

It is a common practice in countries like the U.S. to grant credit insurance in respect of finance to consumers. This kind of insurance is called ‘consumer credit insurance’. The insurance provides for coverage in the eventuality of consumer default in instalment payments. The premium for such insurance is usually collected from the customers.

CONSUMER CREDIT SCORING

As part of the evaluation of credit worthiness of a consumer, and for ascertaining the acceptability criteria of customers, some methods are used. Some of the commonly used methods include Dunham Greenberg Formula, Specific Fixed Formula and Machinery Risk Formula.

Dunham Greenberg Formula

Under this method, points are allotted to various aspects of the consumer’s loan proposal, the total points being 100. It is composed of the following:

Parameter	Score (points)
Applicant employment record	20
Applicant’s income	25
Applicants finance	10
Type of security offered	20
Past payment record	25
Total	100

An applicant is said to enjoy a good credit standing provided the score is 70 points or above.

Specific Fixed Formula

According to this method, a score of over 3.5 would indicate an excellent borrower and a score of over 2.5 indicates a marginal borrower. The scheme of scoring is as follows:

Parameter	Credit Score
Age	0.1 – 0.5
Sex	0.4
Stability of residence	0.042 – 0.42
Occupation	0.16 – 0.55
Industry	0.21
Stability of employment	0.059 – 0.59
Assets	0.20 – 0.45

Machinery Risk Formula

This method is prominently used in government offices for granting loans to employees. According to this method, the loan amount to be sanctioned is determined as follows:

Down payment + (0.124 × Monthly income) + (6.45 × Length of service in months)

CASE FOR CONSUMER FINANCE

Consumer finance plays an important role in the mass production and distribution of consumer durables such as motorcars, refrigerators, TV sets, radios, typewriters, sewing machines, electrical appliances and many other goods. Offering credit is a great convenience to consumers. Further, credit has come to occupy an important place in the modern competitive market. It is used as a selling device and also as an ideal method of sales promotion. A case in point is the wide usage of credit cards. Credit cards, as a tool of modern credit, play a key role in many western countries, enabling consumers to purchase a wide variety of goods and services not only in the home country, but also in foreign countries. It is interesting to note that banks in India have entered the credit cards business in a big way. Following arguments can be given in favor of consumer finance:

1. ***Enjoying possession*** An important benefit of consumer credit is that it allows people to enjoy the possession of goods without having to pay for them immediately. The user does not have to wait and save money for purchasing a dream product.

2. ***Compulsory saving*** Consumer credit allows for a mechanism of compulsory saving. This has the effect of inducing people into using their income more wisely. It promotes thrift among people and enables people with limited means to acquire goods.
3. ***Convenient mode*** Consumer credit, through the open account system, offers a convenient mode of acquiring consumer durables.
4. ***Meeting emergency*** Consumer credit is useful in meeting emergencies, such as illness, accident and death, which involve unexpected expenses. This also helps save the esteem of the consumer in dire circumstances.
5. ***Maximization of revenue*** Consumer credit facilitates speedy disposal of goods, which would have remained unsold in the absence of a credit facility to customers. Credit induces more business. This is quite true with regard to nonessential or luxury goods, such as motorcars, trucks, refrigerators, typewriters, all kinds of electrical appliances, TV sets, sewing machines, etc. It is therefore possible for the manufacturers and dealers to secure ever-increasing sales and profits through credit sales.
6. ***Realization of dreams*** Consumer credit is a boon for a consumer who can enjoy the possession of goods without paying for them immediately. The instalments can be conveniently paid, spread over a fixed future period. Consumers are in a position to budget for the purchase of even expensive capital items out of their regular, fixed and limited income. For instance, it is quite possible for a newly married couple to establish an ultra modern life style and enjoy all the modern amenities of life by acquiring goods immediately, without waiting for the accumulation of savings.
7. ***Accelerates industrial investment*** Consumer credit accelerates investments in the consumer durable industry, ultimately giving rise to growing levels of income and employment. The facility of credit sales makes it possible to acquire goods of high and lasting value, which are otherwise beyond the purchasing power of the middle and lower middle income classes.
8. ***Enhanced living standard*** The facility of credit enables people of even limited means to acquire articles to enhance their general standard of living at an accelerated pace.
9. ***Promoting economic development*** The facility of consumer credit promotes higher levels of investment, employment and income, thus raising the effective level of demand. All these result in industrial prosperity and employment multiplication. Thus, the economy is able to achieve higher standards of growth and development.

10. ***Exportation*** Credit sale, in the form of deferred payments, is a boon to small-scale manufacturers and producers. The enhanced sales pave the way for exportable surplus. Which in turn, induces industrial development. This ultimately contributes to the economic growth of developing countries.
11. ***Effective stock management*** Consumer credit facilitates quick disposal of surplus stocks, even during a period of depression. This helps prevent accumulation of stocks and ensures stable production. Better inventory turnover ratio maximizes sales and minimizes costs.
12. ***Large-scale production*** Consumer credit is responsible for causing production on a large-scale basis. This eventually makes it possible to price goods at a lower rate. This in turn engineers efficient delivery of products in the mass market.
13. ***Protection against inflation*** With inflation becoming a permanent phenomenon, prices of all goods rise every year. Consumer credit serves as an effective antidote against such rising prices, as it is possible to acquire goods without paying cash for the full price, resulting in consumers saving expenses in two ways. Firstly, the evil effects of inflation are warded off and secondly, the effective cash outflow on future instalment payment is less because of depreciated money value.
14. ***National importance*** Consumer credit is a great boon to the modern economy. Credit greatly facilitates sales and distribution of capital goods, which are indispensable to the modern economy. Consumer credit keeps the wheels of industry running smoothly thus contributing to industrial and economic development.

CASE AGAINST CONSUMER FINANCE

Despite the fact that consumer credit for costly and durable goods is convenient and beneficial to all parties concerned, one must guard against excessive or indiscriminate credit demands. Consumer credit suffers from the following drawbacks:

1. ***Thoughtless buying*** Consumer credit being attractive, tempt people to buy goods indiscriminately. The danger may perhaps lie in acquiring them even if they are not needed.
2. ***Insolvency*** Credit forces people to mortgage a substantial portion of their fixed future income. This may lead to insolvency and bad debts on a large scale, which may even ruin the life of the buyer.
3. ***Costly credit*** Consumer credit, along with its benefit of convenient buying, brings with it the severe consequence of costlines of credit.

This is because, the effective rate of interest is much higher than the paper rate of interest. Moreover, the price of goods sold on credit will usually be higher.

4. ***Risk to traders*** Consumer credit poses considerable risk to traders. For instance, in the case of hire purchase financing, although the trader enjoys the right of repossession of the goods sold if the buyer defaults on payments, the article cannot be sold at full price that would be sufficient to pay for the remaining instalments.
5. ***Artificial boom*** Consumer credit creates artificial boom in the consumer durable industry. Hence, the economy witnesses only artificial prosperity.
6. ***Bad debt risk*** Although the various modes of consumer credit generate a substantial amount of revenue for traders, there is always a danger of bad debts. This may jeopardize the interest of the traders many a time. Similarly, granting credit on liberal terms is fraught with the problem of negative consequences to the business community, which may have the effect of derailing the entire economy too.
7. ***Economic instability*** Indiscriminate consumer credit leads to economic instability, i.e. the recurrence of booms and slumps. In boom time, there is overextension of credit. On the other hand, credit is tightened drastically in times of deflation. In a period of recession, default in payment and the consequent bad debts may create financial difficulties. Liberal consumer credit also leads to over-buying and mortgage of future income to such an extent that nations with a rich stock of durable goods face greater economic uncertainty.

BOOM IN CONSUMER FINANCING

At present, the fast moving Indian consumer durables industry is experiencing a boom in consumer financing for the following reasons:

1. Fall in the average age of the consumer for large ticket items like housing, etc.
2. Cheaper rate of interest on borrowings
3. Flexible interest rate structure
4. Increase in the start up salary levels of people
5. Aspirational changes in the life styles
6. The DINK (double income no kid) factor
7. The credit card advantage
8. Spurt in the number of financial services institutions thus increasing competition

9. Increasing tie-ups of manufacturers with financiers
10. Thriving market for used cars
11. The lure of 'zero interest scheme'
12. Attractive terms of lending by financial institutions

HIRE PURCHASE SYSTEM (HPS)

Definition

The mode of acquiring ownership of consumer durables by individuals and productive assets by manufacturers, whereby the payment for the product is conveniently spread over a period of two or three years, is known as 'hire purchase system'. Hire purchase serves as a convenient tool of credit in situations where it is difficult to save in advance to make the purchase of expensive articles but find it easier to make regular payment, weekly or monthly, after they receive the article.

Characteristics

Following are the characteristic features of hire purchase financing:

1. ***Popular method*** Hire purchase is the most popular method used for the sale of expensive and durable goods on credit.
2. ***Rentention right*** In a hire purchase, the seller sells on credit to buyers, the security being the seller's right to retain property rights on the goods sold.
3. ***Instalments*** The hire purchase price is paid in instalments spread over a fixed period.
4. ***Ownership*** The property rights in goods sold remains with the seller, and the buyer gets legal ownership of the article only after the payment of the last instalment.
5. ***Agreement*** The hire purchase transaction takes place through a formal written agreement signed by the seller and the buyer. The agreement provides for the payment of the price in the form of fixed equitable instalments spread over a specified period of time, the instalments being in the nature of rental payables on fixed dates.
6. ***Possession*** The buyer is given possession of the goods on payment of the first rental amount in cash, known as the down payment.
7. ***Default*** When the buyer defaults, i.e. fails to either pay the specified instalments or insure the article in accordance with the terms of the contract, the seller has the right to terminate the hire purchase agreement and take repossession of the article. If the agreement is terminated because of default, the hirer or buyer will have no claim to the amount already paid, since that amount is already treated as rental charges.

8. ***No breach of trust*** Under the hire purchase agreement, the buyer simply hires the article. The buyer cannot commit any criminal breach of trust. If the buyer does so, and manages to sell the article, the seller can recover the article from the sub-buyer, since there is no transfer of ownership.

Hire Purchase Agreement

The hire purchase agreement serves as the basis of hire purchase financing. Following are some of the features of the agreement:

1. ***Formal agreement*** It is a formal agreement between a seller and a buyer, under which the seller agrees to transfer possession of an article to the buyer.
2. ***Document*** It is a document that sets out the terms and conditions on the basis of which goods are sold on credit. It also sets out the payment schedule spread over a fixed future period.
3. ***Property*** The property ownership right for the goods passes from the seller to the buyer only when the last instalment is paid, and only where the buyer fulfills all the terms of the agreement.
4. ***Owner*** The seller is the owner of the goods, right up to the payment of the last instalment. Therefore, the seller can take possession of the article sold in the event of failure to pay the instalments.

Advantages of Hire Purchase System

Hire purchase financing is an ideal mode of consumer and industrial credit in many countries. Presently, it has become a recognized method of doing business whenever it involves the sale of durable and high-price goods. Hire purchase finance offers the following advantages:

1. ***No immediate cash*** Hire purchase finance helps asset creation without having to immediately part with the cash.
2. ***Easy possession*** The hire purchase financing system helps individuals of limited means to realise their dreams by facilitating the possession of the article.
3. ***Economic growth*** Hire purchase finance helps the growth of the economy by enhancing, investment and sales. In addition, the mass sale of expensive and durable goods also contributes to employment generation. It helps mass production and accelerates industrial development and economic growth.
4. ***Thrift*** Hire purchase inculcates/forces the saving habit on the buyer so that it becomes possible to pay instalments without default.

5. ***Relief to buyer*** It relieves the buyer of arranging for loans and advances which eventually involves a financial burden to pay for the asset. It is considered to be advantageous especially for the small sector farmers and industrialists.

Disadvantages of Hire Purchase System

Despite many advantages commanded by the system, there are many drawbacks as detailed below:

1. Available only to reputed buyers
2. Induces mindless, indiscriminate and liberal purchases which may lead to bankruptcy
3. Buyer has to mortgage his/her future income
4. Danger of buyer losing property during depression, as the value of the property diminishes
5. Danger of buyer having to lose even the paid instalments in the event of default
6. Higher price thus making the purchase, an expensive proposition
7. Loss to seller in the event of default by the buyer, which may result in the seller having to repossess an article which may not fetch much market value

Hire Purchase Cost

Hire Purchase finance is a lucrative form of financial investment. Although the field appears speculative, it provides a high interest of income to traders. In fact, traders earn double the nominal interest rates. Under the various systems of consumer credit, interest is calculated on the nominal rate that is added to the cash price of the asset purchased. The amount of the instalment is determined by dividing the purchase price with the number of months of credit provided by the trader. Interest liability remains the same throughout the period of credit as interest is calculated on the fixed cost price of the asset.

For traders, the higher instalment price is justified on the ground that there is an inherent risk of default and repossession, and the article not fetching a price sufficient to pay for the unpaid instalments.

Eligibility

Consumer credit, such as hire purchase and instalment purchase etc. is suitable for individuals who meet the following criteria:

1. Persons with a regular and stable income, and capacity to pay instalments from the current income

2. Persons must be competent to enter into a contract and hence, a minor is not eligible for such sales
3. Not suitable for married women without an independent source of income and personal prosperity
4. Foreigners and persons having no permanent residence in the country are disqualified for such credit sales
5. Persons having no settled or established life at one place are not allowed such credit sales

INSTALMENT CREDIT SYSTEM (ICS)

Definition

A system of consumer financing, whereby the payment of the purchase price is deferred, to be paid in reasonable instalments is known as 'instalment credit system'.

Features

The instalment system, which is a modified hire purchase sale, has the following features:

1. An ordinary sale of goods with easy payment system
2. The buyer obtains ownership and possession on payment of the first instalment
3. Payment is made through a number of instalments
4. No possibility of the article sold being returned to the seller, since sale is complete immediately after the execution of the agreement
5. Seller has no right to recover possession of the goods even if the buyer commits a default in the payment of outstanding instalments and there is no question of forfeiture of paid instalments against default. However, he is entitled to recover his dues with the help of the court

Hire Purchase System (HPS) and Instalment Credit System (ICS)

1. ***Similarities*** The hire purchase and the instalment credit systems have the following features in common:

(i) They are forms of consumer finance for the sale of expensive and durable goods
(ii) They are recognized by the Indian Sale of Goods Act
(iii) Recovery of the price is through instalments spread over a fixed period time
(iv) Both deliver rich dividends in times of prosperity, but suffer heavily during depressions

2. *Suitability* Goods that can be dealt with under both the hire purchase and the instalments systems should have the following features:

(i) Separate identity or individuality to facilitate their recovery when there is a default
(ii) Durability to sustain the long period of instalments and facilitate repossession in the event of a default
(iii) Portability to facilitate repossession in the event of a default
(iv) High enough value to justify a hire purchase agreement
(v) Standard specifications to facilitate reselling, if necessary
(vi) Stable value and good yield, or a sufficient profit margin

The system of HPS and ICS is suitable for goods that help to pay for themselves such as furniture, radio and TV sets, electric cookers, electric washers, refrigerators, typewriters, bicycles, scooters, cars, trucks, houses, vacuum cleaners, air-conditioners, fans, sewing machines, tape recorders, VCR, pianos, machinery, and equipment, etc.

3. *Safeguards* The following factors should be considered when granting credit for hire purchase or instalment sale:

(i) Perishablity of goods
(ii) Capital resources of the trader for investment
(iii) The three Cs of the buyer's financial and moral character, capacity and capital
(iv) Degree of competition to be met and stability of trade
(v) Duration of credit, a shorter period when business is brisk and a longer period during the slack season, with the usual period ranging from five to seven or ten years

HIRE PURCHASE SYSTEM VS. INSTALMENT CREDIT SYSTEM

Sl. No.	Feature	HPS	ICS
1.	Actual Sale	H.P becomes an actual sale only on the payment of the last instalment	The payment of the first instalment is sufficient to make the ICS an outright sale
2.	Legal Ownership	The buyer obtains possession without legal ownership until the last payment	The buyer obtains both ownership and possession immediately after the agreement is executed and the first instalment is paid to the seller

Sl. No.	Feature	HPS	ICS
3.	Hirer/ Owner	The buyer is merely hiring the article, and hence not its real owner	The buyer is the rightful owner on payment of the first instalment
4.	Right to Sell	A hire-purchaser cannot sell the article until the last hire charge is paid	The buyer can sell the article any time
5.	Legal Protection	The seller gets maximum protection of the law	The buyer gets maximum protection of the law
6.	Default	The buyer can lose both the article and the entired amount paid if there is a default	No risk of loss to buyer even on default
7.	Seller's Ownership	The seller can get back ownership and possession if there is a default	The seller cannot repossess but has remedy, can sue buyer in the court.
8.	Bad Debt	Limited risk of bad debts	High risk of bad debts

REVIEW QUESTIONS

Section A

1. What is 'consumer finance'?
2. What is 'revolving credit'?
3. What is 'cash loan'?
4. How is secured finance different form unsecured finance?
5. What are 'credit unions'?
6. What are 'open accounts'?
7. What is 'consumer finance insurance'?
8. What is 'consumer credit scoring'?
9. What is 'Machinery Risk Formula' with regard to consumer credit scoring?
10. What is 'hire purchase system' of consumer financing?
11. What is 'hire purchase cost'?
12. Who are eligible for hire purchase consumer financing?
13. What is 'installment system' of consumer financing?

Section B

1. What are the different types of 'consumer finance'? Explain.
2. Illustrate the mechanism involved in the working of consumer finance.
3. What are the factors that influence the demand for consumer finance?
4. What are the terms and conditions of consumer finance?
5. How is consumer finance priced?
6. How is consumer finance marketed?
7. Explain the 'Dunham Greenberg Formula' with regard to consumer credit scoring.
8. Explain the 'Specific Fixed Formula' with regard to consumer credit scoring.
9. Bring out the case against consumer finance.
10. Identify the factors responsible for the recent boom in Indian consumer finance market.
11. What are the features of hire purchase consumer financing?
12. What are the features of hire purchase agreement?
13. What are the advantages of hire purchase financing system?
14. What are the disadvantages of hire purchase financing system?
15. What are the features of installment system of consumer financing?
16. Bring out the similarities between hire purchase system and installment system of consumer financing.
17. What are the safeguards to be followed while granting credit under hire purchase or installment sale?

Section C

1. Discuss the various available to access the consumer finance.
2. Discuss the different modes of consumer finance available.
3. Give an account of the consumer financing practice in India.
4. What are your arguments in favour of consumer finance?
5. Bring out the differences between hire purchase system and installment system of consumer financing.

Chapter 15

Venture Capital

A form of equity financing designed specially for funding high risk and high reward projects is known as 'Venture Capital'. Venture capital plays an important role in financing hi-tech projects, besides helping research and development projects to turn into commercial production. By financing the technology, venture capital assists in fostering the growth and development of enterprises. In western countries, much of this capital is used for establishing technology and expanding business.

Venture Capital derives its value from brand equity, professional image, constructive criticism, domain knowledge, industry contacts, etc as they bring to table the benefits at a significantly lower management agency cost.

A Venture Capital Fund (VCF) strives to provide entrepreneurs with the support they need to create upscaleable business with sustainable growth, while providing their contributors with outstanding returns on investment, for the higher risks they assume.

Venture Capital Fund activities generally include financing new and rapidly growing companies that are specially knowledge-based, sustainable, upscaleable companies, purchase equity/quasi-equity securities, assisting in the development of new products or services, adding value to the company through active participation, taking higher risks with the expectation of higher rewards, and having a long-term orientation.

MEANING

1. Venture capital refers to an equity/equity-related investment in a growth-oriented small/medium business to enable the investors to accomplish corporate objectives, in return for monetary shareholding in the business or the irrevocable right to acquire it. Venture capital is a typical 'private equity investment'.
2. Venture capital is a popular method by which investors support entrepreneurial talent with finance and business skills to exploit market opportunities with a view to obtaining long-term capital gains. It involves the provision of risk-bearing capital, usually in the form of

equity participation, to companies with high growth potential, besides providing some value addition in the form of management advice and contribution to overall strategy.

3. Long-term investment, generally in high-risk industrial projects with high reward possibilities, is called 'venture capital'. The investment may take place at any stage of implementation of the project, between start-up and commencement of commercial production. Venture Capital is also invested in financing the new business and professional activities that carry a higher degree of success and failure as well. Venture capital implies a high level of risk implicit in the investment of funds.

DEFINITION

1. According to ***Dr. Neil Cross***, a Senior Executive with 3i, one of the world's largest and oldest venture capital companies, and a former Chairman of the European Venture Capital Association, "Venture Capital Investment is defined as the provision of risk bearing capital, usually in the form of a participation in equity, to companies with high growth potential. In addition, the venture company provides some value added in the form of management advice and contribution to overall strategy. The relatively high risks for the venture capitalists are compensated by the possibility of high return, usually through substantial capital gains in the medium-term."
2. According to the ***Bank of England Quarterly Bulletin*** of 1984, "Venture capital investment is defined as an activity by which investors support entrepreneurial talent with finance and business skills to exploit market opportunities and thus obtain long-term capital gains."

The organized financing activity connected with relatively new enterprises in order to achieve substantial capital gains, may be referred to as 'venture financing', such enterprises having very high potential for growth due to advanced technology, new products or services, or other valued innovations.

RATIONALE

The rationale for the venture capital arises on account of the fact that there is a high expectation for large gains for an entrepreneur which acts as the motivation behind taking up risky investments that carry high return profiles. Venture capital investment is made with the objective of obtaining equity ownership in such enterprises initially, and to take part in the growing prospects in the form of capital appreciation subsequently.

FEATURES

1. ***New ventures*** 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. ***Equity 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. ***Objective*** 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 injected to enable the business to grow at a rapid pace, mostly from the start-up stage.
5. ***Hands-on approach*** Venture capital institutions take active part in providing value-added services such as providing business skills, etc to investee firms. They 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 nonliquid.
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 huge capital gains at the time of exit.
7. ***Nature of firms*** Venture capitalists usually finance small and mediumsized 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.

METHODS OF EVALUATION

The evaluation of venture capital investments are generally idea based and growth based, in contrast with the conventional investments, which are asset-based. Venture capitalists employ the following methods in order to evaluate their investments:

1. Conventional Method
2. First Chicago Method
3. Revenue Multiplier Method

Conventional Method

Under this method of valuation, venture capitalists take into account the time at which the investee companies start the venture and the time at which such companies exit their investments. The exit may take place in the form of sale to public/third party and so on. The value of the venture for the purpose of investment involves the following computations:

a. Annual revenue The annual revenue at the time of liquidation of the investments is calculated as follows:

Present annual revenue in the beginning, compounded at an expected annual growth rate for a certain holding period

b. Expected earnings level The expected earnings level is computed as follows:

Future earnings level × After tax margin percentage at the time of liquidation

c. Future market valuation The future market valuation of the venture capitalist is ascertained as follows:

Earnings levels × Expected P/E ratio on the date of liquidation

d. Present value of VC The present value of the venture capital using a suitable discount factor is determined.

e. Minimum percentage of ownership The minimum percentage of ownership required is calculated as follows:

$$\frac{\text{Finance sought} \times 100}{\text{Calculated present value of the venture capitalist}}$$

First Chicago Method

This method gives allowance to the nature of the path between the starting point and the exit point/date, and considers the entire earnings stream.

Following steps are involved in the calculation of the value of venture capital investment:

a. Alternative scenarios The three alternative scenarios such as 'success', 'sideways survival' and 'failure' are to be identified. Probability rating to each of the scenarios is then assigned.

b. Present value of VC The present value of the venture capital investment using a suitable discount factor is determined.

c. Expected value of VC The expected present value of the venture capital investment is computed as follows:

$$\text{Present value} \times \text{Respective probability}$$

d. Minimum percentage of ownership The minimum percentage of ownership required is calculated as follows:

$$\frac{\text{Finance sought} \times 100}{\text{Expected present value of the venture capitalist}}$$

Revenue Multiplier Method

Under this method, a revenue multiplier is used as a factor to estimate the value of the venture capital investments. The venture capital investment is calculated as follows:

$$\text{Annual revenue of the company} \times \text{Estimated revenue multiplier}$$

This method is generally used in the case of early-stage/start-up venture capital investments, where earnings based on after tax profits may be low/negative in the early years, but where there may be revenue/sales income. The drawback of this method is that it is difficult to estimate the revenue multiplier.

ORIGIN AND GROWTH OF VENTURE CAPITAL

The origin and the growth of venture capital funds the world over is presented below briefly:

USA

Venture capital financing originated in the USA after World War II, when investors came forward to invest their funds in new ventures based on new technologies that promised very high returns, growth, and prosperity. Such investments were popular with some of the wealthy American family groups such as the Rockefellers (Standard Oil), Andrew Carnegie, the Phippses (Bessemer Steel), the Rosenwelbs (Sears), the Pitcairn's (Pittsburgh Plate Glass) and the Whitney's (John Hay Whitney and his sister Joan Whitney Payson, heirs of the Vanderbilt Shipping fortune).

The American Research and Development Corporation (ARDC) was formed as the first venture capital organization, in the year 1946. The object was the promotion of new technologies developed in institutions like Massachusetts Institute of Technology (MIT). The other groups that subsequently formed venture capital funds included Draper, Gaither and Anderson, and Davis and Rock. Thereafter, phenomenal growth was witnessed in the venture capital financing.

New groups entered the venture capital field in the 1960s and early 1970s. The Government sponsored Small Business Administration (SBA), which was set up to license companies under the Small Business Investment Act, 1958. These companies were known as Small Business Investment Companies (SIBCs) and were provided venture capital, tax incentive, and Government loans upto four times the initial capital in order to make equity type investments in small business.

Further, a number of close-ended public venture funds were formed for the purpose of providing venture capital financing during this period. These included insurance companies, banks, mutual funds, university endowment funds, foreign investors, investment banker, and incorporated investment companies. Important names amongst the private initiatives included Xerox, and General Electric, which financed technology-based projects. Venture capital financing was a runaway success in the U.S. Invention of the xerographic system of development of Apple computers and setting up of Sillicon Valley, high tech industrial research and development infrastructure bear sufficient testimony to the success story of venture capital in USA.

UK

Venture capital funding originated in Great Britain in the nineteenth century when European merchant bankers and investors were helping the growth of industry in USA, and in their dominions like South Africa, India and elsewhere. Building of railways in parts of America and India, construction of high-risk projects like Suez Canal, etc are examples where pooled resources were put at stake and turned into gold with enormous capital gains.

In the 1980s, several new independent funds like Equity Capital for Industry (ECI), Public Utility Pension Funds, National Enterprise Board, and several semi-state venture capital bodies like Scottish and Welsh Development Agencies were incorporated. The venture capital funds that are active at present in the U.K. may be grouped under the following:

1. Clearing bank captive funds
2. Funds sponsored by savings and investment institutions and merchant bankers

3. Business expansion scheme funds
4. Corporate, academic and other private sector funds
5. Semi-State bodies (both Central and Local Government)

Europe

Venture capital financing became popular in continental Europe in the eighties particularly in France, the Netherlands, Sweden and Belgium under the lead of UK. In 1983, the European Venture Capital Association (EVCA) was formed with a membership of 40 funds, of which 11 are British, 10 French, 6 Dutch and 4 Belgium, 3 Irish, and 3 from Erstwhile West Germany origins. The Fund was primarily aimed at assisting the growth of the small business sector in the member countries of the European community.

The Association was set up with the following objectives:

1. Promoting development of industry across national borders
2. Encouraging the provision of equity finance for innovation and for small to medium sized business
3. Maintaining the highest standard of business conduct and professional competence amongst the members
4. Fostering promotion, research and analysis of venture capital activity in Europe and facilitate contacts with policy makers, research institutions, inventors, trade associations, and other relevant bodies
5. Promoting the use of equity market as appropriate to the exit needs of venture capital investors and investees
6. Promoting financial cooperation and investment within the European community and helping the growth of small businesses in the start-up and development stage through equity participation

Japan and Asia

The kind of industrial development that started taking place in Japan after World War II was attributed to growth in venture capital funding. In Japan, venture capital funds were set up by the leading financial institutions with the main objective of financing high technology industrial units. Some of the important venture capital companies promoted by such finance companies include 'Daiwa Securities' sponsored by Nihon Investment and Finance Company, 'Sanyo Securities' sponsored by Sanyo Finance, and 'Yamaichi Securities Group' and 'International Bank of Japan' sponsored by Yamaichi Sogo Finance.

Other Asian countries also witnessed good growth in venture capital financing. Some of the prominent countries like South Korea, Singapore, Hong Kong, Thailand, and Malaysia started their venture capital experiences in the early seventies and eighties, modelled on American. The main reason for the development of venture capital funds was the strong growth in Gross National Product (GNP) and trade surpluses, which gave rise to the supply of capital for high risk investment.

Taiwan

Hsinchu, the science-based industrial park is the showpiece of Taiwan's success story. 40 percent of the firms established in this government-promoted park was begun by entrepreneurs from the United States. Facilities at Hsinchu include English language teaching for the children of its expatriate entrepreneurs. The Hsinchu experiment has benefited from the generally high quality of education in Taiwan, whose institutes produce 50,000 engineers annually. Taiwan has 74 technical schools, 36 colleges, and 24 universities, two of, which are located near Hsinchu Park. The venture capital environment has also been a favorable factor.

Taiwan's government has been particularly successful in promoting its hardware industry through tax incentives, low tariff barriers, and delivering credit at cheap rates. The government also provides good infrastructure facilities by establishing research institutes. For instance, the Industrial Research Institute, owned by the government, developed technology at the institute. This led to two very successful integrated chip firms, viz. the United Microland Corporation (UMC) and the Taiwan Semiconductor Manufacturing Corporation (TSMC), which were initially promoted by the government, and ultimately privatized.

Taiwan has benefited from its close ties with Silicon Valley. A transnational community of Taiwanese venture capitalists has fostered a two-way flow of capital, skills and information between Silicon Valley and Taiwan. There is also an emerging trend of grouping Taiwanese and Indian high technology talents in Silicon Valley.

Israel

The venture capital industry in Israel has grown well, owing to its expertise in developing technology, rather than software or products. This focus has meant that the larger technology firms most typically acquire new Israeli ventures. Besides, the IPO route in the U.S. markets has also been successful. In fact, Israeli companies are the second largest group of companies listed on the Nasdaq after American companies, a remarkable achievement for a country of 6 million people. Like Taiwan, Israel is another country in which government policy has fostered a successful, highly diversified, self-reliant industry. In the early 1990s, Israel restructured its legal, accounting and regulatory framework to mimic that of the United States.

The new Israeli framework guarantees U.S. investors parity with U.S. tax rates. In 1984, the Israeli government passed a law to encourage industrial research and development (R&D), and created the Office of the Chief Scientist to implement government policy related to this area. The law's strategy is to encourage private companies to invest in R&D projects, with the government sharing the business risk. Under the law, a Research Committee appointed by the Chief Scientist approves proposals for anywhere between 30 and 66 percent of a given projects' funding (up to $2,50,000). These proposals, when funded, also receive tax exemptions for upto 10 years. As an additional incentive to entrepreneurship, the Israeli government has created 26 technology incubators designed to allow start-ups to convert their ideas into commercially viable products.

Israeli government participates in international cooperation, seeking to match the nation's technical skills with global markets, and to share start-up risks up front with later-stage activities such as marketing. The most successful of these ventures has been the Bilateral Industrial Research and Development Foundation (BIRD), a joint venture with the U.S. government. The Israeli high technology industry enjoys the same kinds of transnational ties that have helped Taiwan. Similarly, the Israeli venture capital industry has strong U.S. connections. Several of Israel's experiences have relevance for India. Government policy on incubators, the funding of R&D projects, and the BIRD project provide useful object lessons for the Indian government and business alike.

India

Venture capital that originated in India very late, is still in its infancy. It was the Bhatt Committee (Committee on Development of Small and Medium Entrepreneurs) in the year 1972, which recommended the creation of venture capital. The committee urged the need for providing such capital to help new entrepreneurs and technologists in setting up industries. A brief description of some of the venture capital funds of India is as follows:

a. Risk capital foundation The Industrial Finance Corporation of India (IFCI) launched the first venture capital fund in the year 1975. The fund, 'Risk Capital Foundation' (RCF) aimed at supplementing 'promoters equity' with a view to encouraging technologists and professionals to promote new industries.

b. Seed capital scheme This venture capital fund was launched by IDBI in 1976, with the same objective in mind.

c. Venture capital scheme Venture capital funding obtained official patronage with the announcement by the Central Government of the 'Technology Policy Statement' in 1983. It prescribed guidelines for achieving technological self-reliance through commercialization and exploitation of technologies. The ICICI, an all-India financial institution in the private sector set up a Venture Capital Scheme in 1986, to encourage new technocrats in the private sector to enter new fields of high technology with inherent high risk. The scheme aimed at allocating funds for providing assistance in the form of venture capital to economic activities having risk, but also high profit potential.

d. PACT The ICICI undertook the administration of Program for Application of Commercial Technology (PACT), aided by USAID with an initial grant of U.S.$ 10 million. The program aims at financing specific needs of the corporate sector industrial units along the lines of venture capital funding.

e. Government fund IDBI, as nodal agency, administers the venture capital fund created by the Central Government with effect from April 1, 1986. The government started imposing a Research and Development (R&D) levy on all payments made for the purchase of technology from abroad, including royalty payments, lump sum payments for foreign collaboration and payment for designs and drawings under the R&D Cess Act, 1986. The levy was used as a source of funding the venture capital fund.

f. TDICI In 1988, an ICICI sponsored company, viz. Technology Development and Information Company of India Ltd. (TDICI) was founded, and venture capital operations of ICICI were taken over by it with effect from July 1, 1988.

g. RCTFC The Risk Capital Foundation (RCF) sponsored by IFCI was converted into Risk Capital and Technology Finance Corporation Ltd. (RCTFC) in the year 1988. It took over the activities of RCF, in addition to the management of other financing technology development schemes and venture capital fund.

h. VECAUS VECAUS-I, the UTI sponsored "Venture Capital Unit Scheme" was launched in the year 1989.TDICI was appointed as its managers. In the year 1990, the corporation was also entrusted with the responsibility of managing another UTI sponsored venture fund entitled 'VECAUS-II'. In 1991, UTI launched VECAUS-III and RCTC was appointed as fund manager.

i. Other funds The liberalized guidelines introduced by the government, in 1988, gave rise to the setting up of a number of venture capital funds, especially in the private sector. Some of these funds include the following:

Fund	Year
India Investment Fund	1987
Second India Investment	1989
Canbank Venture Capital	October 1989
Credit Capital Venture	January 1990
APIDC Venture Capital Ltd	October 1990
Gujarat Venture Finance Ltd	November 1990
Twentieth Century Capital Corporation Ltd	August 1991
Indus Venture Capital Management Ltd	October 1991
IL & FS Venture Corporation	1991
IFB Venture Capital Finance Ltd	November 1992
SIDBI Venture Capital Fund	April 1994

VENTURE CAPITAL AND OTHER FUNDS

Venture capital funds are different from other capital funds in many respects as shown below:

Venture Capital and Development Capital

Venture capital is advanced for ventures using a new technology or new innovation. In this type of financing, the venture capital company remains interested in the overall management of the project due to the high risk involved in the venture. Funds are made available throughout the project, commencing from commercial production to the successful marketing of products, to ensure continuous revenue earnings, enhanced worth of the investments, and finally making available a proper exit route for liquidating the investments.

Development capital, on the other hand, is generally granted in the form of loans for setting up industrial units, and also for expansion and modernization. The lender takes special care in ensuring the end use of the credit and requires prompt payment of interest and repayment of the loan amount.

Venture Capital, Seed Capital and Risk Capital

There is no tangible differences between venture capital, seed capital and risk capital. Both seed capital and risk capital are components of venture capital. Seed capital and risk capital are provided by all-India financial institutions in the form of promoters' contribution to the project, with the emphasis on providing interest free finance to encourage professionals to become promotees of industrial projects.

