Chapter 12

Special Financing

This chapter deals with some of the important special finance such as leasing, venture capital, foreign direct investment etc. and also this chapter covers the advantages and disadvantages, application in the present position and institution, which are providing. These finance to the business concern. This part is divided into the following major parts such as:

1. Lease Financing
2. Venture Capital
3. Factoring
4. Foreign Direct Investment
5. Merchant Banking
6. Credit Rating
7. Mutual Funds

LEASE FINANCING

Lease financing is one of the popular and common methods of assets based finance, which is the alternative to the loan finance. Lease is a contract. A contract under which one party, the leaser (owner) of an asset agrees to grant the use of that asset to another leaser, in exchange for periodic rental payments.

Lease is contractual agreement between the owner of the assets and user of the assets for a specific period by a periodical rent.

Definition of Leasing

Lease may be defined as a contractual arrangement in which a party owning an asset provides the asset for use to another, the right to use the assets to the user over a certain period of time, for consideration in form of periodic payment, with or without a further payment.

According to the equipment leasing association of UK definition, leasing is a contract between the lesser and the leaser for hire of a specific asset selected from a manufacturers or vender of such assets by the lessee. The leaser retains the ownership of the asset. The leassee pass possession and uses the asset on payment for the specified period.

Elements of Leasing

Leasing is one of the important and popular parts of asset based finance. It consists of the following essential elements. One should understand these elements before they are going to study on leasing.

1. **Parties:** These are essentially two parties to a contract of lease financing, namely the owner and user of the assets.
2. **Leaser:** Leaser is the owner of the assets that are being leased. Leasers may be individual partnership, joint stock companies, corporation or financial institutions.
3. **Lease:** Lease is the receiver of the service of the assets under a lease contract. Lease assets may be firms or companies.
4. **Lease broker:** Lease broker is an agent in between the leaser (owner) and lessee. He acts as an intermediary in arranging the lease deals. Merchant banking divisions of foreign banks, subsidiaries indian banking and private foreign banks are acting as lease brokers.
5. **Lease assets:** The lease assets may be plant, machinery, equipments, land, automobile, factory, building etc.

Term of Lease

The term of lease is the period for which the agreement of lease remains for operations. The lease term may be fixed in the agreement or up to the expiry of the assets.

Lease Rental

The consideration that the lesae pays to the leaser for lease transaction is the rental.

Type of Leasing

Leasing, as a financing concept, is an arrangement between two parties for a specified period. Leasing may be classified into different types according to the nature of the agreement. The following are the major types of leasing as follows:

(A) Lease based on the term of lease
   1. Finance Lease
   2. Operating Lease

(B) Lease based on the method of lease
   1. Sale and lease back
   2. Direct lease

(C) Lease based in the parties involved
   1. Single investor lease
   2. Leveraged lease

(D) Lease based in the area
   1. Domestic lease
   2. International lease

1. Financing lease

Financing lease is also called as full payout lease. It is one of the long-term leases and cannot be cancelable before the expiry of the agreement. It means a lease for terms that approach the economic life of the asset, the total payments over the term of the lease are greater than the leasers initial cost of the leased asset. For example: Hiring a factory, or building for a long period. It includes all expenditures related to maintenance.

2. Operating lease

Operating lease is also called as service lease. Operating lease is one of the short-term and cancelable leases. It means a lease for a time shorter than the economic life of the assets, generally the payments over the term of the lease are less than the leaser's initial cost of the leased asset. For example: Hiring a car for a particular travel. It includes all expenses such as driver salary, maintenance, fuels, repairs etc.

3. Sale and lease back

Sale and lease back is a lease under which the leasee sells an asset for cash to a prospective leaser and then leases back the same asset, making fixed periodic payments for its use. It may be in the firm of operating leasing or financial leasing. It is one of the convenient methods of leasing which facilitates the financial liquidity of the company.

4. Direct lease

When the lease belongs to the owner of the assets and users of the assets with direct relationship it is called as direct lease. Direct lease may be Dipartite lease (two parties in the lease) or Tripartite lease. (Three parties in the lease)

5. Single investor lease

When the lease belongs to only two parties namely leaser and it is called as single investor lease. It consists of only one investor (owner). Normally all types of leasing such as operating, financially, sale and lease back and direct lease are coming under this categories.

6. Leveraged lease

This type of lease is used to acquire the high level capital cost of assets and equipments. Under this lease, there are three parties involved; the leaser, the lender and the lessee. Under the leverage lease, the leaser acts as equity participant supplying a fraction of the total cost of the assets while the lender supplies the major part.

7. **Domestic lease**

   In the lease transaction, if both the parties belong to the domicile of the same country it is called as domestic leasing.

8. **International lease**

   If the lease transaction and the leasing parties belong to the domicile of different countries, it is called as international leasing.

Advantages of Leasing

Leasing finance is one of the modern sources of finance, which plays a major role in the part of the asset based financing of the company. It has the following important advantages.

1. **Financing of fixed asset**

   Lease finance helps to mobilize finance for large investment in land and building, plant and machinery and other fixed equipments, which are used in the business concern.

2. **Assets based finance**

   Leasing provides finance facilities to procure assets and equipments for the company. Hence, it plays a important and additional source of finance.

3. **Convenient**

   Leasing finance is convenient to the use of fixed assets without purchasing. This type of finance is suitable where the company uses the assets only for a particular period or particular purpose. The company need not spend or invest huge amount for the acquiring of the assets or fixed equipments.

4. **Low rate of interest**

   Lease rent is fixed by the lease agreement and it is based on the assets which are used by the business concern. Lease rent may be less when compared to the rate of interest payable to the fixed interest leasing finance like debt or loan finance.

5. **Simplicity**

   Lease formalities and arrangement of lease finance facilities are very simple and easy. If the leaser agrees to use the assets or fixed equipments by the lessee, the leasing arrangement is mostly finished.

6. **Transaction cost**

   When the company mobilizes finance through debt or equity, they have to pay some amount as transaction cost. But in case of leasing finance, transaction cost or floating cost is very less when compared to other sources of finance.

7. **Reduce risk**

   Leasing finance reduces the financial risk of the lessee. Hence, he need not buy the assets and if there is any price change in the assets, it will not affect the lessee.

8. **Better alternative**

   Now a days, most of the commercial banks and financial institutions are providing lease finance to the industrial concern. Some of the them have specialised lease finance company. They are established to provide faster and speedy arrangement of lease finance.

