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B.B.A. [Banking]

II - Semester

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RURAL BANKING

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SYLLABI-BOOK MAPPING TABLE

Rural Banking

Syllabi	Mapping in Book
BLOCK - I: BASICS OF RURAL BANKING	
Unit 1: Rural Banking: Meaning – Importance – Activities of a Rural Banker – Project counselling – Loan Syndication – Management of Public Issues – Underwriting, Bankers to Issue and Other Services	Unit 1: Overview of Rural Banking (Pages 1-18)
Unit 2: Growth of Rural banking in India — Meaning- Importance – Implication – Need for Control –Types- Scope, Features - Role of the SEBI in Regulating Rural Banking Industry - Role of NSE and OTCEI.	Unit 2: Growth of Rural Banking in India (Pages 19-34)
Unit 3: Project Related Activities of a Rural Banker: Corporate Counselling: Organisational Goals —Loan Syndication: Meaning and Scope – Steps in Syndication–	Unit 3: Project Related Activities of a Rural Banker (Pages 35-51)
BLOCK -II: RURAL BANKING FEATURES	
Unit 4: Capital Issue Related Activities of a Rural Banker: Changing Structure of Indian Capital Market – Management of Pre-issue Activities	Unit 4: Capital Issue Related Activities of a Rural Banker (Pages 52-61)
Unit 5: Corporate Securities: Types and Characteristics – Marketing of Corporate Securities – Steps to be Taken by the Issuing Company and the Lead Manager – Underwriting.	Unit 5: Corporate Securities (Pages 62-83)
Unit 6: Management of Post-issue Activities – Processing of Aata – Reporting to SEBI – Under Subscription – Bridge Loans – Allotment of Shares – Listing of Securities.	Unit 6: Management of Post-Issue Activities (Pages 84-99)
Unit 7: Service Oriented Activities of a Rural Banker: Mergers and Amalgamations: Meaning – Purpose – Types of Mergers.	Unit 7: Service Oriented Activities of a Rural Banker (Pages 100-114)
BLOCK -III: VENTURE CAPITAL AND MISCELLANEOUS	
Unit 8: Role of Rural Bankers in Mergers – Portfolio Management: Functions of Portfolio Managers – Explanation to Risk – CAPM Approach to Market Operations.	Unit 8: Overview of Role of Rural Bankers in Mergers and Portfolio Management (Pages 115-129)
Unit 9: Miscellaneous Activities of a Rural Banker: Venture Capital – Origin – Administration of Venture Capital Fund – Mutual Fund	Unit 9: Miscellaneous Activities of a Rural Banker (Pages 130-140)
Unit 10: Classification of Mutual Funds – Factoring – Mechanism and Types of Factoring Domestic - Cash Management, ST/MT Funding, Meaning and Importance Cash Management, Objectives.	Unit 10: Classification of Mutual Funds (Pages 141-163)

BLOCK - IV: LRR AND CRR

Unit 11: Cash Flow Cycle, Cash Flow Budgeting and Forecasting, Electronic Cash Management, MT and LT Funding, Term Loans, Securitization, Cost Center, Profit Center, Planning and Control, Capital Budgeting.

Unit 11: Cash Flow Cycle
(Pages 164-180)

Unit 12: Liquidity Management- Objectives-Sources-Maturity Concerns: Projected Cash and Core Sources- Contingency Plans- ST/NT Liquidity – Maturity Ladder Limit- Internal Control-Information- Netting.

Unit 12: Liquidity Management
(Pages 181-186)

Unit 13: Regulation, Supervision and Compliance- Need and Significance of Internal and External Audit.

Unit 13: Regulation, Supervision and
Compliance
(Pages 187-206)

CONTENTS

INTRODUCTION

BLOCK I: BASICS OF RURAL BANKING

UNIT 1 OVERVIEW OF RURAL BANKING 1-18

- 1.0 Introduction
- 1.1 Objectives
- 1.2 Rural Banking: Meaning and Important Activities
 - 1.2.1 Project Counselling
 - 1.2.2 Loan Syndication
- 1.3 Management of Public Issues
- 1.4 Answers to Check Your Progress Questions
- 1.5 Summary
- 1.6 Key Words
- 1.7 Self Assessment Questions and Exercises
- 1.8 Further Readings

UNIT 2 GROWTH OF RURAL BANKING IN INDIA 19-34

- 2.0 Introduction
- 2.1 Objectives
- 2.2 Meaning, Importance and Implication
- 2.3 Need for Control: Types, Scope and Control Features
 - 2.3.1 Role of SEBI (Securities and Exchange Board of India) in Regulating Rural Banking Industry
 - 2.3.2 Role of National Stock Exchange of India (NSE)
 - 2.3.3 Role of OTC Exchange of India
- 2.4 Answers to Check Your Progress Questions
- 2.5 Summary
- 2.6 Key Words
- 2.7 Self Assessment Questions and Exercises
- 2.8 Further Readings

UNIT 3 PROJECT RELATED ACTIVITIES OF A RURAL BANKER 35-51

- 3.0 Introduction
- 3.1 Objectives
- 3.2 Project Activities
- 3.3 Corporate Counselling
 - 3.3.1 Organizational Goals
- 3.4 Loan Syndication: Meaning and Scope
 - 3.4.1 Steps in Loan Syndication
- 3.5 Answers to Check Your Progress Questions
- 3.6 Summary
- 3.7 Key Words
- 3.8 Self Assessment Questions and Exercises
- 3.9 Further Readings

BLOCK II: RURAL BANKING FEATURES

UNIT 4 CAPITAL ISSUE RELATED ACTIVITIES OF A RURAL BANKER 52-61

- 4.0 Introduction
- 4.1 Objectives
- 4.2 Capital Issues
 - 4.2.1 Changing Structure of Indian Capital Market
- 4.3 Management of Pre-Issue Activities
- 4.4 Answers to Check Your Progress Questions
- 4.5 Summary
- 4.6 Key Words
- 4.7 Self Assessment Questions and Exercises
- 4.8 Further Readings

UNIT 5 CORPORATE SECURITIES 62-83

- 5.0 Introduction
- 5.1 Objectives
- 5.2 Types and Characteristics of Securities
- 5.3 Marketing of Corporate Securities
- 5.4 Steps to be taken by the Issuing Company
 - 5.4.1 Lead Manager and Underwriting
- 5.5 Answers to Check Your Progress Questions
- 5.6 Summary
- 5.7 Key Words
- 5.8 Self Assessment Questions and Exercises
- 5.9 Further Readings

UNIT 6 MANAGEMENT OF POST-ISSUE ACTIVITIES 84-99

- 6.0 Introduction
- 6.1 Objectives
- 6.2 Processing of Data and Allotment of Shares
 - 6.2.1 Under Subscription
 - 6.2.2 Bridge Loans
- 6.3 Reporting to SEBI
- 6.4 Listing on Stock Exchanges
- 6.5 Answers to Check Your Progress Questions
- 6.6 Summary
- 6.7 Key Words
- 6.8 Self Assessment Questions and Exercises
- 6.9 Further Readings

UNIT 7 SERVICE ORIENTED ACTIVITIES OF A RURAL BANKER 100-114

- 7.0 Introduction
- 7.1 Objectives
- 7.2 Merger and Amalgamation: Meaning and Purpose
 - 7.2.1 Types of Merger
- 7.3 Answers to Check Your Progress Questions
- 7.4 Summary
- 7.5 Key Words
- 7.6 Self Assessment Questions and Exercises
- 7.7 Further Readings

BLOCK III: VENTURE CAPITAL AND MISCELLANEOUS

UNIT 8 OVERVIEW OF ROLE OF RURAL BANKERS IN MERGERS AND PORTFOLIO MANAGEMENT 115-129

- 8.0 Introduction
- 8.1 Objectives
- 8.2 Role of Rural Bankers in Mergers
- 8.3 Portfolio Management
 - 8.3.1 Functions of Portfolio Managers
 - 8.3.2 Capital Asset Pricing Model (CAPM)
- 8.4 Answers to Check Your Progress Questions
- 8.5 Summary
- 8.6 Key Words
- 8.7 Self Assessment Questions and Exercises
- 8.8 Further Readings

UNIT 9 MISCELLANEOUS ACTIVITIES OF A RURAL BANKER 130-140

- 9.0 Introduction
- 9.1 Objectives
- 9.2 Venture Capital and its Administration
 - 9.2.1 Origin
 - 9.2.2 Types of Venture Capital Financing
- 9.3 Mutual Funds
 - 9.3.1 Kinds of Mutual Fund Schemes
- 9.4 Answers to Check Your Progress Questions
- 9.5 Summary
- 9.6 Key Words
- 9.7 Self Assessment Questions and Exercises
- 9.8 Further Readings

UNIT 10 CLASSIFICATION OF MUTUAL FUNDS

141-163

- 10.0 Introduction
- 10.1 Objectives
- 10.2 Types of Mutual Funds
- 10.3 Factoring: Mechanism and Types of Factoring
- 10.4 Cash Management: Meaning, Importance and Objectives
 - 10.4.1 ST/MT Funding
- 10.5 Answers to Check Your Progress Questions
- 10.6 Summary
- 10.7 Key Words
- 10.8 Self Assessment Questions and Exercises
- 10.9 Further Readings

BLOCK IV: LRR AND CRR

UNIT 11 CASH FLOW CYCLE

164-180

- 11.0 Introduction
- 11.1 Objectives
- 11.2 Cash Flow Budgeting and Forecasting
 - 11.2.1 Electronic Cash Management
- 11.3 Securitization
 - 11.3.1 Term Loans
- 11.4 Capital Budgeting
- 11.5 Profit and Cost Centre
- 11.6 Answers to Check Your Progress Questions
- 11.7 Summary
- 11.8 Key Words
- 11.9 Self Assessment Questions and Exercises
- 11.10 Further Readings

