UNIT-I: : Introduction to Financial System and Financial Services

Meaning, Features, Functions and Classification. Financial Services- Concept, Meaning, Scope, Growing importance of financial services in financial system–Classification–Traditional and Modern view–Fund based and non fund based services–Financial engineering–Need for innovation–New financial products and services–An overview of Indian financial services sector scenario and Challenges facing Financial Service

Meaning, Features, Functions and Classification. Financial Services-

Introduction:

Financial service is part of financial system that provides different types of finance through various credit instruments, financial products and services. In financial instruments, we come across cheques, bills, promissory notes, debt instruments, letter of credit, etc.

In financial products, we come across different types of mutual funds. Extending various types of investment opportunities. In addition, there are also products such as credit cards, debit cards, etc.

In services we have leasing, factoring, hire purchase finance etc., through which various types of assets can be acquired either for ownership or on lease. There are different types of leases as well as factoring too. Thus, financial services enable the user to obtain any asset on credit, according to his convenience and at a reasonable interest rate.

Importance of Financial services

It is the presence of financial services that enables a country to improve its economic condition whereby there is more production in all the sectors leading to economic growth.

The benefit of economic growth is reflected on the people in the form of economic prosperity wherein the individual enjoys higher standard of living. It is here the financial services enable an individual to acquire or obtain various consumer products through hire purchase. In the process, there are a number of financial institutions which also earn profits. The presence of these financial institutions promote investment, production, saving etc. Hence, we can bring out the importance of financial services in the following points:

Importance of Financial Services

- Vibrant Capital Market.
- Expands activities of financial markets.
- Benefits of Government.
- Economic Development.
- Economic Growth.
- Ensures Greater Yield.

- Maximizes Returns.
- Minimizes Risks.
- Promotes Savings.
- Promotes Investments.
- Balanced Regional Development.
- Promotion of Domestic & Foreign Trade.

1. Promoting investment

The presence of financial services creates more demand for products and the producer, in order to meet the demand from the consumer goes for more investment. At this stage, the financial services comes to the rescue of the investor such as merchant banker through the new issue market, enabling the producer to raise capital.

The stock market helps in mobilizing more funds by the investor. Investments from abroad is attracted. Factoring and leasing companies, both domestic and foreign enable the producer not only to sell the products but also to acquire modern machinery/technology for further production.

2. Promoting savings

Financial services such as mutual funds provide ample opportunity for different types of saving. In fact, different types of investment options are made available for the convenience of pensioners as well as aged people so that they can be assured of a reasonable return on investment without much risks.

For people interested in the growth of their savings, various reinvestment opportunities are provided. The laws enacted by the government regulate the working of various financial services in such a way that the interests of the public who save through these financial institutions are highly protected.

Financial Services offered by various financial institutions

- Factoring.
- Leasing.
- Forfeiting.
- Hire Purchase Finance.
- Credit card.
- Merchant Banking.
- Book Building.
- Asset Liability Management.
- Housing Finance.
- Portfolio Finance.
- Underwriting.
- Credit Rating.
- Interest & Credit Swap.
- Mutual Fund.

3. Minimizing the risks

The risks of both financial services as well as producers are minimized by the presence of insurance companies. Various types of risks are covered which not only offer protection from the fluctuating business conditions but also from risks caused by natural calamities. Insurance is not only a source of finance but also a source of savings, besides minimizing the risks. Taking this aspect into account, the government has not only privatized the life insurance but also set up a regulatory authority for the insurance companies known as IRDA, 1999 (Insurance Regulatory and Development Authority) .

4. Maximizing the Returns

The presence of financial services enables businessmen to maximize their returns. This is possible due to the availability of credit at a reasonable rate. Producers can avail various types of credit facilities for acquiring assets. In certain cases, they can even go for leasing of certain assets of very high value.

Factoring companies enable the seller as well as producer to increase their turnover which also increases the profit. Even under stiff competition, the producers will be in a position to sell their products at a low margin. With a higher turnover of stocks, they are able to maximize their return.

5. Ensures greater Yield

As seen already, there is a subtle difference between return and yield. It is the yield which attracts more producers to enter the market and increase their production to meet the demands of the consumer. The financial services enable the producer to not only earn more profits but also maximize their wealth.

Financial services enhance their goodwill and induce them to go in for diversification. The stock market and the different types of derivative market provide ample opportunities to get a higher yield for the investor.

6. Economic growth

The development of all the sectors is essential for the development of the economy. The financial services ensure equal distribution of funds to all the three sectors namely, primary, secondary and tertiary so that activities are spread over in a balanced manner in all the three sectors. This brings in a balanced growth of the economy as a result of which employment opportunities are improved.

The tertiary or service sector not only grows and this growth is an important sign of development of any economy. In a well developed country, service sector plays a major role and it contributes more to the economy than the other two sectors.

7. Economic development **Financial services enable the consumers to obtain different types of products and services by which they can improve their standard of living. Purchase of car, house and other essential as well as luxurious items is made possible through hire purchase, leasing and housing finance companies. Thus, the consumer is compelled to save while he enjoys the benefits of the assets which he has acquired with the help of financial services.**

8. Benefit to Government

The presence of financial services enables the government to raise both short-term and long-term funds to meet both revenue and capital expenditure. Through the money market, government raises short term funds by the issue of Treasury Bills. These are purchased by commercial banks from out of their depositors' money.

In addition to this, the government is able to raise long-term funds by the sale of government securities in the securities market which forms apart of financial market. Even foreign exchange requirements of the government can be met in the foreign exchange market. The most important benefit for any government is the raising of finance without offering any security. In this way, the financial services are a big boon to the government.

9. Expands activities of Financial Institutions

The presence of financial services enables financial institutions to not only raise finance but also get an opportunity to disburse their funds in the most profitable manner. Mutual funds, factoring, credit cards, hire purchase finance are some of the services which get financed by financial institutions.

The financial institutions are in a position to expand their activities and thus diversify the use of their funds for various activities. This ensures economic dynamism.

10. Capital Market

One of the barometers of any economy is the presence of a vibrant capital market. If there is hectic activity in the capital market, then it is an indication of the presence of a positive economic condition. The financial services ensure that all the companies are able to acquire adequate funds to boost production and to reap more profits eventually.

In the absence of financial services, there will be paucity of funds which will adversely affect the working of companies and will only result in a negative growth of the capital market. When the capital market is more active, funds from foreign countries also flow in. Hence, the changes in capital market is mainly due to the availability of financial services.

11. Promotion of Domestic and Foreign Trade

Financial services ensure promotion of domestic as well as foreign trade. The presence of factoring and forfeiting companies ensures increasing sale of goods in the domestic market and export of goods in the foreign market. Banking and insurance services further contribute to step up such promotional activities.

12. Balanced Regional development

The government monitors the growth of economy and regions that remain backward economically are given fiscal and monetary benefits through tax and cheaper credit by which more investment is promoted. This generates more production, employment, income, demand and ultimately increase in prices. The producers will earn more profits and can

expand their activities further. So, the presence of financial services helps backward regions to develop and catch up with the rest of the country that has developed already.

Classification–Traditional and Modern view–Fund based and non fund based services–

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

1. Traditional activates
2. Modern activates

Traditional Activates: Financial intermediates have been rendering a wide range of services encompassing both capital and money marketing activities. They can be grouped under 2 categories.

a. Fun based activities
b. Non fun based activates

a. Fund based services

Working Capital Financing:

A firm's working capital is the money available to meet current obligations (those due in less than a year) and to acquire earning assets. Chinatrust Commercial Bank offers corporations Working Capital Finance to meet their operating expenses, purchasing inventory, receivables financing, either by direct funding or by issuing letter of credit.

Key Benefits

- Funded facilities, i.e. the bank provides funding and assistance to actually purchase business assets or to meet business expenses.
- Non-Funded facilities, i.e. the bank can issue letters of credit or can give a guarantee on behalf of the customer to the suppliers, Government Departments for the procurement of goods and services on credit.
- Available in both Indian as well as Foreign currency.

Short Term Financing

The bank can structure low cost credit programmes and cash flow financing to meet your specific short-term cash requirements. The loans are structured to enhance your profitability by scheduling the repayment to match the cash flow available to repay the debt.

Bill Discounting

Bill discounting is a short tenure financing instrument for companies willing to discount their purchase / sales bills to get funds for the short run and as for the investors in them. These are customized to suit your requirement for short-term finance, from the date of sale to the date of receipt of payment there on. We consider two types of bills facility viz. where documents are delivered on payment, i.e. D/P Bills and where the documents are delivered against acceptance i.e. D/A Bills.

Export credit

We offer short-term working capital finance both at the pre-shipment and post-shipment stages .Pre-shipment finance facility provides liquidity for procuring raw materials, processing, packing, transporting, meant for export.

Post-shipment finance is a credit facility extended from the date of shipment of goods till the realization of the export proceeds. The different types of post-shipment advances include:

- Export bills purchased/discounted
- Export bills negotiated (against letter of credit)
- Advances against bills sent on collection basis
- Advances against exports on consignment basis
- Exporters have the option of availing Post-Shipment finance either in rupees or in foreign currency.

Structured finance

Structured Finance describes any "non-standard" way of raising money. These tailor-made securities go beyond "standard" securities like conventional loans, debentures, debt, and equity. The reason to structure a more advanced security may be that conventional securities may be unattractive, unavailable or too expensive. These products are structured for both long and short tenor with exit options at intervals for both parties.

● Term Lending

CTCB offers very competitive rates for term financing. We also provide advisory services to companies for syndication of the term loans to a wide spectrum of financial institutions.

Under Term Finance, **China trust Commercial Bank**, offers the following:

- Fund Based Finance for capital expenditure acquisition of fixed assets towards starting or expanding a business to swap with high cost existing debt from other bank / financial institution
- Non-Fund Based Finance in the form of Deferred Payment Guarantee for acquisition of fixed assets towards starting / expanding a business or industrial unit.

b. Non-Fund Based Services

Letters Of Credit

Letter of credit is a legal document issued by a buyer’s bank that upon presentation of required documents payment would be made. Usually confirmed by the seller's bank, protection is given to the seller that payment will be made if the goods are shipped correctly, following the conditions laid down when the LC is opened or based on subsequent amendments and protection is given to the buyer that the goods will be shipped before payment is made.

The LC facility can be granted to the importers after assessing their requirement/ credit worthiness/ financial strength and other parameters being to the satisfaction of the Bank.

China trust Commercial Bank can extend Import financing through Letters of Credit, which are well accepted globally and are supported by a strong trade finance set-up. We are direct members of SWIFT and have correspondent banking arrangements with many banks worldwide.

Bank Guarantees

Bank Guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default. China trust Commercial Bank sanctions Bank Guarantee limit to facilitate issue of guarantees on behalf of its clients. Various types of guarantees offered are – financial, performance, bid bond, tenders, customs, etc. Our guarantees are accepted by all government agencies including Customs, Excise, Insurance Companies, Shipping Companies, all Capital Market Agencies such as NSE, BSE, ASE, CSE etc. and all major corporates.

Collection Of Documents

We have a full-fledged trade finance set-up catering to all your trade related requirements, which offers you the following advantages:

1. Better turnaround time through timely processing of your documents
2. Facilitating faster payments
3. Lower cost
4. Excellent trade support
5. Arrangement of credit reports of overseas parties

Specialized advice on international trade related issues as well as technical issues such as Exchange Control requirements, RBI reporting, latest circulars and latest international developments.

2. Modern Activities

Beside 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 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 rill the raising of funds for starting the project with necessary Government approvals.
II. Planning for M&A 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 collaborations / joint ventures by identifying suitable joint venture partners and preparing joint venture agreements,
VII. Rehabilitating and restructuring 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 [In- portfolio of large Public Sector Corporations.

X. Undertaking risk management services like insurance services, buy-hack options etc.

XI. Advising the clients on the questions 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 minimization 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 instrument;*.

Financial engineering

Financial engineering is a multidisciplinary field involving financial theory, methods of engineering, tools of mathematics and the practice of programming. It has also been defined as the application of technical methods, especially from mathematical finance and computational finance, in the practice of finance. Despite its name, financial engineering does not belong to any of the fields in traditional professional engineering even though many financial engineers have studied engineering beforehand and many universities offering a postgraduate degree in this field require applicants to have a background in engineering as well. In the United States, the Accreditation Board for Engineering and Technology(ABET) does not accredit financial engineering degrees. In the United States, financial engineering programs are accredited by the *International Association of Quantitative Finance*.

Financial engineering draws on tools from applied mathematics, computer science, statistics and economic theory. In the broadest sense, anyone who uses technical tools in finance could be called a financial engineer, for example any computer programmer in a bank or any statistician in a government economic bureau. However, most practitioners restrict the term to someone educated in the full range of tools of modern finance and whose work is informed by financial theory. It is sometimes restricted even further, to cover only those originating new financial products and strategies. Financial engineering plays a key role in the customer-driven derivatives business which encompasses quantitative modelling and programming, trading and risk managing derivative products in compliance with the regulations and Basel capital/liquidity requirements.

Why does financial innovation occur?

Economic theory has much to say about what types of securities should exist, and why some may not

exist (why some markets should be "incomplete") but little to say about why new types of securities should come into existence.