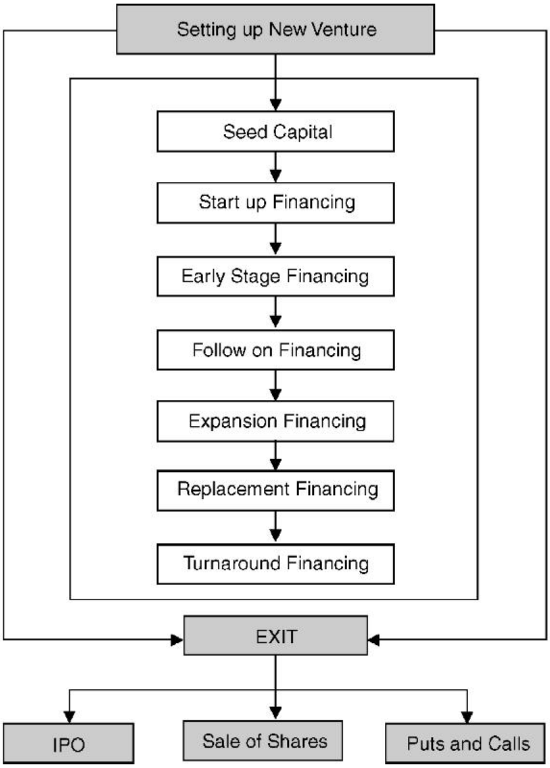
Venture Capital and National Equity Fund for Small Entrepreneur

The National Equity Fund, administered by SIDBI, was established in 1987, with the object of providing seed capital assistance to small entrepreneurs, in the rural as well as urban areas, with a population below 5 lakhs.

STAGES OF VENTURE CAPITAL FINANCING[1]

The various stages involved in a typical venture financing exercise are depicted in Exhibit 11.

Exhibit 11 Venture Financing Process



[1] Adapted from "Introduction to Venture Capital Finance", by Bovaird Chris, published by Pitman Publishing, London, 1990.

Seed Capital

This is an early-stage financing. This stage involves primarily R&D financing. The European Venture Capital Association defines seed capital as, "the financing of the initial product development or the capital provided to an entrepreneur to prove the feasibility of a project and qualify for start-up capital."

This stage involves serious risk, as there is no guarantee for the success of the concept, idea, and process pertaining to high technology or innovation. This stage requires constant infusion of funds in order to sustain the research and development work and establish the process to successful adaptation, going into the commencement of commercial production and marketing. Venture financing constitutes financing of ideas developed by research and development wings of companies or at university centers. Chances of success in hi-tech projects are meagre. The venture capital fund considers the following points to safeguard its own interests:

1. Successful performance record, entrepreneurs' previous experience in similar products, technology and market
2. Qualities of business management and technical innovation in the enterprise, realistic business plan with clear future prospects for which seed capital is required

Start-up Financing

The European Venture Capital Association defines start-up capital as "capital needed to finance the product development, initial marketing and the establishment of product facilities". This too falls under the category of early-stage financing. The term 'start-up' refers to the stage where a new activity is launched. The activity may be one emanating from the R&D stage, or arising from transfer of technology from overseas-based business.

Venture Capital finance is provided to projects which have been selected for commercial production. The activity chosen for funding has the potential for fulfilling effective demand. Venture capitalists provide finance with a view to take advantage of the capital gain arising from equity appreciation on completion of such projects and marketing of its product. The venture capitalists, on their part, take into consideration such factors as the managerial ability, capacity, experience, competence etc of the entrepreneur before making investments.

The entrepreneur should furnish the following information in their proposals to the venture capitalist/merchant bankers:

1. Brief history of business or project
2. A synoptic note on career history of entrepreneur and key managers
3. Description of product/service to be manufactured/rendered
4. Description of market for the product/service with existing/future state of competition, growth prospects in the share market, etc.
5. Description of technical process involved, and technology to be followed in the manufacturing process
6. Degree of technological obsolescence in technical process
7. Financial history and forward projections of turnover profits, cash flow and borrowings over at least a two-year period
8. Proposed deal structure for the funding being sought

Venture capitalists appraise projects by taking the following key factors into consideration, with the basic objective of assessing the degree of risk involved in financing, and then judge the realistic expectation of the gains.

a. The track record The track record of the promoter/entrepreneur/management team/skilled staff resource is analyzed to evaluate the management performance record, ability and capacity of the entrepreneur to handle the proposed business plan successfully.

b. Performance assumptions The technical performance assumptions about the product/process/service, the technical strength of the proposed process service with reference to product life cycle are also analyzed.

c. Market potential Market potential, relating to market size, growth and penetration are analyzed. In addition, evaluation of the existing market sizes, future growth of the market and ability to absorb the product/service, existing state of domestic competition and international competition is also carried out.

d. Cost structure An analysis, in order to evaluate profitability projections on realistic cost assumptions and competitive price setting is undertaken, as part of venture financing.

e. Time schedule Overall completion time is ascertained by evaluating the time schedule given by the client for completion of the plan on a realistic basis, and the experience gained by the venture capitalist/merchant bankers from other projects.

Early-stage Financing

The European Venture Capital Association defines early stage finance as "finance provided to companies that have completed development stage and require further funds to initiate commercial manufacturing and sales. They will not yet be generating profit." This is the kind of financing required for completing the project. It is required immediately after the start-up stage of a project. The enterprise may need further investment before completion of the project. The need for additional funds arises when the project encounters cost and time over-runs, or when the completed project starts making losses, thus necessitating the infusion of equity type funding. This type of funding may also be required when the start up has been successful, and the business is growing.

Follow-on Financing

The European Venture Capital Association defines follow-on financing or second round finance as "the provision of capital to a firm which has previously been in receipt of external capital but whose financial needs have subsequently expanded". Later-stage, in a project, implies that the project has passed the test of acceptability and has proved to be successful. Since project at this stage promises to be attractive in terms of earning potential, it is considered to be the most attractive stage for venture capital financing. Financing, at this point in the project, is preferred by venture capitalists around the world, particularly in the UK and USA.

Expansion Financing

The European Venture Capital Association defines expansion capital or financing as "the finance provided to fund the expansion or growth of a company which is breaking even or trading at a small profit." Expansion or development capital will be used to finance increased production capacity, market or product development and/or to provide additional working capital. This is one of the later-stage financing methods, whereby finance is provided by the venture capitalists for adding production capacity, once it has successfully gained a market share, and faces increased demand for the product. Financing is also made available for acquisition or takeover.

Replacement Financing

A later-stage financing method, also known as 'money-out deal', whereby venture capitalists extend financing for the purchase of the existing shares from an entrepreneur or their associates in order to reduce their holdings in the unlisted company, is known as 'replacement financing'. This sale of shares may be by persons other than entrepreneurs or their associates. The venture capitalist may buy ordinary shares from vendors and may convert them into preference shares bearing a fixed dividend coupon. Such shares may be converted back into ordinary shares if the company is listed, and can thereafter be sold.

Turnaround Financing

This is the type of financing provided by the venture capitalists in the event of an enterprise becoming unprofitable after the launch of commercial production. This is provided in the form of a relief package from the existing venture capital investors, and the enterprise is provided with specialist skills to recover. This form of financing is popular in the U.S. Finance is made available to a nonlisted and nonprofitable venture in need of equity funds to allow for a turnaround. The finance may also be provided to sustain the current operations of the enterprise.

Management Buy-Outs (MBOs)

The European Venture Capital Association defines management buy-outs as "the acquisition of a company (or the shares in that company) from the existing owners by a team of existing management/employees. The vending shareholder may or may not have been actively involved in the running of the company, the acquiring group are presumed to be actively involved in the day-to-day running of the company and are making the acquisition with a view towards becoming active owner-mangers." Deals pertaining to the purchase of management holding of an enterprise are called 'buy-out deals'. Venture capital funds are made available to finance the buy-out of management holding of the enterprise. Buy-out financing originated in the U.S. and is popular in the European venture capital industry too.

The characteristics of MBOs are:

1. It is corporate finance in the form of equity in situations where the ability to obtain debt is constrained
2. MBOs finance is, above all else, an investment in the management of an investee firm
3. It requires the surrender of a portion of the management's equity, in return for finance from the venture capitalists

The danger of MBOs is that funds being so readily available, inadequate management teams may undertake them. One of the biggest problems facing these teams is the sudden realization that corporate-wide services, once taken for granted, are no longer available. Further, MBOs often take place on the instigation of corporate finance teams of merchant banks, rather than the company management.

Management Buy-ins

A management buy-in involves bringing in a management team comprising of outsiders, who are strangers to the company, as opposed to a buy-out, where they are part of the existing team. The European Venture Capital Association defines management buy-in as “funds provided to enable a manager or group of managers from outside the company to buy-in the company with the support of venture capital investors”. Four elements are essential for the successful management buy-ins. They are:

1. A management team with a successful track record, preferably in the same industry as the company they are taking over
2. An existing management, which is willing to stay in place and work with the incoming management as a team
3. An investor, able to judge the good management team, and willing to take on the high risk associated with buy-ins as compared to buy-outs
4. A target company, which is under-performing because of weak management

The risks involved in attempting a management buy-in are numerous. There is likely to be a higher casualty rate than with buy-outs, as teams of new managers, who may not have worked together before, go into industries with which they may not be intimately familiar. This places an extra premium on management skills and on the management’s ability to respond to the problems of the company they are joining. Another danger to the success of management buy-ins is a possible clash of cultures between managers.

Mezzanine Finance

The last stage of equity related funding is known as ‘mezzanine financing’. It is half-way between equity and loan capital, in terms of risk and return. It is often the last type of financing supplied to a private company in the final run up to a trade sale, or a public floatation. Mezzanine financing is supplied as a layer, which ranks behind secured lending, but before ordinary share capital. Thus, mezzanine funding may be supplied either as debt (high coupon bonds), or as high-ranking equity (preference shares).

Mezzanine finance is intended as a bridge finance, and has a maturity period of less than 2 years. When structuring a MBO, the provision of mezzanine finance allows the management to retain a greater share of the business than could otherwise be afforded.

ANALYZING VENTURE CAPITAL PROPOSALS—CRITERIA

A venture capitalist considers the following factors before committing the funds:

Fundamental Analysis

According to Bovaird Chris, fundamental analysis refers to an examination of the fundamental aspects of the business, without which the investor cannot even begin to make an informed decision. As part of fundamental analysis, the following factors are considered:

1. ***History*** A brief history of the company, including date of incorporation and a summary of progress
2. ***Management*** The quality, experience, strategy and motivations of management, directors and existing shareholders
3. ***Products*** A complete description of the company's products or services
4. ***Markets*** The markets which the company serves, including size and nature of the industry, location and characteristics of customer base, potential competition and unique selling points
5. ***Manufacturing*** Manufacturing and operational aspects of the business, including a description of the technology used, access to sources of supply, manufacturing capacity and the premises owned or occupied
6. ***Risks*** An objective analysis of the fundamental risks and the management's plans to cope with the same

Financial Analysis

The purpose of financial analysis is to set out the financial implications of a company's strategy and to measure its performance. Following aspects are considered by a venture capitalist to determine the financial viability of the project:

1. Earnings growth potential
2. Sensitivity of earnings to sales and margins
3. Likely time-lag between investment and return
4. Likely impact on cash flow
5. Expected value of the company at the notional time of divestment
6. Analysis of the financial risks and management's plans to cope with these

Portfolio Analysis

Portfolio analysis consists in examining the venture capitalist's portfolio balance at the time the investment proposal is being considered. Accordingly, the proposed investment must be an acceptable addition to the venture capitalist's portfolio, in terms of its size, its stage of development, its geographic location and its industry sector. Following aspects are considered in this connection:

1. ***Size of investment*** The amount of money per investment has a significant impact on the size of the portfolio. Moreover, if the venture capitalist builds up a very large portfolio, hands-on management will be difficult.
2. ***Stage of development*** A venture capital portfolio will typically consist of some companies, which are in the start-up phase, some companies in a development stage and others in the mature phase of its life cycle, such as MBO investments.
3. ***Geographic location*** In order to reach an acceptable level of portfolio diversity and volume, many funds will go in search of foreign investments. The basic principle of a successful international investment policy is to join a syndicate with a local fund, which will have a superior understanding of the market, and also the social, investment and tax environment.
4. ***Industry sectors*** This is the fourth factor in portfolio diversification. Venture capitalists attempts to diversify the portfolio in order to offset problematic or slow growth investments.

Divestment Analysis

Divestment calls for venture capitalists to have a clear idea about the method, the timing and the valuation of the company upon divestment. There are four principal means by which venture capitalists realize investments. They are:

a. Trade sale The process of selling the investment to a company in the trade, i.e. a competitor wishing to buy the investee's market share or production capacity, a supplier intending to integrate forward, or a customer trying to integrate backward or tie up sources of supply, is referred to as 'trade sale'. A trade sale is in the form of an unexpected and unsolicited bid.

b. Take-out The process of selling the investment to another professional investor, another venture capitalist, by way of private placement with a major institutional investor such as an insurance company or pension fund manager, or to a management holding company, is known as 'take-out'. Under this arrangement, typically, only the venture capital company will sell its shares while the entrepreneur retains his stake.

c. Earn out In this method, the venture capital investment is realized through the entrepreneur buying back the venture capitalist shares with the proceeds of the project. For this purpose, the entrepreneur is given an option at the time of investment.

d. Floatation This is the final exit route for the venture capital investment. Under this method, issue of securities is made in the stock market. In order to float, the company must have a good, and complete management team. The methods of floatation may vary as shown below:

(i) ***Placings,*** where a company's shares are placed with pre arranged buyers
(ii) ***Offer for sale***, where a company invites the public to subscribe to its shares at a fixed price, which is underwritten
(iii) ***Tender***, where the public is invited to name the number of shares and the price it will pay, with a minimum price underwritten

BUY-OUTS

Buy-outs are a recent addition to the services provided by merchant bankers and saving institutions, and a new form of investment in the European venture capital industry. U.S. Banks first launched the concept of buy-out, already in practice in the UK, during the recession in the late sixties and seventies.

Advantages

Buy-outs are popular among the investment managers on account of the following reasons:

1. Lower investment risk
2. Growth of small enterprise
3. Industrial deconcentration
4. Owner-manager concept of business
5. Development of new entrepreneur
6. Management commitment, motivation and drive
7. Good personal relation
8. Facilitating the importation of technological knowledge, problem solving devices, etc.
9. Better industrial relations
10. Enhanced management performance
11. Balanced mix of talents to achieve optimal results and productive efficiency
12. Revenue earning objective is implemented from the first day to generate cash and liquid assets in order to meet the cost of borrowings, and earn profits

Precautions

Following are the precautions to be taken for ensuring the success of buy-outs by venture capitalists and merchant bankers:

1. Avoiding conflict between management teams
2. Reduction of excessive initial debt-gearing
3. Adequacy and conducive atmosphere in the management team for the buy-out enterprise
4. Ensuring pre-investment market survey to locate potential market is order to ensure an adequate market share
5. Ensuring sufficiency of cash

Types

Buy-out deals are of the following types:

1. Management buy-outs
2. Shareholder buy-outs
3. Receivership buy-outs

Management Buy-outs

Management buy-outs, also known as corporate sale buy-outs, are a type of buy-out, whereby existing entrepreneurs transfer the controlling interest to another entrepreneur. The buy-out usually involves 100 percent sale of the total business. It may also be a partial or complete divestment, where the original promoter may retain either a minority interest or none at all in the enterprise. Management buy-out may also be for a subsidiary division or operating in different form, such as business entity or product names.

Corporate sale buy-outs are preferred in circumstances where the unit is unprofitable, but could be rendered profitable through a buy-out. The unit is subsidiary to the core activity, and is required to be separated from it in order to concentrate on the core activity. This way the management resources have greater opportunity cost elsewhere with the post-merger rationalization of unwanted activity.

Management buy-out may take the following forms:

a. Small scale corporate sale This comprises of debt based small-scale buy-outs, equity based small-scale buy-outs and deferred considerations buy-outs. The management team of the company may acquire the business from its parent company at an agreed value. Debt based small scale buy-outs have a higher proportion of debt included in the deal of assets, where realization within a short period is possible in order to repay the debt from assets surplus. Equity based small scale buy-outs assume no assets disposal, and investors may take the equity base as equal to management. In the deferred considerations buy-outs, the vendor may leave a part of the consideration money at no interest rate for several years, and the external debt element in the structure can be reduced.

b. Large scale corporate sale buy-outs These are larger buy-outs and are syndicated by several investors.

Shareholder Buy-outs

Share repurchase involves the existing management team buying out the controlling holdings from the original promoters, who wish to retire from the management. This is done with the help of venture capitalists who supply the required funds.

Receivership Buy-outs

It resembles to start-up financing. A new company is formed to take on the assets and trading names of the group. The capitalization of the new company depends partly on the valuation of assets being acquired from the receiver at a discount.

FINANCIAL SOURCES

Venture capitalists in India, in addition to using their own funds, make use of many other sources such as all India Financial Institutions, Foreign Institutional Investors, Multilateral Development Agencies, Foreign Investors, Private Sector Banks, Nationalized Banks, Public Sector banks, State Financial Institutions, Non resident Indians, Insurance Companies, and other Banks and Mutual Fund, to obtain equity funds.

Some of the debt instruments used for venture capital financing include income notes, nonconvertible debentures, partly convertible debentures, fully convertible debentures, zero interest bonds, secured premium notes, deep discount bonds, conditional loans, etc.

INVESTMENT NURTURING [2]

Definition

The process, by which venture capital companies continue to involve themselves in the operations of concerns assisted by them, is called 'investment nurturing'. There is an enduring relationship of after-funding care between the venture capital companies and the units assisted by them.

---

[2] Adapted from "Study on Accounting and Financial Reporting by Venture Capital Organizations", the Canadian Institute of Chartered Accountants, Toronto, 1987.

Objectives

Following are the objectives of investment nurturing undertaken by the venture capital companies:

1. Ensuring proper utilization of assistance provided, any deviation from the programme/appraisal should be with the prior approval of the VCI
2. Ensuring the implementation of the project/venture within the time and cost/envisaged
3. Assisting in finding additional/supplementary finance, in case of time and cost over-runs beyond the control of the VCU
4. Providing strategic inputs in technology, production, finance, marketing, personnel and so on
5. Anticipating likely problems and advise preventive/remedial actions
6. Ensuring that the venture does not default in any statutory/other obligations
7. Evaluating the performance of the project and suggesting measures for improvement, if required
8. Making use of the feedback received during the course of nurturing the investment, to study any problems and finding suitable solutions
9. Utilizing past experience for a better appraisal of new ventures

Elements

The main elements of nurturing are as follows:

1. Provision of continuing guidance and support to optimize the benefits of investment to both the venture capital companies and the units concerned
2. Building a joint relationship to tackle operational and other problems of business
3. Protection of the investment/interest of the venture capitalists

STYLES OF VENTURE FINANCING[3]

The extent of participation by the venture capital companies in the affairs of the assisted units constitutes the style of nurturing. The style depends upon a variety of factors such as the specialization of the venture capital company, the stage of investment, financing plan, the stage of development

---

[3] Adapted from "Study on Accounting and Financial Reporting by Venture Capital Organizations", the Canadian Institute of Chartered Accountants, Toronto, 1987.

of the venture capital industry, etc. The different categories of styles that are adopted for venture financing are as follows:

Hands-on Nurturing

Continuous and constant involvement in the operations of the investee company by way of representation on the board of directors is referred to as 'hands-on nurturing'. Venture capital companies provide useful guidance on aspects of long-term business planning, technology development, financial planning, marketing strategy, etc. to the units assisted by them. It is an essential style of financing in the early stage of the project. This type of care is provided either by in-house expertise, or by a core group of external advisors/experts in specific areas.

Hands-off Nurturing

According to this style of nurturing, venture capital companies do not take part in the appointment of nominee directors on the board of the assisted firms. The venture capitalists do not normally actively participate in formulating strategies/policy matters, in spite of the right to do so. This type of nurturing style is appropriate in case of syndicated/joint/consortium venture financing. The hands-off style may also be appropriate after the initial plan of the venture is over, and the business is running smoothly.

Hands-holding Nurturing

In this style, the venture capital companies take part in the management of the ventures only when approached by the units. Venture capitalists provide either in-house assistance or arrange assistance, from outside experts.

NURTURING METHODS

Venture capital companies adopt several methods to elicit information in order to carry out the job of nurturing the assisted units. Some of the methods are briefly presented below:

Personal Discussions

In order to be able to assist the investee units in an effective manner, venture capital companies collect information through personal/informal discussion with the entrepreneurs. The information thus collected will provide the most comprehensive and effective insight into the working of the venture. This technique is especially useful when the venture is facing operational problems.

Plant Visits

Plant visits are undertaken by venture capital companies in order to collect first-hand information. For ventures which are at the implementation stage, the purpose of a plant visit is to review the progress of implementation of the project, to see that adequate and well-qualified personnel are appointed for the implementation of the venture, to ensure that the requisite sanctions are obtained for funds from other sources, if necessary, and to check if the venture has initiated action for obtaining working capital from banks. In addition, plant visits help examine aspects such as the staffing pattern of production, marketing, finance and personnel departments, operational performance of the project, marketing aspects with special reference to product acceptance, market penetration, distribution, pricing, product awareness, advertising, competition and so on.

Feedback

Venture capital companies also collect information through the nominee directors. The nominee directors, in addition to protecting the interest of the venture capital companies, contribute effectively to management by providing the requisite guidance. They also ensure that the business is run on a sound basis. The nominee directors should, therefore, have good exposure to industry, have adequate knowledge about technological developments, changes in government policies, financial management, laws, regulations and so on.

Periodic Reports

Information about the operations of the units that have been assisted is also collected by the venture capital companies through periodic reports. The results are then analyzed and compared with the projected performance, and follow-up action is initiated.

Commissioned Studies

These constitute special studies conducted to identify problems and offer solutions so that preventive action can be taken. These are undertaken when the venture capitalists lack experience and face difficulties in nurturing.

COMPENSATION

The mode of compensation to the venture capitalists is determined before undertaking the venture financing. In general, a venture capital company is paid compensation in the form of an annual management fee. This covers the normal operating expenses, such as salary and allowances of employees, administrative expenses and all expenses related to the selection of investments, as well as disinvestments, but excludes legal expenses and professional fee related to investment portfolio, which are reimbursed separately. It is generally 2 to 3 percent of the Net Asset Value (NAV) or the capital of the fund.

FORMS OF ORGANIZATION[4]

The structural aspects of venture capital companies greatly determine their profitability and their contributors and participants. While designing the structure of such companies, objectives such as limited liability of investors, simple operation of funds, tax transparency of the fund in the sense that double taxation is avoided, tax exemption of the carried interest defined as the extra incentive/profit to the managers over and above the share attributed to their capital contribution and the management fee, maximum tax benefits to investors, etc. are considered. A brief description of the generally adopted forms of organizations by the venture capital companies is presented below:

Limited Partnership

Although the partnership form of business organization carries unlimited liability, limited liability partnership has evolved to cater to the needs of the venture capital industry in the USA. It is their most favored method of structuring a venture capital company. The two types of partners in a limited partnership are general and limited. The liability of the general partner is unlimited, and that of the limited partner, is limited. The limited partner does not participate in the actual operations of the business. It is the general partners who actively participate in the affairs of the investee company by carrying out functions such as business identification and development, investment appraisal and investigation of potential investment, negotiation and closing of deals, investment monitoring, advice and assistance to investee companies, arrangement for sale of shares at the exit time, and other fund management functions.

Investment Company

Investment Company is a simple form of organization for venture capital companies. The investment company manages the portfolio of its investments in a wide range of undertakings. Both the venture capital company and the investee company attract taxation.

---

[4] Adapted from "Venture Capital Manual", by Lee, S.J., published by Warren Gorham and Lamont Inc., Boston, 1990.

Investment Trust

Being in the nature of a trust, it is generally not liable to tax on chargeable gains/dividends. However, its other incomes are taxable. The availability of tax concessions is subject to stipulations such as the fact that income should be derived wholly/mainly from investment in shares/securities, holding in any single company other than another investment trust should not exceed 15 percent of the value of the investment, the shares are listed, it distributes at least 85 percent of the income from shares/securities, and so on.

Offshore Investment Company

A company that is incorporated in a country other than the country in which the offshore company makes an investment is known as 'offshore investment company'. Its tax liability depends on the tax laws applicable to the resident status of the company.

Offshore Unit Trust

It resembles offshore investment company in organization, but enjoys tax concessions and is very flexible in structure.

Small Business Investment Company

This type of organization is followed by banks, which participate in ventures in the form of equity and long-term debt. They are prohibited from investing more than 20 percent of their capital and reserves. Similarly, they are not allowed to acquire controlling interest in a single company. The loans must be for more than 5 years. This is a very flexible structure of equity investments.

EXIT MECHANISM

Every venture capital investment is usually liquidated after accomplishment of the purpose of the venture investment. Capital gains are usually made by the venture capitalists since they are in a position to sell their units at a fabulous price in the capital market. The time of exiting is decided in advance, sometimes even at the time of financing the venture companies. Several factors are taken into account before deciding the exit, such as nature of the venture, the extent and type of financial stake, the state of actual and potential competition, market condition, the style of functioning, as well as perception of the venture capital companies, etc.

Methods of Exit

Following are the methods used by the venture capital companies to exit from the venture assistance in terms of equity investments:

1. ***IPO method*** IPO (Initial Public Offering), also known as Going Public or Floatation, is a method of exit adopted by a venture capital company, whereby exiting takes place through a public issue of capital. It is the most popular exit route. The chief advantage of this method is that it facilitates liquidity of investments through listing on stock exchanges. Besides, the method commands benefits such as higher price of securities as compared to private placement, better image and credibility with the public, managers, customers and financial institutions. An important requirement for venture companies resorting to this method is the adoption of reporting requirements, stock exchange regulations, disclosure requirements, etc. The chief drawback of this method is the higher issue costs, increased accountability to shareholders, etc. Venture capitalists can also approach the OTCEI as a public issue for exiting, whereby bought-out deals are struck with the members of the OTCEI, who would in turn offer the shares thus acquired, to the public at a future date.
2. ***Sale of shares method*** Under this method, sale of shares is undertaken by the venture capitalists to entrepreneurs who have promoted the ventures. The entrepreneurs, through employees, can also acquire shares by forming an employee stock ownership trust. The sources of the trust include contribution by the employees/ company and borrowings from financial institutions and banks.
3. ***Puts and calls method*** Under this method, the exit takes place through puts and calls. For this purpose, venture capital companies enter into a formal exit agreement with the entrepreneurs at a price based on a predetermined formula. This is a fairly popular exit route. The put option is the right to sell, while the call option is the right of the entrepreneurs to buy. The put and call values are determined as follows:
   - (i) ***Book value method*** Price is determined using the book value of net assets of the units assisted. This is the method being followed in respect of mature companies that have achieved a reasonable degree of stability in operations.
   - (ii) ***P/E Ratio*** Price is determined as the earnings per share multiplied by the P/E ratio, the method being used for exercising the put-and-call option.
   - (iii) ***Percentage of sales method*** Price is determined with a modified P/E ratio using the pre-tax earnings of the investee company, the method being followed in the early stages.

(iv) ***Multiplier cash flow method*** Cash flow is the basis for sale of investment. The value of the company/shares is determined by multiplying cash flow with the industry multiplier.

(v) ***Independent valuation*** The value of investment is also determined by engaging an independent outside expert. The net value is computed on the basis of the net/realizable value of all the assets, less the liabilities.

(vi) ***Agreed price*** This is the price which the venture capital companies, and the units assisted, have agreed to at the time of financing.

4. ***Trade sales*** Under this method, the entire investee company is sold to another company at an agreed price. This takes place through a management buy-in or buy-out. The most appropriate method for such a sale varies with the circumstances of each individual case, keeping in view taxation and other considerations.

   A variation of this method is to sell the equity stake of the venture capital company to a new investor. The new investor may be a corporate body or even another venture capital organization. The corporate investor may acquire the stake to develop a business relationship due to synergy of operations. The purchase of the equity holdings of a venture capitalist by another, may be related to the nature of the business objectives of the original venture capitalist.

5. ***Liquidation*** Another popular method of exiting the venture capital investment is liquidation. The exit takes place in an involuntary manner. This usually happens under circumstances where the assisted unit makes an utter failure to take off due to stiff competition, technology failure/obsolescence of technology, poor management and so on.

   As regards debt instruments, the exit takes place only at the end of the period of loan. The usual method of exit adopted is conversion of debt into equity, or repayment of debt loan in a lump sum.

REVIEW QUESTIONS

Section A

1. What is venture capital?
2. What is venture capital fund?
3. How is venture capital defined?
4. What is 'First Chicago Method' of evaluating venture capital investment?
5. What is 'revenue multiplier method' of evaluating venture capital investment?

6. What is 'risk capital foundation'?
7. What is 'seed capital'?
8. What is 'National Equity Fund for Small Entrepreneurs'?
9. What is 'start-up financing'?
10. What is 'early-stage financing'?
11. What is 'follow-on financing'?
12. What is 'expansion financing'?
13. What is 'replacement financing'?
14. What is 'turnaround financing'?
15. What are 'management buy-outs'?
16. What are 'management buy-ins'?
17. What is 'mezzanine finance'?
18. What are 'trade sales'?
19. What is 'earn-out'?
20. What are 'Buy-outs'?
21. What are 'shareholder buy-outs'?
22. What are 'receivership buy-outs'?
23. Mention the sources of finance for a venture capitalist.
24. What is 'investment nurturing'?
25. What is 'hands-on nurturing'?
26. What is 'hands-off nurturing'?
27. What is 'hands-holding nurturing'?
28. What are 'commissioned studies'?
29. What is an investment company?
30. What is an investment trust?
31. What is an offshore investment company?
32. What is an offshore unit trust?
33. What is the 'puts and calls' method of exiting by the venture capital funds?

Section B

1. What are the characteristic features of venture capital?
2. How is venture capital investment evaluated under the 'conventional method'?
3. Elaborate the growth of venture capital in the U.S.
4. Elaborate the growth of venture capital in the UK
5. Briefly describe the growth of venture capital in the Japan and Asia.

6. Explain the growth of venture capital in the Taiwan and Israel.
7. Distinguish between venture capital and development capital.
8. Distinguish between venture capital, seed capital and risk capital.
9. What are the factors taken into account by the venture capitalists for appraising projects?
10. What are the factors to be considered while making 'fundamental analysis' of a venture?
11. What are the factors to be considered while making 'financial analysis' of a venture?
12. What are the aspects to be considered while making 'portfolio analysis' of a venture?
13. What are the means by which venture capitalists realize their investments?
14. State the advantages of buy-outs.
15. What are the precautions to be taken for ensuring the success of buy-outs?
16. What are the different types buy-out deals?
17. What are the different forms of management buy-outs?
18. What are the objectives of 'investment nurturing'?
19. What are the elements of 'investment nurturing'?
20. Identify the different nurturing methods adopted by venture capital companies.

Section C

1. Discuss the different methods of evaluating venture capital investments.
2. Discuss the origin and the growth of venture capital funds in the global context.
3. Give an account of the venture capital funds operating in India.
4. Elaborate on the various stages of venture capital financing.
5. How are venture capital proposals analyzed? Explain.
6. Explain the different types of buy-outs.
7. Describe the different styles of venture financing.
8. How are venture capital companies organized? Explain.
9. Discuss the different exit methods available to venture capital financing companies.

Chapter 16

Mutual Funds

Mutual funds origined in Belgium, where, in 1882, a company was started to finance investments in national industries associated with high risks under the name of 'Societe Generale de Belgiue'. In the 1860s, this movement spread to England. In 1868, the Foreign and Colonial Government Trust was formed to spread risks for investors over a large number of securities. The history of mutual funds started in the USA from the beginning of the 20th century. Massachusetts Investors Trust, State Street Investment Corporation and U.S. and Foreign Securities Corporations were the three investment companies which were organized. Mutual funds emerged during the 1920s in Canada, when many close-ended investment companies were organized. The Canadian Investment Fund was the first mutual fund set up in Canada in 1932. Subsequently, hundreds of mutual funds emerged and expanded their wings in many countries in Europe, the Far East and Latin America.

In recent years, mutual funds in Japan and the Far East have been showing good performance, probably as a result of growth and performances of the economies of these countries and their capital markets. Similarly, countries in the Pacific area like Hong Kong, Thailand, Singapore, and Korea have also entered this field in a big way. Mauritius and the Netherlands are emerging as tax havens for offshore mutual funds. Mutual funds are thus a global financial culture now.

DEFINITION

1. A trust that pools the savings of investors who share a common financial goal is known as a 'Mutual Fund'. The money thus collected is then invested in financial market instruments such as shares, debentures and other securities like government paper, etc. The income earned through these investments, and the capital appreciation realized, are shared by its unit holders in proportion to the number of units owned by them. Investments in securities are spread over a wide cross-section of industries and sectors, thus allowing risk

reduction to take place. Diversification reduces the risk because all stocks and/or debt instruments may not move in the same direction and in the same proportion at the same time.

2. A special type of institution that acts as an investment conduit is called a 'Mutual Fund'. It is essentially a mechanism of pooling together the savings of a large number of investors for collective investments with the objective of attractive yields and appreciation in their value. Mutual Funds are an important segment of the financial system. It is a nondepository financial intermediary. Mutual funds are mobilizers of savings, particularly of the small and household sectors, for investment in the stock and money market.
3. A non-depository or nonbanking financial intermediary which acts as an important vehicle for bringing wealth holders and deficit units together, indirectly, is known as 'Mutual Fund'. Mutual funds are corporations that accept money from savers and then use this money to buy stocks, long-term bonds, and short-term debt instruments issued by business or Government units. These corporations pool funds and thus reduce risk by diversification.
4. According to the Mutual Fund Fact Book (published by the Investment Company Institute of the U.S.) "A Mutual Fund is a Financial Service Organization that receives money from shareholders, invests it, earns returns on it, attempts to make it grow and agrees to pay the shareholder cash on demand for the current value of his investment".

Features/Role/Benefits

1. ***Mobilizing small savings*** Mutual funds mobilize funds by selling their own shares, known as units. To an investor, a unit in mutual funds means ownership of a proportional share of securities in the portfolio of a mutual fund. This gives the benefit of convenience and the satisfaction of owning shares in many industries. Thus, mutual funds are primarily investment intermediaries to acquire individual investments and pass on the returns to small fund investors.
2. ***Providing investment avenue*** One of the basic characteristics of a mutual fund is that it provid es an ideal avenue for investment for persons of small means, and enables them to earn a reasonable return with the advantages of relatively better liquidity. It offers investors a proportionate claim on the portfolio of assets that fluctuate in value in comparison to the value of the assets that comprise the portfolio.

3. ***Professional management*** It is possible for the small investors to have the benefit of professional and expert management of their funds. Mutual Funds employ professional experts who manage the investment portfolios efficiently and profitably.

   Investors are relieved of the emotional stress involved in buying or selling securities since mutual funds take care of this function. With their professional knowledge and experience, they act scientifically with the right timing to buy and sell for their clients. Moreover, automatic reinvestment of dividends and capital gains provides relief to the members of mutual funds. Expertise in stock selection and timing is made available to investors so that the invested funds generate returns.
4. ***Diversified investment*** Mutual funds have the advantage of diversified investment of funds in various industry segments spread across the country. This is advantageous to small investors who cannot afford having the shares of highly established corporates because of high market price. Thus, mutual funds allow millions of investors to have investment in a variety of securities of many different companies. Small investors therefore share the benefits of an efficiently managed portfolio and are free of the problem of keeping track of share certificates etc of various companies, tax rules, etc.
5. ***Better liquidity*** Mutual funds have the distinct advantage of offering to its investors the benefit of better liquidity of investment. There is always a ready market available for the mutual funds units. In addition, there is also an obligation imposed by SEBI guidelines. For instance, in the case of open-ended mutual fund units, it is possible for the investor to divest holdings any time during the year at the Net Asset Value (NAV). In the case of close-ended mutual funds, it is obligatory that units are listed and traded, thus offering a secondary market for the units.