Leasing Finance Institutions in India

Presently, leasing finance becomes popular and effective financial sources for most of the business concerns. With the importance of lease finance, now a days banks and financial institutions provide leasing financial assistance to the industrial concern. The following institutions are famous and widely providing lease finance in India:

Leasing financial institutions in India may be classified into the following groups.

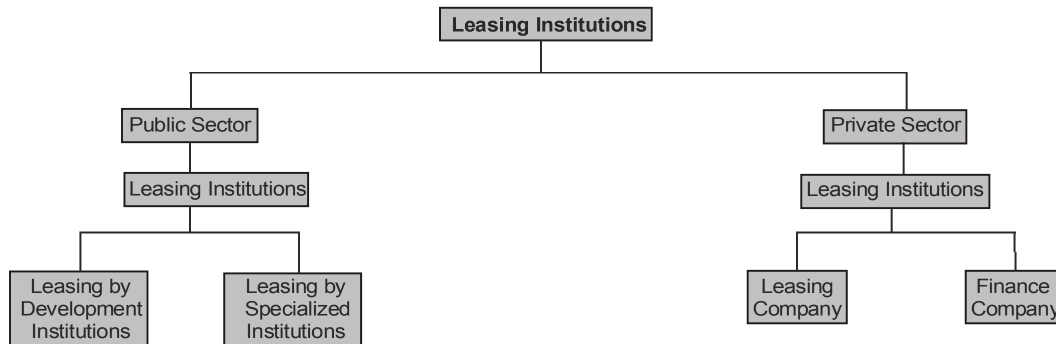

Fig. 12.1 *Leasing Institutions*

Leasing by Development Institutions

All India development institutions are providing leasing finance assistance to industrial concerns. Some of the public sector leasing finance company in India are follows:

- Industrial Credit & Investment Corporation of India (ICICI)
- Industrial Finance Corporation of India (IFCI)
- Industrial Investment Bank of India (IIBI)
- Small Industries Development Corporation (SIDC)
- State Industrial Investment Corporation (SIIC)

Leasing by Specialized Institutions

Specialized financial institutions also provide lease finance to the industrial concern. Some of the lease finance providing institutions are as follows:

- Life Insurance Corporation of India (LIC)
- General Insurance Corporation of India (GIC)

- Unit Trust of India (UTI)
- Housing Development Finance Corporation of India (HDFC)

Private Sector Leasing Company

Private sector leasing companies also provide financial assistance to the industrial concerns. The following are the example of the private sector leasing companies in India:

- Express Leasing Limited
- 20th Century Leasing Corporation Ltd.
- First Leasing Company of India
- Mazda Leasing Limited
- Grover Leasing Limited

Private Sector Financial Company

Private sector financial companies also involve in the field of leasing finance. The following are the example of the private sector finance companies:

- Cholamandal Investment and Finance Company Ltd.
- Dcl Finance Limited
- Sundaram Finance Limited
- Anagram Finance Limited
- Nagarjuna Finance Limited.

VENTURE CAPITAL

Introduction

Venture Capital finance is a new type of financial intermediary which has emerged in India during 1980s. It is a long-term financial assistance provided to projects, which are established to introduce new products, inventions, idea and technology. Venture capital finance is more suitable to risky oriented business which consists of huge investment and provides results after 5 to 7 year.

Meaning of Venture Capital

The term Venture Capital fund is usually used to denote Mutual funds or Institutional investors. They provide equity finance or risk capital to little known, unregistered, highly risky, young and small private business, especially in technology oriented and knowledge intensive business.

Venture Capital termed as long-term funds in equity or semi-equity form to finance hi-tech projects involving high risk and yet having strong potential of high profitability.

Definition of Venture Capital

According to **Jame Koloski Morries**, venture capital is defined as providing seed, start up and first stage financing and also funding expansion of companies that have already

demonstrated their business potential but do not yet have access to the public securities market or to credit oriented institutional funding sources. Venture Capital also provides management in leveraged buy out financing.

1995 finance bill define Venture Capital as long-term equity investment in novel technology based projects with display potential for significant growth and financial return.

Features of Venture Capital

Venture Capital consists of the following important features:

(1) Venture Capital consists of high risk and high return based financing.
(2) Venture Capital financing is equity and quasi equity financing instruments.
(3) Venture Capital provides moderate interest bearing instruments.
(4) Venture Capital reduces the financial burden of the business concern at the initial stage.
(5) Venture Capital is suitable for risky oriented and high technology based industry.

Venture Capital in India

ICICI Venture Capital is the first Venture Capital Financing in India. It was started in 1988 by the joint venture of ICICI and UTI.

The UTI launched Venture Capital Unit Scheme (VECAUS-I) to raise finance in 1990.

Technology Development and Information Company (TDICI) is another major Venture Capital financing institution in India.

Risk Capital and Technology Finance Corporation Ltd. (RCIFC) provides Venture Capital finance to technology based industries.

ANZ Grindlays Bank has set up India's first private sector Venture Capital fund.

SBI and Canara Bank are also involved in Venture Capital Finance. They provide either equity capital or conditionals loans.

S.No	Name of Venture Capital	Year	Funds under Management
1.	Alliance Venture Capital Advisors Ltd	May. 1997	SWISS TEC VCF Rs. 1000 Million
2.	APIDC–Venture Capital Funds	Aug. 1989	APIDE – VCF Rs. 300 Million
3.	Baring Private Equity Partners India Ltd.	Jan. 1992	BII – off shore fund
4.	Canara Bank Venture Capital Fund Ltd.	Feb. 1995	Canara Bank Venture Capital Rs.164.25 Million
5.	Draper International	Mar. 1994	DII Rs. 2090 Million
6.	Gujarat Venture Finance Ltd.	July. 1990	GVCF Rs. 240 Million
7.	HSBC Private Equity Management Mauritius Ltd.	Apl. 1995	HSBC equity fund Rs. 2400 million
8.	ICF Advisors Pvt. Ltd.	July. 1997	Indian capital fund Rs. 750 Million
9.	IL and FS Venture Corporation Ltd.	Feb. 1986	IT fund Rs. 100 Million
10.	Indus Venture Management Ltd.	Feb. 1989	IVC Rs. 210 Million