One interpretation of the Modigliani-Miller theorem is that taxes and regulation are the only reasons for investors to care what kinds of securities firms issue, whether debt, equity, or something else. The theorem states that the structure of a firm's liabilities should have no bearing on its net worth (absent taxes, etc.). The securities may trade at different prices depending on their composition, but they must ultimately add up to the same value.

Furthermore, there should be little demand for specific types of securities. The capital asset pricing model, first developed by Jack L. Treynor and William F. Sharpe, suggests that investors should fully diversify and their portfolios should be a mixture of the "market" and a risk-free investment. Investors with different risk/return goals can use leverage to increase the ratio of the market return to the risk-free return in their portfolios. However, Richard Roll argued that this model was incorrect, because investors cannot invest in the entire market. This implies there should be demand for instruments that open up new types of investment opportunities (since this gets investors closer to being able to buy the entire market), but not for instruments that merely repackage existing risks (since investors already have as much exposure to those risks in their portfolio).

If the world existed as the Arrow-Debreu model posits, then there would be no need for financial innovation. The Arrow-Debreu model assumes that investors are able to purchase securities that pay off if and only if a certain state of the world occurs. Investors can then combine these securities to create portfolios that have whatever payoff they desire. The fundamental theorem of finance states that the price of assembling such a portfolio will be equal to its expected value under the appropriate risk-neutral measure.

Historical examples of financial innovation

Examples of spanning the market

Some types of financial instrument became prominent after macroeconomic conditions forced investors to be more aware of the need to hedge certain types of risk.

- The development of interest rate swaps in the early 1980s after interest rates skyrocketed.
- The development of credit default swaps in the early 2000s after the recession beginning in 2001 led to the highest corporate-bond default rate in 2002 since the Great Depression.

Examples of mathematical innovation

- The market in options exploded after the development of the Black–Scholes model in 1973.
- The development of the CDO was heavily influenced by the popularization of the copula technique (Li 2000).
- Flash trading exists since 2000 at the Chicago Board Options Exchange and 2006 in the stock market. In July 2010, Direct Edge became a U.S. Futures Exchange. Nasdaq and Bats Exchange, Inc created their own flash market in early 2009.

Futures, options, and many other types of derivatives have been around for centuries: the Japanese rice futures market started trading around 1730. However, recent decades have seen an explosion use of derivatives and mathematically complicated securitization techniques. MacKenzie (2006) argues from a sociological point of view that mathematical formulas actually change the way that economic agents use and price assets. Economists, rather than acting as a camera taking an objective picture of the way the world works, actively change behavior by providing formulas that let dispersed agents agree on prices for new assets.

Examples of innovation to avoid taxes and regulation

Miller (1986) places great emphasis on the role of taxes and government regulation in stimulating financial innovation. Modigliani and Miller (1958) explicitly considered taxes as a reason to prefer one type of security over another, despite that corporations and investors should be indifferent to capital structure in a fraction less world.The development of checking accounts at U.S. banks was in order to avoid punitive taxes on state bank notes that were part of the National Banking Act.

Some investors use total return swaps to convert dividends into capital gains, which are taxed at a lower rate.[1]

Many times, regulators have explicitly discouraged or outlawed trading in certain types of financial securities. In the United States, gambling is mostly illegal, and it can be difficult to tell whether financial contracts are illegal gambling instruments or legitimate tools for investment and risk-sharing. The Commodity Futures Trading Commission is in charge of making this determination. The difficulty that the Chicago Board of Trade faced in attempting to trade futures on stocks and stock indexes is described in Melamed (1996).

In the United States, Regulation Q drove several types of financial innovation to get around its interest rate ceilings, including eurodollars and NOW accounts.

The role of technology in financial innovation

Some types of financial innovation are driven by improvements in computer and telecommunication technology. For example, Paul Volcker suggested that for most people, the creation of the ATM was a greater financial innovation than asset-backed securitization.[2] Other types of financial innovation affecting the payments system include credit and debit cards and online payment systems like PayPal.

These types of innovations are notable because they reduce transaction costs. Households need to keep lower cash balances—if the economy exhibits cash-in-advance constraints then these kinds of financial innovations can contribute to greater efficiency. Alvarez and Lippi (2009), using data on Italian households' use of debit cards, find that ownership of an ATM card results in benefits worth €17 annually. These types of innovations may also affect monetary policy by reducing real household balances. Especially with the increased popularity of online banking, households are able to keep greater percentages of their wealth in non-cash instruments. In a special edition of 'International Finance' devoted

to the interaction of electronic commerce and central banking, Goodhart (2000) and Woodford (2000) express confidence in the ability of a central bank to maintain its policy goals by affecting the short-term interest rate even if electronic money has eliminated the demand for central bank liabilities, while Friedman (2000) is less sanguine.

An overview of Indian financial services sector scenario

- The Indian economy is in the process of rapid transformation. Reforms ate taking place in every field / part of economy. Hence financial services sector is also witnessing changes. The present scenario can be explained in following terms

Conservatism to dynamism

- The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocate efficiency of available savings, increase the return on investment and thus to promote (he accelerated growth of the economy as a whole. At present numerous new Fls have started functioning with a view to extending multifarious services to the investing public in the area of financial services

Emergence of Primary Equity Market

- The capital markets, which were very sluggish, have become a very popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994. After the lowering of bank interest rates, capital markets have become a very popular mode of channelizing the saving of medium class people.

Concept of credit rating

- The investment decisions of the investors have been based on factors like name recognition of the company, operations of the group, market sentiments, reputation of the promoters etc. now grading from an independent agency would help the investors in his portfolio management and thus, equity grading is going to play a significant role in investment decision making.

Process of globalization

- The process of globalization has paved the way for the entry of innovative and sophisticated products into our country. Since the government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentialities for the introduction of innovative, international financial products in India are very great. Moreover, our country is likely to enter the full convertibility era soon.

Process of liberalization

- Our government has initiated many steps to reform the financial services industry. The government has already switched over to free pricing of issues .the interest have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. SEBI has liberalized many stringent

conditions so as to boost the capital and money market.

Financial engineering–

Need for innovation–New financial products and services–

An overview of Indian financial services sector scenario and Challenges facing Financial Service

UNIT-II : Leasing and Hire Purchase Concept of leasing, Steps, Classification–advantages-Legal aspects–Lease documentation and contract–Tax and accounting aspects of leasing–Financial evaluation of leasing–NPV and IRR approaches–Break even lease rental-Lease v/s buy decisions and Problems of Leasing. **Hire purchase** concept and features–Legal and tax frame work–Financial evaluation of hire Purchase–H.P. mathematics–Flat and effective interest rates (only theory)

Concept of leasing,

– Meaning

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the land lord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Lease can be defined as the following ways:

- A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.
- The document in which this contract is written.
- A great way companies can conserve capital.
- An easy way vendors can increase sales.

The advantages of leasing include:

- Leasing helps to possess and use a new piece of machinery or equipment without huge investment. .
- Leasing enables businesses to preserve precious cash reserves.
- The smaller, regular payments required by a lease agreement enable businesses with limited capital to manage their cash flow more effectively and adapt quickly to changing economic conditions.
- Leasing also allows businesses to upgrade assets more frequently ensuring they have the latest equipment without having to make further capital outlays.
- It offers the flexibility of the repayment period being matched to the useful life of the equipment.
- It gives businesses certainty because asset finance agreements cannot be cancelled by the lenders and repayments are generally fixed.
- However, they can also be structured to include additional benefits such as servicing of equipment or variable monthly payments depending on a business's needs.
- It is easy to access because it is secured – largely or entirely – on the asset being financed, rather than on other personal or business assets.
- The rental, which sometimes exceeds the purchase price of the asset, can be paid from revenue generated by its use, directly impacting the lessee's liquidity.
- Lease instalments are exclusively material costs.
- Using the purchase option, the lessee can acquire the leased asset at a lower price, as they pay the residual or non-depreciated value of the asset.
- For the national economy, this way of financing allows access to state-of-the-art technology otherwise unavailable, due to high prices, and often impossible to acquire by loan arrangements.

Limitation of leasing

- It is not a suitable mode of project financing because rental is payable soon after entering into lease agreement while new project generate cash only after long gestation period.
- Certain tax benefits/ incentives/subsidies etc. May not be available to lease equipment's.
- The value of real assets (land and building) may increase during lease period. In this case lessee may lose potential capital gain.
- The cost of financing is generally higher than that of debt financing.
- A manufacturer(lessee) who want to discontinue business need to pay huge penalty to lessor for pre-closing lease agreement
- There is no exclusive law for regulating leasing transaction.
- In undeveloped legal systems, lease arrangements can result in inequality between the parties due to the lessor's economic dominance, which may lead to the lessee signing an unfavorable contract.

TYPES OF LEASE

(a) Financial lease

(b) Operating lease.
(c) Sale and lease back
(d) Leveraged leasing and
(e) Direct leasing.

1) Financial lease

Long-term, non-cancellable lease contracts are known as financial leases. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give an option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease the lessor recovers 90% of the fair value of the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from are transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only title deeds remain with the lessor. Financial lease is also known as 'capital lease'. In India, financial leases are very popular with high-cost and high technology equipment.

2) Operational lease

An operating lease stands in contrast to the financial lease in almost all aspects. This lease agreement gives to the lessee only a limited right to use the asset. The lessor is responsible for the upkeep and maintenance of the asset. The lessee is not given any uplift to purchase the asset at the end of the lease period. Normally the lease is for a short period and even otherwise is revocable at a short notice. Mines ,Computers hardware, trucks and automobiles are found suitable for operating lease because the rate of obsolescence is very high in this kind of assets.

3) Sale and lease back

It is a sub-part of finance lease. Under this, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of lease rentals. However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. Sale and lease back transaction is suitable for those assets, which are not subjected depreciation but appreciation, say land. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement.

4) Leveraged leasing

Under leveraged leasing arrangement, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and the asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset is entitled to depreciation allowance associated with the asset.

5) Direct leasing

Under direct leasing, a firm acquires the right to use an asset from the manufacture directly. The ownership of the asset leased out remains with the manufacturer itself. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc

Other types of leasing:

- First Amendment Lease: The first amendment lease gives the lessee a purchase option at one or more defined points with a requirement that the lessee renew or continue the lease if the purchase option is not exercised. The option price is usually either a fixed price intended to approximate fair market value or is defined as fair market value determined by lessee appraisal and subject to a floor to insure that the lessor's residual position will be covered if the purchase option is exercised.

- Full Payout Lease: A lease in which the lessor recovers, through the lease payments, all costs incurred in the lease plus an acceptable rate of return, without any reliance upon the leased equipment's future residual value.

- Guideline Lease: A lease written under criteria established by the IRS to determine the availability of tax benefits to the lessor.

- Net Lease: A lease wherein payments to the lessor do not include insurance and maintenance, which are paid separately by the lessee.

- Open-end Lease: A conditional sale lease in which the lessee guarantees that the lessor will realize a minimum value from the sale of the asset at the end of the lease.

- Sales-type Lease: A lease by a lessor who is the manufacturer or dealer, in which the lease meets the definitional criteria of a capital lease or direct financing lease.

- Synthetic Lease: A synthetic lease is basically a financing structured to be treated as a lease for accounting purposes, but as a loan for tax purposes. The structure is used by corporations that are seeking off-balance sheet reporting of their asset based financing, and that can efficiently use the tax benefits of owning the financed asset.

- Tax Lease: A lease wherein the lessor recognizes the tax incentives provided by the tax laws for investment and ownership of equipment. Generally, the lease rate factor on tax leases is reduced to reflect the lessor's recognition of this tax incentive.

- True Lease: A type of transaction that qualifies as a lease under the Internal Revenue Code. It allows the lessor to claim ownership and the lessee to claim rental payments as tax deductions.

Legal aspects of leasing

As there is no separate statue for leasing in India, the provisions relating to bailment in the Indian Contract Act govern equipment leasing agreements as well section 148 of the Indian Contract Act defines bailment as:

“The delivery of goods by one person to another, for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed off according to the directions of the person delivering them. The person delivering the goods is called the ‘bailor’ and the person to whom they are delivered is called the ‘bailee’.

Since an equipment lease transaction is regarded as a contract of bailment, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (other than those expressly specified in the least contract) as defined by the provisions of sections 150 and 168 of the Indian Contract Act. Essentially these provisions have the following implications for the lessor and the lessee.

- The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset, and to leave the asset in peaceful possession of the lessee during the currency of the agreement.

- The lessor has the obligation to pay the lease rentals as specified in the lease agreement, to protect the lessor’s title, to take reasonable care of the asset, and to return the leased asset on the expiry of the lease period

Contents of a lease agreement: The lease agreement specifies the legal rights and obligations of the lessor and the lessee. It typically contains terms relating to the following:
1. Description of the lessor, the lessee, and the equipment.
2. Amount, time and place of lease rentals payments.
3. Time and place of equipment delivery.
4. Lessee's responsibility for taking delivery and possession of the leased equipment.
5. Lessee's responsibility for maintenance, repairs, registration, etc. and the lessor's right in case of default by the lessee.
6. Lessee's right to enjoy the benefits of the warranties provided by the equipment manufacturer/supplier.
7. Insurance to be taken by the lessee on behalf of the lessor.
8. Variation in lease rentals if there is a change in certain external factors like bank interest rates, depreciation rates, and fiscal incentives.
9. Options of lease renewal for the lessee.
10. Return of equipment on expiry of the lease period.
11. Arbitration procedure in the event of dispute.