   Further, a high level of liquidity is possible for the fund holders because of more liquid securities in the mutual fund portfolio. These securities could be converted into cash at any time. Moreover, mutual fund schemes provide the advantage of an active secondary market by allowing the units to be listed and traded in the stock exchange. This is in sharp contrast to the fact that many of the corporate entities do not have their scrips traded at all.
6. ***Reduced risks*** There is only a minimum risk attached to the principal amount and return for the investments made in mutual fund schemes. This is usually made possible by expert supervision, diversification

and liquidity of units. Mutual funds provide small investors the access to a reduced investment risk resulting from diversification, economies of scale in transaction cost and professional finance management.

7. ***Investment protection*** Mutual funds in India are largely regulated by guidelines and legislative provisions put in place by regulatory agencies such as the SEBI. The Securities Exchange Commission (SEC) in the USA allows for the provision of safety of investments. In order to protect the investor interest, it is incumbent on the part of mutual funds to broadly follow the provisions laid down in this regard.
8. ***Switching facility*** Mutual funds provide investors with flexible investment opportunities, whereby it is possible to switch from one scheme to another. This flexibility enables investors to shift from income scheme to growth scheme, or vice versa, or from a close-ended scheme to an open ended scheme, all at will.
9. ***Tax benefits*** An attractive benefit of mutual funds is that the various schemes offered by them provide tax shelter to the investor. This benefit is available under the provisions of the Income Tax Act.
10. ***Low transaction costs*** The cost of purchase and sale of mutual fund units is relatively lower. This is due to the large volume of money being handled by mutual funds in the capital market. The fees payable, such as brokerage fee or trading commission etc. are lower. This obviously enhances the quantum of distributable income available for investors.
11. ***Economic development*** Mutual funds make contribution to the development of a country's economy. For instance, the efficient functioning of mutual funds contributes to an efficient financial system. This in turn paves the way for efficient allocation of the financial resources of the country, thus contributing to the economic development. This is made possible through the mobilization of more savings and channelizing them to the more productive sectors of the economy.
12. ***Convenience*** Mutual Fund units can be traded easily and with little or no transaction costs. No brokerage is incurred.
13. ***Other benefits*** In addition to the above mentioned advantages, mutual funds also offer the following benefits, as compared to a personal portfolio:
    - (i) Option to reinvest dividends
    - (ii) Strong possibility of capital appreciation
    - (iii) Regular returns

PRODUCTS/SCHEMES

Investors have the option of choosing from a wide variety of schemes in a mutual fund, depending upon their requirements. Mutual funds adopt different strategies to achieve these objectives, and accordingly offer different schemes of investments. Following section presents a detailed classification of mutual funds:

Operational Classification

a. Open-ended scheme When a fund is accepted and liquidated on a continuous basis by a mutual fund manager, it is called 'open-ended scheme'. The fund manager buys and sells units constantly on demand by the investors. Under this scheme, the capitalization of the fund will constantly change, since it is always open for the investors to sell or buy their share units (shares in USA, units in India). The scheme provides an excellent liquidity facility to investors, although the units of such scheme are not listed. No intermediaries are required. There is a certainity in repurchase price, which takes place in accordance with the declared NAV.

b. Close-ended scheme When units of a scheme are liquidated (repurchased) only after the expiry of a specified period, it is known as a close-ended scheme. Accordingly, such funds have fixed capitalization and remain as a corpus with the mutual fund manager. Units of close-ended scheme are to be quoted, and therefore traded, on the floors of a stock exchange in the secondary market. The price is determined on the basis of demand and supply. Therefore, there will be, two prices, one that is market-determined and the other, which is NAV-based. The market price may be either above or below NAV. Managing a close-ended scheme is comparatively easy as it gives fund managers ample opportunity to evolve and adopt long-term investment strategies depending on the life of the scheme. Need for liquidity arises after a comparatively longer period, i.e. normally at the time of redemption.

The main points of distinction between the Open-ended and Close-ended Schemes are as follows:

Sl. No.	Feature	Open-ended	Close-ended
1.	Subscription	Open for public subscription throughout the currency of the scheme	Open for subscription only for a limited period
2.	Corpus	The fund raised from public keeps varying	The corpus of the scheme is fixed for all time to come

Sl. No.	Feature	Open-ended	Close-ended
3.	Exit	Easy and convenient exit, any time	No exit possible till the closure of the scheme
4.	Liquidation	Units can be liquidated any time	Units can be liquidated only at the end of specified period
5.	Maturity	No maturity period	Fixed maturity period
6.	Listing	No listing and hence not traded in stock exchange	Listed in stock exchange and traded
7.	Liquidity	Through re-purchase by MF at NAV or at any other price as may be determined	Through trading in a stock exchange at the current market price

c. Interval scheme It is a kind of close-ended scheme with a peculiar feature that it remains open during a particular part of the year for the benefit of investors, either to off load their holdings or to undertake purchase of units at the NAV. Under SEBI (MF) Regulations, every mutual fund is free to launch any or both types of schemes, including interval scheme. In the USA, UK and Canada, close-ended funds are popularly known as investment companies/ trust, whereas open-ended funds are known as mutual funds.

Return-based Classification

Under this classification fall those mutual fund schemes that are designed to meet the diverse needs of investors and to earn a good return. Returns expected are in the form of regular dividends or capital appreciation, or a combination of these two.

a. Income fund scheme The scheme that is tailored to suit the needs of investors who are particular about regular returns is known as 'income fund scheme'. The scheme offers the maximum current income, whereby the income earned by units is distributed periodically. Such funds are offered in two forms. The first scheme earns a target constant income at relatively low risk, while the second scheme offers the maximum possible income. This obviously implies that the higher expected return comes with a higher potential risk of the investment.

b. Growth fund scheme It is a mutual fund scheme that offers the advantage of capital appreciation of the underlying investment. For such funds, investment is made in growth-oriented securities that are capable of appreciating in the long run. Growth funds are also known as nest eggs or long haul investments. In proportion to such capital appreciation, the amount of risks to be assumed would be far greater.

c. Conservative fund scheme A scheme that aims at providing a reasonable rate of return, protecting the value of the investment and achieving capital appreciation, may be designated as 'conservative fund scheme'. These are also known as middle-of-the-road funds, since such funds offer a blend of all these features. Further, such funds divide their portfolio in common stocks and bonds in such a way as to achieve the desired objectives.

Investment-based Classification

a. Equity fund scheme A kind of mutual fund whose strength is derived from equity-based investments is called 'equity fund scheme'. They carry a high degree of risk. Such funds do well in periods of favorable capital market trends. A variation of the equity fund scheme is the `Index Fund' or `Never beat market fund' which are involved in transacting only those scrips which are included in any specific index e.g. the scrips which constitute the BSE-30 Sensex or 100 shares National index. These funds involve low transaction costs.

b. Bond fund scheme It is a type of mutual fund whose strength is derived from bond-based investments. The portfolio of such funds comprises bonds, debentures, etc. This type of fund carries the advantage of secure and steady income. However, such funds have little or no chance of capital appreciation, and carry low risk. A variant of this type of fund is called 'Liquid funds' which specializes in investing in short-term money market instruments. This focus on liquidity delivers the twin features of lower risks and low returns.

c. Balanced fund scheme A scheme of mutual fund that has a mix of debt and equity in the portfolio of investments may be referred to as a 'balanced fund scheme'. The portfolio of such funds will be often shifted between debt and equity, depending upon the prevailing market trends.

d. Sectoral fund schemes When the managers of mutual funds invest the amount collected from a wide variety of small investors directly in various specific sectors of the economy, such funds are called sectoral mutual funds. The specialized sectors may include gold and silver, real estate, specific industry such as oil and gas companies, offshore investments, etc.

e. Fund-of-fund scheme There can also be Funds of Funds, where funds of one mutual fund are invested in the units of other mutual funds.

There are a number of funds that direct investment into a specified sector of the economy. This makes diversified and yet intensive investment of funds possible.

f. Leverage-fund scheme The funds that are created out of investments, w ith not only the amount mobilized from small savers but also the fund managers who borrow money from the capital market, are known as 'leveraged-fund scheme'. This way, fund managers pass on the benefit of leverage to the mutual fund investors. In order to operate such schemes, there must be provisions available. Normally leverage funds use short sale, whereby the management controlling the fund avails of the advantage of declining markets in order to realize gains in the portfolio. Options, especially call options are used by the leverage funds.

g. Gilt funds These funds seek to generate returns through investment in gilts. Under this scheme, funds are invested only in Central and State Government securities and repos/reverse repo in such securities, and not in equity or corporate debt securities. A portion of the corpus may be invested in the call money market or RBI to meet liquidity requirement. This may provide an alternative investment for the call money market. Government securities carry zero credit risk or default risk. Their prices are however, influenced only by movement in interest rates in the financial system.

h. Index-funds These funds are also known as growth funds, but they are linked to a specific index of share prices. It means that the funds mobilized under such scheme are invested principally in the securities of companies whose securities are included in the index concerned and in the same weightage. Thus, the fund's performance is linked to the growth in the concerned index. Such funds endeavour to attain results commensurate with that of the index concerned, subject to tracking errors.

i. Tax saving schemes Certain mutual fund schemes offer tax rebate on investments made in equity shares, under Section 88 of the Income Tax Act 1961. Income may also be periodically distributed, depending upon surplus. Subscriptions made upto Rs. 10,000 in an assessment year are eligible for tax rebate under Section 88. The broad investment pattern of the scheme includes investment in equities, cumulative convertible preference shares, and fully convertible debentures and bonds to the extent of 80 percent to 100 percent and the rest in money market instruments.

j. Gold exchange traded funds (GETFS) Special funds to be introduced by mutual funds with 'gold' as the underlying assets. The fund aims at enabling the household to buy and sell gold in units for as little as Rs 100. These units can be traced in the manner similar to the other units of mutual funds. The proposed for intorducing GEIFs was muated in the union budget 2005-2006. It aims at using that gold flows take place through the official channels done.

k. Real estate fund This is the fund dedicated to making investment in real estates. The fund would enable the investors to largest the benefit of property value appreciation, besides profits. The money collected will be invested in office buildings, health care facilities, industrial properties, hotels, shopping malls and residential buildings.

An attractive feature of the REF is that if would make possible to own shares in seeral properties with an investment of a few thousand rupees. The fund would provide an opportunity of diversified investment.

The risk attached to this type of fund is the disastors that might be caused to property on account of natural disastors like earthquakes, etc.

l. Other funds In addition to the schemes mentioned above, following are some of the other schemes that are designed and operated by mutual fund managers:

(i) ***'Load funds'***, where mutual fund managers charge a fee over and above the NAV from the purchaser

(ii) ***'No load funds'***, where no load-fee is charged because very little effort is made to promote the sale of the funds unit, except through direct advertising

(iii) ***MMMF***, which is designed to offer tax sops

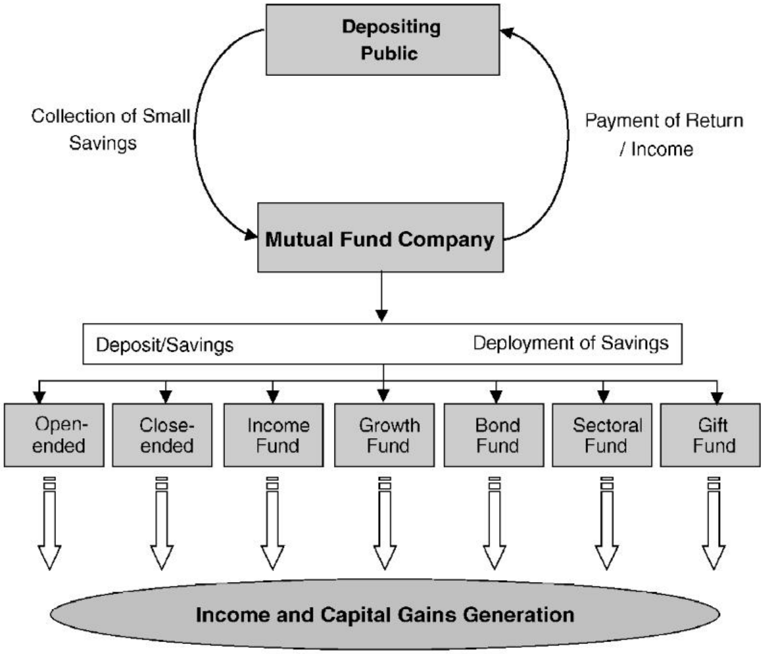
(iv) ***Offshore mutual funds***, also known as regional or country funds, where the funds are mobilized from abroad for deployment in the Indian market

(v) ***Other funds*** such as property funds, art funds, commodity funds, energy funds, etc.

MECHANICS OF MUTUAL FUND OPERATIONS

The entire working mechanism of mutual fund operations is depicted in Exhibit 12.

Exhibit 12 Mechanics of Mutual Fund Operations



MUTUAL FUNDS IN INDIA

The mutual fund industry in India made its debut with the setting up of the largest public sector mutual fund in the world, namely the Unit Trust of India (UTI). It was set up in the year 1964 by a special Act of Parliament. The first unit scheme offered was the "US-64". A host of other fund schemes were subsequently introduced by the UTI. The basic objective behind the setting up of the Trust was to mobilize small savings and to allow channeling of those savings into productive sectors of the economy, so as to accelerate the industrial and economic development of the country.

The monopoly of the UTI ended in the year 1987, when the Government of India permitted commercial banks in the public sector to set up subsidiaries operating as trusts to perform the functions of mutual funds by amending the Banking Regulation Act. SBI set up the first mutual fund, which was followed by Canara Bank. Later, many large financial institutions under government control also came out with mutual funds subsidiaries. Recently, with the beginning of the economic reforms and liberalization of the economy, based on the recommendations of the Abid Hussain Committee, foreign companies were also permitted to start mutual funds in India. The government introduced a number of regulatory measures, through various agencies such as the SEBI, for the purpose of allowing the growth of the mutual funds industry in an orderly fashion for the benefit of the investors, especially the small investors.

MANAGING MUTUAL FUNDS IN INDIA

Mutual funds and the unit trusts are governed by the Investment Act of 1940 in the USA and by the Prevention of Frauds Act in UK. They are governed by the Securities Exchange Commission (SEC) in USA or by the Securities Investment Board (SIB) in the UK. The four-tier system for managing mutual funds in India, ensuring an arms length distance between the sponsor and the funds, as designed by the SEBI, is discussed below:

The Sponsor

Any corporate body, which initiates the launching of a mutual fund, is referred to as 'the sponsor'. The agency, which is expected to have a sound track record and experience in the relevant field of financial services for a minimum period of 5 years, ensures complying with the various formalities required in establishing a mutual fund. According to SEBI norms, the sponsor should have professional competence, financial soundness and a general reputation for fairness and integrity in business transactions. There must be a minimum contribution by the sponsor to the tune of 40 percent of the net worth of the Asset Management Company. The sponsor appoints trustees, an asset management company and custodians in compliance with the regulations.

The Trustees

Persons who hold the property of the mutual fund in trust for the benefit of the unit holders are called 'trustees'. Trustees look after the mutual fund, which is constituted as a trust under the provisions of the Indian Trust Act. For this purpose, a company is appointed as a trustee to manage the mutual fund with prior approval from SEBI. A minimum of 75 percent of the trustees must be independent of the sponsors so as to ensure fair dealings. The important functions of the Trustees:

1. Keep under its custody all the property of the mutual fund schemes administered by the mutual fund
2. Furnish information to unit holders as well as to SEBI about the mutual fund schemes
3. Appoint an asset management company (AMC) for the purpose of floating the mutual funds schemes
4. Evolve an investment management agreement to be entered into with AMC
5. Observe and ensuring that AMC is managing schemes in accordance with the trust deed
6. Dismiss the AMC appointed by the Trustees
7. Supervise the collection of any income due to be paid to the scheme
8. Are paid compensation for their services in the form of trusteeship fee as specified in the provisions of the trust deed. Trustees are to present an annual report to the investors

The Custodians

An agency that keeps custody of the securities that are bought by the mutual fund managers under the various schemes is called 'the custodians'. They ensure safe custody and ready availability of scrips. According to SEBI norms, the custodian who is so appointed should in no way be associated with the AMC and cannot act as sponsor or trustee to any mutual fund. A custodian is supposed to act only for a single mutual fund unless otherwise approved by SEBI. Some of the important functions of the custodians are:

1. Safe keeping of the securities
2. Participation in any clearing system on behalf of the client to effect deliveries of the securities
3. Collecting income/dividends on the securities depending on the terms of agreement
4. Ensuring delivery of scrips only on receipt of payment and payment only upon receipt of scrips
5. Carrying out regular reconciliation of assets with accounting records
6. Ensuring timely resolution of discrepancies and failures
7. Arranging for proper registration or recording of securities

Asset Management Company (AMC)

The investment manager of a mutual fund is technically known as the 'Asset Management Company', and is appointed by the sponsor or the trustees. The AMC manages the affairs of the mutual fund. It is responsible for operating all the schemes of the fund, and can act as the AMC of only one mutual fund. Only activities which are in the nature of management and advisory services to offshore funds, pension funds, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial basis can be undertaken by the AMC. With the permission of SEBI, it can also operate as an underwriter.

SEBI REQUIREMENTS OF AMC

The SEBI requires the AMC to possess the following attributes in order to ensure its efficient management:

Track Record

An AMC should have a sound track record (good net worth, dividend paying capacity and profitability etc.), with a net worth of at least Rs. 100 crores.

Reputation

An AMC shall have a general reputation of fairness in transaction.

Expertise

The directors of an AMC should have an expert knowledge of the relevant fields like portfolio management, investment analysis and financial administration.

Operational Autonomy

Operational autonomy shall be provided to the directors of whom at least 50 percent should have no association with the sponsor or trustees, its Chairman being an independent person.

Contribution

Minimum contribution by the sponsor should be 40 percent of its net worth so as to ensure the stake of the sponsors in the AMC.

FUNCTIONS OF AMC

Many a time, an AMC carries out its functions through outside agencies that are appointed for this purpose. However, the functions remain the same as outlined below:

Registrars and Transfer Agents

The registrars and transfer agents who are appointed by the AMC carry out the following functions:

1. Receiving and processing the application forms of investors
2. Issuing unit certificates
3. Sending refund orders
4. Giving approval for all transfers of units and maintaining all such records
5. Repurchasing the units and redemption of units
6. Issuing dividend or income warrants

These intermediaries are paid compensation for their services by the AMCs. In India almost all AMCs engage such agents.

Fund Accountants

Fund accountants are appointed by the AMC. They are in charge of maintaining proper books of accounts relating to fund transactions and management. The functions performed by these agencies are:

1. Computing the net asset value per unit of the scheme on a weekly basis
2. Maintaining its books and records
3. Monitoring compliance with the schemes, investment limitations as well as the regulations of SEBI and others
4. Preparing and distributing reports on the scheme for the unit holders and SEBI, and monitoring the performance of mutual funds custodians and other service providers

Lead Managers

Lead Managers carry out the following functions:

1. Selecting and coordinating the activities of intermediaries such as advertising agency, printers, collection centers, and marketing the services
2. Carrying out extensive campaigns about the scheme, and acting as marketing associates to attract investors
3. Assisting the AMC to approach potential investors through meetings, exhibitions, contacts advertising, publicity, and sales promotion

Investment Advisors

Investment advisors carry out the following functions:

1. Carrying out the market and security analysis
2. Advising the AMC to design its investment strategies on a continuous basis

They are paid for their professional advice regarding funds investment on the average weekly value of the fund's net assets. The majority of

Indian mutual funds have their own market analysts who design their investment strategies.

Legal Advisors

Legal advisors are appointed to offer legal guidance about planning and execution of different schemes. A group of advocates and solicitors may be appointed as legal advisors. Their fee is in no way associated with the net assets of the fund, but is paid to them as decided.

Auditors

An auditor is required to be appointed by the AMC, and must undertake independent inspection and verification of its accounting activities.

Underwriters

In recent times, mutual funds also undertake the activities of underwriting issues. Such activities generate an additional source of income for mutual funds. Prior approval from SEBI is necessary for undertaking this activity.

WORKING MECHANISM OF AMC

The working of an AMC revolves around the investment functions. The AMC carries out the specialized investment function by designing strategies. The working mechanism of the AMC is described below:

Creating Fund Manager

A fund manager is responsible for managing the funds of an AMC. The fund manager should desirably be an independent agency, as is the practice in the USA. But, according to the practices in India, a single fund manager handles many schemes simultaneously. The basic function of a fund manager is to decide the rate, time, kind and quantum of securities to be bought or sold. It is the fund manager who ensures the success of the fund schemes.

In the case of bank-sponsored funds, committees created for that purpose handle the investment exercise. For instance, the 'Investment Committee', which is a broad based committee having even nominees of the sponsor, decides the primary market investments. The 'Market Operation Committee' handles the assignment of disinvestments and interactions with the secondary market.

Research and Planning

The research and planning cell of the AMC undertakes research activities relating to securities as well as prospective investors. The results of the study are analyzed to draft future policy governing investment management. It is also possible that the research work is assigned to an independent outside agency.

Creating Dealers

Dealers having a deep understanding of stock market operations may be created by the AMC in order to execute the sale and purchase transactions in the capital or money market. It is possible that this job is assigned to a separate marketing division of AMC. Dealers should comply with all the formalities of sale and purchase through brokers, the brokers being appointed by the Board of Directors of AMC. The Board lays down the guidelines for allocation of business to different brokers.

PORTFOLIO MANAGEMENT PROCESS IN MUTUAL FUNDS

The Portfolio management process of a mutual fund involves the following four basic steps:

1. Setting investment goal
2. Identification of specific securities
3. Portfolio designing
4. Portfolio revision

Setting Investment Goal

The first and foremost task of managing the portfolio of a mutual fund is to identify and set the goal for the proposed scheme. The goal is set keeping in mind considerations such as the protection of investors, nature of the scheme, risk and return, market conditions, regulatory norms, size of issue, etc.

Identifying Specific Securities

When once the goal to be accomplished by the proposed scheme has been identified, efforts are made to analyze and identify the right security where funds are required to be invested. For this purpose, security analysis is carried out from the viewpoint of the company, industry and the economy. For each security, risk and return characteristics are evaluated in a broader perspective. For the purpose of analysis, the fund manager considers the strengths and weaknesses of some of the sample securities.

Portfolio Designing

Portfolio designing involves making an ideal mix of debt and equity securities of corporates, government, etc. It is concerned with decisions regarding the type of securities to be bought, the quantum and the timing of issue. Portfolio designing is carried out on the basis of research and analysis of stock markets. Based on their results, the long-term and short-term investment strategies are worked out.

The fund manager makes efforts at building the portfolio that consists of a well-diversified portfolio of securities so as to reduce significantly the unsystematic risk. For this purpose, the expected returns on individual security and portfolio as a whole, is associated with the market or systematic risk. The design will consider the ways and means by which liquid resources in the scheme could be invested in money market instruments like government securities, commercial papers, certificates of deposits, treasury bills, etc.

While designing the portfolio, regulations are to be followed. For instance, as per SEBI, mutual funds:

1. Are prohibited from making investments in unlisted securities
2. Cannot own more than 10 percent of any company's paid up capital carrying voting rights
3. Can make investments in other schemes of the same mutual fund upto 5 percent of the NAV
4. Can make investment only in transferable securities in the money or capital market

Portfolio Revision

The build-up of portfolio needs to be periodically reviewed keeping in mind the risk-return characteristics of all securities under the changing circumstances. The revision of the portfolio has to be undertaken in the context of the dynamic investment world. Further, the exercise is to be taken up to cash on the renewed market opportunities in order to maximize the portfolio returns.

OPERATIONAL EFFICIENCY OF MUTUAL FUNDS

The broad parameters used for judging the operational efficiency of mutual funds are described below:

Net Return

The operational efficiency of a Mutual fund is best judged as its ability to earn the investors better, and safe returns. Returns take the form of appreciation in value of investment made in mutual funds and the dividend or interest received on such investment.

There are some expenses that are always incurred while earning such returns. The expenses are incurred as part of the efforts made at protecting the interest of investors, compliance with the regulatory framework of SEBI, etc. The expenses include trusteeship fee, management fee, administrative expenses, fund accounting fee, custodian fee, initial charges, etc. Net return is computed by taking into consideration the gross return and the expenses. Besides laying down limits on certain specific expenses, SEBI has fixed an overall limit on expenses. All these details are found in the SEBI regulations on mutual funds.

Net Asset Value (NAV)

NAV is another parameter used to measure the operational efficiency of mutual funds. The intrinsic value of a unit under a particular scheme is referred to as the 'NAV' of the scheme. The value gives an idea of the amount that may be obtained by the unit holder on its sale to the mutual fund company. NAV of a unit is calculated as follows:

$$\text{NAV per unit} = [\text{TMV} - \text{CL}] \div \text{SU}$$

where,

TMV	=	Total market value of investment portfolio + the written down value of fixed assets + the cost value of other current assets
CL	=	Current liabilities
SU	=	Number of outstanding units in that scheme

For the purpose of determining the NAV, the scheme of accounting practices as prescribed by the SEBI regulations of 1996 should be followed.

Load

The initial expenses that are incurred by a mutual fund in relation to a scheme operated by it, is referred to as load of the scheme. According to the SEBI guidelines, a certain percentage of load may be borne by the respective scheme. In such a case, the load borne by the scheme will reduce the amount available for investment by the fund manager. Obviously, where the AMC, instead of the respective scheme, bears the load, the entire amount of the unit obtained from the savers is available for investment. On account of the perceived advantages of the 'load schemes', they are gaining popularity.

Disclosures

A highly transparent nature of a mutual fund is said to operate to the benefit of the mutual fund itself, in addition to serving the needs of investors. Mutual Funds are supposed to follow certain norms to ensure adequate and ample disclosure of their operations. Operational efficiency of mutual funds is disclosed through half yearly results and annual reports, where all statistical information relating to all the schemes in operation is disclosed. Accordingly, facts regarding gross income per unit, per unit ratio of expenses to average net asset by percentage, per unit gross income to average net asset by percentage, etc are to be disclosed, as desired by SEBI.

Further, mutual funds are duty-bound to supply a copy of the annual reports, if asked by the investors. The disclosures must be adequate.

Voting Right to Investors

As part of ensuring greater operational efficiency, mutual funds are obligated to obtain the prior permission of the investors of the scheme whenever the fund managers intend bringing about changes in the basic features of the schemes. Investors are granted voting rights when such matters are put up in a meeting of unit holders by the AMC.

Investors' Protection

The fund managers who protect the interest of investors should follow certain safeguards. Towards this end, a greater order of transparency is adopted by the fund managers. Unit Certificates are to be issued to investors within six weeks from the date of closure of subscription list. Units submitted for transfer should be executed within 30 days. Dividend warrants against the scheme are to be despatched within 42 days of the declaration of the dividend. SEBI also desires that within 10 working days from date of redemption, repurchase proceeds should be despatched. In addition, SEBI takes all possible safeguards such as conducting inspections of mutual funds to ensure that their operating policies are not against the interest of investors. Moreover, defaulting AMCs are prohibited from issuing any further new schemes.

EVALUATING MUTUAL FUNDS

In order that mutual fund managers act in a judicious manner so as to bring about ultimate beneficial consequences to the investing community, it is essential that the performance of such funds is evaluated. Such an appraisal would help the funds compare themselves with other funds, besides being a potential source of information to the present and prospective investors, especially the small investors.

From simple evaluation tools to sophisticated models, which take into consideration, the risks and uncertainty associated with the returns, are available for evaluating the performance of mutual funds.

Some of these tools are briefly explained below:

Treynor Model

Jack Treynor evolved this model, which can be used to calculate the return per unit of risk. This is done by assuming that all investors averse to risk would like to maximize this value. The performance measure is calculated as follows:

$$PM = [AR_i - AR_f] \div ß_t$$

where,

AR_i = Average rate of return for portfolio 'i' during a period

AR_f = Average rate of return on a risk-free investment during the period

$ß_t$ = Slop of portfolio 'i' characteristic line which represents the portfolios relative volatility and its systematic risk

PM = The Treynor portfolio performance measure for the period

A positive measure shows a superior, risk adjusted performance of a fund.

Sharpe Model

William F.Sharpe developed this model in 1966. It measures the total risk, not merely systematic risk (as in Treynor model). The relevant performance measure is computed as follows:

$$PM = \frac{AR_i - AR_f}{N_t}$$

where,

N_t = Standard deviation of rate of returns for the portfolio for the period.

The positive performance measure value is indicative of good performance.

MUTUAL FUND HOLDERS' ACCOUNT

There are three types of accounts that are offered by most mutual funds, as described below:

Regular Account

Under this plan, an investor is permitted to purchase any number of units of the mutual fund at any time. The investor will be paid a share of the income accrued from funds investment periodically. This income can be reinvested in acquiring additional stock by the investors without receiving cash.

Accumulation Account

Under this plan, an investor is allowed to begin an account with a very small initial investment and continue adding to the fund periodically. Accumulation account may be voluntary or contractual. In voluntary accumulation plan, an investor has the flexibility to make periodic investment at will. But in a contractual plan, the investor has to make a predetermined amount of investment in the fund at regular intervals for a predetermined period of time, which may range as long as 10 to 15 years.

Withdrawal Account

Under this plan, an individual investor can withdraw a certain amount of funds on a regular basis. This suits old age persons who can supplement social security and pension benefits. Over a period of time, the investors can exhaust the assets of the account.

CAUSES FOR POOR PERFORMANCE OF MUTUAL FUNDS

There are many reasons that have been identified by researchers for the relatively poor performance of mutual funds industry the world over. They are as follows:

1. Expensive securities to be bought as part of portfolio build-up of mutual funds, thus increasing the overall costs and thus reducing the returns.
2. Reduced returns on account of superfluous diversification
3. Poor use of macroeconomic forecast like gross national product, disposable income, forecast of activities of various industries, unemployment rate, inflation rate, interest rate, RBI guidelines, corporate profit, etc.
4. Poor use of investment alternatives.

REVIEW QUESTIONS

Section A

1. What is a mutual fund?
2. How is a mutual fund defined?
3. What is an open-ended scheme of mutual fund?
4. What is a close-ended scheme of mutual fund?
5. What is an income fund?
6. What is a growth fund scheme?
7. What is an equity fund scheme?
8. What is a bond fund?
9. What is a balanced fund scheme?
10. What are sectoral schemes of mutual fund?
11. What is a fund-of-fund?
12. What are leveraged fund schemes of mutual fund?
13. What are gilt funds?
14. What are index funds?
15. What is a 'gold exchange traded fund' (GETF)?
16. What are 'real estate funds'?
17. Who is a 'sponsor' in a mutual fund management?
18. Who is a 'trustee' in a mutual fund management?
19. Who are custodians in a mutual fund management?
20. What is an 'AMC'?
21. Who are lead managers?
22. What is portfolio designing?
23. What is portfolio revision?
24. What is 'NAV'?
25. What is 'load' in the case of mutual fund?

Section B

1. Describe the features and the role of mutual funds.
2. How are mutual funds beneficial?
3. How are open-ended schemes of mutual fund different from the close-ended schemes of mutual fund?

4. Explain the mechanism of mutual fund operation.
5. What are the functions of a 'trustee' in a mutual fund management?
6. What are the functions of a 'custodian' in a mutual fund management?
7. What are the SEBI requirements of AMC?
8. What are the functions of AMC?
9. What are the functions of registrars and transfer agents appointed by the AMC?
10. What are the functions performed by the fund accountants of AMC?
11. What are the functions of lead managers?
12. Explain the working mechanism of AMC.
13. How is NAV calculated?
14. Explain the 'treynor model' of evaluating mutual funds.
15. How is a mutual fund evaluated under the 'Sharpe Model'?
16. What are the types of accounts offered by mutual funds?
17. What do you think are the causes of slow growth of mutual funds in India?

Section C

1. How are mutual funds schemes classified? Explain.
2. Discuss the working of mutual funds in India.
3. Elaborate the system of managing mutual funds in India.
4. Describe the portfolio management process in mutual funds.
5. How will you evaluate the operational efficiency of mutual funds? Explain.
6. How can one evaluate the performance of mutual funds? Explain.

Chapter 17

Credit Rating

In a vibrant market economy, financial markets play the role of an efficient intermediary. They act as a link between savers and investors, mobilizing capital on the one hand, and efficiently allocating them between competing users on the other. Such an efficient capital allocation calls for the use of reliable market information. An investor in search of profitable investment avenues has recourse to various sources of information, such as offer documents of the issuer(s), research reports of market intermediaries, media reports, etc. In addition, he can also base the investment decisions on the grading offered by Credit Rating Agencies. These agencies have increasingly started to play a pivotal role as independent, objective, well-researched and credible information providers, particularly for credit-related opinions on the subject of debt instruments.

IMPETUS

The credit rating system originated in the United States in the seventies. The high levels of default, which occurred after the Great Depression, in the U.S. Capital markets, gave the impetus for the growth of credit rating. The default of $82 million of commercial paper by Penn Central in the year 1970, and the consequent panic of investors in commercial papers, resulted in massive defaults and liquidity crisis. This prompted the capital issuers to get their commercial paper programs rated by independent credit rating agencies. This, according to them, would give the required degree of comfort and reassurance to their investors. Moreover, the real impetus for growth came when regulatory agencies in the U.S. made rating mandatory for institutions such as Government Pension Funds and Insurance Companies, who could not buy securities rated below a particular grade. In addition, investors themselves became aware of the rating mechanism, and started using ratings extensively as a tool for risk assessment. Merchant bankers, underwriters and other intermediaries involved in the debt market also found the rating useful for planning and pricing the debt instruments.

Over the last two decades there have been many other factors that have contributed to the growth and importance of the credit rating system in many parts of the world. They are:

1. The increasing role of capital and money markets consequent to disintermediation
2. Increased securitization of borrowing and lending consequent to disintermediation
3. Globalization of the credit market
4. The continuing growth of information technology
5. The growth of confidence in the efficiency of the market mechanism
6. The withdrawal of Government safety nets and the trend towards privatization

ORIGIN

The origin of credit rating can be traced to the 1840s when following the financial crisis of 1837 the first mercantile credit agency was set up in New York by Louis Tappan in 1841. The agency rated the ability of merchants to pay their financial obligations. The first rating guide was published in 1859. John Bradstreet set up a similar agency in 1849, which published its ratings book in 1857. These two agencies were later merged to form Dun & Bradstreet in 1933, which acquired the 'Moody's Investors Service' in 1962. It is interesting to note that Moody's have a long history in the rating business, spanning over a period of more than a hundred years. In 1900, John Moody founded Moody's Investors Service, and in 1909 published his 'Manual of Railroad Securities'. The rating of utility and industrial bonds in 1914 followed this, along with the rating of bonds issued by U.S. cities and other municipalities in the early 1920s.

In India, the Credit Rating & Information Services of India Ltd. (CRISIL), was set up as the first credit rating agency in 1987, followed by ICRA Ltd. (formerly known as Investment Information and Credit Rating Agency of India Limited) in 1991, and Credit Analysis & Research Ltd. (CARE) in 1994. The ownership pattern of all the three agencies is institutional. Duff and Phelps tied up with two Indian NBFCs to set up Duff and Phelps Credit Rating India (P) Limited in 1996.

DEFINITION

The process of assigning a symbol with specific reference to the instrument being rated, which acts as an indicator of the current opinion on relative capability on the issuer to service its debt obligation in a timely fashion, is known as 'credit rating'. Ratings are usually expressed with alphabetical or alphanumeric symbols. They are simple and easily understood, which enables the investor to differentiate between debt instruments on the basis of their underlying credit quality. The main focus lies in communicating to the investors the relative ranking of the default-loss probability for a given fixed income investment, in comparison with other rated instruments.

According to the Moody's, "A rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security. The rating measures the probability that the issuer will default on the security over its life, which depending on the instrument, may be a matter of days to 30 years or more. In addition, long term ratings incorporate an assessment of the expected monetary loss, should a default occur."

