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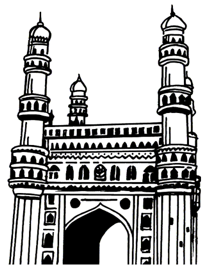

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C O N T E N T S

FINANCIAL MARKETS AND SERVICES

STUDY MANUAL

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SYLLABUS

UNIT - I

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Indian Financial System – Structure, Functions, Types of Financial Markets, Securities traded in Financial Markets, Regulatory Institutions and their functions – RBI & SEBI, Global Financial Markets

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Primary Market – Introduction, Book Building, Free Pricing, Underwriting, On-Line IPOs, e-Prospectus; Secondary Market – Organisation of Stock Exchanges, NSE, BSE and OTCEI, Listing of Securities, Trading and Settlement, Internet Trading, New financial instruments.

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UNIT I

STRUCTURE OF INDIAN FINANCIAL SYSTEM

Indian Financial System – Structure, Functions, Types of Financial Markets, Securities traded in Financial Markets, Regulatory Institutions and their functions – RBI & SEBI, Global Financial Markets

1.1 Indian Financial System

1.1.1 Structure

Q1. Explain the structure of Indian Financial System.

(OR)

Explain structure of financial market service in India.

(OR)

Explain Indian Finance System.

Ans : **(Dec.-19, July-19, Dec.-18, Imp.)**

The economic development of any country depends upon the existence of a well organized financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promote the well being and standard of living of the people of a country. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system. The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilise the savings in the form of money and monetary assets and invest them in productive ventures. As efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development.

Structure of Indian Financial System

The Indian financial system refers to the system of borrowing and lending of funds or the demand for and the supply of funds of all individuals, institutions, companies and of the government. The Indian financial system is broadly classified into two categories.

1. Organized / formal financial system.

2. Unorganized / informal financial system.

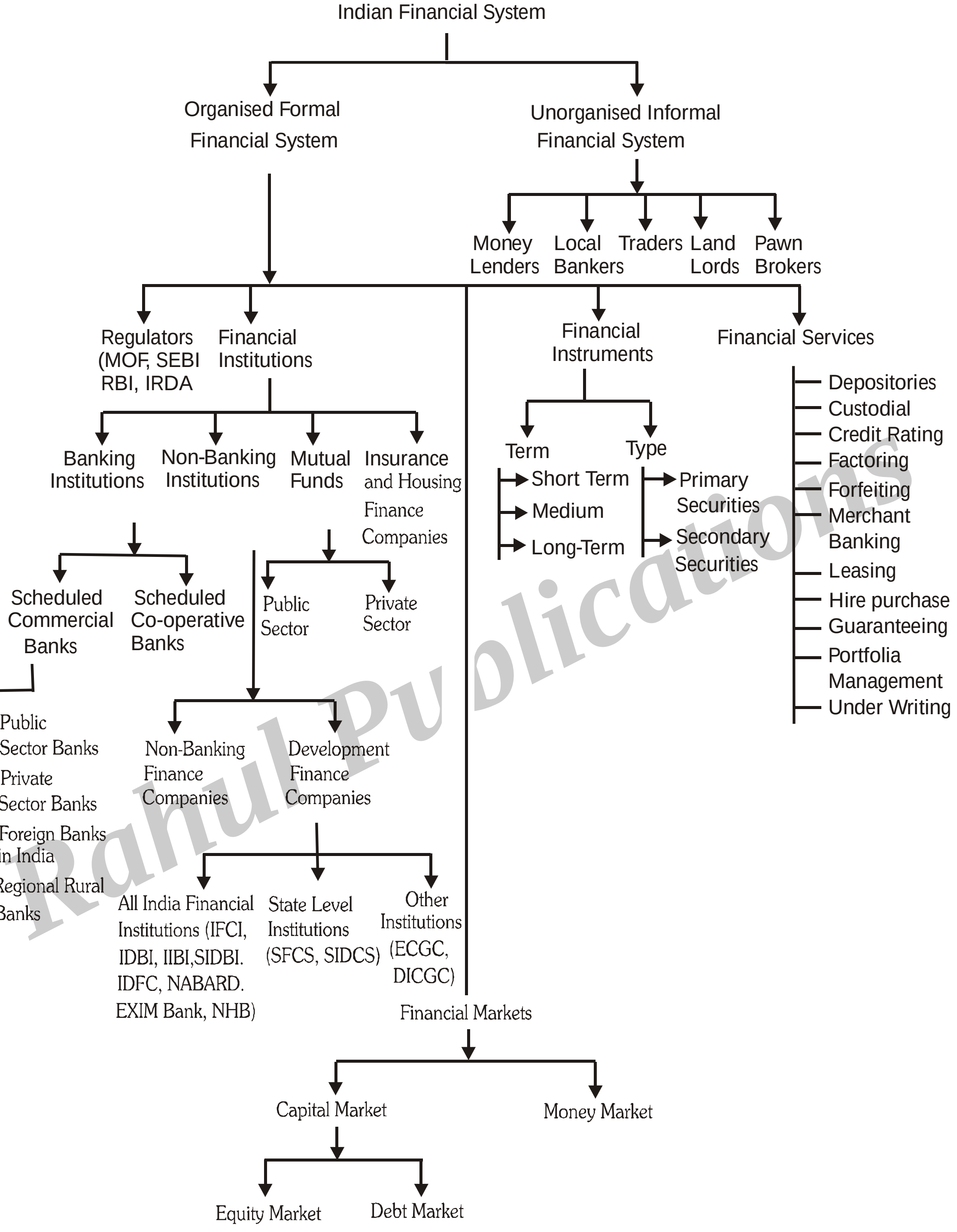

Fig. : Structure of the Indian Financial System

1. Organized/Formal Financial System

The organized or the formal financial system consists of a network of banks, financial institutions, investment institutions and a range of financial instruments, that function in developed capital and money markets. Organized financial system comes under the responsibility of MOF - Ministry of Finance, RBI-Reserve Bank of India, SEBI-Securities and Exchange Board of India and some other regulatory bodies. The organized financial system is divided into four components. They are,

(ii) Financial Institutions: Financial institutions are intermediaries that mobilize savings and help in the allocation of funds in an appropriate way. Financial institutions are classified into four segments - Banking Institutions, non-banking Institutions and Investment Institutions like-mutual funds and housing finance companies. Financial institutions include,

(a) Non-banking financial institutions like DFIs, NBFCs, HFCs etc.

(b) Term-finance institutions like IDBI, ICICI, IFCI, SIDBI and IIBI.

(c) Specialized Financial Institutions like EXIM, TFCI, IDFC, NABARD, NHB.

(d) Mutual Funds such as UTI.

(e) Insurance Activities such as LIC, GIC.

(f) State Level Financial Institutions such as SFCs and SIDCs.

(ii) Financial Markets: Financial markets are those mechanisms that enable the participants (borrowers, lender and financial institutions) to handle the financial claims. These markets also facilitate the participants to combine their demands and requirements and to set prices for their claims. In India, the financial markets are classified into money markets and capital markets. Money market deals with short-term securities of maturity period less than one year.

Whereas, capital market deals with long-term securities of maturity period more than one year. Financial markets can also be classified into primary market and secondary market. Primary market deals with the trading of new securities, whereas, secondary market deals with the trading of already existing securities.

(iii) Financial Instruments: A financial instrument is a claim against an institution or a person regarding the payment to be made at a future date in the form of dividend/interest. Financial instruments are categorised on the basis of term and type. On the basis of 'term', financial institutions are divided into three categories - short-term, medium and long term. On the basis of 'type', they are divided into two categories primary securities and secondary securities. Primary securities also known as direct securities, are issued by the real borrowers of funds to the real savers. Examples: Equity shares and debentures. Secondary securities also known as indirect securities are issued by the financial institution to the real saver. Examples: Bank deposit, mutual funds and insurance policies.

(iv) Financial Services: Financial institutions provide key financial services such as depositories, custodial, credit rating, factoring, forfeiting, merchant banking, leasing, hire purchase, guaranteeing, portfolio management, underwriting. Financial services play a vital role in creating the firms, expanding the industries and attaining economic growth.

2. Unorganised/Informal Financial System

An unorganised financial system consists of money lenders, local bankers, traders, landlords, pawn brokers who are less controlled. Unorganised financial systems are not directly responsive to the Reserve Bank of India (RBI). The informal financial system is divided into,

(i) Individual money lenders like neighbours, relatives, traders, landlords etc.

(ii) Groups of individuals operating in a combined way as funds/associations are fixed fund, association, saving club etc.,

(iii) Partnership firms including pawn brokers, non-financial institutions like chit fund, finance and investment companies.

1.1.2 Functions

Q2. Explain the functions of Indian Financial System.

Ans : **(Dec.-19)**

1. Provision of Liquidity

The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. The term liquidity refers to cash or money and other assets which can be converted into cash readily without loss of value and time.

Hence, all activities in a financial system are related to liquidity — either provision of liquidity or trading in liquidity. In fact, in India the R.B.I. has been vested with the monopoly power of issuing coins and currency notes. Commercial banks can also create cash (deposit) in the form of 'credit creation' and other financial institutions also deal in monetary assets. Over supply of money is also dangerous to the economy.

In India the R.B.I. is the leader of the financial system and hence it has to control the money supply and creation of credit by banks and regulate all the financial institutions in the country in the best interest of the nation. It has to shoulder the responsibility of developing a sound financial system by strengthening the institutional structure and by promoting savings and investment in the country.

2. Mobilisation of Savings

Another important activity of the financial system is to mobilise savings and channelise them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of savings into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

3. Risk Absorption

Apart from performing the process fund transfer, the financial system also absorbs the risks with the help of financial intermediation. The risk is absorbed by establishing innovative financial instruments, advanced financial technologies and professionalization of financial services. If risk absorption is not done adequate then the growth of financial market and financial system will be hindered.

1.2 Types of Financial Markets

Q3. Discuss about various types of financial markets.

(OR)

Write about structure of financial market system in India.

Ans : **(July-21, Dec.-20, Dec.-18)**

Wherever a financial transaction takes place, it is deemed to have taken place in the financial market. Hence financial markets are pervasive in nature since financial transactions are themselves very pervasive throughout the economic system. For instance, issue of equity shares, granting of loan by term lending institutions, deposit of money into a bank, purchase of debentures, sale of shares and so on.

However, financial markets can be referred to as those centres and arrangements which facilitate buying and selling of financial assets, claims

CALSSIFICATION OF FINANCIAL MARKETS

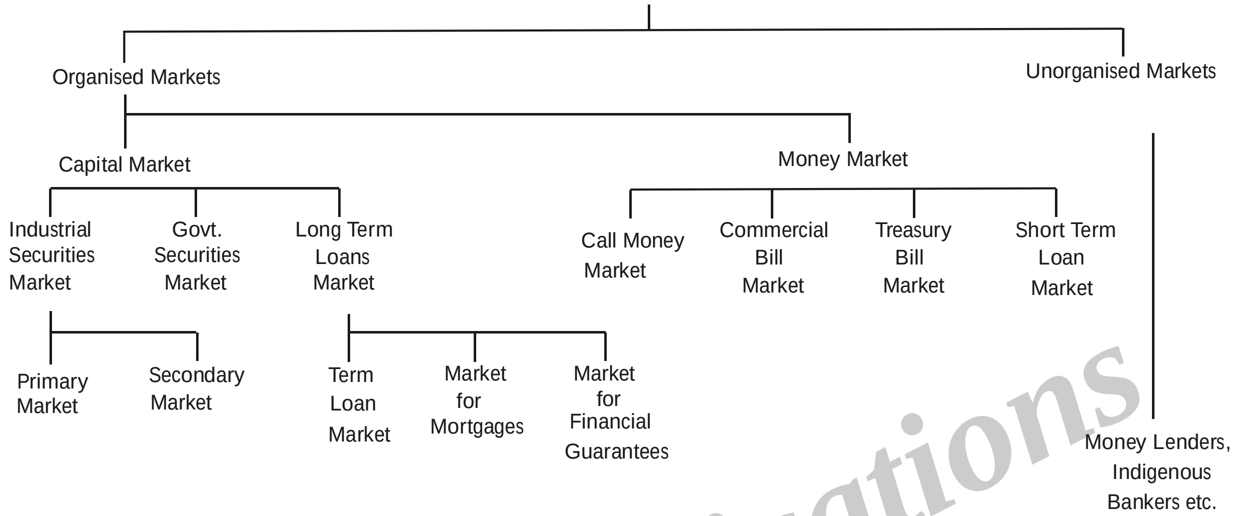

Fig.: Classification of Financial Markets

I) Unorganised Markets

In these markets there are a number of money lenders, indigenous bankers, traders etc., who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc., whose activities are not controlled by the RBI. Recently the RBI has taken steps to bring private finance companies and chit funds under its strict control by issuing non-banking financial companies (Reserve Bank) Directions, 1998. The RBI has already taken some steps to bring the unorganised sector under the organized fold. They have not been successful. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardised.

II) Organized Markets

In the organized markets, there are standardised rules and regulations governing their financial dealings. There is also a high degree of institutionalisation and instrumentalisation. These markets are subject to strict supervision and control by the RBI or other regulatory bodies.

These organized markets can be further classified into two. They are:

1. Capital market
2. Money market

1. Capital Market

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three namely:

(i) Industrial securities market

(ii) Government securities market and

(iii) Long term loans market

(i) Industrial Securities Market

As the very name implies, it is a market for industrial securities namely:

- Equity shares or ordinary shares
- Preference shares, and
- Debentures or bonds.

It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are:

- Primary market or New issue market
- Secondary market or Stock exchange Primary Market

Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long term funds. Thus, primary market facilitates capital formation.

There are three ways by which a company may raise capital in a primary market. They are :

- Public issue
- Rights issue
- Private placement

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

(ii) Government Securities Market

It is otherwise called Gilt-Edged securities market. It is a market where Government securities are traded. In India there are many kinds of Government Securities short-term and long-term. Long-term securities are traded in this market while short term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi-Government authorities like City Corporations, Port Trusts etc. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

Government securities are issued in denominations of Rs.100. Interest is payable half-yearly and they carry tax exemptions also. The role of brokers in marketing these securities is practically very limited and the major participant in this market is the "commercial banks" because they hold a very substantial portion of these securities to satisfy their S.L.R. requirements.

The secondary market for these securities is very narrow since most of the institutional investors tend to retain these securities until maturity.

The Government securities are in many forms. These are generally:

- Stock certificates or inscribed stock
- Promissory Notes
- Bearer Bonds which can be discounted.

Government securities are sold through the Public Debt Office of the RBI while Treasury Bills (short term securities) are sold through auctions.

Government securities offer a good source of raising inexpensive finance for the Government exchequer and the interest on these securities influences the prices and yields in this market. Hence this market also plays a vital role in monetary management.

(iii) Long-Term Loans Market

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long-term loans market may further be classified into:

- Term loans market
- Mortgages market
- Financial guarantees market.

Term Loans Market

In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply long-term and medium term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India, institutions like IDBI, IFCI, ICICI, and other state financial corporations come under this category. These institutions meet the growing and varied long-term financial requirements of industries by supplying long-term loans. They also help in identifying investment opportunities, encourage new entrepreneurs and support modernisation efforts.

Mortgages Market

The mortgages market refers to those centres which supply mortgage loan mainly to individual customers. A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one. Again it may be a first charge or second charge. Equitable mortgage is created by a mere deposit of title deeds to properties as security whereas in the case of a legal mortgage the title in the property is legally transferred to the lender by the borrower. Legal mortgage is less risky.

Similarly, in the first charge, the mortgager transfers his interest in the specific property to the mortgagee as security. When the property in question is already mortgaged once to another creditor, it becomes a second charge when it is subsequently mortgaged to somebody else. The mortgagee can also further transfer his interest in the mortgaged property to another. In such a case, it is called a sub-mortgage.

The mortgage market may have primary market as well secondary market. The primary market consists of original extension of credit and secondary market has sales and re-sales of existing mortgages at prevailing prices.

In India, residential mortgages are the most common ones. The Housing and Urban Development Corporation (HUDCO) and the LIC play a dominant role in financing residential projects. Besides, the Land Development Banks provide cheap mortgage loans for the development of lands, purchase of equipment etc. These development banks raise finance through the sale of debentures which are treated as trustee securities.

Financial Guarantees Market

A Guarantee market is a centre where finance is provided against the guarantee of a reputed person in the financial circle. Guarantee is a contract to discharge the liability of a third party in case of his default. Guarantee acts as a security from the creditor's point of view. In case the borrower fails to repay the loan, the liability falls on the shoulders of the guarantor. Hence the guarantor must be known to both the borrower and the lender and he must have the means to discharge his liability.

Though there are many types of guarantees, the common forms are:

(i) Performance Guarantee, and

(ii) Financial Guarantee. Performance guarantees cover the payment of earnest money, retention money, advance payments, non-completion of contracts etc. On the other hand financial guarantees cover only financial contracts.

In India, the market for financial guarantees is well organized. The financial guarantees in India relate to:

(i) Deferred payments for imports and exports.

(ii) Medium and long-term loans raised abroad.

(iii) Loans advanced by banks and other financial institutions.

These guarantees are provided mainly by commercial banks, development banks, Governments both central and states and other specialised guarantee institutions like ECGC (Export

Credit Guarantee Corporation) and DICGC (Deposit Insurance and Credit Guarantee Corporation). This guarantee financial service is available to both individual and corporate customers. For a smooth functioning of any financial system, this guarantee service is absolutely essential.

2. Money Market

Money market is a market for dealing with financial assets and securities which have a maturity period of upto one year. In other words, it is a market for purely short term funds. The money market may be subdivided into four. They are:

- Call money market
- Commercial bills market
- Treasury bills market
- Short-term loan market.

Call Money Market

The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Mumbai, Kolkata, Chennai, Delhi, Ahmedabad etc. The special feature of this market is that the interest rate varies from day-to-day and even from hour-to-hour and centre-to-centre. It is very sensitive to changes in demand and supply of call loans.

Commercial Bills Market

It is a market for Bills of Exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date the amount specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

In India the bill market is under-developed. The RBI has taken many steps to develop a sound bill market. The RBI has enlarged the list of participants in the bill market. The Discount and Finance House of India was set up in 1988 to promote secondary market in bills. In spite of all these, the growth of the bill market is slow in India. There are no specialised agencies for discounting bills. The commercial banks play a significant role in this market.

Treasury Bills Market

It is a market for treasury bills which have 'short-term' maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because its repayment is guaranteed by the Government. It is an important instrument for short-term borrowing of the Government. There are two types of treasury bills namely (i) ordinary or regular and (ii) ad hoc treasury bills popularly known as 'ad hoes'.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short-term financial needs. Ad hoc treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only. Ad hoes are not marketable in India but holders of these bills can sell them back to RBI. Treasury bills have a maturity period of 91 days or 182 days or 364 days only. Financial intermediaries can park their temporary surpluses in these instruments and earn income.

Short-Term Loan Market

It is a market where short-term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short term loans in the form of cash credit and overdraft. Overdraft facility is mainly given to business people whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But cash credit is for a period of one year and it is sanctioned in a separate account.

Q4. What are the differences between money market and capital market?

(OR)

Compare and contrast Money Market and capital market.

Ans :

S.No.	Money Market	S.No.	Capital Market
1.	It is a market for short-term loanable exceeding a period one year.	1.	It is a market for long-term funds exceeding a period one year
2.	This market supplies funds for financing current business operations, working capital requirements of industries and short period requirements of the Government.	2.	This market supplies funds for financing the fixed capital requirements of trade and commerce as well as the long-term requirements of the Government.
3.	The instruments that are dealt in a money market are bills of exchange, treasury bills commercial papers, certificate of deposit etc.	3.	This market deals in instruments like shares, debentures, Government bonds etc.
4.	Each single money market instrument is of large amount. A TB is of minimum for one lakh. Each CD or CP is for a minimum of Rs.25 lakhs.	4.	Each single capital market instrument is of small amount. Each share value is Rs.10. Each debenture value is Rs.100.
5.	The Central bank and Commercial banks are the major institutions in the money market.	5.	Development banks and Insurance companies play a dominant role in the capital market.
6.	Money market instruments generally do not have secondary markets.	6.	Capital market instruments generally have secondary markets.
7.	Transactions mostly take place over the phone and there is no formal place.	7.	Transactions take place at a formal place viz., stock exchange.
8.	Transactions have to be conducted without the help of brokers.	8.	Transactions have to be conducted only through authorised dealers.

Q5. What is financial service? Classification of financial services.

(OR)

Explain about classification of financial services.

Ans : **(July-21, July-19)**

Financial services refer to services provided by the finance industry. The finance industry consists of a broad range of organizations that deal with the management of money. These organizations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises.

Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities.

Financial services can also be called financial intermediation. Financial intermediation is a process by which funds are mobilized from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. There are various institutions which render financial services. Some of the institutions are banks, investment companies, accounting firms, financial institutions, merchant banks, leasing companies, venture capital companies, factoring companies, mutual funds etc. These institutions provide variety of services to corporate enterprises. Such services are called financial services. Thus, services rendered by financial service organizations to industrial enterprises and to ultimate consumer markets are called financial services. These are the services and facilities required for the smooth operation of the financial markets. In short, services provided by financial intermediaries are called financial services.

Types

Financial service institutions render a wide variety of services to meet the requirements of individual users.

These services may be summarized as below:

1. **Provision of funds**
   (a) Venture capital
   (b) Banking services
   (c) Asset financing
   (d) Trade financing
   (e) Credit cards
   (f) Factoring and forfeiting
2. **Managing investible funds**
   (a) Portfolio management
   (b) Merchant banking
   (c) Mutual and pension funds
3. **Risk financing**
   (a) Project preparatory services
   (b) Insurance
   (c) Export credit guarantee
4. **Consultancy services**
   (a) Project preparatory services
   (b) Project report preparation
   (c) Project appraisal
   (d) Rehabilitation of projects
   (e) Business advisory services
   (f) Valuation of investments
   (g) Credit rating
   (h) Merger, acquisition and reengineering
5. **Market operations**
   (a) Stock market operations
   (b) Money market operations
   (c) Asset management
   (d) Registrar and share transfer agencies
   (e) Trusteeship
   (f) Retail market operation
   (g) Futures, options and derivatives
6. **Research and development**
   (a) Equity and market research
   (b) Investor education
   (c) Training of personnel
   (d) Financial information services

Q6. What are the characteristics and objectives of financial services?

Ans :

Characteristics

1. **Inseparable (Simultaneous)**

   Production and supply of financial service is a simultaneous process. This results in a development of perfect sense of understanding between the financial service firms and its clients.

2. **Perishable**

   Financial services can't be produced and stored. It has to be supplied immediately to cater the needs of clients. Hence, it is obvious that it balances between the demand and supply.

3. **Dynamic**

   Based on socio-economic changes such as disposable income, standard of living, eduction level etc. Financial services needs to be redefined.

Objectives

The major objectives of financial services can be summarised as follows,

(i) Fund Raising

Raising funds is the primary function of financial services. It raises funds from investors, individuals and institutions through a wide range of instruments. The funds raised are again made available to the needs of individuals, corporate and institutions.

(ii) Funds Deployment

Financial services help in effective and optimum deployment of funds raised. A major function of financial services is assisting in deciding to optimum financing mix for their corporate clients.

(iii) Specialisation

Specialised services like credit research and credit rating, leasing, venture factoring capital financing, book building etc., are also performed by financial services besides the regular banking and insurance functions. Stock exchanges, specialised and general financial institutions, non-banking also provides these services.

(iv) Economic Growth

It also performs the function of accelerating economic growth through mobilisation of savings. Financial services aim at developing an economy through channelising the savings into profitable investments.

Q7. State the scope of financial services.

Ans :

Scope of Financial services

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

(i) Traditional activities

(ii) Modern activities

(i) Traditional activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads viz;

(i) Fund based activities and

(ii) Non-fund based activities.

Fund based activities

The traditional services which come under fund based activities are the following :

(i) Underwriting of or investment in shares, debentures, bonds etc. of new issues (primary market activities)

(ii) Dealing in secondary market activities.

(iii) Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.

(iv) Involving in equipment leasing, hire purchase, venture capital, seed capital etc.

(v) Dealing in foreign exchange market activities

Non-fund based activities

Financial intermediaries provide service on the basis of non fund activities also. This can also be called "fee based" activity. Today, customers whether individual or corporate are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services, are being provided under this head. They include the following:

(i) Managing the capital issues, i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issues.

(ii) Making arrangements for the placement of capital and debt instruments with investment institutions.

(iii) Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.

(iv) Assisting in the process of getting all Government and other clearances.

(ii) Modern activities

Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been discussed in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder:

(i) Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approval.

(ii) Planning for mergers and acquisitions and assisting for their smooth carry out.

(iii) Guiding corporate customers in capital restructuring.

(iv) Acting as Trustees to the debenture-holders.

(v) Recommending suitable changes in the management structure and management style with a view to achieving better results.

(vi) Structuring the financial collaboration/joint ventures by identifying suitable joint venture partner and preparing joint venture agreement

(vii) Rehabilitating and reconstructing sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.

(viii) Hedging of risks due to exchange rate risk, interest rate risk economic risk and political risk by using swaps and other derivative products.

(ix) Managing the portfolio of large Public Sector Corporations.

(x) Undertaking risk management services like insurance services, buy-back options etc.

(xi) Advising the clients on the question of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.

(xii) Guiding the clients in the minimisation of the cost of debt and in the determination of the optimum debt-equity mix.

(xiii) Undertaking services relating to the capital market such as:

(a) Clearing services,

(b) Registration and transfers,

(c) Safe-custody of securities,

(d) Collection of income on securities.

(xiv) Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

1.3 Securities Traded in Financial Markets

Q8. Explain various types of Securities Traded in Financial Markets.

Ans :

(i) Derivatives

Derivatives involve making a contract to buy or sell commodities on a specific date at a specific rate. Derivatives are also commonly referred to as F&O stocks or Futures and Options stocks. A Futures contract entails the right and obligation to buy or sell a certain amount, by a predetermined date at a specified rate. An Options contract is similar, but there is no obligation.

This is a slightly more complex area of trading. It is recommended that you begin trading in derivatives only once you've familiar with the workings of the market. If you do choose to trade in derivatives you must keep an eye on Open Interest, i.e. the number of contracts being held. If people are dumping contracts, Open Interest is low, meaning lower buy-in rates and if people are buying contracts then Open Interest is high, thereby meaning higher buy-in rates.

(ii) Bonds

Bonds are one of the safer ways to invest in the stock market, because they assure a certain rate of interest by a certain date. The interest may fluctuate but will not dip below the rate of interest mentioned when they are issued on the stock market. However, bonds also may not display the kind of profits seen in stock trading and derivatives.

(iii) Mutual Funds

A mutual fund refers to the mutual (in other words you and everyone else who invested in the fund) trade of financial instruments on the stock market. Because it calls for many different investors pooling their resources and investing in a variety of different stocks for instance, the risk is much lower than individuals trading in stock themselves. Mutual funds are one of the most popular methods used by Indians when it comes to investing in the stock market.

Q9. State the weakness of Indian Financial System.

Ans :

After the introduction of planning, rapid industrialisation has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing requirements of the Government and the industries, many innovative financial instruments have been introduced. Besides, there has been a mushroom growth of financial intermediaries to meet the ever growing financial requirements of different types of customers. Hence, the Indian financial system is more developed and integrated today than what it was 50 years ago. Yet, it suffers from some weaknesses as listed below:

(i) Lack of Co-ordination between different Financial Institutions

There are a large number of financial intermediaries. Most of the vital financial institutions are owned by the Government. At the same time, the Government is also the controlling authority of these institutions. In these circumstances, the problem of co-ordination arises. As there is multiplicity of institutions in the Indian financial system, there is lack of co-ordination in the working of these institutions.

(ii) Monopolistic Market Structures

In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance the entire life insurance business is in the hands of LIC. The UTI has more or less monopolised the mutual fund industry. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement or lack of effort in mobilising savings of the public and so on. Ultimately it would retard the development of the financial system of the country itself.

(iii) Dominance of Development Banks in Industrial Financing

The development banks constitute the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the financial institutions created by the Government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds from their sponsors. As such, they fail to mobilise the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country. For industries abroad, institutional finance has been a result of institutionalisation of personal savings through media like banks, LIC, pension and provident funds, unit trusts and so on. But they play a less significant role in Indian financial system, as far as industrial financing is concerned. Flowever, in recent times attempts are being made to raise funds from the public through the issue of bonds, units, debentures and so on. It will go a long way in forging a link between the normal channels of savings and the distributing mechanism.

(iv) Inactive and Erratic Capital Market

The important function of any capital market is to promote economic development through mobilisation of savings and their distribution to productive ventures. As far as industrial finance in India is concerned, corporate customers are able to raise their financial resources through development banks. So, they need not go to the capital market. Moreover, they don't resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.

(v) Imprudent Financial Practice

The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So there is a preponderance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. To make matters worse, when corporate enterprises face any financial crisis, these financial institutions permit a greater use of debt than is warranted. It is against the traditional concept of a sound capital structure.

However, in recent times all efforts have been taken to activate the capital market. Integration is also taking place between different financial institutions. For instance, the Unit Linked Insurance Schemes of the UTI are being offered to the public in collaboration with the LIC. Similarly the refinance and rediscounting facilities provided by the IDBI aim at integration. Thus, the Indian financial system has become a developed one.

Q10. How does financial system plays an active role in the economic development of a country?

Ans :

1. Mobilizing Savings

The financial system provides the people with proper incentives as to mobilize their savings. It creates varieties of forms of savings by considering the changing asset preferences of various classes of savers. It has mobilized the idle saving of the people and help them make their businesses more productive.

2. Promoting Investment in Financial Assets

Financial system is quite dynamic in nature, it promotes the savings to flow into financial assets i.e., money and monetary assets rather than physical assets such as land, gold and other goods and services. This helps in economic growth of the country.

3. Encourages Investments

Investment is very important for the economic growth of any country. In this regards, the financial system gathers the savings of people and channel them into investments which inturn results in economic development.

4. Allocation of Savings Based on National Priorities

In order to utilize the scarce capital more efficiently, the financial system allocates the savings in a more effective way. Based on national priorities, it gives preference to some specific sectors from the economic and social perspectives.

5. Provides a Spectrum of Financial Assets

To fulfill the changing requirements and preferences of households, the financial system provides a spectrum of financial assets. It helps them select their asset portfolios in such a manner that they achieve a preferred mix of return risk and liquidity. Therefore, it contributes the economic development.

6. Offering Financial Services

The financial intermediaries are becoming more sophisticated and innovative. They are the provides of finance and offers different varieties of innovative financial products and services according to the requirements and comands of their customers (corporates and individuals).

7. Developing Backward Areas

For the backward areas, the financial institutions which a package of services, appropriate incentives and restructure to ensure healthy growth of industries. This way, they contribution to be development of all regions in the country.

1.4 Regulatory Institutions and their Functions

1.4.1 RBI

Q11. What is RBI ? Discuss the functions of RBI.

Ans : **(Dec.-18)**

The RBI Act, 1934 is a primary legislation for regulating banking services in India. The Reserve Bank of India is given the authority to control all banks from their establishment till their windup. The Act specifies that the direct discounts should be given to customers during special occasions for regulating credit in trade, agriculture and industry.

RBI is a monetary authority and central bank of the country. It has the power to manage, develop and regulate the financial system.

Functions

The main functions of the Reserve Bank of India are,

1. Formulation, implementation and monitoring the monetary policy.
2. Prescribes broad parameters of banking operations within which it need to operate the country's banking and financial system.
3. External trade and payment is facilitated, develops to a higher positions and foreign exchange market is maintained in India.
4. Currencies and coins are issued and exchanged, if at all they are outdated then destroyed.
5. To support national objectives, it performs a wide range of promotional functions.
6. For the central and the state governments, it performs merchant banking function.
7. Banking accounts of all scheduled Banks are maintained.

Q12. Explain the role of RBI in the regulation of money market.

Ans :

RBI has been playing a pivotal role in the management and development of Indian financial markets. Indian financial markets are delivering an average turnover of `.40,000 crores daily. This amount is equal to 2% of the total money supply in Indian economy and 6% of the total output of the commercial banks. This means that India is getting 2% of the annual GDP (Gross Domestic Product) in financial markets in one day itself. Usually, RBI is considered as the important constituent of Indian financial market. Aims of RBI regarding the financial markets are as follows.

1. To maintain liquidity and short-term rates of interest in accordance with the objectives of monetary policy.
2. To allocate adequate credit flow to all the productive sectors.
3. To regulate the foreign exchange market.

   For maintaining optimal liquidity and interest rates, RBI utilises the instruments like indirect monetary control methods (repose, open market operations), Cash Reserve Requirements (CRR) etc. The Reserve Bank set up a working group on the money market under the chairmanship of N. Vagul and this committee presented a blueprint for the institution of money market. Based on this blueprint, RBI introduced certain measures like,

(a) DFH - The Discount and Finance House of India was set up in 1988 as a money market institution on behalf of RBI, public sector banks and financial institutions in order to impart liquidity to money market measurements.

(b) In 1988-89, money market instruments like 185-day treasury bill, certificate of deposit were introduced and in January 1990, commercial papers were introduced.

In August 1991 RBI in accordance to the Narasimham committee introduced the following,

(i) STCI (The Securities Trading Corporation of India) in June 1994.

(ii) Primary dealer system in 1995.

(iii) Satellite dealer system in 1999.

(iv) Liquidity Adjustment Facility (LAF) in June 2000,

With many more changes and initiations in the Indian Financial Markets, RBI effectively managed them, i.e., money market and capital market.

1.4.2 SEBI

Q13. Explain the role of SEBI in regulating the Indian Financial Markets.

Ans : **(Dec.-20)**

Under these circumstances, the government felt the need for setting up to an apex body to develop and regulate the stock market in India. Eventually, the Securities and Exchange Board of India (SEBI) was set up on April 12,1988. To start with, SEBI was set up as a non-statutory body.

It took almost four years for the government to bring about a separate legislation in the name of Securities and Exchange Board of India Act, 1992 conferring statutory powers. The Act, charged to SEBI with comprehensive powers over practically all aspects of capital market operations.

Objectives

According to the preamble of the SEBI Act, the primary objective of the SEBI is to promote healthy and orderly growth of the securities market and secure investor protection. For this purpose, the SEBI monitors the activities of not only stock exchanges but also merchant bankers etc. The objectives of SEBI are as follows:

1. To protect the interest of investors so that there is a steady flow of savings into the capital market.
2. To regulate the securities market and ensure fair practices by the issuers of securities so that they can raise resources at minimum cost.
3. To promote efficient services by brokers, merchant bankers and other intermediaries so that they become competitive and professional.

Functions

Section 11 of the SEBI Act specifies the functions as follows:

1. Regulatory Functions

(a) Regulation of stock exchange and self regulatory organisations.

(b) Registration and regulation of stock brokers, sub-brokers, registrar to all issue, merchant bankers, underwriters, portfolio managers and such other intermediaries who are associated with securities market.

(c) Registration and regulation of the working of collective investment schemes including mutual funds.

(d) Prohibition of fraudulent and unfair trade practices relating to securities market.

(e) Prohilition of insider trading in securities.

(f) Regulating substantial acquisitions of shares and take over of companies.

2. Developmental Functions

(a) promoting investor's education.

(b) Training of intermediaries.

(c) Conducting research and published information useful to all market participants.

(d) Promotion of fair practices. Code of conduct for self-regulatory organisations.

(e) Promoting self-regulatoiry organisations.

1.4.3 Global Financial Markets

Q14. Briefly explain about global financial markets.

Ans : **(Dec.-19)**

Global financial markets refers to forums which exists on international level which facilitate the exchange of financial securities and enable the flow of capital among the financial markets in various parts of the world. Global financial markets comprise of debt and equity markets which constitute the global capital markets and on the other hand money markets which is the market for short term transactions.

Examples of global financial markets include international bond markets, the foreign exchange market, international equity markets and international mortgage markets and all perform the primary function of transferring funds from the surplus units to the deficit units.

The main players are the global institutions such as International Monetary Fund. Bank for International Settlements, central banks and other private institutions. The functions performed by global financial markets include among, a myriad of functions as discussed below.

1. Savings function

The global system of financial markets and institutions provides a conduit for the public's savings. This is explained by the fact that they mobilise savings from the surplus units of the economy to the deficit sectors. The surplus units are the funds' providers or lenders who can be households, firm and governments with excess funds at disposal. The financial markets on international level act as intermediaries mobilizing savings from the public thereby allowing economic agents to maintain savings.

2. Wealth function

The financial instruments sold in the money and capital markets provides an excellent way to store wealth. Economic agents with surplus funds can be able to store their wealth by making savings with financial instruments traded in the global money and capital markets. In some cases they can even earn a return through the investments in these markets, for example prior to the global financial crisis, investors as far as in the Asian markets have invested to accumulate wealth in the Subprime Mortgages in the United States mortgage markets. Global financial markets therefore provides an enabling forum to investors to accumulate wealth as well as storing it.

3. Liquidity function

Financial markets provide liquidity for savers who hold financial instruments but are in need of cash. Liquidity refers to how easily a financial asset can be converted into cash without altering its price. Global financial markets especially of the developed countries have depth which implies that, individual and institutional investors who are in need of cash can sell their securities easily and access liquidity. However in the same vein for developing markets such as Zimbabwe, the markets are less liquid worsened by the liquidity crunch dogging the economy under this multi-currency environment.

4. Credit function

Global financial markets provide credit to finance consumption and investment spending. They advance loans to households who want to finance their expenditures on goods and services through offering personal loans. The credit advanced can be short term or long term depending on the needs of the households. However this is carried out through a strict credit advancement analysis which analyses the character, capital, creditworthiness of the clients to minimize the risks of default. Similarly corporates which are investing in working capital requirements, or are making expansion projects, can also access credit facilities in the global financial markets.

5. Payments function

The global financial markets provide a mechanism for making payments for goods and services, in form of currency, checking accounts, debit cards, digital cash among others. With the advancement of technology in the global financial markets, the payment systems have become advanced especially with debit cards such as VISA, MasterCard. This has enabled the facilitation of international transactions across the globe as these cards are compatible with many financial institutions and points of service across the world. In Zimbabwe the Real Time Gross Settlement (RTGS) is a method of payment which is under the stewardship of the Reserve Bank of Zimbabwe which involves transfer of funds across the banking institutions' accounts.

6. **Risk protection function**

The financial markets offer protection against life, health, property and income risks, by permitting individuals and institutions to engage in both risk-sharing and risk reduction. This is performed by insurance and life assurance companies. Insurance companies insure property against loss through unforeseen events such outbreak of natural phenomena such as floods, or can be man-made such as fire, accidental damage. This function is performed by insurance companies who in return for a premium promise to compensate the policyholders in the event of a loss occurred through an undesirable event. On the other hand life assurance companies promise to give the sum assured in the event of the death of the policyholder. In Zimbabwe the typical examples include Nyaradzo Funeral Assurance Company, Old Mutual and ZB Life Assurance among others.

7. **Policy function**

Financial markets are a channel through which governments may attempt to stabilize the economy and avoid inflation. The government intervenes in the economy with various policies at hand and the typical ones being the fiscal and monetary policy and these are effected through the financial markets. For instance a government adopting a restrictive monetary policy which involves increasing interest rates and reducing the level of money supply. The interest rate policy that the government adopts through the central bank, is also adopted by the whole financial system especially banking institutions. Similarly if the government wants to mop up excess liquidity from the markets, the tools which include open market operations involve the financial markets. This is particularly done by issuing treasury bills through banking institutions.

On the other hand a government adopting a fiscal policy by deliberating influence government expenditure, can involve financial markets especially for the expenditures it incur. This is done through banking institutions when making domestic or international transactions.

8. **Information function**

Global financial markets disseminate information which is vital to investors when they are making decisions regarding which markets to invest in. Through the economic bulletins provided by news agencies in the financial markets such as Reuters, information can be provided which helps savers to make decisions regarding investment. Corporates also access information as to which markets they can invest their surplus funds and on the other hand which debt markets to borrow from. Information dissemination has been aided by the development of the computer technology which has led to real time digital information systems. For example an investor in Zimbabwe can witness the live opening of the New York stock exchange and through the automated quotations, the respective price changes online.

9. Risk diversification function

Global financial markets also act as catalysts for investors to diversify the investment risks across countries. For example a European investor can reduce the exposures associated with the Eurozone crisis by investing in the emerging markets such as South Africa or in the United States. This gives assurance to the investor and offers a sense of protection against risks particular to some regions.

Q15. Explain various Forms of International Financial Markets.

Ans :

Main types and forms of international financial markets. They are:

1. The Foreign Exchange Market
2. Euro Loan or Credit Market
3. Euro Bond Market.

1. The Foreign Exchange Market

Foreign exchange market is not necessarily a physical place, but it is established network of buyer and seller through the latest technology like e-wire, internet, in addition to the postal communication system, through which a currency of one country is converted into the currency of another country. The exchanges of currency from one to another happen to satisfy the need of goods, commodities and services, in addition to invest in financial assets.

Such market is also known as Euro Currency Market. The banks who are involved in euro currency market are generally large sized commercial banks, also known as Euro Banks. Euro banks are involved in acceptance and lend the funds in currencies of the country of the globe, based on need of the citizens of the country where they are operating.

2. Euro Loan or Credit Market

The e-wired or physical market place, where the lending of funds in foreign currency is done for the period of one year or more years is known as Euro credit or Euro Loans market. Euro credit market basically supports the need of corporate, government public sectors, and Non-Government Organisations (NGOs) to operate globally, and to provide their goods, commodities, and services overseas.

3. Euro Bond Market

Euro bond market is a market in which bonds are issued in different currencies other than the currency of the home country in which they are issued. Such bonds are supporting tools for the international firms, government bodies and NGOs to raise capital for long term investment. Euro bonds are normally issued in the currency of the; issuer's home currency in other country's capital market.

Global Scenario of Financial Markets

Prior to 1980, national markets were largely independent of each other. During this period the foreign exchange market and the Euro market alone had the characteristic of being global in their operations. As against this, today there is a greater dependency of national markets. The process of integration has been accelerated due to liberalization and deregulation of economies by various countries.

The emergence of a global unified financial market has resulted in the removal of the distinction between national markets as also between national and offshore markets. The Indian financial markets also started showing signs of integration since 1991. Several measures have been taken by Government of India and the Reserve Bank of India, to ensure the integration of financial markets.