Lease documentation and contract

A real estate lease is a legal and binding contract between the landlord or owner and the tenant. To be binding, it requires that the signing parties be of legal age and competent to enter into an agreement.If your tenant is a student and under the age of consent in your state, you will want to get the signature of a parent or legal guardian as well.

An Adequate Description of the Property

It might seem obvious, but you cannot over-describe the property being rented. The address, complete with a unit or apartment number may be all that you need. However, it never hurts to give the apartment project name, building number, or any other information that makes this leased property unique from all others.

Length and Time Frame of the Lease

It isn't enough to just specify a time frame, as in "six months." Have a beginning date and exact ending date. One more step is also important, and that is a time to vacate. Whether it's midnight or five in the evening, you and the tenant should know precisely when the unit is supposed to be empty of their belongings.

Renewal Terms

If you give your tenant the ability to renew, it should be stated specifically in the lease. This area might also include statements about the new rental rate for this period. Some property managers place escalation clauses for rent.

It is best if you require the tenant to give you written notice of their intent to renew and that they sign a new lease extension document. If you allow them to continue on a month-to-month basis, be clear in this area about the new rules for vacating the property when in this monthly status.

Security Deposits and Rent Payments

State laws differ about how much an owner can require in deposits by type; security, first or last month rent, or pet and damage deposits.

Your lease document should be clear as to the amounts, how the money will be held, and if interest is earned.

Important for deposits is a clear understanding as to how the money will be released at the end of the lease. How will damages be determined and valued? What time period is legal for holding the deposits at lease end?

Make sure that the tenant knows the day that rents are due, how to pay them, and what happens and when if they are late in paying.

Use, Occupancy and Sublet Agreements

Don't just assume that a residential unit will be used for residential purposes. If you allow a home office, say so, or be clear if you do not. If you do, what about business type, visiting customers or parking? How many people can occupy the unit? State a number, or you may find the local fraternity living there.

If you will allow subletting of the unit, be very clear as to the terms, whether you must approve the person, and how the responsibilities of the original tenant pass to the party subletting. Many landlords specifically rule out this practice, or they require that they approve on a case basis.

Your Rights of Entry and Inspection

The longer the lease, the greater the likelihood that you'll want to enter and inspect for property condition.

State your rights in the lease, including the notice you will give, usually a legal requirement. When repairs must be made, be clear as to how repair persons will gain entry and who is authorized. Remember that this is your tenant's home, and their privacy is important to them.

Acceleration of Rents

If legal in your state, you and the tenant should agree in the lease document as to your ability to accelerate the payment of rents if they violate rules, become an annoyance to others, or fail repeatedly to pay rents on time.

If Possible, A Waiver of Notices

Again, depending on your state of residence, you may want to include a waiver of notices. This simply states that it is the tenant's responsibility to know when their lease expires, rents are due, or any other deadlines or due dates. This waives you of the responsibility of notification in each instance.

It's All About Clear Language and State Law

Most real estate investors, owners and landlords get an attorney to draft their lease documents, or purchase a standard form and get their attorney to modify and bless it. This is a good practice, as you do not want to be in violation of your tenant's rights or state laws.

Whether you do-it-yourself or get an attorney, knowing the elements of a good lease document will help you to avoid many negative aspects of landlord-tenant relations. Protecting your rights is as important as doing the same for your tenants.

Tax and Accounting Aspects of Leases

Leasing assets involves a number of tax and accounting considerations, which are examined in this section.

Tax Status of True Leases

Annual lease payments are tax deductible for the lessee if one crucial criterion is met: The IRS must agree that a contract truly is a lease and not just an installment loan called a lease. Before embarking on a lease transaction, all involved parties should obtain an opinion from the IRS regarding the tax status of the proposed lease. The opinion of the IRS normally revolves primarily around the following general rules:

The remaining useful life of the equipment at the end of the lease term must be the greater of 1 year or 20 percent of its originally estimated useful life. Leases in excess of 30 years are not considered to be leases for tax purposes. The lease payments must provide the lessor with a fair market rate return on the investment. This profit potential must exist apart from the transaction's tax benefits. Renewal options must be reasonable, that is, the renewal rate must be closely related to the economic value of the asset for the renewal period. If the lease agreement specifies a purchase option at the end of the lease period, the purchase price must be based on the asset's fair market value at that time. The schedule of lease payments should not be very high early in the lease and very low thereafter. Such a payment schedule suggests that the lease structure is being used merely to avoid taxes In the case of a leveraged lease, the lessor must provide a minimum of 20 percent equity. Limited-use property (valuable only to the lessee) may not be leased.

If the IRS does not agree that a contract is truly a lease, taxes are applied as if the property had been sold to the lessee and pledged to the lessor as security for a loan. The reason for the IRS restrictions previously cited is that the IRS wants to prohibit lease transactions set up purely to speed up tax deductions. For example, a building would normally be depreciated over 39 years under MACRS depreciation rules.

It would be possible to set up a lease over a 3-year period that allowed the lessee to effectively write off the cost of the building for tax purposes over 3 years. This would increase tax deductions for the lessee at the expense of tax receipts to the U.S. Treasury. These IRS guidelines are designed to prevent this type of abuse.

Determining Lease Payments: The Lessor's Perspective

Suppose that the Dole Company (lessee) desires to lease a piece of farm equipment valued at $100,000 from Deere & Company (lessor) for a period of five years. Under the terms of the lease, payments are to be made at the beginning of each of the five years. Deere expects to depreciate the asset on a straight-line basis of $20,000 per year down to a book salvage value of $0. Actual salvage value is expected to be $10,000 at the end of five years.

This sal-vage value will be treated as a recapture of depreciation and taxed at Deere's marginal tax rate of 40 percent. Thus, the after-tax salvage value will be $6,000 ($10,000 actual salvage less $4,000 tax on depreciation recapture). If Deere requires an 11 percent after-tax rate of return on the lease, what will be the annual lease payments?

Step 1: Compute the lessor's amount to be amortized. In this case, it is the $100,000 initial outlay minus the present value of the after-tax salvage at the end of year 5 minus the present value of the after-tax depreciation tax shield for each year. (Recall that depreciation reduces taxable income by the amount

of the depreciation and thus reduces a firm's cash outflow for tax payments by an amount equal to the depreciation times the company's marginal ordinary tax rate.)

(If an accelerated depreciation method, such as MACRS, was used by the lessor, the present value of the annual depreciation tax shield would have to be done using a series of Table PVIF factors, because the annual depreciation tax shield normally will change most years under accelerated depreciation methods.)

Step 2: Compute the annual after-tax lease income. This is the income that the lessor must receive in order to earn the needed 11 percent return Remember that lease payments received by a lessor are treated as taxable, ordinary income. These payments can be computed using the appropriate interest factor for the present value of an annuity (PVIFA from Table). Because lease payments are normally made at the beginning of each year,they constitute an annuity due.

Thus, the last four payments, which occur at the ends of years 1 through 4, are discounted, whereas the present value of the first payment, made at the beginning of year 1, is not discounted. Recall from Chapter 5 that taking the PVIFA for 11 percent and five years and multiplying by (1 + 0.11) gives the required PVIFA for an annuity due. If PMT is the annual after-tax lease income to the lessor, the present value of the lease income may be set equal to the amount to be amortized to determine th required PMT, as follows:

Amount to be amortized = PMT (PVIFA0.11, 5) (1 + 0.11)

$66,874 = PMT (3.696) (1.11)

$66,874 = PMT (4.103)PMT = $16,299

Therefore, Deere & Company needs to receive five beginning-of-the-year, after-tax lease income amounts of $16,301 (calculator accuracy) in order to earn an 11 percent after-tax return on the lease.

Step 3:Convert the lease income requirement of the lessor to a lease payment requirement of the lessee. Recalling that lease payments received by the lessor from the lessee are taxed as ordinary income, we can convert the after-tax lease income requirement of the lessor into a lease payment requirement for the lessee as follows:

Therefore, the Dole Company will have to make an annual lease payment of $27,168 to Deere & Company at the beginning of each year.

Lease–Buy Analysis: The Lessee's Perspective

Financial evaluation of leasing

Financial theorists and model builders have devoted a substantial amount of time and effort to developing an analytical framework within which the differential costs associated with leasing versus buying can be compared. At least 15 different approaches to the problem have been suggested, and there is considerable disagreement as to which one is the best.

In spite of this abundance of models, the perplexed financial manager can take some comfort in the fact that the practical effects resulting from the differences in the models tend to be small because few real - world decisions are changed as a result of which lease –buy model is chosen. One of the most commonly used approaches to the analysis of a lease versus purchase decision assumes that the appropriate

comparison should be between leasing and borrowing to buy. Advocates of this approach argue that a financial lease is much like a loan in that it requires a series of fixed payments. Failure to make lease payments, like failure to make loan payments, may result in bankruptcy.

The basic approach of the lease–buy analysis model is to compute the net advantage to leasing (NAL). The net advantage to leasing compares the present value cost of leasing with the present value cost of owning the asset. If the cost of owning the asset is greater than the cost of leasing the asset, the NAL is positive and the model indicates that the asset should be leased.

The net advantage to leasing calculation is as follows:

Installed cost of the asset Less Present value of the after-tax lease payments Less Present value of depreciation tax shield Plus Present value of after-tax operating costs incurred if owned but not if leased Less Present value of the after-tax salvage value Equals Net advantage to leasing

The installed cost of the asset equals the purchase price plus installation and shipping charges. The installed cost forms the basis on which depreciation is computed.

The present value of the after -tax lease payments that are made if the asset is leased reduces the NAL; hence, they are subtracted when computing the NAL. These lease payments are discounted at the firm's after-tax marginal cost of borrowing to reflect the fact that lease payments are contractually known in advance and thus are not subject to much uncertainty.

The present value of the depreciation tax shield is equal to the depreciation claimed each year if the asset is owned times the firm's marginal tax rate. The depreciation tax shield reduces the cost of ownership and hence is subtracted when computing the NAL. Because the depreciation amounts are also known with relative certainty, they are also discounted at the firm's after -tax marginal cost of borrowing.

Sometimes operating costs are incurred if the asset is owned but not if it is leased. These may include property tax payments, insurance, or some maintenance expenses. If these do exist, they represent a benefit of leasing and increase the NAL. Hence, the after -tax amount of these costs is added in the NAL calculation. These operating cost savings are also discounted at the after-tax marginal cost of borrowing, reflecting their relative certainty.

Finally, if the asset is owned, the owner will receive the after-tax salvage value. This is lost if the asset is leased. Hence the after-tax salvage reduces the NAL and must be subtracted when calculating the NAL. Because asset salvage values are generally subject to substantial uncertainty, they are normally discounted at a rate equal to the firm's weighted (marginal) cost of capital.

Example of Lease–Buy Analysis

Consider the following example to illustrate the lease –buy analysis procedure just described. Suppose that the Alcoa Corporation is trying to decide whether it should purchase or lease a new heavy -duty GMC truck. (The firm has already computed the net present value of this proposed asset acquisition and found the project to be acceptable.) The truck can be purchased for $50,000, including delivery. Alternatively, the truck can be leased from General Motors Acceptance Corporation for a 6-year period at a beginning -of -the -year lease payment of $10,000. If purchased, Alcoa could borrow the needed funds from Mellon Bank at an annual interest rate of 10 percent.

If the truck is purchased, Alcoa estimates that it will incur $750 per year of expenses to cover insurance and a maintenance contract. These expenses would not be incurred if the truck is leased. The truck will be depreciated under MACRS guidelines as a 5-year asset. Alcoa expects the actual salvage value to be $20,000 at the end of six years. Alcoa’s marginal tax rate is 40 percent, and its weighted after-tax cost of capital is 15 percent. Which alternative —leasing or buying —should be chosen? In order to answer this question, we need to compute the NAL. This is shown in Table.

The calculation in Table indicates a net advantage to leasing of -$1,296. Because the NAL is negative, the asset should be owned rather than leased.

Net present value

Net present value (NPV) of a project is the potential change in an investor's wealth caused by that project while time value of money is being accounted for. It equals the present value of net cash inflows generated by a project less the initial investment on the project. It is one of the most reliable measures used in capital budgeting because it accounts for time value of money by using discounted cash flows in the calculation.

Net present value calculations take the following two inputs:

- Projected net cash flows in successive periods from the project.
- A target rate of return i.e. the hurdle rate.

Where,

Net cash flow equals total cash inflow during a period, including salvage value if any, less cash outflows from the project during the period. Hurdle rate is the rate used to discount the net cash inflows. Weighted average cost of capital (WACC)is the most commonly used hurdle rate.

Calculation Methods and Formulas

The first step involved in the calculation of NPV is the estimation of net cash flows from the project over its life. The second step is to discount those cash flows at the hurdle rate.