According to Standard and Poor's, "Credit ratings help investors by providing an easily recognizable, simple tool that couples a possibly unknown issuer with an informative and meaningful symbol of credit quality."

FEATURES

Following are the characteristic features of credit rating:

1. ***Specificity*** The rating is specific to a debt instrument. It is intended as a grade and an analysis of the credit risk associated with that particular instrument. Rating is neither a general-purpose evaluation of the issuer, nor an overall assessment of the credit risk likely to be involved in all the debts contracted by such an entity.
2. ***Relativity*** The rating is based on the relative capability and willingness of the issuer of the instrument to service debt obligations (both principal and interest), in accordance with the terms of the contract.
3. ***Guidance*** The rating primarily aims at furnishing guidance to investors/creditors in determining a credit risk associated with a debt instrument/credit obligation.
4. ***Not a recommendation*** The rating does not provide any sort of recommendation to buy, hold or sell an instrument since it does not take into consideration, factors such as market prices, personal risk preferences and other considerations which may influence an investment decision.
5. ***Broad parameters*** The rating process is based on certain broad parameters of information supplied by the issuer, and also collected

from various other sources, including personal interactions with various entities.

6. ***No guarantee*** The rating furnished by the agency does not provide any guarantee for the completeness or accuracy of the information on which the rating is based.
7. ***Quantitative and qualitative*** While determining the rating grade, both quantitative as well as qualitative factors are employed. The judgment is qualitative in nature, and the role of quantitative analysis is limited to assist in the making of the best possible overall judgment.

ADVANTAGES

Credit rating offers the following advantages:

To Investors

a. Information service Rating information allows for the communication of the relative ranking of the default loss probability for a given fixed income investment in comparison with other rated instruments. The credit rating system allows for the recognition of risk perception by the common investor vis-à-vis debt instruments, and makes the investor familiar with the risk profile of debt instruments.

b. Systematic risk evaluation For the efficient allocation of resources, a systematic risk evaluation is an essential requirement. Rating helps the corporate issuer of a debt instrument to offer every prospective investor the opportunity to undertake a detailed risk evaluation. It helps a heterogeneous group of investors to arrive at a meaningful and consistent conclusion regarding the relative credit quality of the instrument, especially when they do not possess the requisite skills of credit evaluation.

c. Professional competency A credit rating agency, equipped with the required skills, competence and credibility, provides a professional service, making it possible to use well-researched and scientifically-analyzed opinions regarding the relative ranking of different debt instruments according to their credit quality.

d. Easy to understand Credit ratings are symbolic and are therefore easy to understand. The rating seeks to establish a link between risk and return. Investors use the rating to assess the risk level of the instrument by making a comparison of the offered rate of return with the expected rate of return (for the particular level of risk) with a view to optimizing the risk-return preference.

e. Low cost The rating, as provided by a professional credit rating agency, is of significance not just for the individual/small investor, but also for an organized institutional investor. It provides a low cost supplement to their own in-house appraisal system.

f. Efficient portfolio management Big investors may use the credit rating for portfolio diversification by selecting appropriate instruments from a broad spectrum of investment options. Such investors could use the information provided by rating agencies, by carefully watching upgrades and downgrades, and altering their portfolio mix by operating in the secondary market. Banks in some developed countries use the ratings of other banks and financial intermediaries for making decisions regarding inter-bank lending, swap agreements, and other counter-party risks.

g. Other benefits The investor community, in general, also benefits from the other services offered by credit rating agencies, namely, research in the form of industry reports, corporate reports, seminars, and open access to the analysis of the agencies.

To Issuers

a. Index of faith Credit rating acts as an ideal index of faith placed by the market in the issuers. This eventually also acts as a guide for investment decisions.

b. Wider investor base Credit rating offers the advantage of a wider investor base as compared to unrated securities. Rating arms a large section of investors with specific skills to analyze every investment opportunity and helps them make a very considered decision about their investment.

c. Bench mark The opinion of a rating agency enjoys a wide investor confidence. This could enable the issuers of highly rated instruments to access the market even in adverse market conditions. Moreover, a credit rating provides a basis for determining the additional return (over and above a risk-free return), which is required by investors as a compensation for the additional risk borne by them. This could be a useful benchmark for issue pricing as well. The differential in pricing could lead to significant cost savings for highly rated instruments.

To Intermediaries

a. Efficient practice Rating serves as an effective tool for merchant bankers and other capital market intermediaries in the process of planning, pricing, underwriting and placement of issues.

b. Effective monitoring Stock exchange intermediaries like brokers and dealers could use ratings as an input for monitoring their risk exposure. Regulators in some countries specify capital adequacy rules linked to credit rating of securities in a portfolio. Merchant bankers also use credit rating for pre-packaging issues through asset securitization/structured obligations.

To Regulators

Credit rating has facilitated regulatory authorities around the world to issue mandatory rating requirements. For instance, specific rules restrict the entry of new issues that are rated below a particular grade. Moreover, they also stipulate different margin requirements for the mortgage of rated and unrated instruments, and hence prohibit institutional investors from purchasing or holding instruments that are rated below a particular level.

CREDIT RATING SYSTEM—GROWTH FACTORS

Credit rating, to be reliable, depends on the credibility and the analytical ability of the rating agencies. In fact, the driving force behind the rating industry is essentially the reputation for analytical credibility. Wilson (1994) sums it up succinctly, "Every time a rating is assigned, the agency's name, integrity and credibility are on line and subject to inspection by the whole community." This section focuses on the ingredients essential for the rating system to function effectively, and to serve the interests of all market participants and regulators.

Credibility and Independence

Ratings are considered valuable only as long as they are credible. Credibility arises primarily from objectivity, which results from the rating agency being independent of the issuer's business. The investor is willing to accept the judgment only where such credibility exists. When increasing number of investors are willing to accept the judgment of a particular rater, that rater then gains recognition as a reputed rating agency. As expressed by Moody's "The Rating Agency must do all it can to preserve its credibility and integrity in the market place. As a primary ingredient of credibility, the agency must maintain independence from all interested market forces, including issuers, security underwriters, or government."

The credibility of a rating agency is also enhanced by other factors such as objectivity of opinions, analytical integrity and consistency, professionalism, relevant expertise, strict rules of confidentiality, timeliness of the rating review, announcement of changes, ability to reach a wide range of investors through, press reports, print or electronic publications, and investor-friendly research services.

Capital Market Mechanism

A strong demand for investment related information is generated due to the reliance on the capital market for resource allocation. Rating agencies provide this information. Investors consider rating as an important input for their investment decisions only when there is a perceived default risk.

Disclosure Requirements

Rating agencies have assumed importance on account of their task of assigning grades to securities issued by companies. Moreover, it is becoming incumbent for companies, due to regulatory guidelines, to have adequate corporate disclosure and to publish all the essential information required by the investors. These guidelines require a mandatory disclosure of ratings.

Credit Education

Credit rating serves as an effective educator on the modalities of arriving at valid judgments about investing in securities. It is to be noted that the information should not only reach the investor, but it must also enable them to make meaningful interpretations. The investor should also be aware of the limitations of credit rating and should realize that the rating is not an insurance or guarantee against default risk.

Creation of Debt Market

Credit rating is considered as an essential input for guiding investments in bonds. This assumes significance in the context of substantial risks involved in their subscription. In fact, the continued growth and evolution of the credit rating business depends on the size and growth of the debt market. An active primary and secondary debt market is crucial for rating agencies to continue to provide their services.

GLOBAL CREDIT RATING AGENCIES

A brief note on the background of the major international rating agencies is as follows:

Moody's Investors Service (Moody's)

John Moody founded this agency by the turn of the century. The agency offers rating coverage for a wide range of debt related securities, both in U.S. and international markets. In 1919, it assigned sovereign ratings to the debt of countries such as Britain, France, etc, and in 1950, it rated international issuers such as Canada, World Bank, etc. It offered rating of Commercial paper in 1970. By late 1970s this was extended to rating of

Certificate of Deposit, both in the U.S. and internationally. Other services include rating of mortgage and asset backed securities, assessing the financial strength of insurance companies, Mutual Funds, U.S. and international banks, Sovereign nations, public utilities and Municipal bonds. Ratings were internationalized in the mid 1980s with a network of offices in other continents.

Standard and Poor's Corporation (S&P)

S & P is a premier international rating agency, which began its operations with a publication containing financial information on U.S. industrial companies. S & P also offers rating on a wide range of debt securities, both in the U.S. and overseas markets. It has issued outstanding ratings on bonds and preferred stocks, and short-term ratings on U.S. corporates, Municipalities and States. International ratings include government debts, municipalities and sovereign nations. It has also participated in other local rating agencies, such as joint ventures in Australia, France, Sweden, and Thailand. As part of its information desk, it brings out a publication with ratings of common stocks and mutual funds.

Duff and Phelps Credit Rating Co (DCR)

DCR is a major international source of credit information. It has been in existence for over sixty years. It rates all major types of fixed-income securities, long-term and short-term debt of corporations, sovereign nations and financial institutions. It also rates structured financing, mortgage-backed securities and insurance companies. It has established joint ventures, largely in Latin American countries and since 1992, also in Asian countries such as Pakistan and India.

Japan Credit Rating Agency (JCR)

It was established in 1985 and was promoted by financial institutions, banks and insurance companies in Japan. It provides ratings to foreign and domestic debt issuers.

IBCA Limited

This is an independent and privately owned international credit rating agency based in London. First of its kind, it was established with the objective of offering credit analysis on banks in different countries. In 1988, it expanded its coverage to include industrial and commercial corporates. At present, it provides credit analysis on banks and financial institutions in more than 25 countries and large number of corporates in Europe.

Thomson Bank Watch

This rating agency is based in Toronto, Canada. It is a subsidiary of the Thomson Corporation. It is a rating agency exclusively offering grades of rating to financial institutions including banks, securities firms and finance companies.

In addition, Thai Rating and Information Services, Japan Bond Research Institute, Israel Securities Rating Company etc are other leading international rating agencies. The principal characteristics of major rating agencies are shown in the table below.

Profile of Select International Rating Agencies

Name of the Agency	Home Country	Ownership	Principal Rating Areas
Moody's Investors Service	USA	Dun and Bradstreet	Full Service
Fitch Investors Service	USA	Independent	Full Service
Standard and Poor's Corporation	USA	McGraw Hill	Full Service
Canadian Bond Rating Service	Canada	Independent	Full Service (Canada)
Thomson Bank Watch	USA	Thomson Company	Financial Institutions
Japan Bond Rating Institute	Japan	Japan Economic Journal	Full Service (Japan)
Duff and Phelps Credit Rating	USA	Duff and Phelps Corporation	Full Service
Japanese Credit Rating Agency	Japan	Financial Institutions	Full Service (Japan)
IBCA Ltd.	United Kingdom	Independent	Financial Institutions

Most of the rating agencies mentioned above have long had their own symbols. Some of them use alphabets, others use numbers, and many use a combination of the two for ranking the risk of default. The default risk varies from extremely safe to highly speculative.

The table below gives a bird's eye view of the rating grades assigned by major international rating agencies.

Rating Grades of International Raters

Investment Grade Ratings		**Speculative Grade Ratings**		
Name of the Agencies	**Interpretation**	**Name of the Agencies**		**Interpretation**
S&P and Others		**S&P and Others**	**Moody's**	
AAA	Highest Quality	BB+	Ba1	Likely for full obligations, ongoing uncertainty
AA+	High Quality	BB	Ba2	As above
AA	High Quality	BB–	Ba3	As above
AA–	High Quality	B+	B1	High-risk obligations
A+	Strong Payment Capacity	B	B2	High-risk obligations
A	Strong Payment Capacity	B–	B3	High-risk obligations
A–	Strong Payment Capacity	CCC+		Current vulnerability to default, or in default (Moody's)
BBB+	Adequate Payment Capacity	CCC	Caa	As above
BBB	Adequate Payment Capacity	CCC–		As above
BBB–	Adequate Payment Capacity	C	Ca	In bankruptcy or in default, or other marked shortcomings
		D	D	In bankruptcy or in default, or other marked shortcomings

DOMESTIC CREDIT RATING AGENCIES

Credit rating business in India started only recently. It was in the late eighties (1987) that the first rating agency, CRISIL, was established. At present, there are three rating agencies, namely, CRISIL, ICRA Ltd and CARE . The fourth rating agency is a joint venture between Duff and Phelps, U.S. and Alliance Capital Limited, Calcutta.

CRISIL

CRISIL was jointly promoted by ICICI, nationalized and foreign banks, and insurance companies in 1987. It went public in 1992, and is the only listed credit rating agency in India. Since 1995, in strategic alliance with Standard & Poor's, it has extended its credit rating services to borrowers from the overseas market. The services offered are broadly classified as rating, information services, infrastructure services, and consultancy. Rating services cover the rating of long, medium and short-term debt instruments, securitized assets and builders. Information services include corporate research reports and the CRISIL 500 index. The infrastructure and consultancy division provides assistance on specific sectors such as power, telecom and infrastructure financing.

ICRA

ICRA was promoted in 1991, by IFCI and 21 other shareholders comprising of nationalized and foreign banks and insurance companies. It is the second rating agency to be established in India. The services offered can be broadly classified as rating services, advisory services and investment information services. The rating services comprise rating of debt instruments and credit assessment. Advisory services include strategic counseling, general assessment such as restructuring, and services specific to sectors, such as for power, telecom, ports, municipal ratings, etc.

The information desk provides research reports on specific industries, sectors and corporates. The information services also include equity related services, viz., Equity Grading and Equity Assessment. In 1996, ICRA entered into a strategic alliance with Financial Proforma Inc, a Moody's subsidiary, to offer services on Risk Management Training and Software. Moody's and ICRA have entered into a Memorandum of Understanding to support these efforts.

CARE

CARE was incorporated in 1992, with the combined efforts of IDBI, and several other banks and insurance companies. The services cover rating of debt instruments and sector specific industry reports.

CREDIT RATING SYMBOLS

ICRA (Investment Information and Credit Rating Agency of India Limited)

a. Long-term Debt—Debentures, Bonds and Preference Shares

Symbol	Indicator	Profile
LAAA	Highest safety	• Indicates fundamentally strong position • Risk factors are negligible • Visualization of any circumstances adversely affecting the degree of safety • Timely payment of principal and interest as per terms will not be affected
LAA+ **LAA** **LAA–**	High safety	• Modest and slightly varying risk factors • Strong protective factors • Prospect of timely payment of principal and interest as per terms under adverse circumstances, as may be visualized
LA+ **LA** **LA–**	Adequate safety	• Risk factors are more variable and greater in periods of economic stress • Protective factors are average • Any adverse change in circumstances although could be visualized, may alter the fundamental strength and affect the timely payment of principal and interest as per terms
LBBB+ **LBBB** **LBBB–**	Moderate safety	• Considerable variability in risk factors • Protective factors are below average • Adverse changes in business/economic circumstances are likely to affect the timely payment of principal and interest as per terms
LBB+ **LBB** **LBB–**	Inadequate safety	• Timely payment of interest and principal are more likely to be affected by present or prospective changes in business/economic circumstances • Protective factors fluctuate in case of changes in economy/business conditions

Symbol	Indicator	Profile
LB+ **LB** **LB–**	Risk prone	• Risk factors indicate that the obligations may not be met when due • Adverse changes in business/economic conditions could result in inability/unwillingness to service debts on time as per terms
LC+ **LC** **LC–**	Substantial risk	• Presence of inherent elements of risk and timely servicing of debts/obligations could be possible only in case of continued existence of favorable circumstances
LD	Default extremely speculative	• Either already default in payment of interest and/or principal as per terms or expected to default • Recovery is likely only on liquidation or reorganization

b. Medium-term Debt—including Fixed Deposit Programs

Symbol	Indicator	Profile
MAAA	Highest safety	• Best prospect of timely servicing of interest and principal as per terms
MAA+ **MAA** **MAA–**	High safety	• Prospect of timely servicing of the interest and principal as per terms is high, but not as high as in MAAA rating
MA+ **MA** **MA–**	Adequate safety	• Adequate prospect of timely servicing of the interest and principal • Debt servicing may however, be affected by adverse changes in the business/economic conditions
MB+ **MB** **MB–**	Moderate safety	• Timely payment of interest and principal are more likely to be affected by future uncertainties
MC+ **MC** **MC–**	Risk prone	• High susceptibility to default • Adverse changes in business/economic conditions could result in inability/unwillingness to service debts on time and as per terms
MD	Default	• Either already in default or expected to default

c. Short-term Debt—including Commercial Paper

Symbol	Indicator	Profile
A1+ **A1**	Highest safety	• Best prospect of timely payment of debt/obligation
A2+ **A2**	High safety	• Relative safety is marginally lower than A1 rating
A3+ **A3**	Adequate safety	• Prospect of timely payment of interest and installment is adequate, but any adverse change in business/economic conditions may affect the fundamental strength
A4+	Risk prone	• Degree of safety is low. Likely to default in case of adverse changes in business/economic conditions
A5	Default	• Either already in default or expected to default

CRISIL (Credit Rating and Information Services of India Limited)

a. Debenture Rating Symbols

Symbol	Indicator	Profile
AAA (Triple A)	Highest safety	• Offers highest safety of timely payment of interest and principal • Any change in circumstances, providing this degree of safety can be envisaged, and is most unlikely to affect adversely the fundamentally strong position of such issues
AA (Double A)	High safety	• Offers adequate safety of timely payment of interest and principal • Differs in safety from `AAA' issues only marginally
A	Adequate safety	• Offers adequate safety of timely payment of interest and principal • However, changes in circumstances can adversely affect such issues more than those in the higher rated categories
BBB (Triple B)	Moderate safety	• Offers sufficient safety of timely payment of interest and principal for the present • Changing circumstances are, however, more likely to lead to a weakened capacity to pay interest and repay principal than for debentures in higher rated categories

Symbol	Indicator	Profile
BB (Double B)	Inadequate safety	• Carries inadequate safety of timely payment of interest and principal • Less susceptible to default than other speculative grade debentures in the immediate future • However, the uncertainties that the issuer faces could lead to inadequate capacity to make timely interest and principal repayments
B	High risk	• Have greater susceptibility to default • Although current interest and principal repayments are met, adverse business or economic conditions would lead to lack of ability or willingness to pay interest or principal
C	Substantial risk	• Presence of highly vulnerable factors • Timely payment of interest and principal is possible only if favorable circumstances continue
D	Default	• Interest or principal payments are expected to default at maturity Speculative nature of debentures and returns from these debentures may be realized only on reorganization or liquidation

Note:

1. CRISIL may apply '+' (plus) or '–' (minus) signs for ratings from AA to C to reflect comparative standing within the category
2. The contents within parentheses are a guide to the pronunciation of the rating symbols
3. Preference share rating symbols are identical to debenture rating symbols except that the letters 'pf' are prefixed to the rating symbols, e.g. 'pfAAA'

CRISIL Fixed Deposit Rating Symbols

Symbol	Indicator	Profile
FAAA (F Triple A)	Highest safety	• Degree of safety regarding timely payment of interest and principal is very strong
FAA (F Double A)	High safety	• Degree of safety regarding timely payment of interest and principal is strong • However, the relative degree of safety is not as high as for Fixed Deposits of `FAAA' rating
FA	Adequate safety	• Degree of safety regarding timely payment of interest and principal is satisfactory • Changes in circumstances can affect such issues more than those in the higher rated categories

Symbol	Indicator	Profile
FB	Inadequate safety	• Inadequate safety of timely payment of interest and principal • Such issues are less susceptible to default than fixed deposits rated below this category • The uncertainties that the issuer might face could lead to inadequate capacity to make timely interest and principal payments
FC	High risk	• Degree of safety regarding timely payment of interest and principal is doubtful • Such issues have factors present that make them vulnerable to default • Adverse business or economic conditions would lead to lack of ability or willingness to pay interest or principal
FD	Default	• Indicates that the issue is either in default or is expected to be in default upon maturity

Note: CRISIL may apply '+' (plus) or '–' (minus) signs for ratings from FAA to FC to indicate the relative position within the rating category.

CRISIL RATINGS FOR SHORT-TERM INSTRUMENTS

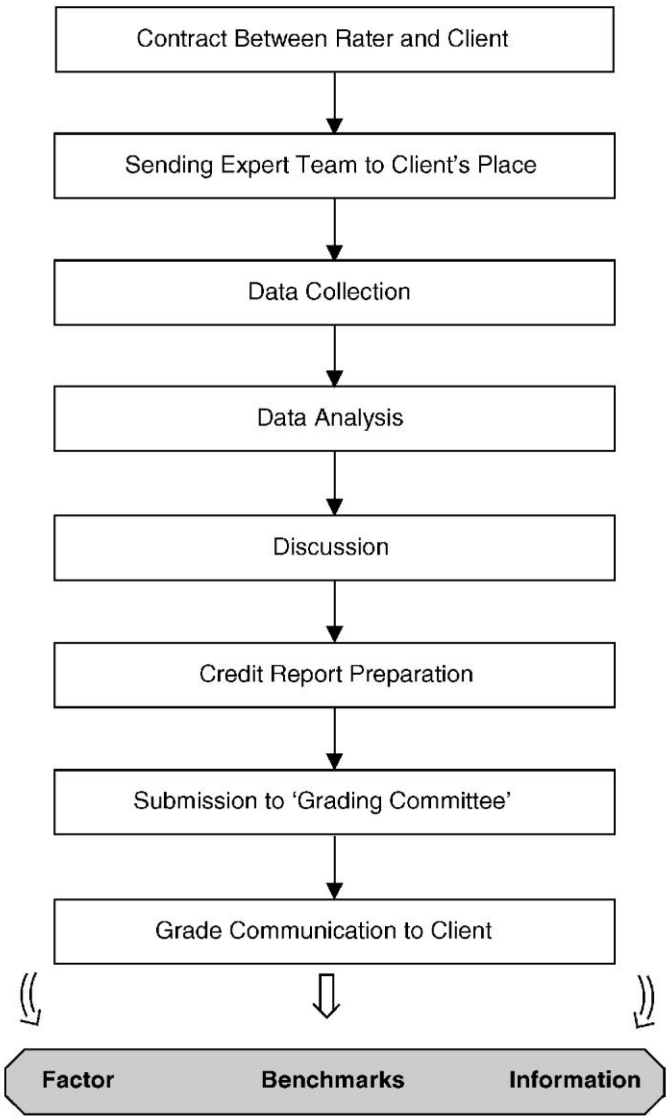
Symbol	Indicator	Profile
P-1	Highest safety	• Degree of safety regarding timely payment on the instruments is very strong
P-2	High safety	• Degree of safety regarding timely payment on the instrument is strong • However, the relative degree of safety is lower than that for instruments `P-1'
P-3	Adequate safety	• Degree of safety regarding timely payment on the instrument is adequate • However, the instrument is more vulnerable to adverse effects due to changing circumstances than an instrument rated in the two higher categories
P-4	High risk	• Degree of safety regarding timely payment on the instrument is minimal and is likely to be adversely affected by short-term adversity or less favorable conditions
P-5	Default	• Instrument is expected to default on maturity or is already in default

Note: CRISIL may apply '+' (plus) or '–' (minus) signs for ratings from P-1 to P-3 to reflect comparative standing within the category.

CREDIT RATING PROCESS

The process of rating credit worthiness of an issue of a bond or equity involves the following steps which is depicted in Exhibit 13.

Exhibit 13 Crediting Rating Process



RATING FRAMEWORK—MAJOR FACTORS

Credit rating aims at providing an opinion on the relative credit risk (or default risk) associated with an instrument. This calls for estimating the cash generation capacity of the issuer, through primary cash flows operations, vis-a-vis its requirements for servicing obligations over the tenure of the instrument. While doing so, an assessment is also made of the secondary cash flow available through the sale of marketable securities. These can be liquidated, if required, to supplement the primary cash flow. This is because secondary cash flows have a greater bearing in the short-term ratings, while the long-term ratings are generally based on adequacy of primary cash flows.

While assigning ratings, all the factors that have a bearing on future cash generation and claims that require servicing, are considered. The major factors that determine the rating profile of a security issue are discussed below:

Business Factors

a. Nature of industry A key determinant of the level and volatility in the earnings of any business is the basic characteristic of the industry to which the firm belongs. This is the most important factor in credit risk assessment. For the purposes of credit risk evaluation, stable businesses (low industry risk) with lower-level cash generation are viewed more favorably compared to businesses with higher cash generation potential but with a relatively higher degree of volatility (higher industry risk).

b. Market position Factors that influence the relative competitive position of the issuer need to be examined in detail. These factors include product positioning, perceived quality of products or brand equity, proximity to the markets, distribution network and relationship with the customers. The result of these factors is reflected in the ability of the issuer to maintain/improve its market share, and command a differential in pricing. Issuers, whose market share is declining, generally do not get favorable long-term ratings.

c. Efficiency of operation For any business unit in a competitive market, operational efficiency is most important, since it is critical to control costs at all levels. Moreover, low cost producers almost always have an edge. Cost of production, to a large extent, is influenced by factors such as location of the production unit(s), access to raw materials, scale of operations, quality of technology, level of integration, experience and the efficiency of the unit.

Relative efficiency of the unit can be determined by comparison with peers. Some of the indicators for measuring production efficiency include resource productivity (both assets and manpower), material usage (or input-output ratios) and energy consumption. Collection efficiency and inventory levels also indicate market position and operation efficiency.

d. Project risk The risk profile of an issuer is greatly influenced by the scale and the nature of new projects. Assessment in greater detail needs to be made of unrelated diversifications into new projects. Effort are also to be made to determine the rationale behind the new project. The main risks to new project include time and cost overruns, noncompletion in extreme cases, financing tie-up, operational risks, and market risk.

e. Protective factors In addition to the above, protective factors are also assessed. These include track record of the management in project implementation, experience and quality of the project implementation team, experience and track record of the technology supplier, implementation schedule, status of the project, project cost comparisons, financing arrangements, tie-up with raw material sources, composition of the operations team and market outlook. Based on the assessment of various project risks, assumptions about completion and contribution to/from these projects have to be incorporated in the issuer's overall projections.

f. Quality of management Quality of management need hardly be overemphasized. When the business conditions are adverse, it is the strength of the management that provides resilience. Much wider insight into management is obtained by having a detailed discussion on its objectives, plans and strategies, competitive position, past performance and future outlook of the business.

It also helps in establishing the management's priorities. A review of the organization structure and information system is done in order to assess its alignment with the management's plans and priorities. Interactions with key operating personnel help in determining the quality of the management. Issues like dependence on a particular individual and succession planning are also addressed. Other important factors that are considered include labor relations, track record of meeting promises specifically relating to returns and project implementation, performance of "group" companies, transactions with "group" companies, etc.

Financial Factors

a. Financing policies The level of financial risk is determined by the type of funding policies followed by a firm. These policies are generally focused on issues such as future funding requirements, level of leveraging, views on retaining shareholding control, target returns for shareholders, views on interest rates, currency exposures including policies to control the currency risk, and asset-liability tenure matching.

b. Flexibility of financial structure The financial flexibility factor generally helps to determine the relative strength within a rating category, and has a greater bearing on short-term ratings. Although the primary source for servicing obligations is the cash generated from operations, an assessment is also made of the ability of the issuer to draw on other sources. These include liquid investments, unutilized lines of credit, financial strength of group companies, market reputation, relationship with financial institutions and banks, and investor's experience of tapping funds from different sources.

c. Past track record Past financial performance of the issuer is assessed to determine the risk profile. A detailed review of previous financial statements is made to determine the future cash flow adequacy for servicing debt obligations. Equally important is the evaluation of the existing financial position for determining the sources of secondary cash flows, besides claims that may have to be serviced in future.

d. Quality of accounting policy Quality of accounting policies followed is a clear indicator of management quality. Consistent and fair accounting policies are a prerequisite for a fair financial evaluation and inter-firm comparisons. Rating analysts review the accounting policies, notes to the accounts and auditors' comments in detail. Where necessary, rating analysts adjust the financial statements to reflect the correct position. In the credit rating agency today, the focus of financial analysis has shifted towards evaluation of cash flow statements, since cash flows are known to show a clear impact of "financial engineering".

e. Financial performance indicators Financial indicators of a firm spanning over a period of five years are analyzed for the purpose of comparison with its peers. Such a comparison makes better understanding of industry trends, and determining the relative position of the issuer. Some of the important financial performance parameters that are analyzed are:

(i) ***Profitability*** It is possible to know the extent of success of any business through measures such as return on capital, return on net worth, gross operating margins, etc. Higher profitability, besides implying a greater cushion to debt holders, determines the market perception, which has a bearing on the support of the stakeholders.

(ii) ***Gearing*** As an important determinant of financial risk, gearing measures such as total debt as a percent of net worth, long-term debt as a percent of net worth, total outside liabilities as a percent of total assets, etc are considered important in determining the overall rating, especially in the long-term.

(iii) ***Coverage ratios*** Coverage ratios, such as interest coverage ratio, debt service coverage ratio, net cash accruals as a percent of total debt, etc reflect the magnitude of business risk. Favorable ratings are assigned where the level of coverage is higher. However, it is quite possible that a business with a lower level of coverage gets a higher rating if the earnings are steady (i.e. business with low industry risk).

(iv) ***Liquidity*** An analysis and comparison of asset-liability tenures is made to determine the liquidity position with respect to inventory, receivables, payables, etc.

(v) ***Cash flow*** Cash flow analysis gives an insight into the extent to which service obligations are successfully met. This is because, the ultimate objective of the rating is to determine the adequacy of cash generation for service obligations. Cash flow reflects the sources from which cash is generated, and the avenues where they are deployed. Future business outlook is considered to draw projections of financial statements. Financial projections are carried out for a number of scenarios, incorporating a range of possibilities for key cash flow drivers. A few important drivers are expectations of growth, selling prices, input cost, working capital requirements, value of currencies, etc.

EQUITY GRADING

The Need

The rating of equity issues of companies is known as 'equity grading'. It is aimed at contributing towards enhancement of the capital mobilizing process by providing authentic information, particularly when the dominant fund raising option is through equity.

The need for equity grading arises due to the following reasons:

a. Quality of information Capital markets play an important role in channeling the savings of both individuals and corporates towards productive use in nation building. In the context of the Indian economy, which is making steady progress in various spheres, resource allocation becomes increasingly significant. Growth and development of financial markets offers new opportunities to investors, issuers and other market participants. Nevertheless, new complexities and risks are also added. For example, inadequate information can lead to market inefficiencies. Availability of quality information is, therefore, considered a necessary pre-condition for the healthy operation of capital markets.

b. Wiser choice In order to make a choice between the various alternatives available, it is essential that an investor knows about a company and its future prospects. Such a choice has so far been largely associated with 'name or brand recognition', whereby the choice of a common investor depends largely on the familiarity with the names or brands of the promoters. But, it is an open secret that an astute investor knows quite well that name recognition is no substitute for an objective evaluation of risk and prospects. This is because there is no guarantee that every venture promoted by a well known name will be successful and, therefore, provide an attractive return on investment.

c. Lesser-known entrepreneurs Ventures that are promoted by relatively lesser-known names may not prove to be good investment options. Moreover, it also denies, relatively lesser-known entrepreneurs, access to a wider investor base. Under such circumstances, it is rarely feasible for a corporate issuer to offer every prospective investor the opportunity to undertake a detailed evaluation of the investment option. The problem is further compounded in the case of a heterogeneous group of investors who do not possess the requisite skills of evaluation where it becomes difficult to arrive at a meaningful and consistent conclusion regarding the relative quality of the equity issue.

d. Availability of international rating agencies International credit rating agencies like Moody's Investors Service (Moody's) and Standard & Poor's (S&P) provide quality grading of corporate equity issues. For instance, while S&P has a method of ranking common stocks on the basis of earnings and dividend record, Moody's has a system of classifying stocks based on their quality into grades like High Grade, Investment Grade, Medium Grade or Speculative Grade.

e. Lack of benchmark The 'close-end' nature of debt has fixed charges to be serviced. This means that the cash accruals of a company can be measured against these obligations in order to arrive at a 'cushion' (benchmark) or safety rating (credit rating). In contrast, equity capital is risky in nature. There are no fixed obligations attached to equity. This 'open-ended' nature of equity defies a credible benchmark for evaluating the performance of the company.

Equity Grading By ICRA—Methodology

The ICRA has succeeded in finding a method of benchmarking for open-ended equity instruments in a manner that would allow an investment process to take place, rather than fuelling speculation in stocks. The methodology is enunciated below:

a. Developing benchmarks Benchmarks are set for certain key performance parameters. The performance of a company is then measured against these benchmarks. Moreover, to ensure the dissemination of quality equity information to retail investors, the opinion on the equity quality is communicated in the form of a symbolic grade. The function of these grades is to help the investor choose between investment options at a given point of time. Equity grading is designed only to help investors make decisions, and are not recommendations to buy, hold or sell. It is left to the investors to decide for themselves what they prefer.

b. Comments on safety levels In order to enable the investors to become familiar with equity grades, 'relative comments' are also furnished about the equity issue. This is done by correlating grades and performance benchmarks. This process helps distinguish between equities.

c. Fundamental analysis Equity grades are helpful in making an analysis of the fundamentals of a company, that not only determine the return on the investment over the medium and long-term, but also decide the resource allocative dynamics of the market. Equity grading encourages the strategy of making an investment in a company, rather than in the stock market. By this logic, equity grading facilitates an information-based investment decision.

d. Analysis of factors The ICRA analyzes and evaluates all relevant factors that have a bearing on the quality of 'equity' of the issuing company. The grades arrived at after a thorough analysis are reflective of the earnings prospects, risk and financial strength associated with that company. Some of the key factors that are appraised by the agency include—quality and philosophy of the management, long-term nature and competitive character of the industry, corporate operations, financial strength, etc.

e. Obtaining opinions Specific attention has to be paid to opinions obtained on the basis of an in-depth study of the industry and the economic/business environment, competence and effectiveness of management, promoters' profile, marketing strategies, size and growth of revenues, competitive edge, state of technology, operational efficiency, liquidity, financial flexibility, asset quality, accounting quality, profitability and hedging of risks. For the purpose of obtaining, an opinion, the agency takes measures such as comprehensive information acquisition, interaction with the management, critical analysis and a collective judgmental process.

Equity Grading Process by ICRA

The process of equity grading is mandate-driven. The exercise is initiated by a mandate from the issuer and involves the following steps:

1. ***Mandate from the issuer*** The agency initiates the job of equity analysis and grading on the basis of instructions received from the issuer.
2. ***Assigning team of analysts*** After obtaining the mandate from the issuer, the agency then proceeds to assign technical teams to the issuing company in order to begin the analysis process.
3. ***Data collection*** The team of experts collects necessary data pertaining to the various aspects of the company. For this purpose, preliminary meetings are held with the company management.
4. ***Data analysis*** The data collected by the team of analysts is analyzed for inferences. The results are then benchmarked against general business and financial parameters.
5. ***Discussions*** Detailed and personal discussions are held with various managerial personnel. In addition, interactions are also held with the bankers and auditors of the company.
6. ***Credit report*** On the basis of the discussions and meetings that are held, and based on the data analyzed, a report on the company is prepared. The report is then presented to the Grading Committee, which in turn assigns the relevant grade.
7. ***Grade communication*** The Grade assigned by the grading committee is then communicated to the company. The option of acceptance or non-acceptance rests with the company. The grade is made public only if the company accepts it. In the event of non-acceptance, the company is given one chance to appeal, and the analysts are provided with fresh inputs/clarifications.

Credit Rating—Drawbacks

In spite of the advantages of the rating process, there are several drawbacks too. Following are some of the shortcomings of the rating process:

a. Guidance, not recommendation The rating process attempts to provide a mere guidance to investors/creditors in determining the level of default risk associated with the instrument/credit obligation. It does not attempt to provide a recommendation, nor does it take into account such factors as market prices and personal risk-reward preferences, in influencing the investment decisions.

b. Based on assumptions The process of rating is basicaly assumption-based. It does not offer any performance audit to assess the performance of a firm. In fact, a rating grade is assigned solely on the basis of the information provided by the issuer. Therefore, the quality of grading is likely to be affected by inaccurate information provided by the issuer.

c. Competitive ratings Wherever a firm believes that it is not possible for it to obtain a favorable rating grade, it may shop around for a much favorable rating. This is quite possible especially due to competition between a relatively large number of players in the credit rating business.