UNIT 12 LIQUIDITY MANAGEMENT

181-186

- 12.0 Introduction
- 12.1 Objectives
- 12.2 Objectives and Sources
 - 12.2.1 Projected Cash and Core Sources
 - 12.2.2 Maturity Ladder
- 12.3 Contingency Plans
- 12.4 Answers to Check Your Progress Questions
- 12.5 Summary
- 12.6 Key Words
- 12.7 Self Assessment Questions and Exercises
- 12.8 Further Readings

UNIT 13 REGULATION, SUPERVISION AND COMPLIANCE

187-206

- 13.0 Introduction
- 13.1 Objectives
- 13.2 Need and Significance of Internal and External Audit
 - 13.2.1 Objectives and Scope of an Audit
 - 13.2.2 Advantages of an Audit
 - 13.2.3 Classification of Audit: External and Internal Audit
- 13.3 Answers to Check Your Progress Questions
- 13.4 Summary
- 13.5 Key Words
- 13.6 Self Assessment Questions and Exercises
- 13.7 Further Readings

INTRODUCTION

NOTES

Rural banking refers to providing banking services to individuals living in rural areas. Rural banking has become integral to the Indian financial markets with a majority of Indian population still living in rural or semi-urban areas. Government of India and the Reserve Bank of India have been continuously working to achieve complete financial inclusion i.e. timely and sufficient access to financial services and credit at an affordable cost, in the vast expanse of our country. Rural banking in India began in earnest with the formation of the regional rural banks on October 2, 1975. Today, these rural banks are present in over 21,398 locations throughout the length and breadth of the country.

This book, *Rural Banking*, is divided into thirteen units that follow the self-instruction mode with each unit beginning with an Introduction to the unit, followed by an outline of the Objectives. The detailed content is then presented in a simple but structured manner interspersed with Check Your Progress Questions to test the student's understanding of the topic. A Summary along with a list of Key Words and a set of Self-Assessment Questions and Exercises is also provided at the end of each unit for recapitulation.

BLOCK - I
BASICS OF RURAL BANKING

*Overview of Rural
Banking*

**UNIT 1 OVERVIEW OF RURAL
BANKING**

NOTES

Structure

- 1.0 Introduction
- 1.1 Objectives
- 1.2 Rural Banking: Meaning and Important Activities
 - 1.2.1 Project Counselling
 - 1.2.2 Loan Syndication
- 1.3 Management of Public Issues
- 1.4 Answers to Check Your Progress Questions
- 1.5 Summary
- 1.6 Key Words
- 1.7 Self Assessment Questions and Exercises
- 1.8 Further Readings

1.0 INTRODUCTION

A rural bank can be defined as rural financial institution/ cooperative/ community bank or deposit taking financial institution that provides customised financial services to rural communities. As a huge section of the country resides in rural areas, it is important from a financial inclusion aspect that rural branches exist to cater to the population. However, banking in the rural areas is different from merchant banking that exists in cities. This unit will begin by examining the activities of a rural banker, underwriting, bankers to issue and other services.

1.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the activities of rural banking
- Discuss project counselling and loan syndication
- Explain management of public issues
- Describe the role of underwriters

1.2 RURAL BANKING: MEANING AND IMPORTANT ACTIVITIES

NOTES

Rural banking is banking that is done in an area that is not close to towns or cities, making it difficult for those who need to conduct banking business. Many times a bank agent will come to the rural area to offer basic banking services. The goals of rural banks are to provide banking services to the rural/ village population of India.

Rural banking is a common practice in places where banking institutions are few and far between and people who need to carry out banking transactions may have difficulty finding a way to do so. With modern technology, more and more people have access to online systems that allow them to conduct certain types of banking without a nearby branch but this technology is not available for everyone and demand for rural banking is still high in some areas.

Rural banking is the process of conducting banking transactions out in the country where bank branches are too far away to be of use. Rural banking is popular for very small towns and farmers who live far away from areas of larger population and cannot make the drive to these locations even when they need to use banking services. Typically an agent of the bank will visit these rural locations and offer to make transactions in an official capacity.

The regional rural banks were established with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas credit and other facilities, particularly to small and marginal farmers, agricultural labourers artisans and small entrepreneurs and for matters connected therewith and incidental thereto. The institution of Regional Rural Banks (RRBs) was created to meet the excess demand for institutional credit in the rural areas particularly among the economically and socially marginalised sections. In order to provide access to low-cost banking facilities to the poor, the Narsimham Working Group proposed the establishment of a new set of banks, as institutions which combine the local feel and the familiarity with rural problems which the cooperative possess and the degree of business organisations ability to mobilize deposits, access to central money markets and modernized outlook which the commercial banks have. The multi-agency approach to rural credit was also to sub serve the needs of the input-intensive agricultural strategy, that is, the green revolution, which by the mid-seventies was ready to spread more widely throughout the Indian countryside. In addition the potential and the need for diversification of economic activities in the rural areas had begun to be recognised and this was a sector where the Regular Rural Banks could play a meaningful role.

The Regional Rural Banks were established on 2nd October 1975. The main objectives of these banks are to provide credit and other facilities particularly to small and marginal farmers and small entrepreneurs so as to develop agriculture

trade, commerce industry and other productive activities in rural areas. The aim of rural banks is to bridge the credit gaps existing in the rural areas and they are supposed to be effective instruments of economic development in rural India. They will extend productive credit to the rural community and they will have purely rural orientation in their activity and in the manner of extending their activity.

Regional rural banks (RRBs) are Indian scheduled commercial banks operating at regional level in different states of India. They have been created with a view of serving primarily the rural areas of India with basic banking and financial services. The area of operation of Regional Rural Banks is limited to the area as notified by Government of India covering one or more districts in the state. Regional Rural Banking perform various functions. These are as follows:

- Providing banking facilities to rural and semi-urban areas
- Carrying out government operations like disbursement of wages of MGNREGA workers, distribution of pensions etc.
- Providing para-banking facilities like locker facilities debit and credit cards, mobile banking internet banking etc.

Functions of Regional Rural Bank

Regional Rural Bank grant loans and advances to small farmers and agricultural labourers so that they can start their own farming activities including purchase of land, seeds and manure. The RRBs charge a lower rate of interest and thus they reduce the cost of credit in the rural areas functions of RRBs are as follows:

- RRBs grant loan and advances to small farmers and agricultural labourers so that can start their own farming activities including purchase of land seed and manure.
- RRBs provide banking services at the doorsteps of the rural people particularly in those areas which are not served by any commercial bank.
- The RRBs charge a lower rate of interest and thus they reduce the cost of credit in the rural areas.
- RRBs provide loan and other financial assistance to entrepreneurs in villages sub-urban areas and small towns so that they become able to enlarge their business.
- Loans to artisans to encourage them for the production of artistic and related goods.
- Encourage the saving habit among the rural and semi-urban population.

A rural bank focuses on providing savings and credit services to people who live in rural areas. The financial products offered respond to the needs of its clients. A rural bank is a smaller size in assets than the very large banks. It is located generally in smaller cities and concentrates in making loans and other services to that immediate locations.

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NOTES

Earlier commercial banks hesitated to open the rural branches due to profitability, infrastructure etc. So the government of India and Reserve Bank of India decided to open a new banking channel i.e. regional rural banks. These banks were allowed to work within a district. The focus of regional rural banks was to provide finance in the agricultural sector only. They were not allowed to finance for vehicles, housing, business loan etc. The salary of regional rural banks was less than the commercial bank. The capital sharing of this district level was 50% of sponsored commercial bank, 35% of central Government and remaining 15% of the state Government. The competition in the banking sector changed all basic rules. The regional rural banks were allowed to finance in every sector. The salary of the employees of the RRBs is equal to commercial bank employees. The sponsored banks were allowed to merge the different district regional rural banks within a state.

Rural banking has become integral to the Indian financial markets. With the majority of Indian population still living in rural or semi urban area, the Government of India and Reserve Bank of India have been continuously working to achieve complete financial inclusion, that is, timely and sufficient access to financial services and credit at an affordable cost in the vast expanse of our country. Pradhan Mantri Jan Dhan Yojana is one of the recent initiatives by the BJP Government which has definitely contributed to bring banking to every household. This scheme with time will significantly reduce the gap between rural and urban areas in terms of financial inclusion. But the fact that about 70% of population of India is still rural and the penetration of banking facilities is as low as only 24%, i.e., only this percentage of people in these areas have formal bank accounts, cannot be ignored. Various Regional Rural Banks have been set up under the Regional Rural Banks Act, 1976 to provide a continuous source of credit for agriculture and other activities. These banks were set up with the aim of reaching every corner of the country and cater to financial needs of rural society comprising small and marginal farmer, agricultural labourers, self-help groups, artisans etc. The credit to weaker sections was made hassle-free and given at cheap or concessional rates. RBI has also encouraged the spread of these banks by undertaking the following:

- Allowing non-target group financing for RRBs
- Recapitalisation and restricting of RRBs
- Simplification of banking procedures as per Gupta committee recommendations
- Special credit plans
- Kisan credit cards
- Deregulation of banking rates
- direct financing for SCBs
- Various relaxations in investment policies and non-fund business

- Allowing direct access to refinance assistance at concessional rates for RRBs

These initiatives have promoted the banking culture by making formal credit available to rural households. These facilities have helped to steer the agriculture dominated economy towards modernisation. The bank have to keep in mind subtleties of the rural culture and understand that the rules of rural economy are different from urban dynamics. However with increased mobility and connectivity the urban and rural integration has increased and many factors which made the urban landscape have come to mark rural settings as well. This has led to diversification in activities and people have started to look at other factors of employment too. Agricultural activities have also been significantly commercialised with increased role of cash crops. Thus, banks are getting a strong demand for credit for both agricultural and non-agricultural uses. Bankers however, have to pay attention to these little cultural cues and customer profits and accordingly carry their services. The staff has to identify with rural customers who are not used to banking procedures and need extra assistance at every step. This will help customers to avail full benefit of banking without any hesitation.