The net cash flows may be even (i.e. equal cash flows in different periods) or uneven (i.e. different cash flows in different periods). When they are even, present value can be easily calculated by using the formula for present value of annuity. However, if they are uneven, we need to calculate the present value of each individual net cash inflow separately.

Once we have the total present value of all project cash flows, we subtract the initial investment on the project from the total present value of inflows to arrive at net present value.

Thus we have the following two formulas for the calculation of NPV:

When cash inflows are even:

$$NPV = R \times \frac{1 - (1 + i)^{-n}}{i} - \text{Initial Investment}$$

In the above formula,
R is the net cash inflow expected to be received in each period;
i is the required rate of return per period;
n are the number of periods during which the project is expected to operate and generate cash inflows.
When cash inflows are uneven:

$$NPV = \left[R_1 \quad + R_2 \quad + R_3 \quad + \ldots \right] - \text{Initial Investment}$$

$(1 + i)^1$ $(1 + i)^2$ $(1 + i)^3$

Where,

i is the target rate of return per period;
R_1 is the net cash inflow during the first period;
R_2 is the net cash inflow during the second period;
R_3 is the net cash inflow during the third period, and so on ...

Decision Rule

In case of standalone projects, accept a project only if its NPV is positive, reject it if its NPV is negative and stay indifferent between accepting or rejecting if NPV is zero.

In case of mutually exclusive projects (i.e. competing projects), accept the project with higher NPV.

Internal rate of return

The **internal rate of return** sometime known as **yield on project** is the rate at which an investment project promises to generate a return during its useful life. It is the discount rate at which the present value of a project's net cash inflows becomes equal to the present value of its net cash outflows. In other words, internal rate of return is the discount rate at which a project's net present value becomes equal to zero.

The **minimum required rate of return** is set by management. Most of the time, it is the cost of capital of the company.

Under this method, If the internal rate of return promised by the investment project is greater than or equal to the minimum required rate of return, the project is considered acceptable otherwise the project is rejected. Internal rate of return method is also known as *time-adjusted rate of return method*.

To understand how computations are made and how a proposed investment is accepted or rejected under this method, consider the following example:

Example:

The management of VGA Textile Company is considering to replace an old machine with a new one. The new machine will be capable of performing some tasks much faster than the old one. The installation of machine will cost $8,475 and will reduce the annual labor cost by $1,500. The useful life of the machine will be 10 years with no salvage value. The minimum required rate of return is 15%.

Required: Should VGA Textile Company purchase the machine? Use internal rate of return (IRR) method for your conclusion.

Solution:

To conclude whether the proposal should be accepted or not, the internal rate of return promised by machine would be found out first and then compared to the company's minimum required rate of return.

The first step in finding out the internal rate of return is to compute a discount factor called *internal rate of return factor*. It is computed by dividing the *investment required for the project* by *net annual cash inflow* to be generated by the project. The formula is given below:

Formula of internal rate of return factor:

$$\text{Internal rate of return factor} = \frac{\text{Net initial investment}}{\text{Annual cash inflow}}$$

Financial evaluation of leasing–NPV and IRR approaches–Break even lease rental- Lease v/s buy decisions and Problems of Leasing.

Hire purchase concept and features–Legal and tax frame work–Financial evaluation of hire Purchase–H.P. mathematics–Flat and effective interest rates (only theory)

Hire purchase

Meaning:
Hire purchase is a method of financing of the fixed asset to be purchased on future date. Under this method of financing, the purchase price is paid in instalments. Ownership of the asset is transferred after the payment of the last instalment.

Features of Hire Purchase:
The main features of hire purchase finance are:
1. The hire purchaser becomes the owner of the asset after paying the last installment.

2. Every installment is treated as hire charge for using the asset.

3. Hire purchaser can use the asset right after making the agreement with the hire vendor.

4. The hire vendor has the right to repossess the asset in case of difficulties in obtaining the payment of installment.

Advantages of Hire Purchase:
Hire purchase as a source of finance has the following advantages:
i. Financing of an asset through hire purchase is very easy.

ii. Hire purchaser becomes the owner of the asset in future.

iii. Hire purchaser gets the benefit of depreciation on asset hired by him/her.

iv. Hire purchasers also enjoy the tax benefit on the interest payable by them.

Disadvantages of Hire Purchase:
Hire purchase financing suffers from following disadvantages:

- Ownership of asset is transferred only after the payment of the last installment.
- The magnitude of funds involved in hire purchase are very small and only small types of assets like office equipment’s, automobiles, etc., are purchased through it.

- The cost of financing through hire purchase is very high.

Legal Framework

There is no exclusive legislation dealing with hire purchase transaction in India. The Hire purchase Act was passed in 1972. An Amendment bill was introduced in 1989 to amend some of the provisions of the act. However, the act has been enforced so far. The provisions of are not inconsistent with the general law and can be followed as a guideline particularly where no provisions exist in the general laws which, in the absence of any specific law, govern the hire purchase transactions. The act contains provisions for regulating:

1. The format / contents of the hire-purchase agreement
2. Warrants and the conditions underlying the hire-purchase agreement,
3. Ceiling on hire-purchase charges,
4. Rights and obligations of the hirer and the owner.

In absence of any specific law, the hire purchase transactions are governed bthe provisions of the Indian Contract Act and the
Sale of Goods Act. In chapter relating to leasing we have discussed the provisions related to Indian Contract Act, here we will discuss the provisions of Sale of Goods Act.

Financial Evaluation

Now let us discuss the framework of financial evaluation of a hire purchase deal vis-à-vis a finance lease from both the hirer's as well as the finance company's viewpoint.

From the Point of View of the Hirer (Purchaser):

The tax treatment given to hire purchase is exactly the opposite of that given to lease financing. It may be recalled that in lease financing, the lessor is entitled to claim depreciation and other deductions associated with the ownership of the equipment including interest on the amount borrowed to purchase the asset, while the lessee enjoys full deduction of lease rentals. In sharp contrast, in a hire purchase deal, the hirer is entitled to claim depreciation and the deduction for the finance charge (interest) component of the hire instalment. Thus, hire purchase and lease financing represent alternative modes of acquisition of assets. The evaluation of hire purchase transaction from the hirer's angle, therefore, has to be done in relation to leasing alternative.

Decision criterion: The decision criterion from the point of view of hirer is the cost of hire purchase vis a vis the cost of leasing. If the cost of hire purchase is less than the cost of leasing, the hirer should prefer the hire purchase alternative and vice-versa.

Cost of hire purchase: The cost of hire purchase to the hirer consists of the following:

1. Down payment
2. + Service Charges
3. + Present value of hire purchase payments discounted by the cost of debt.
4. – Present value of depreciation tax shield discounted by cost of capital.
5. – Present value of net salvage value discounted by cost of capital.

Cost of leasing: The cost of leasing consists of the following elements:

1. Lease management fee
2. + PV of lease payments discounted by cost of debt.
3. – PV of tax shield on lease payments and lease management fee discounted by cost of capital.
4. + PV of interest tax shield on hire purchase by cost of capital.

From the View Point of Vendor / Financer

Hire purchase and leasing represent two alternative investment decisions of a finance company / financial intermediary / hire vendor. The decision criterion therefore is based on a comparison of the net present values of the two alternatives, namely, hire purchase and lease financing. The alternative with a higher NPV would be selected and the alternative having a lower NPV would be rejected.

NPV of Hire purchase Plan: The NPV of HPP consist of
1. PV of hire purchase instalments
2. + Documentation and service fee.
3. + PV of tax shield on initial direct cost
4. – Loan amount
5. – Initial cost.
6. – PV of interest tax on finance income (interest)
7. – PV of income tax on finance income meted for interest tax
8. – PV of income tax on documentation and service fee.

NPV of Leas Plan: The NPV of LP consists of the following elements:
1. PV of lease rentals.
2. + Leas management fee
3. + PV of tax shield on initial direct costs and depreciation.
4. + PV of Net salvage value.
5. – Initial investment
6. – Initial direct costs.
7. – PV of tax liability on lease rentals and lease management fee.

Hire purchase mathematics

Under a HIRE PURCHASE contract, a purchaser pays an initial deposit and takes the item away. He or she then makes regular repayments (instalments). The instalments include both repayment of the debt and the interest being charged by the vendor. At the end of the period of the agreement, the purchaser owns the item.

HIRE PURCHASE FORMULAS

Total amount paid = deposit + instalments
Total interest paid = total amount paid – original price of item

The interest rate being charged under a Hire Purchase Agreement is calculated using the SIMPLE INTEREST formula and is called the ANNUAL FLAT RATE of interest:
$r_f = 100 I / P_t$

Where:
I = total interest paid under agreement
P = amount owed (after deposit is deducted from original price)
t = the number of years over which agreement runs

EFFECTIVE INTEREST IN HIRE PURCHASE

The effective rate of interest in a hire purchase agreement is the interest rate that would be charged in an equivalent *reducing balance* loan. The effective rate of interest is always higher than the flat rate of interest because the effective interest rate takes into account the fact that the amount owed is being progressively reduced by the regular instalment payments, while simple interest does not take this into account.

EFFECTIVE RATE OF INTEREST FORMULA

$$r_{eff} = 2n / n+1 * r_{flat}$$

where n = no. of instalments over the life of the contract
r_{flat}= annual flat rate of interest charged in contract
The effective rate of interest is roughly about twice the flat rate of interest. The more repayments there are, the closer it is to double the flat rate.

UNIT-III: Factoring, Bill Discounting and Forfaiting:

Factoring concept, features, Cost of Factoring, Classification–Functions of factor–Legal aspects–Financial Evaluation of factoring–Decision analysis for factoring–Factoring scenario in India–Kalyan Sundaram Committee – RBI guidelines. **Bill discounting**–Concept and characteristics–Process of bill discounting–Legal aspects–Parties involved and their legal obligations–Financial aspects–Calculation of discount charges and effective interest rates- **Forfeiting** – Definition, factoring Vs Forfaiting, Working, Benefits and Demerits.

Factoring

Meaning and Definition of Factoring

The word factor is derived from the Latin word *facere*. It means to make or do or to get things done. Factoring simply refers to selling the receivables by a firm to another party. The buyer of the receivables is called the factor. Thus factoring refers to the agreement in which the receivables are sold by a firm (client) to the factor (financial intermediary). The factor can be a commercial bank or a finance company. When receivables are factored, the factor takes possession of the receivables and generally becomes responsible for its collection. It also undertakes administration of credit i.e. credit control, sales accounting etc. Thus factoring may be defined as selling the receivables of a firm at a discount to a financial organisation (factor). The cash from the sale of the receivables provides finance to the selling company (client). Out of the difference between the face value of the receivables and what the factor pays the selling company (i.e. discount), it meets its expenses (collection, accounting etc.). The balance is the profit of the factor for the factoring services.

Objectives of Factoring

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-realization 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.

Types of Factoring

There are different types of factoring. These may be briefly discussed as follows:

- Recourse Factoring: In this type of factoring, the factor only manages the receivables without taking any risk like bad debt etc. Full risk is borne by the firm (client) itself.
- Non-Recourse Factoring: Here the firm gets total credit protection because complete risk of total receivables is borne by the factor. The client gets 100% cash against the invoices (arising out of credit sales by the client) even if bad debts occur. For the factoring service, the client pays a commission to the factor. This is also called *full factoring*.
- Maturity Factoring: In this type of factoring, the factor does not pay any cash in advance. The factor pays clients only when he receives funds (collection of credit sales) from the customers or when the customers guarantee full payment.
- Advance Factoring: Here the factor makes advance payment of about 80% of the invoice value to the client.
- Invoice Discounting: Under this arrangement the factor gives advance to the client against receivables and collects interest (service charge) for the period extending from the date of advance to the date of collection.
- Undisclosed Factoring: In this case the customers (debtors of the client) are not at all informed about the factoring agreement between the factor and the client. The factor performs all its usual factoring services in the name of the client or a sales company to which the client sells its book debts. Through this company the factor deals with the customers. This type of factoring is found in UK.

Process of Factoring (Factoring Mechanism)

The firm (client) having book debts enters into an agreement with a factoring agency/institution. The client delivers all orders and invoices and the invoice copy (arising from the credit sales) to the factor. The factor pays around 80% of the invoice value (depends on the price of factoring agreement), as advance. The balance amount is paid when factor collects complete amount of money due from customers (client's debtors). Against all these services, the factor charges some amounts as service charges. In certain cases the client sells its receivables at discount, say, 10%. This means the factor collects the full amount of receivables and pays 90% (in this case) of the receivables to the client. From the discount (10%), the factor meets its expenses and losses. The balance is the profit or service charge of the factor. Thus there are three parties to the factoring. They are the buyers of the goods (client's debtors), the seller of the goods (client firm i.e. seller of receivables) and the factor. Factoring is a financial intermediary between the buyer and the seller.

Functions of a Factor

A factor performs some important functions. These may be discussed as follows:

1. Provision of finance: Receivables or book debts is the subject matter of factoring. A factor buys the book debts of his client. Generally a factor gives about 80% of the value of receivables as advance to the client. Thus the non productive and inactive current assets i.e. receivables are converted into productive and active assets i.e. cash.