Credit rating in India is a recent phenomenon. Fortunately, the concept of credit rating is slowly gaining momentum, thanks to various regulatory measures that have been initiated by the government. Given its significance as an information provider and facilitator for the efficient allocation of resources by the financial market, credit rating services will continue to occupy a place of significance in our growing economy. However, a word of caution about rating in India—the success of the system will ultimately hinge on the preservation of credibility and integrity by the concerned agencies.

REVIEW QUESTIONS

Section A

1. What is credit rating?
2. How is credit rating defined?
3. What do you know of 'S&P'?
4. What do you know of 'Moddy's Investment Services'?
5. What do you know of 'Thomson Bank Watch'?
6. State the rating grades of international rating agencies
7. What do you know of 'ICRA'?
8. What do you know of 'CRISIL'?
9. What do you know of 'CARE'?
10. What does the rating symbol 'AAA' mean?
11. What does the rating symbol 'MAAA' mean?
12. What does the rating symbol 'FAAA' mean?
13. What does the rating symbol 'LAA+' mean?
14. What does the rating symbol 'BBB' mean?
15. What does the rating symbol 'P-1' mean?
16. What does the rating symbol 'FAA' mean?
17. What is 'equity grading'?

Section B

1. What were the factors that contributed for the growth and the importance of the credit rating system?
2. Trace the origin of credit rating financial services in the global financial arena.
3. What are the features of credit rating?
4. How is credit rating advantageous to investors?
5. How is credit rating advantageous to the issuers of financial securities?
6. Write a note on the major global credit rating agencies.
7. Write a note on the major domestic credit rating agencies.
8. Explain the mechanics of credit rating.
9. What is the need for 'equity grading'?
10. Explain the equity grading methodology adopted by the ICRA.
11. Explain the equity grading process adopted by the ICRA.

Section C

1. Discuss the advantages and disadvantages of credit rating.
2. Analyze the factors that are responsible for the growth and development of credit rating as a financial service.
3. What are the factors that are taken into consideration in arriving at an appropriate rating grade in respect of a financial security? Explain.
4. What are the major drawbacks connected with the credit rating system?

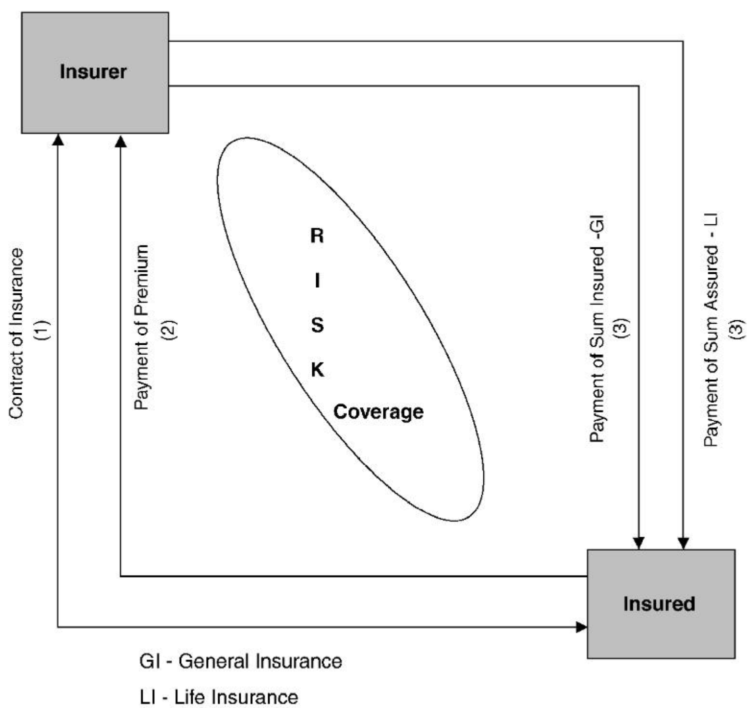
Chapter 18

Insurance—An Overview

DEFINITION

A contract whereby one party, called the 'the insurer or the insurance company', undertakes to compensate the other party called the 'insured', for any loss or damage suffered by the latter, in consideration of payment of 'premium' for a certain period of time, is known as 'insurance'. The working mechanism of insurance services is depicted in Exhibit 14.

Exhibit 14 Mechanics of Insurance Services



BASIC PRINCIPLES OF INSURANCE

A contract of insurance is required to possess the following essential characteristics:

1. ***Good faith*** A contract of insurance is founded on the principle of 'utmost good faith'. Accordingly, both parties to the contract are required to disclose all material facts. The rule of 'caveat emptor' is not applicable in the case of insurance.
2. ***Insurable interest*** The insured party is required to have an insurable interest on the object on which the insurance policy is taken. Insurable interest is required to be present both at the time of the contract, as well as at the time of loss. Insurance interest refers to the pecuniary or financial interest possessed by the beneficiary, which is the insured party, on the object being insured for. This implies that loss or damage caused to such an object would cause financial loss to the insured party.
3. ***Compensation*** An insurance contract undertakes to indemnify the insured for any loss or damage sustained due to the risk against which it is insured. This is applicable only to the general insurance business, where it is possible to calculate the loss or the damage in terms of money. The amount of compensation depends on the value of the insurance policy, and not on the value of the object insured.
4. ***Subrogation*** The term 'subrogation' refers to stepping into the shoes of others. Accordingly, an insurer can step into the shoes of an insured, and become entitled to all the rights and privileges of the insured in relation to the insured object, after making payment to the insured. Under this doctrine, the property in the object will pass on to the insurance company after the payment of insurance claims.
5. ***Contribution*** According to this principle, the amount of compensation forthcoming from an insurance company would depend proportionately on the amount for which the insurance policy has undertaken to compensate for the loss. This is applicable in the case of 'double insurance', whereby the insured insures the object with more than one insurance company.
6. ***Loss mitigation*** In order that the insurance company makes a reasonable payment of claims, it is necessary that the insured party takes all the necessary steps to mitigate the risk of loss in the event that the contingency insured against occurs. The insured must act as a person of ordinary prudence, and should make all reasonable efforts to minimize the loss.

7. ***Causa proxima*** According to this principle, risk coverage is available to the insured party, provided the loss has occurred directly from such events as specified in the insurance policy.

REINSURANCE

The insurance business done between insurance companies is known as 'reinsurance'. It is an arrangement through which it is possible for one insurance company to transfer a portion of its insurance business to other insurance company. Such an arrangement helps an insurance company to minimize its share of claims. There are two types of reinsurance. When one insurance company off-loads a portion of its insurance business to other insurance companies, it is a case of 'reinsurance ceded'. On the other hand, when one insurance company accepts a portion of insurance business of other insurance companies, it is a case of 'reinsurance accepted'.

LIFE INSURANCE

Meaning

A contract in which the insurer undertakes to pay a certain sum of money to the insured, either on the expiry of a specified period, or on the death of the insured, in consideration of payment of 'premium' for a certain period of time, is known as 'life insurance'. It is typically called 'life assurance'. Life insurance serves the purpose of protection, as well as an investment contract. It is a protection contract because it gives protection to the assured in the event of death, by making payment of the entire amount of the 'sum assured'. It is an investment contract too, as it gives the assured/investor the advantage of regaining the money with interest and bonus at the end of the policy.

Policies

Some of the popular types of life assurance policies are as follows:

1. ***Whole life policy*** An ordinary policy which runs throughout the life of the assured is known as 'whole life policy'. The sum assured under this policy is payable only after the death of the assured. The premium payable is low, and is meant to protect the family. This policy offers the advantage of an investment for a life term.
2. ***Endowment policy*** The policy runs for a period as specified in the policy document. The sum assured, along with the bonuses, are payable either on the date of maturity of the policy, or on the death of the assured, whichever occurs earlier. This policy offers the advantage of both protection and investment.

3. ***Annuity policy*** Under this policy, the amount of the policy is paid in the form of annuities for a specified number of years, or till the death of the assured.
4. ***Joint life policy*** When the insurance policy covers the lives of two or more persons, it is called 'joint life policy'.
5. ***Group insurance policy*** When an insurance policy is taken out on the lives of the members of a family, or the employees of a business concern, it is called 'group insurance policy'.

GENERAL INSURANCE

Meaning

A contract whereby, upon periodic payment of a sum of money called premium, the insurer undertakes to compensate the insured in the event of any specified loss or damage suffered by the latter, is known as 'general insurance'. A typical characteristic of general insurance is that it serves only as a protection contract, and not as an investment contract. This means that the money paid as premium will come back to the insured by way of claims only on the occurrence of some specified events resulting in loss or damage to the insured.

TYPES

The various types of general insurance are fire insurance, marine insurance, personal accident insurance, etc.

Fire Insurance

Under fire insurance, the insurance company undertakes to indemnify the loss sustained by the insured party on account of fire accidents. In order that fire claims are admitted by the insurance company, there must be an actual fire that is accidental, and not intentional. The cause of the fire is immaterial for the fire claim to be admitted. However, in the event of a fire breaking out, the insured party must have taken all the precautions that a person of ordinary prudence would take to salvage the subject matter insured.

Some of the popular fire insurance policies are as follows:

a. Valued policy It is a policy wherein the value of the property is agreed upon, and the insurance company undertakes to pay the agreed value in the event of destruction of the property.

b. Average policy A policy wherein, fire claims are paid to the insured in proportion to the actual value of the property at the time of loss, is called 'average policy'. Such a clause aims at preventing under-insurance. The amount of claims under this policy is calculated as follows:

$$\text{Amount of claims} = \frac{\text{Amount of insurance policy} \times \text{Loss assessed}}{\text{Actual market value of subject matter}}$$

c. Specific policy This is a policy wherein risk on account of fire is insured for a specific sum. The maximum coverage under this policy shall be upto the amount of the insurance policy.

d. Floating policy When an insurance policy covers risk pertaining to one or several kinds of goods in different places for a single sum and for a single premium, it is called a 'floating policy'.

e. Excess policy In a policy, where the risk coverage is to the extent of the maximum additional amount by which stocks may sometimes increase, it is called 'excess policy'.

f. Blanket policy Where the risk pertaining to all types of assets, fixed as well as current, is covered under one single insurance policy, it is a case of 'blanket policy'.

g. Comprehensive policy A policy which covers all types of risks arising from fire, explosion, lightning, thunderbolt, riot, civil commotion, strikes, burglary, etc. is called a 'comprehensive policy'.

h. Consequential loss policy Where a fire policy covers the risks arising from loss of profit owing to interruption of business by fire, it is called a 'consequential loss policy'.

Marine Insurance

An insurance contract which covers the risks of loss arising from and incidental to marine adventure, is known as 'Marine Insurance'. The kinds of risks that are covered in this type of insurance are cargo, hull, freight, etc. The different types of marine insurance includes cargo insurance, hull insurance and freight insurance. Cargo insurance covers the risks arising from an act of god, enemy, fire, gales, etc. Hull insurance covers the risk caused to the ship during the voyage. Freight insurance covers risks arising from the non-payment of freight charges to the owner of the ship on account of the perils of the sea voyage.

Policies

Some of the important policies of marine insurance are as follows:

a. Time policy A marine policy which covers a specified time period only

b. Voyage policy A marine policy that covers a specified voyage only

c. Mixed policy A marine policy that covers both specified time period and voyage

d. Blanket policy A marine policy that covers all type of risks

e. Fleet policy A marine policy that covers the entire fleet of liners and steamers

f. Valued policy A marine insurance policy, wherein, the value of the subject matter is agreed upon between the underwriter and the insured

Other Insurances

In addition to fire and marine insurance, other popular types of general insurance includes motor insurance, burglary, theft and robbery insurance.

Liability Insurance

A type of insurance contract that provides insurance protection to a person in the event of damage caused to someone's health or property, if found to be at fault is called 'liability insurance'.

CONCEPT OF INSURANCE SERVICES

Services relating to life and non-life insurance, offered by banks and financial institutions to trade and non-trade customers, on the basis of premium payments, may be referred to as 'insurance services'.

PROFILE OF INSURANCE SERVICE PROVIDERS

With the liberalization of the Indian economy, the insurance industry is witnessing phenomenal growth and development. The industry has a large number of players, especially the private players in the recent past. The Life Insurance Corporation of India (LIC) remains the single largest service provider in the realm of life insurance, while United India Insurance dominates general insurance business. A profile of the various service providers in the insurance industry is presented below:

General Insurers

The General Insurance Corporation of India (GIC) had four subsidiary companies, namely

1. Oriental Insurance Company Limited
2. New India Assurance Company Limited
3. National Insurance Company Limited
4. United India Insurance Company Limited

(With effect from December 2000, these subsidiaries have been de-linked from parent company and made independent insurance companies)

In addition, the following were also registered with the IRDA for carrying out general insurance business:

1. Royal Sundaram Alliance Insurance Company Limited, on 23.10.2000
2. Reliance General Insurance Company Limited, on 23.10.2000
3. IFFCO Tokio General Insurance Company Limited, on 04.12.2000
4. TATA AIG General Insurance Company Limited, on 22.01.2001
5. Bajaj Allianz General Insurance Company Limited, on 02.05.2001
6. ICICI Lombard General Insurance Company Limited, on 03.07.2002
7. Cholamandalam General Insurance Company Limited, on 15.07.2002

Life Insurers

In addition to the LIC of India, the following companies have been registered with the IRDA for providing life insurance services:

1. HDFC Standard Life Insurance Company Limited, on 23.10.2000
2. Max New York Insurance Company Limited, on 15.11.2000
3. ICICI Prudential Life Insurance Company Limited, on 24.11.2000
4. Om Kotak Mahindra Life Insurance Company Limited, on 10.01.2001
5. Birla Sun Life Insurance Company Limited, on 12.01.2001
6. Tata AIG Life Insurance Company Limited, on 12.02.2001
7. SBI Life Insurance Company Limited, on 30.03.2001
8. ING Vysya Life Insurance Company Limited, on 02.08. 2001
9. Allianz Bajaj Life Insurance Company Limited, on 03.08.2002
10. Metlife India Insurance Company Private Limited, on 06.08.2001
11. AMP SANMAR Assurance Company Limited, on 03.01.2002
12. Dabur CGU Life Insurance Company Private Limited, on 14.05.2002

Life Insurance Corporation of India (LIC)

Objectives The LIC of India was set up to achieve the following objectives:

(i) **Wide coverage** To spread life insurance widely, in particular to the rural areas and to the socially and economically backward classes, with a view to reaching all insurable persons in the country and in order to provide them adequate financial cover at a reasonable cost against death

(ii) **Savings mobilization** To maximize mobilization of people's savings by making insurance-linked savings adequately attractive

(iii) **Funds investment** To make a judicious investment of funds to the best advantage of investors as well as the community as a whole, keeping in view national priorities and the obligations of an attractive return

(iv) **Economy** To conduct business with utmost economy, and with the full realization that the amount belong to the policyholders

(v) **Trustee** To act as a trustee of the insured public in their individual and collective capacities

(vi) **Meeting growing needs** To meet the various life insurance needs of the community that would arise in the changing social and economic environment

(vii) **Efficient service** Involve all people working in the Corporation to the best of their capability in furthering the interests of the insured public by providing efficient service with courtesy

(viii) **Motivating people** To promote amongst all agents and employees of the Corporation a sense of participation, pride and job satisfaction through discharge of their duties with dedication towards achievement of the corporation's objective

HEALTH INSURANCE

Meaning

Health insurance is, basically, a promise by an insurance company or health plan to provide or pay for health care services in exchange for payment of premiums.

Helath Insurance Policy

A health insurance policy is a binding contract issued by an insurance company to an individual or group which promises to pay for health care reasonably required by the "insured" or "policy holer" or "certificate holder" to treat illness or injury. If the insurance policy is issued to an individual, the individual applies for the policy and pays the premius either directly or through payroll deduction. Typically, in individual health insurance the individual policyholder is insured and also, in exchange for a higher premium, the insurance covers a spouse and dependent family members.

In the circumstance where the health insurance is obtained by an employer or a group or an association, the entity is the "group policyholder" and the covered individuals receive "certificates" of insurance. Generally, in addition to payment of premiums by the policyholder, the insured is also respondible for payment of deductibles and co-pays (a percentage of actual charges on a fixed amount per visit) which are predetermined in the policy at set amounts or rates.

Health Insurance Plan

A health insurance plan, or health service plan, is generally distinguished from health insurance by the type of promise that is made in the binding contract between the insured and the issuing company.

a. Traditional health insurance policy A health insurance plan or a health service plan protects an insured or member by promising to either pay medical care or provide medical care. In the case of a traditional health insurance policy, there was a provision for the payment of any reasonable, medically necessary care required to treat an illness or injury. Then insured, as a patient, was free to choose his or her health care provider, who would then in turn apply to the insurance company for reimbursement. While traditional fee for service health insurance policies are available, premiums for them have become very expensive.

b. Modern health insurance policy The purpose of the modern health insurance policy is help control health care costs. The have lower premiums. The lower premiums generally are achieved through a reduction in choice of health care providers, a reduction in the type and amount of benefits available, stricter controls on the type and amount of care given by providers and/or negotiated reduction of compensation to health care providers.

Employer Sponsored Plans

Many large private employers provide health coverage through their own sponsored self-funded and administered employee welfare benefit plans. These plans may look very much like private indemnity insurance. An insurance company administers them for the employer.

Government Sponsored Plans

Health coverage is available through the workers' compensation systems in the states if the care relates to injuries suffered on the job. Government susidized or government provided care, includes Medicare for the elderly or disabled, or Medicaid for the disadvantaged, for military dependents, and for the indigent poor at the country level. In addition to the foregoing, in many communities there are private free clinics unaffiliated with any insurance company, plan or government entity.

Indian Scenario

Meaning

A contract of insurance whereby the insurance company undertakes to provide coverage for the health of the individual and or the family, is called health insurance. Health insurance is provided by making available health care facilities through a health care service provider. There are three parties to health insurance services. They are the insured, the insurance the health care entities. Health care entities are essentially hospitals which provide the health can services. Since independence, the health care system in India has been expanded and modernized considerably, with dramatic improvements in life expectancy and the availability of modern health care facilities and better training of medical personnel.

Health care has always been a problem area for India, a nation with a large population and a larger percentage of this population living below the poverty line. In such a situation insurance becomes an important issue in the country. In India, the health sector, *i.e.* the primary health care system is mainly managed by the structure of government health care facilities and other public health care systems in a traditional model of health funding and provision.

The Government finds it difficult to meet the demand for health security by over 200 million of the health insurable population in India, mainly due to service costs being out of reach of many people, absence of good and effective number of physicians, low rate of education programs, less number of hospitals, poor medical equipment and over all, the poor budget of Government towards the health program. Even Social insurance schemes available in India, such as the Employee State insurance Scheme (ESIS) and Central Government Health Scheme (CGHS) have restricted coverage to a very small segment of the population, around 3 percent.

Role of Private Sector

The opening up of the Indian insurance sector is a step towards making this sector a healthier one. The financial burdens of health care in India are enormous and growing. Given the constraints and difficulties in raising additional public resources and the rapid growth in spending on health care, it will be very difficult for the public health system to keep pace. Thus, even if the government decides to increase the level of public spending on health services dramatically, a substantial financial burden will still remain for users of health services. This could perhaps be filled by the private sector.

One theme is that India's health care delivery system relies upon both public and private facilities to provide care. Another theme is that given the constraints on public resources that are available, it is desirable and appropriate for the public sector to increase its effort to subsidize, finance or provide primary health care services, and to seek other revenue sources for doing so. It has also been argued that the emphasis on preventive and promotive health services by the government has been at the expense of curative health care and that this has led to the unregulated growth of the private health care sector. Finally, it has also been recognized that there are considerable variations across different Indian states and union territories in levels of health expenditure the respective shares of public and private health services, and the types of ailments.

A majority of people seek care during illness from private rather than public providers for out patient care. A slight majority of illpeople seek care from public providers for in-patient care. However, given that the out patient episodes are much more common than the in patient ones, a clear majority of all visits in India are to the private providers. Another important feature of the health care system in India is that even visits to public facilities generally involve considerable out of pocket expenditures. Numerous studies have shown that even consumers from the lowest income quintile often pay considerable amounts out of pocket for curative treatment by public.

Need for Health Insurance

a. Recognition as an industry In the mid 80's, the healthcare sector was recognized as an industry. Hence it became possible to get long-term funding from the Financial Institutions. The Government also reduced the import duty on medical equipments and technology.

b. Socio economic changes The rise of literacy rate, higher levels of income and increasing awareness through deep penetration of media channels, contributed to greater attention being paid to health. With the rise in the system of nuclear families, it became necessary for regular health check ups and increase in health expenses.

c. Brand development Many family-run business houses have set up charity hospitals. By lending their name to the hospital, they develop a good image in the market, which further improves the brand image of products from their other businesses.

d. Extension to related business Some pharmaceutical companies like Wockhardt and Max India, have ventured into this sector as it is a direct extension to their line of business.

Public Health Facilities

Indian commands the largest system of health care delivery in the world. It has a diverse network of hospitals, primary health center, community health center, dispensaries and speciality facilities financed and managed by the central and state local governments. These facilities are officially available to the entire population either free or for nominal charges. Along with some other networks of village health workers, maternal and child health programmes and speciality disease prevention programmes, these public facilities carry out a central role in India's primary health care system. The health facilities made available to the public are managed and operated under the authority of central and state agencies. The state governments mostly own and manage the public sector delivery system and have to bear the costs of operation. But the central government plays a major role in the planning, financing and transfer of resources that determine new investment in health facilities and specialized programmes. Much of the funding for health facilities originates from the union ministry of health and family welfare and is channeled to the state governments, which retain considerable authority for the spending decisions. Virtually all decisions are made by the central and state governments – including the staffing and supply decisions, with little autonomy for the providers of health care at the lower levels. Over the years, the central government has been the main source of funds for the primary health care facilities, whereas the states bear the major responsibility of recurrent costs, especially the costs of running hospitals. This system has added to the overall inefficiency of public health facilities.

a. Central government health scheme The Central Government Health Scheme (CGHS) was introduced in 1954 as a contributory health scheme to provide comprehensive medical care to the central government employees and their families. It was basically designed to replace the cumbersome and expensive system of reimbursements (Ministry of health and family welfare, *Annual Report 1993–94*). Separate dispensaries are maintained for the exclusive use of the central government employees covered by the scheme. Over the years the coverage has grown substantially with provision for the non-allopathic systems of medicine as well as for allopathy.

In addition, there were several polyclinics, laboratories and dental units under the scheme. In addition, the CGHS reimburses patients for part of their out of pocket costs on treatment at the government hospitals and some other facilities. The list of beneficiaries includes all categories of current as well as former government employees, members of parliament and so on. Since the large central bureaucracy in India definitely belongs to the middle-income and high-income categories, they are likely to make above average use of health services.

b. Employees state insurance scheme Established in 1948, the Employees State Insurance Scheme (ESIS) is an insurance system which provides both the cash and the medical benefits. It is managed by the Employees State Insurance Corporation (ESIC), a wholly government-owned enterprise. It was conceived as a compulsory social security benefit for workers in the formal sector. The original legislation creating the scheme allowed it to cover only factories which have been 'using power' and employing ten or more workers. However, since 1989 the scheme has been expanded, and it now includes all such factories which are 'not using power' and employing twenty or more persons.

Only employees earning basic salaries of less than Rs 3,000 (recently enhanced to Rs 6,500) per month are eligible for ESIS cover. Any establishment offering benefits similar to or better than the ESIS is exempted.

The premiums for the ESIS are paid through a payroll tax of 4 percent levied on the employer and a tax of 1.5 percent levied on the employee (recently changed to 4.75 percent and 1.75 percent respectively). The primary way in which the medical benefits are provided under the ESIS is through the facilities dedicated to those on the rolls of this scheme. Patients requiring treatment from specialists not available at the ESIS hospitals can receive them at the speciality facilities, with the ESIS programme bearing the expenses.

c. Mediclaim policy of the GIC The GIC was set up by the government in 1973 as a public sector organization to market a range of insurance services, including hospitalization cover. It introduced the standard 'Mediclaim' health insurance scheme in 1986, and became operational in 1987. This policy was modified in 1996 to allow for differentials in premium for six age groups: 5–45, 46–55, 56–65, 66–70, 71–75 and 76 plus. This policy was framed by the GIC for both groups and individuals. Before the GIC came into existence, a number of private insurance companies were engaged in offering group health insurance cover to most corporate bodies. With the formation of the GIC these companies were merged into four of its subsidiaries: the National Insurance Corporation (Calcutta), New India Assurance Company (Bombay), Oriental Insurance Company (New Delhi) and United Insurance Company (Madras). All the four companies operate nationally, although each has a regional concentration reflective of the location of its home office. They offer a full range of insurance types, with health accounting for a very small share of their total business.

One purpose of the merger of all the insurance companies was to standardize the coverage and various medical benefits. This was indeed accomplished. The standard Mediclaim policy covers only hospital care and domiciliary hospitalization benefits. Although some insurance companies have earlier experimented with direct reimbursement to hospitals and other providers, at present all that is offered is reimbursement insurance. With this the 'enrollees' are reimbursed for their medical claims only after the payments have been made out of pocket to the provider.

The GIC so prescribes premiums, eligibility and benefit coverage for all the four subsidiaries that they do not compete along any of these dimensions. All four firms have significant delays in claims processing. We discuss these delays and other related issues below.

d. Specialized insurance scheme The Life Insurance Corporation of India (LIC) introduced a speciality insurance programme in 1993 which covered medical expenses for only four dreaded diseases. This programme was withdrawn subsequently, but reintroduced in 1995. By definition, it is very limited in scope. It does not, therefore, serve to reduce the risk of financial burdens to any significant extent. It also remains to be seen whether or not this programme will be a popular method of insurance. The GIC's Jan Arogya Bima Policy is yet another scheme of medical reimbursement being offered to people on an individual basis. The annual premium for the youngest people age group is only Rs 70, as against the coverage limit of Rs 5,000 per year. Higher premiums are charged for older persons or those with spouses or dependents. Yet the premiums remain low in relation to the maximum coverage. Even

This low-maximum coverage level provides considerable coverage against low cost hospitalizations. Another significant difference is that it also covers maternity expenses. Apart from these few differences, this policy retains most of the Mediclaim features. It remains to be seen how successful it is in comparison to Mediclaim.

e. Employer-managed facilities "Employer-managed health facilities" and the "reimbursements of health expenses by employers" are the other ways to insure people against the risk of illness. These facilities are common for large public and private enterprises. Expenses incurred on these facilities are generally not tabulated in official records.

Like the plantations, the railways also maintain an extensive set of clinics and hospitals for their employees and their dependents. The mining sector provides medical and other facilities to its employees – particularly the mica mines and the iron ore, manganese ore, chrome ore, limestone and dolomite mines (Ministry of Health and F W 1992). Another segment of the public sector which maintains its own medical services is the defence setup which along with other security forces (police, paramilitary forces) employs about two to three million persons.

Yet another segment which provides some of these facilities to its employees comprises certain educational institutions, particularly universities. These facilities compete with other public facilities for staff and financial resources.

f. Employer reimbursement of health expenses Yet another segment of the health insurance system in India comprises numerous reimbursement plans offered by the employers for private medical expenses in the private sector, as well as in autonomous institutions and organizations – including commercial banks. For many workers this is the only form of insurance other than public facilities. Two kinds of reimbursement systems are predominant. In about half the cases, the system requires employees to set apart a share of their own income to save towards medical expenses. In all such plans, employees are able to spend up to the annual level of their own contribution. Typically, limits are set which depend upon a given employee's salary. In some cases contributions are voluntary, but in most cases they are not. Coverage for outpatient expenditures is more common than coverage for hospitalization expenses. The other common system of reimbursement is an employer self-insurance system, generally known as the medical benefit or medical allowance scheme. Under this arrangement, employees incurring medical expenses are required to submit claims to their employers for reimbursement, and reimbursements are not linked to the individual's contribution.

g. The NGO sector An important part of private health finance in India is the services provided by voluntary and charitable organizations. While such groups do not account for a large share of health care, they are often the only source of health services, or the only trusted one, for the population they serve. While it is very difficult to estimate even approximately the exact coverage of these varied services.

Some of the important NGOs offering health services are Child in Need Institute (CINI), Self-Employed Women's Association (SEWA), Streehitkarni and Parivar Seva Sanstha. Most of these NGOs offer comprehensive assistance packages with the underlying assumption that health is only one aspect of development and should therefore be tackled along with other social problems in a holistic fashion.

The government has used the health sector NGOs for two main purposes: to train its functionaries and to implement its health care delivery programmes. CINI and SEWA are good examples of such co-operation. To sumup, NGOs are providing valuable health services in many parts of India, especially in the rural areas and to disadvantaged people. Despite its growing role this sector has not yet reached a level where it can make a significant dent in private expenditure on curative care in India.

h. Private out of pocket expenses Almost all segments of the Indian population bear some direct out of pocket expenses for the utilization of the health care services, the lightest burden being borne by workers in the public sector or those employed in large private firms. The heaviest burden is borne by the people engaged in non-formal rural and urban activities. Even government employees with other forms of coverage bear considerable out of pocket expenses because they use private facilities and pay for drugs and services which would otherwise be cost free.

MOTOR INSURANCE

Meaning

Motor insurance is a type of insurance that insures the damage to the motor vehicle and its accessories, liability for damage to property, death of, or injury to, the assured himself or spouse and it also insures the motor vehicle against the risk of liability for injury to, or the death of third parties caused by the driver's negligence. The policies covering other types of risk or liability are similar to any other property or life insurance policies.

Nature

A motor car policy is a unique combination of several types of General Insurance'. For example, a private motor car comprehensive policy indemnifies the assured against loss or damage to the insured car by external accidental means, by fire, self-ignition, external explosion, lighting, frost, burglary, house-breaking or theft, by malicious act.

Property Accident Aspect

Property Accident Aspect comprises policies that cover the damage to the motor vehicle and its accessories. In motor vehicle insurance, if the motor vehicle is insured, the owner will be indemnified for any loss or damage caused to it by accident. Motor vehicle insurance being a contract of indemnity, the insured is only to entitled indemnity only and that too, in the manner stated in the policy. Medical expenses up to a limit are also payable. If the insured car suffers damage the insurer is entitled at his option to repair or replace the car or any part thereof or pay the amount of loss or damage in cash not exceeding the sum insured or the value at the time of loss whichever is less. It is not often easy to replace parts or accessories especially if it is a foreign vehicle or an outdated and out-modeled vehicle. If the part is not locally available or is exorbitantly costly to obtain from abroad, the insurer often limits the liability to paying in cash the catalogue price issued by the manufacturer or his agent in India together with the cost of fitting such part.

The terms of the policy define the nature and extent of the indemnity provided by the policy. There are two types of policies namely the third party liability policy which is compulsory under the Motor Vehicles Act or a comprehensive policy. Loss of a motor car means loss to the owner of the car. Mere temporary deprivation would not under ordinary circumstances constitute a loss. On the other hand, complete deprivation amounting to a certainty that the goods could never be recovered, is not necessary to constitute a loss. It lies somewhere in between these two extreme cases. (Moore v Evans, Banks)

Personal Accident Aspect

Personal accident aspect comprises policies that provide indemnity for the death or injury to the assured himself or spouse and his driver.

Besides ensuring his personal safety under an ordinary policy, the extension clause indemnifies the assured for the injury caused to him whilst he is driving a motor car not belonging to him or hired to him and also any person driving the insured car on the insured's order or with his permission. Further by paying extra premium he may get extra cover over and above the general cover under the standard policy like accidents to his wife and other specified relatives or friends; and loss or damage due to earthquake, flood, etc. The policy indemnifies the insured to the use of the insured car. However, it is extended in two ways, namely; it extends to the insured not only when he is driving his own insured car but also when he is driving a private motor car (but not a motor cycle) not belonging to him nor hired to him.

The benefit of this extension is available as long as he continues to be the owner of the insured car. It also extends also to any driver, driving the vehicle on the insured's order or with his permission. By the extension clause, the insurer purports to indemnify the authorized driver. The indemnity is however, subject to the terms, exceptions and conditions of the policy as far as it can be applied.

The authorized driver is also deemed to be an insured and in such cases the owner of the car is the primary insured and the driver is also insured. This became important in the interpretation of an exception in the policy. The owner of the car insured is with the usual extension clause extending the cover to the authorized driver. The policy excludes liability to persons in the employment of the insured.

Some of the usual conditions in a motor vehicle policy to make the insurer liable are the insured that will maintain the vehicle in a good state of repair and in an efficient condition; he takes all reasonable steps and precautions to avoid accidents and to select competent and sober drivers etc; and he takes all reasonable steps to safeguard the car from loss or damage.

Where accident is due to defective brakes, the insurer is not held liable, similarly when the loss is due to want of foot brakes or the front tyres were devoid of any trace of tread when the vehicle was taken on icy ground or the vehicle is un-roadworthy and in a dangerous condition, it would amount to the insured not maintaining the vehicle in a good state of repair and effective condition. When any condition of the policy is breached by the insured, the insurer is absolved from his liability to indemnify such an insured.

RURAL INSURANCE

Meaning

Insurance business services that are affored to the people in the rural areas is known as 'rural insurance'.

The insurance industry market in India was liberalized in 2000 and the first private insurance companies opened shop in the same year in November. The industry has now witnessed more than two years of private sector participation. However, the overall market has not really expanded, in real terms, beyond the urban domains. The penetration of insurance in India is low. It therefore requires a greater participation by the insurance companies.

Potential

There exist a vast potential in the rural areas where more than 70 percent of the population lives. But it is a common perception and belief among the insurance companies that it is expensive to do business in the rural areas. Most of them are focusing only on meeting the regulatory requirements from the rural areas and do not see them as commercially viable rural business opportunities, waiting to be exploited.

According to a study by FICCI-ING Insurance promoted Foundation of Research, Training and Education, a high level of awareness about insurance, particularly life insurance, is seen. About one-third of the respondents owned some insurance product or the other. Among those who owned insurance, there was a feeling of being under-insured and those who did not have one, felt the need for insurance cover. Insurance was largely seen as a risk-cover instrument and not so much as an investment option.

The rural market is vibrant and holds tremendous potential for growth of insurance business, particularly because of the strong saving habit. It is worth highlighting the existence of a continuum of economic activity between rural and urban areas. Intermediate settlements such as important villages, *kasbas* and *tehsil* towns play a key role in the process of rural-urban economic integration. Several towns are essentially overgrown than villages of the past and have continued to retain their essential rural character. These towns have indeed, proved critical to rapid economic growth of the rural areas in their hinterland as they provide them significant marketing and financial support.

Challenges

While the prospects in the rural sector are promising, the real challenge lies in distributing and delivering systems cost-effectively and efficiently. It is a common knowledge that the cost of building exclusive delivery systems for selling insurance would be prohibitive. However, valuable data are available on the existence of extensive network built by the rural development agencies, banks, cooperative institutions, NGOs, micro financing institutions, women's SHGs, youth clubs, panchayats and some industrial houses in the rural sector. Insurance companies would, therefore, be well-advised to harness this infrastructure and work out collaborative arrangements with these institutions to their mutual advantage.

These institutions, having spent huge amounts for creating the infrastructure, will be happy to collaborate and recover some of their costs. The insurance companies would save on large investments that would be required to buildup dedicated distribution and delivery systems and leverage the existing network at marginal costs. This, indeed, is a unique 'win-win' situation.