Some of the important measures taken are enumerated below :

a) Deregulation of interest rates;

b) Liberalization of exchange control regulations relating to foreign investments in India;

c) Permission granted to Indian corporates to raise resources in International Financial Markets;

d) Relaxation of control in the end-use of funds raised abroad by issuance of Global Depository Receipts (GDRs), Foreign Currency Convertible Bonds (FCCBs) or by way of External Commercial Borrowings (ECBs);

e) Permission accorded to banks to invest funds mobilized under FCNR(B), EEFC, RFC, etc., in overseas markets. This can be termed as the single most important step in integrat-ing the markets;

(f) Permission given to corporates/banks to deal in derivative products for risk management;

(g) Introduction of Repo/Reverse Repo in government and in certain other types of securities. This has facilitated in influencing call money rates;

(h) Permission granted to banks to initiate cross currency position overseas;

(i) Allowing banks to invest/borrow funds in the overseas market to the extent of 25% of Tier capital. In the case of borrowings, no restrictions were stipulated on end use of funds and on repayment;

(j) Introduction of market determined exchange rates and the conscious decision of the government to borrow at market related interest rate;

(k) Permission accorded to borrow/lend foreign currencies among authorized dealers;

(l) Freedom to banks to fix open position limits and aggregate gap limits subject to approval of RBI;

(m) Removal of interbank borrowings from the purview of CRR/SLR requirements;

Banks can raise rupee resources by sale of foreign currencies for meeting their rupee requirements for lending to corporates provided such lending is profitable. Corporates have been permitted to borrow in INR and/or in foreign currencies, and, also to alternate between the INR loan and the Foreign Currency Loan (FCL).

Corporations will compare the cost of borrowings in INR and in foreign currencies and decide to borrow in the currency on which the effective cost is less. This aspect has also contributed towards the integration of Forex and money markets.

It should however be said here that the swap differentials of currencies may not reflect the interest rate differentials as the Indian markets are not totally free from regulations. The Indian financial markets will also behave in a similar way as the global financial markets when full convertibility in capital account is introduced.

The integration of the various domestic financial markets and the domestic financial markets with the global financial markets will ensure massive cross-border financial flows. Further, the investors will have access to various financial markets in the world and have diversified asset portfolios.

Short Question and Answers

1. Organized Markets.

Ans :

The organized or the formal financial system consists of a network of banks, financial institutions, investment institutions range of financial instruments, that function in developed capital and money markets. Organized financial system comes under the responsibility of MOF - Ministry of Finance, RBI-Reserve Bank of India, SEBI-Securities and Exchange Board of India and some other regulatory bodies. The organized financial system is divided into four components.

2. Capital Market.

Ans :

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three namely:

(i) Industrial securities market

(ii) Government securities market and

(iii) Long term loans market

3. Financial Markets.

Ans :

Financial markets are those mechanisms that enable the participants (borrowers, lender and financial institutions) to handle the financial claims. These markets also facilitate the participants to combine their demands and requirements and to set prices for their claims. In India, the financial markets are classified into money markets and capital markets. Money market deals with short-term securities of maturity period less than one year.

Whereas, capital market deals with long-term securities of maturity period more than one year. Financial markets can also be classified into primary market and secondary market. Primary market deals with the trading of new securities, whereas, secondary market deals with the trading of already existing securities.

4. SEBI

Ans :

Under these circumstances, the government felt the need for setting up to an apex body to develop and regulate the stock market in India. Eventually, the Securities and Exchange Board of India (SEBI) was set up on April 12,1988. To start with, SEBI was set up as a non-statutory body.

It took almost four years for the government to bring about a separate legislation in the name of Securities and Exchange Board of India Act, 1992 conferring statutory powers. The Act, charged to SEBI with comprehensive powers over practically all aspects of capital market operations.

5. Types of financial markets.

Ans :

(i) Unorganised Markets

In these markets there are a number of money lenders, indigenous bankers, traders etc., who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc., whose activities are not controlled by the RBI. Recently the RBI has taken steps to bring private finance companies and chit funds under its strict control by issuing non-banking financial companies (Reserve Bank) Directions, 1998. The RBI has already taken some steps to bring the unorganised sector under the organized fold. They have not been successful. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardised.

(ii) Organized Markets

In the organized markets, there are standardised rules and regulations governing their financial dealings. There is also a high degree of institutionalisation and instrumentalisation. These markets are subject to strict supervision and control by the RBI or other regulatory bodies.

These organized markets can be further classified into two. They are:

1. Capital market
2. Money market

6. RBI

Ans :

The RBI Act, 1934 is a primary legislation for regulating banking services in India. The Reserve Bank of India is given the authority to control all banks from their establishment till their windup. The Act specifies that the direct discounts should be given to customers during special occasions for regulating credit in trade, agriculture and industry.

RBI is a monetary authority and central bank of the country. It has the power to manage, develop and regulate the financial system.

7. Indian Finance System.

Ans :

The economic development of any country depends upon the existence of a well organized financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promote the well being and standard of living of the people of a country. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system. The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilise the savings in the form of money and monetary assets and invest them in productive ventures. As efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development.

8. Financial Instruments

Ans :

A financial instrument is a claim against an institution or a person regarding the payment to be made at a future date in the form of dividend/ interest. Financial instruments are categorised on the basis of term and type. On the basis of 'term', financial institutions are divided into three categories - short-term, medium and long term. On the basis of 'type', they are divided into two categories primary securities and secondary securities. Primary securities also known as direct securities, are issued by the real borrowers of funds to the real savers. Examples: Equity shares and debentures. Secondary securities also known as indirect securities are issued by the financial institution to the real saver. Examples: Bank deposit, mutual funds and insurance policies.

9. Financial Services

Ans :

Financial institutions provide key financial services such as depositories, custodial, credit rating, factoring, forfeiting, merchant banking, leasing, hire purchase, guaranteeing, portfolio management, underwriting. Financial services play a vital role in creating the firms, expanding the industries and attaining economic growth.

10. Financial Institutions.

Ans :

Financial institutions are intermediaries that mobilize savings and help in the allocation of funds in an appropriate way. Financial institutions are classified into four segments - Banking Institutions, non-banking Institutions and Investment Institutions like-mutual funds and housing finance companies. Financial institutions include,

(a) Non-banking financial institutions like DFIs, NBFCs, HFCs etc.

(b) Term-finance institutions like IDBI, ICICI, IFCI, SIDBI and IIBI.

(c) Specialized Financial Institutions like EXIM, TFCI, IDFC, NABARD, NHB.

(d) Mutual Funds such as UTI.

11. Government Securities Market.

Ans :

It is otherwise called Gilt-Edged securities market. It is a market where Government securities are traded. In India there are many kinds of Government Securities short-term and long-term. Long-term securities are traded in this market while short term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi-Government authorities like City Corporations, Port Trusts etc. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

Government securities are issued in denominations of Rs.100. Interest is payable half-yearly and they carry tax exemptions also. The role of brokers in marketing these securities is practically very limited and the major participant in this market is the “commercial banks” because they hold a very substantial portion of these securities to satisfy their S.L.R. requirements.

The secondary market for these securities is very narrow since most of the institutional investors tend to retain these securities until maturity.

The Government securities are in many forms. These are generally:

- Stock certificates or inscribed stock
- Promissory Notes
- Bearer Bonds which can be discounted.

12. Treasury Bills Market.

Ans :

It is a market for treasury bills which have ‘short-term’ maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because its repayment is guaranteed by the Government. It is an important instrument for short-term borrowing of the Government. There are two types of treasury bills namely (i) ordinary or regular and (ii) ad hoc treasury bills popularly known as ‘ad hoes’.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short-term financial needs. Ad hoc treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only. Ad hoes are not marketable in India but holders of these bills can sell them back to RBI. Treasury bills have a maturity period of 91 days or 182 days or 364 days only. Financial intermediaries can park their temporary surpluses in these instruments and earn income.

Choose the Correct Answers

1. Banks implement the RBI's ________ policies. [d]
   (a) Monetary (b) Credit
   (c) Commercial (d) Both a and b
2. ________ is basically a savings and investment corporation. [a]
   (a) UTI (b) IDBI
   (c) SBI (d) RBI
3. Financial services through the network of elements such as ________, serve the needs of individuals, institutions and Corporate. [d]
   (a) Financial institutions (b) Financial markets
   (c) Financial instruments (d) All of the above
4. ________ is regarded as the fourth element of the financial system. [a]
   (a) Financial services (b) Financial markets
   (c) Financial instruments (d) Financial institutions
5. The term ________ is defined as a central location for keeping securities on deposit. [a]
   (a) Depository (b) Instrument
   (c) Institutions (d) None of the above
6. Functions of financial services exclude ________. [d]
   (a) Mobilization of savings (b) Allocation of fund
   (c) Specialized services (d) Collection of tax.
7. Financial service companies exclude ________. [c]
   (a) Commercial banks (b) Insurance companies
   (c) Sole proprietorship (d) Crepitating agencies.
8. The following one is a financial asset : [c]
   (a) gold (b) silver
   (c) share (d) land
9. Which one of the following is a cash asset? [a]
   (a) deposit created out of loans (b) share
   (c) bond (d) post office certificate.
10. The component of a capital market is : [b]
    (a) Treasury Bill Market (b) Government securities Market
    (c) Commercial Bill Market (d) (a) and (b) together.
11. The money market instrument is: [d]
    (a) Bond (b) Debenture
    (c) Stock certificate (d) Certificate of deposit
12. Government Bond is a : [b]
    (a) Short-term security (b) Long-term security
    (c) Medium term security (d) Either short-term or long-term security

13. Financial service institutions pool up savings of small investors to raise funds is ______ [a]
    (a) Mutual funds (b) Factoring
    (c) Leasing (d) Hire purchase
14. In India, the challenges faced by financial service sector are ______ [d]
    (a) No transparency (b) Outdated database
    (c) Need for specialisation (d) All the above
15. Debt market comprises of ______ [d]
    (a) Corporate debt market (b) Govt, securities market
    (c) Money market (d) All the above
16. Which of the following is not a fund-based activity? [b]
    (a) Underwriting of shares
    (b) Capital issue management
    (c) Underwriting of secondary market securities
    (d) Foreign exchange activities
17. The capital market involves, [c]
    (a) Primary market (b) Secondary market
    (c) Both (a) and (b) (d) Money market
18. Financial markets improve economic welfare because ______. [d]
    (a) They allow funds to move from those without productive investment opportunities to those who have such opportunities.
    (b) They allow consumers to time their purchase better.
    (c) They weed out inefficient firms.
    (d) They do (a) and (b) of the above.
19. A breakdown of financial markets can result in ______. [c]
    (a) An efficient allocation of capital (b) Rapid economic growth
    (c) Political instability (d) Stable prices
20. Which of the following can be described as direct finance? [b]
    (a) You take out a mortgage from your local bank.
    (b) You borrow ` 2500 from a friend.
    (c) A pension fund lends money to General Motors.
    (d) You buy shares in a mutual fund.
21. Commercial Bills are a part of which of the following markets? [a]
    (a) Organized money market (b) Unorganized money market
    (c) Stock market (d) None of the above
22. Reserve Bank of India's functions are classified into ______. [a]
    (a) Supervisory and Regulatory (b) Promotional and Developmental
    (c) Refinance Activities (d) All of the above

Fill in the Blanks

1. ________ assets are mostly useful for consumption.
2. The market for new issues is called ________ market.
3. Loan against the security of immovable property is called ________.
4. ________ guarantee cover the payment of earnest money, retention money and advance payments.
5. The SHCIL was set up in the year ________.
6. ________ is the set of interrelated and interconnected components consisting of financial institutions, markets, and securities.
7. ________ intermediation should provide convenience for mobilizing saving to be converted into investment.
8. ________ are intermediations where the general public or the business organization come together to get their fund requirement fulfilled.
9. Financial instruments can also be called ________.
10. ________ securities directly issued by the ultimate investors to the ultimate savers.
11. ________ securities are those which mature within a period of one year.
12. ________ securities are those which have a maturity period of more than five years.
13. A ________ market can be defined as the market in which financial assets are created or transferred.
14. The ________ market is designed to finance the long-term investments.
15. NBFC stands for ________.
16. SDR stands for ________.
17. In a ________ contract, the counterparties agree to exchange, on a specified date, a specified quantity of an underlying item.
18. A ________ is an obligation to make payment against documents received.
19. ADR stands for ________.
20. Private markets use ________ to raise capital denominated in either U.S. dollars or euros.
21. ________ statement for a sector is simply the integration of its income statement with its balance sheet.
22. ________ is defined as the different between assets and liabilities.

Answers

1. Physical
2. Primary
3. Mortgage
4. Performance
5. 1987
6. Financial system
7. Financial
8. Financial Markets
9. Financial securities
10. Primary
11. Short-term
12. Long-term
13. Financial
14. Capital
15. Non Bank Financial Institutions.
16. Special Drawing Rights.
17. Forward
18. Letter of credit
19. American Depositary Receipt.
20. GDRs
21. Sources and uses of funds
22. Net worth

One Mark Answers

1. Expand RBI.

Ans :

Reserve Bank of India

2. Capital Market.

Ans :

The capital market is a market for financial assets which have a long or indefinite maturity.

3. Call Money Market.

Ans :

The call money market is a market for extremely short period loans say one day to fourteen days.

4. Treasury Bills Market.

Ans :

A treasury bill is a promissory note or a finance bill issued by the Government.

5. Expand SEBI.

Ans :

Securities and Exchange Board of India.

6. Financial Institutions.

Ans :

Financial institutions are intermediaries that mobilize savings and help in the allocation of funds in an appropriate way.

UNIT II	**PRIMARY AND SECONDARY MARKET** Primary Market – Introduction, Book Building, Free Pricing, Underwriting, On-Line IPOs, e-Prospectus; Secondary Market – Organisation of Stock Exchanges, NSE, BSE and OTCEI, Listing of Securities, Trading and Settlement, Internet Trading, New financial instruments.

2.1 Primary Market

2.1.1 Introduction

Q1. Define Primary Market.

(OR)

What is meant by New issue Market?

Ans : **(July-21, Dec.-20, Dec.-18, July-19)**

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

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

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

Q2. What are the functions of primary market?

(OR)

Write an essay on the functions of New Issue Market.

Ans :

New issue market basically aims at providing adequate, monetary resources to the companies from the investors. With the help of such resources, a private or partnership ltd. Company can be transformed into a public ltd company. At the same time with the help of these resources, the existing public ltd companies can effectively expand and diversify their operations. The important functions of new issue market are as follows,

(i) Origination

(ii) Underwriting

(iii) Distribution

(i) Origination

Origination basically includes the activities which facilitates the issuers of shares in decision making process with respect to price, size, time, terms and conditions, methods and so on. Investigation, review analysis, authenticating and other consultative services constitutes origination.

(ii) Underwriting

Underwriting is one of the key function of new issue market. Basically in the process of underwriting, an underwriter gives an assurance to the issuer of shares about the successful subscription of all the shares. The subscription may be done either by the investors or through the underwriter himself or by both.

(iii) Distribution

The act of selling securities to the specific investors is known as "Distribution" in new issue market. Distribution is carried out by brokers, agents, sub-brokers and dealers whose main task is to sell securities to the interested investors.

New Instruments Introduced in New Issue Market

The various new instruments introduced in new issue market are as follows,

(i) Prospectus: The issue of prospectus helps in raising the capital. It is a call made to the general public for endorsing towards the capital. It must include all the details with respect to the company.

(ii) Offer for Sale: This approach is quite same as that of the prospectus approach with one difference. In offer for sale, a third party takes up the shares in large quantities.

(iii) Private Placing: In this method, the shares are directly sold by making private appeal to the institutions and individuals.

(iv) Offering Right Issue: By making right issue, the firms can raise capital from the present shareholders.

Q3. State the features of Primary Market.

Ans :

1. It is related with New Issues

The first important feature of the primary market is that it is related with the new issues. Whenever a company issues new shares or debentures, it is known as Initial Public Offer (IPO).

2. It has No Particular Place

Primary market is not the name of any particular place but the activity of bringing in new issues is called the primary market.

3. It has Various Methods of Floating Capital

Following are the methods of raising capital in the primary market:

i) Public Issue : Under this method, the company issues a prospectus and invites the general public to purchase shares or debentures.

ii) Offer for Sale : Under this method, firstly the new securities are offered to an intermediary (generally firms of stock brokers) at a fixed price. They further resell the same to the general public. The advantage of doing this is that the issuing company feels free from the tedious work of making a public issue.

iii) Private Placement : Under this method, the company sells securities to the institutional investors or brokers instead of selling them to the general public. They, in turn, sell these securities to the selected clients at a higher price. This method is preferred as it is a cheaper method of raising funds as compared to a public issue.

iv) Right Issue : This method is used by those companies who have already issued their shares. When an existing company issues new shares, first of all it invites its existing shareholders. This issue is called the right issue. In this case, the shareholder has the right either to accept the offer for himself or assign a part or all of his right in favour of another person.

v) Electronic Initial Public Issue (e-IPOs) : Under this method, companies issue their securities through the electronic medium (i.e. internet). The company issuing securities through this medium enters into a contract with a Stock Exchange.

SEBI registered broker have to be appointed for the objective of accepting applications. This broker regularly sends information about it to the company.

The company issuing security also appoints a Registrar, who helps in making the issue a success by establishing contact with the stock exchange. (Whatever method, out of the above five is adopted, it is the activity of the primary market.)

4. It Comes before Secondary Market

The transactions are first made in the primary market. The turn of the secondary market comes later.

Q4. What are the Methods of Raising Funds in Primary Market?

Ans :

1. Offer through Prospectus

This is a method of public issue. It is also the most used method in the primary market to raise funds. Here the company invites the investors (general members of the public) to invest in their company via an advertisement also known as a prospectus.

After a prospectus is issued, the public subscribes to shares, debentures etc. As per the response, shares are allotted to the public. If the subscriptions are very high, allotment will be done on lottery or pro-rata basis.

The company can sell the shares directly to the public, but it generally hires brokers and underwriters. Merchant banks are another option to help out with the process, especially Initial Public Offerings.

2. Private Placement

Public offers are an expensive affair. The incidental costs of IPO's tend to be very high. This is why some companies prefer not to go down this route. They offer investment opportunities to a select few individuals.

So the company will sell its shares to financial institutes, banks, insurance companies and some select individuals. This will help them raise the funds efficiently, quickly and economically. Such companies do not sell or offer their securities to the public at large.

3. Rights Issue

Generally, when a company is looking to expand or are in need of additional funds, they first turn to their current investors. So the current shareholders are given an opportunity to further invest in the company. They are given the "right" to buy new shares before the public is offered the chance.

This allotment of new shares is done on pro-rata basis. If the shareholder chooses to execute his right and buy the shares, he will be allotted the new shares. However, if the shareholder chooses to let go of his rights issue, then these shares can be offered to the public.

4. e-IPO

It stands for Electronic Initial Public Offer. When a company wants to offer its shares to the public it can now also do so online. An agreement is signed between the company and the relevant stock exchange known as the e-IPO.

This system was introduced in India some three years ago by the SEBI. This makes the process of the IPO speedy and efficient. The company will have to hire brokers to accept the applications received. And a registrar to the issue must also be appointed.

2.1.2 Book Building

Q5. Explain the concept of Book Building.

Ans :

Book building is a price discovery mechanism that is used in the stock markets while pricing securities for the first time. When shares are being offered for sale in an IPO, it can either be done at a fixed price. However, if the company is not sure about the exact price at which to market its shares, it can decide a price range instead of an exact figure. This process of discovering the price by providing the investors with a price range and then asking them to bid on it is called the book building process. It is considered to be one of the most efficient mechanisms of pricing securities in the primary market. This is the preferred method which is recommended by all major stock exchanges and as a result is followed in all major developed countries in the world.

Process

The detailed process of book building is as follows:

1. Appointment of Investment Banker

The first step starts with appointing the lead investment banker. The lead investment banker conducts due diligence. They propose the size of the capital issue that must be conducted by the company. Then they also propose a price band for the shares to be sold. If the management agrees with the propositions of the investment banker, the prospectus is issued with the price range as suggested by the investment banker.

The lower end of the price range is known as the floor price whereas the higher end is known as the ceiling price. The final price at which securities are indeed offered for sale after the entire book building process is called the cut-off price.

2. Collecting Bids

Investors in the market are requested to bid to buy the shares. They are requested to bid the number of shares that they are willing to buy at varying price levels. These bids along with the application money are supposed to be submitted to the investment bankers. It must be noted that it is not a single investment banker who is engaged in the collection of bids. Rather, the lead investment banker can appoint sub-agents to tap into their network especially for receiving the bids from a larger group of individuals.

3. Price Discovery

Once all the bids have been aggregated by the lead investment banker, they begin the process of price discovery. The final price chosen in simply the weighted average of all the bids that have been received by the investment banker. This price is declared as the cut-off price. For any issue which has received substantial publicity and which is being anticipated by the public, the ceiling price is usually the cut-off price.

4. Publicizing

In the interest of transparency, stock exchanges all over the world require that companies make public the details of the bids that were received by them. It is the lead investment banker's duty to run advertisements containing the details of the bids received for the purchase of shares for a given period of time (let's say a week). The regulators in many markets are also entitled to physically verify the bid applications if they wish to.

5. Settlement

Lastly, the application amount received from the various bidders has to be adjusted and shares have to be allotted. For instance, if a bidder has bid a lower price than the cut-off price then a call letter has to be sent asking for the balance money to be paid. On the other hand, if a bidder has bid a higher price than the cut-off, a refund cheque needs to be processed for them. The settlement process ensures that only the cut-off amount is collected from the investors in lieu of the shares sold to them.

Partial Book Building

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

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

Q6. Explain the various types of book building.

Ans :

Three types of options have been provided by SEBI to the issuer companies under book building. These options are as follows:

1. 75% Book Building, 25% Fixed Price Offer

In this type of offer, 75% of the issue is offered to institutional investors who participated in the bidding process. Balance 25% is offered to the public through prospectus and shall be reserved for allocation to individual investors who had not participated in the bidding process. The price for

25% offer is the price as determined through book building. First, the book building portion remains open for 3 to 7 days and on discovery of issue price after the completion of book building process, the fixed price portion opens for subscription.

2. 90% Book Building, 10% Fixed Price Offer

Here issuer company offers 90% of the issue through book building and the balance 10% through fixed price offer at a price discovered through book building. This option was available to the issuers during 1999-2000 and 2000-01 and later on discontinued by SEBI.

3. 100% Book Building Offer

In this type of offer, the whole issue is offered through book building route. Issue opens and closes on the same dates for all categories of investors. Different categories of bidders bid at the point of time. This type of issue takes minimum number of days for the completion of the process of issue and allotment of shares. Generally, the issue is listed on a Recognized Stock Exchange after 3 weeks from the closure of the issue (2 weeks for completion of allotment +1 week for completion of listing formalities).

The principal parties/intermediaries involved in a book building process are:

(a) The Company.

(b) A Book Running Lead Manager who is a category I Merchant Banker registered with SEBI. The book running lead manager is also the lead merchant banker.

(c) Syndicate members who are intermediaries registered with SEBI and who are permitted to carry on activities as underwriters. Syndicate members are appointed by the book running lead manager.

Q7. What are the benefits of Book Building?

Ans :

Book building helps in evaluating the intrinsic worth of the instrument being offered and the company's credibility in the eyes of public. The entire exercise is done on a wholesale basis.

(a) Price of instrument is determined in a more realistic way on the commitments made by the prospective investors to the issue.

(b) The prime objective of book building process is to determine the highest market price for shares and securities and demand level from highest quality investors in order to adjust pricing and allocation decision.

(c) Book building is a process of fixing price for an issue on feedback from potential investors on how they are willing to bid to pick up issues and instruments.

(d) The process of book building is advantageous to the issuer company as the pricing of issue would be more realistic as the final price is decided about 11 to 12 days before the opening of the issue. Book building also offers access to capital more quickly than the public issue.

(e) As the issue is pre-sold, there would be no uncertainties relating to the fate of the issue involved.

(f) The Issuer company saves advertising and brokerage commissions.

(g) Issuers can choose investors by quality.

(h) Investors have a voice in the pricing of issues. They have a greater certainty of being allotted what they demand. Investors need not lockup huge amounts of capital with the Issuer as they pay at the end of the process.

(i) The issue price is market-determined. As it is a distant possibility that the market price of the shares would fall lower than the issue price. Hence, the investor is less likely to suffer from erosion of his investment on listing.

(j) Optimal demand based pricing is possible.

(k) Efficient capital raising with improved issue procedures, leading to a reduction in issue costs, paper work and lead times.

(l) Flexibility to increase/decrease price and/or size of offering the issues is possible.

(m) Transparency of allocations is made.

(n) Upgraded information flow of issues, lead managers, syndicate members and investors is made possible.

(o) Book-building process inspires investors confidence leading to a larger investor universe.

(p) Book-building process creates a liquid and buoyant after market.

(q) As the syndicate members will get firm allocation, the investors to that extent are assured of allotment.

(r) Immediate allotment and listing of placement portion of securities.

Q8. State the limitations of Book Building.

Ans :

The book-building system has various limitations, some of these limitations are summarized as follows:

1. Book building is appropriate for mega issues only. In the case of small issues, the companies can adjust the attributes of the offer according to the preferences of the potential investors. It may not be possible in big issues, since the risk-return preference of the investors cannot be estimated easily.
2. The issuer company should be fundamentally strong and well known to the investors.
3. The book building system works very efficiently in matured market conditions. In such circumstances, the investors are aware of various parameters affecting the market price of the securities. But, such conditions are not commonly found in practice.
4. There is a possibility of price rigging on listing as promoters may try to bailout syndicate members.

2.1.3 Free Pricing

Q9. Explain the concept of Free Pricing.

Ans : **(Dec.-19)**

Primary markets are markets where companies or issuers seek to raise capital from outsiders by issuing securities to them in form of equity and debt. It is called the primary market because investors purchase the security directly from the issuer. It is also called the "new issue market" where securities are issued for the first time.

Pricing of public issues is the most contentious issue in the management of public issues. In case of follow-on public offerings, the pricing of securities is known to some extent from the prices quoted on the floor of the stock exchange. However, in case of Initial Public Offerings (IPOs), the determination of offer price is more complicated. The disclosures made in the offer documents are new to the investors and the performance of the company is yet to be tested in the secondary market. The role of the lead merchant banker acting as issue managers, thus, becomes more important with respect to pricing of IPOs.

Pricing a Public Issue

SEBI regulations allow an issuer to decide the price at which the shares will be allotted to investors in a public issue. This can either be fixed by the issuer in consultation with the managers of the issue or it can be determined by a process of bidding by investors. Based on the method used to determine the price, a public issue can be categorized as:

1. Fixed price issue

In a fixed price issue of shares to the public, the company in consultation with the lead manager would decide on the price at which the shares will be issued. Here the investors know well in advance about the share price that the company is offering. The company decides the price based on the expected performance of the company and consequent increase in the share price.

2. Book Building issue

The objective of a book building process is to identify the price that the market is willing to pay for the securities being issued by the company. Thus unlike fixed price issue the price of book building issue is decided by investors in the market and not the company. To be precise, a price range known as price band of equity shares is declared by the company.

Interested investors can bid within the price band and the prices must be above the floor price i.e the lowest price mentioned in price band. Once the bids are received from investors to issuing company, it is evaluated and the best price according to demand of investors , falling within price band is selected. This price is then called the cut-off price.All investors who bid at , or above the cutoff price are successful bidders and are eligible for allotment of shares.

A reference to a security that has been registered issued and is being sold on a market to the public for the first time. New issues are sometimes referred to as primary shares or new offerings. The term does not necessarily refer to newly issued stocks, although initial public offerings are the most commonly known new issues. Securities that can be newly issued include both debt and equity.

Many investors buy new issues because they often experience tremendous demand and, as a result, rapid price increases. Other investors don't believe that new issues warrant the type that they receive and choose to watch from the sidelines. An investor who purchases a new issue should be aware of all the risks associated with investing in a product that has only been available to the public for a short time; new issues often prove to be rather volatile and unpredictable.

Companies are permitted to price their issues at premium in case of the following

First issue of new companies set up by existing companies with the track record.

- First issue of existing private/closely held or other existing unlisted companies with three-year track record of consistent profitability.
- First public issue by existing private/closely held or other existing unlisted companies without three year track record but promoted by existing companies with a five-year track record of consistent profitability.
- Existing private/closely held or other existing unlisted company with three-year track record of consistent profitability, seeking disinvestments by offers to public without issuing fresh capital (disinvestments).
- Public issue by existing listed companies with the last three years of dividend paying track record. At par value: The price of the share should be at par in case of: a) First public issue by existing private, closely held or other existing unlisted companies without three year track record of consistent profitability and
- Existing private/closely held and other unlisted companies without three-year track record of consistent profitability seeking disinvestments offer to public without issuing fresh capital (disinvest-ments).

2.1.4 Underwriting

Q10. Define Underwriting. Explain the methods of Underwriting.

Ans : **(Dec.-18)**

Meaning

Underwriting is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed, then there is no liability for the underwriter. If a part of share issues remains unsold, the underwriter will buy the shares. Thus, underwriting is a guarantee for the marketability of shares.

Method of Underwriting

An underwriting agreement may take any of the following three forms:

(i) Standing behind the Issue

Under this method, the underwriter guarantees the sale of a specified number of shares within a specified period. If the public do not subscribe to the specified amount of issue, the underwriter buys the balance in the issue.

(ii) Outright Purchase

The underwriter, in this method, makes outright purchase of shares and resells them to the investors.

(iii) Consortium Method

Underwriting is jointly done by a group of underwriters in this method. The underwriters form a syndicate for this purpose. This method is adopted for large issues.

Q11. State the advantages of Underwriting.

Ans :

Underwriting assumes great significance as it offers the following advantages to the issuing company.

1. The issuing company is relieved from the risk of finding buyers for the issue offered to the public. The company is assured of raising adequate capital.
2. The company is assured of getting the minimum subscription within the stipulated time, a statutory obligation to be fulfilled by the issuing company.
3. Underwriters undertake the burden of highly specialised function of distributing securities.
4. They provide expert advice with regard to timing of security issue, the pricing of issue, the size and type of securities to be issued etc.
5. Public confidence on the issue is enhanced when underwritten is done by reputed underwriters.

The underwriters in India may be classified into two categories:

(i) Institutional underwriters.

(ii) Non-institutional underwriters.

2.1.5 On-Line IPOs

Q12. Explain Initial Public Offering (IPO).

Ans : **(Dec.-18)**

An IPO stands for Initial Public Offering, wherein a company issues its shares to the public for the first time. Investors can place requests to buy these shares and once done, the share gets listed in a registered stock exchange and the company uses the share issue proceeds for its development/ growth. Before we take a look at the steps in an IPO process, lets take a look at the entry norms for an IPO.

Entry Norms for an IPO

Not all company's can issue shares to the public. SEBI has provided a list of requirements that need to be met by a company if they wish to go public. A company that wishes to go public needs to meet all of the below mentioned criteria…

Entry Norms I or EN I

1. Net Tangible assets of atleast Rs. 3 crores for 3 full years
2. Distributable profits in atleast 3 years
3. Net worth of atleast 1 crore in 3 years
4. If there was a change in name, atleast 50% of the revenue in the preceding year should be from the new activity
5. The issue size should not exceed 5 times the pre-issue networth of the company

To provide sufficient flexibility and also to ensure that genuine companies do not suffer on account of rigidity of the above mentioned rules, SEBI has provided 2 alternate routes to company's that do not satisfy the criteria for accessing the primary market. They are as follows:

Entry Norms II or EN II

1. Issue shall be only through the book building route with atleast 50% allotted mandatorily to Qualified Institutional Buyers (QIBs)
2. The minimum post issue face value capital shall be Rs. 10 crores or there shall be a compulsory market-making for atleast 2 years.

OR

Entry Norms III or EN III

1. The "Project" is appraised and participated to the extent of 15% by FI's/Scheduled Commercial Banks of which atleast 10% comes from the appraiser(s).

2. The minimum post issue face value capital shall be Rs. 10 crores or there shall be a compulsory market-making for atleast 2 years

3. In addition to the above mentioned 2 points, the company shall also satisfy the criteria of having atleast 1000 prospective allotees in future.

Q13. Explain various steps involved in IPO.

Ans :

Let us now have a look at how an initial public offering process is initiated and reaches its conclusion. The entire process is regulated by the 'Securities and Exchange Board of India (SEBI)', to prevent the possibility of a fraud and safeguard investor interest.

Selection of Investment Bank

The first thing that company management must do when they have taken a unanimous decision to go public is to find an investment bank or a conglomerate of investment banks that will act as underwriters on behalf of the company. Underwriter's buy the shares of the company and resell them to the general public.

The company must also hire lawyers that can guide them through the legal maze that an IPO setup can be. It must be ready with detailed financial records for intensive fiscal health scrutiny that SEBI would perform. Some companies may also opt to directly sell their shares through the stock market, but most prefer going through the underwriters.

Step 1: Preparation of Registration Statement

To begin an IPO process, the company involved must submit a registration statement to the SEBI, which includes a detailed report of its fiscal health and business plans. SEBI scrutinizes this report and does its own background check of the company. It must also see that registration statement fulfils all the mandatory requirements and satisfies all rules and regulations.

Step 2: Getting the Prospectus Ready

While awaiting the approval, the company, with assistance from the underwriters, must create a preliminary 'Red Herring' prospectus. It includes detailed financial records, future plans and the specification of expected share price range. This prospectus is meant for prospective investors who would be interested in buying the stock. It also has a legal warning about the IPO pending SEBI approval.

Step 3: The Roadshow

Once the prospectus is ready, underwriters and company officials go on countrywide 'roadshows', visiting the major trade hubs and promote the company's IPO among select few private buyers (Usually corporates or HNIs). They are fed with detailed information regarding company's future plans and growth potential. They get a feel of investor response through these tours and try to woo big investors.

Step 4: SEBI Approval & Go Ahead

Once SEBI is satisfied with the registration statement, it declares the statement to be effective, giving a go ahead for the IPO to happen and a date to be fixed for the same. Sometimes it asks for amendments to be made before giving its approval. The prospectus cannot be given to the public without the amendments suggested by SEBI. The company needs to select a stock exchange where it intends to sell its shares and get listed.

Step 5: Deciding On Price Band & Share Number

After the SEBI approval, the company, with assistance from the underwriters decide on the final price band of the shares and also decide the number of shares to be sold.

There are two types of issues: Fixed Price and Book Building

i) **Fixed Price:** In a Fixed price issue – the company decides the price of the share issue and the number of shares being sold. Ex: ABC Ltd. public issue of 10 lakh shares of face value Rs. 10/- each at a premium of Rs. 55/- each is available to the public thereby generating Rs. 6.5 Crores.

ii) **Book Building:** A Book building issue helps the company discover the price of the issue. The company decides a price band and it gives the investor an option to choose the price at which he/she wishes to bid for the company shares. Ex: ABC Ltd issue of 10 lakh shares of face value Rs. 10/- each at a price band of Rs. 60 to 70 is available to the public thereby generating upto Rs. 7 Crores.

Here the amount generated through the issue would depend on the highest amount bid by most investors.

Step 6: Available to Public for Purchase

On the dates mentioned in the prospectus, the shares are available to public. Investors can fill out the IPO form and specify the price at which they wish to make the purchase and submit the application. This open period usually lasts for 5 working days which is a SEBI requirement.

Step 7: Issue Price Determination & Share Allotment

Once the subscription period is over, members of the underwriting banks, share issuing company etc will meet and determine the price at which shares are to be allotted to the prospective investors. The price would be directly determined by the demand and the bid price quoted by investors. Once the price is finalized, shares are allotted to investors based on the bid amounts and the shares available.

Note: In case of oversubscribed issues, shares are not allotted to all applicants.

Step 8: Listing & Refund

The last step is the listing in the stock exchange. Investors to whom shares were allotted would get the shares credited to their DEMAT accounts and for the remaining the money would be refunded.

Q14. How to apply IPO's in online?

Ans :

To apply in IPO's online, an investor has to open an demat account / trading account with financial institution that provide this facility. Most national banks (SBI, HDFC, ICICI, PNB etc.) and popular stock brokers (Sharekhan, Angel etc.) in India offers facility to apply IPO's online. Once account is open one should follow below steps to apply online.

1. First login in your trading account and select the IPO you wish to invest in.
2. Transfer funds from your bank account to your trading account.
3. Select the number of shares you want to apply for and the price at which you want to bid for (or use cut off option) and then press submit button.

If you get the allotment, the shares will be credited to your demat account. The remaining money will be credited to your bank account through ECS.

The most convenient way to apply in an IPO online is using 3-in-1 account offered by banks including ICICI Direct, HDFC Securities, Kotak Security etc.

The process of applying IPO's online is extremely convenient. It takes just 2 minutes to order IPO shares online.

Q15. Explain SEBI guidelines for IPOs.

Ans :

The SEBI has been issuing guidelines from time to time with regard to IPOs so as to protect the interest of investors and also to promote a healthy capital market in the country. Some of the important guidelines pertaining to IPO's are :

1. All allotments have to be made within 30 days of the closure of the public issue and 42 days in the case of a rights issue.
2. The set offer to the general public has to be at least 25% of the total issue size for listing on a stock exchange. For listing an IPO on the NSE :
   (a) The paid up capital should be Rs. 20 crores.
   (b) The issuing company should have a track record of profitability.
   (c) The project should be appraised by a financial institution or a commercial bank or category I merchant banker.
3. In case an issue exceeds more than Rs. 100 crores, the issue is allowed to place the whole issue through book-building.
4. A minimum of 50% of the net offer to the public has to be reserved for investors applying for less than 1000 shares.
5. All listing formalities for a public issue have to be completed within 70 days from the date of closure of the subscription list.
6. There should be at least 5 investors for every Rs. 1 lakh of equity offered.

7. The PAN or GIR number should be compulsory quoted in the application where the monetary value of investment is Rs. 50,000 or above.

8. The subscription list for public issues shall be kept open for at least 3 working days and not more than 10 working days.

2.1.6 e-Prospectus

Q16. What is meant by e-Prospectus?

Ans :

e-Prospectus stands for electronic Prospectus means a form of Prospectus, and any amendment or supplement thereto, that meets each of the following conditions:

As used herein, the term "electronic Prospectus" means a form of Time of Sale Prospectus, and any amendment or supplement there to, that meets each of the following conditions:

(i) It shall be encoded in an electronic format, satisfactory to the Underwriter, that may be transmitted electronically by the Underwriter to offerees and purchasers of the Securities;

(ii) It shall disclose the same information as the paper Time of Sale Prospectus, except to the extent that graphic and image material cannot be disseminated electronically, in which case such graphic and image material shall be replaced in the electronic Prospectus with a fair and accurate narrative description or tabular representation of such material, as appropriate; and

(iii) It shall be in or convertible into a paper format or an electronic format, satisfactory to the Underwriter, that will allow investors to store and have continuously ready access to the Time of Sale Prospectus at any future time, without charge to investors.

Q17. Discuss the pricing strategies in Indian.

Ans : **(July-21, July-19, Dec.-18)**

Price is the value that is put to a product or service and is the result of a complex set of calculations, research and understanding and risk taking ability. A pricing strategy takes into account segments, ability to pay, market conditions, competitor actions, trade margins and input costs, amongst others. It is targeted at the defined customers and against competitors.

There are several pricing strategies:

i) **Premium pricing:** High price is used as a defining criterion. Such pricing strategies work in segments and industries where a strong competitive advantage exists for the company.

Example: Porche in cars and Gillette in blades.

ii) **Penetration pricing:** Price is set artificially low to gain market share quickly. This is done when a new product is being launched. It is understood that prices will be raised once the promotion period is over and market share objectives are achieved. Example: Mobile phone rates in India; housing loans etc.

iii) **Skimming strategy:** High price is charged for a product till such time as competitors allow after which prices can be dropped. The idea is to recover maximum money before the product or segment attracts more competitors who will lower profits for all concerned

Example: The earliest prices for mobile phones, VCRs and other electronic items where a few players ruled attracted lower cost Asian players

2.2 Secondary Market

Q18. What is meant by Secondary Market?

Ans : **(July-21, July-19, Dec.-18)**

A secondary market is the market in which the remaining or the existing securities are traded between the investors. Secondary market helps the investors by providing them a mechanism for trading the existing securities. In this market, securities are resold when investors consider these securities as attractive opportunities. Secondary market is the place where common and preferred stock, warranty, bonds and puts and calls are traded among the investors.

Q19. Explain the various functions of Stock Exchange.

(OR)

Write about the functions of stock exchange.

Ans : **(July-21, July-19)**

In a capitalistic type of economic, it is necessary to hWfc-a well-organized and perfectly controlled stock exchange. A stock exchange carries out various useful economic functions as follows,

1. **Offers Organized Market for Securities:** The main function of a stock exchange is to provide a liquid and consistent market for securities. It is a ready market for securities wherein the buyers and seller of securities can meet and carries out the securities transaction.

2. **Offers Liquidity to Securities:** Stock exchanges offer liquidity facility to securities as the securities can be changed into cash anytime as per the wish of investors by simply selling them at the market prices. This helps in encouraging the investors to invest in capital market.

3. **Offers Safety to Funds:** Stock exchanges assures the protection of invested funds as they need to operate by following the rules and regulations and the bye laws. Implementation of set of rules helps in avoiding the over-trading, illegitimate speculation, insider trading and so on which further encourages the confidence levels of the investors.

4. **Indicates Trends in Business Cycle:** The stock exchanges are easily affected by economics, political and social changes of the national economy as well as the international markets. The index of share prices highlights the boom or depression conditions that exist in the company, in the industry and the economy as a whole.

5. **Facilitates the Marketing of New Issues:** The companies which list their shares on the stock exchange have greater acceptability in the market as stock exchanges offer a ready market for listed securities. The underwriting cost of such issues is less even the public responses are high and positive to new issues.

6. **Enables Collateral Lending by the Banks:** Usually the banks give acceptance approval as collateral securities to those securities which are listed and quoted on the stock exchange. The daily quotations help the bankers in identifying the real value of the shares and stocks which in turn enables them in ascertaining the loan amount that can be finalised for the security of such securities.

7. **Evaluates Securities:** The stock exchanges help in ascertaining the real value of the securities with the help of free play of demand and supply forces. The bargained market price by the stock exchange for securities are recorded and disclosed to the public. This would further facilitate the brokers and investors to make a comparison and assess the securities and to make a decision about their portfolio.

8. **Protects the Interest of Investors:** The stock exchange carries out its operation by following particular rules and bye-laws which are enforced by the law. These laws control the activities of the members. The strict implementation of rules, regulations and bye-laws by the stock exchange authorities protects the interest of the investors.

9. **Monitors Company Management:** It is necessary for a company to meet few conditions prior to the process of getting recognized on the stock exchange. Even after recognition, the company is consistently governed and regulated according to given rules and regulations of the stock exchanges. This controls the activities and functions of the companies.

10. **Generates and Guides the Capital:** Stock exchanges act as the agents for capital formation. They usually give chance to the investors for investing in profitable investments by providing various kinds of shares and securities. Thus, savings are utilized and perfectly guided in productive way by the stock exchanges.

11. **Offers Opportunities for Speculation:** The stock exchanges offer opportunity to speculators for making profits by speculation. The stock exchange members who forecast about the market enter into contract, if their predictions and expectations are correct then they will enjoy huge profits.