2. Administration of sales ledger: The factor maintains the sales ledger of every client. When the credit sales take place, the firm prepares the invoice in two copies. One copy is sent to the customers. The other copy is sent to the factor. Entries are made in the ledger under open-item method. In this method each receipt is matched against the specific invoice. The customer's account clearly shows the various open invoices outstanding on any given date. The factor also
gives periodic reports to the client on the current status of his receivables and the amount received from customers. Thus the factor undertakes the responsibility of entire sales administration of the client.

3. Collection of receivables: The main function of a factor is to collect the credit or receivables on behalf of the client and to relieve him from all tensions/problems associated with the credit collection. This enables the client to concentrate on other important areas of business. This also helps the client to reduce cost of collection.

4. Protection against risk: If the debts are factored without resource, all risks relating to receivables (e.g., bad debts or defaults by customers) will be assumed by the factor. The factor relieves the client from the trouble of credit collection. It also advises the client on the creditworthiness of potential customers. In short, the factor protects the clients from risks such as defaults and bad debts.
5. Credit management: The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to buy all trade debts of the customer. Factor assesses the credit standing of the customer. This is done on the basis of information collected from credit relating reports, bank reports etc.
6. Advisory services: These services arise out of the close relationship between a factor and a client. The factor has better knowledge and wide experience in the field of finance. It is a specialised institution for managing account receivables. It possesses extensive credit information about customer's creditworthiness and track record. With all these, a factor can provide various advisory services to the client. Besides, the factor helps the client in raising finance from banks/financial institutions.

Advantages of Factoring

A firm that enters into factoring agreement is benefited in a number of ways. Some of the important benefits of factoring are summarised as follows:

- Improves efficiency: Factoring is an important tool for efficient receivables management. Factors provide specialised services with regard to sales ledger administration, credit control etc. Factoring relieves the clients from botheration of debt collection.
- Higher credit standing: Factoring generates cash for the selling firm. It can use this cash for other purposes. With the advance payment made by factor, it is possible for the client to pay off his liabilities in time. This improves the credit standing of the client before the public.
- Reduces cost: The client need not have a special administrative setup to look after credit control. Hence it can save manpower, time and effort. Since the factoring facilitates steady and reliable cash flows, client can cut costs and expenses. It can avail cash discounts. Further, it can avoid production delays.
- Additional source: Funds from a factor is an additional source of finance for the client. Factoring releases the funds tied up in credit extended to customers and solves problems relating to collection, delays and defaults of the receivables.
- Advisory service: It provides all management and administrative support from the stage of deciding credit extension to the customers to the final stage of debt collection. It advocates the best credit policy suitable for the firm.
- Acceleration of production cycle: With cash available for credit sales, client firm's liquidity will improve. In this way its production cycle will be accelerated.
- Adequate credit period for customers: Customers get adequate credit period for payment of assigned debts.
- Competitive terms to offer: The client firm will be able to offer competitive terms to its buyers. This will improve its sales and profits.

Limitations of Factoring

The main limitations of factoring are outlined as below:

- Factoring may lead to over-confidence in the behaviour of the client. This results in overtrading or mismanagement.
- There are chances of fraudulent acts on the part of the client. Invoicing against non-existent goods, duplicate invoicing etc. are some commonly found frauds. These would create problems to the factors.
- Lack of professionalism and competence, resistance to change etc. are some of the problems which have made factoring services unpopular.
- Factoring is not suitable for small companies with lesser turnover, companies with speculative business, companies having large number of debtors for small amounts etc.

- Factoring may impose constraints on the way to do business. For non – recourse factoring most factors will want to pre- approve customers. This may cause delays. Further ,the factor will apply credit limits to individual customers.

Legal aspects of factoring

The growth of a company depends largely on its liquidity. Many business projects, sales and credit expansion are hindered by lack of immediate cash. Today, the companies which are increasingly exporting face the risk of insolvency of its customers in addition to affecting the margin of the company. This weakens the results and becomes a permanent menace in achieving financial balance. So finding different financial variants is necessary which includes factoring.

Factoring in its traditional conception includes the management and collection of loans granted by the client and accepted by the factor, which assumes according to the contract the risk of insolvency of debtors. However there are certain legal aspects of factoring which you need to be aware of before you consider it as another financial variant.
The following are the legal aspects of factoring:

- The sale is taking place on a credit basis and the factor takes the responsibility for collecting payment from the buyer. For this purpose, the agreement between the seller and the factor should clearly state the role of each party involved in the sale.
- The seller should give due authority to the factor for collecting money from the buyer.
- Legally, the claim on the buyer is assigned by the seller to the factor. For this, a letter of authority is given by the seller to the factor.
- The buyer is also informed by the seller that he should make payment only to the factor.
- All the rights of the seller on the buyer now get transferred to the factor in his capacity as an assignee.
- In case of default by the buyer, it is the factor who will take action against the buyer in his capacity as an assignee.
- No other creditor can have any claim settled with the buyer towards the sale of goods except the factor.
- The banker will be informed that he should not finance the seller for any post sales requirements or accounts receivable discount, as it is the factor who has been assigned with the bills.
- Disputes arising between the seller and buyer should be settled by the parties concerned and they should not affect the factor.
- The factor must have the right to take legal action against the buyer in the case of default.

Factoring scenario in India

Factoring service in India is of recent origin. It owes its genesis to the recommendations of the Kalyanasundaram Study Group appointed by the RBI in 1989. Pursuant to the acceptance of these recommendations, the RBI issued guidelines for factoring services in 1990. The first factoring company – SBI Factors and Commercial Ltd (SBI FACS) started operation in April 1991. This article highlights the important aspects of the factoring services in India.

The main recommendations of the Committee/Group are listed as follows:

- Taking all the relevant facts into account, there is sufficient scope for introduction factoring services in India which would be complementary to the services provide by banks.
- The introduction of export factoring services would provide additional facility to exporters.

- While quantification of the demand for factoring services has not been possible, it is assessed that it would grow sufficiently so as to make factoring business a commercially viable proposition within a period of two/three years.
- On the export front, there would be a fairly good availment of various services offered by export factors.
- With a view to attaining a balanced dispersal of risks, factors should offer their services to all industries and all sectors in the economy.
- The pricing of various services by factors would essentially depend upon the cost of funds. Factors should attempt a mix from among the various sources of funds to keep the cost of funds as low as possible, in any case not exceeding 13.5 percent per annum, so that a reasonable spread is available.
- The RBI could consider allowing factoring organizations to raise funds from the Discount and Finance House of India Ltd, as also from other approved financial institutions, against their usance promissory notes covering receivables factored by them, on the liens of revised procedure under bills discounting scheme.
- The price for financing services would be around 16 per cent per annum and the aggregate price for all other services may not exceed 2.5 percent to 3 percent of the debts services.
- In the beginning only select promoter institutions/groups of individuals with good track record in financial services and competent management should be permitted to meter into this new field. Initially the organizations may be promoted on a zonal basis.
- There are distinct advantages in the banks being associated with handling of factoring business. The subsidiaries or associates of banks are ideally suited for undertaking this business; initially, it would be desirable to have only four or five organizations which could be promoted either individually by the leading banks or jointly by a few major banks having a large network of branches.
- Factoring activities could perhaps be taken up by the Small Industries Development Bank of India, preferably in association with one or more commercial banks.
- The business community should first be educated through bank branches about the nature and scope of these services and the benefits accruing there from.
- Factors cannot extend their services efficiently, effectively and economically without the support of computers, as quick and dependable means of communication. Concurrent with consideration of various aspects relating to commencement of factoring operations the promoters should initiate measures for organizing network of computers /dedicated lines the branches/agents in different parts of the country for accounting follow up remittance and other activities involved in factoring business.
- The Central Government ad RBI should initiate appropriate measures immediately for setting up specialized agencies for credit investigations; until such agencies become fully operative, factors may have to rely on such information about clients/customers as could be collected through banks or other sources.

- Since the suppliers would be able to obtain financial services from both banks and factors, it is necessary to provide for proper linkage between banks and factoring organizations.

- The factoring of Small Scale Industrial (SSI) units could to be mutually beneficial to both factors and SSI units and the factors should make every effort to orient their strategy to crystallize, the potential demand for this sector.

Kalyanasundaram Standing Committee Report Summary

- The Regulation of Factor (Assignment of Receivables) Bill, 2011
- The Standing Committee on Finance submitted its 39thReport on ‘The Regulation of Factor (Assignment of Receivables) Bill, 2011’ on August 30, 2011. The Chairperson was Shri Yashwant Sinha.
- The Bill seeks to provide for and regulate the assignment of receivables by making provisions for registration of factoring organisations and their regulation by the Reserve Bank of India (RBI). In addition, the Bill provides for the rights and obligations of parties to contract for the assignment of receivables from one to another.
- The Committee opined that there is a lack of clarity in the definitions and title of the Bill, which gives the impression that a law to regulate factors already exists. In addition, the Committee noted that the Hindi version of the Bill translates ‘factor’ to ‘adhatia’. This may give the impression that factors are to serve as intermediaries between enterprises and buyers of products, which is prohibited by the Bill.
- The Report noted that the Ministry, in response to the Committee’s concerns, has stated its intention to replace the word ‘adhatia’ in the Hindi version with the word ‘factor’ and to specifically exclude agents of agricultural produce from the definition of ‘factor’ in the Bill. In addition, the Ministry has stated its intention to change the name of the Bill to ‘The Factoring Regulation Bill, 2011’. The Committee recommends that the Ministry incorporate these modifications in to the Bill.
- The Committee noted that the 1988 report of an Expert Group headed by C.S. Kalyansundaram, former chairman of State Bank of India, recommended that assignment of receivables in favour of a factor be exempt from stamp duty. The Committee stated that although it is in agreement with the recommendation of the Expert Group, no such provision is included in the Bill.
- The Report of the Committee states that the Ministry, in response to the Committee’s concerns, has agreed with its view and will bring an amendment to the Indian Stamp Act, 1889 through a schedule to the Bill. The Committee found this appropriate.
- The Report notes that the Bill does not include any provision on the amount of commission or discount charged by factors. The Committee stated its concern that unregulated pricing will lead to exploitative practices, and recommends that guidelines on factor pricing be issued by the RBI.
- The Committee opined in its Report that clauses 8 and 18 of the Bill are inconsistent. Clause 8 provides that the debtor is responsible to make payment to the assignee (factor) only after notice of assignment is served upon him by the assignor. Clause 18 provides that in case the assignor commits a breach of contract against the debtor, the debtor is not entitled to recover payments already made to the assignor or assignee (factor). The Committee felt that clause 18 does not mention the rights of the debtor and is thus inconsistent with clause 8, which determines the responsibilities of all parties.
- The Report notes that the Ministry, in response to the concerns of the Committee, submitted that clause 18 does not preclude the right of the debtor to claim any losses on account of defective goods or short supply from the assignor, and that an explanation to this effect may be added to clause 18. The Committee recommends that such amendment be made to the Bill.
- Clause 32 of the Bill states that the government may make rules in respect to the “form and manner in which transactions of assignments of receivables in favour of a non-banking financial company shall be filed.” The Committee recommends that the phrase ‘non-banking financial company’ be changed to ‘factor’, since the definition of ‘factor’ includes other statutory companies as well. The Report notes that the government has agreed to this change.

The move comes close on the heels of the RBI receiving five applications for licence from international companies who want to set up factoring business.

Factoring is selling of a company's accounts receivables at a discount to an entity which assumes the credit risk. This entity makes upfront payment to the exporter, freeing it from the job of getting payments from the buyer. The recovery of payment for bills becomes a lookout of the factor.

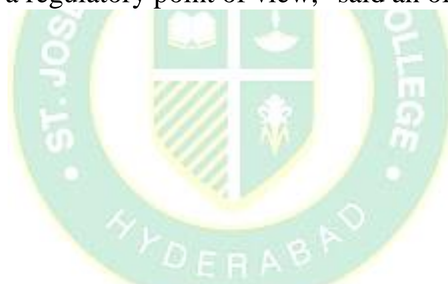
The proposed regulation by the central bank for standalone factoring companies is expected to cover the minimumcapital requirement for setting up a factoring business, direction, end use, due diligence, foreign exchange dealers' approval, prudential norms, regulatory reporting requirements, inspection by regulatory bodies, classification of loans which remain unpaid for a certain period and whether public deposits should be accepted or not, said an industry source.

Bibby Financial Services is one of the licence seekers. The Australian company has business interests ranging from shipping and logistics to distribution of financial services such as factoring, invoice discounting, recruitment finance, asset finance, construction finance and trade services.

The second application is from UAE Exchange, an exchange house in the Middle East catering to the remittances by Non-Resident Indians (NRIs) in partnership with Dr B R Shetty. Other applications are from US firms.

Currently, schedule banks can do factoring without an RBI licence. However, non-banking finance companies need an authorised dealers licence from the RBI for getting into export and import factoring. On the other hand, no licenses is required for domestic factoring and NBFCs registered with the RBI can enter into the filed.