Delivery Channels

Delivery channels hold the key to a successful spread of rural insurance. Some of the important channels are explained below:

a. Nongovernmental organizations Nongovernmental organizations may be involved in the task of promoting rural insurance. The use of NGOs for developing rural insurance is justified in the following ways:

- A number of NGOs are working in the rural areas to enhance income opportunities, improve living conditions, make available health and education to the villagers. The focus of these efforts is largely the low-income households with whom they develop a close relationship (such as family). Their involvement in social causes generates goodwill among the locals also.

- NGOs involved in micro-finance have the experience of extending loans and handling repayments. Their organizations provide micro-finance to SHGs.
- A number of thrift and saving groups have been organized by government and nongovernment agencies across the country. These are mostly women groups of 15–20 members, which extend micro-credit to their members for starting an economic activity to augment family income.
- Only these NGOs would be well suited for marketing insurance as they are already familiar with financial transactions and work extensively with the rural poor. Group insurance will be best-suited for women belonging to BPL (below poverty line) or low-income segments.

b. Newly-emerging post office Similar to NGOs, it is also possible to utilize the services of the newly merging post offices to tap the potent rural market for promoting insurances services. As per the Department of Post's Annual Report 2001-02, 1, 55,279 post-office, including 1, 38,756 in rural areas, India has the largest postal network in the world. On an average, a post office serves an area of 21.17 sq. km. and a population of 6614. The use of post offices will be of much use in this regard. The advent of courier services, easy Internet facilities and modern telecommunication methods is forcing the postal services out from the urban markets. However, this service continues to be relevant in the villages where the post-office is a place for savings deposit, postal services and also the village telephone (pay phone for public use). People are also largely satisfied with the services of the post office.

The postal department also markets its own life insurance product because of which it may not commercially get involved in marketing insurance products of other companies.

c. Rural agents Rural agents can be identified in order to market the insurance products. In this regard, the following categories of persons could be identified as potential agents; their competency to sell insurance products can be made use of by the insurance companies.

d. Postal agents The post-office sells saving certificates such as Kisan Vikas Patra, National Savings Certificate and also generates recurring deposits through postal agents. These agents are recruited by the district savings officer, Office of the Collectorate, and given a three-year renewable licence. Insurance companies can recruit and train these agents for marketing insurance products. The familiarity with financial instruments (savings) will be advantageous to these agents and to the insurance company as well.

e. Cable TV operator Cable TV operators are educated and have access to all homes in the village that have a cable connection, that is, about 400 households in villages with a population of more than 5000. He visits the homes atleast once a month to collect the subscription for the cable TV. His accessibility to rural homes makes him a potential insurance agent.

f. Youth club members The youth clubs in the villages are active and are in activities such as starting a library, digging village ponds, processing official documents for villagers and organizing rural sports event and cultural shows to ensure better quality of life in the village. They are also a part of government programmes where they get involved in spreading information and awareness on health and sanitation, government schemes and assist in government health camps. These youth are educated and seek avenues for generating income for themselves. Leaders of youth clubs can be selected and recruited for marketing insurance products by companies.

g. Doctors and school teachers Registered medical practitioners and teachers are the most educated persons in a village and command considerable respect and influence. Villagers also trust them. Many of them have worked as agents for LIC, post office and other financial institutions. As these persons are well-educated, they can be easily trained under the IRDA curriculum and appointed as insurance agent by the private agencies. Rural market is vibrant and holds tremendous potential for growth of insurance business. These are the markets, which would provide the future numbers and growth, and the companies which take early decision to enter these markets would certainly have the early move advantage.

The general notion that it is expensive to do business in the rural areas is due to its inaccessibility and other factors, does not hold good due to the institutional infrastructure there, which can be profitably harnessed for reaching out to these areas. The challenge of developing a cost-effective delivery system is not insurmountable and there is enough scope for innovative collaborations. The process of penetration in the rural areas could be pushed further through an appropriate use of IT and a more pragmatic definition of 'Rural'

Micro Insurance—A Case Study

Tata AIG Life Insurance Company Ltd has announced the launch of 'Micro-Insurance Project' for the landless daily-waged rural poor in Andhra

Pradesh. The objective of this project is to alleviate poverty through significant initiatives, including financial reforms.

The rural insurance initiative of Tata AIG Life Insurance Company is being financially supported by the Financial Deepening Challenge Fund (FDCF) set up by the British Government's Department for International Development (DFID). In India, the fund is currently only operational in Andhra Pradesh and Madhya Pradesh. This fund, having a corpus of £18mn, is working in 14 countries in South Asia and Africa. To date, the Fund has committed over £12mn to 20 projects in 10 countries. This is the first of the eight projects sanctioned in India. The fund provides matching financial assistance to profit oriented sound business organizations operating in the financial services sector. The objective of the fund is to encourage these organizations to design and develop innovative financial products/services for the lower strata of society who were previously denied an access to any kind of formal financial products/services. Deloitte Haskins and Sells has been appointed to provide certain services for implementation of the Fund in India.

Tata AIG's rural insurance initiative today culminated in signing of a contract on a matching fund basis with the Fund Managers of FDCF, Enter-plan International (UK), represented in India by Deloitte, Haskins &Sells, for Micro-Insuring the lives of landless daily waged rural poor in the state of Andhra Pradesh. As per this agreement, FDCF will be contributing £89,500 (approximately Rs.65 Lakhs) while Tata AIG will contribute £104,000 (approximately Rs.75 Lakhs), thus taking the total corpus for 'Micro Insurance Project' to £ 193,500 (approximately Rs14mn). This is in addition to ongoing initiative of spreading rural insurance in the states of Tamil Nadu and Karnataka through the strategic tie-up with The Bridge Foundation.

The highlights of the Micro-Insurance project are:

1. ***Spread of insurance awareness*** among the economically and socially backward sections of rural Andhra Pradesh.
2. ***Develop a cost-effective rural insurance delivery*** and servicing channel that covers a large geographical area. Tata AIG is aiming to make this channel self-sustaining within three years of the commencement of the project.
3. ***Employment of Self Help Group (SHG) members***, thereby contributing directly to their incomes and livelihood.
4. ***Building a long-term savings and protection culture*** in the target market.

5. ***Encouraging investment*** through insurance to provide for education in the target market.
6. ***Development of a rural base*** of insurance customers and the financial infrastructure that would enable provision of other services such as Micro credit.

The implementation of the project is proposed through the development of Community Enterprises i.e. CRIGS (Rural Community Insurance Groups). This will be the grassroot unit that the company would train and develop into a self-sustainable rural insurance channel. Apart from providing gainful employment to the channel members the project will educate and train the channel periodically to enable them to take on other entrepreneurial assignments within the domain of rural services. In the long run, the CRIGs will become the backbone for providing other financial services to the rural poor.

The company's rural product development effort resulted in three products meant specifically for the rural markets; Kalyan Yojana, Karuna Yojana and Jana Suraksha Yojana. These policies are ideally suited for individuals who live below the poverty line and the monthly premium for some of these can be afforded just by saving less than Re.1 per day.

Recognizing the need for an efficient rural delivery mechanism Tata AIG has tied-up with The Bridge Foundation (TBF), an NGO headquartered at Bangalore that reaches out to the rural poor in all the four southern states and Orissa. TBF is a implementer programme in this project. Tata AIG is in the process of tying up with several NGOs who will act as the bridge between TBF and the CRIGs. The NGOs will facilitate mentoring and monitoring the front end operations of the CRIGs.

ANNUITY

Definition

According to George E. Rejda, "an annuity is defined as a periodic payment that continues for a fixed period or for the duration of a designated life or lives. The person who receives the periodic payments or whose life governs the duration of payment is known as the 'annuitant'.

Features

Following are the features of an annuity:

a. Protection for living An important feature of annuity is that it provides protection against living too long and exhausting one's life savings while the individual is still alive.

b. Purpose The purpose of an annuity is to provide for a lifetime income that cannot be outlived. Annuity protects against the loss of income because of excessive longevity and the exhaustion of savings.

c. Pooling of risk Annuities are possible because the risk of excessive longevity is pooled by the group. For instance, where some annuitants die early, their un-liquidated principal can be utilized to provide additional payments to annuitants who survive beyond their life expectancy.

d. Principle Payment of annuity income is based on the principle that some will die early before exhausting their savings, whereas others will still be alive after exhausting their principal.

e. Contribution The insurance company calculates the amount to be contributed by each member (annuitant) of the group by determining the approximate annuitants who will be alive.

f. Sources of annuity The payment of annuity consists of three sources such as premium payments, interest earnings, and the un-liquidated principal.

Types

Annuities are of three types. They are:

1. Fixed annuity
2. Variable annuity, and
3. Equity-indexed equity.

Fixed Annuity

An annuity which pays periodic income payments that are guaranteed and fixed in amount is known as 'fixed annuity'. Following are the features of fixed annuity:

a. Interest rates Under fixed annuity, there are two types of interest. One is guaranteed interest rate and the other is current interest rate. Guaranteed interest rate is the minimum interest rate that will be credited to the funds in the fixed annuity contract. Current rate of interest, on the other hand, is that rate of interest which is based on current market conditions. Current rate interest are guaranteed only for a limited period.

b. Guaranteed income During the liquidation period, the amount accumulated by the annuitant is paid to him in the form of a guaranteed life time income.

c. Inflation Since fixed payments only are made to annuitants, fixed annuity provides only limited protection against inflation.

Types of Fixed Annuity

The various types of fixed annuity are immediate annuity and deferred annuity.

a. Immediate annuity A fixed type of annuity where the income payments start immediately on the purchase of a lump sum amount by the annuitant is known as 'immediate annuity'. For example, if the income is to be paid monthly, the first payment is due one payment interval from the date of purchase.

b. Deferred annuity A fixed type of annuity that provides for a periodic income beginning from a certain future period is known as 'deferred annuity'. Under this type of annuity a annuitant accumulates money through a periodic payment, prior to retirement on a tax-deferred basis. If the annuitant dies before completing the mandatory period of contract, he will be paid a 'death benefit' that is equivalent to the sum of gross premiums paid by the annuitant. On the maturity date of the contract, the annuitant has the option of either obtaining the funds in a lump sum or obtaining periodical receipts.

Deferred annuity is of two types. A single-premium deferred annuity is one wherein a deferred annuity can be purchased with a lump sum. A flexible-premium annuity is one which allows the annuitant to vary the premium payments.

Variable Annuity

An annuity which pays periodic income payments that are not guaranteed but variable in amount is known as 'variable annuity'. Following are the features of variable annuity:

a. Purpose The fundamental purpose of a variable annuity is to provide an inflation-hedge. This is made possible by maintaining the real purchasing power of the periodic payments during retirements.

b. Common stock investment Premiums are invested in a portfolio of common stock or in such other portfolios which are likely to see rise in value on account of inflation.

c. Accumulation units Premiums are used to purchase accumulation units during the period prior to retirement and the value of each accumulation unit varies depending on common stock prices. At retirement, accumulation units are converted into annuity units. This way, although the number of accumulation units remains constant, the value of the same keeps changing. Hence, the value of annuity will depend on the level of common stock prices.

d. Death benefits Variable annuities provide the advantage of guaranteed death benefit in the form of payment higher than the amount invested in the contract or the sale value of the account at the time of death.

e. Enhanced death benefits In addition to the above, variable annuities also provide enhanced death benefits such as guaranteed principal plus interest or periodically adjust the value of the account to lock in investment gains.

f. Fees and charges Annuitants pay several type of charges such as investment management charges, administration charges, risk charge, surrender charge, etc.

g. Investment choice Annuitants avail several investment choices similar to mutual funds. Premiums are invested in investment portfolios called sub-accounts such as growth stock fund, corporate bond fund, etc.

Equity-indexed Annuity

'George E. Rejda defines 'equity-indexed annuity' as a fixed, deferred annuity that allows the annuity owner to participate in the growth of the stock market and also provides downside protection against the loss of principal and prior interest earnings if the annuity is held to term, the term ranges from one to ten years.

Following are the features of an 'equity-indexed annuity':

a. Linkage The value of equity-indexed annuity is based on the value of stock market index. Accordingly, the value of equity-indexed annuity will go up if the stock market index rises. However, if the stock market index declines, the annuity earns a minimum returns.

b. Participation rate A component of equity-indexed annuity is concerned with the rate at which the growth rate of stock market index is captured into the contract. Value of annuity depends on the participation rate.

c. Maximum gain A component of equity-indexed annuity which is concerned with the maximum percentage of gain is credited to the contract.

d. Indexing method A component of equity-indexed annuity which is concerned with the method of crediting excess interest to the annuity.

e. Guaranteed minimum value A component of equity-indexed annuity which is concerned with the provision of downside protection against the loss of principal if the annuity is held to term; there is a minimum value that is guaranteed to the annuitant.

REVIEW QUESTIONS

Section A

1. Define insurance.
2. What is ‘insurable interest’?
3. What is ‘subrogation’?
4. What is ‘contribution’?
5. What is ‘life insurance’?
6. What is ‘fire insurance’?
7. What is ‘marine insurance’?
8. What is ‘health insurance’?
9. What is ‘motor insurance’?
10. What is ‘general insurance’?
11. What are the types of general insurance?
12. What is ‘average policy’?
13. What is ‘floating policy’?
14. What is ‘blanket policy’?
15. What is ‘consequential loss policy’?
16. What is ‘comprehensive policy’?
17. What is ‘voyage policy’?
18. What is ‘time policy’?
19. What is ‘fleet policy’?
20. What is ‘valued policy’?
21. What is liability insurance?
22. What are insurances services?
23. What is ‘rural insurance’?
24. What is ‘micro insurance’?
25. What is ‘annuity’?
26. What is ‘fixed annuity’?
27. What is ‘variable annuity’?
28. What is ‘equity-indexed annuity’?
29. What is ‘immediate annuity’?
30. What is ‘deferred annuity’?
31. What is ‘traditional health insurance policy’?
32. What is ‘modern health insurance policy’?

Section B

1. Explain the mechanics of insurance.
2. What are the different types of life insurance policies?
3. What are the different types of fire insurance policies?

4. What are the different types of marine insurance policies?
5. Name the life insurance service providers in India.
6. Name the general insurance service providers in India.
7. State the objectives of setting up the Life Insurance Corporation of India.
8. What is the need for health insurance?
9. Explain 'employer-managed insurance facility'.
10. State the role of NGOs in the insurance services sector.
11. What is 'property Accident Aspect' of motor insurance?
12. What is 'personal Accident Aspect' of motor insurance?
13. What is the potential for 'rural insurance' in India?
14. What are the challenges facing rural insurance in India?
15. How will post offices useful in delivering insurance in India?
16. How are rural agents useful in delivering insurance in India?
17. How will youth club members useful in delivering insurance in India?
18. What are the features of an annuity?
19. Explain the different types of annuity.
20. What are the features of 'fixed annuity'?
21. What are the features of 'variable annuity'?
22. What are the features of 'equity-indexed annuity'?

Section C

1. Discuss the basic principles of insurance.
2. Give an account of insurance service providers operating in the Indian financial system.
3. How do you see the health insurance scenario as far as India is concerned?
4. Discuss the broad facilities of health insurance made available to the people of India.
5. What is role of private sector in the realm of provision of insurance coverage?
6. What is role of public sector in the realm of provision of insurance coverage?
7. Discuss the channels of delivery of rural insurance in India.
8. Write a case study for 'micro insurance services-conception and delivery', in India.

Chapter 19

Insurance—Regulatory Framework

The newly constituted Insurance Regulatory and Development authority (IRDA) regulates the insurance services sector in India. The regulatory framework available for the insurance services is presented below:

THE INSURANCE ACT

The Act provided for the setting up of the Controller of Insurance to act as a strong and powerful supervisory and regulatory authority for the insurance business. In the post-nationalization era, the role of Controller of Insurance diminished considerably since private insurance companies started operating alongside the government owned companies. With the opening up of the insurance industry to the private sector, the need for a strong, independent and autonomous Insurance Regulatory authority was felt. Realizing that the enacting of legislation would have taken time, the then Government constituted, through a Government resolution, an Interim Insurance Regulatory authority, pending the enactment of a comprehensive legislation.

The Insurance Regulatory and Development authority Act, 1999 provides for the establishment of an authority to protect the interests of insurance policy holders, to regulate, promote and ensure orderly growth of the insurance industry, and for matters connected therewith or incidental thereto. It also aims to amend the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalization) Act, 1972 in order to end the monopoly of the Life Insurance Corporation of India (for life insurance business) and General Insurance Corporation and its subsidiaries (for general insurance business).

INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

Composition

The Insurance Regulatory and Development authority (IRDA), was constituted by an act of Parliament. Under Section 4 of IRDA Act 1999). The authority is a ten member team consisting of a Chairman, five whole-time members and four part-time members, all appointed by the Government of India.

Duties

Under Section 14 of the IRDA act, the authority's duty is to regulate, promote and to ensure an orderly growth of the insurance and the re-insurance business.

Powers and Functions

Under sub section 1 of Section 14 of the IRDA act, the authority has the following powers and functions:

1. ***Registration*** Issuance of certificate of registration, or to renew, modify, withdraw, suspend or cancel such registration.
2. ***Protection*** Protection of the interests of policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions in contracts of insurance.
3. ***Qualification*** Specifying the requisite qualifications, code of conduct and practical training for insurance intermediaries and agents.
4. ***Code of conduct*** Specifying the code of conduct for surveyors and loss assessors.
5. ***Efficiency*** Promoting efficiency in the conduct of the insurance business.
6. ***Professionalism*** Promoting and regulating professional organizations connected with the insurance and re insurance business.
7. ***Fees*** Levying fees and other charges for carrying out the objectives of this Act.
8. ***Information*** Calling for information from, undertaking inspection of, and conducting enquiries and investigations, including audit of the insurers, intermediaries, insurance intermediaries and other organizations connected with the insurance business.
9. ***Terms of business*** Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers for general insurance, business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938).
10. ***Books of accounts*** Specifying the form and the manner in which books of account shall be maintained, and statement of accounts shall be rendered by insurers and other insurance intermediaries.

11. ***Funds investment*** Regulating investment of funds by insurance companies.
12. ***Margin of solvency*** Regulating the maintenance of margin of solvency.
13. ***Adjudication*** Adjudication of disputes between insurers and intermediaries or insurance intermediaries.
14. ***Supervising*** Supervising the functioning of the Tariff Advisory Committee.
15. ***Premium income*** Specifying the percentage of the premium income going into finance schemes for promoting and regulating professional organizations pursuing assurance business.
16. ***Rural Insurance etc*** Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector.
17. ***Others*** Exercising other powers as may be prescribed.

Constitution

The Insurance Regulatory and Development authority was constituted as a corporate body, having perpetual succession and a common seal with power, subject to the provisions of the Act. The authority shall acquire, hold and dispose property, can contract and can sue or be sued in its own name.

Composition of Authority

The authority consists of a Chairperson, not more than five whole-time members and not more than four part-time members, all appointed by the Central Government from amongst persons of ability, integrity and standing, who have knowledge or experience in life insurance, general insurance, actuarial science, finance, economics, law, accountancy, administration or any other discipline which would, in the opinion of the Central Government, be useful to the Authority. Similarly, the Central Government, while appointing the Chairperson and whole-time members, ensures that there is at least one person with knowledge or experience in life insurance, general insurance, and actuarial science respectively.

Tenure of Office

The Chairperson and every other whole-time member holds office for a term of five years from the date of entry to the office and is eligible for reappointment. However, no person shall hold office as Chairperson after the age of sixty-five years, and no person shall hold office as whole-time member after the age of sixty-two years. A part-time member shall hold office for a term not exceeding five years from the date of entry to the office. A member may relinquish office by giving in writing a notice of not less than three months, to the Central Government, or be removed from office in accordance with the following provisions:

Removal from office The Central Government may remove from office any member who is, or at any time has been, adjudged as insolvent, has become physically or mentally incapable of acting as a member, has been convicted of any offence which, in the opinion of the Central Government, involves moral turpitude, has acquired such financial or other interest as is likely to prejudicially affect his functions as a member, has so abused the position as to render the member's continuation in office detrimental to public interest. No member shall be removed unless a reasonable opportunity of being heard in the matter has been given.

Bar on future employment The Chairperson and the whole-time members shall not, for a period of two years from the date on which they cease to hold office as such, accept any employment either under the Central Government or under any State Government or any appointment in any company in the insurance sector except with the previous approval of the Central Government.

Administrative Powers

The Chairperson has the powers of general superintendence and direction with regard to all administrative matters of the authority.

Meeting of Authority

The authority meets at such times and places, and observes such rules and procedures in regard to transaction of business at its meetings (including quorum at such meetings) as may be determined by regulations. The Chairperson presides, or who, if for any reason, is unable to attend a meeting of the authority, any other member, is chosen by the members present from amongst themselves at the meeting to preside over the meeting. All questions which come up before any meeting of the authority is decided by a majority vote of the members present, and in the event of an equality of votes, the Chairperson or the person presiding, as the case may be, has a second or casting vote. The authority may make regulations for the transaction of business at its meetings.

Grants by Central Government

The Central Government may, after due appropriation in the Parliament by law on this behalf, make to the authority, grants of such sums of money, as the Government may think fit, for being utilized for the purposes of this Act.

The Fund

A Fund, to be called **"The Insurance Regulatory and Development Authority Fund"**, is to be established and the following sums will be credited thereto:

1. All Government grants, fees and charges received by the authority
2. All sums received by the authority from such other source as may be decided upon by the Central Government
3. The percentage of prescribed income received from the insurer

   The Fund shall be applied for meeting the following expenses:

   1. Salaries, allowances and other remuneration of the members, officers and other employees of the authority
   2. Other expenses of the authority in connection with the discharge of its functions, and for the purposes of this Act

Accounts and Audit

The authority maintains proper accounts and other relevant records, and prepares an annual statement of accounts in the form as may be prescribed by the Central Government in consultation with the Comptroller and Auditor General of India. The accounts of the authority are audited by the Comptroller and Auditor General of India at such intervals as may be specified by him, and any expenditure incurred in connection with such audits are payable by the authority to the Comptroller and Auditor General of India. The Comptroller and Auditor General of India and any other person appointed by him in connection with the audit of the accounts of the authority have the same rights, privileges and authority as the Comptroller and Auditor General generally has in case of an audit of the Government accounts. In particular, they have the right to demand books, accounts, connected vouchers and any other documents and papers, and to inspect any of the officers of the authority. The accounts of the authority, as certified by the Comptroller and Auditor General of India or any other person appointed by him on his behalf, together with the audit report thereon shall be forwarded annually to the Central Government, and the Government shall lay the same before each House of Parliament.

Powers of Central Government

The authority, in the exercise of its powers or the performance of its functions under this Act, is bound by directions on questions of policy, other than those relating to technical and administrative matters, as the Central Government may give in writing to it from time to time. However, the authority must, as far as possible, be given an opportunity to express its views before any such direction is given. The decision of the Central Government, on all matters, shall be final.

Superceding Powers

Under the following circumstances, the Central Government commands the superceding powers:

a. Inability to perform If, on account of circumstances beyond the control of the authority, it is unable to discharge its functions or perform the duties imposed on it by or under the provisions of this Act.

b. Persistent default That the authority has persistently defaulted either in complying with any direction given by the Central Government under this Act, or in the discharge of functions or performance of the duties imposed on it by or under the provisions of this Act, and as a result, the financial position or administration of the authority has suffered.

c. Public interest If circumstances exist and which render it necessary in the public interest so to do, the Central Government may, by notification, and for reasons to be specified therein, supersede the authority for such period, not exceeding six months, as may be specified in the notification, appoint a person as the Controller of Insurance. However, before issuing any such notification, the Central Government shall give a reasonable opportunity to the authority to make representations against the proposed supersession, and shall consider the representations, if any, of the authority.

On the publication of a notification superseding the authority, the Chairperson and other members shall, from the date of supersession, vacate their offices. All the powers, functions and duties which may, by or under the provisions of this Act, be exercised or discharged by or on behalf of the authority shall, until the authority is reconstituted, be exercised and discharged by the Controller of Insurance. All properties owned or controlled by the authority shall, until the authority is reconstituted, vest in the Central Government. On or before the expiry of the period of supersession specified in such a notification, the Central Government shall reconstitute the Authority by a fresh appointment of its Chairperson and other members, and any person who had vacated office under the notification shall not be deemed disqualified for reappointment.

The Central Government shall lay a copy of the notification issued, call for a full report of any action taken under this section and the circumstances leading to such action before each House of Parliament at the earliest.

d. Furnishing of returns, etc. The authority must furnish to the Central Government, at such time and in such form and manner as may be prescribed, or as the Central Government may direct, returns, and statements and other particulars with regard to any proposed or existing programme for the promotion and development of the insurer of the authority, subject to such conditions, if any, as may be specified in the order of its powers and functions under this Act, as it may deem necessary. The authority may, by a general or special order in writing, also form Committees of the members and delegate to them the powers and functions of the authority, as may be specified by the regulations.

e. Power to make rules The Central Government may, by notification, make rules for carrying out the purposes of this Act. Such rules may provide for all or any of the following matters:

(i) The salary and allowances payable to, and other conditions of service, of the members other than part-time members
(ii) The allowances to be paid to the part-time members
(iii) Other powers as may be performed by the authority
(iv) The form of annual statement of accounts to be prepared by the authority
(v) The time at, the form and the manner in which returns, statements and other particulars are to be furnished to the Central Government
(vi) The matters on which the Insurance Advisory Committee shall advise the authority
(vii) Any other matter which is to be, or may be prescribed, or in respect of which provision is to be or may be made by the rules

INSURANCE ADVISORY COMMITTEE

The authority may, by notification, establish with effect from such date as it may specify in such notification, a Committee, to be known as the Insurance Advisory Committee. The Insurance Advisory Committee shall consist of not more than twenty-five members, excluding ex-officio members, to represent the interests of commerce, industry, transport, agriculture, consumer fora, surveyors, agents, intermediaries, organizations engaged in safety and loss prevention, research bodies and employees' associations in the insurance sector. The Chairperson and the members of the authority shall be the ex-officio Chairperson and ex-officio members of the Insurance Advisory Committee. The objects of the Insurance Advisory committee shall be to advise the authority on matters relating to the formulation of the regulations. The Insurance Advisory Committee may also advise the authority on such other matters, as may be prescribed.

POWER TO MAKE REGULATIONS

The authority may, by notification, make regulations consistent with this Act, and the rules made thereunder to carry out the purposes of this Act. Such regulations may provide for all or any of the following matters:

1. The time and place of meetings of the authority, and the procedure to be followed at such meetings, including the quorum necessary for the transaction of business
2. The transactions of business at its meetings
3. The terms and other conditions of service of officers and other employees of the authority
4. The powers and functions which may be delegated to Committees of the members
5. Any other matter which is to be, or may be, specified by regulations, or in respect of which provision is to be made, or may be made by regulations

MAJOR AMENDMENTS TO INSURANCE ACT

The main amendments to the insurance act, 1938 are as follows:

The First Schedule

Definitions

By a new definition of "Indian Insurance Company" it means any insurer being a company, which is formed and registered under the Companies Act, 1956, in which the aggregate holding of equity shares by a foreign company, either by itself, or through its subsidiary companies or its nominees, does not exceed twenty-six percent, the paid up capital in such an Indian insurance company whose sole purpose is to carry on life insurance, general insurance or re-insurance business.

Under Clause 23A of Section 2 of the Income Tax Act, a foreign company has been defined to mean a company which is not a domestic company. A domestic company means an Indian company, and includes any company, which has made arrangements prescribed for deduction of income tax at source on dividends declared, distributed or paid out of its income, taxable in India.

Registration

No insurer other than an Indian insurance company can carry on any class of insurance business in India under this Act, on or after the commencement of the Insurance Regulatory and Development authority Act, 1999. Any person or insurer doing so, for which no registration certificate was necessary prior to such commencement, may continue to do so for a period of three months from such commencement or, if an application has been made for such registration within the said period of three months, until the disposal of such application. However, any certificate of registration, obtained immediately before the commencement of the Insurance Regulatory and Development authority Act, 1999, shall be deemed to have been obtained from the authority in accordance with the provisions of this Act. Every application for registration shall be made in such manner as may be determined by regulations made by the authority, and shall be accompanied by the required details, with requisite fees being not exceeding Rs. 50,000.

The authority may, by order, suspend or cancel any registration in such manner as may be determined by the regulations made by it. However, no such order shall be made unless the person concerned has been given reasonable opportunity of being heard. The authority may, on payment of a fee, not exceeding Rs. 50,000, as may be determined by the regulations, issue a duplicate certificate of registration to replace a certificate which has been lost, destroyed or mutilated, or in any other case where the authority is of opinion that the issue of a duplicate certificate is necessary.

Capital Requirements

No insurer carrying on the business of life insurance, general insurance, or reinsurance in India, on or after the commencement of the Insurance Regulatory and Development authority Act, 1999, shall be registered unless the insurer has a paid-up equity capital of rupees one hundred crores, in case of a person carrying on the business of life insurance or general insurance, or a paid-up equity capital of rupees two hundred crores, in case of a person carrying on exclusively the business as a reinsurer.

In determining the paid-up equity capital specified, the deposit to be made under Section 7 and any preliminary expenses incurred in the formation and registration of the company shall be excluded. An insurer carrying on the business of life insurance, general insurance or reinsurance in India before the commencement of the Insurance Regulatory and Development authority Act, 1999, and who is required to be registered under this Act, shall have the requisite paid-up equity capital as specified above within six months of the commencement of that Act. Where the nominal value of the shares intended to be transferred by any individual, firm, group, constituents of a group, or corporate body under the same management, jointly or severally, exceeds one percent of the paid up capital of the insurer, previous approval of the authority must be obtained for the transfer.

Divesting Excess Shareholding

No promoter shall at any time hold more than twenty-six percent, or such other percentage as may be prescribed, of the paid up capital in an Indian insurance company, provided that, in a case where an Indian insurance company begins the business of life insurance, general insurance or reinsurance in which the promoters hold more than twenty-six percent of the paid up capital or such other excess percentage as may be prescribed, the promoters shall divest the share capital in excess of the twenty-six percent of the paid up capital or such excess paid up capital as may be prescribed, in a phased manner after a period of ten years from the date of commencement of the said business by such Indian insurance company, or within such period as may be prescribed by the Central Government. The manner and procedure for divesting the excess share capital shall be specified by regulations made by the authority.

Every insurer, on or after the commencement of the Insurance Regulatory and Development authority Act, 1999, in respect of insurance business transacted by the insurer and in respect of shareholders' funds, shall, at the expiration of each financial year, prepare with reference to that year, a balance sheet, a profit and loss account, a separate account of receipts and payments, and a revenue account in accordance with the regulations made by the authority. Every insurer shall keep separate accounts relating to funds of shareholders and policyholders.

Conditions of Investment

The authority may, in the interests of the policyholders, specify, by regulations made by the Authority, the time, manner and other conditions of investment of assets to be held by an insurer for the purposes of this Act. The authority may, after taking into account the nature of business and to protect the interests of the policyholders, issue directions relating to the time, manner, and other conditions of investment of assets to be held by the insurer. However, no directions shall be issued unless the insurer concerned has been given a reasonable opportunity of being heard.

Rural or Social Sector

Every insurer shall, after the commencement of the Insurance Regulatory and Development authority Act, 1999, undertake such percentages of life insurance business and general insurance business in the rural or social sector, as may be specified, in the Official Gazette by the authority, in this behalf.

Investigation and Inspection

The authority may, at any time, by order in writing, direct any person (to be called "Investigating authority") specified in the order, to investigate the affairs of any insurer, to report to the authority on any investigation made by such Investigating authority. The Investigating authority may, wherever necessary, employ any auditor or actuary, or both, for the purpose of assisting in an investigation. The Investigating authority may, at any time, and shall, on being directed to do so by the authority, make an inspection of any insurer, and his books and account through one or more officers under the Investigating authority. The Investigating authority shall supply to the insurer a copy of the inspection report.

It shall be the duty of every manager, managing director or other officer of the insurer to produce before the Investigating authority, directed to make the investigation or inspection, such books of account, registers and other documents in their custody or power and to furnish any statement and information relating to the affairs of the insurer as the said Investigating authority may require, within such time as the said Investigating authority may specify.

Any Investigating authority, directed to make an investigation inspection may examine on oath, any manager, managing director or other officer of the insurer in relation to the business, and may administer oaths accordingly. The Investigating authority shall, if directed by the authority to do so, cause an inspection to be made, and may, in any other case, report to the authority on any inspection made.

On receipt of any such report, the authority may, after giving such opportunity to the insurer to make a representation in connection with the report as, in the opinion of the authority, seems reasonable, by order in writing require the insurer, to take such action in respect of any matter arising out of the report as the Authority may think fit, or cancel the registration of the insurer, or direct any person to apply to the court for the winding up of the insurer, of a company, if the registration of the insurer has been cancelled.

The authority may, after giving reasonable notice to the insurer, publish the report submitted by the Investigating authority, or such portion thereof as may appear to it to be necessary. The Authority may, by the regulations made by it, specify the minimum information to be maintained by the insurers in their books, the manner in which such information shall be maintained, the checks and other verifications to be adopted by insurers in that connection, and all other matters incidental thereto as are, in its opinion, necessary to enable the Investigating Authority to discharge satisfactorily the functions under this section.

No order made under this section, other than an order of cancellation of registration of insurer, shall be capable of being called in question in any court. All expenses of, and incidental to, any investigation made under this section shall be defrayed by the insurer, shall have priority over debts due from the insurer and shall be recoverable as an arrear of land revenue.

INSURANCE AGENTS, INTERMEDIARIES AND SURVEYORS

Insurance Agents

The authority, or an officer authorized by it in this behalf shall, in the manner determined by the regulations made by it and on payment of the fee determined by the regulations, which shall not be more than Rs. 250, issue to any person making an application in the manner determined by the regulations, a licence to act as an insurance agent for the purpose of soliciting or procuring insurance business. However, it is necessary that, in the case of an individual, the person does not suffer from any of the relevant disqualifications, and in the case of a company or firm, none of its directors or partners does not suffer from any of the said disqualifications.

Any licence issued immediately before the commencement of the Insurance Regulatory and Development authority Act, 1999, shall be deemed to have been issued in accordance with the regulations, which provide for such licence. A licence issued under this section, after the date of the commencement of the Insurance Regulatory and Development authority Act, 1999, shall remain in force for a period of three years only from the date of issue.

The authority may, if satisfied that undue hardship would be caused otherwise, accept any application in contravention of this subsection on payment of a penalty of Rs. 750 by the applicant. An insurance agent, among other things, must possess the requisite qualifications and practical training for a period not exceeding twelve months, and must pass such examination as may be specified by the regulations made by the authority in this behalf. The agent must not violate the code of conduct as may be specified by the authority. The authority may issue a duplicate licence to replace a licence that has been lost, destroyed or mutilated, on payment of such fee not exceeding Rs. 50, may be determined by regulations.

Issue of Licence to Intermediary

The authority or an officer authorized by it in this behalf shall, in the manner determined by regulations and on payment of the fees determined by the Authority issue, to any person making an application in the manner determined by regulations, a licence to act as an intermediary or an insurance intermediary under this Act. This is subject to the condition that in the case of an individual, the person does not suffer from any points of disqualifications, or in the case of a company or firm, any of its directors or partners does not suffer from any of the said disqualifications. A licence issued under this section shall entitle the holder thereof to act as an intermediary or insurance intermediary.

A licence issued under this section, shall remain in force for a period of three years only from the date of issue, but shall, if the applicant, being an individual does not, or being a company or firm any of its directors or partners does not, suffer from any of the disqualifications, and the application for renewal of licences reaches the issuing authority at least thirty days before the date on which the licence ceases to remain in force, be renewed for a period of three years at any one time on payment of the fee determined by regulations made by the authority and an additional fee for an amount determined by the regulations not exceeding Rs. 100 by way of penalty, if the application for renewal of the licence does not reach the issuing authority at least thirty days before the date on which the licence ceases to remain in force.

No application for renewal of a licence under this section shall be entertained if the application does not reach the issuing authority before the licence ceases to remain in force. The authority may, if satisfied that undue hardship would be caused otherwise, accept any application in contravention of this subsection on payment of Rs. 750 by the applicant as a penalty.