2.2.1 Organisation of Stock Exchanges

2.2.2.1 NSE, BSE and OTCEI

Q20. Explain the organization of Secondary Exchanges.

Ans : **(Dec.-20)**

1. Bombay Stock Exchange (BSE)

BSE is the leading and the oldest stock exchange in India as well as in Asia. It was established in 1887 with the formation of "The Native Share and Stock Brokers' Association". BSE is a very active stock exchange with highest number of listed securities in India. Nearly 70% to 80% of all transactions in the India are done alone in BSE.

Companies traded on BSE were 3,049 by March, 2006. BSE is now a national stock exchange as the BSE has started allowing its members to set-up computer terminals outside the city of Mumbai (former Bombay). It is the only stock exchange in India which is given permanent recognition by the government. At present, (Since 1980) BSE is located in the "Phiroze Jeejeebhoy Towers" (28 storey building) located at Dalal Street, Fort, Mumbai Pin Code-400021.

In 2005, BSE was given the status of a full fledged public limited company along with a new name as "Bombay Stock Exchange Limited". The BSE has computerized its trading system by introducing BOLT (Bombay On Line Trading) since March 1995. BSE is operating BOLT at 275 cities with 5 lakh (0.5 million) traders a day. Average daily turnover of BSE is near Rs. 200 crores.

2. National Stock Exchange (NSE)

Formation of National Stock Exchange of India Limited (NSE) in 1992 is one important development in the Indian capital market. The need was felt by the industry and investing community since 1991. The NSE is slowly becoming the leading stock exchange in terms of technology, systems and practices in due course of time. NSE is the largest and most modern stock exchange in India. In addition, it is the third largest exchange in the world next to two exchanges operating in the USA.

The NSE boasts of screen based trading system. In the NSE, the available system provides complete market transparency of trading operations to both trading members and the participates and finds a suitable match. The NSE does not have trading floors as in conventional stock exchanges. The trading is entirely screen based with automated order machine. The screen provides entire market information at the press of a button. At the same time, the system provides for concealment of the identify of market operations. The screen gives all information which is dynamically updated. As the market participants sit in their own offices, they have all the advantages of back office support, and facility to get in touch with their constituents.

1. Wholesale debt market segment,
2. Capital market segment, and
3. Futures and options trading.

3. Over the Counter Exchange of India (OTCEI)

The OTCEI was incorporated in October, 1990 as a Company under the Companies Act 1956. It became fully operational in 1992 with opening of a counter at Mumbai. It is recognised by the Government of India as a recognised stock exchange under the Securities Control and Regulation Act 1956. It was promoted jointly by the financial institutions like UTI, ICICI, IDBI, LIC, GIC, SBI, IFCI, etc.

Q21. Write about the organization of Stock Exchanges in India.

Ans :

At present, 23 stock exchanges are operating in India which is includes Over The Counter Exchange of India (OTCEI) and National Stock Exchange (NSE).

In 1875, the Bombay Stock Exchange (BSE), which was introduced as "the native share and stock brokers association" was the only non-profit making association. It is the oldest stock exchange operating in Asia. The Tokyo stock exchange started its functioning in 1878 and the Bombay stock exchange started functioning as a public limited company from 8th August 2005.

India has nearly 10,000 listed companies and occupies a unique position for having the highest number of listed companies in the world.

After the implementation of securities contracts Act. 1956, the stock exchanges which were identified by the government can carry out its operations in India. According to the government policy, only one stock exchange should operate at one place.

Executive committee/council of management /governing body manages the stock exchange.

The government has the authority to appoint executive committee/council of management/ goveming body and rules and regulations should be followed as per the criteria stated by the government. Government has the right to withdraw the permission given to the stock exchange in public interest or in the interest of trade.

Government has the authority to take the place of a governing body after giving a chance to the governing body to deal with the matter which may arise any time. Government also has the authority to appoint any other person for performing the functions of the governing body and suspending the stock exchange business under specific conditions for the duration of not more than seven days in public interest or interest of trade. The duration of suspension can be exceeded as per the situation on timely basis only after giving the chance to the governing body to deal with such matter.

When dealers and brokers trades outside the region of recognized stock exchange then they have to receive license from the government.

The members and authorized clerks are allowed to participate and manage the buying and selling of securities at stock exchange. The brokers and intermediaries helps the buyers and sellers in their dealings.

1. Members

Previously, only an individual used to be the member of stock exchange. But at present, the companies are also entitled to become its members. Multiple membership is also allowed in stock exchange.

2. Authorized Clerks

Members are allowed to appoint a specified number of personnel as 'authorized clerks' who helps them in making transactions at stock exchange. The number of clerks differs from one exchange to another. The authorized clerks can operate as the agents of the members and can buy or sell the securities from their employers side but not from their own side.

3. Remisers

Remisers refers to the subbrokers who are appointed by a member for protecting the business. They are not allowed to enter the business grounds for exchange dealings. The main aim of remisers is to protect the business from the outsiders. They play a significant role in protecting the business as the share brokers and are not allowed to make advertisements.

4. Taravaniwalas and Brokers

There are two types of members present in Indian stock exchange which are discussed below, Taravaniwala is a dealer in securities who performs the same job as the 'jobber' performs at London Stock Exchange. Broker acts as an 'agent' of buyer or seller of securities. Jobbers are concerned with only brokers and not with the public. On the other hand, broker is an intermediary between the jobber and the actual buyer/seller. It is found that taravaniwalas plays double role i.e., 'dealer-cum-broker' in India.

5. Clearing House

Clearing house refers to an agency which makes arrangements for the delivery of securities and its payment by the respective parties. It integrates all the bargains done by each member of the stock exchange for determining the resulted position and determining the final-buyers and sellers of securities to keep in touch with each other. Thus, clearing house simplifies and expedites the work.

2.3 Listing of Securities

Q22. What do you mean by Listing of Securities?

Ans : **(Dec.-19)**

Listing of securities means that the securities are admitted for trading on aVecognised stock exchange. Transactions in the securities of any company cannot be conducted on stock exchanges unless they are listed by them. Hence, listing is the very basis of stock exchange operations. It is the green signal given to selected securities to get the trading privileges of the stock exchange concerned. Securities become eligible for trading only through listing.

Listing is compulsory for those companies which intend to offer shares/debentures to the public for subscription by means of issuing a prospectus. Moreover, the SEBI insists on listing for granting permission to a new issue by a public limited company. Again, financial institutions do insist on listing for underwriting new issues. Thus, listing becomes an unavoidable one today.

The companies which have got their shares/ debentures listed in one or more recognised stock exchanges must submit themselves to the various regulatory measures of the stock exchange concerned as well as the SEBI. They must maintain necessary books, documents etc. and disclose any information which the stock exchange may call for.'

Group A, Group B and Group C Shares (BSE)

The listed shares are generally divided into two categories namely:

(i) Group A shares (Specified shares or cleared securities).

(ii) Group B shares (Non-specified shares or non-cleared securities).

Group A shares represent large and well established companies having a broad investor base. These shares are actively traded. Naturally, these shares attract a lot of speculative multiples. These facilities are not available to Group B shares. However, shares can be moved from Group B to Group A and vice versa depending upon the criteria for shifting. For instance, the Bombay Stock Exchange has laid down several criteria for shifting shares from Group B to Group A, such as, an equity base of Rs. 10 crores, a market capitalisation of Rs. 25-30 crores, a public holding of 35 to 40 per cent, a shareholding population of 15,000 to 20,000, good dividend paying status etc. Group B2 shares are again divided into B_1 and B shares on the Bombay Stock Exchange. B_1 shares represent well traded scrips among the B Group and they have weekly settlement.

Apart from the above, there is another group called Group C shares. Under Group C, only odd lots and permitted securities are included. A number of shares that are less than the market lot are known as odd lots. Market lot refers to the minimum number of shares of a particular security that must be transacted on a stock exchange. Odd lots have settlement once in a fortnight or once on Saturdays. Permitted securities are those that are not listed on a stock exchange but are listed on other stock exchanges in India. So they are permitted to be traded on this stock exchange. Odd lots cannot baeasjly transacted on the stock exchange and so they are illiquid in nature.

Q23. Point out the merits and demerits of Listing of Securities?

Ans :

Merits

The advantages of listing may be summarised as follows:

(i) Facilitates Buying and Selling Securities: Listing paves way for easy buying and selling of securities. Com! int marketing facilities are assured for listed securities.

(ii) Ensures Liquidity: The prices of listed securities are quoted daily in the market He oe, securities can be converted into cash readily at quoted prices and to ms listing ensures liquidity.

(iii) Offers wide Publicity: Listed securities give wide publicity to the companies concerned. It is so because the names of listed companies are frequently mentioned in stock market reports, T.V., Newspapers, Radio, etc. This has an advertising effect for such companies and this will automatically widen the market for their securities. According to Hasting, “A listed security will receive more attention from investment advisory services than an unlisted one”.

(iv) **Assures Finance:** The very fact that a security is listed in a recognised stock exchange adds to the prestige of that company and it enables the company to raise the necessary finance by the issue of such securities expeditiously.

(v) **Enables Borrowing:** Listed securities are preferred as collateral securities by commercial banks and other lending institutions because they are rated high in market quotations and there is a ready market for them also. Thus borrowings are made easier against the securities of the listed companies.

(vi) **Protects Investors:** Listing companies have to necessarily submit themselves to the various regulatory measures by disclosing vital informations about their assets, capital structure, profits, dividend policy, allotment procedure, bonuses etc. Hence, listing aims at protecting the interest of investors to a greater extent.

Demerits

At the same time, listing brings some bad effects also. The disadvantages of listing are as follows:

(i) Leads to Speculation

Listed securities offer wide scope for the speculators to manipulate the values in such a way as may be detrimental to the interests of the company. In such a situation, artificial forces play a more dominant role than the free market forces. The stock market may not reflect the true picture of a listed security. Again, the managerial personnel may themselves indulge in speculative activities with regard to listed securities by misusing the inside information available to them.

(ii) Degrades Company's Reputation

Some times listed securities are subject to wide fluctuations in then values. They may become a victim of depression. They are immediately reflected on the stock exchange whereas unlisted securities escape from this misery. These wide fluctuations in their values have the effect of degrading the company's reputation and image in the eyes of the public as well as the financial intermediaries.

(iii) Discloses Vital Informations to Competitors

For getting the securities listed, a company has to disclose vital informations such as, dividends and bonuses declared, a brief history of the company, sales, remuneration to managerial personnel and so on. It amounts to leaking of secrecy of the company's operations to trade rivals. Even trade unions may demand higher wages and bonus on the basis of these informations. Thus, listing may prove disadvantageous to a company.

Q24. Describe the concept of listing procedure.

Ans :

Listing enables a company to include its securities in the official list of one or more recognised stock exchanges for the purpose of trading. A company which requires its securities to be listed must comply with the following formalities:

The company concerned must apply in the prescribed form along with the following documents and details:

(i) Certified copies of Memorandum and Articles of Association, Prospectus or Statement in lieu of Prospectus, Underwriting agreements, agreements with vendors and promoters etc.

(ii) Specimen copies of shares and debenture certificates, letter of call, allotment, acceptance and renunciation.

(iii) Copies of balance sheets and audited accounts for the last 5 years.

(iv) Copies of offers for sale and circulars or advertisements offering any securities for subscription or sale during the last 5 years.

(v) Certified copies of agreements with managerial personnel.

(vi) Particulars of dividends and bonuses paid during the last 10 years.

(vii) A statement showing dividends or interest in arrears if any.

(viii) A brief history of the company since its incorporation, giving details of its activities.

(ix) Particulars regarding its capital structure.

(x) Particulars of shares and debentures for which permission to deal is applied for and their issue.

(xi) A statement showing the distribution of shares along with a list of highest 10 holders of each class or kind of securities of the company stating the number of securities held by them.

(xii) Particulars of shares forfeited.

(xiii) Certified copies of agreements if any with the Industrial Finance Corporation, ICICI etc.

(xiv) Listing agreement with the necessary initial and annual listing fee.

Q25. State the criteria for listing of securities.

Ans :

A company which desires its securities to be listed on a recognised stodcexchange must satisfy the following conditions:

(i) At least 60% of each class of securities issued must be offered to the public for subscription and the minimum issued capital should be Rs. 3 crores.

(ii) The minimum public offer for subscription must be at least 25°/. of each issue and it must be offered through advertisement in newspapers at least for a period of 2 days.

(iii) The company should be of a fair size having broad based capital structure and public interest in its securities.

(iv) There must be at least 10 public shareholders for every Rs. 1 lakh share of fresh issue of capital and it is 20 in the case of subsequent issue of shares. This criterian is different for investment companies.

(v) A company having more than Rs. 5 crore paid up capital must list its securities on more than one stock exchange. Listing on the regional stock exchange is compulsory.

(vi) The company must pay interest on the excess application money received at the rates ranging between 4% and 15% depending on the delay beyond 10 weeks from the date of closure of the subscription list.

(vii) The Articles of Association of the company must provide for the following:

(a) A common form of transfer shall be used.

(b) Fully paid shares will be completely free from lien.

(c) Partly paid up shares will be subject to lien only to the extent of call money due at a fixed time.

(d) Calls in advance carry only interest and not dividend rights.

(e) Unclaimed dividends shall not be forfeited before the claim becomes time barred.

(f) The right to call of shares shall be given only after the necessary sanction by the general body meeting.

(g) Transfer of shares shall be registered within 30 days of deposit of request and the balance certificates shall be issued within the same period.

(viii) The existing companies must adhere to the ceiling in expenditure of public issues.

(ix) A certificate to the effect that shares from promoter's quota are not sold or transferred for a period of 3 years must be submitted.

2.4 Trading and Settlement

Q26. Explain Trading and Settlement procedure in securities market.

(OR)

Discuss the settlement procedure of stock market trading activities.

Ans : **(Dec.-19)**

The business transactions in stock exchanges involves the following stages,

1. **Order Placement with Broker**

   In the first stage, an order is placed by the client with the stock broker who is responsible for conducting the business in the stock exchange for purchasing or selling the firm's shares at the best market prices.

2. **Order Execution**

   In this stage, the order is executed by the broker or by his authorized clerk and the information about this will appear in the regular official list of stock exchange which includes, the price and number of shares at which the transactions has taken place.

3. **Reporting the Deal to the Client**

   After the deal is transacted, client will receive contract note from the broker which provides information about the security that is purchased or sold the price, the broker's commission etc.

4. **Settlement of Transactions**

   (i) For the settlement of the ready delivery transactions, the payments should be made instantly on the transfer of securities or within a time period ranging from one to seven days.

   (ii) For settling the forward delivery transactions, the payment has to be made on a fixed day. This method also includes carry-over system which means delaying or postponing the delivery. It also offers a huge scope to speculate in the forward market.

Carry Forward Transactions

A business which performs trading for clearing with a facility to carry forward transaction from one settlement term to another term is called as "Badla System". In this system, the whole amount is not paid when the purchase is made against the security of blank transfer deed and share certificates. The Badla rate is set according to the demand and supply conditions. However, Badla system was prohibited by the SEBI during December, 1993 as it was encouraging high speculative activities.

Badla system was changed and recom-mended in a different manner which consists of following aspects,

1. **Transfer of Market Position**

   Under this, the carry forward facility is provided to the buyer/seller who can either address the transactions at the end of settlement time by making actual payment/receipt and acceptance/transfer of the security or carry-forward the transactions from one settlement time to another by making changes in the transactions.

2. **Short Lending/Short Selling**

   The sellers who sells the shares without holding them are called as the short sellers who also provides a scope for higher investment. In a falling or decreasing market, the short sellers buy the shares to protect their sales position whereas, in a rising or increasing market, the individuals who agrees to purchase should sell the securities to balance their position. Thus, it prevents an increase in the prices of shares.

SEBI made it compulsory for the short sellers to report their short-sales position daily (at the end of each day) from November 18th, 1996.

3. Borrowing/Lending in Money Market

Bulls and Bears under Badla system either has excess/ surplus funds or require funds for protecting their position till the next settlement period. Thus, in the latter case, they make borrowings from the money market and in the former case, they acts as Tenders' to the money market.

Revised Forward Trading System

SEBI initiated revised forward trading system on 6th October, 1995, which started functioning from 9th October, 1995. It laid down capital adequacy norms, around 3% for individual brokers and around 6% for corporate/institutional brokers. With the execution of capital adequacy norms, 25% limit of the turnover which was charged on carry forward transactions by brokers was eliminated. At present, the brokers are permitted to perform self-certification on their status on settlements rather than preferring for monthly audit. SEBI is authorized to recheck this certification. Transactions can be carried forward with the duration of 90 days and balancing is allowed upto fifth settlement, which is of 75 days duration. The transactions which are open at the expiry of this time limit should be handled by making the delivery or payment (as per the situation).

After taking the permission from SEBI, the stock exchanges can carry forward trading/carry forward transaction. This permission is given if the stock exchange has the following aspects screen-based trading, effective monitoring, surveillance and reporting system and attains other infrastructural requirements.

2.5 Internet Trading

Q27. Explain the concept of internet trading.

Ans :

Online Trading of Shares means you have an online platform where the investors can buy or sell shares. buy and sell the securities online and the fund is also transferred online.

With the online trading platform trade different types of investment vehicles. There are stocks–equities, commodities, mutual funds, and other investment vehicles as well.

Advantages

Mentioned below are some of the advantages of trading online:

1. Easier and convenient way to own shares
2. Immediate transfer
3. Zero stamp duty on transfer of shares
4. Safer than paper shares, e.g., fake signatures, delay, thefts, etc.
5. Lesser paperwork for transfer of securities
6. Less transaction cost
7. No "odd" problems. Even a single share can be sold.
8. D.P. registers a change in address with all companies. No need for the investor to contact the companies immediately.

9. DP transmission of securities, thus eliminating the need of notifying the companies.

10. Automatic credit in demat accounts

11. Both equity and debt instruments can be held by a demat account

The depository system aids in reducing the expenditure of new issues due to lesser printing and distribution costs. It increases the efficiency of the registrars and transfer agents and the secretarial department of a company. It provides better facilities for communication and timely service to shareholders and investors.

Disadvantages

The disadvantages of online trading are mentioned below:

1) Investors, who are trading for the first time, go with the flow and get immersed in technology and actually temporarily forget that they are actually using their real money.

2) There is no relationship that of a mentor between a professional broker and an online trading account holder, thus leaving the investor on his own to make choices of the right shares.

3) Users who are not familiar with the ins and outs of the basics of brokerage software can make mistakes which can prove to be a costly affair.

4) This is like any other financial strategy, where your commitment to online trading takes research and dedication to make sure by yourself that everything is up to par. You have to take time out to do your own research where you will have to overcome a great learning curve to make some money from online trading a possibility.

Q28. Discuss the role of SEBI in regulating primary and secondary markets.

Ans : **(Dec.-18)**

Role of SEBI in Primary Security Market

The following points highlights the role of SEBI in primary securities markets,

1. The capital issues does not need any permission from any authority to make an issue and price it.

2. SEBI increased the standards of disclosure of the public issues and therefore, has improved transparency.

3. At the draft stage itself the offer document is made public.

4. Public should be offered with more than 20% of equity (issued).

5. Book building requirement was initiated for the issues above 100 crore.

6. SEBI evaluates the draft prospectus to assure disclosure sufficiency.

7. Portfolio managers and bankers to an issue must be registered with the SEBI.

8. The companies holding with or without three years track record are promoted by a company holding five years track record. Thereafter they can price the issues and list the shares on a stock exchange.

9. The companies who make first issue without any track record can price the issue, at par only. At the first issue, the companies are free to price its securities on the condition that it shows profits in immediate past 3 years subjected to its prevailing disclosure needs.

10. In the pricing of preferential allotment scheme, the individual investors who apply for less than 1000 securities should be given a minimum of 50% of the net offer to the public reservation and the remaining must be given to the applications who apply for more than 1,000 securities.

11. The prevailing listed companies are enabled to raise fresh capital by providing further issues at free price, wherein the price is decided after discussing it with the lead managers to the issue. The offer document should show the high and low prices for the previous two years. SEBI evaluates the draft proposal to assure the correctness of disclosure.

Role of SEBI in Secondary Security Market

The following points highlights the role of SEBI in secondary securities markets,

1. The governing body and the different stock exchange committees are identified, restructured in broad based.

2. All the 23 stock exchanges were inspected in order to ascertain among other things, the degree to which it is following the SEBI principles.

3. In stock exchange corporate membership is permitted, promoted, preferred and encouraged. The articles of association of stock exchange is amended in order to increase its membership.

4. The BSE was instructed/ordered to decrease the trading period or settlement cycle from 14 to 7 days for 'B' group shares.

5. A clearing house or a clearing corporation were supposed to be setup by all the stock exchanges.

6. In order to enhance the working of "Over The Counter Exchange of India (OTCEI)", all the recommendations suggested by Dave Committee were accepted.

7. Especially, BSE was permitted by G.S Patel Committee recommendations to initiate a revised Carry Forward System (CFS) of trading while the other stock exchanges could initiate forward trading only with the SEBI's permission.

2.6 New Financial Instruments

Q29. Explain the various new financial instruments traded in Indian Capital Market.

Ans : **(Dec.-19, Dec.-18)**

In recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. This has helped them to keep in tune with the changing times and changing customer needs. Accordingly, many innovative financial instruments have come into the financial market in recent times. Some of them have been discussed hereunder :

1. **Commercial Paper**

   A paper is a short-term negotiable money market instrument. It has the character of an unsecured promissory note with a fixed maturity of 3 to 6 months. Banking and non-banking companies can issue this for raising their short term debt. It also carries an attractive rate of interest. Commercial papers are sold at a discount from their face value and redeemed at their face value. Since its denomination is very high, it is suitable only to institutional investors and companies.

2. **Treasury Bill**

   A treasury bill is also a money market instrument issued by the Central Government. It is also issued at a discount and redeemed at par. Recently, the Government has come out with short term treasury bills of 182-days bills and 364-days bills.

3. **Certificate of Deposit**

   The scheduled commercial banks have been permitted to issue certificate of deposit without any regulation on interest rates. This is also a money market instrument and unlike a fixed deposit receipt, it is a negotiable instrument and hence it offers maximum liquidity. As such, it has a secondary market too. Since the denomination is very high, it is suitable to mainly institutional investors and companies.

4. Inter-bank Participations (IBPs)

The scheme of inter-bank participation is confined to scheduled banks only for a period ranging between 91 days and 180 days. This may be 'with risk' participation or 'without risk' participation. However, only a few banks have so far issued IBPs carrying an interest rate ranging between 14 and 17 per cent per annum. This is also a money market instrument.

5. Zero Interest Convertible Debenture/ Bonds

As the very name suggests, these instruments carry no interest till the time of conversion. These instruments are converted into equity shares after a period of time.

6. Deep Discount Bonds

There will be no interest payments in the case of deep discount bonds also. Hence, they are sold at a large discount to their nominal value. For example, the Industrial Development Bank of India issued in February 1996 deep discount bonds. Each bond having a face value of Rs. 2,00,000 was issued at a deep discounted price of Rs.5300 with a maturity period of 25 years. Of course, provisions are there for early withdrawal or redemption in which case the deemed face value of the bond would be reduced proportionately. This bond could be gifted to any person.

7. Index-Linked Guilt Bonds

These are instruments having a fixed maturity. Their maturity value is linked to the index prevailing as on the date of maturity. Hence, they are inflation-free instruments.

8. Option Bonds

These bonds may be cumulative or non-cumulative as per the option of the holder of the bonds. In the case of cumulative bonds, interest is accumulated and is payable only on maturity. But, in the case of non-cumulative bond, the interest is paid periodically. This option has to be exercised by the prospective investor at the time of investment.

9. Secured Premium Notes

These are instruments which carry no interest of three years. In other words, their interest will be paid only after 3 years, and hence, companies with high capital intensive investments can resort to this type of financing.

10. Medium Term Debentures

Generally, debentures are repayable only after a long period. But, these debentures have a medium term maturity. Since they are secured and negotiable, they are highly liquid. These types of debt instruments are very popular in Germany.

11. Variable Rate Debentures

Variable rate debentures are debt instruments. They carry a compound rate of interest, but this rate of interest is not a fixed one. It varies from time to time in accordance with some pre-determined formula as we adopt in the case of Dearness Allowance calculations.

12. Non-Convertible Debentures with Equity Warrants

Generally debentures are redeemed on the date of maturity. but, these debentures are redeemed in full at a premium in instalments as in the case of anticipated insurance policies. The instalments may be paid at the end of 5th, 6th, 7th and 8th year from the date of allotment.

13. Equity with 100% Safety Net

Some companies make "100% safety net" offer to the public. It means that they give a guarantee to the issue price. Suppose, the issue price is Rs. 40/- per share (nominal value of Rs. 10/- per share), the company is ready to get it back at Rs. 40/- at any time, irrespective of the market price. That is, even if the market price comes down to Rs. 30/- there is 100% safety net and hence the company will get it back at Rs. 40/-.

14. Cumulative convertible Preference Shares

These instruments along with capital and accumulated dividend must be compulsorily converted into equity shares in a period of 3 to 5 years from the date of their issue, according to the discretion of the issuing company. The main object of introducing it is to offer the investor an assured minimum return together with the prospect of equity appreciation. This instrument is not popular in India.

15. Convertible Bonds

A convertible bond is one which can be converted into equity shares at a per-determined timing neither fully or partially. There are compulsory convertible bonds which provide for conversion within 18 months of their issue. There are optionally convertible bonds which provide for conversion within 36 months. There are also bonds which provide for conversion after 36 months and they carry 'call' and 'put' features.

16. Debentures with 'Call' and 'Put' Feature

Sometimes debentures may be issued with 'Call' and 'Put' feature. In the case of debentures with 'Call feature', the issuing company has the option to redeem the debentures at a certain price before the maturity date. In the case of debentures with 'Put features', the company gives the holder the right to seek redemption at specified times at predetermined prices.

17. Easy Exit Bond

As the name indicates, this bond enables the small investors to encash the bond at any time after 18 months of its issue and thereby paving a way for an easy exit. It has a maturity period of 10 years with a call option any time after 5 years. Recently the IDBI has issued this type of bond with a face value of Rs. 5000 per bond.

18. Retirement Bond

This type of bond enables an investor to get an assured monthly income for a fixed period after the expiry of the 'wait period' chosen by him. No payment will be made during the 'wait period'. The longer the wait period, the higher will be the monthly income. Besides these, the investor will also get a lump sum amount on maturity. For example, the IDBI has issued Retirement Bond '96 assuring a fixed monthly income for 10 years after the expiry of the wait period. This bond can be gifted to any person.

19. Regular Income Bond

This bond offers an attractive rate of interest payable half yearly with the facility of early redemption. The investor is assured of regular and fixed income. For example, the IDBI has issued Regular Income Bond '96 carrying 16% interest p.a. It is redeemable at the end of every year from the expiry of 3 years from the date of allotment.

20. Infrastructure Bond

It is a kind of debt instrument issued with a view to giving tax shelter to investors. The resources raised through this bond will be used for promoting investment in the field of certain infrastructure industries. Tax concessions are available under Sec.88, Sec.54 EA and Sec.54EB of the Income Tax Act. HUDCO has issued for the first time such bonds. Its face value is : 19 : Rs.1000 each carrying an interest rate of 15% per annum payable semi annually. This bond will also be listed in important stock exchanges.

21. Carrot and Stick bonds

Carrot bonds have a low conversion premium to encourage early conversion, and sticks allow the issuer to call the bond at a specified premium if the common stock is trading at a specified percentage above the strike price.

22. Convertible Bonds with a Premium put

These are bonds issued at face value with a put, which means that the bond holder can redeem the bonds for more than their face value.

23. Debt with Equity Warrant

Sometimes bonds are issued with warrants for the purchase of shares. These warrants are separately tradable.

24. Dual Currency Bonds

Bonds that are denominated and pay interest in one currency and are redeemable in another currency come under this category. They facilitate interest rate arbitrage between two markets.

25. ECU Bonds (European Currency Unit Bonds)

These bonds are denominated in a basket of currencies of the 10 countries that constitute the European community. They pay principal and interest in ECUs or in any of the 10 currencies at the option of the holder.

26. Yankee Bonds

If bonds are raised in U.S.A., they are called Yankee bonds and if they are raised in Japan, they are called Samurai Bonds.

27. Flip-Flop Notes

It is a kind of debt instrument which permits investors to switch between two types of securities e.g. to switch over from a long term bond to a short term fixed-rate note.

28. Floating Rate Notes (FRNs)

These are debt instruments which facilitate periodic interest rate adjustments.

29. Loyalty Coupons

These are entitlements to the holder of debt for two to three years to exchange into equity shares at discount prices. To get this facility, the original subscriber must hold the debt instruments for the said period.

30. Global Depository Receipt (GDR)

A global depository receipt is a dollar denominated instrument traded on a stock exchange in Europe or the U.S.A./ or both. It represents a certain number of underlying equity shares. Though the GDR is quoted and traded in dollar terms, the underlying equity shares are denominated in rupees. The shares are issued by the company to an intermediary called depository in whose name the shares are registered. It is the depository which subsequently issues the GDRs.

Short Question and Answers

1. What is meant by New issue Market?

Ans :

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

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

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

2. Functions of primary market?

Ans :

(i) Origination

Origination basically includes the activities which facilitates the issuers of shares in decision making process with respect to price, size, time, terms and conditions, methods and so on. Investigation, review analysis, authenticating and other consultative services constitutes origination.

(ii) Underwriting

Underwriting is one of the key function of new issue market. Basically in the process of underwriting, an underwriter gives an assurance to the issuer of shares about the successful subscription of all the shares. The subscription may be done either by the investors or through the underwriter himself or by both.

(iii) Distribution

The act of selling securities to the specific investors is known as "Distribution" in new issue market. Distribution is carried out by brokers, agents, sub-brokers and dealers whose main task is to sell securities to the interested investors.

3. Rights Issue

Ans :

Generally, when a company is looking to expand or are in need of additional funds, they first turn to their current investors. So the current shareholders are given an opportunity to further invest in the company. They are given the "right" to buy new shares before the public is offered the chance.

This allotment of new shares is done on pro-rata basis. If the shareholder chooses to execute his right and buy the shares, he will be allotted the new shares. However, if the shareholder chooses to let go of his rights issue, then these shares can be offered to the public.

4. e-IPO

Ans :

It stands for Electronic Initial Public Offer. When a company wants to offer its shares to the public it can now also do so online. An agreement is signed between the company and the relevant stock exchange known as the e-IPO.

This system was introduced in India some three years ago by the SEBI. This makes the process of the IPO speedy and efficient. The company will have to hire brokers to accept the applications received. And a registrar to the issue must also be appointed.

5. Book Building.

Ans :

Book building is a price discovery mechanism that is used in the stock markets while pricing securities for the first time. When shares are being offered for sale in an IPO, it can either be done at a fixed price. However, if the company is not sure about the exact price at which to market its shares, it can decide a price range instead of an exact figure. This process of discovering the price by providing the investors with a price range and then asking them to bid on it is called the book building process. It is considered to be one of the most efficient mechanisms of pricing securities in the primary market. This is the preferred method which is recommended by all major stock exchanges and as a result is followed in all major developed countries in the world.

6. Free Pricing.

Ans :

Primary markets are markets where companies or issuers seek to raise capital from outsiders by issuing securities to them in form of equity and debt. It is called the primary market because investors purchase the security directly from the issuer. It is also called the "new issue market" where securities are issued for the first time.

Pricing of public issues is the most contentious issue in the management of public issues. In case of follow-on public offerings, the pricing of securities is known to some extent from the prices quoted on the floor of the stock exchange. However, in case of Initial Public Offerings (IPOs), the determination of offer price is more complicated. The disclosures made in the offer documents are new to the investors and the performance of the company is yet to be tested in the secondary market. The role of the lead merchant banker acting as issue managers, thus, becomes more important with respect to pricing of IPOs.

7. Define Underwriting.

Ans :

Underwriting is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscri-bing to the issue. If the issue is fully subscribed, then there is no liability for the underwriter. If a part of share issues remains unsold, the underwriter will buy the shares. Thus, underwriting is a guarantee for the marketability of shares.

8. Advantages of Underwriting.

Ans :

Underwriting assumes great significance as it offers the following advantages to the issuing company.

i) The issuing company is relieved from the risk of finding buyers for the issue offered to the public. The company is assured of raising adequate capital.

ii) The company is assured of getting the minimum subscription within the stipulated time, a statutory obligation to be fulfilled by the issuing company.

iii) Underwriters undertake the burden of highly specialised function of distributing securities.

iv) They provide expert advice with regard to timing of security issue, the pricing of issue, the size and type of securities to be issued etc.

9. Initial Public Offering.

Ans :

An IPO stands for Initial Public Offering, wherein a company issues its shares to the public for the first time. Investors can place requests to buy these shares and once done, the share gets listed in a registered stock exchange and the company uses the share issue proceeds for its development/growth. Before we take a look at the steps in an IPO process, lets take a look at the entry norms for an IPO.

Entry Norms for an IPO

Not all company's can issue shares to the public. SEBI has provided a list of requirements that need to be met by a company if they wish to go public. A company that wishes to go public needs to meet all of the below mentioned criteria.

10. e-Prospectus?

Ans :

e-Prospectus stands for electronic Prospectus means a form of Prospectus, and any amendment or supplement thereto, that meets each of the following conditions:

As used herein, the term "electronic Prospec-tus" means a form of Time of Sale Prospec-tus, and any amendment or supplement thereto, that meets each of the following conditions:

(i) It shall be encoded in an electronic format, satisfactory to the Underwriter, that may be transmitted electronically by the Underwriter to offerees and purchasers of the Securities;

(ii) It shall disclose the same information as the paper Time of Sale Prospectus, except to the extent that graphic and image material cannot be disseminated electronically, in which case such graphic and image material shall be replaced in the electronic Prospectus with a fair and accurate narrative description or tabular representation of such material, as appropriate; and

(iii) It shall be in or convertible into a paper format or an electronic format, satisfactory to the Underwriter, that will allow investors to store and have continuously ready access to the Time of Sale Prospectus at any future time, without charge to investors.

11. What is meant by Secondary Market?

Ans :

A secondary market is the market in which the remaining or the existing securities are traded between the investors. Secondary market helps the investors by providing them a mechanism for trading the existing securities. In this market, securities are resold when investors consider these securities as attractive opportunities. Secondary market is the place where common and preferred stock, warranty, bonds and puts and calls are traded among the investors.

12. Bombay Stock Exchange (BSE)

Ans :

BSE is the leading and the oldest stock exchange in India as well as in Asia. It was established in 1887 with the formation of "The Native Share and Stock Brokers' Association". BSE is a very active stock exchange with highest number of listed securities in India. Nearly 70% to 80% of all transactions in the India are done alone in BSE.

Companies traded on BSE were 3,049 by March, 2006. BSE is now a national stock exchange as the BSE has started allowing its members to set-up computer terminals outside the city of Mumbai (former Bombay). It is the only stock exchange in India which is given permanent recognition by the government. At present, (Since 1980) BSE is located in the “Phiroze Jeejeebhoy Towers” (28 storey building) located at Dalal Street, Fort, Mumbai. Pin code - 400021.

In 2005, BSE was given the status of a full fledged public limited company along with a new name as “Bombay Stock Exchange Limited”. The BSE has computerized its trading system by introducing BOLT (Bombay On Line Trading) since March 1995. BSE is operating BOLT at 275 cities with 5 lakh (0.5 million) traders a day. Average daily turnover of BSE is near Rs. 200 crores.

13. National Stock Exchange (NSE)

Ans :

Formation of National Stock Exchange of India Limited (NSE)in1992 is one important development in the Indian capital market. The need was felt by the industry and investing community since 1991. The NSE is slowly becoming the leading stock exchange in terms of technology, systems and practices in due course of time. NSE is the largest and most modern stock exchange in India. In addition, it is the third largest exchange in the world next to two exchanges operating in the USA.

The NSE boasts of screen based trading system. In the NSE, the available system provides complete market transparency of trading operations to both trading members and the participates and finds a suitable match. The NSE does not have trading floors as in conventional stock exchanges. The trading is entirely screen based with automated order machine. The screen provides entire market information at the press of a button. At the same time, the system provides for concealment of the identify of market operations. The screen gives all information which is dynamically updated. As the market participants sit in their own offices, they have all the advantages of back office support, and facility to get in touch with their constituents.

1. Wholesale debt market segment,
2. Capital market segment, and
3. Futures & options trading.

14. Over the Counter Exchange of India (OTCEI)

Ans :

The OTCEI was incorporated in October, 1990 as a Company under the Companies Act 1956. It became fully operational in 1992 with opening of a counter at Mumbai. It is recognised by the Government of India as a recognised stock exchange under the Securities Control and Regulation Act 1956. It was promoted jointly by the financial institutions like UTI, ICICI, IDBI, LIC, GIC, SBI, IFCI, etc.

15. Listing of Securities

Ans :

Listing of securities means that the securities are admitted for trading on aVecognised stock exchange. Transactions in the securities of any company cannot be conducted on stock exchanges unless they are listed by them. Hence, listing is the very basis of stock exchange operations. It is the green signal given to selected securities to get the trading privileges of the stock exchange concerned. Securities become eligible for trading only through listing.

Listing is compulsory for those companies which intend to offer shares/debentures to the public for subscription by means of issuing a prospectus. Moreover, the SEBI insists on listing for granting permission to a new issue by a public limited company. Again, financial institutions do insist on listing for underwriting new issues. Thus, listing becomes an unavoidable one today.

16. New Financial Instruments

Ans :

In recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. This has helped them to keep in tune with the changing times and changing customer needs. Accordingly, many innovative financial instruments have come into the financial market in recent times.

Choose the Correct Answer

1. Who controls the capital market in India? [a]
   (a) SEBI (b) RBI
   (c) IRDA (d) NABARD
2. Which of the following reasons is not responsible for the ups and downs in the Sensex? [d]
   (a) Rain (b) Monetary policy
   (c) Political instability (d) None of the following
3. How many companies are included in the SENSEX of India? [a]
   (a) 30 (b) 50
   (c) 111 (d) 25
4. Which of the following is not a credit rating agency? [c]
   (a) CRISIL (b) ICRA
   (c) NIKKEI (d) CARE
5. How many companies are included in the SENSEX? [c]
   (a) 50 (b) 111
   (c) 30 (d) None
6. Which of the following is responsible for the fluctuations in the Sensex? [d]
   (a) Political instability (b) Monetary policy
   (c) Rain (d) All of the above
7. When was Nifty established? [a]
   (a) 1996 (b) 1952
   (c) 1965 (d) None of these
8. The first computerised online stock exchange in India was ________. [a]
   (a) NSE (b) OTCEI
   (c) BSE (d) MCX
9. In primary markets, the property of shares which made it easy to sell newly issued security is considered as ________. [a]
   (a) Increased liquidity (b) Decreased liquidity
   (c) Money flow (d) Large funds
10. The money market where debt and stocks are traded and maturity period is more than a year is classified as ________. [b]
    (a) Shorter term markets (b) Capital markets
    (c) Counter markets (d) Long-term markets

Fill in the blanks

1. An ________ market is a market in which shares are issued and traded, either through exchanges or over-the-counter markets.
2. ________ means an issue of an equity by a listed company to the selected investors at a price.
3. The Primary Market, also known as a ________.
4. ________ shares represent ownership position in a company.
5. ________ shares are those which enjoy some extra benefits when compare to other types of shares.
6. ________ are the middlemen between purchaser and seller of securities.
7. IPO stands for ________.
8. Under ________ price, the company going public determines a fixed price at which its shares are offered to investors.
9. FPO stands for ________.
10. In ________ auction method, company can fetch a substantially high value for shares.

ANSWERS

1. Equity
2. Preferential Allotment
3. New Issue Market
4. Equity
5. Preference
6. Brokers
7. Initial Public Offering.
8. Fixed
9. Follow-on Public Offering.
10. French

One Mark Answers

1. Expand IPO

Ans :

Initial Public Offering

2. Book Building

Ans :

Book building is a price discovery mechanism that is used in the stock markets while pricing securities for the first time.

3. Define Underwriting

Ans :

Underwriting is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue.

4. BSE

Ans :

Bombay Stock Exchange

5. OTCEI

Ans :

Over the Counter Exchange of India

UNIT III

LEASING AND HIRE PURCHASE

Asset/ Fund Based Financial Services – Leasing, Concept and classification, Advantages and Limitations, Hire Purchase – Definition, mechanism, Differences between Leasing and Hire Purchase, Venture Capital – Definition, Rationale, stages of financing.

3.1 Asset/ Fund Based Financial Services

Q1. Discuss about various Asset/ Fund Based Financial Services.

Ans :

The different asset based financial services are as follows,

(i) Lease Finance

According to James C.Van Horne lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent".

Leasing is an agreement which is made between two parties i.e., the leasing company or lessor and the user or lessee where in the former makes arrangement to buy capital equipment for the usage of the latter for a pre-determined agreed period of time in return for the payment of rent.

(ii) Consumer Credit

According to the Federal Reserve Board of U.S, "Consumer credit is the short or medium term loan issued for personal consumption of goods and services or repayment of the debts caused from the consumption through the normal commercial channel".

(iii) Hire Purchase Finance

Hire purchase is one of the means of financing the price of goods that are to be sold on a future date. In a hire - purchase transaction, the goods allowed to be hired, whereas the purchase price is being paid in installments and hirer can buy the goods by paying all the installments. A hire-purchase agreement is defined as a particular type of transaction wherein goods are let on hire with an option to the hirer to buy them.

(iv) Factoring

The term factor is derived from a Latin word 'Facese'. The meaning of this term is to make or do or to get things done. The concept of factoring was originally emerged in the countries such as USA, UK, France etc., in which specialized financial institutions were developed to help the firms in meeting their working capital requirements by procuring their receivables. It is a fund-based financial service which offers resource to finance receivables and helps in collecting the receivables.

(v) Forfeiting

Forfeiting refers to a type of financing of receivables which results out of the international business. In forfeiting a bank or a financial institution undertakes purchase of trade bills notes without recourse to the seller. The purchase is made via discounting the documents including the complete risk of non-payment at the time of collection. The complete risk becomes the whole and sole responsibility of the forfeiter i.e., purchaser/ buyer. The buyer pays cash to the seller after discounting the bills/promissory notes.

(vi) Bills Discounting

Bill discounting, as a fund-based activity, emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in turn with the emerging financial scenario in India.

In the post-1992 (scam) period its importance has substantially declined primarily due to restrictions imposed by the Reserve Bank of India.

(vii) Housing Finance

Housing finance refers to a collection of all financial arrangements that have been made by Housing Finance Companies (HFCs) in order to meet the needs of housing.

(viii) Venture Capital Financing (VCF)

The concept of venture capital financing started emerging in the post-1990 throughout the nation India. Venture capital financing has contributed significantly in the developed countries economy in small and medium scale industries specially in UK and USA.