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11.	IDBI	July. 1984	IDBI – Rs. 1823.32 Million
12.	Industrial Venture Capital Ltd.	Sep. 1996	TN Venture fund Rs. 90 Million
13.	International Venture Capital Management Ltd.	Feb. 1996	Nandi Investment $ 30 Million
14.	JF Electra Advisors India Ltd.	Aug. 1995	JFE–$ 24 Million
15.	Marigold Capital Services Ltd.	Aug. 1995	MM fund Rs. 200 Million
16.	Pathfinder Investment Company Ltd.	Nov. 1993	Rs. 299.50 Million
17.	Risk Capital and Investment Company Pvt. Ltd.	Jan. 1998	Rs.1000 Million
18.	SIDBI	Apl. 1990	Rs. 600 Million
19.	TDICI Ltd.	Jan. 1998	Rs. 5500 Million and $ 75 Million
20.	Kitven	Aug. 1998	Rs. 18 Crore

FACTORING

Factoring is a service of financial nature involving the conversion of credit bills into cash. Accounts receivables, bills recoverables and other credit dues resulting from credit sales appear, in the books of accounts as book credits. Here the risk of credit, risk of credit worthiness of the debtor and as number of incidental and consequential risks are involved. These risks are taken by the factor which purchase these credit receivables without recourse and collects them when due. These balance-sheet items are replaced by cash received from the factoring agent.

Factoring is also called “Invoice Agent” or purchase and discount of all “receivables”. Although these can be with recourse or without recourse, normally the risk is taken by the factoring agent. The discount rate includes the loss of interest, risk of credit and risk of loss of both principal and interest on the amount involved.

Myths on Factoring

Myth	Fact
Factoring is nothing but bill discounting or bill finance	Factoring and bill discounting are two different products tailored for two different markets. Factoring is meant for “Open account sales” and caters largely to a buyer’s market. Bill discounting is normally prevalent in a seller’s market. Factoring unlike bill discounting offers a continuous relationship.
Factoring reduces bankers business	Factoring is not merely financing and includes a package of services like collection and follow-up of each invoice, credit insurance. MIS support etc., and improves the health of bank’s clients, improveds cash flow through factoring, increases production cycles and need for more working capital. Factoring essentially aims at replacing high cost market credit and not necessarily reduce bank finance.

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Factoring is an high cost borrowing	Comparable to interest rates of banks. (SSI – 13.50% to 15.75% Non-SSI 13.50% to 17.25%) Will to offer SBI's PLR selectively)
Factoring service charge is high	Service Charge is 0.1% to 0.3% only whereas in Bills discounting, the collection charge is 0.5% to 0.6%.
Factoring is meant for manufacturing units only	Extended to all sectors namely Manufacturing, Trading and Services.
Factoring limits falls within MBBF/ Assessed Bank finance	Factoring is to be classified as other Current liability as per RBI guidelines and Factoring replaces market credit and not bank borrowings.

History of the Early Factoring in Roman

Factoring has not been documented as having been used by the Romans. However, the word 'factoring' has a Roman root. It is derived from the Latin verb 'facio' which can be translated as "he who does things". In Roman times this referred to agent of a property owner, i.e., his business manager. Though the root word has nothing to do with the industry, as they attempt to help their clients through their financial problem.

Factoring in United States

Factoring arose in the United States during 19th century, as direct result of the inability of manufacturers to maintain constant and timely communications with their sales forces in the field. At that time, as the case today, the sales force was paid by communications. If all sales were at the risk of the manufacturer, the salesman had no incentive to exercise prudence in connection with whom to sell to on credit.

On the other hand, the distant manufacturer was not in the position to make the credit risk on sales. The risk of defective or non-conforming merchandise remained with the manufacturer. The credit risk was now separated from disputes as to quality, workmanship and conformity of goods. Soon after, the salesman began to act as independent sales agencies. It was common for them to act for more than one manufacturer. Still later the sales function was separated from the credit function and "Traditional Factoring" as the people know, it had, at that point, developed in the United States.

Factoring in India

Banks provide generally bill collection and bill discounting and with recourse. They provide working capital finance based on these bills classified by amounts maturity wise. Such bills if accumulated in large quantities will burden the liquidity and solvency position of the company and reduces the credit limits from the banks. It is therefore felt necessary that the company assigns these book debts to a factor for taking them off from the balance sheet. This reduces the workload, increases the solvency and improves the liquidity position of the company.

In 1998 a study group under the chairmanship of C.S. Kalyana Sundram was constituted to examine the feasibility of factoring services in India, their constitution, organizational set up and scope of activities. The group recommended the setting up of specialized agencies or subsidiaries for providing the factoring services in India with a professional expertise in credit assessment, debt collection and management of sales ledger, and other related services. Defaults or delays in collection and repayment can still remain which is the risk to be taken by the factor for a fee. The group has estimated a good potential for this service to the tune of about Rs. 4000 crores mainly emerging a collection problem, and delays in collection and consequential liquidity problems.

Later the **Vaghul Committee** report on money market reforms has confirmed the need for factoring services to be developed in India as part of the money market instruments. Many new instruments were already introduced like Participation certificates, Commercial papers, Certificate of deposits etc., but the factoring service has not developed to any significant extent in India.

The Reserve Bank allowed some banks to set up subsidiaries on a zonal basis to take care of the requirements of companies in need of such service. Thus Canara Bank, State Bank of India, Punjab National Bank and a few other banks have been permitted to set up jointly some factor, for Eastern, Western, Northern, and Southern Zones. The progress of the activity did not show any worth while dimension, so far.

Modus of Operations

If a company wants to factor its receivables it submits a list of customers, their credit rating, amount involved in maturity and other terms. If the factor scrutinizes the list of buyers and they are in the approved list, the factor gives its decision of the clients and the amounts they may take all receivables on wholesale discounting basis. The factor then takes all the documents in respect of approved list and pays up to 80% to 90% of the amount due less commission to the company which in turn removes these instruments, from base of accounts and shows cash flow as against bills receivables written off.

Factoring services rendered the following services:

1. Purchase of book debts and receivables.
2. Administration of sales ledger of the clients.
3. Prepayments of debts partially or fully.
4. Collection of book debts or receivables or with or without documents.
5. Covering the credit risk of the suppliers.
6. Dealing in book debts of customers without recourse.

Why Factoring?

Factoring is one of the most important and unavoidable part of the business concern which meets the short-term financial requirement of the concern. Factoring is favorable to the industrial concern for the following reasons.