The disqualifications referred to above shall be any of the following:

1. That the person is a minor
2. That the individual is found to be of unsound mind by a court of competent jurisdiction
3. That the person has been found guilty of criminal misappropriation, criminal breach of trust, cheating, forgery or an abetment of or attempt to commit any such offence by a court of competent jurisdiction. However, where at least five years have elapsed since the completion of the sentence imposed on any person in respect of any such offence, the authority shall

ordinarily declare in respect of such person that the conviction shall cease to operate as a disqualification under this clause

4. That in the course of any judicial proceedings relating to any policy of insurance of the winding up of an insurance company, or in the course of an investigation of the affairs of an insurer, it has been found that the person has been guilty of, has knowingly participated in or connived at any fraud, dishonesty or misrepresentation against an insurer or an insured
5. That the individual does not possess the requisite qualifications and practical training for a period not exceeding twelve months, as may be specified by the regulations made by the authority in this behalf
6. That the person has not passed such examinations as may be specified by the regulations made by the authority in this behalf
7. That the person violates the code of conduct as may be specified by regulations made by the authority

If it is found that an intermediary or an insurance intermediary suffers from any of the foregoing disqualifications and if the intermediary or insurance intermediary has knowingly contravened any provision of this Act, without prejudice to any other penalty to which the person may be liable, the authority shall cancel the licence issued to the intermediary or insurance intermediary under this section.

The authority may issue a duplicate licence to replace a licence that has been lost, destroyed or mutilated, on payment of such fee, as may be determined by regulations made by the authority. Any person who acts as an intermediary or an insurance intermediary without holding a licence issued under this section to act as such, shall be punishable with a fine, and any insurer or any person acting on behalf of an insurer, who appoints as an intermediary or an insurance intermediary any person not licensed to act as such, or transacts any insurance business in India through any such person, shall be punishable with a fine.

Where the person contravening the above provisions is a company or a firm, then, without prejudice to any other proceedings, which may be taken against the company or firm, every director, manager, secretary or other officer of the company, and every partner of the firm who is knowingly a party to such contravention shall be punishable with a fine.

Surveyors

Every person who intends to act as a surveyor or loss assessor after the expiry of a period of one year from the commencement of the Insurance Regulatory and Development authority Act, 1999, shall make an application to the authority within such time, in such manner and on payment of such fee as may be determined by the regulations made by the authority. However, any licence issued immediately before the commencement of the Insurance Regulatory and Development authority Act, I999, shall be deemed to have been issued in accordance with the regulations providing for such licence. Every surveyor and loss assessor shall comply with the code of conduct in respect of their duties, responsibilities and other professional requirements as may be specified by regulations made by the authority.

REVIEW QUESTIONS

Section A

1. State the objective of the Insurance Act, 1938.
2. What is the purpose of Insurance Regulatory and Development Authority (IRDA) Act, 1999?
3. State the scope of 'Insurance Advisory Committee'
4. Who are insurance agents?
5. Who are insurance intermediaries?
6. Who are insurance surveyors?

Section B

1. What re the administrative powers of the chairperson of the IRDA?
2. What are the sums credited to the 'IRDA Fund'?
3. What are the powers of the central government to make rules with regard to the administration of the IRDA Act?
4. What are the powers of the 'Insurance Advisory Committee'?

Section C

1. Discuss the powers and functions of IRDA.
2. Discuss the composition of the IRDA.
3. What are the powers of the central government with regard to the administration of the IRDA Act?
4. Discuss the major amendments to the Insurance Act of 1938.

Chapter 20

Pension Plan

CONCEPT OF PENSION

Meaning

Retirement income contract between the employee and employer that represents the benefit payable, either as a lump sum amount or in the form of annuities, by an employer to an employee, for the service rendered by the latter, is known as 'pension'. It is an important constituent of the broader concept of social security.

Definition

According to Algoed and Spinnewyn (2001), 'pensions are a means of transferring purchasing power from the working phase to the retirement phase of the life cycle'.

According to the Supreme Court of India (1982), 'pension is a term applied to periodic money payments to a person who retires at a certain age, considered age of disability; payments usually continue for the rest of the natural life of the recipient'.

PENSION FUND

Meaning

A fund established by private employers, governments or unions for the payment of retirement benefits is known as a 'pension fund'. The entities that establish pension plans are called 'plan sponsors'.

PENSION SYSTEM

Meaning

Pension system refers to the framework of arrangements, (based either on statute or on private contract or both), under which individuals gain specified entitlements to a regular income in retirement called pension, in return for the payment of specified sums (contributions) made either by themselves or by their employers during their working lives.

Types

Pension system may be of two types. They are voluntary pension system and compulsory pension system. In the case of *voluntary pension system*, individuals freely enter into contracts committing themselves to making payments to intermediaries, who in turn, commit themselves to financing the payment of pensions on specified terms when the individuals eventually retire. Under this system, employers either voluntarily enter into contracts with financial intermediaries or make internal financial arrangements with a view to providing pensions for their employees on retirement. However, the workers are obliged to accept such arrangements, including making contributions from salary, as part of the contract of employment.

Under the *compulsory and government pension system,* workers and employers are legally obligated to make payments to the State (such as national insurance contributions in the case of UK). The State commits itself to making payment of pensions directly to retired individuals according to rules laid down in Statute.

To run a pension plan, employees and employers enter into pension contracts with financial intermediaries according to the terms of the contract specified by the Statute. In the same manner, workers and firms are also allowed to contract with any intermediary approved by the government for this purpose.

OBJECTIVES/FEATURES OF PENSION FUND

A pension fund commands the following features:

Insurance Against Infirmness

Pension funds are designed to provide for poverty relief, consumption smoothing and insurance in respect of longevity, etc. In the words of the Asian Development Bank (ADB), ‘old age pensions are designed to meet the requirements of an individual when, due to ageing, his/her capacity for work declines to the point where he/she is unable to be self-sufficient’.

Socio-economic Justification

A pension fund not merely affords compensation for the loyal service rendered in the past, but in a broader significance, works as a measure of socio-economic justice. It provides economic security in the fall of life when physical and mental prowess of an individual is receding corresponding to ageing process, and, therefore, one is required to fall back on savings. It is a social welfare measure rendering socio-economic justice to those who in the heydays of their life have toiled ceaselessly for the employer on an assurance that in their old age they would not be left in the lurch.

Employee's Right

A pension is neither a bounty nor a matter of grace that depend upon the sweet will of the employer. In fact, it creates a vested right on the part of the employee. Pension is not an ex-gratia payment but is a payment for the past service rendered.

Balance of Interest

The design of a pension fund aims at obtaining a balance between retirement benefit of the employees and the financial burden of the State Governments. Hence, the pension arrangements take into consideration the needs of the employees in their old age on the one hand and the financial burden of the State Governments on the other.

TYPES OF PENSION FUND

There are different types of pension funds. They are explained below:

Based on Generic

1. ***Defined Benefit (DB) pension fund*** The contractual arrangement that sets out the rights and obligations of all parties and where pensions are paid from a separate pool of assets, set aside to provide collateral for the promised benefits, it is a case of 'Defined Benefit Pension Fund'. The level of pension benefit is determined as a function of both years of service and wage history.

Features/Benefits

Following are the features of defined benefit plan:

1. ***Sponsor payment*** Under this type of pension plan, the sponsor agrees to make specified periodical payment to qualifying employees beginning at retirement (and some payments to beneficiaries in case of death before retirement). The amount of pension is paid by the pensionfund management company depending on such factors as each employee's life expectancy, retirement age, salary prior to retirement, and the expected returns achieved by the pension plan. Defined benefit pension fund is a fully funded plan.
2. ***Governing rules*** Defined benefit schemes set down precise rules governing how much each individual will receive in pension payments. Most occupational schemes have defined benefit schemes in which the individual's pension right is determined on a final salary basis.

3. ***Benefits*** Under this plan, the pensioner receives benefits in the form of an annual pension equal to a specified fraction of his/her final salary and a lump sum on retirement equal to a fraction of final salary for every year worked. Under this plan, pension contribution usually happens monthly.
4. ***Pension formula*** Retirement payment is determined by taking into account the length of service and earnings of the employee.
5. ***Pension obligations*** Pension obligations are essentially a debt obligation of the plan sponsor. This obligation thus exposes the plan sponsor to the risk of having insufficient funds in the plan to satisfy the regular contractual payments that must be made to retired employees.
6. ***Insured benefit plan*** Defined benefit plans that are guaranteed by life insurance products are called insured benefit plans. Plan sponsor who establishes a defined benefit plan can use the payments made into the fund to invest/purchase an annuity policy from a life insurance company. Contractual payment of retirement benefit under this plan depends on the ability of the life insurance company. Hence, it is not necessarily safer than a non-insured plan. The contractual payment in the case of a non-insured plan depends on the ability of the plan sponsor.
7. ***Vesting of benefits*** Benefits become vested when employees reach a certain age and complete enough years of service so that they meet the minimum requirements for receiving benefits upon retirement. The payment of benefits is not contingent upon a participant's continuation with the employer or union.
8. ***Pension forecast*** Under this plan, it is possible to make a reasonably reliable forecast of pension income by working out the years of service that would be accomplished. The plan offers members a high degree of security. The employer bears the brunt of any investment risk. Although the value of the pension can be undermined by inflation, index-linked pension schemes pass on the risk to the employer.
9. ***Risk bearing*** The biggest advantage of this system of pensions is that the rest of the society bears the risk of economic failure or an increase in life expectancy.
10. ***Real security*** Defined benefit schemes offer real security in old age to individuals who expect to clock up a long period of service with an employer and to be earning a reasonable final salary by the time they retire.
11. ***Undisturbed employment*** The feature of defined benefit schemes, which give rise to these equity considerations, has a positive

implication for economic efficiency. For instance, it creates a financial incentive for workers to stay with the same employer. This tends to discourage labour mobility. As a result, staff turnover may be reduced and this may benefit firms and through them the wider economy.

Limitations

The defined benefit pension plan suffers from the following limitations, in spite of its commanding features:

1. ***Reduced labor mobility*** Defined benefit schemes tend to discourage labour mobility and thus labour market flexibility. This would prove difficult for growing firms, perhaps the most dynamic enterprises in the economy, to attract labor that they can use effectively. Economic growth could suffer as a result.
2. ***Unsuitability*** The plan is not suitable for those people who will not be in continuous, reasonably well-paid employment. For example, some will suffer illness or unemployment, and many will have to interrupt their careers to care for children or elderly relatives. Defined benefit scheme will not be sufficient to ensure a reasonable level of pension entitlement for people in these categories. Accordingly, people who change jobs frequently may lose out.
3. ***Minimum service*** In order that benefits are made available under this plan, it is essential that there shall be a minimum period of service put on by the individual. If he or she leaves the job before the end of that period he or she will have accrued no pension entitlement. Even if the right is vested, it will be frozen until the individual retires.
4. ***No protection against inflation*** Where pension entitlement is fixed in money terms it hardly offers any protection against the hazards of spiraling inflation. Even under circumstances where pensions are index-linked, the individual remains at a disadvantage, as there is always a possibility that the Retail Price Index may rise more slowly than the salary that would be earned by staying in the company and to which the pension would have been tied. This way, the individual loses the opportunity to enhance the value of his or her early contributions by achieving promotion at an early stage.
5. ***Lower pensions*** There is a possibility of lower pension amount at the end of career of a person. This is because pensions typically depend on the wages in the last few months/years of employment. Accordingly, a sluggish wage increase towards the end of the career would reduce the pension amount commensurately. Similarly, in the case of occupational direct benefit plan, where workers bear the risk,

there is a possibility of losing pensions because of employer insolvency or worker mobility. In the case of public direct benefit plan, workers bear the risk in the event of decline in the taxing ability of the Government or change in the political regime and in the event of the new Government repudiating the pension arrangements made by a previous Government.

2. ***Defined contribution (DC) pension fund*** A pension system that involves defined annual contributions, whose benefits depend on the return on investments and the length of contribution, is called 'defined contribution pension fund'. Under this system future annual benefits are uncertain because of a considerable uncertainty about future rates of return and the duration of working and retirement periods. In the same manner, investment returns depend on the economic health of the country.

   Where in a pension plan, the plan sponsor is responsible only for making specified contributions into the plan for and on behalf of qualifying participants, and not making specified payments to the employee after retirement, it is a case of a 'defined contribution plan'.

   Defined contribution (otherwise known as money purchase) scheme is a kind of a 'personal pension'. Here the individual pays in contributions over his or her working life, which is invested to produce a fund that is used when the person retires to buy an annuity payable for the rest of his/her life.

Features/Benefits

Following are the features and benefits of a defined contribution plan:

1. ***No guaranteed pension*** Defined contribution pension plan does not offer any guaranteed fixed retirement benefit. The amount of pension varies depending on the earnings performance of the assets in which the pension plan's managers have invested. Similarly, it also depends on contribution made by the employer and the employee.

2. ***Employee's concern*** It is not a fully funded plan. The plan makes the employee concerned to achieve a desired level of pension. Under this scheme, the employee will not know the size of his or her pension until the day he/she retires.

3. ***Pension size*** The size of the eventual pension received depends on the value of contributions paid in by the individual. Moreover, pensions also depend on the returns earned on these contributions, and the market rate for annuities at the time of retirement.

4. ***Contribution mode*** Amount of contribution takes the form of either a percentage of the employee's salary and/or a percentage of the employer's profits.
5. ***Payment mode*** Plan sponsor does not guarantee any specific amount at retirement. The payment that will be made to qualifying participants upon retirement depends on the growth of the plan assets.
6. ***Investment*** Retirement benefit payments are determined by the investment performance of the funds in which the assets are invested and are not guaranteed by the plan sponsor. The plan sponsor merely gives the participants various options as to the investment vehicles in which they may invest.
7. ***Legal forms*** Several legal forms of defined contribution pension plans exist. They are 401(k) plans, etc. Under the 401 (k) plan, the employer makes a specified contribution to a specific plan/program, the mode of investment being chosen by the employee. The plan is attractive to the employee because it offers some control over how the pension money is managed. In fact, plan sponsors frequently offer participants the opportunity to invest in one or more of a family of mutual funds.

Drawbacks

Although schemes of defined contributions generally have a more close linkage between benefits and contributions than defined benefit schemes, many a time this relationship is broken. This happens in cases where guaranteed minimum benefits, rate of return guarantees and benefits based on rates of return fixed by the pension fund, and the actual returns are lower than the market returns. Direct contribution schemes often have high administrative costs. They are also subject to capital market risks on account balances and interest rate risks on monthly benefits when they are annuitised.

Defined Benefit Plan Vs. Defined Contribution Plan

There are many fundamental differences as specified below that exist between defined benefit plan and defined contribution plan:

Sl. No	Feature	Defined benefit plan	Defined contribution plan
1	**Retirement Benefits**	Plan sponsor guarantees the retirement benefits	No guarantee of retirement benefit by the employer
2	**Investment Option**	Selected by the employer	Selected by the employee

Sl. No	Feature	Defined benefit plan	Defined contribution plan
3	**Investment Risk**	Plan sponsor/employer bears the investment risk, in the event of inadequate investment earnings in order to fund the guaranteed retirements benefits	Employee bears the risk arising from investment
4	**Popularity**	Most popular of all the available pension plans; constituting 76 percent of the total pension businesses	Not so popular
5	**Funding**	Concept of full funding is ambiguous, whether public or private because of uncertainties about the future rate of return, longevity of pensioners, and age-earnings profiles	No ambiguity about full funding concept of pensioners' entitlements as they are from the proceeds of their individual accounts
6	**Administration**	Simple to administer	Not simple to administer
7	**Income Source**	Secure source of income to pensioners	No secure source of income
8	**Growth**	Largely depends on the macros such as growth of the economy, the labour market conditions and political risks	Depends on the investment performance and attractive investment returns
9	**Pressure**	Pressure on State's finances	Pressure on pensioners; makes them susceptible to financial insecurity
10	**Business Cycle**	Will not have any impact on the pensioners' income	Phases of business cycle will have significant impact on the pensioner's income; during boom periods, earnings will be more and vice versa
11	**Suitability**	Suitable for those who are primarily interested in having a regular and steady income stream during the retired life	Because of uncertainty of income, it is not suitable for those who are primarily interested in having a regular and steady income stream during the retired life

3. ***Notional defined contribution (NDC) pension fund*** NDC is a variant of defined contribution pension. Under this type of pension system, a notional account is accumulated during the working life of an employee based on contributions, both by the employee and the employer. The (notional) interest obtained on them is converted into pension at retirement, by means of an annuity. The scheme, which is an element of direct contribution method, considers not only the market rate of interest but some other indicators such as the rate of growth of GDP, or the rate of growth of wages. The scheme is generally mandatory and managed by the Government.

   The major advantages claimed by the NDC pension fund are as follows:

   a. Avoidance of problems associated with the direct benefit formula as benefits are related to contributions paid
   b. Enhancement of "actuarial fairness"
   c. Transparency and easy comprehensibility of accumulation of pension entitlement
   d. Adoption of a more flexible approach as regards the age at which the accumulated account is transformed into pension
   e. Advantage of passing on the cost of improvement in life expectancy to participants through the factor for converting accumulated amounts in individual accounts into pension

   The shortcomings of the approach are as follows:

   a. Individual beneficiaries to bear the longevity risk in view of the long periods involved and in view of the need for calculating the value of the annuity over the expected lifetime of the pensioners
   b. Risks related to economic progress, or those demographic risks arising from previous increases in birth rates, to be borne by contributors
   c. Need to provide a minimum pension for those risks whose lifetime earnings are insufficient to provide a basic, anti-poverty income in old age

4. ***PAYG pension fund*** Under the PAYG (Pay-As-You-Go) scheme, current pensioners are paid through the contributions of taxes of the current generation of workers. Under this plan, a direct transfer of resources takes place from the current workforce to those in receipt of pensions. Accordingly, a plan's current revenues cover its current obligation and therefore there will be no stock of savings to pay for

future pensions. A low ratio of retirees to current workers (old age dependency ratio) and a high rate of productivity and real wages allow for high benefits or low contribution to workers. High dependency ratio and high unemployment rates could make non-funded schemes increasingly unviable unless real pension costs are significantly contained.

The benefit of PAYG system is that contributions also earn a return. This comprises the growth rate of the population and the growth rate of wages. Further, the system commands the cost advantage or higher rate of return in the long run if the growth rate of earnings and the labour force exceed the interest rate. However, if the rate of earnings growth and labour force growth fall below the interest rate, the long run cost advantage and the higher rate of return goes to fully funded schemes.

PAYG is cheaper than a fully-funded plan especially in the early years of an old age support program when the system dependency rate is very low due to a lower proportion of eligible beneficiaries. However, as the system matures and the proportion of beneficiaries rises, this temporary advantage disappears. Nevertheless, PAYG will continue to have a cost advantage or higher rate of return in the long run if the earnings growth rate plus the labour force growth rate exceed the interest rate.

PAYG would make all generations better off by giving them a higher present value of pensions than what was paid in as contributions. However, if the rate of earnings growth plus labour force growth falls below the rate of interest, a fully funded programme would have the long-run advantage in costs and returns. In the absence of rapid growth in population and earnings, the financing method chosen affects the distribution of lifetime income across generations.

Based on Funding Nature

Depending upon the nature of funding available, a pension plan is categorized as follows:

1. ***Fully-funded plan*** Where the pension plan has a separate fund from where the pension liabilities are fully met, it takes the form of a fully funded plan. In a fully funded scheme, a fund is built out of accumulation of financial assets through contributions from members. Investment returns from financial assets also form part of the fund. Pension payments are made from such a fund. Such a fund also covers the present value of the entire stream of future obligations.

Under this type of plan, where the sponsor creates a trust and places some amount of assets under its control for the purpose of making investment of such funds in income earning securities so as to provide for adequate funds for the retirement period, it is a case of 'funded pension'. The amount of pension promised to employees will comprise periodic contributions to the pension fund and earnings on invested assets.

2. ***Non-funded plan*** Where there is no separate fund for meeting pension obligations, it is a case of non-funded pension plan. Where in a pension fund, the employer although accepts the responsibility to provide retirement benefits to employees, does not set aside adequate funds in the present period to meet the future retirement obligations, it is a case of non-funded pension.
3. ***Under-funded plan*** Where the pension fund has assets that command lower present value of the promised benefits, the plan is said to be under-funded.
4. ***Over-funded plan*** Where the market value of assets of a plan exceeds the present value of the plan's liabilities, it is a case of over-funded plan.
5. ***Partially funded pension*** Where in a pension fund a small fraction of total benefits are funded, it is a case of partially funded pension.

Based on Sponsors

Based on sponsors, pension plans can be categorized as follows:

Private Pension Fund

Where a sponsor is in the nature of a private business entity that acts for its employees, it is a case of 'private pension fund'. It is also known as 'corporate pension plan'. Pension programs that are operated by private agencies are called private pension funds.

Some of largest corporate pension funds in the U.S. are General Motors, General Electric, Lucent Technologies, IBM, SBC Communications, Boeing, Ford Motors, Bell Atlantic, Lockheed Martin, and AT & T etc. The private pension plan involves investing in an asset called the pension contract. Such a contract is very illiquid. It cannot be used, not even as a collateral, until retirement. The key factor in pension fund growth is the employer's contributions, specified amount of the employee's contributions, as well as the earnings of the fund's assets.

Private pension fund investments are heavily concentrated in two types of capital market securities such as corporate bonds and stocks.

Further, investments are also concentrated on such securities as Mutual fund shares, Treasury securities, government bonds, Tax gain bonds, corporate and foreign bonds, Mortgages, Open-market paper, Other financial assets, etc.

Of all the securities, equity is the most dominant. The reasons are not far to seek. Equities offer higher rate of return, often much higher than the long-term bonds. Similarly, equities offer the means of hedging against inflation in the case of variable annuity policy. In the same manner, pension funds are pulled into the stock market not merely by the apparent attractiveness of the yields available in equities, but due to the pressure of management to lower pension costs to sponsoring companies by increasing the assumed rate of earnings from investments made by the pension fund.

The biggest advantage of the private pension funds is that they have greater incentive to allocate capital to those assets, which would give the best risk-return combination irrespective of whether these are issued by the Government or the private sector.

However, the primary area of concern of private pension funds is that no budgetary gain would possibly be generated if investment is made by private pension funds only in government bonds nor does it provide any budgetary gain. This results in a situation where there is no channeling of resources into productive sectors, thus causing considerable additional administrative costs. Hence, success of private pension funds would depend on such factors as the following:

- Existence of well-developed financial markets
- Adequate public and government understanding and trust in private pension funds
- Adequacy of information with the individuals/employers about the efficiency of the fund managers to make a right choice of investment
- Existence of effective government regulation

Public Pension Fund

Pension funds that are sponsored by the Government, either for its own workers or for the general population, are called 'public pension plans'. Where a sponsor is in the nature of federal, state, and local entities that acts for their employees, it is a case of a 'public pension plan'.

Public pension funds are popular in U.S. For instance, the OASDI (Old Age, Survivors, and Disability Insurance Fund) is the U.S. government's 'Social Security' retirement program. Further, some of the largest public funds in the U.S. are State of California Public Employee

Retirement Fund, New York State Common Retirement Fund, California State Teachers Retirement Fund, State Investment Board of Florida, Federal Retirement Thrift Board, New York State Teachers Retirement Fund, Teachers Retirement Fund of Texas, New Jersey Division of Investments, State of Wisconsin Investment Board, Public Employees Retirement System of Ohio, etc.

Public funds are better suited to achieve income redistribution, prevent market failures, reduce operating costs and increase paternalism. However, the drawback of the public fund is that it requires investment of funds in government/quasi-government securities. It could result in yielding negative returns especially in times of inflation and in situations where the securities are issued at below market interest rates. Further, such a situation imposes a hidden tax on the contributors. This happens because the funds earn less than they would have in the open market. All these result in higher contribution rates and lower dispensing of retirement benefits.

Similarly, the level and the pattern of investment depend on how the Government responds to the availability of cheap resources. For instance, if access to pension funds does not alter the government's spending and tax policy, then there will be an increase in private sector investment. This happens because bond buyers who would have otherwise bought government bonds would shift their resources to the private sector. Moreover, government bonds are subscribed by the public pension funds (at lower interest rates). If, on the other hand, the Government is induced to spend more because of access to cheaper funds, it may crowd out private investment. Moreover, since borrowing from pension funds is less transparent than that from the open market, the impact of expenditures and trade offs may not be explicit. Investing part of the assets of the public pension funds in private sector will be effective only if one can ensure that fund managers are governed by economic and not political considerations.

Taft Hartley Pension Plan

Where a sponsor is in the nature of union acting for and behalf of its employees, it is a case of 'Taft Hartley plan'.

Individual Pension Plan

Where a sponsor is an individual himself acting on his/her own behalf, it is a case of an individually sponsored pension plan.

OTHER CATEGORIES

Voluntary Pension Fund

Pensions that are based on personal savings of employees and sponsored by employers are called 'voluntary pensions'. The objective is to provide accommodation of diverse tastes, lighten the administrative burden on the Government, and to have the lowest evasion and disincentive costs.

Voluntary pensions however suffer from certain disadvantages such as inability to fill up the gaps in the insurance market; failure to eliminate poverty among the old; and presence of hidden, probably regressive, tax costs.

Mandatory Pension Fund

Pensions that are mandated by government agencies are called 'mandatory pensions'. The objective is to have a wider coverage so as to prevent people from becoming a burden on the Government. Besides, mandatory pensions also aim at redistributing income to the old who are long-term poor. The disadvantage of mandatory pensions is that they require extensive government management or regulation. The regulation is bound to strain the resources of a country. Further, they also involve high administrative costs in relation to per capita income and total contributions in low-income countries.

Income Smoothing Pension Fund

Where in a pension the emphasis is on saving or income smoothing, it is a case of 'income smoothing pension fund'. Smoothing takes place by way of a shift of current consumption over to the future lifetime. In fact, current consumption is reduced to pave way for future consumption. Under this pension scheme, the lifetime expected value of benefits and contributions would be equal for each individual. In fact, there is a direct link between benefits and contributions.

Under this system, benefits are directly dependent upon contributions. It discourages evasion and disincentive effects on labor. Further, it reduces political pressure for designing features that lead to inefficient, inequitable outcomes. The system however, fails to alleviate poverty among old people who do not have sufficient resources to save or reliable financial institutions in which to place their savings.

Redistributive Pension Fund

Under this system of pensions, the expected lifetime benefit of a group of people is redistributed to another group. In other words, there is a shift in income across groups. Accordingly, the pension received by one group is greater than its lifetime contributions as compared with another group. The drawback of this system of pensions is that it establishes a weak link between benefits and contributions.

Insured Pension Fund

Where the administration of a pension plan is under the control of an insurance company, it takes the form of an insured pension. Under this plan, the employer makes an annual contribution to the pension fund and the insurance company provides a retirement annuity to employees for the retirement period. The amount of the annuity payable depends on certain assumed rate of earnings on the fund accumulated during the savings period prior to the beginning of the retirement years. Annuities take the form of paid-up annuity units bought by annual contributions, pensions paid from funds accumulated in a large pool of assets, separate annuity contracts, etc.

Non-insured Pension Fund

In the case of a non-insured pension, the plan takes the form of a trust chosen by the employer and by the life insurance company. This type of pension is most popular. The trustees of this plan may be employees of the firm or of some other individual or institution. The trustees, subject to the influence of the employer, determine the investment policies of the non-insured fund. In many cases, the trust departments of commercial banks serve as trustees for non-insured pension funds during the accumulation period and also administer the payment of benefits during the retirement period.

There are different types of non-insured pension funds such as corporate pension funds established voluntarily for executive and non-executive employees, funds established because of labor union pressure and funds that are established for the employees of state and local governments.

Qualified Pension Fund

Pension funds that attract tax incentives offered by the Government are called 'qualified pension funds'. In essence, a pension is a form of employee remuneration for which the employee is not taxed until funds are withdrawn. This tax incentive results from meeting the government requirements. Accordingly, if the plan meets certain requirements, it qualifies for tax exemptions.

Hybrid Pension Fund

Hybrid pension fund represent a combination of defined benefit pension plan and defined contribution plan. There are several types of hybrid plans, including pension equity, floor-offset, and others. The most common hybrid form is the cash balance plan.

Hybrid pension plans came to be introduced in order to help overcome the limitations of defined benefit pension plan and defined contribution plan. For instance, the defined benefit pension plan is difficult to administer for the plan sponsor. Further, the plan does not allow for portability from one job to another by employees, especially in an increasingly mobile working environment. Similarly, the defined contribution plan puts the investment choices and investment risk on the employee.

CASH BALANCE PENSION FUND

A pension fund where retirement benefits are based on a fixed annual employer contribution and a minimum guaranteed annual investment return is known as 'cash balance pension fund'. The concept of cash balance pension plan came to be used first by the Bank of America in the mid 1980s as an alternative to the more traditional retirement vehicles. The plan became popular during the late 1990s when IBM adopted it.

Features

Cash balance pension fund has the following features:

1. ***Resembles 'defined benefit fund'*** A cash balance fund resembles to a very great extent the defined benefit and has some of the features of a defined contribution fund. It defines future pension benefits, and not employer contributions. Further, retirement benefits are based on a fixed annual employer contributions and a guaranteed minimum annual investment return.
2. ***Distinct account*** Under the cash balance fund, each participant is assigned a distinct account that is credited with the employer contribution. The contribution is generally determined as a percentage of pay. The account is also credited with interest pertaining to some fixed or variable index, such as the Consumer Price Index, (CPI) etc.
3. ***Benefit distribution*** Under the cash balance plan, the benefit distribution takes place in the form of a lumpsum annuity. Employee's account is credited with interest calculated as per the rate specified in the plan. The promised benefits are fixed, and the investment gains or losses are borne by the employer.

4. ***Portable plan*** Cash balance plans are portable from one job to another. This is also characteristic in that it allows the employee to take a lump sum payment of vested benefits when terminating and the same can be rolled over into an IRA (Indirected Retirement Account) or to the new employer's plan. This is more suitable in today's job-changing workforce. This way, the plan works like a defined contribution.
5. ***Uniform accumulation*** In a cash balance pension fund, benefits build more uniformly each year. A striking feature of the plan is that it allows for a uniform accumulation of retirement pension benefits. Employees who do not commit their entire careers to one company can enjoy this.

FUNCTIONS/BENEFITS OF PENSION FUND

Pension funds are highly useful to individuals. It is required therefore that they shall start contributing to a pension fund as soon as he/she starts earning. Though almost all salaried class are making mandatory contributions to the Employee Provident Fund (EPF), the total fund accumulated in the corpus usually is not enough to sustain the same lifestyle after the retirement.

On the other hand, government employees do have a pension but it's not enough to pay for post-retirement expenses like health care, which is one of the biggest expenditures in the retired life. Whether it's a government employee or a private sector employee it makes sense to enroll into a pension fund as soon as a person starts earning. The advantage is that if a person joins the pension scheme at the earliest age, he/she would pay less and get more by way of retirement income per month. This way, today's savings would go a long way in mitigating the post-retirement blues.

Although it is possible for individuals to provide for their old age by accumulating savings during their working lives and then financing their needs during retirement by spending the income (dividends, interest, etc) generated by their capital, the need for pension fund is greatly felt because of the following advantages accruing from it.

As a constituent of financial system of a country, pension fund carries out the following functions:

Peaceful Retired Living

Pension funds make it possible for a person to lead an unruffled life after retirement. The savings mechanism built into the pension system allows for sufficient accumulation of money in the early ages of the person so as to be used in the latter part of one's life. An individual would be able to achieve a higher level of economic well-being with the help of pension funds.

Income Opportunity

Pension funds offer an opportunity for an individual to earn regular income through a host of financial markets and institutions operating in the pension market. Pension funds provide for the investment of surplus funds today for greater consumption and a higher standard living of tomorrow.

Cushion Against Volatile Income

Acting as financial intermediaries, pension funds help in bridging the gap between rising desired expenditures during the retirement period and the abrupt decline in income at the cessation of the individual's work career. In fact, pension fund managers have a fiduciary responsibility to deliver promised pension benefits. For this purpose, they are usually subject to extensive government regulations covering the quality of their investments and the treatment of pension plan members.

Fair Determination of Income

Pension funds provide for accumulation of funds (savings) during the working years of an individual's lifetime. This happens through contributions from both employer and employee and the investment of those funds in a portfolio of financial assets (equity and bonds). Investment also happens in real assets. This way, knowledge of the amount of funds contributed etc. helps determine fairly and precisely the amount of an individual's retirement income.

Low Risk Option

By providing for a low-cost method for the employees of business firms and governments to accumulate a highly diversified portfolio of assets, pension funds carry fairly low risk.

Professional Management

Pension funds claim the advantage of expert knowledge through professional management. The asset management thus undertaken by them is highly beneficial even to a person who has no knowledge of making quality investment of funds.

Tax Advantage

In order to sustain the pension and motivate employees to take part in the pension system, it is essential that necessary tax incentives be extended to beneficiaries. Further, providing tax relief to contributions constitutes an important incentive in creating an environment for the acceptance of the scheme.

Pension funds make available tax incentives under the following circumstances:

1. Where the individual makes a contribution to pension funds
2. Where income is earned from investment by the pension fund
3. Where the individual on retirement receives the benefit in the form of a pension

Different types of tax incentives that are made available as part of promoting pension funds are as follows:

- Exemption on contribution, exemption on fund return and tax on pension (EET)
- Tax on saving income with exemption on fund return and exemption on pension (TEE)
- Contribution from taxed income, tax on fund return and exemption on pension (TTE) and
- Exemption on contribution, tax on earnings from fund and on pension (ETT)

Planned Retirement

The greatest advantage of pension fund is that it helps in planned retirement for an individual. It helps make a right amount of savings during the working tenure of an individual.

Voluntary Offer

Pension fund allows for voluntary savings by employees to provide for a peaceful and happy retired life.

Confidence

Pensions give the advantage of infusing confidence and strength in a person especially in the old age. It affords a person a satisfactory standard of living throughout his/her lifetime.

Regular Income

Pensions give the benefit of guaranteed regular income throughout the retired life of a person. Such a contract would effectively eliminate the longevity risk too.

Less Risk

Pension funds take care of the risks associated with the individual investment. Risk reduction in pensions is accomplished by holding a more diversified asset portfolio than any individual will be able to achieve. There is also least cost that is accomplished through an expert fund management, which is otherwise not possible for an individual to achieve.

Protection Against Longevity Risk

Pension fund allows for helping individuals overcome the longevity risk that they would face if left entirely to their own devices in the matter of providing for old age. This happens under an efficient financial system. The financial system of a country makes it possible for individuals to make profitable investment of funds. Thus, the use of pension fund becomes all the more significant from viewpoint of social security of employees with a view to ensuring ultimate protection against longevity risk.

Financial 'Myopia'

The phenomenon of not being far-sighted enough to save for a retired life is referred to as 'financial myopia or financial improvidence'. Many a time, it happens that individuals fail to save sufficiently before they retire. The people who suffer from this handicap tend to think that present enjoyment is more precious and important than the future retirement benefits. Such people, however, promptly realize the value of pensions only when they approach old age. At that point of time, it might be too late to do anything about planning a pension for oneself. In order that individuals reap the retirement benefits it is essential that they are a part of the pension system.

Poverty Alleviation

Pension becomes important in that it contributes towards poverty alleviation especially in the latter part of a person's life. This could happen through the public pension plans. Such arrangements are also likely to result in a redistribution of income and wealth towards the poor. This will be regarded as desirable in the light of undesirable market economies such as production of unfair and random economic inequalities in the society.

Social Solidarity

A fundamental reason for the existence of a pension system is that there is a need for reinforcing social solidarity. Such a system would reflect concern for the well-being of fellow beings. In fact, an effective pension system would serve as a vehicle of sharing one's affinity through guaranteeing everyone, an acceptable standard of living in retirement. Although the state-operated and financed pension plan is needed for this purpose, even a privately operated pension plan would deliver to meet the expectations of the society.