It plays a dominant role in providing finance to SSIs and highly technical and riskier ventures. Venture capital is regarded as a synonym of risky capital'. The term venture capital can be understood in several ways. In a narrow sense it implies, making investment in new and tried enterprises that suffer from inadequate growth.

3.2 Leasing

3.2.1 Concept

Q2. What is Leasing?

(OR)

Define term leasing.

Ans : **(Dec,-19, Dec.-18)**

Leasing, as a financing concept, is an arrangement between two parties, the leasing company or lessor and the user or lessee, whereby the former arranges to buy capital equipment for the use of the latter for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. However, the lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Definitions

(i) According to Dictionary of Business and Management, 'Lease is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent.'

(ii) According to James C. Van Horne, 'Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.'

(iii) Equipment Leasing Association of UK, 'A Contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has possession and use of the asset on payment of specified retain over the period.'

Thus in a contract of lease there are two parties involved (i) lessor and the lessee. The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities. The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

Q3. What are the characteristics of leasing?

Ans :

The following are the characteristics of a lease,

1. The Parties

Lease agreement involves two parties *i.e.*, the lessor and the lessee. Lessor is the person who transfers the right to use an asset in consideration of a periodical rental payment whereas lessee is the person who acquires the right to use an asset from the lessor for periodical rental payment for an agreed period (pre-determined) of time.

2. The Asset

Leasing is mostly used to finance the use of fixed assets of high value. The asset is the property which is to be leased out such as automobile, an aircraft, plant and machinery, building, and so on. In leasing the ownership of an asset is segregated from the use of the asset. During the lease period, ownership lies with the lessor where as its use is being transferred to the lessor.

3. The Term

The term of lease agreement is known as lease period. It is considered as illegal to have a lease without a specified period of term. In case of a perpetual lease, lease period is for an infinite period of time and in case of financial lease, lease period is in connection with the economic life of the asset. Sometimes, the lease period is being divided into primary lease period and secondary lease period.

4. The Lease Rentals

Lease rentals forms the consideration which is payable by the lessee as being mentioned in the lease transaction. Rentals are ascertained in order to cover up cost i.e., interest on the lessor's investment, any repairs and maintenance costs which forms the part of the lease package, depreciation on the leased asset and any other service charges in relation to the lease.

Q4. Who are the parties involved in leasing?

(OR)

What are the major constituents of the leasing industry?

Ans :

1. Lessors

Lessors are of different types such as specialized leasing companies, one-off lessors, manufacturer-lessor, banks-sponsored leasing companies, financial institutions, in-house lessors, etc.

2. Lessees

The lessee comprises wide range of companies i.e., from blue chip companies to small units, which get the financial services from the lessor companies. The considerations for which and the conditions under which such companies operate changes over a course of time. Most of the Indian lessees belong to the private sector.

3. Lease Brokers

Lease brokers are those intermediaries who are operating between the lessors and the lessees. Such individuals are responsible for recognizing the suitable lessor for a prospective lessee and vice versa. Lease brokers have adequate information about different types of lessors, they also maintains relationship which is helpful for lessors and the lessees as they provide financial benefits through tough negotiations.

4. Lease Financiers

Lease financiers are those banking institutions which provide financial support to the lessors with an objective of attaining the leased assets. Such assistance is provided as a result of the hypothecation of the leased asset and also by the provision of lease rentals.

3.2.2 Classification

Q5. Explain the classification of leasing.

(OR)

Explain the different kinds of leasing.

Ans : **(Dec.-18, Imp.)**

(i) Financial Lease

A financial lease is also known as Capital lease, Long-term lease, Net Tease and Close lease. In a financial lease, the lessee selects the equipments, settles the rice and terms of sale and arranges with a leasing company to buy it. He enters into a irrevocable and non-cancellable contractual agreement with the leasing company. The lessee uses the equipment exclusively, maintains it, insures and avails of the after sales service and warranty backing it. He also bears the risk of obsolescence as it stands committed to pay the rental for the entire lease period.

The financial lease could also be with purchase option, where at the end of the predetermined period, the lessee has the option to buy the equipment at a predetermined value or at a nominal value or at fair market price. The financial lease may also contain a non cancellable clause which means that the lessor transfers the title to the lessee at the end of the lease period.

Under a financial lease, the rate of lease would be fixed based on the kind of lease, the period of lease, periodicity of rent payment, and the rate of depreciation and other tax benefits available. The leasing company also charges nominal service charges to cover legal and other costs. The leasing company may also insist on collaterals or bank's guarantee in individual cases. In a large number of cases, the financial leases are used as financing cum tax planning tool.

The financial lease is very popular in India as in other countries like USA, UK and Japan. On an all India basis, at present, approximately a lease worth Rs. 75 to Rs. 100 crores is transacted as a tax planning device. The high cost of equipments such as office equipment, diesel generators, machine tools, textile machinery, containers, locomotives etc., are leased under financial lease.

(ii) Operating lease

An operating lease is also known as Service lease, Short term lease or True lease. In this lease, the contractual period between lessor and lessee is less than the full expected economic life of equipment. This means that the lease is for a limited period, may be a month, six months, a year or few years. The lease is terminable by giving stipulated notice as per the agreement. Normally, the lease rentals will be higher as compared to other leases on account of short period of primary lease. The risk of obsolescence is enforced on the lessor who will also bear the cost of maintenance and other relevant expenditure. The lessor also does the services like handling warranty claims, paying taxes, scheduling and performing maintenance and keeping complete records lease is suitable for,

(a) Computers, copy machines and other office equipments, vehicles, material handling equipments etc. Which are sensitive to obsolescence and

(b) Where the lessee is interested in tiding over temporary problem.

(iii) Leverage Lease

A leverage lease is used for financing those assets which require huge capital outlay. The outlay for purchase cost of the asset generally varies from Rs. 50 lakhs to Rs. 2 crore and has economic life of 10 years or more. The leverage lease agreement involves three parties, the lessee, the lessor and the lender. The lessor acquires the assets as per the terms of the lease agreement but finances only a part of the total investment, say 20% to 50%. The balance is provided by a person or a group of persons in the form of loan to the lessor. The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments. The position of the lessee under a leveraged leasing agreement is the same as in the case of any other type of lease. In leveraged lease, a wide range of equipments such as rail road, rolling stock, coal mining, electricity generating plants, pipe lines, ships etc. are acquired.

Under a leverage lease, there are some attractive investment features in the form of after-tax consequences for the owner of the equipment. By investing 20% or 25% of the cost of an asset, the lessor is entitled to 100% allowance for depreciation plus the investment allowance. In addition, interest expenses related to his borrowings are also tax deductible. From the point of view of lessee, lease rentals are deductible in full as an operating expense.

(iv) Sale and Lease back

Under this type of lease, a firm which has an asset sells it to the leasing company and gets it back on lease. The asset is generally sold at its market value. The firm receives the sale price in cash and gets the right to use the asset during the lease period.

The firm makes periodical rental payment to the lessor. The title to the asset vests with the lessor. Most of the lease back agreements are on a net — net basis which means that the lessee pays all maintenance expenses, property taxes and insurance. In some cases, the lease agreement allows the lease to repurchase, the property at the termination of lease.

The sale and lease back agreement is beneficial to both lessor and lessee. The lessor gets immediate cash which becomes available for working capital or for further expansion and lessor gets tax benefits. Retail stores, office buildings, multipurpose industrial building and shopping centres are financed under this method.

(v) Cross Border Lease

Cross border lease is international leasing and is known as transactional leasing. It relates to a lease transaction between a lessor and lessee domiciled in different countries and includes exports leasing.

In other words the lessor may be of one country and the lessee may be of another country. To illustrate, if a leasing company in USA makes a available an Air bus on lease to Air India, there would be a cross border lease.

Q6. Compare and contrast financial lease and operating lease.

Ans : **(Imp.)**

S.No.	Financial Lease	S.No.	Operating Lease
1.	A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over a specified period original cost of equipment during of time. The lessee commits to a contractual period.	1.	An operating lease is a rental agreement. The lessee is not committed to paying more than the series of payment which in total exceed the cost of the equipment.
2.	It excludes provisions for maintenance or taxes which are paid separately by maintenance expenses and taxes of the lessee.	2.	Operating lease provides for the lessor.
3.	The risk of obsolescence is assumed by the lessee.	3.	Leasing company assumes risk of obsolescence.
4.	Contract period ranges from medium to long term.	4.	Contract period ranges from intermediate to short-term.
5.	Contracts are usually non cancellable.	5.	Contracts are usually cancellable either by the lessor or by the lessee.
6.	Air crafts, land and building heavy machinery are leased.	6.	Computers, office equipments, automobiles, truck etc. are leased.
7.	The lease involves a financial commitment similar to a loan by a leasing company. it places the lessee in a position of borrow.	7.	The financial commitment is restricted to regular rental payment. The rentals find a place in the P & L A/c of the lessee.
8.	The lessor fulfills financial function.	8.	The lessor fulfills service function.

3.2.3 Advantages and Limitations

Q7. Explain the advantage of leasing.

(OR)

What are the Advantages and Limitations of leasing?

Ans : **(Dec.-19, Dec.-18, Imp.)**

Advantages

The following are the advantages of leasing :

(i) Permit Alternative use of Funds

A leasing arrangement provides a firm with the use and control over asset without incurring huge capital expenditure. The firm is required only to make periodical rental payments. It saves considerable funds for alternative uses which would otherwise be tied up in fixed capital.

(ii) Faster and Cheaper Credit

Depending on tax structure of the lessee it costs less than other methods of acquiring assets. It permits firms to acquire new equipment without going thorough formal scrutiny procedure. Hence acquisition of assets under leasing agreement is cheaper and faster than any other source of finance.

(iii) Flexibility

Leasing arrangements may be tailored to the lessee's needs more easily that ordinary financing. Lease rentals can be structured to match the lessee's cash flows. It can be skipped during the months when the cash flows are expected to below.

(iv) Facilitates Additional Borrowings

Leasing may increase long-term ability to acquire funds. The lessee can utilize more funds for working capital needs. Moreover, acquisition of assets under the lease agreement does not alter debt equity ratio. Hence, the lessee can go for additional borrowings in case need arises.

(v) Protection against obsolescence

A firm can avoid risk of obsolescence by entering into operating lease agreement. This is highly useful in respect of assets which become obsolete at a faster rate.

(vi) No Restrictive Covenants

The restrictive covenants such as debt equity ratio, declaration of dividend etc., which are usually imposed under debenture or loan agreement are absolutely absent in a lease agreement.

(vii) Hundred Percent Financing

Lease financing enables a firm to acquire the use of an asset without having to make a down payment. So hundred percent financing is assured to the lessee.

(viii) Boon to Small Firm

The firms which are either small or have uncertain records of earning are able to obtain the use of asset through lease financing. It is a boon to small firms and technocrats who are able to make promoter's contribution as required by financial institutions.

Disadvantages

i) Lease is not suitable mode of project finance. This is because rentals are repayable soon after entering into lease agreement while in new projects cash generations may start only after a long gestation period.

ii) Certain tax benefits/incentives such as subsidy may not be available on leased equipment.

iii) The value of real assets such as land and building may increase during lease period. In such a case the lessee loses the advantage of a potential capital gain.

iv) The cost of financing is generally higher than that of debt financing.

v) A manufacturer who wants to discontinue a particular line of business will not in a position to terminate the contract except by paying heavy penalties. If it is a owned asset the manufacturer can sell the equipment at his will.

vi) If the lessee is not able to pay rentals regularly, the lessor would suffer a loss particularly when the asset is a sophisticated one and less liquid.

vii) In case of lease agreement, it is lessor who has purchased the asset from the supplier and not the lessee. Hence, the lessee by himself is not entitled to any protection in case the supplier commits breach of warranties in respect of the leased assets.

viii) In the absence of exclusive laws dealing with the lease transaction, several problems crop up between lessor and lessee resulting in unnecessary complications and avoidable tension.

Q8. Write a detail note on evolution of leasing industry in India?

(OR)

Critically examine the development of leasing industry in India.

Ans : **(July-19)**

The history of leasing dates back to 200 BC when Sumerians leased gooder-Romans had developed a full body law relating to lease for movable and immovable property. However the modern concept of leasing appeared for the first time in 1877 when the Bell Telephone Company began renting telephones in the U.S.A. In 1832, Cottrell and Leonard leased academic caps, gowns and hoods. Subsequently, during 1930s the Railway Industry used leasing service for its rolling stock needs. In the post war period, the American Air Lines leased their jet engines for most of the new air crafts. This development ignited immediate popularity for the lease and generated growth of leasing industry.

Since World War II the use of leasing has been greatly expanded and is constantly used for new products and new industries. In May 1952, Henry Scholfeld set up a separate Corporation in the USA to handle lease transaction. He founded the US Leasing Corporation with a capital of $20,000. Since 1963, commercial banks have been allowed to engage themselves in direct leasing. In the early 1960s leasing entered the United Kingdom following its successful and rapid development in the USA.

The concept of financial leasing was pioneered in India during 1973. The First Company was setup by the Chidambaram group in 1973 in Madras. The company undertook leasing of industrial equipment as its main activity. The Twentieth century Leasing Company Limited was established in 1979. By 1981, four finance companies joined the fray. The performance of First Leasing Company Limited and the Twentieth Century Leasing Company Limited motivated others to enter the leasing industry. In 1980's financial institutions made entry into leasing business. Industrial Credit and Investment Corporation was the first all India financial institution to offer leasing in 1983. Entry of commercial banks into leasing was facilitated by an amendment of Banking Regulation Act, 1949. State Bank of India was the first commercial bank to set up a leasing subsidiary, SBI capital market, in October 1986. Can Bank Financial Services Ltd., BOB Financial Service Ltd., and PNB Financial Services Limited followed suit. Industrial Finance Corporation's Merchant Banking division started financing leasing companies as well as equipment leasing and financial services. There was thus virtual explosion in the number of leasing companies rising to about 400 companies in 1990.

In the subsequent years, the adverse trends in capital market and other factors led to a situation where apart from the institutional lessors, there were hardly 20 to 25 private leasing companies who were active in the field. The total volume of leasing business transacted by both private and public sector leasing companies was Rs. 5000 crores in 1993 and it is expected to cross Rs. 10,000 crores by March 1995.

Q9. What are the problems of leasing in India?

Ans :

Leasing has great potential in India. However, leasing in India faces serious handicaps which may mar its growth in future. The following are some of the problems.

(i) Unhealthy Competition

The market for leasing has not grown with the same pace as the number of lessors. As a result, there is over supply of lessors leading to competition. With the leasing business becoming more competitive, the margin of profit for lessors has dropped from four to five percent to the present 2.5 to 3 percent. Bank subsidiaries and financial institutions have the competitive edge over the private sector concerns because of cheap source of finance.

(ii) Lack of Qualified Personnel

Leasing requires qualified and experienced people at the helm of its affairs. Leasing is a specialised business and persons constituting its top management should have expertise in accounting, finance, legal and decision areas. In India, the concept of leasing business is of recent one and hence it is difficult to get right man to deal with leasing business. On account of this, operations of leasing business are bound to suffer.

(iii) Tax Considerations

Most people believe that lessees prefer leasing because of the tax benefits if offers. In reality, it only transfers, the benefit, i.e., the lessee's tax shelter is lessor's burden. The lease becomes economically viable only when the transfer's effective tax rate is low. In addition, taxes like sales tax, wealth tax, additional tax, surcharge etc. add to the cost of leasing. Thus leasing becomes more expensive from of financing than conventional mode of finance such as hire purchase.

(iv) Stamp Duty

The States treat a leasing transaction as a sale for the purpose of making them eligible to sales tax. On the contrary, for stamp duty, the transaction is treated as a pure lease transaction. Accordingly a heavy stamp duty is lived on lease documents. This adds to the burden of leasing industry.

(v) Delayed Payment and Bad Debts

The problem of delayed payment of rents and bad debts add to the costs of lease. The lessor does not take into consideration this aspect while fixing the rentals at the time of lease agreement. These problems would disturb prospects of leasine business.

3.3 Hire Purchase

3.3.1 Definition

Q10. Explain the meaning and characteristics of hire purchase.

Ans : **(Dec.-20, Dec.-18)**

Meaning

Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company (creditor) to the hire purchase customer (hirer). The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with creditor and passes on to hirer on the payment of last instalment.

Features

i) Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.

ii) Each installment is treated as hire charges.

iii) The ownership of the goods passes from buyer to seller on the payment of the installment.

iv) In case the buyer makes any default in the payment of any installment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charge.

v) The hirer has the right to terminate the agreement any time before the property passes. The is, he has the option to return the goods in which case he need not pay installments falling due thereafter. However, he can not recover the sums already paid as such sums legally represent hire charge on the goods in question.

3.3.2 Mechanism

Q11. Explain the Mechanism of Hire Purchase.

Ans :

The accounting for hire purchase agreements can get considerably complicated. However, the complexity is beyond the scope of this article. We will simply explain the common sense approach that is used behind such transactions.

i) Down Payment

The buyer starts by making a down payment to the hire purchase vendor. This is when the possession of the assets may actually change hands. The down payment is not recorded towards revenue obtained by selling goods. Instead, the down payment is recorded as rental revenue.

ii) Instalments

The hire purchase buyer than keeps on making monthly payments to the vendor. However, these payments reflect the rent that is being paid to use the fixed asset rather than amortization payments reducing the balance of a loan.

iii) Loss/Transfer of Ownership

The hire purchase agreement creates no loan liability on the books! However, one must understand that there is indeed a theoretical loan being made here. A hire purchase buyer cannot stop making monthly payments to the vendor. If they do, the vendor can just repossess the goods, and all the payments that they made in the past will be worthless. The ownership of goods only changes hands if all the instalments are paid as agreed upon. Only at the end of such payments does an option become active when the hire purchase buyer can purchase the asset at a pre-determined nominal sum.

Thus, even though technically there is no loan, nonpayment of monthly dues can lead to loss of control over the asset as well as loss of sums that were made as rental payments previously. Hire purchase buyers will therefore not default on their obligations unless they have no other alternative since they have gone bankrupt or they no longer value the asset.

iv) Pre-closure of the Deal

The hire purchase agreement need not necessarily run its entire course of time. The hire purchase buyer does have the option of closing the deal when they wish to do so. They just have to pay all the pending instalments as a lump sum and the option of buying the asset for a nominal price immediately becomes active. The interest on such instalments may be waived off. In addition, the hire purchase vendor may give a certain rebate to encourage early repayment of the loan.

3.3.3 Differences between Leasing and Hire Purchase

Q12. Compare the contrast between leasing and hire purchase.

(OR)

Write the differences between Leasing and Hire Purchase.

Ans : **(July-21, Dec.-20, Imp.)**

S.No.	Characteristics	Leasing	Hire purchase
1.	**Ownership**	With the finance company, the lessor.	It is transferred to the hirer on the payment of the last installment
2.	**Depreciation**	Lessor, and not the lessee is entitled to claim depreciation tax shield.	The hirer is entitled to claim depreciation tax shield.
3.	**Capitalization**	Done is the books of lessor.	Done in the books of hirer.
4.	**Payments**	The entire lesease payments are eligible for tax computation in the books of lessee.	Only the hire interest is eligible for tax computtion in the books of hirer.
5.	**Magnitude**	Used as a source of finance, usually for acquiring high cost assets such as machinery, ships etc.	Used as a source of finance, usually for acquiring low cost assets such as automobiles, office equipments etc.
6.	**Maintenance of asset**	Lessee in case of financial, 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.
7.	**Nature of asset**	Asset-as a fixed asset of the lessor.	Shows the asset either as a stock in trade or as receivables.
8.	**Down payment**	No down payment required.	It is required.

Q13. What are the advantages of hire purchase system?

Ans :

1. Advantages to Hire Purchase

(i) Use of Expensive Goods

In hire purchase system, people can fulfill their dream of owning luxurious and expensive goods such as cars, machineries and so on.

(ii) Easy Payment

In this method, goods are paid in the form of monthly installments which is an easy mode of payment.

(iii) Encouragement to Savings

In hire purchase, as the payment of goods need to be made over a long period of time, it requires buyer to avoid other expenses in order to pay installments. As a result, it develops savings among them.

2. Advantages to Seller

(i) Increase in Sales

People who get attracted are facilitated to valuable goods through the hire purchase financing which also increases the sales of valuable goods in the market.

(ii) Recovery of Instalment Easily

If purchaser makes default in the payment of instalment then hire vendor can take back his goods from the buyer without refunding the amount received in past. In order to overcome this issue, the buyer himself makes the payment on time.

(iii) Establish Good Relation between the Buyer and Seller

Good relationship is established between the buyer and seller due to regular transaction and it helps the seller to get the information about the goods. Defective goods must be removed.

(iv) Possibility of Sales of other Goods

When buyer visit the showroom to make payment of installment, other attractive goods can also be offered to him. In this manner, additional sales can be generated.

(v) Facility to Get Capital at Lower Rate

Creditors provide capital to the seller at low rate with full confidence so as to recover installment amount regularly from the buyer.

3. Advantages to Society

(i) More Production

In hire purchase transaction, there is a rise in sales which results in increase of production, employment and income.

(ii) Facilitate in Business

In hire purchase, payments are made in installments, which requires less capital in business. So business can be done easily.

(iii) Increase in Standard of Living

The hire purchase system facilitates the person to use the valuable goods which increases his standard of living.

Q14. Discuss the legal framework and tax advantage of hire purchase system.

Ans :

Legal Framework

The hire Purchase Act, 1972 defines a hire purchase agreement 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 agreement under which :

i) Payment is to be made in instalments over a specified period.

ii) The possession is delivered to the purchaser at the time of entering into a contract.

iii) The property in the goods passes to the purchaser on payment of the last instalment.

iv) Each instalment is treated as hire charge so that if default is made in payment of any one instalment, the seller is entitled to take away the goods.

v) The hirer/purchaser is free to return the goods without being required to pay any further instalments falling due after the return.

Tax Advantage

If in case, the agreement is terminated by outright purchase of the equipment then the deduction in the same manner would terminated from its termination date. Ultimately, the consideration would be considered as the rental charge instead of interest. In case of an agreement contract representing the "option of purchasing the goods at any time (or) of returning the same before the total amount is paid" then no tax deduction at source would be made from the consideration of hire paid to the owner.

The hire-purchase, which is considered as a financing alternative usually provides tax benefits to both the hire vendor i.e., hire-purchase finance company and also the hire-purchaser i.e., user of the asset.

Assessment of Hire-purchaser-(Hirer)

As per the circular issued by the Central Board of Direct Taxes in the year 1943 and several court rulings, the hirer is being entitled to the following,

(a) The tax shield on depreciation being computed with respect to the cash purchase price.

(b) And the tax shield on the consideration for hire (total charge for credit).

The hirer is being entitled to claim depreciation as a deduction on the complete/whole purchase price inspite of the fact that the hirer is not the real owner of the asset. In the someway, the hirer can also claim the deduction on account of consideration for hire i.e., finance charge. The difference between the hire purchase price and cash price is called as the finance charge. The finance charge amount to be deducted annually must be distributed equally over the term of the agreement. But in reality, there is no such particular method for equally distributing the finance charge.

The hirer can select among any of the following alternatives,

(i) Level/Equal distribution.

(ii) Distribution based on sum-of-years-digits method or

(iii) Rate of return method.

If in case, the hire-purchase agreement does not take place and is being terminated by return of the asset to the owner then no deduction is allowed for finance charge after the termination date.

3.4 Venture Capital

3.4.1 Definition

Q15. Explain the concept and features of Venture Capital Financing.

Ans : **(July-21, Dec.-19. Dec.-18, July-19, Imp.)**

The concept of venture capital financing started emerging in the post-1990 throughout the nation India. Venture capital financing has contributed significantly in the developed countries economy in small and medium scale industries specially in UK and USA.

It plays a dominant role in providing finance to SSIs and highly technical and riskier ventures. Venture capital is regarded as a synonym of 'risky capital'. The term venture capital can be understood in several ways. In a narrow sense, it implies, making investment in new and tried enterprises that suffer from inadequate growth.

Definition Venture Capital

A venture capital company is defined as, "a financing institution which joins an entrepreneur as a co-promoter in a project and shares the risks and rewards of the enterprise".

Features

Some of the features of venture capital financing are as under :

i) Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.

ii) Investment is made only in high risk but high growth potential projects.

iii) Venture capital is available only for commercialization of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.

iv) Venture capitalist joins the entrepreneur as a co-promoter in projects and share the risks and rewards of the enterprise.

v) There is continuous involvement in business after making an investment by the investor.

vi) Once the venture has reached the full potential the venture capitalist disinvest his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestment.

vii) Venture capital is not just injection of money but also an input needed to set-up the firm, design its marketing strategy and organize and manage it.

viii) Investment is usually made in small and medium scale enterprises.

Q16. Discuss the scope of venture capital in India.

Ans :

Venture capital may take various forms at different stages of the project. There are four successive stages of development of a project *viz*. development of a project idea, implementation of the idea, commercial production and marketing and finally large scale investment to exploit the economics of scale and achieve stability. Financial institutions and banks usually start financing the project only at the second or third stage but rarely from the first stage. But venture capitalists provide finance even from the first stage of idea formulation. The various stages in the financing of venture capital are described below:

1. Development of an Idea - Seed Finance

In the initial stage venture capitalists provide seed capital for translating an idea into business proposition. At this stage investigation is made in-depth which normally takes a year or more.

2. Implementation Stage - Start up Finance

When the firm is set up to manufacture a product or provide a service, start up finance is provided by the venture capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

3. Fledging Stage - Additional Fiance

In the third stage, the firm has made some headway and entered the stage of manufacturing a product but faces teething problems. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

4. Establishment Stage - Establishment Finance

At this stage the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that it can reap economies of scale and attain stability. At the end of the establishment stage, the firm **is** listed on the stock exchange and at this point the venture capitalist disinvests their shareholdings through available exit routes.

Before investing in small, new or young hi-tech enterprises, the venture capitalists look for percentage of key success factors of a venture capital project. They prefer projects that address these problems. An idea developed for these success factors has been presented in Table 1.

After assessing the viability of projects, the investors decide for what stage they should provide venture capital so that it leads to greater capital appreciation.

All the above stages of finance involve varying degrees of risks and venture capital industry, only after analysing such risks invest in one or more. Hence they specialize in one or more but rarely all.

Q17. What are the functions of venture capital financing?

Ans :

Venture capital financing plays an important role in developing the industries of the world. The various functions of venture capital are as follow,

i) Venture capital not only provides finance but also gives new skills to the new businesses and new ventures of existing ones.

ii) During the development stage and conceptual stage, a business plan is prepared by venture capitalists along with entrepreneur. This plan shows the market opportunities. The product, the development and financial needs.

iii) Venture capitalist doesn't restrict itself to only the supply of funds, it also act as an active partner with total investment in the project.

iv) In launching a new business, it acts as a trigger and a catalyst in stimulating existing firms to attain maximum performance.

v) It performs the role of both financier and a skilled intermediary which provides specialist services i.e., technical, managerial, financial commercial and entrepreneurial.

Q18. What are the advantages and disadvantages of venture capital?

Ans : **(Imp.)**

Advantages

Venture capital is of great practical value to every corporate enterprise in modern times.

I) Advantages to investing Public

1. The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business they would be able to stop malpractices by management.

2. Investors or have no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyse the prospects of the business.

3. The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome.

II) Advantages to Promoters

1. The entrepreneur for the success of public issue is required to convince tens of underwriters, brokers and thousands of investors but to obtain venture capital assistance, he will be required to sell his idea to justify the officials of the venture fund.

2. Public issue of equity shares has to be proceeded by a lot of efforts viz. Necessary statutory sanctions, underwriting and brokers arrangement, publicity of issue etc. The new entrepreneurs find it very difficult to make underwriting arrangements require a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.

3. Costs of public issues of equity share often range between 10 percent to 15 percent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above, to incur recurring costs, for maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc. These items of expenditure can be ill afforded by the business when it is new. Assistance from venture fund does not require such expenditure.

III) Advantages General

1. A developed venture capital institutional set-up reduces the time lag between a technological innovation and its commercial exploitation.

2. It helps in developing new processes/ products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.

3. Venture capital acts as a cushion to support business borrowings, as bankers and investors will not lend money with inadequate margin of equity capital.

4. Once venture capital funds start earning profits, it will be very easy for them to raise resources from primary capital market in the form of equity and debts. Therefore, the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing business when venture fund disposes its own holding. This mechanism will help to channelise investment in new high-tech business or the existing sick business. These business will take-off with the help of finance from venture funds and this would help in increasing productivity, better capacity utilization etc.

Disadvantages

The venture capital financing also suffers from few disadvantages as follows,

1. Acquiring a contract with a venture capital might be a lengthy and a complicated process.
2. The borrowers are supposed to frame a complete business plan which is inclusive of the financial projections for which the entrepreneur needs the professional help.
3. It is compulsory to pay legal and accounting fees if VC passes through the negotiation stage i.e., whether he may or may not be successful in acquiring funds.
4. As the risk is taken over by venture capitalist, he may also have management control as it passes from the hands of entrepreneur to the venture capitalist.
5. The venture capitalists needs to share even the benefits which he earned from business.

3.4.2 Rationale

Q19. Explain the Rationale of venture capital financing.

Ans : **(Dec.-20, Imp.)**

(i) Promotes Entrepreneurs

Just as a scientist brings out his laboratory findings to reality and makes it commercially successful, similarly, an entrepreneur converts his technical know-how to a commercially viable project with the assistance of venture capital institutions.

(ii) Promotes Products

New products with modern technology become commercially feasible mainly due to the financial assistance of venture capital institutions.

(iii) Encourages Customers

The financial institutions provide venture capital to their customers not as a mere financial assistance but more as a package deal which includes assistance in management, marketing, technical and others.

(iv) Brings out Latent Talent

While funding entrepreneurs, the venture capital institutions give more thrust to potential talent of the borrower which helps in the growth of the borrowing concern.

(v) Promotes Exports

The Venture capital institution encourages export oriented units because of which there is more foreign exchange earnings of the country.

(vi) As Catalyst

A venture capital institution acts as more as a catalyst in improving the financial and managerial talents of the borrowing concern. The borrowing concerns will be more keen to become self dependent and will take necessary measures to repay the loan.

(vii) Creates more Employment Opportunities

By promoting entrepreneurship, venture capital institutions are encouraging self employment and this will motivate more educated unemployed to take up new ventures which have not been attempted so far.

3.4.3 Stages of Financing

Q20. Explain the stages of venture capital financing.

Ans : **(July-21, Dec.-20, Imp.)**

Further the early stage and the later stage are classified as follows;

(i) Early Stage

(a) Seed-capital or pre-start up.

(b) Start-up

(c) Second-round financing.

(ii) Later Stage

(a) Mezzanine/development capital

(b) Bridge/expansion

(c) Buyouts

  (i) Management buyouts

  (ii) Management buyins

(d) Turnarounds.

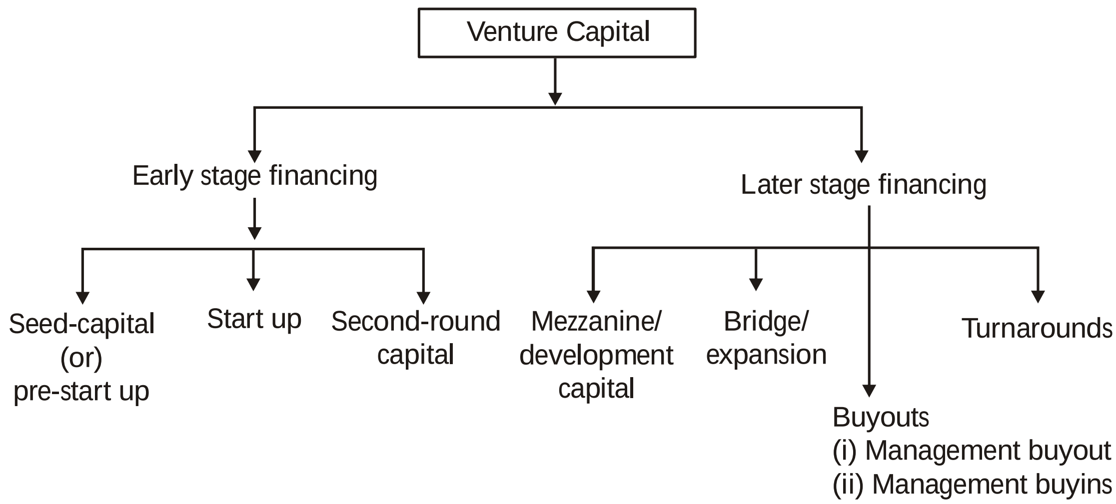

Fig.: Stages of Venture Capital Financing

1. Early Stage Financing

The early stage financing comprises of the following,

(a) Seed-capital/Pre-start Up

Seed capital is the first stage of early stage financing wherein new ideas and concepts of the promoters form the basis of a pre-commercialisation research project which is mostly expected to result in a prototype which may or may not lead to the establishment of the business. This stage is basically an "applied research" phase and it moves towards the development stage further resulting in prototype product testing and ultimately to the commer-cialisation process. VCIs have to make sure while evaluating the project that the technical competencies of the entrepreneur are as per the specifications and standards required in the market.

This stage involves greater marketing risk. The promoter's commercial decisions such as making optimum utilisation of the market opportunity, knowledge about competition, product launch time etc., all these form the essential components of the appraisal. Higher levels of risk prevail at this stage. As a result, only few venture capital institutions makes the seed-capital investment in the pre-commercialisation stage of product development.

(b) Start-up

Start-up stage of VC financing enables the commercial manufacturing to begin. Venture capitalists provides finance in this stage mainly for the product development and initial marketing. This stage holds greater significance because the product/service is commercialised for the first time in collaboration with the VCIs.

It comprises of different types of projects like,

(i) The greenfield projects which are either based on high technology or are new.

(ii) New business in which entrepreneur holds good knowledge about the work.

(iii) New projects by established companies.

(iv) A new company promoted by an existing company with scarce or meagre capital to commercialise new technology.

This stage indicates the availability of potential markets for the introduction of new product/service.

The participation level of VCIs in start-up projects is usually less/minimal due to partial equity dilution syndrome which results because of two reasons firstly, promoter's resistance to the dilution of control of the business and secondly, due to the unviability of the small amount of equity investment. The risk levels are also high.

(c) Second-round Financing

This stage indicates that the product has already been launched in the market, but the business has not grown enough to make public offerings in order to attract new customers. The promoter has already invested his own funds in the business but also requires the funds from venture capital institutions. The time period is less when compared to start-up investment. The VCIs provides/makes huge investment at this stage than at any other stage. A part of financing is also done in the form of debt, in order to provide some income to them.

2. Later Stage Financing

Later stage financing includes already existing businesses which needs additional financial support but cannot make public offerings. It includes the following,

(a) Mezzanine/Development Capital

Mezzanine capital provides finance to those existing businesses which have already gone through the high-risk early stage, have gained profits but not that enough to make public offerings and raise money from the capital market/conventional sources. Venture capital financing helps in purchasing new plant and machinery, widening the marketing and distribution facilities, refinance of an existing debt, capturing new areas, establishing new management and so on.

The development capital is usually provided for a time period of one to three years and holds medium risk level. It forms an important part of venture capital institution's activities.

(b) Bridge/Expansion

Bridge or expansion capital is financed for a period ranging from one to three years and holds lower levels of risk. Bridge capital or expansion capital is used for expanding business by growing their own productive assets or by acquiring other firm's assets. In simple words, it depicts the last round of financing before a planned exit.

(c) Buyouts

Buyouts means transfer of management control. Buyouts are basically of two types,

(i) Management Buyouts (MBOs)

(ii) Management Buyins (MBIs).

(i) Management Buyouts (MBOs): In MBOs, venture capital institutions provides finance to allow smooth functioning of the business and helps the existing operating management and the investors to acquire an existing product line or business. They form an important part of VCIs activities.

(ii) Management Buyins (MBIs): MBIs are the funds which are offered to allow an outside group or a third party usually managers to form a group and buy an ongoing company. MBIs pull in together three important elements,

- A management team
- A target company
- An investor.

Management buyins are not popular as management buyouts. Basically, MBIs are more riskier than MBOs because of the difficulty faced by the outside management to judge or acumen the real potential of the target company. Mostly, MBIs target the weaker or under performing companies.

The time period for buyouts ranges from one to three years with usually low risk perception.

(d) Turnarounds

Turnarounds are a sub-set of buyouts and includes buying the authority or control of a sick company. Turnarounds need two types of inputs, 'money' and 'management'. The venture capital institutions need to recognise good management and operation leadership. Turnarounds have medium to high levels of risks and their time period ranges from three to five years. Turnarounds are becoming popular day by day and are being accepted on large scale and draws major part of VCIs attention.

Q21. What is the strategic role of venture capital in the development of a country?

Ans :

A brief account of major ingredients of Indian venture capital industry is presented here.

1. IDBI Venture Capital Fund

The initial impetus was given by IDBI's Technology Division when venture capital fund was set up in 1986 for encouraging commercial application of indigenously developed technology and adopting imported technology for wider domestic applications.

The salient features of the scheme are :

1. Financial assistance under the scheme is available to projects whose requirements range between Rs. 5 lakhs and 2.5 crores. The promoters stake should be at least 10% for the ventures below Rs. 50 lakhs and 15% for those above Rs. 50 lakhs.

2. Assistance was extended in the form of unsecured loan involving minimum legal formalities. Interest at a confessional rate of 9% is charged during technology development and trial run production and 17% once the product is introduced in the market.

3. The fund extends financial assistance to ventures such as chemicals, computer softwares, electronics, bio-technology, non-conventional energy, food processing, medical equipment etc.

4. If the project does not succeed, IDBI can insist on transfer of technology to some other promoter designated by it on mutually agreed terms and conditions.

2. The Risk Capital and Technology Finance Corporation

The Risk Capital and Technology Finance Corporation Ltd., (RCTC) the subsidiary of IFCI provides venture capital through technology - finance and development scheme to meet the specific needs of such ' technology development. The RCTC, apart from providing assistance in the form of risk capital, is expected to finance high tech projects in the form of venture capital for technology upgradation and development. The assistance is provided in the form of short term conventional loan or interest free conditional loans allowing profit and risk sharing with the project sponsors or equity participation.

3. Technology Development and Information Company of India Limited (TDICI - 1998)

The venture capital fund was jointly created by Industrial Credit and Investment Corporation of India (ICICI) and Unit Trust of India (UTI) to finance projects of professional technocrats in the small and medium size industries who take initiative in designing and developing indigenous technology in the country. TDICI's first venture capital fund of Rs. 20 crores was subscribed equally by ICICI and UTI under the new Venture Capital Unit Scheme I of UTI. Under the scheme TDICI sanctioned financial support of Rs. 20 crores to 40 projects which include computer hardware, computer integrated manufacturing system, tissue culture, chemicals, food and feed technology, environmental engineering etc.

The TDICI's second venture Fund of Rs. 100 crores has been contributed by UTI, ICICI, other financial institutions, banks, corporate sector etc. By March 31, 1993, TDICI has disbursed Rs. 25.81 crores to 42 companies under scheme I and Rs. 79.29 crores to 79 companies under scheme II in a variety of industries such as computer, electronics, bio-technology, medical, non-conventional energy etc. Many of these projects are set-up by first generation entrepreneurs.

(i) TDICI invests in companies with attractive growth and earnings potential with a view to achieving long term capital gain. TDICI involves in seed, start-up, and growth stage companies in a wide spectrum of industrial sub-sectors.

(ii) The scheme seeks to assist technocrats involved in developing commercially viable technologies or products, implementing indigenously developed yet untested technologies on a commercial scale, and adapting innovative technologies for domestic applications.

(iii) The assistance per project may be up to Rs. 2 crore in the form of equity and/or conditional loan (with flexible interest rates and repayment period).

(iv) The equity in the project would be held for a period of 5-8 years and thereafter sold to the promoter (at a mutually price) or disposed in the secondary market.

(v) During the development phase, the conditional loan would carry no interest; during the post-development phase the interest fate on it would depend on the commercial viability of the project.

4. Gujarath Venture Finance Ltd. (GUFL)

The Gujarath Industrial Investment Corporation promoted Gujarat Ventrue Finance Ltd., the first state level venture finance company to begin ventrue finance activities since 1990. It provides financial support to the ventures whose requirements range between 25 lakhs and 2 crore. GUFL provides finance through equity participation and quasi equity instruments. The firms engaged in bio-technology, surgical instruments, conservation of energy and food processing industries are covered by GUFL. Total corpus of Rs. 24 crores of the fund was co-financed by GIIC, IDBI, state level finance corporations, some private corporate and the World Bank.

5. Andhra Pradesh Industrial Development Corporation's Venture Capital Ltd. (APIDC - VCL)

The APIDL -VCL was launched in June 1990 with a fund of Rs. 13.50 crore of which Rs. 4.5 crore was contributed by the World Bank, Rs. 3 crore by IDBI and Rs. 1.5 crore was committed by Andhra Bank. APIDC -VCL has a few proposal for venture capital financing in the sphere of biotechnology and computer software applications. Assistance to each venture is in the range of Rs. 25 lakhs to Rs. 1 crore and does not exceed 49 percent of the total equity of a project. Assistance is normally in the form of equity but depending on the circumstances loans may also be provided.

6. Canara Bank

Canara Bank has set up a venture capital fund called canbank venture capital fund worth Rs. 10 crore. It sanctions funds to diverse fields like chemicals, machines, food stuffs etc.

7. State Bank of India Capital Markets Ltd. (SBICAP)

The State Bank of India's subsidiary SBI Capital Markets Ltd. extend venture capital assistance to technical entrepreneurs who have good technique ability but lack financial strength. The support is by way of either direct subscription or by way of underwriting support to the company. In any case direct participation will not be in excess of 49% of the total paid up capital of the assisted unit. The projects in high priority, thrust areas such as import substitute, high export potential, hi-tech options are preferred. The equity holdings of assisted companies are generally disinvested in a period of three years either by way of sale to public, sale in the OTC exchange of India, sale by private treaty or by buy back arrangements with promoters or their nominees.

Q22. Make suggestions for the success of venture capital in India.

Ans :

Suggestions for the Growth of Venture capital funds

Venture capital industry is at the take off stage in India. It can play a catalytic role in the development of entrepreneurship skill that remains unexploited among the young and energetic technocrats and other professionally qualified talents. It can help promote new technology and hi-tech industries, which involve high risk but promises attractive rate of return. In order to ensure success of venture capital in India, the following suggestions are offered:

(i) Exemption Concession for Capital Gains

Capital gains law represents a hurdle to the success of venture capital financing. The earnings of the funds depend primarily on the appreciation in stock values. Further, the capital gains may arise only after 3 to 4 years of investment and that the projects, being in new risky areas, may not even succeed. Capital gains by corporate bodies in India are taxed at a much higher rate than gains of individual investors. Taking into account the high investment risk and long gestation period this is a deterrent to the development of VCFs.