1. Quickest response–Customer oriented timely decisions and decision on sanction within a week.
2. Low cost.
3. Low service charges (0.1% to 0.3%).
4. Low margin (20% onwards).
5. Instant finance–against each invoice.
6. Generous grace period.
7. Improves cashflow.
8. Substitutes sundry creditors.
9. Increases sales through better terms on sales.
10. More operating cycles and more profits.
11. No upfront recovery of charges.
12. Interest on daily products.
13. Very easy to operate.
14. Flexible credit periods.
15. No penal interest up to grace period.
16. Empowers cash purchase.
17. Improves credit reputation.
18. Follow up of each invoice.
19. Collection of receivables.
20. MIS reports like customers overdue invoices enabling constant evaluation of customers.
21. Outstation payments at nominal rates.

Mechanics of Factoring

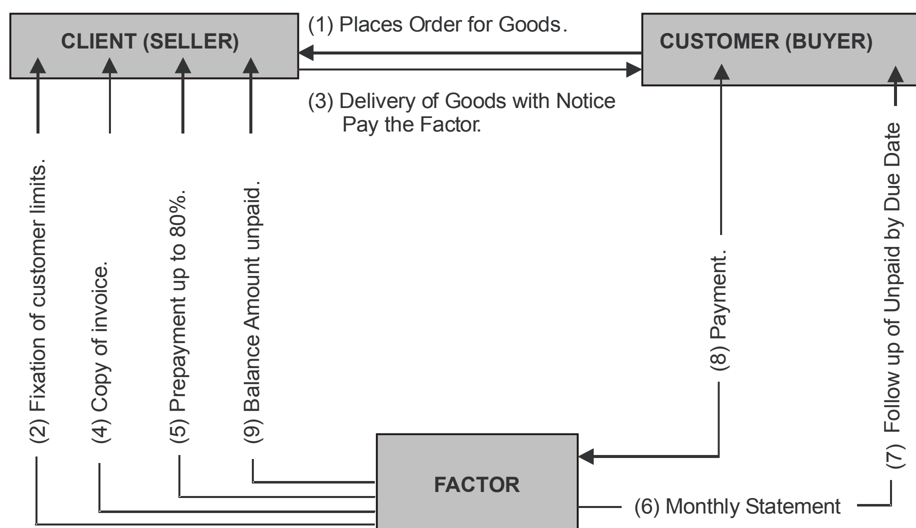

Fig. 12.2 *Mechanics of Factoring*

The following are the steps for factoring:

1. The customer places an order with the seller (client).
2. The factor and the seller enter into a factoring agreement about the various terms of factoring.
3. Sale contract is entered into with the buyer and the goods are delivered. The invoice with the notice to pay the factor is sent alongwith.
4. The copy of invoice covering the above sale to the factor, who maintains the sale ledger.
5. The factor prepays 80% of the invoice value.
6. The monthly statement are sent by the factor to the buyer.
7. Follow up action is initiated if there are any unpaid invoices.
8. The buyer settles the invoices on the expiry of the credit period allowed.
9. The balance 20% less the cost of factoring is paid by the factor to the client.

Types of factoring

(1) Notified factoring: Here, the customer is intimated about the assignment of debt to a factor, also directed to make payments to the factor instead of to the firm. This is invariably done by a legend and the invoice has been assigned to or sold to the factor.

(2) Non-notified or confidential factoring: Under this facility, the supplier/factor arrangement is not declared to the customer unless or until there is a breach of the agreement on the part of the client, or exceptionally, where the factor considers himself to be at risk.

(3) With recourse or without recourse factoring: Under recourse arrangements, the client will carry the credit risk in respect of debts sold to the factor. In without recourse factoring, the bad debts are borne by the factor.

(4) Bank Participation Factoring: The client creates a floating charge on the factoring reserves in favour of banks and borrow against these reserves.

(5) Export Factoring: There is usually the presence of two factors: an export factor and an import factor. The former buys the invoices of a client exporter and assumes the risk in case of default by the overseas customers. Because of distance, different condition or lake of information, the export factor usually forms out to an agent, known as the import factor, the administrative job of servicing the debts owed to its exporting clients.

FOREIGN DIRECT INVESTMENT

According to the definition given by **JMF**, FDI is the category of international investment that reflects the objective of a resident entity in one economy (direct investor or parent enterprise) by obtaining a ‘lasting interest’ and control in an enterprise resident in another economy (direct investment enterprise).

The **IMF** definition of FDI includes as many as twelve different elements, namely: equity capital, reinvested earnings of foreign companies, inter-company debt transactions including short-term and long-term loans, overseas commercial borrowings (financial leasing, trade credits, grants, bonds), non cash acquisition of equity, investment made by foreign vantage capital investors, earning data of indirectly held FDI enterprises, control premium, non-competition fee and so on.

FDI in India

FDI is permitted as under the following form of investments:

Through financial collaborations;

Through joint ventures and technical collaborations;

Through capital markets Via Euro Uses.

Through Private Placements or Preferential Allotments

1. The government has reviewed the guidelines pertaining to foreign/technical collaborations under automatic route for foreign financial/technical collaborations with previous ventures/tie-ups in India as per Press Note No. 18 (1998), it has been decided that new proposals for foreign investment/technical collaborations would henceforth be allowed under the automatic route, subject to sectored policies as per the following guidelines.
   (a) Prior approval of the government would be required only in cases where the foreign investor has an existing joint venture for technology transfer/trade mark agreement in the 'same' field.
   (b) Even in the above mentioned cases, the approval of the government would not be required in respect of the following :
      (1) Investments to be made by venture capital funds registered with SEBI.
      (2) Where the existing joint venture investments by either of the parties is less than 3%; or
      (3) Where the existing, venture/collaboration is defunct or sick.
   (c) In so far as joint venture to be ordered after the date of dated January, 12, 2005 are concerned, the joint venture agreement may embody a 'conflict of interest' clause to safeguard the interest of joint venture partners in the event of one of the partners desiring to set up another joint venture or a wholly owned subsidiary in the 'same' field of economic activity.
2. Increase in the FDI limits in Air Transport Services (Domestic Airlines) up to 49% through automatic route and up to 100% by Non-resident Indians (RRIs) through automatic routes (No direct or indirect equity participation by foreign airlines is allowed).
3. Foreign investment in the banking sector has been further liberalized by raising, FDI limit in private sector books to 74% under the automatic route including, investment by FIIs.