The Pradhan Mantri Gram Sadak Yojana or PMGSY is a nationwide plan in India to provide good all weather road connectivity to unconnected villages. The centrally sponsored scheme was introduced in 2000 by then Prime Minister of India Shri Atal Bihari Vajpayee. The Assam Tribune has reported that the scheme has started to change the lifestyle of many villagers as it has resulted in new roads and upgradation of certain inter-village routes in Manipur.

The objective of the Swarnjayanti Gram Swarozgar Yojana (SGSY) is to bring the assisted poor families above the poverty line by ensuring appreciable sustained level of income over a period of time. The objective is to be achieved by inter alia organising the rural poor into Self Help Groups (SHGs) through the process of social mobilization, their training and capacity building and provision of income generating assets. The SHG approach helps the poor to build their self-confidence through community action interactions in group meetings and collective decision making enables them in identification and prioritization of their needs and resources. This process ultimately lead to the strengthening and socio-economic empowerment of the rural poor as well as improve their collective bargaining power.

The main purpose of Regional Rural Banks is to mobilise financial resources from rural/semi-urban areas and grant loans and advances mostly to small and marginal farmers, agricultural labourers and rural artisans. The area of operations of RRBs is limited to the area as notified by Government of India covering one or more districts in the state RRBs also perform a variety of different functions RRBs perform various functions in following heads. Providing banking facilities to rural and semi-urban areas. Carrying out government operations like disbursement of wages MGNREGA workers, distribution of persons etc. Providing Para-Banking facilities like locker facilities, debit and credit cards.

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1.2.1 Project Counselling

Project counselling includes preparation of project reports, deciding upon the financing pattern, appraising the project relating to its technical, commercial and financial *viability*. It includes filling up of application forms for obtaining funds from financial institutions.

Project counselling may be rendered independently or may be, it relates to project finance and broadly covers the study of the project and offering advisory assistance on the project viability and procedural steps for its implementation, proudly including following aspects: general review of the project idea/ project profile, advice on procedural aspects of project implementation, review of technical feasibility of the project on the basis of the report prepared by own experts or by the outside consultants, selecting Technical Consultancy Organisation (TCO) for preparing project reports and market survey, or review of the project reports or market survey report prepared by the TCO preparing project report from financial angle and advice and act on various procedural steps including obtaining government, consent for implementation of projects. This assistance can include obtaining of the following approvals licence/permission/grants etc. from the government agencies viz letter of intent industrial license and DGTC registration and government approval for foreign collaboration.

In addition, the facility provides guidance to Indian entrepreneurs for making investment projects in India. Indian joint ventures overseas is also covered under this activity.

Project counselling may also include identification of potential investments avenues, precise capital structuring shaping the pattern of financing, arranging and negotiating foreign collaborations, amalgamations, mergers and turnover financial study of the project and preparation of viability reports to advice on the framework of institutional guidelines and laws governing corporate finance, assistance in the preparation of project profiles and feasibility studies based on preliminary project ideas in order to indicate the potential. These reports would cover the technical, financial and economic aspects of the project from the point of view of their acceptance by the financial institutions and banks, advising and assisting clients in preparing the applications for obtaining letters of intent industrial license and DGTD registrations etc. seeking approvals from the government of India for foreign technical and financial collaboration agreements, guidance on investment opportunities for entrepreneurs coming to India.

Pre-investment studies are directed mainly for the prospective investor. Some of the critical issues that a study of this genre deals will include in depth investigation of environment and regulatory factors, location of raw material, supplies, demand projections and financial requirements.

Such a study assess the financial and economic viability for a given project and help the clients identify and shortlist those projects that are built upon his inherent strength so as to accentuate corporate profitability and growth in long run.

Project counselling as a facility to provide assistance to entrepreneurs through the services of merchant corporate banking will not only improve and shape the support of project management, but will give a better skill set to entrepreneurs.

1.2.2 Loan Syndication

Loan syndication refers to the services rendered by the financial service expert or firm in procurement of term loans and working capital facilities from financial institutions banks and other financing and investment firms for its clients. The loan syndication services are rendered by the merchant bankers, practising accounting professionals financial and management consultants etc. The service is rendered on fee base and generally as a percentage on the loan amount syndicated. These services are rendered for both existing companies as well as new projects. This will save the time of the management and the promoters in raising necessary finance for the business. The expertise of the syndicators can be used for the advantage of the concern for at a reasonable cost of raising finance. The major activities involved in syndication of loans consists of the following:

- Preparation of project reports and other necessary information with the help of his client
- Scouting for location or identification of source of finance
- Shortlisting the providers of funds and preliminary discussion with them about the possibilities of finance and viability of the proposal
- Selection of financial institution for loan syndication
- Preparation and filing of loan applications with the finance firms which show interest in financing
- Submission of all necessary information for appraisal of the proposal
- Obtain in principle letter sanctioning the loan.
- Getting the loan documentation completed between the lender and the borrower and also help in creation of security for the loan.
- Compliance of terms and conditions for availment of loan
- Getting disbursement of loan to the client
- Ensure the clients in complying with the terms and conditions as per the loan agreement entered.

The syndicator of loan will charge his client the fee for the services rendered.

Check Your Progress

1. What is the objective of the Swarnjayanti Gram Swarozgar Yojana?
2. What is loan syndication?

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1.3 MANAGEMENT OF PUBLIC ISSUES

Public issue of corporate securities as a source of financing projects has gained tremendous popularity in the recent past. Due to the increased awareness on the part of an average investor of the advantages of investing his funds in shares and debentures, there is a rising trend in the issue activities of the capital market which has reached a level beyond the expectation of Government and stock exchange authorities. A choice of investment avenues is now being offered to the investors giving rise to complexities in the manner of raising capital.

Public issue is essentially an exercise involving active participation of a number of agencies. The situation, a couple of decades ago was that it was a sole effort on the part of the company and its personnel. However, with the growth of the number of public issues and the complexities in the efforts involved, today it has become necessary to enlist the active participation and support of a number of agencies in making any public issue a success. Following are the various agencies associated with the public issue.

1. Managers to the Issue

The manager to the issue is actively associated and plans the timing of the issue, strategies to be adopted by way of publicity and marketing of the issue etc. He advises the company on the selection of the registrars to the issue, Underwriters Brokers, Bankers to the issue, Advertising agents, printers etc. and also gives a sense of direction to the entire issue. Besides, the other activities mainly performed by them are drafting of prospectus, getting it vetted and approved from SEBI, obtaining underwritings for the issue, assisting in selection of various agencies, ensuring that one SEBI authorised agencies are involved with the public issue work, preparing Budget of expenses, suggesting the appropriate timings for the public issue assisting in marketing the public issue successfully etc.

There are a number of agencies specialising in the role of managers to the issue. They include Merchant Banking Divisions of some of the all India Financial Institutions Subsidiaries of commercial Bank's Merchant Banking divisions, Private sector, SEBI authorised merchant bankers are Traditional stock brokers who have graduated into providing specialised merchant banking services.

2. Registrars to the Issue

The registrars to the issue, also known as issue house, are responsible normally for receiving the share applications from various collection centres through controlling branches of bankers to the issue, analysing them, recommending the basis of allotment to the Regional Stock Exchange for its approval, arranging for despatch of allotment letters and preparing the Register of Members etc.

Their job normally starts with sending instruction to all collecting branches, the opening of subscription list, and continues till the share certificates are

despatched and the Register of Members along with other related Registers/details are handed over to the company. Sometimes, the Registrars to the issue continue their association with the company in the role of share Transfer Agents, even after the issue is completed.

Rules regulating the activities of the Registrars to the issue were notified by the Central Government under the heading Securities and Exchanges Board of India (Registrar to an Issue and Share Transfer Agents) Rules 1993.

3. Underwriters

The underwriters are the people who actually ensure that the company is able to raise the capital issued by it for a commission charged by them. They make a commitment to get the issue subscribed either by others or themselves usually the underwriters can be divided into two categories, namely Financial Institutions and Banks on the one hand and brokers underwriters and approved investment companies on the other.

Keeping in view the huge devolvement on underwriters in some of the mega issues, which could not be met by them and the lack of uniformity in the underwriting agreement entered by the companies with the underwriters a model underwriting agreement has been formulated by SEBI.

Bearing in mind the important role to be played by underwriters the SEBI has notified Underwriters Rule 1993. According to which:

- Net worth norms have been prescribed for underwriters
- Members of OTCEI and NSE can etc. as underwriters
- Brokers-underwriters have to take approval for underwriting from their respective Stock Exchanges.

4. Brokers to the Issue

These are the people who actually bring the prospective investors and the company together. The success or failure of a public issue depends to a large extent on the reaction of the brokers.

They are the members of recognised stock exchanges including OTCEI and NSE with a view to provide better and professional services to investing public and to promote development of capital on healthy lines, the Government has since allowed multiple membership to members of stock exchanges and accorded recognition to corporate entities and the financial institutions including subsidiaries of the Banks. All the member of recognised Stock Exchanges including OTCEI and NSE can work for the issue and the company has to pay brokerage to them and statement to this effect can be given in prospectus. Only brokers registered with SEBI can act for this purpose. SEBI has notified SEBI (Stock-Brokers and Sub-Brokers) Rules 1992.