The benefit of capital gains, under section 48 of the Act is not significant. Hence, it would be advisable that all long term capital gains earned by VCCs should be exempted from tax or subjected to concessional flat rate. Further, capital gains reinvested in new ventures should also be exempted from tax. Section 52(E) of the Act should be amended to give effect to this.

(ii) Development of Stock Markets

Guidelines issued by finance ministry provides for the sale of investment by way of public issue at the price to be decided on the basis of book value and earning capacity. However, this method may not give the best available prices to venture fund as it will not be able to consider the future growth potential of the invested company.

One of the major factors which contributed to the success of venture funds in the West is development of secondary and tertiary stock markets. These markets do not have listing requirements and are spread over all important cities and towns in the country. These stock markets provide excellent disinvestment mechanism for venture funds. In India, however, stock market is not developed beyond a few important cities.

Success of venture capital fund depends very much upon profitable disinvestment of the capital contributed by it. In US and UK, secondary and tertiary markets helped in accomplishing the above. However, in India, promotion of such makers is not feasible in the prevailing circumstances as such laissez faire policy may attack persons with ulterior motives in the business to the determent of the general public. However, stock market operation may be started at many more big cities where, say, the number of stock exchanges can be increased to 50. Further, permission to transact in unlisted securities with suitable regulation will ensure firsthand contact between venture fund and investors.

(iii) Fiscal Incentives

Fiscal incentives may be given in the form of lowering the rate of Income Tax. It can be accomplished by :

(i) Application of provisions applicable to non-corporate entities for taxing long term capital gains.

(ii) An allowance to funds similar to Section 80-CC of Income Tax Act, say 20 percent of the investment in new venture which can be allowed as deduction from the income.

(iv) Private Sector Participation

In US and UK where the economy is dominated by private sector, development of venture fund market was possible due to very significant role played by private sector which is often willing to put money in high risk business provided higher returns are expected. The guidelines by finance ministry provide that non-institutional promoter's share in the capital of venture fund cannot exceed 20 percent of total capital; further they cannot be the single largest equity holders. The private sector, because of this provision, may not like to promote venture fund business.

Promotion of venture funds by private sector, in addition to public financial institution and banks, is recommended as :

(a) Private sector is in advantageous position as compared to financial institutions and banks to provide managerial support to new ventures as leading industrial houses have a pool of experienced professional managers in all fields of management viz. marketing, production and finance.

(b) The leading business houses will be able to raise funds from the investing public with relative ease.

Q23. Explain the problems faced by venture capital firms in India.

Ans : **(Dec.-19, Imp.)**

There are certain pertinent issues of venture capital financing in India which synonymously are the issues of private equity as well are as follows:

- **Product risk:** The product risk concerned with little and no track records in the market as they have high rate of obsolescence.
- **Entrepreneur risk:** Another issue related to the venture capital financing is that it is very difficult to assess information of new management and new established business without prior track record.
- **Concentration risk:** Concentrating on small market which may be based either on product bases or on geographical basis, raises risk for sectorial downturn
- **Technology risk:** It is very difficult to assess new technology for small set of products.
- **Duration risk:** There is longer payback period for funding is needed
- **Asset risk:** There is high percentage of obsolete fixed assets, along with high fraction of man power, there is lack of collateralized assets, which is one of the issue concerned with venture capital financing.
- **Small deal size:** This is not found economical by most investors.

Short Question and Answers

1. Hire Purchase.

Ans :

Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company (creditor) to the hire purchase customer (hirer). The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with creditor and passes on to hirer on the payment of last instalment.

2. Financial Lease

Ans :

A financial lease is also known as Capital lease, Long-term lease, Net Tease and Close lease. In a financial lease, the lessee selects the equipments, settles the rice and terms of sale and arranges with a leasing company to buy it. He enters into a irrevocable and non-cancellable contractual agreement with the leasing company. The lessee uses the equipment exclusively, maintains it, insures and avails of the after sales service and warranty backing it. He also bears the risk of obsolescence as it stands committed to pay the rental for the entire lease period.

The financial lease could also be with purchase option, where at the end of the predetermined period, the lessee has the option to buy the equipment at a predetermined value or at a nominal value or at fair market price. The financial lease may also contain a non cancellable clause which means that the lessor transfers the title to the lessee at the end of the lease period.

Under a financial lease, the rate of lease would be fixed based on the kind of lease, the period of lease, periodicity of rent payment, and the rate of depreciation and other tax benefits available. The leasing company also charges nominal service charges to cover legal and other costs. The leasing company may also insist on collaterals or bank's guarantee in individual cases. In a large number of cases, the financial leases are used as financing cum tax planning tool.

3. Define term leasing.

Ans :

Leasing, as a financing concept, is an arrangement between two parties, the leasing company or lessor and the user or lessee, whereby the former arranges to buy capital equipment for the use of the latter for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. However, the lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Definitions

(i) **According to Dictionary of Business and Management,** 'Lease is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent.'

(ii) **According to James C. Van Horne,** 'Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.'

(iii) **Equipment Leasing Association of UK,** 'A Contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has possession and use of the asset on payment of specified retain over the period.'

Thus in a contract of lease there are two parties involved (i) lessor and the lessee. The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities. The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

4. Venture Capital.

Ans :

The concept of venture capital financing started emerging in the post-1990 throughout the nation India. Venture capital financing has contributed significantly in the developed countries economy in small and medium scale industries specially in UK and USA.

It plays a dominant role in providing finance to SSIs and highly technical and riskier ventures. Venture capital is regarded as a synonym of risky capital'. The term venture capital can be understood in several ways. In a narrow sense it implies, making investment in new and tried enterprises that suffer from inadequate growth.

5. Who are the parties involved in leasing?

Ans :

1. Lessors

Lessors are of different types such as specialized leasing companies, one-off lessors, manufacturer-lessor, banks-sponsored leasing companies, financial institutions, in-house lessors, etc.

2. Lessees

The lessee comprises wide range of companies i.e., from blue chip companies to small units, which get the financial services from the lessor companies. The considerations for which and the conditions under which such companies operate changes over a course of time. Most of the Indian lessees belong to the private sector.

3. Lease Brokers

Lease brokers are those intermediaries who are operating between the lessors and the lessees. Such individuals are responsible for recognizing the suitable lessor for a prospective lessee and vice versa. Lease brokers have adequate information about different types of lessors, they also maintains relationship which is helpful for lessors and the lessees as they provide financial benefits through tough negotiations.

4. Lease Financiers

Lease financiers are those banking institutions which provide financial support to the lessors with an objective of attaining the leased assets. Such assistance is provided as a result of the hypothecation of the leased asset and also by the provision of lease rentals.

6. Leverage Lease.

Ans :

A leverage lease is used for financing those assets which require huge capital outlay. The outlay for purchase cost of the asset generally varies from Rs. 50 lakhs to Rs. 2 crore and has economic life of 10 years or more. The leverage lease agreement involves three parties, the lessee, the lessor and the lender. The lessor acquires the assets as per the terms of the lease agreement but finances only a part of the total investment, say 20% to 50%. The balance is provided by a person or a group of persons in the form of loan to the lessor. The loan is generally secured by mortgage of the asset besides assignment of the leased rental payments. The position of the lessee under a leveraged leasing agreement is the same as in the case of any other type of lease. In leveraged lease, a wide range of equipments such as rail road, rolling stock, coal mining, electricity generating plants, pipe lines, ships etc. are acquired.

Under a leverage lease, there are some attractive investment features in the form of after-tax consequences for the owner of the equipment. By investing 20% or 25% of the cost of an asset, the lessor is entitled to 100% allowance for depreciation plus the investment allowance. In addition, interest expenses related to his borrowings are also tax deductible. From the point of view of lessee, lease rentals are deductible in full as an operating expense.

7. Sale and Lease back

Ans :

Under this type of lease, a firm which has an asset sells it to the leasing company and gets it back on lease. The asset is generally sold at its market value. The firm receives the sale price in cash and gets the right to use the asset during the lease period. The firm makes periodical rental payment to the lessor. The title to the asset vests with the lessor. Most of the lease back agreements are on a net — net basis which means that the lessee pays all maintenance expenses, property taxes and insurance. In some cases, the lease agreement allows the lease to repurchase, the property at the termination of lease.

The sale and lease back agreement is beneficial to both lessor and lessee. The lessor gets immediate cash which becomes available for working capital or for further expansion and lessor gets tax benefits. Retail stores, office buildings, multipurpose industrial building and shopping centres are financed under this method.

8. Advantage of leasing.

Ans :

The following are the advantages of leasing :

(i) Permit Alternative use of Funds

A leasing arrangement provides a firm with the use and control over asset without incurring huge capital expenditure. The firm is required only to make periodical rental payments. It saves considerable funds for alternative uses which would otherwise be tied up in fixed capital.

(ii) Faster and Cheaper Credit

Depending on tax structure of the lessee it costs less than other methods of acquiring assets. It permits firms to acquire new equipment without going thorough formal scrutiny procedure. Hence acquisition of assets under leasing agreement is cheaper and faster than any other source of finance.

(iii) Flexibility

Leasing arrangements may be tailored to the lessee's needs more easily that ordinary financing. Lease rentals can be structured to match the lessee's cash flows. It can be skipped during the months when the cash flows are expected to below.

(iv) Facilitates Additional Borrowings

Leasing may increase long-term ability to acquire funds. The lessee can utilize more funds for working capital needs. Moreover, acquisition of assets under the lease agreement does not alter debt equity ratio. Hence, the lessee can go for additional borrowings in case need arises.

(v) Protection against obsolescence

A firm can avoid risk of obsolescence by entering into operating lease agreement. This is highly useful in respect of assets which become obsolete at a faster rate.

9. Characteristics of hire purchase.

Ans :

i) Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.

ii) Each installment is treated as hire charges.

iii) The ownership of the goods passes from buyer to seller on the payment of the installment.

iv) In case the buyer makes any default in the payment of any installment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charge.

v) The hirer has the right to terminate the agreement any time before the property passes. The is, he has the option to return the goods in which case he need not pay installments falling due thereafter. However, he can not recover the sums already paid as such sums legally represent hire charge on the goods in question.

10. Operating lease.

Ans :

An operating lease is also known as Service lease, Short term lease or True lease. In this lease, the contractual period between lessor and lessee is less than the full expected economic life of equipment. This means that the lease is for a limited period, may be a month, six months, a year or few years. The lease is terminable by giving stipulated notice as per the agreement. Normally, the lease rentals will be higher as compared to other leases on account of short period of primary lease. The risk of obsolescence is enforced on the lessor who will also bear the cost of maintenance and other relevant expenditure. The lessor also does the services like handling warranty claims, paying taxes, scheduling and performing maintenance and keeping complete records lease is suitable for,

(a) Computers, copy machines and other office equipments, vehicles, material handling equipments etc. Which are sensitive to obsolescence and

(b) Where the lessee is interested in tiding over temporary problem.

Choose the Correct Answers

1. _______ is a long term risk capital to finance high technology projects which involve risk but at same time has strong potential for growth. [a]

   (a) Venture capital (b) Hedge finance

   (c) Merchant banker (d) Hire purchaser

2. _______ act as an intermediary to link up the sources of ideas and the sources of fund. [a]

   (a) Venture capital (b) Merchant banking

   (c) Leasing (d) None of these.

3. Which of the following is not a fee based financial service? [b]

   (a) Corporate counseling (b) Lease financing

   (c) Profit management (d) Issue management

4. Generally, a maximum of _______ lead managers are appointed as lead managers for issues less than ` 50 crores. [a]

   (a) Two (b) Three

   (c) Four (d) Five

5. A type of lease where the lessor is not related to the repairs and maintenance of the leased asset is known as, [a]

   (a) Net lease (b) True lease

   (c) Full payout lease (d) Financial lease

6. Companies which enters into leasing business for the purpose of taking the advantage of huge depreciation and tax benefits is, [b]

   (a) Specialized leasing companies (b) One-off lessors

   (c) Manufacturer lessors (d) Financial institutions

7. Select the benefits for lessor. [d]

   (a) Stable business (b) Second-hand market

   (c) Wider distribution (d) All the above

8. The following are the step of the leasing process, [d]

   (a) Lease selection (b) Lease contract

   (c) Lease period (d) All the above

9. Parties involved in hire purchase transaction are, [c]

   (a) Hirer (b) Hire-vendor

   (c) Both (a) & (b) (d) Lessor

10. The initial amount paid in hire purchase transaction is known as, [a]

   (a) Down payment (b) Interest

   (c) Depreciation (d) Cost of asset

Fill in the Blanks

1. In financial lease, _______ bears the risk of obsolescence.
2. _______ lease is for a limited period.
3. The leased asset is shown on the Balance sheet of the _______
4. An equipment lease transaction is regarded as a contract of _______
5. The entire lease rental is treated as _______ in the books of lessor.
6. The minimum size of VC Fund is Rs _______.
7. Venture capital originated in _______
8. In the implementation stage of a project venture capital firms provide _______ finance.
9. VC firms are allowed to invest in leasing upto _______ of the total funds deployed.
10. VC firms usually invest in _______ and _______ scale industries.
11. In _______ the ownership of asset is separated from economic use of an asset or equipment.
12. The consideration paid by the lessee as mentioned in the lease transaction is called as _______.
13. In _______ the parties stays in different countries.
14. A means of financing the price of goods to be sold on a future date is _______.
15. _______, and _______ are included in taxation aspects of hire-purchase transactions.
16. The rate of interest which is charged in HP as a percent of the original cash price of the asset is _______.
17. _______ is the balance amount which is by the hirer after making the down payment.
18. _______ refers to the total holding of securities of an investor.

Answer

1. Lessee
2. Operating lease
3. Lessor
4. Bailment

5. Income
6. Rs. 10 crs.
7. USA
8. Start up
9. 15%
10. Small and Medium
11. Leasing
12. Lease rentals
13. International lease
14. Hire-purchase
15. Income tax, sales tax and interest tax
16. Add-on rate of interest
17. Equated Monthly Installments (EMIs)
18. Portfolio

One Mark Answers

1. Define lessor.

Ans :

The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities.

2. Define lessee.

Ans :

The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

3. What is Hire purchase?

Ans :

Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company (creditor) to the hire purchase customer (hirer).

4. What is Venture Capital?

Ans :

"A financing institution which joins an entrepreneur as a co-promoter in a project and shares the risks and rewards of the enterprise".

5. Expand TDICI

Ans :

Technology Development and Informa-tion Company of India Limited

UNIT IV

NON FUND FINANCIAL SERVICES :

Non-Fund Based Financial Services–Credit Rating, Factoring and Forfaiting, Merchant Banking–Definition, Features, Mechanism, Types.

4.1 Non-Fund Based Financial Services

Q1. What are Non-Fund Based Financial Services?

Ans :

Financial intermediaries provide services on the basis of non-fund activities also. This can also be called "fee based" activity. Today, customers whether individual or corporate are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services, are being provided under this head. They include the following:

(i) Managing the capital issues, i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issues.

(ii) Making arrangements for the placement of capital and debt instruments with investment institutions.

(iii) Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.

(iv) Assisting in the process of getting all Government and other clearances.

4.2 Credit Rating

Q2. What is meant by Credit Rating?

Ans : **(Dec.-18)**

Definitions

(i) **According to Moody's** "Ratings are designed exclusively for the purpose of grading bonds according to their investment qualities".

(ii) **According to Australian Ratings,** "A Corporate Credit rating provides lenders with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted".

(iii) **According to CRISIL,** "Credit rating is an unbiased and independent opinion as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy/sell or hold a particular security."

(iv) **According to ICRA,** "Ratings are opinions on the relative capability of timely servicing of corporate debt and obligations. These are not recommendations to buy or sell neither the accuracy nor the completeness of the information is guaranteed."

From the above definitions it is understood that :

(i) Credit rating is an assessment of the capacity of an issuer of debt security, by an independent agency, to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument through out the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.

(ii) The ratings are expressed in code number which can be easily comprehended even by the lay investors. The ratings are the quickest way of understanding a company's financial standing without going into the complicated financial reports. Credit rating is only a guidance to the investors and not a recommendation to a particular debt instrument. The important element for investment decision making in debt security are (i) yield to maturity (ii) risk tolerance to investor and (iii) credit risk of the security. Clearly the focus of credit rating is on any one of these three elements viz., credit risk of the security and hence it can not by itself be a basis for investment decision making. It is only a current opinion on the relative capacity of firms to repay debt in time.

(iii) Credit rating, as it exists in India, is done for a specific debt security and not for a company as a whole. No rating agency tells that it is an indicator of the financial status of the company. All that a rating agency claims is that the rating symbols indicate the capacity of the company to honour the terms of contract of a debt instrument.

(iv) A debt rating is not a one time evaluation of credit risk, which can be regarded as valid for the entire life of the security. It is an on going appraisal. Changes in dynamic world of business may imply a change in the risk characteristics of the security. Hence debt rating agencies monitor the business and financial conditions of the issuer to determine whether modification in rating is warranted.

(v) A credit rating does not create a fiduciary relationship between the rating agency and the users of rating since there is no legal basis for such relationships.

Q3. What are the functions of credit rating?

Ans :

The credit rating firms are supposed to do the following functions:

1. Superior Information

Rating by an independent and professional firm offers a superior and more reliable source of information on credit risk for three inter related risks:

(a) it provides unbiased opinion.

(b) due to professional resources, a rating firm has greater ability to assess risks.

(c) it has access to lot of information which may not be publicly available.

2. Low Cost Information

A rating firm which gathers, analyses, interprets and summarises complex information in a simple and readily understood format for wide public consumption represents a cost effective arrangement.

3. Basis for a Proper Risk-Return Trade Off

If debt securities are rated professionally and if such ratings enjoy widespread investor acceptance and confidence, a more rational risk return trade off would be established in the capital market.

4. Healthy Discipline on Corporate Borrowers

Public exposure has healthy influence over the management of issuer because of its desire to have a clear image.

5. Formulation of Public Policy Guidelines on Institutional Investment

The public policy on the kinds of securities that are eligible for inclusion in different kinds of institutional portfolios can be developed with great confidence if securities are rated professionally by independent agencies.

Q4. Explain the benefits of credit rating?

(OR)

Discuss the advantages of credit rating.

Ans : **(Dec.-19)**

I) Benefits of Credit Rating

(i) Low Cost Information

Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information is done by a specialized agency which a group of investors can trust.

(ii) Quick Investment Decision

In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

(iii) Independent Investment Decision

For rated instruments, investors need not depend upon the advice of the financial intermediaries. As the rating symbol suggests the credit worthiness of the instrument and indicates the degree of risk involved in it, the investors can make direct investment decisions.

(iv) Investors Protection

Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. The creditible and objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

II) Benefits to Rated Companies

(i) Sources of Additional Certification

Credit rating agency provides additional information to the issuers or debt/financial instruments. A highly rated firm can enter the market with great confidence. Indian experience shows that use of rating, benefit a great deal by getting larger amount of money from a wider audience at a lower cost.

(ii) Increase the Investors Population

A sound credit rating system gives an alternative method to name recognition as a determining factor in making investment and helps increase the population of those investing in debt obligations of the company.

(iii) Forewarns Risks

Credit rating acts as a guide to companies which get a lower rating. It forewarns the management of the perception of risk in the market and prompts to take steps on their operating and marketing risks and thereby changes the perception in the market.

(iv) Encourages Financial Discipline

Ratings also encourage discipline among corporate borrowers to improve their financial structure and performance to obtain better rating for their debt obligations.

(v) Merchant Bankers Job Made Easy

Merchant bankers and brokers will be relieved of the responsibility of guiding investors as to the risk of a particular investment. Merchant bankers and brokers, in the absence of objective information, go on the basis of name recognition in guiding their clients. With the advent of credit rating, what they would be required to do is to bring to the attention of their clients the ratings of debt obligations.

(vi) Foreign Collaborations Made Easy

The foreign collaborators always ask for credit rating while “negotiating with an Indian company. Credit rating enables to identify instantly the relative credit standing of the company. The importance of credit rating is being increasingly recognised in the Euro-markets.

(vii) Benefits the Industry as a Whole

Relatively small and unknown companies use ratings to instill confidence in investors. Higher rate companies get larger amount of money at a lower cost. Thus the industry as a whole can benefit from ratings by direct mobilization of savings from individuals rather than from intermediary lending institutions.

(viii) Low Cost of Borrowing

A company with highly rated instrument has the opportunity to reduce the cost of borrowing by quoting lesser interest rate on fixed deposits or debentures as the investors with low risk preference would invest in safe securities though yielding low rate of return.

(ix) Rating as a Marketing Tool

Companies with rated instruments, use rating as a marketing tool to create better image in dealing with their customers, lenders and creditors.

Q5. Discuss the limitations of credit rating.

Ans : **(Dec.-19)**

Limitations

If the quality of credit rating is not good, then it may cause the following disadvantages,

1. If the rating is biased, then people make wrong decisions relating to investment. People lose faith in rating system which adversely affects the volume of investment made in the country.

2. Rating gives information about the degree of security of a special debt instrument or debt obligation but it does not provide complete information about the financial situation of the company. The high degree of rating investment in special debt instrument is unsafe and may result in heavy loss for investors.

3. Rating of a company depends on the existing and past data which does not provide complete information for future. Rating system has a major drawback that is, it is of static nature which does not provide any indication about the future changes.

Thus, in the absence of high quality rating, investors undergo several problems. So, it is necessary for a credit rating to be of high quality and without any bias.

Q6. Explain the classifications of credit rating.

Ans :

Types of Credit Rating

Credit rating is classified into four major types which are as follows,

1. **Bond Rating:** Bond rating deals with grading of bonds or securities which are issued by a company, government or semi-government institution. It denotes the possibilities of payment on the maturity of the bond. In other words, it ascertains whether the level of risk involved is more or less.

2. **Equity Rating:** The rating of shares which are traded in capital market are called as equity rating.

3. **Commercial Paper Rating:** A company is statutorily bound to avail rating level from a rating agency before issuing commercial paper. It is known as commercial paper rating. In India, the rating of commercial papers issued by corporate bodies is compulsory.

4. **Sovereign Rating:** Sovereign rating is related with the payment of the credit of the government of a country.

Q7. Outline the steps involved in credit rating process.

Ans : **(Oct.-20, Imp.)**

1. **Receipt of the Request**

   The rating process begins, with the receipt of formal request for rating from a company desirous of having its issue obligations under proposed instrument rated by credit rating agencies. An agreement is entered into between the rating agency and the issuer company.

   The agreement spells out the terms of the rating assignment and covers the following aspects:

   i) It requires the CRA (Credit Rating Agency) to keep the information confidential.

   ii) It gives right to the issuer company to accept or not to accept the rating.

iii) It requires the issuer company to provide all material information to the CRA for rating and subsequent surveillance.

2. Assignment to Analytical Team

On receipt of the above request, the CRA assigns the job to an analytical team. The team usually comprises of two members/ analysts who have expertise in the relevant business area and are responsible for carrying out the rating assignments.

3. Obtaining Information

The analytical team obtains the requisite information from the client company. Issuers are usually provided a list of information requirements and broad framework for discussions. These requirements are derived from the experience of the issuers business and broadly confirms to all the aspects which have a bearing on the rating. The analytical team analyses the information relating to its financial statements, cash flow projections and other relevant information.

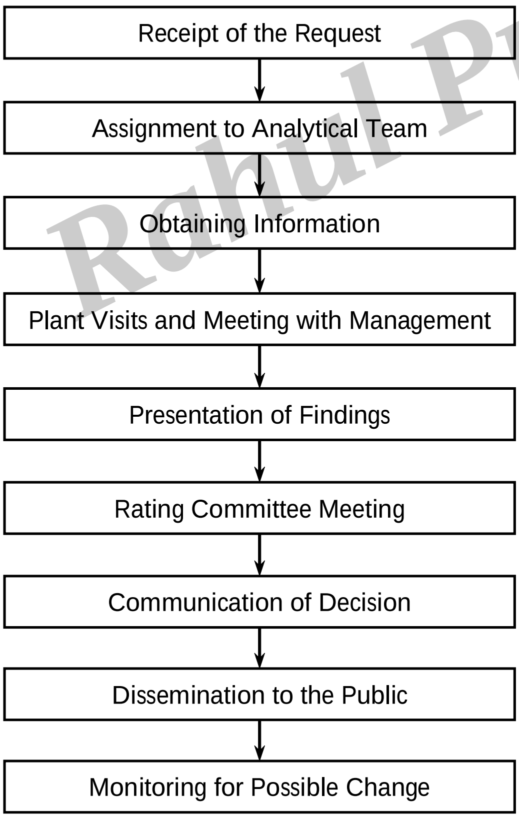

Fig.: Credit Rating Process

4. Plant Visits and Meeting with Management

To obtain classification and better understanding of the client's operations, the team visits and interacts with the company's executives. Plants visits facilitate understanding of the production process, assess the state of equipment and main facilities, evaluate the quality of technical personnel and form an opinion on the key variables that influence level, quality and cost of production. A direct dialogue is maintained with the issuer company as this enables the CRAs to incorporate non-public information in a rating decision and also enables the rating to be forward looking. The topics discussed during the management meeting are wide ranging including competitive position, strategies, financial policies, historical performance, risk profile and strategies in addition to reviewing financial data.

5. Presentation of Findings

After completing the analysis, the findings are discussed at length in the Internal Committee, comprising senior analysts of the credit rating agency. All the issues having a bearing on rating are identified. An opinion on the rating is also formed. The findings of the team are finally presented to Rating Committee.

6. Rating Committee Meeting

This is the final authority for assigning ratings. The rating committee meeting is the only aspect of the process in which the issuer does not participate directly. The rating is arrived at after composite assessment of all the factors concerning the issuer, with the key issues getting greater attention.

7. Communication of Decision

The assigned rating grade is communicated finally to the issuer along with reasons or rationale supporting the rating. The ratings which are not accepted are either rejected or reviewed in the light of additional facts provided by the issuer. The rejected ratings are not disclosed and complete confidentiality is maintained.

8. Dissemination to the Public

Once the issuer accepts the rating, the credit rating agencies disseminate it through printed reports to the public.

9. Monitoring for Possible Change

Once the company has decided to use the rating, CRAs are obliged to monitor the accepted ratings over the life of the instrument. The CRA constantly monitors all ratings with reference to new political, economic and financial developments and industry trends. All this information is reviewed regularly to find companies for, major rating changes. Any changes in the rating are made public through published reports by CRAs.

Q8. Explain the rationale of credit rating agencies in India.

Ans : **(July-21, July-19)**

The important credit rating agencies in India.

(i) IICRA

(ii) CARE

(iii) DCR

(iv) ONICRA

(v) CRISIL

(i) Investment Information and Credit Rating Agency of India (IICRA)

The IICRA was set up by Industrial Finance Corporation of India on 16th January, 1991. It is a public limited company with an authorised share capital of Rs. 101 crores. The initial paid up capital of Rs. 3.50 crores is subscribed by IFC, UTI, LIC, GIC, SBI and 17 other banks. IICRA started its operations from 15th March 1991.

During 1994-95, IICRA rated 212 debt instruments covering a debt volume of Rs. 5343 crores. The cumulative number of instruments rated since its inception till March 1995 has been 485 covering a total debt volume of Rs. 17,638 crores.

(ii) Credit Analysis and Research Limited (CARE)

The CARE was promoted in 1993 jointly with investment companies, banks and finance companies. Services offered by CARE are

(i) Credit rating

(ii) Information service

(iii) Equity research

(iv) Rating of paralled market of LPG and kerosene.

Since its inception till the end of March 1995, CARE has rated 249 debt instruments covering a total debt volume of Rs.9,729 crores.

(iii) Duff and Phelps Credit Rating India Private Ltd. (DCR)

The Duffs and Phelps is a leading international credit rating agency. The J.M. Financial and Allance Group in joint venture with Duffs and Phelps has now set-up DCR in India. Its main objective is to give credit rating to debt instruments. On special request it may undertake rating of companies and countries as well. The popular symbol employed by DCR is Dl, D2, D3 etc. depending upon the credit status. For example, the RBI has stipulated a minimum credit rating of D-2 DCR India for the purpose of issuing commercial papers by instructions.

(iv) Onida Individual Credit Rating Agency Ltd. (ONICRA)

Almost all credit rating agencies established in India undertake credit analysis work of corporate bodies only. Unlike these agencies, the ONICRA Ltd. has taken up the individual borrowers. It has been sponsored by the Onida Finance Ltd. In all credit transactions relating to credit cards, Housing Finance, Rental/H.P. agreements, personal loan etc., it becomes imperative that one should know the quantum of default risk associated with such transactions before entering into those transactions. It is where the ONICRA comes into picture. It does not rate the individual as such but the risk associated with entering into those credit transactions with that individual at a certain period. Thus, it helps the users of this rating to know risks associated with credit transactions while dealing; with individuals. It is gaining popularity among financial institutions.

(v) Credit Rating Information Service Ltd. (CRISIL)

Credit Rating Information Services Limited (CRISIL) the first credit agency was floated on January 1, 1988. It was started jointly by ICICI and UTI with an equity capital of Rs.4 crores. Each of them holds 18% of the capital. The other promoters are Asian Development Bank (15%), the LIC and General Insurance Corporation and its subsidiaries and the SBI (5% each), the Housing Finance Development Corporation (6.2%), nine public sector and private sector banks (19.25%) and 10 foreign banks (7.55%).

The principal objective of CRISIL is to rate the debt obligations of Indian Companies. Its rating guides investors about the risk of timely payment of interest and principal on a particular debt instrument.

Objectives

- To assist both individual and institutional investors in making investment decisions in fixed income securities.
- To enable corporates to raise large amounts at fair cost from a wide spectrum of investors.
- To enable intermediaries in placing their debt instruments with investors by providing them with an effective marketing tool.

CRISIL has five offices one each in Mumbai, Delhi, Kolkata, Chennai and Bangalore.

Q9. Explain the methodology followed by CRISIL in rating credit instruments.

(OR)

Explain the credit rating procedure adopted by CRISIL.

Ans : **(Dec.-20)**

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Rating Methodology

- CRISIL commences a rating exercise at the request of a company. In accordance with industry practice all over the world, the methodology involves an analysis of the past performance of the company and assessment of its prospects.
- The first analysis relates to the past performance of the company. However, the past is viewed not as a guide, but to understand why the company performed in the way it did, what problems it faced and what the management's response to these problems was.

- To assess the future prospects, CRISIL studies the industry or industries in which the company operates and the company's position within the industry. It also makes an evaluation of the management and cash flow projections of the company and identifies the key issues concerning the company.
- The industry is studied by analysing demand and supply growth, nature and basis of competition, Government policy for the company and the effect of change in Government policy on the future of the company. The position of the company within the industry is studied to understand how the company would fare in the future.
- CRISIL, therefore, looks at the operating efficiency in terms of locational advantage, raw material, power and labour situation; its cost structure as compared to that of its nearest competitors and the company's market position in terms of its market share, product strength, selling and distribution arrangements, competitive advantage, customer delivery etc.
- CRISIL, evaluates the management of the company with reference to its tract record, the recruitment and training system, planning and control system, depth of managerial talents and succession plans, goals for the company, the philosophy of doing business, attitudes towards taking business risks and the strategies for the company. The tenacity, determination and drive of the management to overcome problems as they arise in the company is yet another factor assessed by the CRISIL.
- Then, CRISIL makes its own assessment of cash flows and decides the degree of comfort available from the cash flows to meet cash needs of the company for capital expenditure, working capital growth and debt servicing obligations. In addition, it assesses the company's ability to raise funds quickly in various ways in times of necessity to meet the requirements of servicing debt.
- The rating process seeks to identify the key issues concerning the company. For instance, if a company is putting up a new project, the key issue in the rating is the likelyhood of timely completion of the project. The rating is a composite assessment of all these factors with the key issue getting greater attention from the Rating agency.
- In evaluating the ratings, crisil employs both qualitative and quantitative criteria. The judgement made by the crisil is necessarily subjective and the quantitative analysis is meant to assist in making best possible overall qualitative judgement.
- CRISIL employs a multi-layered decision-making process in assigning ratings. When it receives a request for ratings it assigns two teams on the job. The first team meets the officials and makes an assessment of the industry, company and management. The second team is also required to make its own study of the industry. Then the first team interacts with the back up team. The findings of the interactions are presented simultaneously in a detailed note to the Branch Internal Committee comprising atleast three senior analysts of CRISIL and an Internal Committee of six senior executives and thereafter the note is presented with the recommended ratings to the Rating Committee comprising six directors of the company who are not connected with any shareholders of CRISIL. The Rating Committee members are chosen carefully so that they do not have any links with industries or investment agencies connected with the units being rated. This multi-layered process ensures that no individual decides on rating and that prejudices and biases are eliminated.

The evaluation of the company is made on a confidential basis. The rating process ensures complete confidentiality of information that may be provided by the company.

Credit rating Symbols

CRISIL uses the conventional rating symbols used in the USA and widely accepted in many other countries.

The following table shows the investment-wise rating symbols assigned by CRISIL and the meaning of each rating from the angle of safety to the investors.

CRISIL Debenture Rating Symbols

High Investment Grades		
AAA (Triple A)	:	Highest Safety
AA (Double A)	:	High Safety
Investment Grades		
A	:	Adequate Safety
BBB (Triple B)	:	Moderate Safety
Speculative Grades		
BB (Double B)	:	Inadequate Safety
B	:	High Risk
C	:	Substantial Risk
D	:	Default

Notes

1. CRISIL may apply '+' (plus) or (minus) sign for ratings from AA to C to reflect comparative standing within the category.
2. The contents within parenthesis are a guide to the pronunciation of the rating symbols.
3. Preference shares rating symbols are identical to debenture rating symbols except the letters 'pf' are prefixed to the rating symbols, e.q., pf AAA ("pf Triple A").

CRISIL Fixed Deposit Rating Symbols

Investment Grades		
FAAA (F-Triple A)	:	Highest Safety
FAA (F-Double A)	:	High Safety
FA	:	Adequate Safety
Speculative Grades	:	
FB	:	Inadequate Safety
FC	:	High Risk
FD	:	Default

Note

(1) CRISIL may apply '+' (plus) or (minus) sign for ratings from FAAA to FC to indicate the relative position within the rating category.

(2) The contents within parenthesis are a guide to the pronounciation of the rating symbols.

CRISIL monitors the ratings it assigns constantly. The ratings may be upgraded, downgraded or withdrawn depending upon new information or developments concerning the company whose debt obligation is rated. It has the right to widely disseminate the ratings through the media, through its own publications or through any other methods.

Credit Rating for Short Term Instruments

Rating Symbol	Indication
	(Each rating indicates that the degree of safety regarding timely payment on the instrument is shown against the symbol)
P_{-1}	Very Strong
P_{-2}	Strong
P_{-3}	Adequate
P_{-4}	Minimal
P_{-5}	Expected to be in default on maturity or in default

Note:

CRISIL may apply " + " signs for ratings from PO-1 to P-3 to reflect a comparatively higher standing within the category.

Operations of CRISIL

During 1994-95, CRISIL rated 379 instruments covering a debt volume of Rs.34,544 crores. The cumulative number of instruments rated by CRISIL since its inception in January 1988, till the end of March 1995 has been 1305 and the value of instruments covered has been Rs. 78,151 crores.

The CRISIL has published CRISIL Bond Yield Tables to provide handy reference to investors for determining yield-to-maturity on a debenture, given the price of debenture, its coupon rate and its maturity period.

During the year 1990-91, CRISIL started a quarterly publication called CRISIL RATING SCAN containing rating reports on companies whose instruments have been rated by CRISIL during the quarter and which are using the rating. These rating reports contain details of rating instruments, rationale for rating assigned, brief details of the business of the borrower and the key issues involved in the rating. CRISIL RATING SCAN also includes details of rating in use, ratings reviewed during the quarter, the instruments which have been placed under 'rating watch' and rating symbols with definition.

"CRISIL CARD" service was developed by CRISIL during the year 1990-91. The service provides details about a company such as business it is engaged in shareholding pattern, key management personnel, plant location, equity share record, analysed profit and loss accounts and balance sheet for the last four years, accounting practices, key financial ratios, raw material consumption, major competitors, major lenders excerpts from the Directors' reports and events after the balance sheet date.

CRISIL has won international recognition. It is one of the four international companies shortlisted by the Asian Development Banks for being appointed as consultant for setting up a credit rating organization in Thailand.

The CRISIL has set up an information company in collaboration with Extel Financial Limited of the U.K. called CRISIL Information Limited. The company has a paid up equity capital of Rs.50 lakhs of which EXTEL and CRISIL have contributed 26 per cent each and the balance is paid by the employees. CRISIL Information Limited provides a wide range of information based on published data.

Standard and Poor's Rating Services, a global rating agency from the USA, has formed strategic alliance with CRISIL for providing analytical and business development co-operation.

CRISIL has so far rated a cumulative debt volume exceeding $ 30 billions covering 1500 debt instruments covering 1000 companies.

Q10. What is CIBIL? Who are its members? What are the objectives of CIBIL?

(OR)

Write a short note on CIBIL.

Ans : **(Dec.-19, May-19, Imp.)**

Credit Information Bureau (India) Limited, commonly known as CIBIL, is India's first Credit Information Company or Credit Bureau. It maintains records of all credit-related activity of individuals and companies including loans and credit cards. The records are submitted to CIBIL by registered member banks and other financial institutions on a periodic (usually monthly) basis. Based on this data, CIBIL issues a Credit Information Report or CIR (commonly referred to as a credit report) and a credit score.

CIBIL was founded in 2000 in order to bring greater efficiency and transparency in the credit space. Trans Union International (a global credit bureau) and Dun and Bradstreet (a global provider of credit information) are technical partners of CIBIL in India. CIBIL's mission is "To catalyze growth of Credit in India through: solutions that enable well informed Credit decisions; technology that enables superior information availability; and people that provide high quality services." It has an ISO 27001 rating, which is the highest security standard in the world.

Shareholders in CIBIL include Trans Union International, ICICI, SBI, IOB, HSBC, Union Bank of India, Bank of India, Bank of Baroda, and Allahabad Bank.

CIBIL has two focus areas: A Consumer Bureau that deals with consumer credit records and a Commercial Bureau that deals with the records of companies and institutions.

It is important to note that CIBI is a database of credit information. It does not make any lending decisions. It provides data to banks and other lenders who use it as a quick and efficient resource to filter loan applications.

CIBIL is one of the four authorized credit bureaus in India which provide a credit score, the others being Equifax, Experience and CRIF High Mark.

The most important factor in your credit score is your repayment history. Your payment record forms approximately 30% of your credit score. Making your all your credit repayments (on loans and credit cards) on time and in full plays a substantial role in building a good credit score. Below are some of the important factors that impact your credit score.

Members

The following are the members of CIBIL

1. Financial Institution
2. Banks
3. SFC
4. NBFC
5. Housing financial companies

Objectives

- CIBIL aims to give full information to lenders by collecting, collecting and distributing credit information related both to lenders as well as the borrowers.
- Banks, Financial Institutions, Non-Banking Financial Companies, Housing Finances Companies and Credit Card Companies use CIBIL services.
- Data is shared with only those members who have submitted all their credit data.
- It takes pride in having the topmost credit information sharing in India that makes enable the credit grantor in accepting payment and information backed decisions.
- CIBIL has gained knowledge, experience and expertise to offer data and technology backed solutions
- Wide gamut solutions were developed diligently for helping our customers in making intelligent decision in entire stage of customer life cycle.

4.3 Factoring

Q11. What is Factoring? Explain the functions of factoring.

Ans : **(Dec.-20, Dec.-19, July-19, Imp.)**

Meaning

The word ‘Factor’ has been derived from the Latin word ‘Facere’ which means ‘to make or to do’. In other words, it means ‘to get things done’. According to the Webster Dictionary ‘Factor’ is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client’s trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 percent payment. To put it in a layman’s language, a factor is an agent who collects the dues of his client for a certain fee.

Definitions

(i) According to Robert W. Johnson in his book ‘Financial Management’ states, “factoring is a service involving the purchase by a financial organization, called a factor, of receivables owned to manufacturers and distributors by their customers, with the factor assuming full credit and collection responsibilities”.

(ii) According to V. A. Avadhani, “factoring is a service of financial nature involving the conversion of credit bills into cash”.

(iii) According to Kohok, “factoring is an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods”. Prof. S.P. Singh, a member of the study group appointed by the RBI to examine the feasibility of introducing factoring services in India feels that “factoring which traditionally meant buying of book debts for cash is not merely invoice discounting or credit insurance.

Functions

Factoring involves the following functions:

1. Purchase arid collection of debts.
2. Sales ledger management,
3. Credit investigation and undertaking of credit risk,
4. Provision of finance against debts, and
5. Rendering consultancy services.

1. Purchase and Collection of debts

Factoring envisages the sale of trade debts to the factor by the company, i.e., the client. It is where factoring differs from discounting. Under discounting, the financier simply discounts the debts backed by account receivables of the client. He does so as an agent of the client. But, under factoring, the factor purchases the entire trade debts and thus, he becomes a holder for value and not an agent. Once the debts are purchased by the factor, collection of those debts becomes his duty automatically.

2. Sales ledger management

Sales ledger management function is a very important one in factoring. Once the factoring relationship is established, it becomes the factor’s responsibility to take care of all the functions relating to the maintenance of sales ledger. The factor has to credit the customer's account whenever payment is received, send monthly statements to the customers and to maintain liaison with the client and the customer to resolve all possible disputes. He has to inform the client about the balances in the account, the overdue period, the financial standing of the customers/etc. Thus, the factor takes up the work of monthly sales analysis, overdue , invoice analysis and credit analysis.

3. Credit investigation and undertaking of credit risk

The factor has to monitor the financial position of the customer carefully, since, he assumes the risk of default in payment by customers due to their financial inability to pay. This assumption of credit risk is one of he most important functions which the factor accepts. Hence, before accepting the risk, he must be fully aware of the financial viability of the customer, his past financial performance record, his future ability, his honesty and integrity in the business world etc. For this purpose, the factor also undertakes credit investigation work.

4. Provision of finance against debts

After the finalisation of the agreement and sale of goods by the client, the factor provides 80% of the credit sales as prepayment to the client. Hence, the client can go ahead with his business plans or production schedule without any interruption. This payment is generally made without any recourse to the client. That is, in the event of non-payment, the factor has to bear the loss of payment.

5. Rendering consultancy services

Apart from the above, the factor also provides management services to the client. He informs the client about the additional business opportunities available, the changing business and financial profiles of the customers, the likelihood of coming recession etc.

Q12. What are the objectives of factoring?

Ans : **(Imp.)**

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.
2. To minimize the risk of bad debts arising on account of non-realisation of credit sales.
3. To adopt better credit control policy.
4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

Q13. What are the features of factoring?

Ans : **(Dec.-18)**

The features of factoring are as follows,

1. The Nature

The nature of the factoring contract is same like the nature of bailment contract. Factoring is considered as a specialized activity through which a firm can transform its receivables into cash by selling them to a factoring organization. The factor usually bears the risk involved in the collection or receivables and at the time of non-payment by the customers debtors. He also bears the risk of a bad debt loss.