"Though the RBI in last December had introduced guidelines for NBFCs which are non-deposit taking and having assets of more than Rs 100 crore (now categorised as systemically important NBFCs). The RBI is considering whether activity wise, there should be additional guidelines from a regulatory point of view," said an official.



Bill discounting–

BILL DISCOUNTING

1 INTRODUCTION:

Bills of exchange that are used in the course of normal trade and commercial activities are called commercial bills_. Bill financing, is an ideal mode of short-term financing available to business concerns. It imparts flexibility to the money market, besides providing liquidity within the banking system. It also contributes towards the effectiveness of the monetary policy of the central bank of a country.
According to the Indian Negotiable Instruments Act 1881, ―Bill of Exchange is an instrument in writing containing an unconditional order, signed by the marker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument. The bill of exchange is essentially a trade-related instrument, and is used for financing genuine transactions. Bill financing, is an ideal mode of short term financing available to business concerns. It imparts flexibility to the money market, besides providing liquidity within the banking system. It also contributes towards the effectiveness of the monetary policy of the central bank of a country.

2 BILL DISCOUNTING

When the seller (drawer) deposits genuine commercial bills and obtains financial accommodation from a bank or financial instit instead of discounting the bill immediately may choose to wait till the date of maturity.

When the seller (drawer) deposits genuine commercial bills and obtains financial accommodation from a bank or financial institution, it is known as 'bill discounting'. The seller, instead of discounting the bill immediately may choose to wait till the date of maturity. Commercial, the option of discounting will be advantageous because the seller obtains ready cash, which can be used for meeting immediate business requirements. However, in the process, the seller may lose a little by way of discount charged by the discounting banker.

3 Following are the salient features of bill discounting financing:

1. Discount charge:

The margin between advance granted by the bank and face value of the bill is called the discount, and is calculated on the maturity value at rate a certain percentage per annum.

2. Maturity:

Maturity date of a bill is defined as the date on which payment will fall due. Normal maturity periods are 30, 60, 90 or 120 days. However, bills maturing within 90 days are the most popular.

3. Ready finance:

Banks discount and purchase the bills of their customers so that the customers get immediate finance from the bank. They need not wait till the bank collects the payment of the bill.

4. Discounting and purchasing:

The term discounting of bills is used for demand bills, where the term purchasing of bills is used for usance bills. In both cases, the bank immediately credits the account of the customer with the amount of the bill, less its charges. Charges are less in case of purchasing of bill because the bank can collect the payment immediately by presenting the bill to the drawee for payment. Charges are, however, higher in the case of discounting of bill because the bank charges include not only the charges for service rendered, but also the interest for the period from the date of discounting the bill to the date of its maturity. In addition, there are also charges when bills are dishonoured. In such circumstances, the bank will debit the account of the customer with the amount of the bill along with interest and other charges. Since the bank is granting advance to the customers in both the discounting and purchasing of bills, bills discounted and purchased are shown as advances (Schedule 9) by a bank in its balance sheet.

4 Steps In Discounting And Purchasing Following steps are involved in the discounting and purchas8isng of commercial bills of exchange:

1. **Examination of Bill:** The banker verifies the nature of the bill and the transaction. The banker then ensures that the customer has supplied all required documents along with the bill.
2. **Crediting Customer Account** after examining the genuineness of the bill, the banker grants a credit limit, either on a regular or on an ad net amount of the bill i.e. value of bill minus discount charges. The amount of discount is the income earned by the bank on discounting / purchasing. The amount of the bill is taken as advance by the bank.
3. **Control over Accounts:** To ensure that no customer borrows more than the sanctioned limit, a separate register is maintained for determining the amount availed by each customer. Separate columns are allotted to show the names of customers, limits sanctioned, bills discounted, bills collected, loans granted and loans repaid. Thus, at any given point in time the extent of limit utilized by the customer can be readily known.
4. **Sending Bill for collection:** The bill, together with documents duly stamped by the banker, is sent to the banker's branch (or some other banks branch if the banker does not have a branch of its own) for presenting the bill for acceptance or payment, in accordance with the instructions accompanying the bill.

5. **Action by the Branch:** On receipt of payment, the collecting bank remits the payment to the banker which has sent the bill for collection.

6. **Dishonour:** In the event of dishonour, the dishonour advice is sent to the drawer of the bill. It would be appropriate for the collecting banker to get the protested for dishonour. For this purpose, the collecting banker or branch of the bank maintains a separate register in which details such as date on which the bills are to be presented, the party to whom it is to be presented, etc. are recorded. The banker then presents them for acceptance or payment, as required. The banker debits the customers' (drawer / borrower) account with the amount of the bill and also all charges incurred due to dishonour of the bill. Such a bill should not be purchased in the event of its being presented again. However, the banker may agree to accept it for collection.

5 BILL SYSTEMS There are essentially two systems of bills, the drawer bill system and the drawee bill system, which are explained blow:

Drawer Bills System 'Drawer Bills System's characterize sellers of goods on the buyer of the goods 2. Bills being discounted or purchased at the instance of the drawer of the bills 3. The banker primarily taking into consideration the credit of the drawer of bill, while discounting or purchasing these bills this system of financing goods is quite popular in our country.

Drawee Bills System „Drawee Bills System's characterized by: a. The banker accepting the bill drawn by the seller at the instance of the buyer (the drawee) b. The banker providing assistance, primarily on the strength of the creditworthiness of the buyer the two types of the drawee bills system are as follows:

1. **Acceptance credit system:** Under this system, the buyers banker accepts the bill of exchange for the goods purchased by the drawee. Such a bill may either be drawn on the buyer or the banker.

The banker also requires the borrower to show separately, the goods purchased under acceptance credit in periodical stock statements submitted to the banker.

2. **Bills discounting system:** Under this system, the seller directly draws the bill on the buyer's bank discounts the bill and sends the proceeds to the seller. The buyer's banker will show the bill as bill discounted. Under both the systems, the banker keeps a record of the bills, both accepted and still outstanding. This is to ensure that the advance sanctioned does not exceed the credit limit. The main advantages of the Drawee bill scheme are as follows:
   a. **Assured payment:** Since the banker has accepted the bill, the seller is assured of payment. Moreover, if the
   seller decides to get it discounted, the discount rate will be lower because the drawee is the banker itself.

   b. **Buying advantage:** Due to the surety and standing of the banker, it is possible for the buyer to obtain goods at competitive rates.

3. **Safety of funds:** There is hardly any risk for the buyers bank because the bill is accepted or discounted against the security of the goods purchased by the buyer. Moreover, the goods are under the control of the banker. It is equally advantageous for the seller's bank, since the discounted bill may be rediscounted with any other financial institution. This is because; a banker has accepted the bill.

Parties involved in Bills of Exchange

Bills of exchange is used primarily in International trade, and is a written order by one person to pay another a specific sum on a specific date sometime in the future. It is known as "**Draft**" in the United States. If the bill of exchange is drawn on a bank, it is called a **bank draft**.

A bill of exchange may involve the following parties

1. **Drawer** This is the person who writes and signs the bill.
2. **Drawee** This is the person on whom the bill is drawn.
3. **Acceptor** This is the person who accepts the bill. In practice, the drawee is the acceptor but a third person may accept a bill on behalf of the drawee.
4. **Payee** This is the person to whom the money stated in the bill is payable. He may be the drawer or any other person to whom the bill has been endorsed.
5. **Holder** This is the person who is in the possession of the bill, after being drawn. He /She may be the original payee, endorsee and bearer in case of a bearer bill.
6. **Endorser** The person, either the drawer or holder, who endorses the bill to any one by signing on the back of it is called an endorser.
7. **Endorsee** He/ She is the person in whose favour the bill is endorsed.

8. **Drawee in case of need** This is a person who is introduced at the option of the drawer. Any endorser may insert the name of such person, and the effect of it is that a resort may be had to him in case the bill is dishonoured for non-acceptance or non-payment or in any other need.
9. **Acceptor for honour** The person who may voluntarily become a party to a bill as acceptor in the event of the refusal by original drawee to accept the bill if demanded by the notary. The acceptor for honour offers to accept the bill *supra protest** with a view to safeguard the honour or prestige of the original drawer or any other endorser, as the case may be. This happens when the bill gets dishonoured and a formal certificate of dishonour, known as protest, is issued by the Notary Public to the holder of a bill in question. Hence the term supra protest.

* This happens when the bill gets dishonoured and a formal certificate of dishonour, known as protest, is issued by the Notary Public to the holder of a bill in question. Hence the term supra protest. It is not necessary that all the above mentioned parties are involved in one bill of exchange. Usually there are three parties to a bill of exchange. They are

- Drawer,
- Drawee, and
- Payee.

It is also not necessary that three separate persons should answer to the description of drawer, drawee, and payee. Depending upon the situation one person may fill any two of three positions. Accordingly, drawer and payee may be the same person. For instance, when the bill is drawn as '***pay to me or my order***', drawer and drawee may be the same person. Similarly, when a principal draws a bill on his agent or upon himself, drawee and payee may be the same person.

BILL DISCOUNTING PROCESS

The process of bill discounting is simple and logical.

- The seller sells the goods on credit and raises invoice on the buyer.
- The buyer accepts the invoice. By accepting, the buyer acknowledges paying on the due date.
- Seller approaches the financing company to discount it.
- The financing company assures itself of the legitimacy of the bill and creditworthiness of the buyer.
- The financing company avails the fund to the seller after deducting appropriate margin, discount and fee as per the norms.
- The seller gets the funds and uses it for further business.

- On the due date of payment, the financial intermediary or the seller collects the money from the buyer. 'Who will collect the money' depends on the agreement between the seller and financing company.

ADVANTAGES OF BILL DISCOUNTING

The business gets the cash instantaneously giving business cycle a better momentum. It allows an entrepreneur to do business without funds. This works like a bank overdraft, the borrower pays the interest only on the amount of money utilized. There is a tough competition in the market to extend such credit and hence there are a plenty of different products to suit the needs of the client. There are borrowers who even cover the risk of bad debt along with the service. Obviously, the charge may be little more.

DISADVANTAGES OF BILL DISCOUNTING

It can be an expensive form of financing compared to other modes of financing such as bank overdraft etc. In many countries like India, where the central bank encouraged the scheme of bill discounting and allowed a lower percentage of interest. But, it was not successful due to various misuses by financing brokers, banks etc.

Suppose there are two sister companies A & B, A draws bill on B without any judicious transaction. B accepts it and A discounts it with the bank and utilizes the credit illegitimately. If the intentions are bad, A & B may default on payment and the banks will have to suffer.

Note: Situation of invoice discounting is different in different countries. The norms of financing differ in different countries and they are different with different borrowers of the same countries as well. This depends on the business policies of the banks and financial institutions engaging in the discounting business.

Forfeiting –

Definition, factoring Vs Forfaiting, Working, Benefits and Demerits.

UNIT: IV Venture Capital Financing and Credit Rating

Venture Capital Financing–Concept , features, Scope –Venture Capital funding process–Funding and entry strategies of VCF–Structuring venture capital financing–Valuation of VCF-Conventional valuation method–First Chicago method–Revenue multiplier method–Exit strategies of VCF– Ventures capital financing scenario in India–Regulatory frame work of VCF and Suggestions for Growth of Venture Capital Funds. **Credit Rating -** Concept and advantages of ratings–Types of ratings–Symbols of ratings and grades- Dimensions of credit rating methodology and process–Credit rating agencies in India and their rationale. .

Venture Capital Financing–

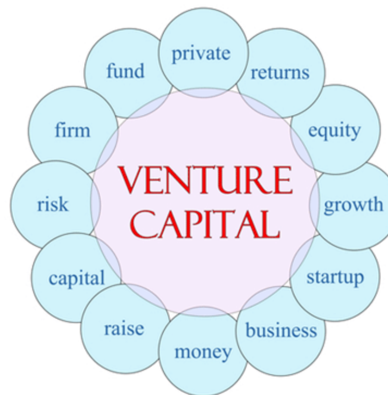
It is a private or institutional investment made into early-stage / start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business.

Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify.

Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

Venture Capital is the most suitable option for funding a costly capital source for companies and most for businesses having large up-front capital requirements which have no other cheap alternatives .*Software and other intellectual property* are generally the most common cases whose value is unproven. That is why; Venture capital funding is most widespread in the fast-growing technology and biotechnology fields.



Features of Venture Capital investments

- High Risk
- Lack of Liquidity
- Long term horizon
- Equity participation and capital gains
- Venture capital investments are made in innovative projects
- Suppliers of venture capital participate in the management of the company

Methods of Venture capital financing

- Equity
- participating debentures
- conditional loan

THE FUNDING PROCESS: *Approaching a Venture Capital for funding as a Company*

The venture capital funding process typically involves four phases in the company's development:

- Idea generation
- Start-up
- Ramp up
- Exit

Step 1: Idea generation and submission of the Business Plan

The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

Step 2: Introductory Meeting

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

Types of Venture Capital funding

The various types of venture capital are classified as per their applications at various stages of a business. The three principal types of venture capital are early stage financing, expansion financing and acquisition/buyout financing.