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5. Bankers to the Issue

The bankers to the issue are the commercial banks authorised by SEBI which will receive the share application money along with the share application forms from the prospective investors—depending upon the size of the issue the number of the banks are designated as bankers to the issue. Different branches of these banks are named at various locations where such application money is accepted. These branches are called collecting branches. These collecting branches send application forms and the money received by them to a Specified Branch where the details of the applications are consolidated. Such specified branch of the Bankers to the issue is called Controlling Branch. The controlling branch is usually selected in the city where the Managers to the issue/Registrars to the issue/Registered office of the company is situated. Public issue collection account is opened with the Controlling Branch. The Company and Banker to the issue are required to enter into a MOU (Memorandum of Understanding) SEBI has notified SEBI (Bankers to an issue) Rules 1994 to regulate the work.

6. Publicity and Advertising Agents

Since public issue is an effort to motivate and persuade members of the public to invest in the shares of the company, it is essential that the general public is made aware of the company, its activities, its plans for future etc. It is of vital importance that publicity as given before the public issue creating the right image about the company to attract the prospective investors through the newspaper and TV advertisements, Press releases, Press/Brokers conferences, leaflets and brochures, hoardings and posters and even audio-visual shows are the usual media of publicity used for public issue. There are some advertising agencies which specialise in advertising and publicity campaigns for public issue. They are known as Financial Advertising agencies. SEBI has laid down certain norms regarding issue advertisement, minimum advertisement matter and print size which must be kept in view.

7. Financial Institutions

Term lending institutions at the time of sanctioning underwriting support/term loans to the company usually stipulate that the draft to the prospectus and also the proposed programme for public issue is approved by them. Sometimes state financial institutions also stipulate the same, therefore, it is advisable to check the major loan covenants beforehand. The three principal All India Financial Institutions are the IDBI, IFCI and ICICI. Even when all the three institutions jointly finance a project under their participating finance scheme one of them is generally chosen as the lead financial institution which acts on behalf of the other two hence, it is generally adequate if the company obtains the necessary approval from the Regional office of the lead institution only in some cases where other institutions like the LIC, GIC, UTI etc. have also given financial assistance, it might be necessary to seek separate approvals from them, if required. Generally, an advance copy of

draft prospectus is sent to them with a request to forward their comments, if any, directly to the lead institution.

8. Other Agencies

The company also interacts with other agencies like auditors, legal advisers taxation or technical experts whose names or statement are mentioned or quoted in the prospectus.

9. Government/Statutory Agencies

Various statutory/government agencies that are connected with public issues are:

1. Securities and Exchange Board of India to whom the draft offer document/prospectus made out in accordance with the SEBI guidelines for disclosure and investor protection should be submitted for vetting.
2. Registrar of Companies of the State where the registered office of the company is situated with whom the prospectus has to be filed for registration before the public issue.
3. Reserve Bank of India from whom necessary permission has to be obtained from non-resident investment, if any, in the company
4. The stock exchanges where the company share/debentures are to be listed
5. The Central Secretariat for Industrial Approvals, Foreign Investment Promotion Board for approval, if any required.
6. Pollution control authorities and other local authorities from when the clearance may have to be obtained and such clearance should be referred to in the prospectus
7. Various other Government/Semi-Government agencies such as State Electricity Boards Bankers to the company as their consent and Account position in to be ascertained State Government for change of land, use subsidiary availability or for any other backward area and tax benefits availability etc.

Underwriting

The underwriters are the people who actually ensure that the company is able to raise the capital issued by it for a commission charged by them. They make a commitment to get the issue subscribed either by others or themselves. Usually, underwriters can be divided into two categories, namely, Financial Institutions and Banks, on the one hand, and broker underwriters and approved investment companies on the other. As per SEBI guidelines, the lead managers have to compulsory underwrite a minimum percentage of the issue. However, as per existing SEBI guidelines, it is not mandatory to underwrite the issue company may or may not get the issue underwritten.

- Mutual Funds have been allowed to underwrite the issue.

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- All underwriters have to be SEBI authorised.
- SEBI has framed rules in this regards.

The major players in the underwriting business are:

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- (a) Lead Managers, Co-Managers, Advisors etc. related with the issue
- (b) Banks
- (c) Central and state Financial Institution
- (d) SEBI authorised merchant Bankers
- (e) Brokers of the recognised Stock Exchange
- (f) Any other agency registered with SEBI

Under the relevant rules for the purpose while doing the underwriting the agencies concerned cannot exceed their exposure more than the limits specified in this regard. Therefore, certificate is taken in this regard from each underwriter. Based on which lead manager and company generally gives a statement in the prospectus that the sources of the underwriters are sufficient to meet their obligations.

The brokers of the recognised stock exchange have to obtain specific permission from their respective stock exchanges to underwrite the issue, which must be ensured by the company and the names of only those brokers should be included. Who have obtained such permission names of the brokers should be mentioned under their respective stock exchange centres. The maximum underwriting commission payable is 2.5% in case of equity shares.

However, the company may negotiate for less underwriting commission. No underwriting commission is payable on promoters quota or preferential allotment for employees/directors etc.

The managers to the issue will then write to the brokers along with a copy of draft prospectus/project profile and obtain draft letter of underwriting from then stating the amount of underwriting. SEBI while making out the rules/ regulations for underwriters has suggested a model underwriting agreement. The company is at option to underwrite that portion of issue which has been kept reserved for preferential allotment for various categories, however, it is a general practice to get this portion underwritten on contingent basis. No commission is allowed to be paid on this portion. However, the commission can be paid on portion left unsubscribed and merged with the public issue. The underwriting agreements are addressed to the company and the company has to accept the same and send the confirmation of the amount accepted to the respective underwrites. The company is also required to obtain a consent from the underwriters pursuant to the provisions of section 60 of the Act. The stockbrokers who are interested to underwrite the public issue should also be requested to send a copy of the permission of their respective stock exchanges to act as underwriter for the amount agreed by them as well as official brokers to the issue. This has now been the practice to safeguard against the blacklisted or defaulter stock brokers.

Bankers to the Issue

As discussed, the bankers to the issue play an important role in public issues. They receive applications with cheques/drafts/cash from the investors and acknowledge receipt thereof by stamping and returning the acknowledgement slips attached at the bottom of the application form. Depending upon the size of the issue at least 3 to 4 banks are designated as bankers to the issue. The branches of the bankers to the issue which are directly accountable to the company are called controlling branches and the branches which are under the direction of the controlling branches are known as collecting branches.

Functions of Collecting Branches

The functions of the controlling branches and collecting branches of the bankers to the issue are as follows:

- To receive instructions from the controlling branches for collection of application forms from the investors, informing them of the daily collection figures till the subscription list is closed, to receive information as to opening and closure of subscription list to transfer funds realised to controlling branch and forward the applications realised after tabulating them in the listing pad or along with computer control sheet.
- To receive stationery (application forms, prospectus, brochures bank schedules, posters, banners from the company).
- To affix rubber stamp of the branch under underwriting/broker column in the application.
- To acknowledge receipt of the application with proceeds by stamping and returning the acknowledgement slips attached at the bottom of the application form.
- To send for immediate clearing cheques/demand drafts received from the investors and to forward applications for which moneys realised to the controlling branches for further processing by the company.
- To send the applications back to the investors by registered post where cheques/drafts are returned dishonoured.
- To remit periodically the proceeds realised to the controlling branch.
- To issue certificate to the effect that no applications received by them have been realised and remitted to the controlling branches to enable the registrar to the issue for reconciling the applications collected and amount realised branch-wise.

Functions of Controlling Branches

- To issue consent letters to the company for acting as bankers to the issue.
- To attend meetings convened by the company for finalising list of collecting branches and for finalising the instruction manual.

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- To open separate bank account of the company to credit the proceeds realised from the investors against applications.
- To forward the instruction manual prepared by the company to all collecting branches with their instructions.
- To inform all collecting branches as to opening and closure of subscription list including extension if any of date of closure of the subscription list.
- To prepare a summary of daily collections made by them as also of their collecting branches and forward the summary to the company/registrar to the issue till the subscription list is closed.
- To hold in trust application money realised by them and collecting branches till the allotment of securities.
- To liaison with the registrar to the issue for communicating all particulars as would be required by them for processing the applications forms.
- To issue provisional final certificate indicating therein the total number of applications collected by them and their collecting branches and amount collected branch wise to reconcile the same by the registrar to the issue with their records and to furnish the same to the stock exchanges at the time of seeking their approval for allotment of securities.

Merchant Banking

A merchant bank is a bank whose function is provision of long term equity and loan finance for industrial and other companies' particularly new securities. Merchant banker acts as a financial intermediary in providing long term finance to the corporate. The merchant banks are called as investment banks in the US. The activities performed by merchant bankers include the following:

1. Management of issue of corporate securities of existing companies as newly floated companies
2. Offering financial expertise in mergers takeover, capital reorganisation to corporate sectors
3. Management of investment trusts
4. Handling insurance business
5. Loan syndication and corporate advisory services
6. Portfolio management
7. Custodial and Depository Services
8. Broking of corporate securities
9. Attraction of foreign investment
10. Liquidity management
11. Underwriting of securities

12. Bill discounting
13. Lease Financial
14. Arrangement of venture capital
15. Acting as trustees for debentures
16. Mobilisation of public deposits and managing fixed deposits etc.

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The scope of merchant banking activities has been expanding in India over the years. The recent changes in the Indian economy and financial markets has given further impetus to the faster development of merchant banking. Merchant banker benefit corporate clients in a number of way. They help in releasing valuable management time by looking into the legal and procedural complications involved in the securities issues and raising of loans. They also provide professionally competent advice to corporate clients. Merchant bankers also help in cultivating investment attitude and climate as well as financial innovativeness in the individual investors as well as corporate clients merchant bankers deal with individual and corporate clients. They require a high degree of integrity, transparency and accountability in their dealings with clients. Therefore, there is a need for the prudent regulation of the merchant banking activity. SEBI has been entrusted with the task of regulating the merchant banking it. It has provided for a code of conduct, specified obligations and responsibilities and is empowered to inspect the operation of merchant bankers.