2. The Form

As factoring includes only those receivables which are usually not promoted by negotiable instruments like bills of exchange etc., it is in the form of "invoice factoring". This is mainly because the firm adopts the practice of bill discounting with its bankers when the receivables are supported by the bills. Factors helps the debtors of the firms to become the debtors of the factor.

3. The Assignment

In the factoring process the debt is assigned in support of the factor. This is considered as the primary prerequisite for the working of a factoring service.

4. Fiduciary Position

The factor holds fiduciary position as it occurs from the relationship with the client firm. The factor is held liable for meeting the terms of contract between the parties.

5. Professionalism

The factoring firms are professionally talented and have competent employees who manages the credit sales realizations for various clients in different trends for effective management of credit.

6. Credit Realizations

The factors helps in the realization of credit sales. The also assist in avoiding the risk of bad debt loss.

7. Less Dependence

The factors assists in decreasing the dependence on bank finance towards the working capital. This in turn helps the firm to relieve from finding the financial facility

8. Recourse Factoring

Factoring can be non-resource wherein the factor does not have any resource to the supplier on non-payment from the customer. The factoring can also be a recourse wherein the factors will have a recourse to the seller at the time of non-payment by the buyers.

9. Compensation

The factor generally operates for a service charge which is generally computated on the turnover. After subtracting the required charges the factor pays the net amount.

Q14. Explain the different types of factoring and their significance.

Ans :

Types

The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc. In general, the factoring services can be classified as follows :

(i) Full service factoring or without recourse factoring

(ii) With Recourse Factoring

(iii) Maturity Factoring

(iv) Bulk Factoring

(v) Invoice Factoring

(vi) Agency Factoring

(vii) International Factoring

(viii) Suppliers Guarantee Factoring

(ix) Limited Factoring

(x) Buyer Based Factoring

(xi) Seller Based Factoring

(i) Full service factoring or without recourse factoring

Under this type, a factor provides all kinds of services discussed above. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility falls on the shoulders of the factor since he assumes the credit risk also. He can not pass on this responsibility to his client and, hence, this type of Factoring is also called 'Without Recourse' Factoring.

(ii) With Recourse Factoring

As the very name suggests, under this type, the factor does not assume the credit risk. In other words, if the debtors do not repay their dues in time and if their debts are outstanding beyond a fixed period, say 60 to 90 days from the due date, such debts are automatically assigned back to the client. The client has to take up the work of collection of overdue account by himself. If the client wants the factor to go on with the collection work of overdue accounts, the client has to pay extra charges called 'Refactoring Charges'.

(iii) Maturity Factoring

Under this type, the factor does not provide immediate cash payment to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire .amount collected less factoring fees is paid to the client immediately. Hence it is also called 'collection Factoring'. In fact, under this type, no financing is involved. But all other services are available.

(iv) Bulk Factoring

Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring is resorted to when the factor is not fully satisfied with the financial condition of the client. The work relating to sales ledger administration, credit control, collection work etc., has to be done by the client himself. Since the notification has been made, the factor simply collects the debts on behalf of the client. - This is otherwise called as "Disclosed Factoring" or "Notified Factoring".

(v) Invoice Factoring

Under this type, the factor simply provides finance against invoices without undertaking any other functions. All works connected with sales administration, collection of dues etc. have to be done by the client himself. The debtors are not at all notified and hence they are not aware of the financing arrangement. This type of factoring is very confidential in nature and hence it is called 'Confidential Invoice Discounting' (or) 'Undisclosed Factoring'.

(vi) Agency Factoring

The word agency has no meaning as far as factoring is concerned. Under this type, the factor and the client share the work between themselves as follows:

(i) The client has to look after the sales ledger administration and collection work and

(ii) The factor has to provide finance and assume the credit risk.

(vii) International Factoring

Under this type, the services of a factor in a domestic business are simply extended to international business. Factoring is done purely on the basis of the invoice prepared by the exporter. Thus, the exporter is able to get immediate cash to the extent of 80% of the export invoice under international factoring. International factoring is facilitated with the help of export factors and import factors.

(viii) Suppliers Guarantee Factoring

This type of factoring is suitable for business establishments which sell goods through middlemen. Generally, goods are sold through wholesalers, retailers or through middlemen. In such cases, the factor guarantees the supplier of goods against invoices raised by the supplier upon another supplier. The bills are assigned in favour of the factor who guarantees payment of those bills. This enables the supplier to earn profits without much financial involvement.

(ix) Limited Factoring

Under this type, the factor does not take up all the invoices of a client. He discounts only selected invoices on merit basis and converts credit bills into cash in respect of those bills only.

(x) Buyer Based Factoring

In most cases, the factor is acting as an agent of the seller. But under this type, the buyer approaches a factor to discount his bills. Thus, the initiative for factoring comes from the buyers' end. The approved buyers of a company approach a factor for discounting their bills to the company in question. In such cases, the claims on such buyers are paid by discounting the bills without recourse to the seller and the seller also gets ready cash. This facility is available only to reputed credit worthy buyers and hence it is also called selected Buyer Based Factoring.

(xi) Seller Based Factoring

Under this type, the seller, instead of discounting his bills, sells all his accounts receivables to the factor, after invoicing the customers. The seller's job is over as soon as he prepares the invoices. Thereafter, all the documents connected with the sale are handed over to the factor who takes over the remaining functions. This facility is extended to reputed and credit worthy sellers and hence it is also called 'Selected Seller Based Factoring.

Q15. What are the advantages factoring?

Ans : **(Dec.-18)**

Factoring offers a number of benefits to the clients. Some of the important benefits are :

(i) Financial Service

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. This has been a great handicap to the small and medium scale manufacturers because they have to wait for 3 months to 9 months to realise their debts. In the meantime, the business may suffer due to want of funds. Infact, many business concerns fail more as a result of inadequate cash flow than anything else. The key to successful working capital management lies in the ability of an enterprise to convert sales into cash flow and the speed at which it is done. The major benefit of the factoring service is that the clients will be able to convert their trade debts into cash upto 80% immediately as soon as the credit sales are over. They need not wait for months together to get cash for recycling.

Another major advantage is that there are no constrains by way of fixed limits as in the case of cash credit or O.D. As sales grow, the financial assistance also grows and both are directly proportional to each other.

The greatest advantage is that factoring assures immediate cash flow. When the cash position improves, the client is able to make his purchases on cash basis and thus, he can avail of cash discount facilities also.

(ii) Collection Service

Collection of debts is another problematic area for many concerns. It is found that over 60% of the total sales of the SSI sector and over 50% of total sales of the medium and large scale sector are made on "On Account Terms of Payment", i.e., credit sales. It means that collection of debts becomes an important internal credit management and it requires more and more time. So, industrialists cannot concentrate on production. Delay in collection process often leads to delay in production and supplies. Moreover, the interest cost of financing book debts is also on the increase. Ultimately, it affects the profitability of the company. Now, this collection work is completely taken up by the factoring organization, leaving the client to concentrate on production alone. This is an important service rendered by a factor to his client. The cost of collection is also cut down as a result of the professional expertise of a factor.

(iii) 'Credit risk' Service

In the absence of a factor, the entire credit risk has to be borne by the client himself. Bad debts eat away the profits of a concern and in some cases, it may lead to the closure of a business. But, once the factoring relationship is established, the client need not bother about the loss due to bad debts. The factor assumes the risk of default in payment by customers and thus, the client is assured of complete realisation of his book debts. Even if the customer fails to pay the debt, it becomes the responsibility of the factor to pay that amount to the client. It is the greatest advantage of factoring.

(iv) Provision of Expertised 'Sales Ledger Management' Service

Administration of sales ledger is purely an accounting function which can be performed efficiently only by a few. Infact, the success of any organization depends upon the efficiency with which the sales ledger is managed. It requires a specialized knowledge which the client may not possess. But, the client can receive services like maintenance of accounting records, monthly sales analysis, overdue invoice analysis and customer payment statement from the factor. Besides, he maintains contact with customers to ensure that they repay their dues promptly. Thus, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. Thus, factoring offers an excellent credit control for the client.

(v) Consultancy Service

Factors are professionals in offering management services like consultancy. They collect information regarding the credit worthiness of the customers of their clients, ascertain their track record, quality of portfolio turnover, average size of inventory etc., and pass on the same to their clients. It helps the clients avoid poor quality and risky customers. They also advise their clients on important financial matters. Generally, no time is available to the client for investigating his customer's credit standing. Now, the factor takes up this work on behalf of his client.

(vi) Economy in Servicing

Factors are able to render very economic service to their clients because their overhead cost is spread over a number of clients. Moreover, their service charges are also reasonable. Factoring is a cheap source of finance to the client because the interest rate is charged only on the amount actually provided to the client, say, for instance, 80% of his total invoices and not on the total amount of the invoices. Thus, clients are able to get factoring services at economic rates.

(vii) Trade Benefits

Availability of ready cash against bills enables the supplier to negotiate better prices for the inputs and also offer finer terms to customers. It ensures a steady flow of inputs on the one hand and better market prospects on the other. Again, factoring enables the supplier to concentrate on production and materials management without bothering about the financial management. Factoring enables clients to offer longer credit facilities to their customers and thus to attract more business. Thus many trade benefits are available under factoring.

(viii) Miscellaneous Service

Generally, factors are able to computerise their operations fully. So they are able to render prompt service at reasonable rates. They spend more on M.I.S. analysis. They also build bigger credit library of debtors by means of collecting information about new debtors.

Thus, improved cash flow through realisation of trade debts by factoring, efficient follow up of collections, computerised sales ledger maintenance and the competitive rates are the main benefits of factoring.

Q16. Examine the problems of factoring services in India.

Ans : **(Dec.-18)**

The following are the problems of factoring are :

1. Credit Information

There is no authentic source of information available for factors so they have to rely on their own database for evaluating the credit of the clients. The system of multiple data bases formed by individual factors is expensive and lacks uniformity which is a serious obstacle in the growth of factoring service. The development of specialized credit information agency is needed urgently.

2. Stamp Duty

The stamp duty which is changed by the states is influenced by debt assignment, the stamp duty is more than 15 percent on the amount which is more than ? 2 lakh. It increases the cost of operations of service and minimizes the profitability of the factors. A very strong case is available for waiving the stamp duty on the assignment of debt factors.

3. Legal Framework

The kalyansundaram Committee suggested that changes are to be made in the other parts of the present legal framework for assuring that the factoring attains success in India.

4. Funding

In India, the factors are not allowed to access extensive funding sources on scales provided for other finance companies. The virtual dependence on equity funds, does not allows them to have optimal funding. In order to have cost effective financing of these companies, there is an urgent need to have greater access to the debt and money markets such as leasing and other finance companies.

5. Disclaimer Certificate

A factor requires a disclaimer certificate from banks for purchasing a book debt of its clients. In the present scenario, they are not willing to issue such a certificate, hence the factoring companies must be allowed to purchase book debts without needing such certificate from banks.

6. Limited Coverage

In India, only domestic factoring of the advance with recourse in allowed and offered. Even though, ECGC and SBI FACS have introduced various measures for export factoring, headway has not been made. Hence, it is necessary and is the right time to offer export factoring to Indian exporters.

4.4 Forfaiting

Q17. Define Forfaiting.

(OR)

What is meant by Forfaiting?

Ans : **(July-19)**

Meaning

Forfaiting is another source of financing against receivables like factoring. This technique is mostly employed to help an exporter for financing goods exported on a medium term deferred basis.

The term 'a forfait' is a French word denoting 'to give something' or 'give up one's rights' or 'relinquish rights to something'. In fact, under forfaiting scheme, the exporter gives up his right to receive payments if future under an export bill for immediate cash payments by the forfaitor This right to receive payment on the due date passes on to the forfaitor since, the exporter has already surrendered his right to the forfaitor. Thus the exporter is able to get 100% of the amount of the bill minus discount charges immediately and get the benefits of cash sale. Thus, it is a unique : medium which can convert a credit sale into a cash sale for an exporter The entire responsibility of recovering the amount from the importer rests with the forfaitor. Forfaiting is done without any recourse to the exporter, i.e., in case the importer makes a default, the forfaitor cannot go back to the exporter for the recovery of the money.

Definition

Forfaiting has been defined as "the non-recourse purchase by a bank or any other financial institution, of receivables arising from an export of goods and services.

Q18. Compare and contrast Factoring and Forfaiting.

Ans :

S.No.	Nature	Factoring	Forfaiting
1.	**Meaning**	Factoring is an arrangement that converts your receivables into ready cashand you don't need to wait for the payment of receivables at a future date.	For faiting implies a transaction in which the for faiter purchases claims from the exporter in return for cash payment.
2.	**Maturity of receivables**	Involves account receivables of short maturities.	Involves account receivables of medium to long term maturities.
3.	**Goods**	Trade receivables on ordinary goods.	Trade receivables on capital goods.
4.	**Finance up to**	80-90%	100%
5.	**Type**	Recourse or Non-recourse	Non-recourse
6.	**Cost**	Cost of factoring borne by the seller (client).	Cost of for faiting borne by the overseas buyer.
7.	**Negotiable Instrument**	Does not deals in negotiable instrument.	Involves dealing in negotiable instrument.
8.	**Secondary market**	No	Yes

Q19. Explain the steps involved in forfaiting.

Ans :

Steps :

The following steps are followed in forfeiting,

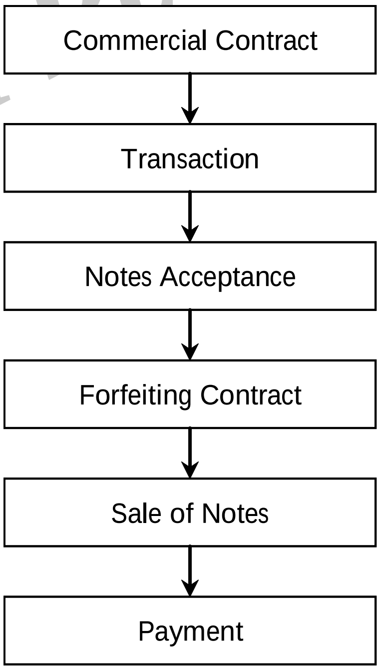


Fig.: Steps in Forfeiting

1. Commercial Contract

A contract is made between the buyer and the seller, which includes the various basic terms like the forfeiting cost, margin to cover risk, commitment cost, grace days, fee to compensate the forfeiter for loss of interest because of transfer and payment delays, forfeiting period, repayment instalment, interest rate and so on. The factoring cost depends on the term of the bill, the denominated currency, the credit rating, the nation, importer's risk and so on.

2. Transaction

The seller sells and delivers the goods to the buyer on the deferred payment system.

3. Notes Acceptance

The buyer accepts the promissory notes in favour of the seller for payment inclusive of the interest charges. These notes are then being sent to the seller. Bank guarantee with respect to the promissory note is also acquired.

4. Forfeiting Contract

The seller and the forfeiting agent signs a forfeiting contract, along with the forfeiter which is mostly re- owned bank inclusive of the seller's bank.

5. Sale of Notes

The seller sells the note or a bill to the forfeiter at a discount without recourse.

6. Payment

The seller makes the payment to the forfeiter as the face value of the note or bill, with less discount. The forfeiter can keep these notes or bills upto their maturity for making payment by the importer's bank or securities them for selling them as short-term high-yielding unsecured paper in the secondary market.

Q20. What are the characteristics of forfeiting.

Ans :

The main characteristics of forfeiting are:

1. It is 100% financing without recourse to the exporter.
2. The importer's obligation is normally supported by a local bank guarantee (i.e., 'aval').
3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.
4. Finance can be arranged on a fixed or floating rate basis.
5. Forfeiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.
6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

Q21. Explain the elements of forfeiting.

Ans :

The pricing consists of four elements: discount rate, commitment fees, grace days, and handling fee.

1. Discount Rate

Discount rate is the interest element and reflects the cost of funds. It is the rate at which the face value of a negotiable instrument is discounted. The discount rate is usually quoted as a margin over London Inter-Bank Offer Rate (LIBOR). The margin depends upon the country/bank risk and the credit period. A high country risk and longer credit period will attract higher margins.

2. Commitment Fees

The commitment fees is calculated from the date the forfeiter is committed to undertake the financing until the date of discounting.

3. Grace Days

These are the number of days beyond the stated maturity. They represent the anticipated number of days required for transmission and receipt of funds at maturity. It normally ranges from 2-5 days and can extend upto 15 days and beyond.

4. Handling Fee

A handling fee is applicable for documentation and custom clarification.

Q22. What are the benefits and drawbacks of Forfaiting?

Ans :

Benefits

(i) Profitable and Liquid

From the forfeiter's point of view, it is very advantageous because he not only gets immediate income in the form of discount charges, but also, can sell them in the secondary market or to any investor for cash.

(ii) Simple and Flexible

It is also beneficial to the exporter. All the benefits that are available to a client under factoring are automatically available under forfaiting also. However, the greatest advantage is its simplicity and flexibility. It can be adopted to any export transaction and the exact structure of finance can also be determined according to the needs of the exporter, importer and the forfaitor.

(iii) Avoids Export Credit Risks

The exporter is completely free from many export credit risks that may arise due to the possibility of interest rate fluctuations or exchange rates fluctuations or any political upheaval that may affect the collection of bills. Forfaiting acts as an insurance against all these risks.

(iv) Avoids Export Credit Insurance

In the absence of forfaiting, the exporter has to go for export credit insurance. It is very costly and at the same time it involves very cumbersome procedures. Hence, if an exporter goes for forfaiting, he need not purchase any export credit insurance.

(v) Confidential and Speedy

International trade transactions can be carried out very quickly through a forfaitor. It does not involve much documentary procedures. Above all, it is very confidential. The speed and confidentiality with which deals are made are very beneficial for both the parties namely the exporter and the importer. No banking relationship with the forfaitor is necessary, since, it is a one time transaction only.

(vi) Suitable to all Kinds of Export Deal

It is suitable to any kind of goods whether capital goods exports or commodity exports. Any export deal can be subject to forfaiting.

(vii) Cent per cent Finance

The exporter is able to convert his deferred transaction into cash transaction through a forfaitor. He is able to get 100 per cent finance against export receivables.

(viii) Fixed Rate Finance

Forfaiting provides finance always at a fixed rate only. So, there is no need to enter into any hedging transactions to protect against interest rate and exchange rate risks.

Drawbacks

(i) Non-availability for Short and Long Periods

Forfaiting is highly suitable to only medium term deferred payments. Forfaitors do not come forward to undertake forfeit financing for long periods, since, it involves much credit risks. Similarly, it cannot be used for availing short term credit or contracts involving small amounts because they do not give rise to any bills or notes. Hence, exporters who require short term and long term credit have to seek some other alternative source.

(ii) Non-availability for Financially weak Countries

Similarly, forfaitors generally do not come forward to undertake any forfeit financing deal involving an importer from a financially weak country. Generally, the forfaitor has a full grasp of the financial and political situation prevailing in different countries, and hence, he would not accept a deal if the importer stays in a risky country. In exceptional cases, it can be undertaken at a higher price.

(iii) Dominance of Western Currencies

In International forfaiting, transactions are dominated in leading western currencies like Dollar, Pound Sterling, Deutshe Mark and

French and Swiss Francs. Hence, our trade contracts have to be in foreign currencies rather than in Indian rupees.

(iv) Difficulty in Procuring International Bank's Guarantee

Forfaitors do not normally finance an export deal unless it is supported by an unconditional and irrevocable guarantee from an international bank known to the forfaitor. Generally, it is the duty of the exporter to procure a guarantee of this kind and it is a stupendous task for an exporter to do so.

Q23. Explain the concept of Forfaiting in India.

Ans :

Forfaiting, as a source of finance, has gained substantial momentum abroad. Though it had its origin in 'Zurich', it has been well established in all the financial centres of the world. Some of the important forfaiting centres are London, Zurich, Hong Kong, Singapore and Frankfurt. It has become a popular source of finance among Europeans.

In India, forfaiting is slowly emerging as a new product in the liberalised financial market. It was approved by the Union Government only in January, 1994. The existing scheme available for exporters like concessional finance by commercial banks, insurance cover against export credit risks by ECGC etc. are available mainly to large and well established exporters. In this context, forfaiting may be a real boon to the small, as well as, new exporters.

In India, forfaiting is done by the EXIM Bank. The minimum value of a forfaiting transaction is Rs. 5,00,000/-. A special form of pronote/Bill has to be used for forfaiting transactions. An Indian exporter who wants to avail of this service has to approach the EXIM bank through his bank. The EXIM Bank would obtain the forfaiting quotation from the forfaiting agency abroad. Based on this, the exporter would work out his price to be quoted to the importer. If the importer accepts the price and the payment terms, the contract would be finalised and executed. The exporter would then get cash through forfaiting arrangements for which he has to enter into a separate contract with the forfaitor through the EXIM bank.

However, in order to encourage forfaiting finance business, it is necessary to designate export contracts in leading international currencies. In the wake of economic liberalisation and opening of our economy to the global market, there are good prospects for forfaiting business in India. To promote forfaiting business, it is essential that we should denominate our trade contracts in foreign currencies rather than in Indian rupees. Now, since the rupee has gained strength, it is time for us to denominate our trade obligations in foreign currencies so that the pace of forfaiting business may be accelerated mainly to boost our export trade.

4.5 Merchant Banking

4.5.1 Definition

Q24. Define Merchant Banking.

Ans : **(July-21, Dec.-18)**

Introduction

The term merchant banking is used differently in different countries and so there is no precise definition for it. In London, merchant banker refers to those who are members of British Merchant Banking and Securities House Association who carry on consultation, leasing, portfolio services, assets management, euro credit, loan syndication etc. In America, merchant banking is concerned with mobilising savings of people and directing the funds to business enterprise.

Definition

There is no universal definition for merchant banking. It assumes diverse functions in different countries. So merchant banking may be defined as, 'an institution which covers a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counselling, insurance etc.

The Notification of the Ministry of Finance defines a merchant banker as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management".

Q25. The scope of Merchant Banking is great in India. Discuss.

(OR)

Explain the scope of Merchant Banking in India.

Ans : **(Dec.-18)**

In the present day capital market scenario, the merchant banks play the role of an encouraging and supporting force to the entrepreneurs, corporate sectors and the investors. There is vast scope for merchant bankers to enlarge their operations both in domestic and international market.

1. Growth of New Issues Market

The growth of new issue market is unprecedented since 1990-91. The amount of annual average of capital issues by non-government public companies was only about 90 crores in the 70s, the same rose to over Rs. 1,000 crs in the 80s' and further to Rs. 12,700 crores in the first four years of 1990's. This figure could be well beyond Rs. 40,000 crores by the end of 1994-95. The number of capital issues has also increased from 363 in 1990-91 to 900 in 1993-94. The trend is expected to continue in future.

2. Entry of Foreign Investors

An outstanding development in the history of Indian capital market was its opening up in 1992 by allowing foreign institutional investors to invest in primary and secondary market and also permitting Indian companies to directly tap foreign capital through euro issues. Within two years to March 1994, the total inflow of foreign capital through these routes reached to about $5 billion. It is estimated that this figure may go up to $ 35-40 billion by the turn of this century. Further, foreign direct investment as also investment by NRIs have risen considerably due to number of incentives offered to them. They need the services of Merchant Bankers to advise them for their investment in India. The increasing number of joint ventures abroad by Indian companies also require expert services of Merchant Bankers.

3. Changing Policy of Financial Institutions

With the changing emphasis in the lending policies of financial institutions from security orientation to project orientation, corporate enterprises would require the expert services of merchant bankers for project appraisal, financial management etc. The policy of decentralisation and encouragement of small and medium industries will further increase the demand for technical and financial services which can be provided by merchant bankers.

4. Development of Debt Market

The concept of debt market has set to work through National Stock Exchange and the Over the Counter Exchange of India. Experts feel that of the estimated capital issues of Rs. 40,000 crores in 1994-95, a good portion may be raised through debt instruments. The development of debt market will offer tremendous opportunity to Merchant Bankers.

5. Innovations in Financial Instruments

The Indian capital market has witnessed innovations in the introduction of financial instruments such as non-convertible debentures with detachable warrants, cumulative convertible preference shares, zero coupon bonds, deep discount bonds, triple option bonds, secured premium notes, floating rate bonds, auction rated debentures etc. This has further extended the role of Merchant Bankers as market makers for these instruments.

6. Corporate Restructuring

As a result of liberalisation and globalization the competition in the corporate sector is becoming intense. To survive in the competition, companies are reviewing their strategies, structure and functioning. This had led to corporate restructuring including mergers, acquisitions, splits, disinvestments and financial restructuring. This offers good opportunity to Merchant Bankers to extend the area of their operations.

7. Disinvestment

The government raised Rs. 2000 crores through disinvestment of equity shares of selected public sector undertakings in 1993-94. The government proposes to shift the present method of periodic sale of public sector shares to round the year off loading of shares directly on the stock exchange from the year 1995-96. The government will sell the shares of identified public sector at any time during the year when they get a good price above minimum stipulated level. This is likely to provide good business to Merchant Bankers in future.

The above discussion highlights, that the scope of merchant banking is vast and there lies immense opportunities ahead of Merchant Bankers. They should develop adequate infrastructure including expertise in order to provide full range of merchant banking services to corporate sector.

4.5.2 Features

Q26. Explain the features of Merchant Banking.

(OR)

Explain the role and functions of Merchant Banking.

Ans : **(July-21, Dec.-19, July-19)**

The financial institutions in India could not meet the demand for long-term funds required by the ever expanding industry and trade. The corporate sector enterprises, therefore, meet their requirements through issue of shares and debentures in the capital market. To raise money from capital market, promoters bank upon merchant bankers who manage the whole show by rendering multifarious services. The merchant bankers also advise the investors of the incentives available in the form of tax reliefs and other statutory obligations.

The services of merchant bankers are described in detail in the following section.

1. Corporate Counselling

Corporate counselling covers the entire field of merchant banking activities viz., project counselling, capital restructuring, project management, public issue management, loan syndication, working capital, fixed deposit, lease financing, acceptance credit etc. The scope of corporate counselling is limited to giving suggestions and opinions to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

2. Project Counselling

Project counselling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising project report with the financial institutions or banks. Project reports are prepared to obtain government approval, get financial assistance from institutions and plan for the public issue. The financing mix is to be decided keeping in view the rules, regulations and norms prescribed by the government or followed by financial institutions. The projects are appraised, as to the location, technical, commercial and financial viability of the project. Project counselling also includes filling up of application forms with relevant information for obtaining funds from financial institutions.

3. Loan Syndication

Loan syndication refers to assistance rendered by merchant banks to get mainly term loans for projects. Such loans may be obtained from a single development finance institution or a syndicate or consortium. Merchant Bankers help corporate clients to raise syndicated loans from commercial banks.

4. Issue Management

Management of issue involves marketing of corporate securities viz., equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it.

The issue function may be broadly dividend into pre-issue management and post issue management. In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be co-ordinated.

5. **Underwriting of Public Issue**

Underwriting is a guarantee given by the underwriter that in the event of under subscription the amount underwritten, would be subscribed by him. It is an insurance to the company which proposes to make public offer against risk of under subscription. The issues packed by well known underwriters generally receive a high premium from the public. This enables the issuing company to sell securities quickly.

All public issues have to be fully underwritten. Only Category I, II and III merchant bankers are permitted to underwrite an issue subject to the limit that the outstanding commitments of any such individual merchant banker at any point of time do not exceed five times of his net worth (paid-up capital and free reserves excluding revaluation reserves). This criteria is applicable to brokers also. Lead managers have to underwrite mandatorily 5% of the issue or Rs. 2.5 lakh whichever is less. Banks/ Merchant banking subsidiaries cannot underwrite more than 15% of any issue.

By ensuring a direct stake in the underwriting, the merchant bankers make raising of external resources easy.

6. **Managers, Consultants or Advisers to the Issue**

The managers to the issue assist in the drafting of prospectus, application forms and completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies are free to appoint one or more agencies as managers to the issue. SEBI guidelines insist that all issues should be managed by atleast one authorised merchant banker. Ordinarily, not more than two merchant bankers should be associated as lead managers, advisers and consultants to a public issue. In issues of over Rs. 100 crores, upto a maximum of four merchant bankers could be associated as managers.

7. **Portfolio Management**

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the government. It is not merely a collection of unrelated assets but a carefully blended asset combination within a unified framework. Portfolio management refers to maintaining proper combination of securities in a manner that they give maximum return with minimum risk.

Merchant bankers provide portfolio management service to their clients. Today the investor is very prudent. Every investor is interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. They need expert guidance. Merchant bankers have a role to play in this regard. They have to conduct regular market and economic surveys to know.

(i) Monetary and fiscal policies of the government.

(ii) Financial statements of various corporate sectors in which the investments have to be made by the investors.

(iii) Secondary market position, i.e., how the share market is moving.

(iv) Changing pattern of the industry.

(v) The competition faced by the industry with similar type of industries.

8. Advisory Service Relating to Mergers and Takeovers

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A take over is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the offeree and offeror. Being a professional expert they are apt to safeguard the interest of the shareholders in both the companies. Once the merger partner is proposed, the merchant banker appraises merger/takeover proposal with respect to financial viability and technical feasibility. He negotiates purchase consideration and mode of payment. He gets approval from the government/RBI, drafts scheme of amalgamation and obtains approval from financial institutions.

9. Off Shore Finance

The merchant bankers help their clients in the following areas involving foreign currency.

(i) long-term foreign currency loans

(ii) joint venture abroad

(iii) financing exports and imports and

(iv) foreign collaboration arrangements.

The bankers render other financial services such as appraisal, negotiations and compliance with procedural and legal aspects.

10. Non-Resident Investment

The services of merchant bankers include investment advisory services to NRI in terms of identification of investment opportunities, selection of securities, investment management etc. They also take care of the operational details like purchase and sale of securities, securing necessary clearance from RBI for repatriation of interest and dividend.

4.5.3 Mechanism

Q27. Explain the mechanism of merchant banking.

Ans :

1. Raising Finance for Clients

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

2. Broker in Stock Exchange

Merchant bankers act as brokers in the stock exchange. They buy and sell shares on behalf of their clients. They conduct research on equity shares. They also advise their clients about which shares to buy, when to buy, how much to buy and when to sell. Large brokers, Mutual funds, Venture capital companies and investment Banks offer merchant banking services.

3. Project Management

Merchant bankers help their clients in the many ways. For e.g. advising about location of a project, preparing a project report, conducting feasibility studies, making a plan for financing the project, finding out sources of finance, advising about concessions and incentives from the government.

4. Advice on Expansion and Modernization

Merchant bankers give advice for expansion and modernization of the business units. They give expert advice on mergers and amalgamations, acquisition and takeovers, diversification of business, foreign collaborations and joint-ventures, technology up gradation, etc.

5. Managing Public Issue of Companies

Merchant bank advice and manage the public issue of companies. They provide following services:

(i) Advise on the timing of the public issue.

(ii) Advise on the size and price of the issue.

(iii) Acting as manager to the issue, and helping in accepting applications and allotment of securities.

(iv) Help in appointing underwriters and brokers to the issue.

(v) Listing of shares on the stock exchange, etc.

6. Handling Government Consent for Industrial Projects

A businessman has to get government permission for starting of the project. Similarly, a company requires permission for expansion or modernization activities. For this, many formalities have to be completed. Merchant banks do all this work for their clients.

7. Special Assistance to Small Companies and Entrepreneurs

Merchant banks advise small companies about business opportunities, government policies, incentives and concessions available. It also helps them to take advantage of these opportunities, concessions, etc.

8. Services to Public Sector Units

Merchant banks offer many services to public sector units and public utilities. They help in raising long-term capital, marketing of securities, foreign collaborations and arranging long-term finance from term lending institutions.

9. Revival of Sick Industrial Units

Merchant banks help to revive (cure) sick industrial units. It negotiates with different agencies like banks, term lending institutions, and BIFR (Board for Industrial and Financial Reconstruction). It also plans and executes the full revival package.

10. Portfolio management

A merchant bank manages the portfolios (investments) of its clients. This makes investments safe, liquid and profitable for the client. It offers expert guidance to its clients for taking investment decisions.

11. Corporate Restructuring

It includes mergers or acquisitions of existing business units, sale of existing unit or disinvestment. This requires proper negotiations, preparation of documents and completion of legal formalities. Merchant bankers offer all these services to their clients.

12. Money Market Operation

Merchant bankers deal with and underwrite short-term money market instruments, such as:

(i) Government Bonds.

(ii) Certificate of deposit issued by banks and financial institutions.

(iii) Commercial paper issued by large corporate firms.

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

13. Leasing Services

Merchant bankers also help in leasing services. Lease is a contract between the lessor and lessee, whereby the lessor allows the use of his specific asset such as equipment by the lessee for a certain period. The lessor charges a fee called rentals.

14. Management of Interest and Dividend

Merchant bankers help their clients in the management of interest on debentures / loans, and dividend on shares. They also advise their client about the timing (interim / yearly) and rate of dividend.

4.5.4 Types

Q28. Explain the various types of merchant banking.

Ans :

In India a common organizational set up of merchant bankers to operate is in the form of divisions of Indian and Foreign banks and Financial institutions, subsidiary companies established by bankers like SBI, Canada Bank, Punjab National Bank, Bank of India, etc. some firms are also organized by financial and technical consultants and professionals. Securities and exchanges Board of

India (SEBI) has divided the merchant bankers into four categories based on their capital adequacy. Each category is authorized to perform certain functions. From the point of Organizational set up India's merchant banking organizations can be categorized into 4 groups on the basis of their linkage with parent activity. They are:

(a) Institutional base

Where merchant banks function as an independent wing or as subsidiary of various Private/ Central Govemments/State Governments Financial institutions. Most of the financial institutions in India are in public sector and therefore such set up plays a role on the lines of governmental priorities and policies.

(b) Banker base

These merchant bankers function as division/ subsidiary of banking organization. The parent banks are either nationalized commercial banks or the foreign banks operating in India. These organizations have brought professionalism in merchant banking sector and they help their parent organization to make a presence in capital market.

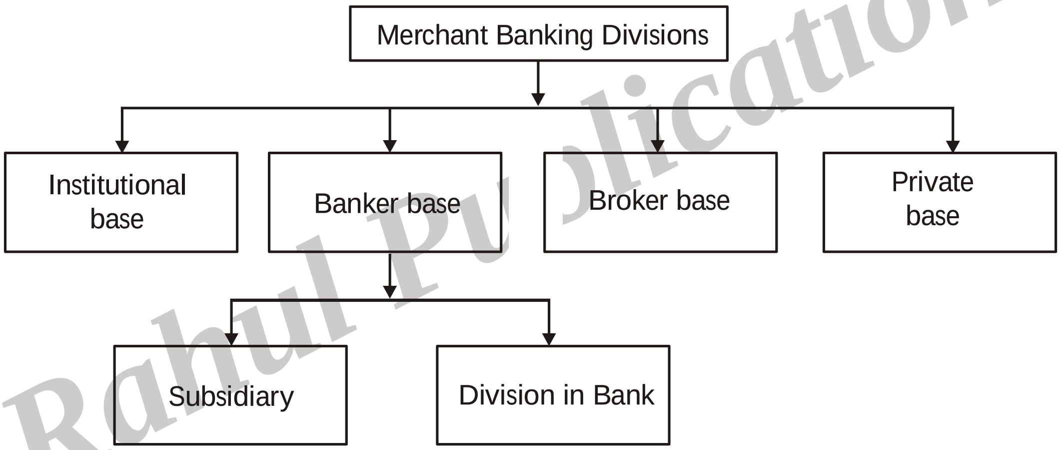


Fig.: Classification of Merchant Banking in India

(c) Broker base

In the recent past there has been an inflow of Qualified and professionally skilled brokers in various Stock Exchanges of India. These brokers undertake merchant baking related operating also like providing investment and portfolio management services.

(d) Private base

These merchant banking firms are originated in private sectors. These organizations are the outcome of opportunities and scope in merchant banking business and they are providing skill oriented specialized services to their clients. Some foreign merchant bankers are also entering either independently or through some collaboration with their Indian counterparts. Private Sectors merchant banking firms have come up either as sole proprietorship, partnership, private limited or public limited companies. Many of these firms were in existence for quite some time before they added a new activity in the form of merchant banking services by opening new division on the lines of commercial banks and All India Financial Institution (AIFI)

Q29. What are the services provided by the merchant banker.

Ans :

1. Project Counselling

Project counselling comprises preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising the project report with the financial institutions and banks. It also includes filling up of application forms with significant information for obtaining funds from financial institutions and obtaining government approval.

2. Management of Debt and Equity offerings

This is the major function of the merchant banker. They assist the companies in raise funds from the market. The main areas of work in this regard include;

- Instrument designing
- Pricing the issue
- Registration of the offer document
- Underwriting support
- Marketing of the issue
- Allotment and refund
- Listing on stock exchanges.

3. Issue Management

Management of issue involves marketing of corporate securities like equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as an intermediary to transfer capital from those who own it to those who need it. After taking action as per SEB1 guidelines, the merchant banker organizes a meeting with company representatives and advertising agents to finalize arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing date of board meeting to approve and sign prospectus and pass the necessary resolutions. Pricing of issues is done by the companies in consultant with the merchant bankers.

4. Design of Capital Structure

Capital Structure of a firm has to be distinguished from financial structure. Capital structure is financed by long term sources which consist of debt and equity. On the other hand, a financial structure which includes all forms debt and equity covers all financial resources. These include short term as well as long-term sources.

5. Managers, Consultants or Advisers to the Issue

The managers to the issue assist in the drafting of prospectus, application forms and ' completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies can appoint one or more agencies as managers to the issue.

6. Underwriting of Public Issue

Underwriting is a guarantee given by the underwriter that in the occurrence of under subscription, the amount underwritten would be subscribed by him. Banks/Merchant banking institutions cannot underwrite more than 15% of any issue.

7. Portfoiio Management

Portfolio indicates investment in different types of securities such as shares, debentures or bonds issued by different companies. Portfolio management means maintaining proper combinations of securities in a mode that they give maximum return with minimum risk.

8. Restructuring Strategies

A merger is a blending of two companies into a single company where one survives and other loses its corporate existence. A takeover is the purchase by one company obtaining controlling interest in the share capital of another existing company. Merchant bankers act as the middlemen in setting negotiation between the two companies. Merchant bankers assist the management of the client company to successfully restructure various activities such as mergers and acquisitions, divestitures, management buyouts, joint venture among others.

9. **Off Shore Finance**

The merchant bankers help their clients in the following areas involving foreign currency.

- Long term foreign currency loans Joint Ventures abroad
- Financing exports and imports
- Foreign collaboration arrangements

10. **Non-Resident Investment**

The services of merchant banker includes investment advisory services to NR1 in terms of classification of investment opportunities, selection of securities, investment management, and operational services like purchase and sale of securities.

11. **Loan Syndication**

Loan syndication is an assistance provided by merchant bankers to get mainly term loans for projects. Such loans may be obtained from a single development finance institution or a syndicate or consortium. Merchant bankers help corporate clients to raise syndicated loans from banks and other financial institutions.

Q30. Discuss the problems of merchant banking in India.

Ans :

1. SEBI guidelines have authorised merchant bankers to undertake issue related activities only with an exception of portfolio management. These guidelines have made the merchant bankers either to restrict their activities or think of separating these activities from the present one and float new subsidiary and enlarge the scope of its activities.
2. SEBI guidelines stipulate a minimum net worth of Rs. 1 crore for authorization of merchant bankers. Small but professional and specialized merchant bankers who do not have a net worth of Rs.l crore may have to close down their business. The entry is denied to young, specialized professionals into merchant banking business.
3. Non-co-operation of the issuing companies in timely allotment of securities and refund of application money is another problem of merchant bankers. The guidelines have put the responsibility on the merchant bankers. They have to seek the co-operation of the issuing company to shoulder the responsibility.

Q31. Discuss the legal framework of merchant banking system in India.

Ans :

Registration

It is mandatory for the merchant bankers to register (under SEBI Merchant Banking Regulation Act 1992). As per 1990 guidelines of SEBI, following is the criteria for authorization to merchant bankers to carry out business.

- Professional qualification in finance law or business.
- Adequate infrastructure.
- Employment of atleast two experienced merchant bankers.
- Capital adequacy.

As per the 1992, guidelines. Merchant Bankers into four categories.

1. Merchant bankers carrying on issue management activates belonged to category I, It included activities like preparation of prospectus, tie up financiers, determining the financial structure, final allotment of securities, underwriting consultant to an issue, portfolio management etc.

2. The second category constituted merchant bankers playing the role of advisors, consultants, co-managers, underwriters to an issue etc.

3. The third category merchant bankers could act as underwriter advisor or consultant to an issue.

4. Merchant bankers of fourth category were authorized to act only as advisors or consultants. We see that only category I merchant bankers were authorised to act as lead managers. This classification was however valid only upto 1997. Now, only category I merchant bankers are required to be registered by SEBI.

Grant of Certificate

Based on the above criteria, SEBI grants a certificate of registration to the corporate bodies other than a non-banking financial corporate, or merchant bankers registered by the RBI to act as primary or satellite dealer to carry on merchant banking.

Capital Adequacy

Based on the classification, the minimum net worth requirement for each of the four, categories was Rs. 1 crore, Rs. 50 lakhs, Rs. 20 lakhs and respectively.

SEBI is authorised to collect a fee for original registration, annual fee, as well as the few time of renewal. With effect from 1999, merchant bankers have to pay a renewal fee Rs. 2.5 lakhs every three years from the fourth year of initial registration, least the registration may be suspended.

Restriction on Business

Merchant bankers are not allowed to carry on funds asset-based (like leasing hire purchasing) business etc. Besides, banks and financial institutions in public sector, however. Merchant banks registered with RBI as primary satellite dealers can carry on business other than that in the securities market.

Number of Lead Managers

SEBI requires all public issues to be managed by atleast one merchant banker acting as lead manager. The minimum number of lead managers depends on the size of the issue. Generally a maximum of two lead managers are appointed as lead managers for issues less than Rs. 50 crores. For issues exceeding 100 crores, 200 crores maximum of four lead managers can be associated. With the approval of SEBI the number may be raised to five or more for an issue size of 200-400 crores and above.

Responsibilities of Lead Managers

Merchant bankers should submit to the SEBI in case of greater than one lead manager the specific responsibilities of each lead manager before the issue. General responsibilities include the following.

➢ Every lead manager has to enter into an agreement with the issuing companies, setting out their mutual rights, liabilities and obligations relation to issues. Particularly, the agreement should consider disclosure, allotment and refund, preparation and maintenance of books of accounts and half-yearly reports.

➢ The agreement details has to be submitted with the SEBI atleast 30 days prior to the opening issues of the subscription.

➢ No lead managers can manage an issue of its associate companies.

➢ Leader merchant bankers should not associate with merchant bankers who are not registered with the SEBI.