4. FDI in telecom has been raised to 74% subject to certain security measures. From August 1991 to August 2004, 926 proposals of FDI of Rs. 41,368 crore were approved. The actual FDI inflow of approximately Rs. 5,763 crore between January 2001 and August 2004 alone was about 56% of the total FDI flow in telecom since its inception in 1991. In terms of approval of FDI, the telecom sector is the second largest, after power and oil references.
5. FDI in construction sector has been opened. Still some more sectors vis-à-vis retail mining and pension are under the consideration of the government.
6. A part of FDI comes from NRIs, to oversee the difficulties faced by NRIs government has set up a separate NRI Ministry for facilitating hassle free investment procedure and clearances.

A Comparative Study Between India and China

Country	FDI Inflows ($bn)												
India	0.08	0.24	0.54	0.97	2.15	2.53	3.35	2.64	2.17	2.32	3.40	3.45	4.27
China	4.32	16.16	27.52	33.79	36.85	40.18	44.24	45.46	40.2	40.72	46.88	52.74	53.51
World FDI	1581	168	208	226	332	338	473	691	1087	1388	818	679	560
*	2.22	6.67	13.23	14.98	10.80	11.90	9.35	6.58	3.71	2.93	5.73	7.77	9.56
**	6.06	0.14	0.26	0.43	0.65	0.75	0.71	0.38	0.20	0.17	0.42	0.51	0.76

* FDI in China as a % of World FDI.

** FDI in India as a % of World FDI.

Source : UNCTAD, World Investment Report, Various Issues (1991–2004).

Foreign Institutional Investors (FIIs)

The Union Government allowed Foreign Institutional Investors to enter both the primary and secondary markets in India under liberalized policy resume. The large inflow and outflow of capital by FIIs affect the sensex movements. A certain degree of front running by the traders in anticipation of FIIs demand also determines the market direction.

FIIs have to appoint an agency as consolidation to deal in the securities and reporting. Accounts have to be maintained on daily basis. Semi model reports should be submitted by the custodian to SEBI and RBI. SEBI can conduct direct inspections on the accounting books of a registered FII. A Foreign Institutional Investor is permitted to appoint more than one domestic custodian with prior approval of the Board but only one custodian may be appointed for a single sub-account of FIIs.

SEBI and FIIs

SEBI announced its guidelines for FIIs registration and their operations in India in 1992 in February, 1993 SEBI has granted registration to 12 FIIs for investing in the Indian Stock market. At the end of 1996, 97, 439 FIIs were registered with SEBI. SEBI permitted registered FIIs to invest in all securities traded on the primary and secondary markets including: equity, other securities and instruments of companies listed on stock exchanges including OTCEI.

According to the 1995 regulation, no person can buy or sell or otherwise deal in securities as a foreign institutional investor unless he holds a certificate granted by SEBI. The certificate would be given to FIIs only after considering—

1. The applicant's track record, professional record, professional competence, financial soundness, experience, general reputation of fairness and integrity.
2. Whether the applicant is regulated by an appropriate foreign regulatory authority.
3. Whether the applicant has been granted permission under the provisions of FERA Act 1973, for making investments in India as FII.
4. Whether the applicant is
   (a) An institution established or incorporated outsides Indian as Pension Fund or Mutual Fund or Investment Trust, or
   (b) An Asset Management Company or Nominee Company or Bank or Institutional Portfolio Manager, established or incorporated outside India and proposing to make investment in India on behalf of broad based funds or
   (c) A Trustee or Power of Attorney holder, incorporated or established outside India and proposing to make investments in India on behalf of broad based funds.

The certificate is valid for a period of 5 years from the date of its grant. Provisions are made for the renewal of the certificate.

FIIs are allowed to place orders directly. Separate codes are given to FIIs and stock exchange have to use the code number. The code number have to be approved by SEBI. All the transactions carried out on behalf to FIIs have to be on delivery basis. In other words, the registered FIIs should not engage in short selling and have to take delivery of all purchase and give delivery of sold securities .

To case the inflow of foreign capital, amendments have been made in the regulations regarding the FIIs investment. They are given below.

1. SEBI exempted FIIs to attach copy of RBI approved with market lot where shares are sold and a custodian signed the transfer deed on their behalf.
2. FIIs individual limit on investment in a company was raised from 5 per cent to 10 per cent. Further, they have been allowed to unlisted stock of any company. The FIIs list has also been increased.
3. SEBI (FIIs) Regulations 1995, have been changed to allow the FIIs to invest not only in the equity but also in debt instruments of corporate bodies. FIIs were allowed to invest up to 100 per cent of the funds in debt instruments of Indian companies through 100 per cent dedicated debt funds from January 15, 1997.
4. SEBI amended SEBI (FIIs) Regulations 1997, to make it mandatory for FIIs, having securities of Rs. 10 crore of these as on own interest.
5. In June 1998, SEBI permitted
   (a) FIIs to invest in unlisted companies through the 100% debt route and to tender their serenities directly in responses to an open offer made in terms of the SEBI regulations 1997.

(b) SEBI simplified the process of approval of Sub-accounts of registered FIIs.
(c) SEBI permitted FIIs to buy derivative contracts, which are traded on the stock exchanges.

6. The aggregate investment of FII/NRI/OCB has been raised to 30 per cent of the equity of the company by the union budget for 1997–98. The Finance Minister in his budget speech in February 2000 announced of this limit to 40 per cent.

MERCHANT BANKING

Introduction

Merchant banking is one of the fee based financial services which includes underwriting, consultancy and other allied services to the business concern. The term merchant banking has been used in different terms in different countries. In UK merchant banking is termed as accepting and issuing house and in the USA it is known as investment banking.

Meaning

A merchant banking is one who underwrites corporate securities and advises clients on issue like corporate mergers. Merchant banking is basically service banking which provides non financial services such as issue management, portfolio management, asset management, underwriting of new issues, to act as registrar, share transfer agents, trustees, provide leasing, project consultation, foreign credits, etc. The merchant bankers may function in the form of a bank, financial institutions, company or firm.

Merchant Banking in India

In India, the first merchant banking services were started only in 1967 by National Grindlays Bank followed by Citi Bank in 1970. In 1972 State Bank of India started a merchant banking division, followed by ICICI Bank in 1973. Nowadays, most of the public sectors, private sectors, commercial banks and financial institutions established a separate division of merchant banking services.

Classification of Merchant Banking

According to the Securities Exchange Board of India regulations, merchant bankings are classified into the following categories on the basis of their activities and capital adequacy. The merchant banking must register themselves with Securities Exchange Board of India.