Check Your Progress

3. What is the role of the registrars to the issue?
4. Who are underwriters?

1.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The objective of the Swarnjayanti Gram Swarozgar Yojana (SGSY) is to bring the assisted poor families above the poverty line by ensuring appreciable sustained level of income over a period of time.
2. Loan syndication refers to the services rendered by the financial service expert or firm in procurement of term loans and working capital facilities from financial institutions banks and other financing and investment firms for its clients.
3. The registrars to the issue, also known as issue house, are responsible normally for receiving the share applications from various collection centres through controlling branches of bankers to the issue, analysing them, recommending the basis of allotment to the Regional Stock Exchange for its

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approval, arranging for despatch of allotment letters and preparing the Register of Members etc.

4. The underwriters are the people who actually ensure that the company is able to raise the capital issued by it for a commission charged by them. They make a commitment to get the issue subscribed either by others or themselves.

1.5 SUMMARY

- Rural banking is banking that is done in an area that is not close to towns or cities, making it difficult for those who need to conduct banking business.
- Rural banking is a common practice in places where banking institutions are few and far between and people who need to carry out banking transactions may have difficulty finding a way to do so.
- The Regional Rural Banks were established on 2nd October 1975. The main objectives of these banks are to provide credit and other facilities particularly to small and marginal farmers and small entrepreneurs so as to develop agriculture trade, commerce industry and other productive activities in rural areas.
- Regional Rural Bank grant loans and advances to small farmers and agricultural labourers so that they can start their own farming activities including purchase of land, seeds and manure.
- A rural bank focuses on providing savings and credit services to people who live in rural areas.
- Project counselling includes preparation of project reports, deciding upon the financing pattern, appraising the project relating to its technical, commercial and financial viability.
- Loan syndication refers to the services rendered by the financial service expert or firm in procurement of term loans and working capital facilities from financial institutions banks and other financing and investment firms for its clients.
- The service is rendered on fee base and generally as a percentage on the loan amount syndicated. These services are rendered for both existing companies as well as new projects.
- Public issue of corporate securities as source of financing projects has gained tremendous popularity in the recent past.
- Due to the increased awareness on the part of an average investor of the advantages of investing his funds in shares and debentures, there is a rising trend in the issue activities of the capital market which has reached a level beyond the expectation of Government and stock exchange authorities.

- The manager to the issue is actively associated and plans the timing of the issue, strategies to be adopted by way of publicity and marketing of the issue etc. He advises the company on the selection of the registrars to the issue, Underwriters Brokers, Bankers to the issue, Advertising agents, printers etc. and also gives a sense of direction to the entire issue.
- The underwriters are the people who actually ensure that the company is able to raise the capital issued by it for a commission charged by them.
- The bankers to the issue are the commercial banks authorised by SEBI which will receive the share application money along with the share application forms from the prospective investors depending upon the size of the issue the number of the banks are designated as bankers to the issue
- A merchant bank is a bank whose function is provision of long term equity and loan finance for industrial and other companies' particularly new securities.

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1.6 KEY WORDS

- **Underwriting:** It is the process through which an individual or institution takes on financial risk for a fee.
- **Debentures:** They are medium- to long-term debt instruments used by large companies to borrow money, at a fixed rate of interest.
- **Brokers:** It refers to persons who buy and sell goods or assets for others.
- **Financial Institutions:** They are corporations that provide services as intermediaries of financial markets.

1.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Why were regional rural banks established in India?
2. What is project counselling?
3. List the activities involved in the syndication of loans.
4. Who are the brokers to the issue?

Long Answer Questions

1. Discuss the functions of Regional Rural Bank
2. Examine the activities of the rural banks.
3. Explain the functions of controlling and collecting branches.

4. Discuss underwriting. Who are the major players in the underwriting business?

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1.8 FURTHER READINGS

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UNIT 2 GROWTH OF RURAL BANKING IN INDIA

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Structure

- 2.0 Introduction
- 2.1 Objectives
- 2.2 Meaning, Importance and Implication
- 2.3 Need for Control: Types, Scope and Control Features
 - 2.3.1 Role of SEBI (Securities and Exchange Board of India) in Regulating Rural Banking Industry
 - 2.3.2 Role of National Stock Exchange of India (NSE)
 - 2.3.3 Role of OTC Exchange of India
- 2.4 Answers to Check Your Progress Questions
- 2.5 Summary
- 2.6 Key Words
- 2.7 Self Assessment Questions and Exercises
- 2.8 Further Readings

2.0 INTRODUCTION

In the previous unit, you were introduced to basic concepts of rural banking. In this unit, the discussion will turn towards the growth of rural banking in India. As you learnt, regional rural banks were established in India in 1975. Since then, regional banks have been set up at 21,398 locations throughout the country. This unit will discuss the role of SEBI in regulating rural banks, the need and types of control of rural banks as well as the role of the NSE and OTCEI.

2.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the role of the SEBI in regulating rural banking
- Explain the role of the NSE and OTCEI
- Describe the meaning and importance of rural banking

2.2 MEANING, IMPORTANCE AND IMPLICATION

Rural development has to play a vital role in the overall socio-economic development of a country like India, where the majority of the population lives in rural areas. The rural sector affects directly or indirectly almost all the economic activities in the country and provides employment to the maximum number of

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people. A large part of the revenue of the government is also generated from rural regions. The necessity of rural finance arose because moneylenders, landlords and traders etc. exploited farmers and small entrepreneurs by charging exorbitant rate of interest and forced farmer to sell their products at a low price to them. Rural people also face the risk of unpredictable production of crop due to high dependency on monsoon. They also suffer from lack of seeds, fertilisers, water supply and other facilities which lead to rural indebtedness.

In India, more than 70 per cent of the population live in rural areas. Obviously, in any development planning, rural development has to get a priority. Finance being the most important part of any development process, providing banking facilities drew the attention of the policy makers since independence. Cooperative banking structure made its appearance long before that in the British era in 1904 and the Reserve Bank in 1935. But the real effort in rural banking started in the 1950s with the All India Rural Credit Survey 1954. Subsequently the All India Rural Credit Review in 1969 introduced social banking for commercial banks, followed by bank nationalisation.

Role of Regional Rural Banking for Rural Development

Regional Rural Banks were established with the following responsibilities in mind:

1. Taking the banking services to the doorstep of rural masses, particularly in hitherto unbanked rural areas.
2. Identifying financial need especially in rural areas.
3. Making available institutional credit to the weaker sections of the society who had by far little or no access to cheaper loans and had been depending on private money lenders.
4. To enhance banking and financing facilities in backward or unbanked areas.
5. Mobilise rural savings and channelize them for supporting productive activities in rural areas.
6. To provide finance to the weaker sections of society like small farmers, rural artisans, small producer, rural labourers etc.
7. To create a supplementary channel for the flow of the central money market to the rural areas through references.
8. To provide finance to cooperative societies, primary credit societies, agricultural marketing societies.
9. Generating employment opportunities in rural areas and bringing down the cost of providing credit to rural areas.
10. Enhance and improve banking facilities to semi-urban, rural and other untapped market

With these objectives in mind, knowledge of the local language by staff is an important qualification.

Every Regional Rural Bank is authorized to transact the business of banking as defined in the Banking Regulation Act and may also engage in other business specified in Section 6(1) of the said Act. In particular, a RRB is required to undertake the business of:

1. Granting loans and advances to small and marginal farmers and agricultural labourers whether individually or in groups and to cooperative societies including agricultural marketing societies, agricultural processing societies, cooperative farming societies, primary agricultural credit societies, or farmers services societies, primary agricultural purposes, or agricultural operatives or other related purposes and
2. Granting loans and advances to artisans, small entrepreneurs and persons of small means engaged in trade commerce industry or other productive activities, within its area of operation.

The Reserve Bank of India has brought RRBs under the ambit of priority sector lending on par with the commercial banks. They have to ensure that forty per cent of their advances are accounted for the priority section. Within the 40% priority to get 25% should go to weaker section or 10% of their total advances to go to weaker section.

Regional Rural Banks in India

The State Bank of India is one of the major commercial banks having regional rural banks. These are 30 Regional Rural Banks in India, under the State Bank of India and it is spread across 13 states in India. The number of branches of SBI Regional Rural Banks is more than 2000. Several other banks, apart from the State Bank of India, also function as the promoter of rural development in India. The other Regional Rural Bank in India are:

Haryana State Cooperative Apex Bank Limited: The main purpose of the Haryana State Cooperative Apex Bank Limited is to financially assist the artisans in the rural areas, farmers and agrarian unskilled labour, and the small rural entrepreneurs of Haryana. Haryana State Cooperative Apex Bank Limited also referred as the HARCO BANK, is one of the apex organisations in the state of Haryana. The HARCO BANK holds a special economic position in the state of Haryana. The Haryana State Cooperative Apex Bank Limited offers several types of financial assistance to the individuals. The financial aids include credit for the promotion of agriculture, non-agrarian credit and bank deposit facilities. The HARCO BANK have been functioning as an investor for many decades.

National Bank for Agriculture and Rural Development (NABARD) is an apex development bank in India having headquarters based in Mumbai (Maharashtra) and other branches are all over the country. The committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD), set up the Reserve Bank of India (RBI) under the chairmanship of Shri B Sivaraman conceived and recommended the establishment of the National

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Bank for Agriculture and rural Development (NABARD). It was established on 12 July, 1982 by a special act of the parliament and its main focus was to uplift rural India by increasing the credit flow for elevation of agriculture and rural non-farm sector and completed its 25 years in 12 July, 2007. It has been accredited with matter concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas in India. RBI sold its stake in NABARD to the Government of India, which now holds 99% stake. NABARD is active in developing financial inclusion policy and is a member of the Alliance for Financial Inclusion.