➢ Lead managers of category one merchant bankers ought to accept a minimum underwriting obligation of 5% of the total underwriting commitment or Rs. 25 lakhs whichever is less. If he fails, associate merchant banker should underwrite the equal amount by intimating it to the SEBI. Under capital adequacy requirement, merchant bankers are excepted to submit half-yearly unaudited financial results for SEBI to monitor capital adequacy.

Due Diligence Certificate

The lead manager is also responsible for verifying the contents of prospectus or letter of offer of an issue. According to SEBI, every lead manager has to submit a due diligence certificate at least 15 days before the issue. He should verify that,

(a) The prospectus or the offer letter confirm the document relevant to the issue.

(b) All legal requirements have been complied with.

(c) The disclosures are adequate for an investor to make an investment decision and that they are true and fair.

Submission of Documents

Lead manager should submit issue particulars, prospectus, other literature for investors and shareholders and other legal documents and prospectus should be submitted with the prescribed fee atleast two weeks before the date of tiling with the registrar of companies or regional stock exchanges.

Acquisition of Shares

SEBI prohibits merchant bankers from acquiring securities of any company using unpublished, price sensitive information obtained during the professional services as merchant banker. If any securities are acquired of the issuing company he is serving the merchant banker should submit full particulars to the SEBI within 15 days of the date of transactions.

Disclosures

A merchant banker is required to disclose the following information to the SEBI when needed.

(a) His responsibilities related to the issue management.

(b) Any change in previously submitted information.

(c) Names of the companies whose issue to has manage or associated with.

(d) Particulars regarding the breach of capital adequacy requirements.

(e) Particulars of his activities as manager. Underwriting, consultants etc.

Code of Conduct

Merchant bankers are required to follow the code of conduct prescribed by the SEBI. He should make all efforts to protect investors interest. He should render high quality of service all the time and exercise due diligence, and independent professional judgment. He should act in ethical manner and make no discrimination in client except in commercial conditions. The bankers should fulfill all the obligation and adhere to the code of conduct with high degree of fairness.

Inspection

SEBI is entitled to inspect a merchant bankers books of accounts, records and documents in order to ensure that all the provisions of the regulations are duly complied with. The objective may also be to investigate complaints received from investors or others, merchant bankers should obligate and furnish the required documents for inspection and assist the inspecting authority. However, merchant banker is allowed reasonable time after the notice of inspection before the inspection takes place. The merchant bankers is also given an opportunity to explain after the inspection report is submitted. The SEBI may then advise the concerned merchant banker to take measure and comply with the SEBI rules and regulations.

Regulations as to Default

SEBI is empowered to suspend or cancel the registration of the merchant banker who violates the regulations of SEBI. The penalty of suspension may be granted in the following cases.

(i) Violation of provisions of the SEBI act.

(ii) Failure to furnish or faulty submission of required information.

(iii) Guilt of misconduct or indulgence in price ragging or manipulation of activities.

(iv) Violation of conditions of registration.

The registration may be cancelled under the following conditions,

(i) Deliberate manipulation of activities affecting investors interest or price rigging.

(ii) Deterioration of financial position of the merchant banker.

(iii) Guilt of fraud or a criminal offence and

Short Question and Answers

1. CRISIL.

Ans :

Credit Rating Information Services Limited (CRISIL) the first credit age Agency was floated on January 1, 1988. It was started jointly by ICICI and UTI with an equity capital of Rs.4 crores. Each of them holds 18% of the capital. The other promoters are Asian Development Bank (15%), the LIC and General Insurance Corporation and its subsidiaries and the SBI (5% each), the Housing Finance Development Corporation (6.2%), nine public sector and private sector banks (19.25%) and 10 foreign banks (7.55%).

The principal objective of CRISIL is to rate the debt obligations of Indian Companies. Its rating guides investors about the risk of timely payment of interest and principal on a particular debt instrument.

2. Credit rating symbols.

Ans :

CRISIL uses the conventional rating symbols used in the USA and widely accepted in many other countries.

The following table shows the investment-wise rating symbols assigned by CRISIL and the meaning of each rating from the angle of safety to the investors.

CRISIL Debenture Rating Symbols

High Investment Grades		
AAA (Triple A)	:	Highest Safety
AA (Double A)	:	High Safety
Investment Grades		
A	:	Adequate Safety
BBB (Triple B)	:	Moderate Safety
Speculative Grades		
BB (Double B)	:	Inadequate Safety
B	:	High Risk
C	:	Substantial Risk
D	:	Default

3. Discuss the advantages of credit rating.

Ans :

I) Benefits of Credit Rating

(i) Low Cost Information

Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information is done by a specialized agency which a group of investors can trust.

(ii) Quick Investment Decision

In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

(iii) Independent Investment Decision

For rated instruments, investors need not depend upon the advice of the financial intermediaries. As the rating symbol suggests the credit worthiness of the instrument and indicates the degree of risk involved in it, the investors can make direct investment decisions.

(iv) Investors Protection

Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. The creditible and objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

4. ICRA

Ans :

The IICRA was set up by Industrial Finance Corporation of India on 16th January, 1991. It is a public limited company with an authorised share capital of Rs. 101 crores. The initial paid up capital of Rs. 3.50 crores is subscribed by IFC, UTI, LIC, GIC, SBI and 17 other banks. IICRA started its operations from 15th March 1991.

During 1994-95, IICRA rated 212 debt instruments covering a debt volume of Rs. 5343 crores. The cumulative number of instruments rated since its inception till March 1995 has been 485 covering a total debt volume of Rs. 17,638 crores.

5. What is meant by Credit Rating?

Ans :

Definitions

(i) According to Moody's "Ratings are designed exclusively for the purpose of grading bonds according to their investment qualities".

(ii) According to Australian Ratings, "A Corporate Credit rating provides lenders with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted".

(iii) According to CRISIL, "Credit rating is an unbiased and independent opinion as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy/sell or hold a particular security."

(iv) According to ICRA, "Ratings are opinions on the relative capability of timely servicing of corporate debt and obligations. These are not recommendations to buy or sell neither the accuracy nor the completeness of the information is guaranteed."

6. What is Factoring?

Ans :

Meaning

The word 'Factor' has been derived from the Latin word 'Facere' which means 'to make or to do'. In other words, it means 'to get things done'. According to the Webster Dictionary 'Factor' is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 percent payment. To put it in a layman's language, a factor is an agent who collects the dues of his client for a certain fee.

Definitions

(i) **According to Robert W. Johnson** in his book 'Financial Management' states, "factoring is a service involving the purchase by a financial organization, called a factor, of receivables owned to manufacturers and distributors by their customers, with the factor assuming full credit and collection responsibilities".

(ii) **According to V. A. Avadhani,** "factoring is a service of financial nature involving the conversion of credit bills into cash".

(iii) **According to Kohok,** "factoring is an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods". Prof. S.P. Singh, a member of the study group appointed by the RBI to examine the feasibility of introducing factoring services in India feels that "factoring which traditionally meant buying of book debts for cash is not merely invoice discounting or credit insurance.

7. What are the features of factoring?

Ans :

The features of factoring are as follows,

1. The Nature

The nature of the factoring contract is same like the nature of bailment contract. Factoring is considered as a specialized activity through which a firm can transform its receivables into cash by selling them to a factoring organization. The factor usually bears the risk involved in the collection or receivables and at the time of non-payment by the customers debtors. He also bears the risk of a bad debt loss.

2. The Form

As factoring includes only those receivables which are usually not promoted by negotiable instruments like bills of exchange etc., it is in the form of "invoice factoring". This is mainly because the firm adopts the practice of bill discounting with its bankers when the receivables are supported by the bills. Factors helps the debtors of the firms to become the debtors of the factor.

3. The Assignment

In the factoring process the debt is assigned in support of the factor. This is considered as the primary prerequisite for the working of a factoring service.

4. Fiduciary Position

The factor holds fiduciary position as it occurs from the relationship with the client firm. The factor is held liable for meeting the terms of contract between the parties.

5. Professionalism

The factoring firms are professionally talented and have competent employees who manages the credit sales realizations for various clients in different trends for effective management of credit.

8. Define Forfaiting.

Ans :

Meaning

Forfaiting is another source of financing against receivables like factoring. This technique is mostly employed to help an exporter for financing goods exported on a medium term deferred basis.

The term 'a forfait' is a French word denoting 'to give something' or 'give up one's rights' or 'relinquish rights to something'. In fact, under forfaiting scheme, the exporter gives up his right to receive payments if future under an export bill for immediate cash payments by the forfaitor This right to receive payment on the due date passes on to the forfaitor since, the exporter has already surrendered his right to the forfaitor. Thus the exporter is able to get 100% of the amount of the bill minus discount charges immediately and get the benefits of cash sale. Thus, it is a unique : medium which can convert a credit sale into a cash sale for an exporter The entire responsibility of recovering the amount from the importer rests with the forfaitor. Forfaiting is done without any recourse to the exporter, i.e., in case the importer makes a default, the forfaitor cannot go back to the exporter for the recovery of the money.

Definition

Forfaiting has been defined as "the non-recourse purchase by a bank or any other financial institution, of receivables arising from an export of goods and services.

9. What are Non-Fund Based Financial Services?

Ans :

Financial intermediaries provide services on the basis of non-fund activities also. This can also be called "fee based" activity. Today, customers whether individual or corporate are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services, are being provided under this head. They include the following:

(i) Managing the capital issues, i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issues.

(ii) Making arrangements for the placement of capital and debt instruments with investment institutions.

(iii) Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.

10. What are the functions of credit rating?

Ans :

The credit rating firms are supposed to do the following functions:

1. Superior Information

Rating by an independent and professional firm offers a superior and more reliable source of information on credit risk for three inter related risks:

(a) it provides unbiased opinion.

(b) due to professional resources, a rating firm has greater ability to assess risks.

(c) it has access to lot of information which may not be publicly available.

2. Low Cost Information

A rating firm which gathers, analyses, interprets and summarises complex information in a simple and readily understood format for wide public consumption represents a cost effective arrangement.

3. Basis for a Proper Risk-Return Trade Off

If debt securities are rated professionally and if such ratings enjoy widespread investor acceptance and confidence, a more rational risk return trade off would be established in the capital market.

4. Healthy Discipline on Corporate Borrowers

Public exposure has healthy influence over the management of issuer because of its desire to have a clear image.

11. Define Merchant Banking.

Ans :

Introduction

The term merchant banking is used differently in different countries and so there is no precise definition for it. In London, merchant banker refers to those who are members of British Merchant Banking and Securities House Association who carry on consultation, leasing, portfolio services, assets management, euro credit, loan syndication etc. In America, merchant banking is concerned with mobilising savings of people and directing the funds to business enterprise.

Definition

There is no universal definition for merchant banking. It assumes diverse functions in different countries. So merchant banking may be defined as, 'an institution which covers a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counselling, insurance etc.

The Notification of the Ministry of Finance defines a merchant banker as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management".

Choose the Correct Answers

1. A merchant bank is a financial institution conducting money market activities and: [d]
   (a) Lending (b) Underwriting and financial advice
   (c) Investment service (d) All of the above
2. Formal merchant banking activity in India was originated in ______. [b]
   (a) 1978 (b) 1969
   (c) 1769 (d) 1987
3. State Bank of India started merchant banking in ______ followed by ICICI in ______. [c]
   (a) 1972, 1974 (b) 1978, 1980
   (c) 1973, 1974 (d) 1980, 1981
4. The early growth of merchant banking in the country is assigned to the ______. [b]
   (a) FEMA (b) Foreign Exchange Regulation Act, 1973
   (c) Securities Contracts Act (d) Income-tax Act
5. Developmental activities of merchant banking: [d]
   (a) Sources of funds forever
   (b) Expanding industry and trade
   (c) Leaving a widening gap unbridged between supply and demand of investible funds.
   (d) All of the above
6. The term 'Merchant Bank' is used in: [b]
   (a) United States (b) United Kingdom
   (c) America (d) India
7. Issue management is an important function of ______ and ______. [a]
   (a) Merchant banker, lead manager (b) Public banker, Merchant banker
   (c) Lead banker, Private banking (d) None of the above
8. Role of merchant bankers ______. [d]
   (a) Mobilization of funds (b) Promotional function
   (c) Innovation (d) All of these
9. Refactoring charges have to be paid in the case of ______. [b]
   (a) Maturity factoring (b) With recourse factoring
   (c) Invoice factoring (d) Full service factoring.

10. Under forfaiting the client is able to get credit facility to the extent of ________. [a]

(a) 100% of the value of the export bill (b) 80% of the value of the export bill

(c) 75% of the value of the export bill (d) 90% of the value of the export bill.

11. Onder factoring, the factor acts in the capacity of ________. [c]

(a) an agent of his client (b) a trustee

(c) a holder for value (d) an administrator.

12. The first bank in India to start factoring business is ________. [b]

(a) Canara Bank (b) State Bank of India

(c) Punjab National Bank (d) Allahabad Bank

Fill in the Blanks

1. Ratings are expressed in ________.
2. AAA refers to ________.
3. Rating is only a guidance and not ________ to a debt instrument.
4. Ratings indicate the ________ status of a company.
5. Credit rating is a one time evaluation out ________ appraisal.
6. ________ is a source of low cost information to investors.
7. The word 'Factor' has been derived from the Latin word 'Facere' which means ________ (or) to ________.
8. The term 'a forfait' is a French word denoting ________.
9. ________ refers to assistance rendered by merchant banks to get mainly term loans for projects.
10. ________ Banking helps its clients to raise finance through issue of shares, debentures, bank loans, etc.

ANSWERS

1. Code Numbers
2. Highest Security
3. Recommendation
4. Financial
5. Ongoing
6. Credit rating
7. to make do
8. to give something
9. Loan syndication
10. Merchant

One Mark Answers

1. What is rating?

Ans :

Ratings are designed exclusively for the purpose of grading bonds according to their investment qualities.

2. Expand CRISIL.

Ans :

Credit Rating Information Services Limited

3. What is CIBIL?

Ans :

Credit Information Bureau (India) Limited, commonly known as CIBIL, is India's first Credit Information Company or Credit Bureau.

4. What is Forfaiting?

Ans :

It is mostly employed to help an exporter for financing goods exported on a medium term deferred basis.

5. Expand IICRA.

Ans :

Investment Information and Credit Rating Agency of India.

UNIT V

MUTUAL FUNDS :

Mutual Funds – History, Definition, Classification, Advantages and Disadvantages, Estimating the Net Asset Value, Mechanics of MF Operations, Functions of AMC, Evaluating Mutual Funds.

5.1 Mutual Funds

5.1.1 Definition

Q1. What are Mutual Funds?

(OR)

Define Mutual Funds.

(OR)

What is a Mutual Funds.

Ans : **(July-21, July-19, Dec.-18)**

There are many investment avenues available in the financial market for an investor. Investors can invest in bank deposits, corporate debentures and bonds, post office saving schemes etc. where, there is low risk together with low return. They may invest in stock of companies where the risk is high and sometimes the returns are also proportionately high.

For retail investors, who do not have the time and expertise to analyze and invest in stock, Mutual Funds is a viable investment alternative. This is because Mutual Funds provide the benefit of cheap access to expensive stocks.

A Mutual Fund is a collective investment vehicle formed with the specific objective of raising money from a large number of individuals and investing it according to a pre-specified objective, with the benefits accrued to be shared among the investors on a pro-rata basis in proportion to their investment.

Definitions

According to Encyclopedia Americana, "Mutual funds are open end investment companies that invest shareholders' money in portfolio or securities. They are open ended in that they normally offer new shares to the public on a continuing basis and promise to redeem outstanding shares on any business day."

According to Securities and Exchange Board of India Regulations, 1996 a mutual fund means "a fund established in the form of trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments".

5.1.2 History

Q2. Explain the History of mutual funds.

(OR)

Explain evolution of mutual funds.

Ans : **(July-19)**

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and Reserve Bank of India. The history of mutual funds in India can be broadly divided into four distinct phases

1. First Phase - 1964-1987

Unit Trust of India (UTI) was established in 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs. 6,700 crores of assets under management.

2. Second Phase - 1987-1993 (Entry of Public Sector Funds)

1987 marked the entry of non-UTI, public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first non-UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990.

At the end of 1993, the mutual fund industry had assets under management of Rs. 47,004 crores.

3. Third Phase - 1993-2003 (Entry of Private Sector Funds)

With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993.

The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996.

The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1,21,805 crores. The Unit Trust of India with Rs. 44,541 crores of assets under management was way ahead of other mutual funds.

4. Fourth Phase - since February 2003

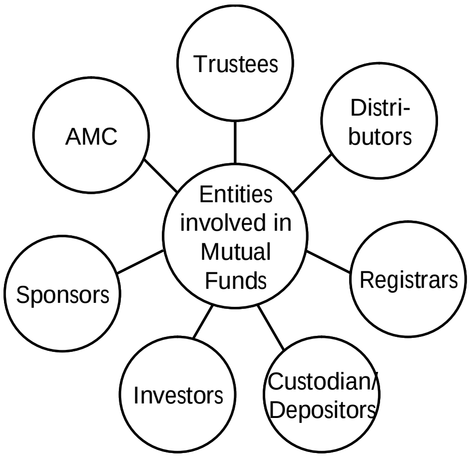
In February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs. 29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs. 76,000 crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth.

Q3. Explain the parties involved in mutual fund.

Ans :

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



1. Investors

Every investor, given his/her financial position and personal disposition, has a certain inclination to take risk. The hypothesis is that by taking an incremental risk, it would be possible for the investor to earn an incremental return.

Mutual fund is a solution for investors who lack the time, the inclination or the skills to actively manage their investment risk in individual securities. They delegate this role to the mutual fund, while retaining the right and the obligation to monitor their investments in the scheme.

In the absence of a mutual fund option, the money of such "passive" investors would lie either in bank deposits or other 'safe' investment options, thus depriving them of the possibility of earning a better return. Investing through a mutual fund would make economic sense for an investor if his/her investment, over medium to long term, fetches a return that is higher than what would otherwise have earned by investing directly.

2. Sponsors

Sponsor is the company, which sets up the Mutual Fund as per the provisions laid down by the Securities and Exchange Board of India (SEBI). SEBI mainly fixes the criteria of sponsors based on sufficient experience, net worth, and past track record.

3. Asset Management Company (AMC)

The AMC manages the funds of the various schemes and employs a large number of professionals for investment, research and agent servicing. The AMC also comes out with new schemes periodically. It plays a key role in the running of mutual fund and operates under the supervision and guidance of the trustees. An AMC's income comes from the management fees, it charges for the schemes it manages. The management fees, is calculated as a percentage of net assets managed.

An AMC has to employ people and bear all the establishment costs that are related to its activity, such as for the premises, furniture, computers and other assets, etc. So long as the income through management fees covers its expenses, an AMC is economically viable. SEBI has issued the following guidelines for the formation of AMCs:

(a) An AMC should be headed by an independent non-interested and nonexecutive chairman.

(b) The managing director and other executive staff should be full-time employees of AMC.

(c) Fifty per cent of the board of trustees of AMC should be outside directors who are not in any way connected with the bank.

(d) The board of directors shall not be entitled to any remuneration other than the sitting fees.

(e) The AMCs will not be permitted to conduct other activities such as merchant banking or issue management.

4. Trustees

Trustees are an important link in the working of any mutual fund. They are responsible for ensuring that investors' interests in a scheme are taken care of properly. They do this by a constant monitoring of the operations of the various schemes. In return for their services, they are paid trustee fees, which are normally charged to the scheme.

5. Distributors

Distributors earn a commission for bringing investors into the schemes of a mutual fund. This commission is an expense for the scheme. Depending on the financial and physical resources at their disposal, the distributors could be:

(a) Tier 1 distributors who have their own or franchised network reaching out to investors all across the country; or

(b) Tier 2 distributors who are generally regional players with some reach within their region; or

(c) Tier 3 distributors who are small and marginal players with limited reach.

The distributors earn a commission from the AMC.

6. Registrars

An investor's holding in mutual fund schemes is typically tracked by the schemes' Registrar and Transfer Agent (R & T). Some AMCs prefer to handle this role on their own instead of appointing R & T. The Registrar or the AMC as the case may be maintains an account of the investors' investments and disinvestments from the schemes. Requests to invest more money into a scheme or to redeem money against existing investments in a scheme are processed by the R & T.

7. Custodian/Depository

The custodian maintains custody of the securities in which the scheme invests. This ensures an ongoing independent record of the investments of the scheme. The custodian also follows up on various corporate actions, such as rights, bonus and dividends declared by investee companies. At present, when the securities are being dematerialized, the role of the depository for such independent record of investments is growing. No custodian in which the sponsor or its associates hold 50 percent or more of the voting rights of the share capital of the custodian or where 50 per cent or more of the directors of the custodian represent the interest of the sponsor or its associates shall act as custodian for a mutual fund constituted by the same sponsor or any of its associates or subsidiary company.

5.1.3 Classification

Q4. Furnish the Classification of mutual funds.

(OR)

Explain types of mutual funds.

Ans : **(Dec.-18)**

In the investment market, one can find a variety of investors with different needs, objectives and risk taking capacities. For instance, a young businessman would like to get more capital appreciation for his funds and he would be prepared to take greater risks than a person who is just on the verge of his retiring age. So, it is very difficult to offer one fund to satisfy all the requirements of investors. Just as one shoe is not suitable for all legs, one fund is not suitable to meet the vast requirements of all investors. Therefore, many types of funds are available to the investor. It is completely left to the discretion of the investor to choose any one of them depending upon his requirement and his risk taking capacity.

Mutual fund schemes can broadly be classified into many types

- Mutual Fund
  - On the basis of execution and operation
    - Close-ended
    - Open-ended
  - On the basis of yield and investment pattern
    - Income Fund
    - Growth Fund
    - Balance Fund
    - Specialised Fund
    - Money Market Mutual Fund
    - Taxation Fund
  - Other Classification
    - Leveraged Funds
    - Dual Funds
    - Index Funds
    - Bond Funds
    - Aggressive Growth Funds
    - Off-Shore Mutual Funds
    - Property Fund
    - Fund-of-Funds

I) On the Basis of Execution and Operation

(i) Close-ended Funds

Under this scheme, the corpus of the fund and its duration are prefixed. In other words, the corpus of the fund and the number of units are determined in advance. Once the subscription reaches the pre-determined level, the entry of investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding. Thus, the fund ceases to be a fund, after the final distribution.

Features

The main features of the close-ended funds are :

- The period and/or the target amount of the fund is definite and fixed beforehand.
- Once the period is over and/or the target is reached, the door is closed for the investors. They cannot purchase any more units.
- These units are publicly traded through stock exchange and generally, there is no repurchase facility by the fund.
- The main objective of this fund is capital appreciation.
- The whole fund is available for the entire duration of the scheme and there will not be any redemption demands before its maturity. Flence, the fund manager can manage the investments efficiently and profitably without the necessity of maintaining and liquidity.
- At the time of redemption, the entire investment pertaining to a closed-end scheme is liquidated and the proceeds are distributed among the unit holders.
- From the investor’s point of view, it may attract more tax since the entire capital appreciation is realised in to at one stage itself.
- If the market condition is not favourable, it may also affect the investor since he may not get the full benefit of capital appreciation in the value of the investment.

(ii) Open-ended Funds

It is just the opposite of close-ended funds. Under this scheme, the size of the fund and/or the period of the fund is not pre-determined. The investors are free to buy and sell any number of units at any point of time. For instance, the unit scheme (1964) of the Unit Trust of India is an open ended one, both in terms of period and target amount. Anybody can buy this unit at any time and sell it also at any time at his discretion.

Features

The Main Features of the Open-Ended Funds are:

- There is complete flexibility with regard to one's investment or disinvestment. In other words, there is free entry and exit of investors in an open-ended fund. There is no time limit. The investor can join in and come out from the Fund as and when he desires.
- These units are not publicly traded but, the Fund is ready to repurchase them and resell them at any time.
- The investor is offered instant liquidity in the sense that the units can be sold on any working day to the Fund. In fact, the Fund operates just like a bank account wherein one can get cash across the counter for any number of units sold.
- The main objective of this fund is income generation. The investors get dividend, rights or bonuses as rewards for their investment.
- Since the units are not listed on the stock market, their prices are linked to the Net Asset Value (NAV) of the units. The NAV is determined by the Fund and it varies from time to time.
- Generally, the listed prices are very close to their Net Asset Value. The Fund fixes a different price for their purchases and sales.
- The fund manager has to be very careful in managing the investments because he has to meet the redemption demands at any time made during the life of the scheme.

To put it in a nutshell, the open ended funds have a perpetual existence and their corpus is ever-changing depending upon the entry and exit of members.

II) On the Basis of Yield and Investment Pattern.

(i) Income Funds

As the very name suggests, this Fund aims at generating and distributing regular income to the members on a periodical basis. It concentrates more on the distribution of regular income and it also sees that the average return is higher than that of the income from bank deposits.

Features

The main features of the Income Funds are

- The investor is assured of regular income at periodic intervals, say half-yearly or yearly and so on.
- The main objective of this type of Fund is to declare regular dividends and not capital appreciation.
- The pattern of investment is oriented towards high and fixed income yielding securities like debentures, bonds etc.
- This is best suited to the old and retired people who may not have any regular income.
- It concerns itself with short run gains only.

(ii) Pure Growth Funds (Growth Oriented Funds)

Unlike the Income Funds, Growth Funds concentrate mainly on long run gains, i.e., capital appreciation. They do not offer regular income and they aim at capital appreciation in the long run. Hence, they have been described as "Nest Eggs" investments.

Features

The Main features of the Growth Funds are

- The growth oriented Fund aims at meeting the investors' need for capital appreciation.
- The investment strategy therefore, conforms to the Fund objective by investing the funds predominantly on equities with high growth potential.

- The Fund tries to get capital appreciation by taking much risks and investing on risk bearing equities and high growth equity shares.
- The fund may declare dividend, but its principal objective is only capital appreciation.
- This is best suited to salaried and business people who have high risk bearing capacity and ability to defer liquidity. They can accumulate wealth for future needs.

(iii) Balanced Funds

This is otherwise called "income-cum-growth" fund. It is nothing but a combination of both income and growth funds. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

(iv) Specialised Funds

Besides the above, a large number of specialised funds are in existence abroad. They offer special schemes so as to meet the specific needs of specific categories of people like pensioners, widows etc. There are also Funds for investments in securities of specified areas. For instance, Japan Fund, South Korea Fund etc. In fact, these funds open the door for foreign investors to invest on the domestic securities of these countries.

Again, certain Funds may be confined to one particular sector or industry like fertilizer, automobiles, petroleum etc. These funds carry heavy risks since the entire investment is in one industry. But, there are high risk taking investors who prefer this type of Fund. Of course, in such cases, the rewards may be commensurate with the risk taken. At times, it may be erratic. The best example of this type is the Petroleum Industry Funds in the U.S.A.

(v) Money Market Mutual Funds

These funds are basically open ended mutual Funds and as such they have all the features of the Open ended Fund. But, they invest in highly liquid and safe securities like commercial paper, banker's acceptances, certificates of deposits, Treasury bills etc. These instruments are called money market instruments.

They take the place of shares, debentures and bonds in a capital market. They pay money market rates of interest. These funds are called 'money funds' in the U.S.A. and they have been functioning since 1972. Investors generally use it as a "parking place" or "stop gap arrangement" for their cash resources till they finally decide about the proper avenue for their investment, i.e., long-term financial assets like bonds and stocks.

(vi) Taxation Funds

A taxation fund is basically a growth oriented fund. But, it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March. In India, at present the law relating to tax rebates is covered under Sec. 88 of the Income Tax Act, 1961. An investor is entitled to get 20% rebate in Income Tax for investments made under this fund subject to a maximum investment of Rs. 10,000/- per annum. The Tax Saving Magnum of SBI Capital Market Limited is the best example for the domestic types UTI's US $60 million India Fund, based in the USA, is an example for the foreign type.

III) Other Classification

(i) Leveraged Funds

These funds are also called borrowed funds since they are used primarily to increase the size of the value of portfolio of a mutual fund. When the value increases, the earning capacity of the fund also increases. The gains are distributed to the unit holders. This is resorted to only when the gains from the borrowed funds are more than the cost of borrowed funds.

(ii) Dual Funds

This is a special kind of closed end fund. It provides a single investment opportunity for two different types of investors. For this purpose, it sells two types of investment stocks viz., income shares and capital shares. Those investors who seek current investment income can purchase income shares. They receive all the interest and dividends earned from the entire investment portfolio.

However, they are guaranteed a minimum annual dividend payment. The holders of capital shares receive all the capital gains earned on those shares and they are not entitled to receive any dividend of any type. In this respect, the dual fund is different from a balanced fund.

(iii) Index Funds

Index funds refer to those funds where the portfolios are designed in such a way that they reflect the composition of some broad based market index. This is done by holding securities in the same proportion as the index itself. The value of these index linked funds will automatically go up whenever the market index goes up and vice versa. Since the construction of portfolio is entirely based upon maintaining proper proportions of the index being followed, it involves less administrative expenses, lower transaction costs, less number of portfolio managers etc. It is so because only fewer purchases and sales of securities would take place.

(iv) Bond Funds

These funds have portfolios consisting mainly of fixed income securities like bonds. The main thrust of these funds is mostly on income rather than capital gains. They differ from income funds in the sense income funds offer an average returns higher than that from bank deposits and also capital gains lesser than that in equity shares.

(v) Aggressive Growth Funds

These funds are just the opposite of bond funds. These funds are capital gains oriented and thus the thrust area of these funds is 'capital gains'. Hence, these funds are generally invested in speculative stocks. They may also use specialised investment techniques like short term trading, option writing etc. Naturally, these funds tend to be volatile in nature.

(vi) Off-Shore Mutual Funds

Off-shore mutual funds are those funds which are meant for non-residential investors. In other words, the sources of investments for these funds are from abroad. So, they are regulated by the provisions of the foreign countries where those funds are registered. These funds facilitate flow of funds across different countries, with free and efficient movement of capital for investment and repatriation. Off-shore funds are preferred to direct foreign investment, since, it does not allow foreign domination over host country's corporate sector.

However, these funds involve much currency and country risk and hence they generally yield higher return.

(vii) Property Fund

It is a real estate mutual fund. It is an investment vehicle which buys, develops, manages and sells real estate assets. Its investment also includes shares/bonds of companies involved in real esta e and mortgage backed companies.

(viii) Fund-of-Funds

A fund of funds scheme is a mutual fund scheme that invests in other mutual fund schemes. The concept is widely prevalent abroad. Mutual Funds in India are being allowed to launch fund-of-funds.

In India, these funds are subject to the approval of the Department of Economic Affairs, Ministry of Finance and the RBI monitors such funds by issuing directions then and there. In India, a number of off-shore funds exist. 'India Fund' and 'India Growth Fund' were floated by the UTI in U.K. and U.S.A. respectively. The State Bank of India floated the India Magnum Fund in Netherlands. 'The Indo-Suez Himalayan Fund N.V.' was launched by Canbank Mutual Fund in collaboration with Indo-Suez Asia Investment Services Ltd. It also floated 'Commonwealth Equity Fund'.

Q5. Explain the importance of mutual funds.

Ans :

The mutual fund industry has grown at a phenomenal rate in the recent past. One can witness a revolution in the mutual fund industry in view of its importance to the investors in general and the country's economy at large. The following are some of the important advantages of mutual funds:

(i) Channelising Savings for Investment

Mutual funds act as a vehicle in galvanising the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. A number of schemes are being offered by MFs so as to meet the varied requirements of the masses, and thus, savings are directed towards capital investments directly.

(ii) Offering Wide Portfolio Investment

Small and medium investors used to burn their fingers in stock exchange operations with a relatively modest outlay. If they invest in a select few shares, some may even sink without a trace never to rise again. Now, these investors can enjoy the wide portfolio of the investment held by the mutual fund. The fund diversifies its risks by investing on a large varieties of shares and bonds which cannot be done by small and medium investors. This is in accordance with the maxim 'Not to lay all eggs in one basket'. These funds have large amounts at their disposal, and so, they carry a clout in respect of stock exchange transactions. They are in a position to have a balanced portfolio which is free from risks. Thus MF's provide instantaneous portfolio diversification. The risk diversification which a pool of savings through mutual funds can achieve cannot be attained by a single investor's savings.

(iii) Providing Better Yields

The pooling of funds from a large number of customers enables the fund to have large funds at its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus, they are able to command better market rates and lower rates of brokerage.

(iv) Rendering Expertised Investment Service at Low Cost

The management of the Fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus, investors are assured of quality services in their best interest.

(v) Providing Research Service

A mutual fund is able to command vast resources and hence it is possible for it to have an indepth study and carry out research on corporate securities. Each Fund maintains a large research team which constantly analyses the companies and the industries and recommends the fund to buy or sell a particular share.

(vii) Introducing Flexible Investment Schedule

Some mutual funds have permitted the investors to exchange their units from one scheme to another and this flexibility is a great boon to investors. Income Units can be exchanged for growth units depending upon the performance of the funds. One can not derive such a flexibility in any other investments.

(viii) Providing Greater Affordability and Liquidity

Even a very small investor can afford to invest in Mutual Funds. They provide an attractive and cost effective alternative to direct purchase of shares. In the absence of MFs, small investors cannot think of participating in a number of investments with such a meagre sum. Again, there is greater liquidity.

(ix) Simplified Record Keeping

An investor with just an investment in 500 shares or so in 3 or 4 companies has to keep proper records of dividend payments, bonus issues, price movements, purchase or sale instruction, brokerage and other related items. It is very tedious and consumes a lot of time.

(x) Supporting Capital Market

Mutual funds play a vital role in supporting the development of capital markets. The mutual funds make the capital market active by means of providing a sustainable domestic source of demand for capital market instruments. In other words, the savings of the people are directed towards investments in capital markets through these mutual funds. Thus, funds serve as a conduit for dis-intermediating bank deposits into stocks, shares and bonds.

(xi) Promoting Industrial Development

The economic development of any nation depends upon its industrial advancement and agricultural development. All industrial units have to raise their funds by resorting to the capital market by the issue of shares and debentures.

(xii) Acting as Substitute for Initial Public Offerings (IPOs)

In most cases investors are not able to get allotment in IPOs of companies because they are often oversubscribed many time. Moreover, they have to apply for a minimum of 500 shares which is very difficult particularly for small investors. But, in mutual funds, allotment is more or less guaranteed. Mutual Funds are also guaranteed a certain percentage of IPOs by companies. Thus, by participating in MFs, investors are able to get the satisfaction of participating in hundreds of varieties of companies.

(xiii) Reducing the Marketing Cost of New Issues

Moreover the mutual funds help to reduce the marketing cost of the new issues. The promoters used to allot a major share of the Initial Public offering to the mutual funds and thus they are saved from the marketing cost of such issues.

(xiv) Keeping the Money Market Active

An individual investor can not have any access to money market instruments since the minimum amount of investment is out of his reach. On the other hand, mutual funds keep the money market active by investing money on the money market instruments.

Q6. What are the differences between open ended and closed ended mutual funds ?

Ans :

Open-ended Mutual Funds	Closed-ended Mutual Funds
1. Open-ended schemes accept funds from investors and sell shares to the investors on a regular basis.	1. Closed-ended schemes offer subscriptions only for a limited period.
2. Open-ended schemes provide the facility of withdrawing funds to the investors by following the re-purchase arrangement.	2. Closed-ended schemes do not provide the facility of with-drawing funds to the investors as per their preference.
3. Open-ended schemes are not listed on secondary market.	3. Closed-ended schemes are listed on stock exchange/ secondary market.
4. In open-ended schemes of mutual fund duration is not specified for redemption.	4. In closed-ended schemes of mutual fund duration is specified for redemption.
5. The main feature of open-ended scheme is the liquidity.	5. The main feature of closed-ended schemes are market forces of demand and supply.

5.1.4 Advantages and Disadvantages

Q7. Explain the Advantages and Disadvantages of mutual funds.

Ans : **(July-21, Dec.-19)**

Advantages

Investors derive a number of advantages by investing their money in mutual funds. Some of these advantages are as under,

1. Reduced Risk

Mutual funds invest in a number of reputed and well managed blue chip companies. So, the fall in the price of a few scrips, will not affect them much. Because of such diversification and economies of scale in transaction cost, the risk of loss due to a fall in the value of few scrips is minimized. In other words, investors risk is reduced to the minimum.

2. Expertise of Professional Management

The investors get the expertise of professional money managers who watch the funds portfolio and take necessary decisions on what scrips are to be purchased, what scrips are to be sold and when they should be bought and sold. The fund managers maximize the income of the fund.

3. Diversification of Portfolio

When a person invests in a mutual fund, he participates in a large basket of shares of many different companies in a number of different industries which are included in the fund's portfolio. To achieve a similar degree of diversification, an individual investor has to spend considerable time and money. Further, since a fund purchase shares in large volumes it has the advantage of paying the minimum brokerage.

4. Automatic Reinvestment

In a mutual fund, it is possible to reinvest the dividends and capital gains. An individual investor, on the other hand, may not always find it easy to reinvest his dividends, which usually get frittered away.

The automatic reinvestment feature of a mutual fund is a form of forced saving and can make a big difference in the long run.

5. Selection and Timings of Investment

Expertise in the selection of shares, debentures etc., and timing is made available to investors so that invested funds generated higher returns to them.

Disadvantages

The following factors have impeded the growth of mutual fund industry in India,

1. Wrong Positioning

The mutual funds in India have been quite wrongly promoted as an alternative to equity investing, thus creating very high expectations in the minds of investors.

2. Limited Product Range

Indian mutual funds have remained centered around a limited product range basically income, income-cum- growth and tax saving schemes. Efforts to develop and expand the market through innovative new products have been negligible.

3. Confused Market Situation

Probably the introduction and implementation of new regulatory norms has contributed in some measure to market sluggishness, as the emerging market was initially, not able to respond to the regulatory objectives.

4. Absence of Innovative Marketing Network

The absence of product diversification and a confused market situation has been made worse by the absence of an innovative marketing network for mutual funds. The agent oriented network has largely been a failure because most of the agents have not been specifically trained to sell mutual fund products. This has led to a significant communication gap which has come in the way of market expansion.

5. Lack of Adequate Research Infrastructure

The passive approach of some mutual funds in managing investors funds is compounded by the lack of adequate research infra-structure. Consequently, returns commensu-rate with the market movement could not be realized by many schemes, which has tended to show up Indian mutual funds in a bad light.

6. Inefficient Management

Management is considered to be a key factor for the operational efficiency of any business venture. This factor becomes even more crucial for service ventures such as mutual funds. What mutual funds require ask managers who have a clear understanding of the prevailing and emerging market potential, investor preference and macro economic fundamentals.

7. Lack of Investors Education

The market success of any new product, particularly a financial product, depends largely on its acceptance by consumers. In the case of investors, mutual funds must undertake a well-designed and comprehen-sive programme of investor education, especially aimed at investors in rural and semi-urban areas. However, this has been mostly neglected in India.

Q8. What are the functions of mutual funds?

Ans :

1. It mobilise the savings of small investors and use them as investment in securities market,

2. It helps the small investors to hold a share in a diversified portfolio of assets which may lower the risks of investment.
3. It pools the investors savings in a scheme and distribute the returns among investors in the proportion equal to their investment.
4. It helps the small investors to secure 'high return and low risk out of their equities and other assets.
5. It enables the small investors to take the professional management advantage which there by increases the earning rate.
6. Mutual funds operate in various diversified areas such as,
   (i) Offshore funds management.
   (ii) Management of money market funds.
   (iii) Provident funds and pension funds management
   (iv) Real estate funds management etc.

5.2 Estimating the Net Asset Value

Q9. What is Net Asset Value? How is it computed?

Ans : **(July-21)**

The repurchase price is always linked to the Net Asset Value (NAV). The NAV is nothing but the market price of each unit of a particular scheme in relation to all the assets of the scheme. It can otherwise be called "the intrinsic value" of each unit. This value is a true indicator of the performance of the fund. If the NAV is more than the face value of the unit, it clearly indicates that the money invested on that unit has appreciated and the Fund has performed well.

Illustration

For instance, Fortune Mutual Fund has introduced a scheme called Millionaire Scheme. The scheme size is 100 crores. The value of each unit is Rs. 10/-. It has invested all the funds in shares and debentures and the market value of the investment comes to Rs.200 crores.

Now

$$\text{NAV} = \frac{200 \text{ crores}}{100 \text{ crores}} \times \text{value of each unit}$$

$$= 2 \times 10 = 20$$

Thus, the value of each unit of Rs. 10/- is worth Rs. 20.

Hence the NAV = Rs.20.

This NAV forms the basis for fixing the repurchase price and reissue price.

The investor can call up the Fund any time to find out the NAV. Some MFs publish the NAV weekly in two or three leading daily newspapers.

5.3 Mechanics of MF Operations

Q10. Explain the Mechanism of Mutual Fund Operations.

Ans : **(Dec.-19, Dec.-18)**

1. Sponsors

Sponsors (The first tier), which thinks of starting a mutual fund. The Sponsor approaches the Securities & Exchange Board of India (SEBI), which is the market regulator and also the regulator for mutual funds.

SEBI checks whether the person is of integrity experience in the financial sector, his net worth etc.

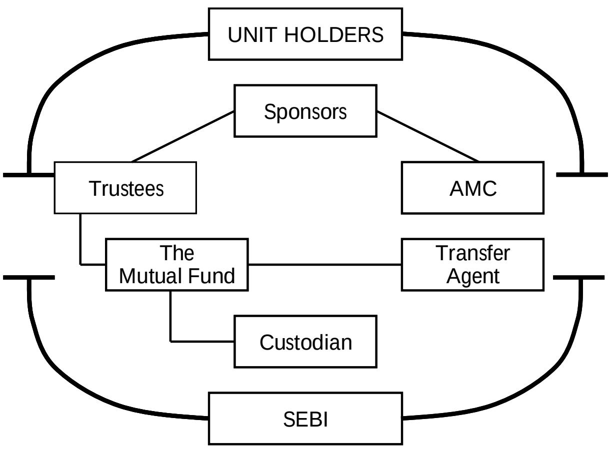


Fig. : Mechanics of Mutual Fund

2. Public Trust

Public Trust (the Second tier) as per the Indian Trusts Act, 1882. Trusts have no legal identity in India and cannot enter into contracts, hence the Trustees are the people authorized to act on behalf of the Trust Contracts are entered into in the name of the Trustees. Once the Trust is created, it is registered with SEBI after which this trust is known as the mutual fund. It is important to understand the difference between the Sponsor and the Trust. They are two separate entities. Sponsor is not the Trust, i.e., Sponsor is not the Mutual Fund. It is the Trust which is the Mutual Fund. The Trustees role is not to manage the money. Their job is only to see, whether the money is being managed as per stated objectives. Trustees may be seen as the internal regulators of a mutual fund.

3. Asset Management Company

Asset Management Company (the Third tier). Trustees appoint the Asset Management Company (AMC), To manage investor's money. The AMC in return charges a fee for the services provided and this fee is borne by the investors as it is deducted from the money collected from them. The AMC's Board of Directors must have at least 50% of Directors who are independent directors.