Category	Minimum Net worth for Capital adequacy	Activities Permitted by SEBI
Category I	Rs. 5 Crore	Issue Manager, Advisor, Consultant, Underwriter and Portfolio Manager
Category II	Rs. 50 Lakhs	Advisor, Consultant, Underwriter and Portfolio Manager
Category III	Rs. 20 Lakhs	Advisor, Consultant, Underwriter
Category IV	–NIL	Advisor and Consultant service only.

Functions of Merchant Banking

Merchant banking is one of the non financial services which provides to the corporate sectors, commercial banks and financial institutions. The major functions of merchant banking are explained as follows:

1. Management, Marketing and Underwriting of new issues.
2. Project finance and project promotion services.
3. Syndication of credit and other facilities.
4. Leasing including project leasing.
5. Corporate advisory services.
6. Investment advisory services.
7. Bought out deals.
8. Venture capital.
9. Mutual funds and off shore funds.
10. Investment Management.
11. Investment services for non resident Indians.
12. Management dealing in commercial paper.
13. Treasury management.
14. Stock broking.
15. Foreign Collaboration and foreign currency finance.
16. Counseling to Small Scale Industries.
17. Capital Structure counseling to cooperative sectors.
18. Meeting the working capital needs.

Merchant Banking Organizations

In India, merchant banking services are provided by the following types of organizations:

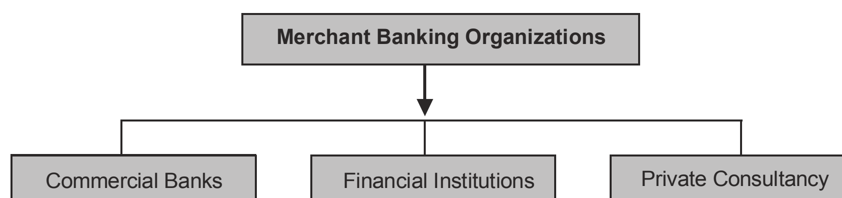

Fig. 12.3 *Merchant Banking Organizations*

The following commercial banks are wholly owned subsidiaries to carry out merchant banking activities.

State Bank of India – SBI Capital Markets Limited.

Canara Bank – Can Bank Financial Service Limited

Bank of Baroda – BOB Fiscal Services Limited.

Grindlays Bank – Grindlays Merchant Banking Limited.

ICICI, IFIC and IDBI are some of the examples of the All India financial institutions which are involving in the merchant banking activities.

DSP Financial Consultants, Credit Capital Finance Corporation Limited, J.M Financial and Investment Services Limited are some of the examples of the private consultancy firms which are involving merchant banking activities.

CREDIT RATING

Introduction

Credit rating is one of the fee based financial services which are provided by specialized agencies like CRISIL, ICRA and CARE. It is a mechanism by which the reliability and viability of a credit instrument is brought out. It is usually the effort of investors in financial instrument to minimize or eliminate default risk. Credit rating service is useful to the investors. According to Securities Exchange Board of India, credit rating is a compulsory mechanism for listing of the companies in the stock market and also it is essential to the corporate sectors who want to raise capital with the help of issue of fixed deposits, commercial papers and other short-term instruments.

Meaning of Credit Rating

Credit rating is an act of assigning values to credit instruments by estimating or assessing the solvency, and expressing them through predetermined symbols.

"Credit rating is designed exclusively for the purpose of granting bonds according to their investment quality".

Corporate or municipal debt rating is a current assessment of the credit worthiness of the obligator with respect of a specific obligation.

Objectives of Credit Rating

These are the important objectives of the credit rating:

- To impose a healthy discipline on borrowings.
- To lend greater belief to financial and other representations.
- To facilitate formulation of public guidelines on institutional investment.
- To help merchant bankers, brokers and regulatory authorities.
- To encourage the information disclosure, better accounting standards, etc.
- To reduce interest cost for highly rated company.

Credit Rating in India

Credit rating in India begins from 1988. At present there are four credit rating agencies very popular in rating.

Operational Performance of Credit Rating Business in India

Rs. in crore

Rating Agency	1994–95		1995–96		Cumulative Up to March 96	
	Number	Amount	Number	Amount	Number	Amount
CRISAL	384	24,544	427	43,086	1736	1,14,873
ICRA	212	5,343	293	75,742	778	93,380
CARE	184	8,403	217	13,909	445	23,638
Total	780	38,290	937	1,32,737	2,959	2,31,891

Basis for Credit Rating

Credit rating agencies consider the following important informations for granting the rating symbol to the borrowing company;

1. Historical background of the company.
2. Track record of the company.
3. Financial efficiency and profitable position.
4. Operational efficiency.
5. Market share of the company.
6. Labour efficiency and their turnover.
7. Future prospects.

Credit Rating Information Service of India Limited (CRISIL)

Credit Rating Information Service of India Limited was the first credit rating agency in India, in January 1988 jointly by ICICI, UTI, LIC, GIC and ADB. The following are the major objectives of the Credit Rating Information Service of India Limited.

(a) To rating of companies debentures, fixed deposits programmes, short-term instruments etc.
(b) To provide corporate reports to business concern.
(c) To conduct industry studies.

Credit Rating Symbols of Credit Rating Information Service of India Limited

Long-term Instrument	Medium-term Instrument	Short-term Instrument	Remarks
AAA	FAAA	P1	Highest Safety
AA	FAA	P2	High Safety
A	FA	P3	Adequate Safety
BBB	–	–	Moderate Safety

Contd....

BB	FB	P4	Inadequate Safety
B	FC	-	Risk Prone
C	-	-	Substantial Risk
D	FD	P5	Default

Operational Result of Credit rating Information Service of India Limited

Credit Rating Information Service of India Limited is one of the well known and largest credit rating agencies in India which provides credit rating to corporate and banking sectors. The operational performances of the Credit Rating Information Service of India Limited are explained in the table below:

(Rs. in crore)

Instruments	1994-95		1995-96		Cumulative Up to March 96	
	Number	Amount	Number	Amount	Number	Amount
Debenture	103	7,641	161	13,342	646	45,700
Fixed deposits	97	9,130	218	14,153	543	38,625
Commercial Papers	137	1,629	21	3,255	459	11,415
Others	49	6,144	27	12,336	88	19,133
Total	384	25,544	427	43,086	1,736	1,14,873

Source: RBI reports.