PENSION FUND OF GROWTH-FACTORS

The numerous advantages claimed by pension funds such as low-cost method of accumulating a highly diversified portfolio of assets have been the most important reason for the growth and development of pension funds the world over. Factors such as rising incomes, the breakdown of the extended family, and increasing concern for financial security have all combined to foster support for the pension movement. For instance, pension funds were considered fundamental under the Social Security program launched during the 1930s, in the U.S.

Pension fund, which exists in some form in all developed and developing economies are the major institutional investors and participants in the financial markets. Several factors are responsible for the growth of the pension funds in the global financial system. Following are some of them:

Growth in Income

It is not only the need for providing for one's retirement income in an usual way that primarily caused the growth of pension funds the world over, but the steady growth of income and wealth over the post -II World War period, left households with more money for long-term savings.

Longer Life Expectancy

Another important factor for the growth of the pension market in the world is the enhanced life expectancy of people, thanks to modern technology and scientific innovation. This necessitated more financial needs for longer retirement periods.

Tax Advantage

Among the many factors responsible for the growth of pension funds, the most important has been the advantage of tax deductibility of incomes earned by the employer taking part in the pension plans. Similarly, there is also an advantage that allows participating employees to avoid paying taxes on their retirement benefits until each member actually draws upon his or her benefits.

Qualified pension funds are exempt from income taxes. Thus, pension fund assets can be accumulated tax-free. Consequently, pension funds do not invest in assets that have the advantage of being largely or completely tax exempt. Further, pensions provide tax benefits by way of compensation to an employee that is free of tax liability until after the worker retires. In the same manner, pension contributions also offer the employer tax deductibility to the income.

PENSION FUND VS. MUTUAL FUND

Pension fund, a funding arrangement for retirement differs from mutual fund, a funding arrangement for collective investments:

Sl. No.	Features	Pension Fund	Mutual Fund
1.	**Concept**	A fund established for the payment of retirement benefits, entities that establish pension plans are called 'plan sponsors'	A trust that pools the savings of investors; the money collected being invested in financial market instruments such as shares, debentures and other securities like government paper, etc.
2.	**Insurance**	Offers insurance against infirmness and old age of the beneficiary	No such insurance cover available to the beneficiary
3.	**Social Justification**	Socially a justifiable proposition because of provision of economic/financial security to the beneficiary during the retired life	No social considerations; economic considerations play a crucial role in offering benefits to the user
4.	**Retired Life**	Offers an ideal mechanism for a peaceful retired life	No such mechanism exists exclusively for retired life; it is merely a savings plan
5.	**Burden**	Pension funds (direct benefit plan) cause financial burden to the State's exchequer, which stems from the contract of employment between the State and the employee	There is no burden, financial or otherwise for the State
6.	**Types**	Pension funds are of different types such as direct benefit plan, direct contribution pension plan, etc.	Different types of mutual funds are open-ended plans, close-ended plans, income fund, equity fund, bond fund, etc.
7	**Tax Benefit**	Investments in pension funds offer the advantage of tax rebate under the Income Tax Act	Mutual fund investments offer no such benefit

Sl. No.	Features	Pension Fund	Mutual Fund
8.	**Poverty Alleviation**	Pension funds work for reinforcing social solidarity as an expression of concern for the welfare of the fellow beings	No such social solidarity is at work
9.	**Investment Constraints**	Limits and constraints are imposed by the government on the pattern of investment of pension funds especially in the case of civil service pension schemes	Investment constraints are imposed by the SEBI guidelines
10.	**Regulatory Authority**	PFRDA (Pension Fund Regulatory and Development Authority)	SEBI, RBI, GOI
11.	**Structure**	Pension funds are structured as Pillar I representing basic pensions, Pillar II representing compulsory superannuation and Pillar III representing voluntary pensions, in addition to a multi-pillar pension system	Mutual funds are structured on the basis of operations, returns, and investments
12.	**Fund Management**	There are models of social security system which are used for understanding the different approaches of pension fund management	No such models are available for mutual fund management
13.	**Operational Efficiency**	No standard measures are available for measuring the operational efficiency of pension funds	Models such as Treynor model and Sharpe model are available for evaluating mutual funds
14.	**Service Provider**	Pension funds are offered by insurance companies	Mutual funds are offered by organizations established for that purpose

CHILEAN MODEL

Many types of models are available as to the management of pension funds. Popular among them is the 'Chilean Model'. The model is followed worldwide. The Indian Government too is all set to adopt this model to undertake the much needed and long-awaited pension reforms in the country. The system provides for collection and investment of the employees provident fund. Similarly, the Chile's experience in this regard has interesting lessons for India. Chile, which began its economic liberalization program 20 years ago, has managed to maintain a sustained and impressive growth in its national savings, largely by creating a safe and innovative institutional framework for attracting and investing the savings of its huge middle class.

Some of the *essential features* of the Chilean Model of pension fund management are as follows:

1. ***Capital market linkage*** Chile's model of pension fund management lays emphasis on the ability of the pension fund to link the massive corpus of employees' pension fund to the capital market. The objective is to create a market driven fund by both domestic funds as well as by the Foreign Institutional Investors (FIIs). The huge pension fund market in Chile has been responsible for safeguarding the country against the shock waves sent out by the Mexican crisis in that region.
2. ***Higher return*** According to the Chilean model, management of pension funds by the government is inefficient which gave only a low rate of return to the investor. The Chilean model advocates taking away the PFs (Pension Funds) completely from Government control so that smaller fund managers could manage them privately but strictly working under the control of the government supervision.

   Thus, the PFs will act as quasi-mutual funds giving the investor the maximum return. The privatized pension funds in Chile give an average rate of return of 14 percent with a host of options to a retiree. For instance, on retirement, the private pension funds in Chile give a lump sum to the employees. In addition, they also offer added incentive for retention of part of the funds to be distributed as pension in the later years.
3. ***Wide options*** Under this model, the employee has the option to choose from the scores of pension funds, which are run privately, but strictly monitored by 'Superintendency of Pension Fund Administrators'. There is one administrator, who acts as a regulatory authority, for each pension fund. The employees go for the fund, which charges the lowest fee with an indicative return.
4. ***Portfolio composition*** The portfolio composition of funds is highly regulated and investments are made on the basis of a very conservative risk evaluation system. Most importantly, the Government stands as

a guarantor to compensate the employee in the event of occurrence of fraud. Besides, there are also specific measures, which limit the losses of the pension saver.

5. ***Portfolio management*** Pension fund administration companies invest in stocks, bonds and government debt. They also invest in safe instruments in the international market. This acts as a cushion when there is a sudden dollar outflow when foreign institutional investors operating in Chile book their profits by selling stocks.
6. ***Modus operandi*** Under the Chilean model, each worker gets a passbook from the fund manager. It shows the amount accumulated in the account. The worker has to deposit a minimum of 10 percent of his gross salary each month on an annual basis of upto $ 20,000. On retirement when the amount is withdrawn, the worker has to pay a lower tax. The pension fund manager covers widows and orphan benefits, insurance against premature death, permanent disability and so on. To ensure comprehensive coverage and prompt service, the pension fund manager organizes insurance coverage for their clients.

PENSION INVESTMENT POLICY

A set of procedures adopted by a pension fund manager to make an efficient investment of the accumulated funds of pension schemes in various type of securities is referred to as 'pension investment policy'. A brief description of the investment policy generally adopted by pension fund managers is presented below:

Investment Factors

The aim of a pension plan is to allow a certain sum of money by way of a retirement income to the employees. The amount of pension benefit and the success of a pension plan are dependent on the nature of investment policy pursued by Asset Management Company (AMC) in which the pension contributions are invested. The pension fund investment policies are influenced by a number of factors. These include source of funding, incidence of taxation, quality of sponsoring firm's management, the nature of fund obligations, limitations on the investment policy of a fund, etc. The relevant factors are outlined below:

a. Funding source One of the important factors that shape the amount of retirement benefit is the source of funding chosen by the sponsor or the employee. It is imperative that the funding source is stable. This emanates from the fact that contractual nature of contributions made by employers and employees are highly stable in nature. This makes possible any prediction of the expected future outflows in the form of pension.

Stability of contribution into the pension fund is much afforded by pension contributions made by the younger age group which is not immediately becoming payable as pension. Further, this does not call for liquidating existing assets or even using the earnings from existing assets to provide the necessary cash.

Pension fund managers, in order to provide for pension in future, make investment of contributions in long-term capital market instruments such as equity, preferred stock, etc. In fact, pension funds have become the dominant purchasers of equity securities in the U.S. capital market.

b. Taxes Taxes strongly influence the pension policy of an organization. Taxes affect both the mix of contributions by employers and employees, and the nature of fund investments. For instance, the tax incentive available to an employer facilitates making contributions for building a pension fund for the benefit of the employees. Further, as there are no taxes payable, pension fund managers command the incentive of making investment of funds.

c. Management wish An important factor that influences the investment policy of a pension fund is that the management wish to achieve a high return on any funds placed with the pension program. The objective is to ensure payment of promised retirement benefits at minimum cost to the sponsoring employer. This, in fact, helps the employer to promise adequate build-up and payment of retirement income. Thus, the management desires to pay more to employees, prompts making substantial investments in common stock. In the same manner, investments are also made in 'private placement market'.

d. Funding obligations The nature of funding obligations promised to the pension beneficiaries determine, to a great extent, the types of investments that will be made by pension funds. The funding obligations are of two types. They are fixed annuity and the variable annuity.

Under the fixed annuity-funding obligation, the amount of a beneficiary's retirement income is fixed at the time of retirement and remains unchanged throughout the payment period. Fixed annuity obligation remained a dominant form of pension fund obligation. However, it primarily jacked up the cost of pension administration. A fixed fund obligation makes investment of contributions on fixed-income instruments such as bonds and mortgages.

Under the variable annuity funding obligation, pension payments that are promised to the beneficiary is subject to variations depending on the investment performance of the contributions made prior to retirement and in subsequent years. Investments are made in variable income fetching securities such as equity. A balanced fund, a combination of both fixed and variable annuities makes investment of its contribution on both debt and equity securities. Under this type of fund, contributions during the accumulation period are invested in equities, which are then transferred to a fixed annuity on retirement.

Investment Constraints

Constraints are often imposed by the regulators on the investment policies of pension funds. The limitations require asset managers to invest a portion of their funds on the bond issues of the state or local government. This is common in respect of public investment programs. The aim is to reduce the risk exposure of the fund.

Investment Pattern

The pattern of investment adopted by pension managers is described as follows:

a. As regards direct benefit plan In the case of direct benefit plan, performance of the fund does not affect the value of the pension received by the member as it is based on some pre-determined formula with respect to last drawn salary and years of service. Since investment performance of the fund is very important, the managers of the direct benefit plan employ the techniques of asset-liability management. Besides, they also try to maximize their returns.

b. As regards direct contribution plan In the case of direct contribution plan, the pension manager generally aims at maximizing risk-adjusted returns on their assets. This is because, the pension outgo depends on the returns generated by the fund.

Managers of the schemes gauge the members' degree of risk tolerance, which decided the asset allocation or investment pattern across broad asset categories such as equities, bonds, and property. Low risk aversion managers would induce the fund managers to invest more in equities or unit-linked schemes, as they have a high weighting in equities. On the other hand, high-risk aversion behavior of the members would require fund managers to predominantly invest in deposit administration schemes.

Performance of the pension fund managers broadly depend on the *strategic asset allocation* which is decided on the basis of the advice of their actuaries. This is based on the liability structure, and the selection of securities and market timings, and active fund management through tactical asset allocation. Generally, active fund management does not yield higher return than the market index. Hence, strategic asset allocation is made in equity index funds which track the market index. Generally, the managers of the funded DB schemes use the techniques to match their asset-liabilities, while the managers of DC schemes attempt to maximize risk-adjusted returns on their assets.

PENSION STRUCTURE

Pension schemes across the countries can be structured into three pillars based on the need they address and the nature of funding adopted by pension fund managers. Each of these pillars has some combination of the features such as voluntary and mandatory pensions; savings and redistributive pensions; direct benefit, direct contribution and notional direct contribution pensions, funded pensions and PAYG; private and publicly managed pensions, etc.

The three pillars of pension systems are as follows:

Pillar I

Pillar I represents basic pensions. This is primarily made available for old age. Its components are redistributive pensions, PAYG, mandatory pensions, defined benefit pensions, public pension plans, etc. The pension funds forming part of pillar I command certain features. For instance, payment of benefits occurs after a certain fixed number of years. Further, the funding may be either a partial funding or no funding. The success of pillar I pension system depends on the "dependency ratio" or "support ratio". The ratio of pensioners to contributors is the dependency ratio. The sustainability of the system requires that current contributors afford to pay social insurance contributions at a level that will support current pension expenditure.

Sustainability problem would arise in the event of decline in the working population on account of pursuit of higher education, unemployment and early retirements. Similarly, increase in life expectancy due to better health care and living conditions further compound the problem for both the public and private pension schemes. In order to remedy the situation parametric changes need to be introduced in the realm of retirement age, the value of pensions, contributions, contributory period, rules on indexation, etc.

Following are the features of Pillar I pension system:

1. *Income transfer* to poorer workers to accomplish a positive impact on poverty
2. *Funding* takes place through contributions from employee and employer

3. *Pension payment* from current contributions
4. *Correction of personal myopia* about survival in old age
5. *Permission of integrated contributions* covering all social insurance benefits
6. *Delivery of positive consequences* under conditions of prosperous economy
7. Works well when *contributors outnumber current pensioners*
8. Subject to *political risk* leading to reduced entitlement

Pillar II

Pillar II represents compulsory Superannuation. Forced/contractual savings characterizes Pillar II. Its components are vertical equity pensions (income smoothing), funding pensions, mandatory pensions, defined contribution pensions and occupational pension plans for individual risk.

Under the Pillar II system, pensions are placed in individual or group funds and are managed either by private sector pension companies or by the public sector. In the case of the latter, it is by way of provident funds. They do not bring about a redistribution of income, but smooth consumption over each individual's life span. They can help develop capital markets of the economy.

Following are the features of Pillar II pension system:

1. *No transfer of resources* to poorer workers
2. *Contributions collected by government* and transferred to private fund managers
3. *Asset owned by individual contributors* and invested in financial markets
4. *Annuities and/or lump sums paid at retirement* from the returns on such investments
5. Encouragement of *personal responsibility*
6. Facilitating the *growth of capital market*
7. Not directly subject to demographics
8. Possibility of *risk diversification*
9. Works on the *government minimum pension guarantee* (which may have high cost to the Government in case of a recession in the capital market)
10. Administrative charges of private fund managers may be high
11. Requires a *strict regulatory regime*

Pillar III

Pillar III represents voluntary Superannuation. Voluntary savings characterizes it. Its components include voluntary pensions, income smoothing pensions, funding pensions, and pensions for individual risk—e.g. personal pension plans and additional contributions made by individuals to occupational scheme.

Schemes under Pillar III comprise voluntary personal pensions, which are encouraged through tax concessions. These pension schemes are intended to increase the range of individual choice. In the absence of any guarantee, workers can also suffer losses caused by business failures or fraudulent behavior on the part of the employers. Charges by fund managers may also be high and, if kept low by law, may lead to a compromise in service.

Multi-pillar System

Under the multi-pillar pension system, the characteristic features of pillars I, II and III are conveniently combined to deliver the maximum benefit to the user. The multi-pillar system commands several advantages. The system may be used for creating sustainable mandatory public pension system.

In countries such as Sweden in OECD, Hungary, Latvia and Poland in transition economies, Hong Kong in Asia, and Argentina, Peru and Uruguay in Latin America, the combination of PAYG first pillar with a second pillar scheme of funded individual accounts has been the most popular. Similarly, with a view to reducing the size of DB schemes, countries have mostly effected parametric changes such as increasing the number of years required for full benefit and introduction of life expectancy factor into the DB formula. In the same manner, countries, which desire to maintain larger first pillar, have preferred NDC schemes. This provides direct link between contribution and benefits and account for life expectancy at the benefit, pay out phase.

PENSION RISKS

Risks of several types occur in the management of pensions either by the private sector or by the Government. This is because factors such as the health of the individual, the industry, and the economy as a whole, determine to a large extent the planning for old age. Further, enormous uncertainties surround the pension management, and there is also a problem relating to who and how the risk is to be borne.

The major risk factors that would affect the viability of the pension scheme are macroeconomic in nature. The risks include output risks, inflationary risks, demographic risks, political risks, management risks, investment risks, and market risks.

1. ***Output risks*** Output risks are caused by change in the volume of output in the economy. Output risks affect all pension schemes as it shrinks the contribution base of a PAYG scheme. Further, it reduces the value of financial assets of the funded schemes.
2. ***Inflationary risks*** These are the risks caused by the reduction in purchasing power of people influenced by inflationary spiral. Such risks tend to shake the pension system. Private defined benefit schemes are more vulnerable to inflationary shocks. This problem may, however, be overcome to a great extent by price indexing the pensions. This would happen in the case of PAYG pensions. In the same manner, in the case of defined contribution plans, inflationary shocks could be absorbed during the period of accretion to the pension fund contributions and investments. This happens during the accumulation phase. Shock absorption is also possible during the withdrawal phase that marks the retirement. Annuities can be purchased at a specified rate of anticipated inflation.
3. ***Demographic risks*** Demographic risks are caused by shrinkage in contribution base due to a reduction in working population. These affect PAYG schemes. The risk is caused by the shock that operates through inflation in the goods market and/or through deflation of the financial assets in pension funds.
4. ***Political risks*** These are risks arising from political and government policies concerning macroeconomic management. Political risks happen for publicly managed funds, where political risk and investment risk are intertwined. This happens through government interventions to limit investment options and returns.
5. ***Management risks*** These are risks arising from incompetency or fraudulent behavior of the managers of pension funds. It is possible to reduce such risks by strengthening the regulatory and supervisory framework.
6. ***Investment risks*** Pension funds also face the risk of differential pension portfolio performance. For instance, the investment risks related to defined-benefit schemes fall on the industry and hence can be shared broadly across the industry's current workers, shareholders and customers, or spread across past or future generations of its workers. The inability of workers to evaluate the competence of investment companies and the possibility of outright fraud further increase investment risk. Investment risks, however, can be reduced

by collecting contribution through payroll taxes and limiting the advertising costs. It also needs simplification of procedures for running the fund and, allowing flexibility over the timing of conversion from lump sum to annuity.

7. ***Annuity market risks*** This is the risk caused by variation in interest rates at the time of retirement on such safe assets as long-term government bonds, etc. For instance, lower interest rates lead to lower annuities during the lifetime of the pensioner. The problem is further compounded if the annuity markets are thin as is the case in most countries. Thus, the opportunity of economies of scale is largely lost, leading to high transaction costs and lower value of annuity irrespective of interest rate fluctuations.
8. ***Longevity risks*** These are the risks arising from the period of post-retirement life of individuals. These risks are minimized by pooling across a large number of people since the average outcome for the group is much more certain than the experience of any particular individual.
9. ***Disability risks*** This is the risk happening on account of moral hazard problems.

SOCIAL SECURITY

The allowance of security for the people of a country to live a decent life after retirement without undergoing the hassles of inflation and other difficulties is termed as 'social security'. The main purpose of the universal social security scheme especially in the unorganized sector is poverty elimination.

Models

Social security as a system evolved first in the Western countries in response to the socio-political consciousness developed during the industrial revolution. The two models under which most prevalent social security systems can be classified are the German model and the British model.

a. German model The German model also known as Bismarckian model or social security/social market economy model, focuses on maintenance of living standard; and the benefits a earnings-related. Countries like Italy, France, and Japan follow this model.

b. British model The British model also known as Beveridgean model or the Basic-income model, focuses on provision of minimum guarantee only of a subsistence income to all older people at a flat, universal rate. Countries like Australia, Switzerland and the Scandinavian countries follow the Beveridgean model.

Since the 1970s, there has, however, been greater convergence in the social security policy. While Bismarckian countries have introduced poverty prevention measures, Beveridgean countries have extended coverage of occupational pensions, which are earnings related.

Theories

Many theories have been propounded to gain understanding of the virtues of a social security scheme. A brief discussion of different type of pension fund theories is presented below:

a. Optimal redistribution theory According to the optimal redistribution theory, a social security scheme which is devised and implemented by the Government aims at distributing the wealth of the economy in such a manner as to help alleviate poverty among the elderly. The theory propounds that transfer of resources from younger generation to the older generation takes place.

One of the criticisms levelled against the theory is that it does not explain the reason as to why individuals who earn more are able to get higher benefits under the social security scheme if the objective is to alleviate poverty and to achieve optimal redistribution.

b. Risk sharing theory According to the theory of risk sharing, social security is an agreement made by individuals with each other against future uncertainty about the labour productivity. The theory propounds that the benefits accruing would vary across the individuals according to the premia paid by each person. The theory explains the reason as to why those who earn more during their working years pay more taxes and enjoy higher benefits.

c. Inducement theory The theory is based on the premise that human capital tends to depreciate with age and so the elderly tend to have less than average human capital efficiency. According to this theory, social security is designed so as to induce the elderly to retire. This is because aggregate GDP is larger if the elderly don't work than if they do. Each individual's productivity depends positively on his own capital and on the average human capital in the economy. Hence, the elderly have a negative impact on the productivity of the young. The young, therefore, have the incentive to induce the elderly to seek retirement.

d. Insurance theory According to the theory, the objective of social security is to replace income that is lost to a family through the retirement, death or disability of a worker through and with the help of insurance.

Social security aims at protecting against these 'risks'. This is based on the premise that accumulating savings when one is young is a sure way to "insure" against inability to earn income when one is old. This often calls for the intervention of the Government to make insurance programs mandatory. This is the essence of the social security system.

e. Paternalistic theory According to the paternalistic theory, the Government shall arrange for a forced savings program so as to ensure social security of its people. The theory is based on the assumption that many individuals will not save enough for retirement if left to their own devices because of:

(i) Lack of information necessary to make an informed judgment about their post-retirement needs
(ii) Inability to make effective decisions about long-term issues, because of the unwillingness to accept the inevitability of aging
(iii) Failure to give sufficient weightage to the future while making decisions

f. Excess savings theory According to the theory, the need for pension arises because non-funded social retirement system could 'cure' the problem of capital over-accumulation by diminishing the incentives to save. This happens through the transfer of taxes from the young to the retirees. The young would save less because they expect that they too will be beneficiaries of transfers at a later age. The U.S. social security system was conceived in the 1930s, during the Great Depression, as a means to reduce national savings in order to stimulate consumption and thereby increase the level of aggregate demand.

g. Longevity insurance theory According to the theory retirement plans are driven by the uncertainty about the length of life. Accordingly, risk-averse older individuals are willing to give up a certain portion of their resources in order to gain access to an actuarially fair annuity.

PENSION FINANCING

Pension financing refers to the arrangements through which resources are raised to meet the expenditure on benefits as well as administration of a pension scheme. It aims at fixing the initial and future contribution rates at levels considered affordable by the respective contributing parties. Besides, it also aims at tailoring the accumulation of the reserves to the projected investment needs and absorptive capacity of the economy.

Pension funds are financed by contributions by the employer. In some plans, employees match employer contributions to some degree. The nature of financing pensions is greatly influenced by demographic and economic considerations. Further, other factors such as the rate of interest, the rate of growth of new entrants, the rate of escalation of insured salaries, the rate of pension indexation, the (age-specific) mortality rates, invalidity and other decrements, and the rate of inflation, also determine the method of pension financing.

The ratios of the number of pensioners to the active population, the aged dependency ratio, also determine the pension financing needed. In the initial stages of a new pension scheme, administration expenditure may predominate, but as the scheme matures, its importance relative to the expenditure on benefits will fall considerably.

a. ***As regards private pensions*** The private pension, also called 'PAYG' (Pay-As-You-Go) is the mode of financing arrangement followed in UK State Pension Scheme. Under this arrangement, national insurance contributions received from current generation of workers go to pay the pensions of current retired generation. This is a useful way of pension financing as the working labor is used to finance successfully the future pensions. However, the PAYG is an unsuitable basis for financing the occupational pensions of workers in the private sector because of the possible diminution in the workforce of a private firm resulting in a situation of its pensions outnumbering its current workforce thus resulting in a situation of current contributions into the firm's pension fund exceeding its current liabilities to pay pensions. Similarly, there might be a situation of leaving pensioners uncovered in the event of the firm ceasing business.

b. ***As regards public pensions*** In the case of public pensions, financing takes place in the same manner as in the case of a private pension fund. However, in the case of public funds, there is an additional facility available. Accordingly, in the event of any financing problem, it shall always be possible for the government to manage the situation at least by printing currencies. Similarly, the State may be forced to levy more taxes for the working population. This might however, take away the standard of living of the workforce especially if economic growth is weak, and produce disincentive effects that could have adverse effects on economic growth. Moreover, the State might face tough financing problems under the conditions of rising life expectancy. This implies an expanding pension population, and stagnant or declining numbers of people of working age to provide for their own and everybody else's needs.

Financing Mode

Different ways of financing a pension scheme, as described below, are available:

I. ***For defined benefit scheme*** In the case of ***defined benefit scheme*** the benefit formula is specified and the financing arrangements are determined as the amounts needed to finance the benefits. Following are the methods used in this regard:

- **Pay-As-You-Go (PAYG)** financial system requires contributions such that inflows and outflows into the scheme match, (i.e. zero reserve) at every period. In other words, contributions exactly balance expenditures in selected time intervals (e.g. annually).
- **General Average Premium (GAP) System** Based on the concept of a constant contribution rate applicable throughout the subsequent lifetime of the pension scheme.
- **Autonomous Funding System (AFS)** Initial population and new entrants constitute separate autonomous risk pools, and the respective average premiums are applied as contribution rate. The contribution rate function is the weighted average of the average premium of the initial population and the average premium of the new entrants, the weights being the respective insured salary functions, at a particular point of time, of the initial population and the new entrants. A higher reserve will be generated than under the GAP.
- **Terminal Funding System (TFS)** Involves each pension being capitalized at the time it is awarded. In other words, contributions exactly balance capital value of new pension awards in selected time intervals (e.g. annually), i.e. full pre-funding at the time of award.
- **Intermediate Financial Systems** Works between the PAYG and GAP systems, generated by dividing the time span of a pension scheme into successive intervals of limited duration and determining a level contribution rate for each interval such that the reserve function satisfies a given condition over the interval.
- **Scaled Premium System (SPS)** Characterized by steadily increasing level contribution rates in successive control periods and a nondecreasing reserve fund.

II. ***For defined contribution scheme*** Defined contribution schemes are occupational pension schemes that are sponsored by individual employers or set up through negotiations by trade unions with several employers (multi-employer plans). These schemes reflect the similar characteristics as that of other social security pension schemes.

An occupational pension scheme aims at achieving financial equilibrium on a closed fund basis. This implies that only the existing membership (and not the future entrants) will be taken into account. Under this scheme, the assets are assumed to be separate from that of the sponsor and held in trust on behalf of the members. The type of funding method used for this scheme is called ***actuarial cost method***. Actuarial cost method is employed in two ways. In the case of individual cost method, the total results for individuals are obtained which is then summed up to obtain the results for the aggregate. These address the financial equilibrium of new entrants and then consider adjustments required to achieve close-fund equilibrium of the initial population. Contribution paid over a new entrant generation's active lifetime should, by retirement age, accumulate to the capital value of pensions of those attaining that age.

Under the ***aggregate cost method***, the time related contribution rate function (the level rate which would ensure the close-fund financial equilibrium of the scheme taking into account the accumulated reserve) is determined for the entire group together on a collective basis.

The methods can be further divided into accrued benefit methods and entry age methods. In the case of accrued benefit cost method funding takes place in each time interval to the extent of the portion of the ultimate pension benefit earned during that interval. This gives reserve fund equal to the probable present value of the portion of ultimate benefit accrued up to that age. Age-related contribution rate is determined in such a way that for new entrants, age-related reserve fund equals accrued benefits based on current service and current or projected salary, allowing for pension indexation. Initial accrued liability is funded separately (e.g. through uniform payments spread over active lifetime of the youngest initial entrant).

Under the entry age method a level contribution rate or amount in function of the entry age is established. For new entrants, benefit is funded through level contribution rate over active lifetime. Initial accrued liability is funded as for accrued benefit method. Occupational pension schemes are considerably more pre-funded than social security pension schemes.

Actuarial Valuations

Actuarial valuations of social security pension schemes are generally statutory requirements at prescribed intervals. In addition, interim internal valuations may sometimes be performed. The main purpose of periodic valuation of an ongoing scheme is to test its long-term solvency, that is to assess whether under the existing financing arrangements benefits can be paid and reserve funds maintained at the required levels. In this regard, particular importance is attached to changes in income and expenditure projections in successive valuations, which may signal the need to change the financing arrangements.

PROJECTING PENSIONS

Different methodologies are adopted making prediction of social security pension scheme. Some of these are actuarial methods, econometric methods, and mixed methods. Actuarial methods involve successive iterations of projection formulae. Econometric methods are in effect extrapolations of past trends using regression techniques. For the purpose of making future projections, the population is divided into subgroups (active insured persons, retirees, invalids, widows/widowers, orphans) and transition probabilities of moving from one status to another are estimated on the basis of actual data. Then the transition probabilities are applied to the demographic data (estimates of the number of people in each subgroup) and successive iterations generate the projections.

In case of financial data, e.g. estimates of the total annual insured salary bill and total annual amounts of the different categories of pensions in force, these aggregates are obtained by applying the appropriate per capita average amounts (of salaries or of pensions, as the case may be) to each individual element of the demographic projections and then summing. The average amounts are computed year by year in parallel with the progress of the corresponding demographic projection.

Present Value Technique

This method is more suited for the valuation of occupational pension schemes, which are generally fully funded. It involves computation of the probable present values of the future insured salaries of one cohort of insured persons at a time, and of the pension benefits payable to the members of the cohort and to their survivors. The present values are calculated using suitable assumptions on interest rates and corresponding discounting factors.

REVIEW QUESTIONS

Section A

1. Define pension plan.
2. What is a pension fund?
3. What is a pension system?
4. What is a compulsory pension system?
5. What is a voluntary pension system?
6. What is a defined benefit pension fund?
7. What is a defined contribution pension fund?
8. What is a notional defined contribution pension fund?
9. What is a PAYG pension fund?
10. What is a fully funded pension fund?
11. What is a non-funded pension fund?
12. What is a under funded pension fund?
13. What is an over funded pension fund?
14. What is a partially funded pension fund?
15. What is a private pension fund?
16. What is a public pension fund?
17. What is a 'Taft Hartley' pension fund?
18. What is an individual pension fund?
19. What is a voluntary pension fund?
20. What is a mandatory pension fund?
21. What is an income smoothing pension fund?
22. What is a redistributive pension fund?
23. What is an insured pension fund?
24. What is a non-insured pension fund?
25. What is a qualified pension fund?
26. What is a hybrid pension fund?
27. What is a cash balance pension fund?
28. What is 'Pillar I pension structure'?
29. What is 'Pillar II pension structure'?
30. What is 'Pillar III pension structure'?
31. What is 'multi-pillar system pension structure'?
32. What is 'social security'?
33. What is 'insurance theory' of pension management?
34. What is 'paternalistic theory' of pension management?
35. What is 'longevity insurance theory' of pension management?

36. What is pension financing?
37. What are ‘actuarial valuations’?

Section B

1. What are the types of pension system?
2. What are the objectives and features of a pension fund?
3. What are the features and benefits of a defined benefit pension fund?
4. What are the limitations of a defined benefit pension fund?
5. What are the features and benefits of a defined contribution pension fund?
6. What are the drawbacks of a defined contribution pension fund?
7. What are the major advantages of notional defined contribution pension fund?
8. What are the benefits of a PAYG pension fund?
9. Write a note on private pension funds.
10. Ho ware public pension funds useful?
11. What are the features of a cash balance pension fund?
12. What are the features of ‘Pillar I pension structure’?
13. What are the features of ‘Pillar II pension structure’?
14. What are the different models of ‘social security’?
15. What are the different theories of ‘social security’?
16. Explain the different modes of pension financing.
17. How is a pension fund different form a mutual fund?

Section C

1. Discuss the different types of pension fund?
2. Bring out the differences between a defined benefit pension plan and defined contribution pension plan.
3. Explain the features of sponsored pension plans.
4. What are the functions and features of pension fund? Explain.
5. Identify and explain the factors responsible for the growth of pension fund market in India.
6. Explain the ‘Chilean Model’ of management of pensions.
7. Elaborate on the broad factors involved in the pension investment policy of a pension fund manager.
8. Discuss the structure of pension system?
9. Discuss the different types of risks involved in the management of pension funds.

Model Question Paper 1

Core Course: Financial Services
[Common for B.Com., (General), B.Com., (A & F),
B.Com., (MM), B.Com., (BM) and BBA]

Time: 3 hours | Max: 100 marks

Section A

Answer any TEN of the following
All questions carry equal marks
Each answer not to exceed 50 words

1. What are ‘financial services’? Name them.
2. Name the intermediaries in the financial services market.
3. What is ‘credit syndication’?
4. What is a pension fund?
5. Who is an ‘issue manager’ in a financial market?
6. What is ‘New Issues Market’ (NIM)?
7. What is ‘red herring prospectus’? When is it filed?
8. What is ‘book building method’ of issue of securities of a corporate entity?
9. What is ‘firm underwriting’?
10. What is ‘stock-invest’?
11. What are ‘zero-coupon bonds’?
12. Define the term ‘factoring’.

Section B

Answer any FIVE of the following

All questions carry equal marks

Each answer not to exceed 100 words

13. How is interest rate determined? Illustrate.
14. What is venture financing? How is it different from lease financing?
15. What are the advantages of private placement of securities?
16. Describe the services rendered by the NIM.
17. Distinguish between money market and capital market.
18. Explain the steps in 'stock trading'.
19. What are the objectives for which the SEBI was set up?
20. Distinguish between financial lease and operating lease.

Section C

Answer any TWO of the following

All questions carry equal marks

Each answer not to exceed 1000 words

21. Discuss in detail the various functions rendered by a merchant banker in India.
22. What are 'bought-out deals'? What are their features? How are they different from private placements?
23. Describe and discuss the various functions rendered by stock exchanges.
24. Discuss the powers and functions of the SEBI in the realm of investor protection and the efficient management of the Indian stock market.

Model Question Paper 11

Core Course: Financial Services
[Common for B.Com., (General), B.Com., (A & F),
B.Com., (MM), B.Com., (BM) and BBA]

Time: 3 hours | Max: 100 marks

Section A

Answer any TEN of the following
All questions carry equal marks
Each answer not to exceed 50 words

1. What is a venture capital fund?
2. Who are merchant bankers?
3. What is ‘portfolio management’?
4. What are ‘mutual funds’?
5. What is ‘private placement’?
6. What is ‘ESOP’?
7. What are ‘bought-out deals’?
8. What is a ‘gilt-edged market’?
9. What is a ‘stock exchange’?
10. What are nonvoting rights shares?
11. Define the term ‘insurance’.
12. What is a financial lease?

Section B

Answer any FIVE of the following

All questions carry equal marks

Each answer not to exceed 100 words

13. Bring out the points of distinction between the NIM and the secondary market.
14. What are the benefits of underwriting of securities?
15. Briefly explain the salient features of an insurance contract.
16. Explain the leasing process with the help of a chart.
17. Explain with the help of a chart the mechanism of factoring.
18. What are the characteristic features of venture capital?
19. How is credit rating advantageous to investors?
20. What are the objectives and features of a pension fund?

Section C

Answer any TWO of the following

All questions carry equal marks

Each answer not to exceed 1000 words

21. Discuss the different stages in the growth and development of financial services market in India over the ages.
22. Discuss the different categories of public issue of securities.
23. Discuss the various functions performed by the capital market in the context of the economic development of a country.
24. Discuss the powers and functions of Insurance Regulatory and Development Authority (IRDA).

Index