The main purpose of the National Bank for Agriculture and Rural Development is to provide credit for the development and publicity of small scale industries, handicrafts, rural crafts, village industries, cottage industries, agriculture etc. The NABARD also supports all other related economic operations in the rural economic operations in the rural sector promotion of sustainable growth in the rural sector. The NABARD also plays the role of a contributor to the rural development by the means of promoting institutional development, facilitating reference to loan providers in the rural sector inspection, monitoring and evaluation of client financial corporations. National Bank for Agriculture and Rural Development (NABARD) was established as the premiere rural development bank.

Sindhaur Urban Souharda Cooperative Bank: The main purpose of the Sindhaur Urban Souharda Cooperative Bank is to provide financial support to the rural sector. The Sindhaur Urban Souharda Cooperative Bank is more commonly known as the SUCO Bank.

United Bank of India: The role played by United Bank of India (UBI) as one of the regional rural banks is phenomenal. The UBI has propagated the network of branches in order to actively take part in the rural improvement and development.

Syndicate Bank: The Syndicate Bank has its grassroots in the rural sector. The development of the Syndicate Bank was in accordance to the development of the banking sector in India and the Syndicate Bank has performed actively in the development of the small sector in India. The Regional Rural Banks in India has actively contributed to the growth of the rural sector. The growth of the rural industries in India and the development of the rural business and economy have been dependent largely on the investment and financial aids provided by the Regional Rural Banks in India.

Regional Rural Banks in Tamil Nadu: Indian Bank has sponsored two Regional Rural Banks (RRBs) viz Saptagiri Grameen Bank and Pallavan Grama Bank.

Pallavan Grama Bank with its Headquarters at Salem is operating in 14 districts of Tamil Nadu viz Salem, Namakkal, Krishnagiri, Dharmapuri, Villupuram, Cuddalore, Coimbatore, Karur, Erode, Nilgiris, Vellore, Tiruvannamalai,

Kancheepuram and Tiruvallur. The third RRB sponsored by Indian Bank is Pudukkottai Bharathiar Grama Bank at Union Territory of Puducherry with its headquarters at Puducherry.

Commercial Banks face high transaction cost in their rural branches. The problematic issues in rural banking of commercial banks are lack of infrastructure, reluctance of staff to serve in remote rural areas, large number of accounts dealing in small amounts, difficulty in getting financial information on rural borrowers leading to some amount of uncertainty in the minds of the bankers and lack of security for carrying cash in remote areas by mobile banking. Considerable amount of paper work requirement of multiple visits to the banks are other existing problems. As a result, farmers incur considerable transaction costs in obtaining bank loans. This state of affairs appears to be partly because of lack of effective enforcement of directives to the scheduled commercial banks and RRBs in simplifying procedures. In the context where banks are expected to play the role of providing credit counselling to the farming community, simplifying procedures and transparency in providing credit need special attention.

The problem areas observed by some studies are listed briefly below:

1. In spite of vast expansion of rural credit by banks, non-institutional credit still continues in the rural areas.
2. The credit deposit rate shows that despite the intermediation of banks, the ratio continues to be low in the rural area.
3. The all in costs of credit from banks, after factoring in timelines transaction costs and access appear high for agriculture relative to private corporate sector even after accounting for the risks as reflected by the level of actual non-performing assets.
4. The performance of some of the public sector banks in rural and agricultural lending is also inadequate, but that of most of the private and foreign banks is even lower, despite considerable expansion of the scope of priority sector lending.
5. Credit system in rural areas finds it difficult to cope with the rising demands of commercialized agriculture and in any case, there are few credible risk mitigation measures for the borrowers resulting in greater distress to the farmers in areas with significant presence of commercial crops.
6. Although there has been notable progress in micro finance, it is mostly confined to the states with fairly well-developed banking system. Further, the cost of credit at around 20 to 30% also appears high.
7. The cooperative credit system is, in most parts, dormant and it is commented that the three-tier structure helps finance the bureaucracy rather than benefiting the farmers. Similarly, in many parts of the country, RRBs are less active though in some others they are expanding.

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8. Although there has been significant growth in rural credit in the recent years, its medium-term sustainability is contingent upon growth in agriculture and improvements in the institutional settings.

The banks need to encourage agriculture by providing larger amount of term loans. Generally, the non-agricultural sector indirectly helps the rural economy in many ways keeping in view, the RRBs may enhance the percentage of loan to this sector. This finding may be of considerable use to rural banking institutions and policy makers in developing and shaping the appropriate credit structure as RRBs are integral part of the rural credit structure in India.

The importance of rural banking in the economic development of a country cannot be over looked. As Gandhi Ji said, “Real India lies in villages” and the village economy is the backbone of Indian economy. Without the development of economic planning cannot be achieved. Hence, banks and other financial institutions are considered to be a vital for the development of the rural economy in India. The main goal of establishing Regional Rural Banks in India is to provide credit to the rural people who are not economically strong enough, especially the small and marginal farmers, artisans, agricultural labourers and even small entrepreneurs.

2.3 NEED FOR CONTROL: TYPES, SCOPE AND CONTROL FEATURES

Control is the fundamental management function. It signifies the measurement and correction of the performance of subordinates in order to make sure that enterprise objectives and the plans devised to attain them are accomplished. Control consists in verifying whether everything occurs in conformity with the plan adopted, the instructions issued and principles established. It has for object to point out weaknesses and errors in order to rectify them and prevent recurrence. Control means to see that everything is done in accordance with the rules laid down and the instructions given control ensures work accomplishment according to plans.

The basis for control action is information. Information shows that a deviation has occurred and a complete analysis of the information is required to remedy the situation. If all these details are not available control will be meaningless and self-defeating. Control action can be taken only on the basis of reports and information, generally called as feedback. Feedback enables a manager to determine how far operations have gone in complying with plans and if there is any need for any corrective action.

Effective control calls for personal observation on the part of managers. Tools like budgets, charts, diagrams, statistical data reports and other devices of control and the newer and more sophisticated control machineries help visualize the nature of accomplishment. But the problem of control is still one of the measuring activities of human beings which necessitates personal attention.

Traditional control devices are called traditional because they have been used over the years as control techniques. The main traditional control devices are budgetary control, standard costing, financial ratio-analysis, internal audit etc.

Non-traditional devices are of relatively recent origin and have brought management control into sharper focus to improve quality control. Some of the non-traditional control devices are performance budgeting, zero base budgeting programme planning and budgetary system, responsibility accounting. Critical Path Method (CPM) Programme Evaluation and Review Technique (PERT) selective quality centre etc.

Traditional devices focus on non-scientific methods, whereas non-traditional devices are based on scientific methods and are more accurate.

A good control system fulfils the specific requirements of an enterprise. For instance, if a deviation is feared at a certain point and an organisation feels that it would need one week's notice to put the action plan back on rails, then the control system must provide for that one week's notice. If it does not incorporate that one week's notice in its set up, then it is not suitable for that particular organisation.

Managers are all individuals. They differ from one another, only as a group. They may differ greatly from another similar group in another organisation. A good control system should meet the personal requirements of these managers. Modern control system focus on workers rather than work or job. Control is good and effective only when people who handle material resources for results are involved. Where some corrective action is to be taken persons accountable for results are to be found to take remedial action. When an organisation shows enough interest in people, this kind of control through people yields better result.

Control is exercised through managers and as such they should reflect the organisation pattern. Each managerial position should be provided with adequate authority to exercise self-control and take corrective action.

Many a time in the name of modernity highly sophisticated control techniques are recommended for an organisation, without keeping in view organisation size, capacity and capability of managers to implement such a control programme obviously such a programme is only not good but is also likely to fail. Really good control involves tailoring control devices to suit the industrial plan, the organisation the specific needs of the enterprise and to personal requirements of the manager.

2.3.1 Role of SEBI (Securities and Exchange Board of India) in Regulating Rural Banking Industry

With a view to develop an effective and efficient monitoring and control system for Indian capital markets, the Government of India has passed the Securities and Exchange Board of India Act 1992. Under the provisions of the said Act, a Board was established in the name Securities and Exchange Board of India (SEBI).

SEBI is a body having perpetual succession and a common seal. It has the power to acquire, hold and dispose of movable and immovable property. It has

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the power to enter into contracts. It can sue and be sued in its name. The head office of SEBI is at Mumbai with power to establish offices at other places in India. SEBI shall consist of members appointed by the Central Government. The general superintendence direction and management of the affairs of SEBI Vest in Board of Members.

The SEBI and Government of India issued various rules, regulations and guidelines covering different aspects of operations and working of Indian Capital markets. Different Stock exchanges too have introduced improved methods and new operations. New rules, laws and byelaws have also been added by the stock exchanges authorities for effective control of the working of members of stock exchanges.

Powers of SEBI

SEBI has been obligated to protect the interests of the investors in securities and to promote, develop and regulate the securities market by such measures as it thinks fit. SEBI has been empowered in:

- Regulating the business in stock exchanges and any other securities market.
- Registering and regulating the working of stock brokers, sub brokers, share transfer agents, bankers to as issue trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediary who may be associated with securities markets in any manner.
- Registering and regulating the working of the depositories participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as SEBI may, by notification, specify in this behalf.
- Registering and regulating the working of venture capital funds and collective investment schemes including mutual funds
- Promoting and regulating self-regulatory organisation.
- Prohibiting fraudulent and unfair trade practices relating to securities markets.
- Promoting investors education and training of intermediaries of securities markets.
- Prohibiting insider trading in securities.
- Regulating substantial acquisition of shares and takeover of companies.
- Calling for information from undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds and other persons associated with the securities market and intermediaries and self-regulatory organisations in the securities market.
- Performing such functions and exercising such powers under the Securities Contracts (Regulation) Act 1956 as may be delegated to it by the Central Government.