Investment Information and Credit Rating Agency of India Limited (ICRA)

Investment Information and Credit Rating Agency is one of the largest credit rating service providers next to Credit Rating Information Service of India Limited. It was established mainly for the purpose of rating of short-term, medium-term and long-term debt instruments of the corporate and banking companies. It was set up in the year 1991 by the leading banking and financial institutions.

Credit Rating Symbols of Investment Information and Credit Rating Agency of India Limited

Long-term Instrument	Medium-term Instrument	Short-term Instrument	Remarks
LAAA	MAAA	A1	Highest Safety
LAA	MAA	A2	High Safety
LA	MA	A3	Adequate Safety
LBBB	–	–	Moderate Safety
LBB	MB	–	Inadequate Safety
LB	MC	A4	Risk Prone
LC	–	–	Substantial Risk
LD	MD	P5	Default

Operational Result of ICRA

Investment Information and Credit Rating Agency of India Limited is also performing well in the field of credit rating to various instruments. The operational result of the Investment Information and Credit Rating Agency of India Limited is explained in the table below:

(Rs. in crore)

Instruments	1994–95		1995–96		Cumulative Up to March 96	
	Number	Amount	Number	Amount	Number	Amount
Debenture	45	1,779	66	8,224	223	18,599
Fixed deposits	87	540	192	50,507	360	54,481
Commercial Papers	80	3,023	35	17,011	195	22,299
Total	212	5,343	293	75,742	774	93,380

Source: RBI reports

Credit Analysis and Research Limited (CARE)

Credit Analysis and Research Limited was set up by Industrial Development Bank of India in November 1993, Credit Analysis and Research Limited also provides rating to long-term, medium-term and short-term instruments.

The rating symbols of Credit Analysis and Research Limited are mentioned below:

Credit Rating Symbols of Credit Analysis and Research Limited

Long-term Instrument	Medium-term Instrument	Short-term Instrument	Remarks
CARE AAA	CARE AAA	PR1	Highest Safety
CARE AA	CARE AA	PR2	High Safety
CARE A	CARE A	PR3	Adequate Safety
CARE BBB	CARE BBB	-	Moderate Safety
CARE BB	CARE BB		Inadequate Safety
CARE B	CARE B	PR 4	Risk Prone
CARE C	CARE C	-	Substantial Risk
CARE	CARE	PR5	Default

Operational Result of Credit Analysis and Research Limited

Credit Analysis and Research Limited is one of the latest origins in the field of credit rating which provides rating to various instruments. The operational result of the Credit Analysis and Research Limited as explained in the table below:

(Rs. in crore)

Instruments	1994-95		1995-96		Cumulative Up to March 96	
	Number	Amount	Number	Amount	Number	Amount
Debenture	34	3,429	54	9,330	93	13,572
Fixed deposits	112	1,639	39	1,692	179	3,704
Commercial Papers	38	3,335	124	2,887	173	6,362
Total	184	8,403	217	13,909	445	23,638

Source: RBI reports

MUTUAL FUNDS

Introduction

Mutual fund is one of the funds based financial services which provides the stock market benefits to small investors. It is a concept, leading to attract the small investors to invest their pooling of savings in a trusted as well as profitable manner. Mutual funds business becomes very popular in developed countries and it is fast growing in developing countries like India also. Mutual funds act as a link between the investor and the stock market. Now in India mutual funds activities are performed by public, private and foreign sector financial institutions.

Origin of Mutual Funds

In the year 1822 the concept of mutual funds was found in Belgium. In 1868, foreign colonial government trust was established in England to spread the risks in securities market. Mutual funds concept was spread to USA and some of the mutual funds institutions were established. Unit Trust of India was established in 1964 as a public sector mutual funds institution by the central government. It is the first mutual fund in India.

Structure of Mutual Fund in India

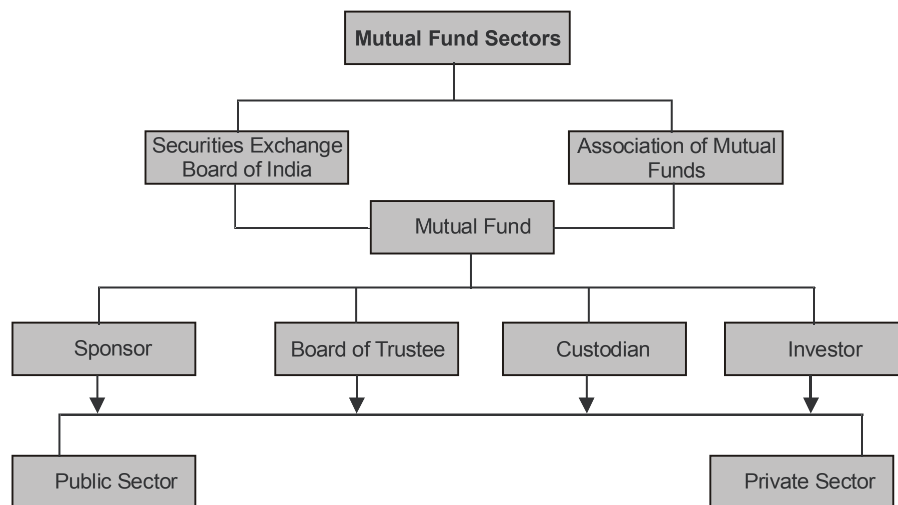

Fig. 12.4 *Structure of Mutual Fund in India*

Meaning of Mutual Fund

A mutual fund is an investment vehicle for investors who pool their savings for investing in diversified portfolio of securities with the aim of attractive yields and appreciation in their value. Mutual fund is a trust that attracts savings which are then invested in capital markets.

According to SEBI, mutual fund define is as a fund, established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more scheme for investing in securities, including money market instruments.

Investment company institute of the US defined mutual fund is a financial service organisation that receives money from shareholders, invests it, earns return on it, attempts to make it grow and agrees to pay the shareholders cash on demand for the current value of his investment.