The venture capital funding procedure gets complete in six stages of financing corresponding to the periods of a company's development

- *Seed money: Low level financing for proving and fructifying a new idea*
- *Start-up: New firms needing funds for expenses related with marketingand product development*
- *First-Round: Manufacturing and early sales funding*
- *Second-Round: Operational capital given for early stage companies which are selling products, but not returning a profit*
- *Third-Round: Also known as Mezzanine financing, this is the money for expanding a newly beneficial company*
- *Fourth-Round: Also calledbridge financing, 4th round is proposed for financing the "going public" process*

A) Early Stage Financing:

Early stage financing has three sub divisions seed financing, start up financing and first stage financing.

- Seed financing is defined as a small amount that an entrepreneur receives for the purpose of being eligible for a start up loan.
- Start up financing is given to companies for the purpose of finishing the development of products and services.
- First Stage financing: Companies that have spent all their starting capital and need finance for beginning business activities at the full-scale are the major beneficiaries of the First Stage Financing.

B) Expansion Financing:

Expansion financing may be categorized into second-stage financing, bridge financing and third stage financing or mezzanine financing.Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way. Bridge financing may be provided as a short term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers as a major business strategy.

C) Acquisition or Buyout Financing:

Acquisition or buyout financing is categorized into acquisition finance and management or leveraged buyout financing. Acquisition financing assists a company to acquire certain parts or an entire company. Management or leveraged buyout financing helps a particular management group to obtain a particular product of another company.

Advantages of Venture Capital

- They bring wealth and expertise to the company
- Large sum of equity finance can be provided
- The business does not stand the obligation to repay the money
- In addition to capital, it provides valuable information, resources, technical assistance to make a business successful

Disadvantages of Venture Capital

- As the investors become part owners, the autonomy and control of the founder is lost
- It is a lengthy and complex process
- It is an uncertain form of financing
- Benefit from such financing can be realized in long run only

Exit route

There are various exit options for Venture Capital to cash out their investment:

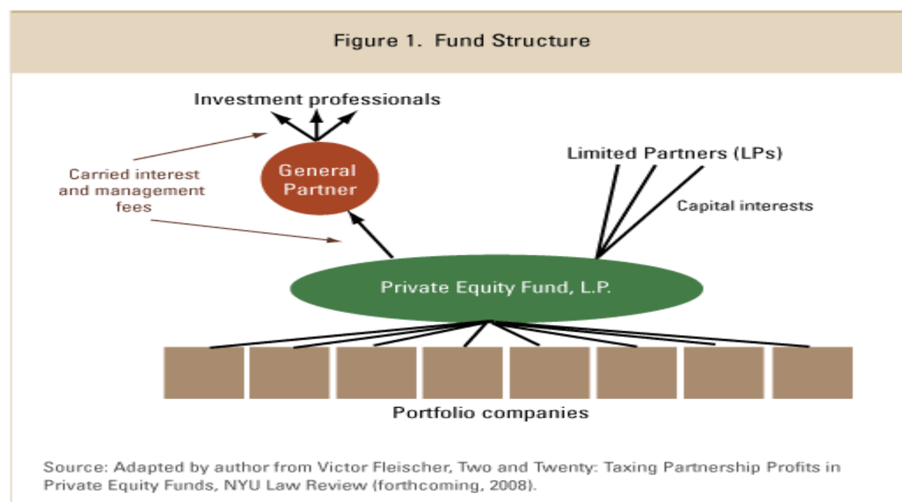
- IPO
- Promoter buyback
- Mergers and Acquisitions
- Sale to other strategic investor

Examples of venture capital funding

Kohlberg Kravis & Roberts (KKR), one of the top-tier alternative investment asset managers in the world, has entered into a definitive agreement to invest USD150 million (Rs 962crore) in Mumbai-based listed polyester maker JBF Industries Ltd. The firm will acquire 20% stake in JBF Industries and will also invest in zero-coupon compulsorily convertible preference shares with 14.5% voting rights in its Singapore-based wholly owned subsidiary JBF Global Pte Ltd. The funding provided by KKR will help JBF complete the ongoing projects.

Pepperfry.com, India's largest furniture e-marketplace, has raised USD100 million in a fresh round of funding led by Goldman Sachs and Zodius Technology Fund. Pepper fry will use the funds to expand its footprint in Tier III and Tier IV cities by adding to its growing fleet of delivery vehicles. It will also open new distribution centres and expand its carpenter and assembly service network. This is the largest quantum of investment raised by a sector focused e-commerce player in India.

The Venture Fund Structure



Venture Fund is the main investment vehicle used for venture investing. Each is structured as a limited partnership governed by partnership agreement covenants, of finite life (usually 7–10 years). It pays out profit sharing through carried interest (about 20% of the fund's .

Management Company is the business of the fund. The management company receives the management fee from the fund (about 2%) and uses it to pay the overhead related to operating the venture firm, such as rent, salaries of employees, etc. It makes carried interest only after the Limited Partners have been repaid.

Limited Partners (LPs) is someone who commits capital to the venture fund. LPs are mostly institutional investors, such as pension funds, insurance companies, endowments, foundations, family offices, and high net worth individuals.

General Partner (GP) is the venture capital partner of the management company. GPs raise and manage venture funds, set and make investment decisions, and help their portfolio companies exit, because they have a fiduciary responsibility to their Limited Partners.

Portfolio Companies (Start ups) receive financing from the venture fund in exchange for shares of *preferred equity*. The fund can only realize gains if there is a liquidity event (such as mergers and acquisitions or IPOs) and these shares can be converted to cash.

Methods in evaluation of projects by Venture Capital Institutions

The venture capital institutions invariably finance industries either on the basis of idea or on the basis of growth. It is here they are different from other financial institutions which are *assets-based*. We can now see different approaches in the evaluation of projects by venture capital institutions.

Methods of evaluation of projects by VCI

There are basically three methods adopted by venture capital institutions (VCI) while financing projects. These are –

- Conventional venture capitalist evaluation method.
- The First Chicago method.
- The revenue multiplier method.

1. Conventional venture capitalist evaluation method

ln this method, VCIs give importance to two aspects, which are

- the **time of starting the investment** and
- the **time of quitting the investment**.

The institution will judge the borrowing concern in the following manner—

1. **Annual revenue** of the borrowing concern over a **period of 7 years** and whether these revenues are on the upward trend.

2. The borrowing concerns' **expected earnings** (after deducting tax liability) at the initial stage and also at the time of quitting the borrowing concern will be taken into consideration.

3. **Market evaluation** of the borrowing concern on the basis of P/E ratio (P = price of the security and E= earnings of the security). The evaluation of this ratio is the lesser the ratio, better will be the condition of the borrowing company.

4. Finding out the **net present value (NPV)** of the borrowing concern, based on suitable discount factor.

5. The borrowing concern must have net worth equivalent to the borrowing amount.

Example: If the value of enterprise is Rs. 10 crores, and the borrower wants Rs. 4 crores, then he must have a net worth of 40 percent of the total value.

The above method may not be practically feasible as most of the borrowing firms will not be in a position to provide regular stream of income and in the case of firms incurring losses, this method cannot be worked out.

2. The First Chicago method

This method is different from the previous conventional method of evaluation, as it gives some discount to the starting point and the exit point. There is more consideration given for the earnings during the entire period. This scheme has the following aspects.

1. Three alternative positions are taken which are

- Success
- Sideways survival
- failure.

A **probability rating** is given to the three positions.

2. Through the discounted cash flow, the **discounted present value is assessed** by giving a high discount rate to accommodate the risk factor.

3. The discounted value is multiplied by probability ratings which will provide **expected present value**.

4. If the expected present value is Rs. 10 lakhs, and the fund required is Rs. 5 lakhs, then the borrowing concern must have a **minimum net worth** of 50%.

3. Revenue Multiplier method

In this method, the **value of the borrowing concern is based on an estimated value**. The estimated value is calculated on the basis of

1. Present value of the borrowing concern

2. Annual revenue

3. Expected rate of growth of revenue per year

4. Expected holding period (number of years for the repayment)

5. Profit margin after tax

6. Expected P/E ratio at the time of quitting the borrowing concern.

This method will be useful for such concerns which have started earning and where in the course of years their revenue will be increasing. But this system is based on more data which may not be available, especially in underdeveloped countries.

Exit Strategies for Venture Capital Funds

An important aspect of venture capital investing is the exit strategies. Venture capital funds primarily invest with an exit in mind after a few years. After successfully funding at seed, pre-production, production and expansion stages, a venture capitalist will start assessing exit strategies. The exit in the form of disinvestment or liquidation is the last and final stage of the venture capital funding. The key types of liquidation/disinvestment are trade sales, sale of quoted equity post initial public offering (IPO), and write-offs. Let's look at each of these in detail:

Trade Sales: In this type of strategy the private company is sold or merged with an acquirer for stocks, cash, or a combination of both.

IPO: If the company has done well, the venture capital investors will take the IPO route, by issuing shares registered for public offering. An example is the upcoming Facebook IPO, which is expecting to raise about $15 billion through IPO and is valued at approx. 100 billion. The venture capital investors and other private investors will get their portion of shares who can put them in the open marketplace for trading after an initial lock-in period.

Write-offs: These are voluntary liquidations that may or may not result in any proceeds.

Apart from the above three types of disinvestment, there are a few other options:

Bankruptcy: The company may just go bankrupt.

Buy-back: In this method the entrepreneur buys-back the investment share from the venture capitalists and takes it back to being a privately held company.

Investors who invest in a venture capital fund get distributions of public stock or cash from realized venture capital investments. Sometimes the fund may require further investments from limited partners. At other times, they may make cash or share distributions at random times during the lifetime of the fund. Investors can sell their interests to another buyer if they find one.

In a bad case scenario, some funds find themselves with highly illiquid, barely there companies. In a good scenario, they have good investments, which they disinvest from at a stage and find new investments to fund.

Current Scenario of Venture Capital Financing In India

For Beginners, a venture is a business or any other project that has risk associated with it. Venture capital is a type of private equity financing option that is invested in high-potential startups and venture capital firms are the organizations run by venture capitalists who take the risk of investing in startups that show huge market potential. Venture capital is not only beneficial for entrepreneurs but even the investors and the economy too benefits hugely from type of financing.

Now let’s move on to the current scenario of venture capital financing in India. India is definitely one of the most powerful countries in Asia with a fast-developing economy owing to the presence of huge talents and people to boost those talents. Although venture capital financing in India has already started spreading its roots, the industry is still in its nascent stage.

However, the present stage of the industry in India is a clear indication that there’s a lot to happen in the VC industry of India. The biggest per-requisite for the establishment of an active venture capital industry is the presence of wide varieties of financial instruments to take care of the investors’ high-risk investments. The easy availability of these instruments reduces the risks and ensure a greater return for the venture capitalists.

Over the last few years, venture capital financing in India has witnessed a significant expansion with the entry of large numbers of local and international venture capital firms. These firms have already raised billions of dollars to invest in the local start ups. The huge amount of talent, dynamic business policies and a favorable business environment are together luring the global investors too to spread their base in India and boost the entrepreneurial industry.

The investors offering venture capital financing in India are mainly targeting sectors like technology, software, enterprise software, consumer internet, online retail, healthcare, energy, advertising, real estate, infrastructure, private equity, etc. With the surge of activity in the VC industry of India, there is definitely a lot of scope for new start ups; all this while the private equity capital was solely meant for the growing and established companies and there was very less scope for the newbie’s to materialize their potential ideas.

But today, the scenario is quite different. Venture capital financing in India is open to all provided they find a unique business idea with a growing market, an efficient management team, an innovative business model and home-run potential. Once they find a start up with all the necessary items that make it ideal for

an investment, the VCs waste no time to back it with an aim to gain huge profits. The success of Flipkart is no more new story and is largely because of venture capital that the firm has managed to raise. In less than 7 years, the firm has earned revenue of over $1 billion.

Venture capital financing in India not only comes with capital but also with guidance and mentor ship and of course, the strong network that is a must for every business to reach the ultimate point of success. The investors are, usually, actively involved in the invested company's managerial affairs and also keep an eye on where the capital is being invested so as to ensure that everything goes into profit making both for the company and the VC firm.

The venture capital funds in India are of different varieties; some are backed by the central government, some by state government, some by public banks, and some by public sector organizations while some by the overseas venture capital companies. Depending on the suitability of sector, stage of development and location, the investors choose their portfolio companies in India.

If you are one of those investors looking to raise venture capital financing in India, all you need is a unique product or service, a great management team, an innovative business model, a strong value proposition to gain the confidence of the investors and a reliable referral. With all these things in the right place, it won't be difficult for you to raise venture capital in India.

To make your search for the right investor faster, you can also consider becoming a member of an intelligent network, like Merger Alpha, that offers a common platform to entrepreneurs, buyers, sellers, financial and strategic investors and financial advisers.

Regulatory frame work of venture capital financing

Venture Capital Fund: means a fund established in the form of a trust or a company including a body corporate and registered under these regulations which-

i. has a dedicated pool of capital,
ii. raised in a manner specified in the regulations, and
iii. invests in accordance with the regulations.

Venture Capital Undertaking; means a domestic company :-

i. whose shares are not listed on a recognized stock exchange in India;
ii. which is engaged in the business for providing services, production or manufacture of article or things or does not include such activities or sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf.