- Laying fees or other charges for carrying out the purpose of this section.
- Conducting research for the above purposes.
- Calling from or furnishing to any such agencies as may be specified by SEBI such information as may be considered necessary by it for the efficient discharge of its functions.
- Performing such other functions as may be preserved.

For discharging these functions SEBI has been vested with powers of a civil court under the code of Civil Procedure 1908 while trying a suit in respect of the following matters:

- a) The discovery and production of stocks of account and other documents, at such place and such time as may be specified by SEBI.
- b) Summoning and enforcing the attendance of persons and examining them on oath and
- c) Inspection of any books, registers and other documents of any person referred to in Section 12.

2.3.2 Role of National Stock Exchange of India (NSE)

The National Stock Exchange of India Limited was promoted by IDBI, ICICI, IFCI, GIC, LIC, State Bank of India, SBI Capital Markets Limited, SHCIL and ILOFS as a Joint Stock Company under the Companies Act, 1956 on November 27, 1992. The Government of India granted recognition with effect from April 26, 1993 initially for a period of five years. The Government of India appointed IDBI as a lead promoter. To form the infrastructure of NSE, IDBI had appointed a Hong Kong Bound consulting firm M/s International Securities Consulting Limited for helping in setting of the NSE. The main objective of NSE is to ensure comprehensive nationwide securities trading facilities to investors through automated screen based trading and automatic post trade clearing and settlement facilities. The NSE encourages corporate trading members with dealer networks, computerised trading and short settlement cycles. It proposes to have two segments, one dealing with wholesale debt instruments and other dealing with dealer networks, computerised trading and short settlement cycles. It proposes to have two segments, one dealing with wholesale debt instruments and other dealing with capital market instruments. The Electronic Clearing and Depository System (ECDS) proposed to be set up by the stock Holding Corporation of India Limited (SHCIL) would provide the requisite clearing and settlement systems.

Features

The recommendations of the High Power Committee setting up of the National Stock Exchange, a Model Exchange at New Mumbai to act as a National Stock Exchange (NSE) would provide access to investors from all across the country on an equal footings, and work as integral component of the National Stock Market System.

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The NSE has the following features:

- NSE is promoted by Financial Institutions, Mutual Funds, and financed on a self-sustaining basis through levy of membership fees. The capital outlay of 30 crores of rupees could be financed by admitting 1000 members with an entry fee of ₹ 10 lakhs each. Fees for corporate and institutional members could be pegged at a higher level of ₹ 25 lakhs.
- NSE is a company incorporated under the Companies Act of 1956. It is constituted by the Board of Directors (Board) and managed by it. 50 per cent of the Managing Board of the Exchange should comprise of professionals who are not members. These professionals must be from a cross section of finance and industry and must actively contribute to ensuring that the stock exchange functions in a balanced and fair manner.
- It is trading on medium sized securities of equity shares and debt instruments.
- NSE receives full support from the National Clearing and Settlement divisions. SHCIL and the Securities Facilities Support Corporation. It is using modern computer technology for the clearance and settlement procedures.

Better Transparency System for the Securities

NSE provides nationwide computerised debt and stock trading facility to investors. NSE will operate in two segments i.e. the debt market and the capital market in the debt segment, there would be transactions in securities such as Government Securities, Treasury Bills, PSU bonds, Units of the UTI-64 Scheme of UTI, Commercial Papers (CP) and certificates of Deposits (CD). The capital market segment will cover trading in equities convertible/non-convertible debenture and hybrids; the existing permissible Repo-transactions Treasury Bills can now be routed through the NSE. This move is expected to provide a boost to trading in the secondary market for debt instruments.

National Stock Exchange is a fully automated exchange both in terms of trading in securities and settlement of transactions. NSE is different from other stock exchanges on the point that brokers registered in other stock exchanges are also the shareholders and therefore have a say in the management of such stock exchanges whereas with respect to NSE, financial institutions lead by IDBI would be the shareholders and would be allowed to trade on it just as brokers. Whole functioning as a model this stock exchange provide access to investors across the country. Brokers registered with any stock exchange in India are allowed to trade on NSE.

NSE provides nationwide stock trading facilities and equal access to investors from all over the country through a network of trading members all over the country without any trading floor. Each trading member can have a computer at his office anywhere in India which will be connected to the central computer at the exchange by a telecommunication link. Through this link the trading members enter their order for sale or purchases of soups in computer which is stacked in its memory.

The moment some other person enters his corresponding order for purchase or sale the deal is struck whole entering the order the member can enter various conditions or options subject to which he wishes to strike the deal. All the end of the day the computer will generate a list of transactions carried out by a member through the computer network. For striking the deal the trading member may specify limit on the price or the time period for which the order is valid.

The automatic trading and marketing system of NSE is very efficient and transparent as it assures the members the best price and the securities can be traded at the same price from anywhere in the country. Thus NSE provide good trading and investment opportunities increase the volume of trade and improve liquidity considerably.

Further, in order to expedite the settlement process so that the money/ securities are recovered on settlement day, a depository has been set up. As and when securities are sold and delivery made to the clearing system, they are transferred to a depository. Each trading member has a passbook account in the depository wherein securities deposited by the trading member are recorded. Every client of the trading member has a sub-account where records of shareholding client will be maintained. As and when delivery is made or received by each trading member, the passbook of the trading member and the client shall be updated by electronic book entry transfer the investor in whose account the securities are hold will be the beneficial owner of the securities and while the securities are kept with the depository. These remains absolute safety of securities against loss by theft and good delivery assured as there are no problems of unmatched signatures. Physical with drawl of securities from the depository are allowed for investors who wish to take physical possession of securities for whatever reason.

The NSE is different from the existing stock exchanges except OTCEI in the following aspects- dealing in the scripts will be on a screen base instead of the outcry system prevalent on other stock exchanges. Any broker registered with any stock exchange in the country will be allowed to trade on NSE. The electronic exchange works on international lines and prove a boon for investors. Presently, brokers registered with other exchanges are also their shareholders, but in case of NSE, financial institutions would be the shareholders and brokers are allowed to trade on it just as brokers. In other words, NSE is operated by non-members and without being influenced by the brokers.

2.3.3 Role of OTC Exchange of India

The OTC Exchange of India (OTCEI) has been set up to provide a cost effective and convenient platform for raising finance from the capital market. OTCEI was promoted by a consortium of financial institutions and it started its operations in 1992. It is a ringless electronic nationwide stock exchange committed to providing entrepreneurs with a smooth economical vehicle for going public, and investors with a fair stable and efficient market. Thus the OTCEI brings investors and promoters closer together.

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In OTCEI there are two Product Segments– Listed Segment Comprises of Securities which are listed on OTCEI and Permitted Segment Comprises of Securities which are listed on other Stock Exchanges but are permitted for trading on OTCEI.

Features

The important features of OTCEI are as follows:

- **Nationwide Listing:** The OTC exchange is spread all over India through member, dealer and representative, office counters. Hence by listing on just one stock exchange, the company and its products get nationwide exposure and investors all over India can start trading in that scrip.
- **Sponsorship:** The companies that seek listing on the OTC exchange have to approach one of the members appointed by the OTC for acting as the sponsor to the issue. The sponsor appraises the project. By entering into the sponsorship agreement, the sponsor is committed to market in that scrip by giving a buy/sell quote for a minimum period of 1½ years. Investors are benefited by this as it enhances the liquidity of the soups listed on the OTC Exchange.
- **Bought-out Deals:** Through the concept of bought-out deals OTC allows companies to place its equity meant to be offered to the public with the sponsor-member at a mutually agreed upon price. This ensures swifter availability of funds to companies for timely completion of projects and a listed status at a later date.
- **Listing of Small and Medium Sized Companies:** In the past many small and medium sized companies were not able to enter the capital market, due to the listing requirement of the Securities Contracts (Regulation) Act 1956 that specifies a minimum issued equity capital of ₹ 3 crores. The OTC Exchange provides an ideal opportunity to these companies to enter the capital market. In fact, any company with a paid up capital of more than ₹ 30 lakhs and less than ₹ 25 crores can raise finance from the capital market through the OTC Exchange.
- **Liquidity through Market Making:** The sponsor member is required to give two-way quotes (buy and sell) for the scrip for 18 months from the date of commencement of trading. Besides the compulsory market maker, there is an additional market maker and voluntary market makers who give two way quotes for the scrip. Competition among market produces efficient pricing, reduces spreads between buy and sell quotations and increases the capacity to absorb larger volumes. The market makers continually analyses companies and provide information about them to their investors, thus intensifying investor interest.
- **Ringless and Screen-based Trading:** For the first time in India, the OTC Exchange has introduced automated, screen based trading in place of the

traditional trading ring found in other stock exchanges. The network of on-line computers provides all relevant information on the computer screens of the market participants. Allowing them the luxury of executing their deals from the comfort of their own offices.

- **Transparency of Transactions:** At the OTC Exchange, the investor can see the available quotations on the computer screen at the dealer's office before placing the order. The confirmation slip/trading document generated through the computer gives him the exact price of the transaction and the brokerage charge. So the investors' interest is totally safeguarded. This system also ensures that transactions are done at the best prevailing quotation in the market.
- **Faster Delivery and Payment:** On the OTC Exchange, the transaction is settled within an incredibly short span of 7 days. Which means, the investor actually gets the delivery of the Scrip or the payment for the scrip sold within 7 days.
- **Technology:** The most distinguishing characteristic of the OTC Exchange is its state of the art technology. The OTC Exchange uses computers and telecommunications technologies of the information age to bring members/dealers together electronically, enabling them to trade with one another over the computer rather than on a trading floor in a single location. All the information needed for trading is in the open and easily accessible on the OTC computer screen, by going into the respective units.