Advantages of Mutual Funds

Mutual fund consists of the following important advantages:

1. **Attract small and medium group investors:** Mutual funds promote savings among the lower and middle income groups of investors because mutual fund units are available with a single unit of Rs. 10 and multiples by the same value.
2. **Attractive return:** If the investor invests in mutual fund, they can get attractive returns because mutual funds are linked with stock market. The benefits of stock market goes to the mutual fund investors.
3. **Reduce the risk:** Mutual fund investments minimize the risk on investments by diversifying the investments into various portfolios such as shares, debentures, bonds etc.
4. **Assure return:** Mutual funds are managed by experts in the field of investment management; hence there is no risk and mutual fund offers assured return.
5. **Tax concession:** If the mutual funds belong to infrastructure development bonds, there will be a tax concession to the mutual fund investment.
6. **Liquidity:** Mutual fund investment is one of the highly liquidity based investments which can be recapitalized at any time or sold the mutual fund units at any time.
7. **Convenience:** Mutual fund investment is one of the most convenient investments for those who want to invest or get back their investment through selling of the units of mutual fund.
8. **Flexibility:** Mutual fund can be transfered from one scheme to the other scheme on the basis of present market condition.
9. **Benefits to minorities:** Mutual fund investment schemes are most suitable to the old age pensioners, widows middle class women, etc.
10. **Contribution to the economy:** Mutual fund companies promote the saving habits of middle class people. Hence, the money invested in mutual fund schemes are invested into the major economical activities like infrastructure development construction of bridge, buildings, etc.

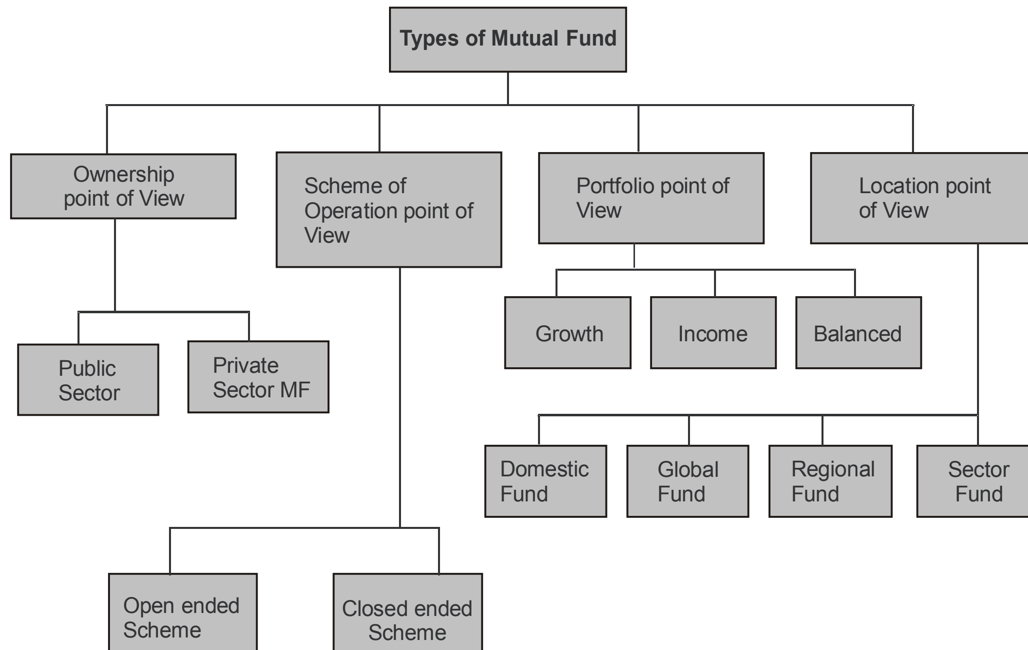

Fig. 12.5 *Types of Mutual Fund*

Public Sector Mutual Fund

Unit Trust of India is one of the public sector mutual funds operating from 1964 and it enjoys the monopoly power in the field of mutual funds up to 1987. After 1987, Public Sector Commercial Banks and Life Insurance Corporation of India also entered into mutual funds activities. State Bank of India, Canara Bank, Punjab National Bank, General Insurance Corporation are some of the public sector mutual funds activities.

Private Sector Mutual Fund

Apart from UTI and public sector commercial banks, some of the private sector financial institutions also entered into the mutual fund activities in India from 1990 onwards. Kothari Pioneer mutual fund, Twentieth century mutual fund, ICKI mutual fund, Morgan Stanly mutual fund, Taurus mutual fund and CRB mutual fund are some of the examples of the private sector mutual fund.

Open Ended Mutual Fund

When the units are sold and redeemed at any time on-going basis at the price determined by the funds Net Assets Value (NAV) is called as open ended mutual fund. These mutual fund has no fixed maturity periods. There is no ceilling on the amount invested by the investors in these funds, and they can sell the units back to mutual funds whenever they decide. Net Assets Value of the mutual fund is calculated by the following formula:

$$\text{Net asset value of the unit} = \frac{\text{Net assets value of fund}}{\text{Number of outstanding units}}.$$

Closed Ended Mutual Fund

Closed ended mutual funds have fixed maturity period ranging from two to 15 years. The units of closed ended mutual funds are not repurchased or redeemed by mutual funds before the maturity period. The investors cannot buy units directly from the fund after the closing period.

Growth Generated Mutual Fund

Mutual fund investments which are reinvested in highly growth oriented equity shares are called as growth oriented mutual fund. It consists of high return with growth potentials.

Income Generated Mutual Fund

If the investor needs regular income for their investment, they can select income oriented mutual fund. It provides regular income to its investors.

Balanced Mutual Fund

Balanced mutual fund is a combination of mutual fund investment in company securities as well as the government bonds. Investors can get moderate return with safety options.

Domestic Mutual Fund

When the mutual fund mobilizes savings from a particular country or region, it is called domestic mutual fund.

Global Mutual Fund

When the mutual fund investment stocks are traded in markets throughout the world with the exemption of the country which launches the fund.

Regional Mutual Fund

When the mutual fund consists of a particular region or a country, it is also called as off shore mutual fund.

Sector Mutual Fund

Sector mutual funds are specializing in a particular industry which consist of aggressive funds.

Top Ten Mutual Fund

- UTI Mutual Fund
- Prudential ICICI Mutual Fund
- Franklin Templeton Mutual Fund
- SBI Mutual Fund
- Kotak Mahindra Mutual Fund
- Reliance Mutual Fund
- HDFC Mutual Fund
- Birla Sun Life Mutual Fund
- DSP Merrill Lynch Mutual Fund
- Tata Mutual Fund

MODEL QUESTIONS

1. Explain the types of leasing.
2. Discuss the advantages of lease financing.
3. Explain the features of venture capital.
4. Explain the types of factoring.
5. What is FDI? Explain it.
6. Discuss the functions of merchant banking.
7. Critically evaluate the role of credit rating agencies.
8. Enumerate the types of mutual funds.