The AMC has to be approved by SEBI. The AMC functions under the supervision of it's Board of Directors and also under the direction of the Trustees and SEBI. It is the AMC, which in the name of the Trust, floats new schemes and manage these schemes by buying and selling securities. In order to do this the AMC needs to follows all rules and regulations prescribed by SEBI and as per the Investment Management Agreement it signs with the Trustees.

SEBI regulations define Sponsor as any person who either itself or in association with another body corporate establishes a mutual fund. Sponsor sets up a mutual fund to earn money by doing fund management through its subsidiary company which acts as Investment manager of the fund. Largely, a sponsor can be compared with a promoter of a company. Sponsors activities include setting up a Public Trust under Indian Trust Act, 1882 (the mutual fund), appointing trustees to manage the trust with the approval of SEBI, creating an Asset Management Company under Companies Act, 1956 (the Investment Manager) and getting the trust registered with SEBI.

Eligibility of Sponsor

Mutual funds involve managing retail investor's money and hence, it becomes important to ensure that it is run by entities with capabilities and professional merits. SEBI (Mutual fund) Regulations, 1996 specifies the following eligibility criteria in this regard:

(i) Sponsor is required to have financial services business experience of at least 5 years and a positive Net worth in all the preceding five years,

(ii) Sponsors' Net worth in the immediately preceding year is required to be more than the capital contribution to AMC.

(iii) Sponsor is required to be profit making in at least three out of the last five years including the last year.

(iv) Sponsor must contribute at least 40% of the Net worth of the Asset Management Company. Any entity, which contributes at least 40% to the Net worth of an AMC, is deemed sponsor and therefore is required to fulfil all the requirements given in 1 to 4.

Trustees

The trust is created through a document called the trust deed which is executed by the fund sponsor in favour of the trustees. Trustees manage the trust and are responsible to the investors in the mutual funds. They are the primary guardians of the unit-holders funds and assets. Trustees can be formed in either of the following two ways -Board of Trustees, or a Trustee Company. The provisions of Indian Trust Act, 1882, govern board of trustees or the Trustee Company. A trustee company is also subject to provisions of Companies Act, 1956.

Obligations of Trustees

Trustees ensure that the activities of the mutual fund are in accordance with SEBI (mutual fund) regulations, 1996. They check that the AMC has proper systems and procedures in place. Trustees also make sure that all the other fund constituents are appointed and that proper due diligence is exercised by the AMC in the appointment of constituents and business associates. All schemes floated by the AMC have to be approved by the trustees. Trustees review and ensure that the net worth of the AMC is as per the regulatory norms. They furnish to SEBI, on a half-yearly basis, a report on the activities of AMC.

5.4 Asset Management Company

Q11. Explain Asset Management Company.

Ans : **(July-19)**

The Asset Management Company (AMC) is the investment Manager of the Trust. The sponsor, or the trustees is so authorized by the trust deed, appoints the AMC as the "Investment Manager" of the trust (Mutual Fund) via an agreement called as 'Investment Management Agreement'. An asset management company is a company registered under the Companies Act, 1956. Sponsor creates the asset management company and this is the entity, which manages the funds of the mutual fund (trust). The mutual fund pays a small fee to the AMC for management of its fund. The AMC acts under the supervision of Trustees and is subject to the regulations of SEBI too.

Role of AMC

The AMC is an operational arm of the mutual fund. AMC is responsible for all carrying out all functions related to management of the assets of the trust. The AMC structures various schemes, launches the scheme and mobilizes initial amount, manages the funds and give services to the investors. In fact, AMC is the first major constituent appointed. Later on AMC solicits the services of other constituents like Registrar, Bankers, Brokers, Auditors, Lawyers etc. and works in close co-ordination with them.

Activities

In India, regulator has ensured that an AMC focuses just on its core business and that the activities of AMCs are not in conflict of each other. These are ensured through the following restrictions on the business activities of an AMC. a. An AMC shall not undertake any business activity except in the nature of portfolio management services, management and advisory services to offshore funds etc., provided these activities are not in conflict with the activities of the mutual fund. b. An AMC cannot invest in any of its own schemes unless full disclosure of its intention to invest has been made in the offer document. An AMC shall not act as a trustee of any mutual fund.

1. Custodian

Though the securities are bought and held in the name of trustees, they are not kept with them. The responsibility of safe-keeping the securities is on the custodian. Custodians keep the investment account of the mutual fund.

2. Responsibility of Custodian

Following are the responsibility of a custodian:

(i) Provide post-trading and custodial services to the Mutual Fund.

(ii) Keep securities and other instruments belonging to the Scheme in safe custody.

(iii) Ensure smooth inflow outflow of securities and such other instruments as and when necessary, in the best interests of the unit holders.

(iv) Ensure that the benefits due to the holdings of the Mutual Fund are received and

(v) Be responsible for loss of or damage to the securities due to negligence on its part or on the part of its approved agents. The Custodian normally charge portfolio fee, transaction fee and out-of product experience in accordance with the terms of the Custody. Agreement and as per any modification made thereof from time to time.

5.4.1 Functions

Q12. What are the functions of Asset Management Company.

Ans : **(Dec.-20)**

Functions of the Asset Management company are :

1. **Asset Allocation**

   Mutual fund comes with a definite financial aim that helps the asset manager to shortlist and decide on which asset to invest in. For instance, many debt-oriented funds put no more than 20% of their assets under management inequities. Or a balanced fund may choose to invest only 60% of assets inequities. This asset allocation one of the crucial decisions a fund manager has to take.

2. **Research and Analysis**

   Building portfolio rides on plenty of in-depth studies daily. Analysts study the market, micro, and macro-economic aspects and fund performances regularly, and pass the reports to the manager.

3. **Portfolio Construction**

   An AMC will have a team of researchers and analysts who report their market findings and trends to the fund manager. Based on these findings and investment objectives, he chooses which securities to buy, sell, or whether to hold them.

4. **Performance Review**

   Even with disclaimers in the fine print, an AMC faces a lot of flak from the investors and trustees, if it cannot justify its investment decisions. It must also send regular updates to investors on sales and purchases, NAV, portfolio details, etc.

AMCs range from personal money managers, handling high-net-worth individual accounts, to large investment companies sponsoring mutual funds. AMC managers are compensated via fees, usually a percentage of a client's assets under management.

Q13. What are the benefits of Asset Management Company.

Ans :

The following are the advantages

1. **Economies of Scale**

   Economies of scale are the cost advantages that a company can gain from increasing the scale of operations. With larger operations, the per-unit costs of operating are lower.

   For example, asset management companies can purchase securities in larger quantities and can negotiate more favorable trading commission prices. Also, they can invest a lot of capital in a single office, which reduces overhead costs Overheads Overheads are business costs that are related to the day-to-day running of the business. Unlike operating expenses, overheads cannot be.

2. **Access to Broad Asset Classes**

   Access to broad asset classes means that asset management companies can invest in asset classes that an individual investor will not be able to. For example, an AMC can invest in multi-billion-dollar infrastructure projects, such as a power plant or a bridge. The investments are so large that an individual investor will not usually be able to access them.

3. **Specialized Expertise**

   Specialized expertise refers to asset management companies hiring finance professionals with extensive experience in managing investments that most individual investors lack. For example, an AMC can hire various professionals who specialize in certain asset classes, such as real estate, fixed income, sector-specific equities, etc.

5.4.2 Evaluating Mutual Funds

Q14. How to evaluate a Mutual Fund?

Ans :

When evaluating mutual funds, investors should consider a few different factors.

1. Investment Strategy

One of the most important parts of a mutual fund is its investment strategy.

Every fund should have a stated strategy and goal that investors can use to decide on whether to invest in a fund. For example, one fund might invest primarily in large companies' stocks while another focuses on government bonds, and a third focuses on small international businesses.

Depending on an investor's goals, any of the above funds could be a good fit for their portfolio.

2. Fees

Investing in mutual funds involves paying fees, which can have a significant impact on your investment's outcome.

Mutual funds have an expense ratio, usually expressed as a percentage. A fund's expense ratio shows the cost of investing in that fund for a single year. For example, if a fund's expense ratio is 0.5%, investors must pay 0.5% of their invested assets each year in fees.

The fund automatically accounts for these fees when calculating the price of a share of the fund after each trading day. Investors don't have to keep money set aside to pay the fees.

Expense ratios can have a massive impact on investment performance, especially over the long term.

Some mutual funds also charge transaction fees called loads. Investors typically pay these fees when working with a broker or financial advisor that charges commissions instead of a flat fee.

Mutual funds with loads can charge them when an investor purchases shares, when an investor sells shares, or — like expense ratios — for as long as the investor holds shares in the mutual fund.

3. Holdings

Mutual funds should publish their holdings, which gives investors a chance to look at what they're investing in.

While two funds might have similar strategies, such as investing in large businesses, how they go about executing their strategy might differ. Looking at a fund's holdings can help investors get a closer look at a fund's investment strategy.

4. Performance Compared to Benchmarks and Competitors

Past performance doesn't indicate how a fund will perform in the future, but looking at performance is still an important part of evaluating a mutual fund.

Investors can compare mutual funds against different benchmarks and against other, similar funds to see how they perform. For example, an investor who wants to buy shares in a fund that focuses on intermediate-term bonds might compare the fund's previous performance to other mutual funds that also focus on intermediate-term bonds.

5. Management

Mutual funds are managed by finance professionals. Fund managers are tasked with following the fund's strategy and making sure it accomplishes its stated investing goals.

In general, there are two management styles for mutual funds.

(i) Some funds are actively managed. These funds typically aim to beat the market, with managers focusing on buying low and selling high by making regular moves into and out of positions.

(ii) Passively managed funds do much less buying and selling of securities. They build their target portfolio and hold their investments for the long term. Investments such as index funds are a popular type of passively managed fund.

Q15. Explain the recent scenario of Indian mutual fund industry.

Ans : **(Dec.-20)**

1. Formulation

(i) Mutual funds are to be established in the form of trusts under the Indian Trust Act and are to be operated by separate Asset Management Companies (AMCs).

(ii) AMCs should have a minimum net worth of ` 10 crore.

(iii) AMCs and trustees of mutual funds are to be two separate legal entities. An AMC to its affiliate cannot act as a manager in any other fund.

(iv) All the schemes launched by the Asset Management Company should be approved by the trustees and a copy of the offer document should be filed with SEBI.

2. Schemes

(i) The AMC should mention the following in offer document.

(a) The minimum amount it wishes to raise under the scheme and

(b) The amount of funds it may retain in case of oversubscription. In this case, all the applications who apply for five thousand units or less should be given full allotment keeping in view the over-subscription levels.

(ii) The mutual fund as well as the AMC are liable to refund the application money back wholly or in part if,

(a) The mutual funds does not receive the minimum amount which it mentions in the prospectus and

(b) The amount received for units is in excess of subscription.

(iii) Every close-ended scheme launched by the AMC should be listed on a recognized stock exchange within a period of six months from the date of closure of the subscription.

However, this is not mandatory in cases where,

(a) There is a provision in the scheme for periodic repurchase facility to all the unit holders.

(b) The scheme provides for monthly income or if it takes into account the needs of certain classes of persons like senior citizens, women, widows or physically handicapped and children with a provision for periodic repurchase of units.

(c) The details of the repurchase facility are disclosed in the offer document.

(d) The scheme opens for repurchase within a period of six months from the date of closure of the subscription.

(iv) The AMC at its discretion can repurchase or reissue the units under the close-ended scheme.

(v) The close-ended scheme should be redeemed completely at the end of its maturity period.

3. Investment Norms

(i) If the AMC decides to invest in debt instruments, they should be rated and it should not be below the investment grade. The rating should be from an authorized credit rating agency.

In case the debt instrument is not rated, the AMC should take the approach from its board.

(ii) No mutual fund, under all its schemes can own more than ten percent of any company's paid-up capital carrying voting rights.

(iii) If the AMC wishes to transfer investments from one of its schemes to its other schemes, it will be allowed only if,

(a) The transfer of funds is done at the current market price of the said instruments on spot basis and

(b) The securities transferred satisfy the objectives of the scheme to which they are transferred.

(iv) A scheme can invest in other scheme managed by the same AMC or in a scheme managed by other mutual fund without charging any fees, only if the total interscheme investment made by the schemes managed by the same AMC or in schemes of other mutual funds does not exceed 5% of the NAV of the mutual fund.

4. Rights of Investors

(i) Certificates

An investor is entitled to receive shares/ unit certificates allotted to him within a period of 6 weeks from the date of closure of the subscription.

(ii) Transfer

An investor is entitled to get the unit/ share certificates transferred within a period of 3 days from the date of lodgment for transfer.

(iii) Refund

If the total collection of the funds by a mutual fund is less than the minimum amount of subscription planned to be raised, as mentioned in the prospectus, the applicants are entitled to receive the entire application money as refund, within a period of six weeks from the date of closure of subscription.

The refund may be delayed beyond this period, the applicants are entitled to receive, along with the application money, interest at the rate of 15% p.a for the period of delay.

Q16. Explain the future of mutual fund industry.

(OR)

Give an overview of mutual fund industry in India.

Ans : **(July-21)**

Inspite of the above bottlenecks, the mutual fund industry is having a good prospect in our country. It is likely to show a good progress in the coming years due to a variety of factors:

(i) The Securities and Exchanges Board of India is lending its full support for the promotion of the mutual fund industry directly as well as indirectly. For instance, it has allowed the promoters of a company to retain 75 per cent holding. It has raised the minimum subscription amount to Rs. 5000 for an individual investor for direct investment. It has also introduced the proportionate allotment scheme. All these factors stand in the way of small investors from entering into the capital market directly and they favour only big investors. So, a small investor has to necessarily seek the services of a mutual fund industry with his meagre savings.

(ii) Moreover, ever since the disbanding of the Controller of Capital Issues Office, many companies have entered into the market with a petty premium on their shares. Naturally, the small investors find them out of their reach, and hence, they have to seek the blessings of the mutual fund industry. One can easily subscribe to mutual funds shares at par with one's little investment.

(iii) In recent times, the interest rates on bank deposits have been declining. The household savers are looking for alternative avenues which could bring higher returns. The returns on the mutual fund schemes compare favourably with the returns on bank deposits.

(iv) The trend of rising PE ratio, the entry of large domestic institutional investors, the opening of the market to the foreign investors etc. would make stock market inaccessible to the small investors. Hence, they have to necessarily go to the mutual fund industry.

(v) Mutual Funds provide a wider range of products so as to meet the diverse needs of the investing public. The investors have a good choice to meet their different expectations like security, growth and liquidity.

(vi) The Government has also given the necessary impetus by providing tax concessions and tax exemptions. When the mutual fund industry is receiving a preferential treatment at the hands of the Government, it is bound to grow in future.

(vii) The Department of Company Affairs has agreed to amend the companies Act to grant voting rights in companies for mutual funds.

(viii) Again mutual funds have been permitted to underwrite shares also.

(ix) The Union Budget 1999-2000 contains many measures to encourage the mutual fund industry. These measures include.

(x) a three year dividend tax exemption from U.T.I. and equity dominated open-ended mutual funds, and

(xi) a full income tax exemption for all income from the U.T.I. and other mutual funds in the hands of the investors.

Short Question and Answers

1. What is Net Asset Value?

Ans :

The repurchase price is always linked to the Net Asset Value (NAV). The NAV is nothing but the market price of each unit of a particular scheme in relation to all the assets of the scheme. It can otherwise be called "the intrinsic value" of each unit. This value is a true indicator of the performance of the fund. If the NAV is more than the face value of the unit, it clearly indicates that the money invested on that unit has appreciated and the Fund has performed well.

2. What are Mutual Funds?

Ans :

There are many investment avenues available in the financial market for an investor. Investors can invest in bank deposits, corporate debentures and bonds, post office saving schemes etc. where, there is low risk together with low return. They may invest in stock of companies where the risk is high and sometimes the returns are also proportionately high.

For retail investors, who do not have the time and expertise to analyze and invest in stock, Mutual Funds is a viable investment alternative. This is because Mutual Funds provide the benefit of cheap access to expensive stocks.

A Mutual Fund is a collective investment vehicle formed with the specific objective of raising money from a large number of individuals and investing it according to a pre-specified objective, with the benefits accrued to be shared among the investors on a pro-rata basis in proportion to their investment.

According to Encyclopedia Americana, "Mutual funds are open end investment companies that invest shareholders' money in portfolio or securities. They are open ended in that they normally offer new shares to the public on a continuing basis and promise to redeem outstanding shares on any business day."

According to Securities and Exchange Board of India Regulations, 1996 a mutual fund means "a fund established in the form of trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments".

3. Close-ended Funds

Ans :

Under this scheme, the corpus of the fund and its duration are prefixed. In other words, the corpus of the fund and the number of units are determined in advance. Once the subscription reaches the pre-determined level, the entry of investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding. Thus, the fund ceases to be a fund, after the final distribution.

Features

The main features of the close-ended funds are :

- The period and/or the target amount of the fund is definite and fixed beforehand.
- Once the period is over and/or the target is reached, the door is closed for the investors. They cannot purchase any more units.
- These units are publicly traded through stock exchange and generally, there is no repurchase facility by the fund.
- The main objective of this fund is capital appreciation.
- The whole fund is available for the entire duration of the scheme and there will not be any redemption demands before its maturity. Flence, the fund manager can manage the investments efficiently and profitably without the necessity of maintaining and liquidity.

- At the time of redemption, the entire investment pertaining to a closed-end scheme is liquidated and the proceeds are distributed among the unit holders.
- From the investor's point of view, it may attract more tax since the entire capital appreciation is realised in to at one stage itself.
- If the market condition is not favourable, it may also affect the investor since he may not get the full benefit of capital appreciation in the value of the investment.

4. Off-Shore Mutual Funds

Ans :

Off-shore mutual funds are those funds which are meant for non-residential investors. In other words, the sources of investments for these funds are from abroad. So, they are regulated by the provisions of the foreign countries where those funds are registered. These funds facilitate flow of funds across different countries, with free and efficient movement of capital for investment and repatriation. Off-shore funds are preferred to direct foreign investment, since, it does not allow foreign domination over host country's corporate sector.

However, these funds involve much currency and country risk and hence they generally yield higher return.

5. Open-ended Funds

Ans :

It is just the opposite of close-ended funds. Under this scheme, the size of the fund and/or the period of the fund is not pre-determined. The investors are free to buy and sell any number of units at any point of time. For instance, the unit scheme (1964) of the Unit Trust of India is an open ended one, both in terms of period and target amount. Anybody can buy this unit at any time and sell it also at any time at his discretion.

Features

The Main Features of the Open-Ended Funds are:

- There is complete flexibility with regard to one's investment or disinvestment. In other words, there is free entry and exit of investors in an open-ended fund. There is no time limit. The investor can join in and come out from the Fund as and when he desires.
- These units are not publicly traded but, the Fund is ready to repurchase them and resell them at any time.
- The investor is offered instant liquidity in the sense that the units can be sold on any working day to the Fund. In fact, the Fund operates just like a bank account wherein one can get cash across the counter for any number of units sold.
- The main objective of this fund is income generation. The investors get dividend, rights or bonuses as rewards for their investment.
- Since the units are not listed on the stock market, their prices are linked to the Net Asset Value (NAV) of the units. The NAV is determined by the Fund and it varies from time to time.
- Generally, the listed prices are very close to their Net Asset Value. The Fund fixes a different price for their purchases and sales.
- The fund manager has to be very careful in managing the investments because he has to meet the redemption demands at any time made during the life of the scheme.

6. Balanced Funds

Ans :

This is otherwise called "income-cum-growth" fund. It is nothing but a combination of both income and growth funds. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

7. Taxation Funds

Ans :

A taxation fund is basically a growth oriented fund. But, it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March. In India, at present the law relating to tax rebates is covered under Sec. 88 of the Income Tax Act, 1961. An investor is entitled to get 20% rebate in Income Tax for investments made under this fund subject to a maximum investment of Rs. 10,000/- per annum. The Tax Saving Magnum of SBI Capital Market Limited is the best example for the domestic types UTI's US $60 million India Fund, based in the USA, is an example for the foreign type.

8. Fund-of-Funds

Ans :

A fund of funds scheme is a mutual fund scheme that invests in other mutual fund schemes. The concept is widely prevalent abroad. Mutual Funds in India are being allowed to launch fund-of-funds.

In India, these funds are subject to the approval of the Department of Economic Affairs, Ministry of Finance and the RBI monitors such funds by issuing directions then and there. In India, a number of off-shore funds exist. 'India Fund' and 'India Growth Fund' were floated by the UTI in U.K. and U.S.A. respectively. The State Bank of India floated the India Magnum Fund in Netherlands. 'The Indo-Suez Himalayan Fund N.V.' was launched by Canbank Mutual Fund in collaboration with Indo-Suez Asia Investment Services Ltd. It also floated 'Commonwealth Equity Fund'.

9. Explain the importance of mutual funds.

Ans :

(i) Channelising Savings for Investment

Mutual funds act as a vehicle in galvanising the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. A number of schemes are being offered by MFs so as to meet the varied requirements of the masses, and thus, savings are directed towards capital investments directly.

(ii) Offering Wide Portfolio Investment

Small and medium investors used to burn their fingers in stock exchange operations with a relatively modest outlay. If they invest in a select few shares, some may even sink without a trace never to rise again. Now, these investors can enjoy the wide portfolio of the investment held by the mutual fund. The fund diversifies its risks by investing on a large varieties of shares and bonds which cannot be done by small and medium investors. This is in accordance with the maxim 'Not to lay all eggs in one basket'. These funds have large amounts at their disposal, and so, they carry a clout in respect of stock exchange transactions. They are in a position to have a balanced portfolio which is free from risks. Thus MF's provide instantaneous portfolio diversification. The risk diversification which a pool of savings through mutual funds can achieve cannot be attained by a single investor's savings.

(iii) Providing Better Yields

The pooling of funds from a large number of customers enables the fund to have large funds at its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus, they are able to command better market rates and lower rates of brokerage.

(iv) Rendering Expertised Investment Service at Low Cost

The management of the Fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus, investors are assured of quality services in their best interest.

10. Explain the Mechanism of Mutual Fund Operations.

Ans :

(i) Sponsors

Sponsors (The first tier), which thinks of starting a mutual fund. The Sponsor approaches the Securities & Exchange Board of India (SEBI), which is the market regulator and also the regulator for mutual funds. SEBI checks whether the person is of integrity experience in the financial sector, his net worth etc.

(ii) Public Trust

Public Trust (the Second tier) as per the Indian Trusts Act, 1882. Trusts have no legal identity in India and cannot enter into contracts, hence the Trustees are the people authorized to act on behalf of the Trust Contracts are entered into in the name of the Trustees. Once the Trust is created, it is registered with SEBI after which this trust is known as the mutual fund. It is important to understand the difference between the Sponsor and the Trust. They are two separate entities. Sponsor is not the Trust, i.e., Sponsor is not the Mutual Fund. It is the Trust which is the Mutual Fund. The Trustees role is not to manage the money. Their job is only to see, whether the money is being managed as per stated objectives. Trustees may be seen as the internal regulators of a mutual fund.

(iii) Asset Management Company

Asset Management Company (the Third tier). Trustees appoint the Asset Management Company (AMC), To manage investor's money. The AMC in return charges a fee for the services provided and this fee is borne by the investors as it is deducted from the money collected from them. The AMC's Board of Directors must have at least 50% of Directors who are independent directors.

The AMC has to be approved by SEBI. The AMC functions under the supervision of it's Board of Directors and also under the direction of the Trustees and SEBI. It is the AMC, which in the name of the Trust, floats new schemes and manage these schemes by buying and selling securities. In order to do this the AMC needs to follows all rules and regulations prescribed by SEBI and as per the Investment Management Agreement it signs with the Trustees.

11. Asset Management Company.

Ans :

The Asset Management Company (AMC) is the investment Manager of the Trust. The sponsor, or the trustees is so authorized by the trust deed, appoints the AMC as the “Investment Manager” of the trust (Mutual Fund) via an agreement called as ‘Investment Management Agreement’. An asset management company is a company registered under the Companies Act, 1956. Sponsor creates the asset management company and this is the entity, which manages the funds of the mutual fund (trust). The mutual fund pays a small fee to the AMC for management of its fund. The AMC acts under the supervision of Trustees and is subject to the regulations of SEBI too.

12. What are the benefits of Asset Management Company.

Ans :

The following are the advantages

(i) Economies of Scale

Economies of scale are the cost advantages that a company can gain from increasing the scale of operations. With larger operations, the per-unit costs of operating are lower.

For example, asset management companies can purchase securities in larger quantities and can negotiate more favorable trading commission prices. Also, they can invest a lot of capital in a single office, which reduces overhead costs Overheads Overheads are business costs that are related to the day-to-day running of the business. Unlike operating expenses, overheads cannot be.

(ii) Access to Broad Asset Classes

Access to broad asset classes means that asset management companies can invest in asset classes that an individual investor will not be able to. For example, an AMC can invest in multi-billion-dollar infrastructure projects, such as a power plant or a bridge. The investments are so large that an individual investor will not usually be able to access them.

(iii) Specialized Expertise

Specialized expertise refers to asset management companies hiring finance professionals with extensive experience in managing investments that most individual investors lack. For example, an AMC can hire various professionals who specialize in certain asset classes, such as real estate, fixed income, sector-specific equities, etc.

Choose the Correct Answer

1. Example of equity fund [d]
   (a) Index funds (b) Sectorial funds
   (c) Diversified funds (d) all
2. Example of debt funds [d]
   (a) Money market (b) gilt funds
   (c) Income funds (d) all
3. Investment objective is [a]
   (a) regular income (b) past performance
   (c) global linkage (d) all
4. AMC stands for _______ [a]
   (a) asset management company (b) all management company
   (c) about management company (d) all
5. Mutual fund scheme in India [d]
   (a) UTI 1964 (b) SBI 1987
   (c) LIC (d) all
6. Factor of evaluating mutual fund [d]
   (a) risk adjustment return (b) performance against index
   (c) defne the investment goal (d) all
7. Limitaton of mutual fund ________ [d]
   (a) loss of control (b) poor performance
   (c) size (d) all
8. Component of mutual fund _______ [d]
   (a) AMC (b) Trustees
   (c) Custodian (d) all
9. Which of the following can be described as direct finance? [b]
   (a) You take out a mortgage from your local bank.
   (b) You borrow $2500 from a friend.
   (c) A pension fund lends money to General Motors.
   (d) You buy shares in a mutual fund.
10. Which of the following can be described as involving direct finance? [c]
    (a) A corporation takes out a loan from a bank.
    (b) People buy shares in a mutual fund.
    (c) A corporation buys a short-term security issued by another corporation.
    (d) An insurance company buys shares of common stock in the over-the-counter markets.

Fill in the blanks

1. ETF stands for ________
2. FMP stands for ________
3. Advantage of Mutual Fund ________
4. Disadvantage of Mutual fund _______
5. NAV stands for _________
6. Establishment of Mutual fund skim in India ________
7. SEBI regulation for mutual fund _________
8. _________ type of mutual fund skim
9. ________ type of mutual fund
10. FOF stands for _________

ANSWERS

1. Exchange Traded Funds
2. Fixed maturity plan
3. Increased Diversification
4. No Insurance
5. Net Asset Value
6. 1964
7. Registration
8. Open Ended Skim
9. Debt fund
10. Fund of funds

One Mark Answers

1. Mutual Fund

Ans :

Mutual funds are open end investment companies that invest shareholders' money in portfolio or securities.

2. Define AMC.

Ans :

Asset Management Company.

3. Expand NAV.

Ans :

Net Asset Value

4. Asset Management Company (AMC)

Ans :

The AMC manages the funds of the various schemes and employs a large number of professionals for investment, research and agent servicing.

5. Open-ended Mutual Funds

Ans :

Open-ended schemes accept funds from investors and sell shares to the investors on a regular basis.

6. Closed-ended Mutual Funds

Ans :

Closed-ended schemes offer subscriptions only for a limited period.

FACULTY OF MANAGEMENT

B.B.A III Year V-Semester (CBCS) Examination

July - 2021

FINANCIAL MARKETS AND SERVICES

Time : 2 Hours] [Max. Marks : 80

PART - A (4 × 5 = 20 Marks)

Note: Answer **Four** questions following.

ANSWERS

1. SEBI **(Unit-I, SQA-4)**
2. Financial Market **(Unit-I, SQA-3)**
3. IPO **(Unit-II, SQA-9)**
4. Venture Capital **(Unit-III, SQA-4)**
5. Mutual Funds **(Unit-V, SQA-2)**
6. NAV (Net Asset Value) **(Unit-V, SQA-1)**
7. Leasing **(Unit-III, SQA-3)**
8. OTCEI **(Unit-II, SQA-14)**

PART - B (4 × 15 = 60 Marks)

Note: Answer **Four** questions following.

9. Explain about Classification of financial services. **(Unit-I, Q.No.5)**
10. Write about structure of financial markets system in India? **(Unit-I, Q.No.1)**
11. Write about the functions of stock exchange. **(Unit-II, Q.No.18)**
12. Discuses about the primary market and secondary market. **(Unit-II, Q.No.1,17)**
13. Write the differences between leasing and Hire purchase. **(Unit-III, Q.No.12)**
14. Define Venture Capital? Explain the stages of financing. **(Unit-III, Q.No.15)**
15. Define merchant banking? Explain its roles and functions. **(Unit-IV, Q.No.24,26)**
16. Discuss the Credit Rating mechanism in India. **(Unit-IV, Q.No.8)**
17. Define Mutual Fund? Write about its advantages and disadvantages. **(Unit-V, Q.No.1,7)**

18 Give an overview of mutual fund industry in India. **(Unit-V, Q.No.16)**

FACULTY OF MANAGEMENT

B.B.A III Year V-Semester (CBCS) Examination

November / December - 2020

FINANCIAL MARKETS AND SERVICES

Time : 2 Hours] [Max. Marks : 80

PART – A (4 × 5 = 20 Marks)

Note: Answer any **Four** questions.

ANSWERS

1.	Organized markets	**(Unit-I, SQA-1)**
2.	Capital markets	**(Unit-I, SQA-2)**
3.	Primary market	**(Unit-II, SQA-1)**
4.	OTCEI	**(Unit-II, SQA-14)**
5.	Hire purchase	**(Unit-III, SQA-1)**
6.	Operating lease	**(Unit-III, SQA-10)**
7.	CRISIL	**(Unit-IV, SQA-1)**
8.	Credit rating symbols of CRISIL	**(Unit-IV, SQA-2)**

PART – B (4 × 15 = 60 Marks)

Note: Answer any **Four** questions.

9.	Discuss about various types of financial markets.	**(Unit-I, Q.No.3)**
10.	Explain the role of SEBI in regulating the Indian Financial Markets.	**(Unit-I, Q.No.13)**
11.	Discuss the pricing strategies in Indian Primary Market.	**(Unit-II, Q.No.17)**
12.	Explain the organization of Secondary exchanges.	**(Unit-II, Q.No.20)**
13.	Compare and contrast between leasing and hire purchase.	**(Unit-III, Q.No.12)**
14.	Explain the rationale and stages of venture capital financing.	**(Unit-III, Q.No.19,20)**
15.	What is factoring? Explain the function of factoring.	**(Unit-IV, Q.No.11)**
16.	Explain the credit rating procedures adopted by CRISIL.	**(Unit-IV, Q.No.9)**
17.	Discuss the recent scenario of Indian Mutual Fund Industry.	**(Unit-V, Q.No.15)**
18.	Explain the functions of AMC.	**(Unit-V, Q.No.12)**

FACULTY OF MANAGEMENT

B.B.A III Year V-Semester (CBCS) Examination

November / December - 2019

FINANCIAL MARKETS AND SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

Note: Answer any **Five** of the following questions in not exceeding 20 lines each.

ANSWERS

1. Answer the following in not exceeding 20 lines.

(a) Capital market **(Unit-I, SQA-2)**

(b) Treasurery bills **(Unit-I, SQA-12)**

(c) Free pricing **(Unit-II, SQA-6)**

(d) Listing of securities **(Unit-II, SQA-15)**

(e) Financial Lease **(Unit-III, SQA-2)**

(f) Venture capital **(Unit-III, SQA-4)**

(g) Factoring **(Unit-IV, SQA-6)**

(h) Credit rating advantages **(Unit-IV, SQA-3)**

(i) Offshore mutual funds **(Unit-V, SQA-4)**

(j) ICRA **(Unit-IV, SQA-4)**

PART - B (5 × 12 = 60 Marks)

Note: Answer the following questions in not exceeding four pages each, using Internal choice.

2. (a) Explain the structure and functions of Indian financial system. **(Unit-I, Q.No.1,2)**

OR

(b) Briefly explain about global financial markets. **(Unit-I, Q.No.14)**

3. (a) Explain various new financial instruments traded in Indian Capital Markets. **(Unit-II, Q.No.29)**

OR

(b) Discuss the settlement procedure of stock market trading activities. **(Unit-II, Q.No.26)**

4. (a) What is leasing? Explain the advantages of leasing. **(Unit-III, Q.No.2,7)**

OR

(b) Explain problems faced by venture capital firms in India. **(Unit-III, Q.No.23)**

5. (a) Explain the features of merchant banking. **(Unit-IV, Q.No.26)**

OR

(b) Discuss the advantages and limitations of credit rating. **(Unit-IV, Q.No.4,5)**

6. (a) Explain the advantages of mutual funds. **(Unit-V, Q.No.7)**

OR

(b) Explain the classification of mutual funds. **(Unit-V, Q.No.4)**

FACULTY OF MANAGEMENT

B.B.A III Year V-Semester (CBCS) Examination

June / July - 2019

FINANCIAL MARKETS AND SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

Note: Answer any **Five** of the following questions in not exceeding 20 lines each.

ANSWERS

1. Financial Market **(Unit-I, SQA-3)**
2. SEBI **(Unit-I, SQA-4)**
3. IPO's **(Unit-II, SQA-9)**
4. OTCEI **(Unit-II, SQA-14)**
5. Leasing **(Unit-III, SQA-3)**
6. Factoring and Forfeiting **(Unit-IV, SQA-6,8)**
7. Mutual Fund **(Unit-V, SQA-2)**
8. NAV (Net Asset Value) **(Unit-V, SQA-1)**

PART - B (5 × 12 = 60 Marks)

Note: Answer the following questions in not exceeding four pages each, using Internal choice.

9. (a) Explain structure of financial market service in India. **(Unit-I, Q.No.1)**

OR

(b) What is financial service? Classification of financial services. **(Unit-I, Q.No.5)**

10. (a) Discuss the primary market and secondary market. **(Unit-II, Q.No.1,18)**

OR

(b) Explain about functions of stock exchanges. **(Unit-II, Q.No.19)**

11. (a) Write a detailed note on evolution of Leasing Industry in India. **(Unit-III, Q.No.8)**

OR

(b) Explain the concept and features of venture capital financing. **(Unit-III, Q.No.15)**

12. (a) Discuss the credit rating mechanism in India. **(Unit-IV, Q.No.8)**

OR

(b) Explain the role and functions of Merchant Banking. **(Unit-IV, Q.No.26)**

13. (a) Explain evolution of mutual funds. **(Unit-V, Q.No.2)**

OR

(b) Explain Asset Management Company (AMC). **(Unit-V, Q.No.9)**

FACULTY OF MANAGEMENT

B.B.A III Year V-Semester (CBCS) Examination

November / December - 2018

FINANCIAL MARKETS AND SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

Note: Answer any **Five** of the following questions in not exceeding 20 lines each.

ANSWERS

1. Types of Financial Markets **(Unit-I, SQA-5)**
2. RBI **(Unit-I, SQA-6)**
3. Underwriting **(Unit-II, SQA-7)**
4. New Financial Instruments **(Unit-II, SQA-16)**
5. Venture Capital **(Unit-III, SQA-4)**
6. Credit Rating **(Unit-IV, SQA-5)**
7. Merchant Banking **(Unit-IV, SQA-11)**
8. Mechanics of Mutual funds Operations **(Unit-V, SQA-10)**

PART - B (5 × 12 = 60 Marks)

Note: Answer the following questions in not exceeding four pages each, using Internal choice.

9. (a) Explain Indian Finance System. **(Unit-I, Q.No.1)**

(OR)

(b) Discuss briefly SEBI guidelines related to new issue management. **(Unit-II, Q.No.28)**

10. (a) Briefly explain the primary market and secondary market **(Unit-II, Q.No.1,18)**

(OR)

(b) Explain Initial Public Offering (IPO). **(Unit-II, Q.No.12)**

11. (a) Define Leasing? Classification of leasing, Advantages and Limitations. **(Unit-III, Q.No.2,5,7)**

(OR)

(b) Explain the meaning and characteristics of hire purchase. **(Unit-III, Q.No.10)**

12. (a) What are the features, advantages and disadvantages of factoring? **(Unit-IV, Q.No.11,13,15,16)**

(OR)

(b) Explain the scope of Merchant Banking in India. **(Unit-IV, Q.No.25)**

13. (a) Define Mutual Fund. Explain types of Mutual Funds. **(Unit-V, Q.No.1,3)**

(OR)

(b) Explain Mechanics of Mutual Fund Operations. **(Unit-V, Q.No.10)**

FACULTY OF MANAGEMENT

BBA III Year V-Semester (CBCS) Examination

MODEL PAPER - I

FINANCIAL MARKETS AND SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

Note : Answer all the questions

ANSWERS

1. Answer any Five of the following in not exceeding 20 lines.

(a) Capital Market. **(Unit - I, SQA-2)**

(b) Financial Markets. **(Unit - I, SQA-3)**

(c) Listing of Securities. **(Unit - II, SQA-15)**

(d) Asset Management Company. **(Unit - V, SQA-11)**

(e) Define term leasing. **(Unit - III, SQA-3)**

(f) CRISIL **(Unit - IV, SQA-1)**

(g) Define Merchant Banking. **(Unit - IV, SQA-11)**

(h) What are Mutual Funds? **(Unit - V, SQA-2)**

PART - B (5 × 12 = 60 Marks)

Note : Answer all the questions using the internal choice.

2. (a) Explain the structure of Indian Financial System. **(Unit - I, Q.No.1)**

OR

(b) What is RBI ? Discuss the functions of RBI. **(Unit - I, Q.No.11)**

3. (a) Explain the various functions of Stock Exchange. **(Unit - II, Q.No.19)**

OR

(b) Explain Trading and Settlement proce-dure in securities market. **(Unit - II, Q.No.26)**

4. (a) Explain the classification of leasing. **(Unit - III, Q.No.5)**

OR

(b) Compare the contrast between leasing and hire purchase. **(Unit - III, Q.No.12)**

5. (a) Outline the steps involved in credit rating process. **(Unit - IV, Q.No.7)**

OR

(b) Explain the features of Merchant Banking. **(Unit - IV, Q.No.26)**

6. (a) Explain the History of mutual funds. **(Unit - V, Q.No.2)**

OR

(b) What are the functions of Asset Management Company. **(Unit - V, Q.No.12)**

FACULTY OF MANAGEMENT

BBA III Year V-Semester (CBCS) Examination

MODEL PAPER - II

FINANCIAL MARKETS AND SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

Note : Answer all the questions

ANSWERS

1. Answer any Five of the following in not exceeding 20 lines.

   (a) Financial Services **(Unit - I, SQA-9)**

   (b) RBI **(Unit - I, SQA-6)**

   (c) Over the Counter Exchange of India (OTCEI) **(Unit - II, SQA-14)**

   (d) Explain the importance of mutual funds. **(Unit - V, SQA-9)**

   (e) Venture Capital. **(Unit - III, SQA-4)**

   (f) Credit rating symbols. **(Unit - IV, SQA-2)**

   (g) Define Forfaiting. **(Unit - IV, SQA-8)**

   (h) What is Net Asset Value? **(Unit - V, SQA-1)**

PART - B (5 × 12 = 60 Marks)

Note : Answer all the questions using the internal choice.

2. (a) Discuss about various types of financial markets. **(Unit - I, Q.No.3)**

   OR

   (b) Explain the role of SEBI in regulating the Indian Financial Markets. **(Unit - I, Q.No.13)**

3. (a) Explain the various new financial instruments traded in Indian Capital Market. **(Unit - II, Q.No.29)**

   OR

   (b) Define Underwriting. Explain the methods of Underwriting. **(Unit - II, Q.No.10)**

4. (a) What are the Advantages and Limitations of leasing? **(Unit - III, Q.No.7)**

   OR

   (b) Explain the concept and features of Venture Capital Financing. **(Unit - III, Q.No.15)**

5. (a) Explain the rationale of credit rating agencies in India. **(Unit - IV, Q.No.8)**

OR

(b) The scope of merchant banking is great in India. Discuss. **(Unit - IV, Q.No.25)**

6. (a) Explain the Advantages and Disadvantages of mutual funds. **(Unit - V, Q.No.7)**

OR

(b) Explain the recent scenario of Indian mutual fund industry. **(Unit - V, Q.No.15)**

FACULTY OF MANAGEMENT

BBA III Year V-Semester (CBCS) Examination

MODEL PAPER - III

FINANCIAL MARKETS AND SERVICES

Time : 3 Hours] [Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

Note : Answer all the questions

ANSWERS

1. Answer any Five of the following in not exceeding 20 lines.

(a) Treasury Bills Market. **(Unit - I, SQA-12)**

(b) Organized Markets. **(Unit - I, SQA-1)**

(c) What is meant by New issue Market? **(Unit - II, SQA-1)**

(d) Close-ended Funds **(Unit - V, SQA-3)**

(e) Operating lease. **(Unit - III, SQA-10)**

(f) What is Factoring? **(Unit - IV, SQA-6)**

(g) Discuss the advantages of credit rating. **(Unit - IV, SQA-3)**

(h) Open-ended Funds **(Unit - V, SQA-5)**

PART - B (5 × 12 = 60 Marks)

Note : Answer all the questions using the internal choice.

2. (a) What is financial service? Classification of financial services. **(Unit - I, Q.No.5)**

OR

(b) Briefly explain about global financial markets. **(Unit - I, Q.No.14)**

3. (a) Discuss the role of SEBI in regulating primary and secondary markets. **(Unit - II, Q.No.28)**

OR

(b) Explain the organization of Secondary Exchanges. **(Unit - II, Q.No.20)**

4. (a) Explain the meaning and characteristics of hire purchase. **(Unit - III, Q.No.10)**

OR

(b) Explain the stages of venture capital financing. **(Unit - III, Q.No.20)**

5. (a) What is Factoring? Explain the functions of factoring. **(Unit - IV, Q.No.11)**

OR

(b) Discuss the legal framework of merchant banking system in India. **(Unit - IV, Q.No.31)**

6. (a) Explain the Mechanism of Mutual Fund Operations. **(Unit - V, Q.No.10)**

OR

(b) Explain the future of mutual fund industry. **(Unit - V, Q.No.16)**