Negative List

i. Non-banking financial services excluding those Non-Banking Financial companies which are registered with Reserve Bank of India and have been categorized as Equipment Leasing or Hire Purchase companies
ii. Gold Financing excluding those companies which are engaged in gold financing for jewellery
iii. Activities not permitted under industrial policy of Government of India.
iv. Any other activity which may be specified by the Board in consultation with Government of India from time to time."

Associate Company: means a company in which a director or trustee or sponsor or settlor of the venture capital fund or asset management company holds either individually or collectively, equity shares in excess of 15% of its paid-up equity share capital of venture capital undertaking".

Equity Linked Instruments: includes instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity

Investible Funds: means corpus of the fund net of expenditure for administration and management of the fund.

Unit : means beneficial interest of the investors in the scheme or fund floated by trust or shares issued by a company including a body corporate

Incorporation & Registration of a VCF

Application for Grant of Certificate: Any company or trust or body corporate proposing to carry on any activity as a venture capital fund must apply to SEBI for grant of a certificate of carrying out venture capital activity in India. An application for grant of certificate must be made in Form A and must be accompanied by a non-refundable application fee of Rs 25,000/- payable by bank draft in favor of the Securities and Exchange Board of India at Mumbai. Registration fee for grant of certificate is Rs 500,000.

Eligibility Criteria

For the purpose of grant of certificate by SEBI, the following conditions must be satisfied :-

If the application is made by a company

The main object of the company as per its Memorandum of Association must be the carrying on of the activity of venture capital fund.

- It is prohibited by its Memorandum and Articles of Association from making an invitation to the public subscribe to its securities.
- None of its directors or its principal officer or employee is involved in any litigation concerned with the securities market which may have an adverse bearing on the business of the applicant. The directors or the principal officer or employee must not have been at anytime convicted for an offense involving moral turpitude or any economic offense and is a fit and proper person to act as director or principal officer or employee of the company

A. If the application is made by a trust

a. The instrument of trust (Trust Deed) is in the form of a deed and has been duly registered under the provisions of the Indian Registration Act, 1908.
b. The main object of the trust is to carry on the activity of a venture capital fund
c. None of its trustees or directors of the trustee company, if any, is involved in any litigation connected with the securities market which may have an adverse bearing in the business of the venture capital fund.
d. The directors of its trustee company or the trustees have not at anytime being convicted of an offense involving moral turpitude or any economic offense.
e. the applicant is a fit and proper person

B. if the application is made by a body corporate

a. it is set up or established under the laws of the Central or State Legislature.
b. the applicant is permitted to carry on the activities of a venture capital fund.
c. the applicant is a fit and proper person.
d. the directors or the trustees, as the case may be, of such body corporate have not been convicted of any offence involving moral turpitude or of any economic offense.
e. the directors or the trustees, as the case may be, of such body corporate, if any, is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant.

Procedure for Grant of Certificate: If SEBI is satisfied that the applicant is eligible for grant of certificate, it shall send intimation to the applicant of its eligibility. On receipt of intimation, the applicant must pay to SEBI, registration fee of Rs 500,000 and on the receipt of such fees, SEBI shall grant a certificate of registration in Form B

Conditions for the Grant of Certificate

a. The venture capital fund shall abide by the provisions of the SEBI Act and these regulations.
b. The venture capital fund shall not carry on any other activity other than that of a venture capital fund.
c. The venture capital fund shall inform SEBI in writing of any information or details previously submitted to SEBI which have changed after grant of the certificate.
d. If the information or details submitted are found to be false or are misleading in any particular manner, suitable penal action can be taken

Raising Finance

A venture capital fund may raise money from any source, whether Indian, foreign or non resident Indian by way of issue of units. No venture capital fund shall accept any investment from any investor less than Rs500,000. However this condition is not applicable to :-

a. employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust
b. the employees of the fund manager or asset management company
c. Each scheme launched or fund set up by a venture capital fund shall have firm commitment from the investors for contribution of an amount of at least Rupees five crores before the start of operations by the venture capital fund.

Investments Conditions & Restrictions

All investment made or to be made by a venture capital fund shall be subject to the following conditions, namely:-

a. venture capital fund shall disclose the investment strategy at the time of application for registration;
b. venture capital fund shall not invest more than 25% corpus of the fund in one venture capital undertaking;
c. shall not invest in the associated companies; and
d. venture capital fund shall make investment as enumerated below: -
    i. at least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking .
    ii. Not more than 33.33% of the investible funds may be invested by way of:
        a. subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed ;
        b. debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity
        c. preferential allotment of equity shares of a listed company subject to lock in period of one year.
        d. the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.

           Explanation 1 - For the purpose of these regulations, a "financially weak company" means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its networth as at the beginning of the previous financial year.
        e. Special Purpose Vehicles which are created by a venture capital fund for the purpose of facilitating or promoting investment in accordance with these Regulations

           Explanation - The investment conditions and restrictions stipulated in clause (d) of regulation 12 shall be achieved by the venture capital fund by the end of its life cycle."venture capital fund shall disclose the duration of life cycle of the fund."

Prohibition on Listing

No venture capital fund shall be entitled to get its securities or units listed on any recognized stock exchange upto the expiry of three years from the date of issue of securities or units by the venture capital fund.

General Obligations and Responsibilities

No venture capital fund shall issue any documents or advertisement inviting offers from the public for the subscription of the purchase of any of its securities or units.

Private placement

A venture capital fund may raise money only through private placement of its securities or units. The venture capital fund before issuing any securities or units must file with SEBI a placement memorandum.

Placement Memorandum or Subscription Agreement: The venture capital fund must :-

a. issue a placement memorandum which shall contain details of the terms and conditions subject to which monies are proposed to be raised from investors; or
b. enter into contribution or subscription agreement with the investors which shall specify the terms and conditions subject to which monies are proposed to be raised.

The Venture Capital Fund must file with the Board for information, the copy of the placement memorandum or the copy of the contribution or subscription agreement entered with the investors along with a report of money actually collected from the investor

The placement memorandum and /or subscription agreement must give the following details:

1. Details of the trustee or the trustee company and the directors or chief executives of the venture capital fund.
2. the proposed corpus of the fund and the minimum amount to be raised for the fund to be operational.
3. the minimum amount to be raised for each scheme and the provision for refund of monies to investor in the event of non receipt of minimum amount
4. details of entitlements units of venture capital fund for which subscription is being sought
5. Tax implications that are likely to apply to the investors.
6. Manner of subscription to the units or securities of the Venture Capital Fund
7. Period of maturity of the Fund.
8. Manner in which the fund is to be wound up.
9. Manner in which the benefits accruing to the investors in the units of the trust are to be distributed.
10. Details of the fund manager or asset management company if any, and the fees to be paid to such manager
11. The details about performance of the fund, if any, managed by the Fund Manager
12. investment strategy of the fund.
13. any other information specified by the Board.

Maintenance of Books and Records: Every venture capital fund must maintain for a period of 8 years books of accounts, records and documents which must give a true and fair picture of state of affairs of the venture capital fund.

Power to Call for Information: SEBI may at anytime call for any information from the venture capital fund in respect to any matter relating to its activity as a venture capital fund. Such information must be submitted within the time specified by days to SEBI.

Submission of reports to SEBI: SEBI may at anytime call upon the venture capital fund to file such report as it deems fit with regards to the activity carried out by venture capital fund.

Winding -up: A scheme of venture capital fund setup as a trust shall be wound up:

i. When the period of the scheme as mentioned in the placement memorandum is over ; or
ii. If, in the opinion of the trustees or the trustee company, it is in the interest of the investors that be wound-up ; or
iii. If 75 % of the investors in the scheme pass a resolution at a meeting of unit holders of the scheme that the scheme be wound up ; or
iv. If SEBI so directs, in the interest of investors.

The venture capital fund setup as a company shall be wound up according to provision of the Companies Act, 1956.

A venture capital fund set up as a body corporate shall be wound up in accordance with the provisions of the statute under which it is constituted.

The trustees or trustee company of the venture capital fund set up as a trust or the Board of Directors in the case of the venture capital fund is set up as a company (including body corporate) shall intimate the Board and investors of the circumstances leading to the winding up of the Fund or Scheme.

Effect of winding up

1. On and from the date of intimation of the winding up, no further investments shall be made on behalf of the scheme to be wound up.
2. Within three months from the date of intimation, the assets of the scheme shall be liquidated and the proceeds accruing to the investors in the scheme distributed to them after satisfying all liabilities.

Notwithstanding anything contained in sub-regulation (2) and subject to the conditions, if any, contained in the placement memorandum or contribution agreement or subscription agreement, as the case may be, in-specie distribution of assets of the scheme, shall be made by the venture capital fund at any time, including on winding up of the scheme, as per the preference of investors, after obtaining approval of at least 75% of the investors of the scheme.

Powers of SEBI for Inspection & Investigation: Details covered under Chapter -V of the Regulations

Procedure for Action in Case of Default - Offences & Penalties: Details covered under Chapter -VI of the Regulations

Venture capital funds which desire to claim exemption from income tax are required to follow rules given hereunder:

- Registration with SEBI
- Claiming Income tax exemption in respect of dividend and capital gains income.
- Not more than 40 percent of equity in a venture
- 80 percent of monies raised for investment are required to be invested in equity shares of domestic companies whose shares are not listed on recognized stock exchange
- Shares of investee companies are required to be held for a period of at least 3 years. However, these shares can be sold either if they are listed on recognized stock exchange in India

Exit strategies of VCF–

Credit Rating -

UNIT V: Securitization of Debt: Meaning, Definition, Secured and Unsecured debt-Debt Financing Concept Advantages and Disadvantages. Residential mortgage backed securities (MBS) -Asset backed securities (ABS)-Collateralized debt obligations (CDO)-Commercial mortgage backed securities (CMBS)-Future flow securitization.

Meaning, Definition, Secured and Unsecured debt-Debt Financing Concept Advantages and Disadvantages. Residential mortgage backed securities (MBS) –

Debt securitization is the process of packaging **debts** from a number of sources into a single security to be sold to investors. Many such securities are batches of home mortgage loans that are sold by the banks that granted them. The buyer is typically a trust that converts the loans into a marketable security.

Asset backed securities (ABS)-Collateralized debt obligations

Types of CDOs

These tranches of securities become the final investment products: bonds, whose names can reflect their specific underlying assets. For example, mortgage-backed securities (MBS) are comprised of mortgage loans, and asset-backed securities (ABS) contain corporate debt, auto loans, or credit card debt. CDOs are called "collateralized" because the promised repayments of the underlying assets are the collateral that gives the CDOs their value.

Other types of CDOs include collateralized bond obligations (CBOs)—investment-grade bonds that are backed by a pool of high-yield but lower-rated bonds, and collateralized loan obligations (CLOs)—single securities that are backed by a pool of debt, that often contain corporate loans with a low credit rating.

(CDO)-Commercial mortgage backed securities

More About Creating CDOs

Collateralized debt obligations are complicated, and numerous professionals have a hand in creating them:

- Securities firms, who approve the selection of collateral, structure the notes into tranches and sell them to investors
- CDO managers, who select the collateral and often manage the CDO portfolios
- Rating agencies, who assess the CDOs and assign them credit ratings
- Financial guarantors, who promise to reimburse investors for any losses on the CDO tranches in exchange for premium payments
- Investors such as pension funds and hedge funds

KEY TAKEAWAYS

- A collateralized debt obligation is a complex structured-finance product that is backed by a pool of loans and other assets.
- These underlying assets serve as collateral if the loan goes into default.
- Though risky and not for all investors, CDOs are a viable tool for shifting risk and freeing up capital.

(CMBS)-Future flow securitization.

A Brief History of CDOs

The earliest CDOs were constructed in 1987 by the former investment bank, Drexel Burnham Lambert—where Michael Milken, then called the "junk bond king," reigned.[1] The Drexel bankers created these early CDOs by assembling portfolios of junk bonds, issued by different companies. Ultimately, other securities firms launched CDOs containing other assets that had more predictable income streams, such as automobile loans, student loans, credit card receivables, and aircraft leases. However, CDOs remained a niche product until 2003–04, when the U.S. housing boom led CDO issuers to turn their attention to subprime mortgage-backed securities as a new source of collateral for CDOs.[2]

CDOs and the Global Financial Crisis

Collateralized debt obligations exploded in popularity, with CDO sales rising almost tenfold from $30 billion in 2003 to $225 billion in 2006.[3] But their subsequent implosion, triggered by the U.S. housing correction, saw CDOs become one of the worst-performing instruments in the subprime meltdown, which began in 2007 and peaked in 2009. The bursting of the CDO bubble inflicted losses running into hundreds of billions of dollars for some of the largest financial services institutions. These losses resulted in the investment banks either going bankrupt or being bailed out via government intervention and helped to escalate the global financial crisis, the Great Recession, during this period.

Despite their role in the financial crisis, collateralized debt obligations are still an active area of structured-finance investing. CDOs and the even more infamous synthetic CDOs are still in use, as ultimately they are a tool for shifting risk and freeing up capital—two of the very outcomes that investors depend on Wall Street to accomplish, and for which Wall Street has always had an appetite.