The eligibility criteria for listing says that the issued equity capital of the company should be between ₹ 30 lakhs and ₹ 25 crores. The company should make a minimum office of 25 per cent of its capital or ₹ 20 lakhs in face value, whichever is higher. The company should not be listed on any other stock exchange in India.

Benefits

The benefits which OTC Exchange offer are:

To Companies

- a) Provide a method of raising funds through capital market instruments which are priced fairly. In OTC the company is able to negotiate the issue price with the sponsors who market the issue.
- b) Save unnecessary issue expenses on raising funds from capital markets. Almost all associated costs are eliminated.
- c) Retain greater degree of management stability OTC Exchange list scrips with 20% of the capital made available for public trading.
- d) Provide greater accessibility to large pool of captive investor base-enhancing fund raising power substantially. OTC Exchange create a nationwide network

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where investors are serviced and form the captive investor base for companies.

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To Investors

- a) Investment in stock has become easier with the OTC Exchange's wide network.
- b) Provides greater confidence and fidelity of trade investor can look up the prices displayed at each OTC Counter and the investor can trade scrips at the right market price.
- c) Enables transactions to be completed quickly. Investors can settle the deals across the counter and the money or scrip proceeds from the deal are settled in a matter of days.
- d) Provide definite liquidity to investors and there is sufficient opportunity to exit.
- e) Investor get a greater sense of security because all scrips are researched.

Check Your Progress

1. What is the main purpose of Haryana State Cooperative Apex Bank Limited?
2. What is control?
3. Why was the OTC Exchange of India (OTCEI) set up?

2.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The main purpose of the Haryana State Cooperative Apex Bank Limited is to financially assist the artisans in the rural areas, farmers and agrarian unskilled labour, and the small rural entrepreneurs of Haryana.
2. Control is the fundamental management function. It signifies the measurement and correction of the performance of subordinates in order to make sure that enterprise objectives and the plans devised to attain them are accomplished.
3. The OTC Exchange of India (OTCEI) has been set up to provide a cost effective and convenient platform for raising finance from the capital market.

2.5 SUMMARY

- Rural development has to play a vital role in the overall socio-economic development of a country like India, where the majority of the population lives in rural areas.

- The rural sector affects directly or indirectly almost all the economic activities in the country and provides employment to the maximum number of people.
- Every Regional Rural Bank is authorized to transact the business of banking as defined in the Banking Regulation Act and may also engage in other business specified in Section 6(1) of the said Act.
- The State Bank of India is one of the major commercial banks having regional rural banks. These are 30 Regional Rural Banks in India, under the State Bank of India and it is spread across 13 states in India.
- Commercial Banks face high transaction cost in their rural branches. The problematic issues in rural banking of commercial banks are lack of infrastructure, reluctance of staff to serve in remote rural areas, large number of accounts dealing in small amounts, difficulty in getting financial information on rural borrowers leading to some amount of uncertainty in the minds of the bankers and lack of security for carrying cash in remote areas by mobile banking.
- The banks need to encourage agriculture by providing larger amount of term loans. Generally, the non-agricultural sector indirectly helps the rural economy in many ways keeping in view, the RRBs may enhance the percentage of loan to this sector.
- Control is the fundamental management function. It signifies the measurement and correction of the performance of subordinates in order to make sure that enterprise objectives and the plans devised to attain them are accomplished.
- With a view to develop an effective and efficient monitoring and control system for Indian Capital Markets. Government of India has passed the Securities and Exchange Board of India Act 1992.
- The National Stock Exchange of India Limited was promoted by IDBI, ICICI, IFCI, GIC, LIC, State Bank of India, SBI Capital Markets Limited, SHCIL and ILOFS as a Joint Stock Company under the Companies Act, 1956 on November 27, 1992.
- NSE provides nationwide stock trading facilities and equal access to investors from all over the country through a network of trading members all over the country without any trading floor.
- The OTC Exchange of India (OTCEI) has been set up to provide a cost effective and convenient platform for raising finance from the capital market. OTCEI was promoted by a consortium of financial institutions and it started its operations in 1992.

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2.6 KEY WORDS

- **Scripts:** It is a provisional certificate of money subscribed to a bank or company, entitling the holder to a formal certificate and dividends.

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- **OTCEI:** It is an electronic stock exchange based in India that consists of small- and medium-sized firms aiming to gain access to the capital markets like electronic exchanges in the U.S.
- **NSE:** It is India's largest financial market. Incorporated in 1992, the NSE has developed into a sophisticated, electronic market, which ranked fourth in the world by equity trading volume in 2015.
- **NABARD:** It is an apex development financial institution in India entrusted with 'matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas in India'.

2.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What is the main purpose of NABARD?
2. What are the benefits of the OTC Exchange of India?
3. Write a short-note on the role of the NSE.
4. Why is control needed in management?

Long Answer Questions

1. Discuss the various regional rural banks in India.
2. Examine the features of OTCEI.
3. Describe the role of the SBI in regulating rural banking.

2.8 FURTHER READINGS

- Ram Jitendra. 2015. *Regional Rural Banks of India: Evolution, Performance and Management*. Gurgaon: Partridge Publishing.
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UNIT 3 PROJECT RELATED ACTIVITIES OF A RURAL BANKER

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Structure

- 3.0 Introduction
- 3.1 Objectives
- 3.2 Project Activities
- 3.3 Corporate Counselling
 - 3.3.1 Organizational Goals
- 3.4 Loan Syndication: Meaning and Scope
 - 3.4.1 Steps in Loan Syndication
- 3.5 Answers to Check Your Progress Questions
- 3.6 Summary
- 3.7 Key Words
- 3.8 Self Assessment Questions and Exercises
- 3.9 Further Readings

3.0 INTRODUCTION

As has been discussed in the previous units, rural banking is being promoted by the Indian government with great impetus being given to this sector. Various rural banks have been set up in different parts of the country with this objective in mind. Pradhan Mantri Jan Dhan Yojana is one of the recent initiatives by the new government which has definitely contributed to bring banking to every household. These efforts have helped to direct the agriculture driven economy towards modernization. This unit will help you understand the project related activities of a rural banker, corporate counselling, categories of organizational goals, meaning, scope and steps involved in loan syndication.

3.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the project related activities of a rural banker
- Explain the concept of corporate counselling
- Describe the categories of organizational goals
- Define the scope of loan syndication
- List the steps involved in loan syndication

3.2 PROJECT ACTIVITIES

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The appraisal of a project involves a thorough investigation into the project by a financial institution which is not connected to the entrepreneur. The appraiser would evaluate the objectives of the entrepreneur in the right perspective. It would involve the consideration of the input data, analyse the data product outcome and measure the attainability of the objectives of the project.

The project appraisal can be termed as an independent examination of the project concerned by the entrepreneurs. The appraisal of the project is done to make a second look on the assumptions made and to reassess the future projections given by the promoters. Project appraisal is primarily intended to evaluate the project from various facts to indicate the viability of the project. A project appraisal involves a study of all aspects of the project including the product to be manufactured, technical process involved in manufacturing, availability of infrastructure, plant and machinery, technology and its adaptability to the local conditions, availability of utilities, raw material, availability of skilled manpower, marketing facilities and arrangements, proximity to the markets and overall prospects of the market.

The financial institutions appraise the project to ensure the technical feasibility, environmental and economic viability, financial and commercial viability, managerial competence of the promoters and their background. The financial institutions use their knowledge and expertise to assess the overall position of the project and decide whether the project is viable for consideration or not. The financial institutions take a decision regarding the provision of financial assistance to the project after a thorough project appraisal and after carefully considering the results of the project appraisal.

The various steps involved in project appraisal are as follows:

- 1. Financial Feasibility:** The basic data required for a financial feasibility analysis can be grouped as under:
 - o Cost of project and means of financing
 - o Cost of production and profitability
 - o Cash flow estimates during currency of loans
 - o Proforma balance sheet as at the end of each financial year during period of loan.

Cost of the Project

The cost of the project can be broadly classified into the following:

- **Land and Site Development:** It includes the cost of the land, conveyance expenses, premium payable on leasehold land, cost of levelling the site and other site development expenses, cost of internal roads, cost of fencing and compound wall and cost of providing gates etc.

- **Building and Civil Works:** It includes construction cost of the main factory building, building of auxiliary services, factory administrative building, storehouse, workshops, godowns, warehouses, open yard facilities, canteen, workers rest rooms, sanitary works, staff quarters and so forth.
- **Plant and Machinery:** It includes the cost of main plant and machinery, stores and spares, auxiliary equipment, transportation cost, installation cost, cost of test runs, foundation cost, cost of erection and commissioning.
- **Technical Knowhow and Engineering Fees:** It includes fees payable to provide the technology and knowhow and travelling expenses payable to technicians and foreign collaborators.
- **Miscellaneous Fixed Assets:** It includes the cost of office furniture and equipment like tables, chairs, air conditioners, water coolers, miscellaneous store items and others.
- **Preliminary and Preoperative Expenses:** The preliminary expenses includes the cost of raising finances like public issue expenses, commission and fees payable to brokers and consultants in raising term loans, expenses incurred for incorporation of the company, legal charges, underwriters commissions, cost of advertising the public issue etc. The preoperative expenses include salaries, establishment expenses, rent, trial run expenses and other miscellaneous expenses incurred before the commercial production.
- **Provision for Contingences and Escalation:** It includes the provision for meeting the unforeseen expenses and costs not provided on the other heads of the cost of the project. It also includes the cost of escalation of the major heads of cost like land and site development building and civil works, plant and machinery, technical knowhow fees and others.
- **Working Capital Margin:** The working capital margin required for the project which is not being financed by the banks will also be included in the cost of the project.

Though machinery cost often constitutes a major element in the total project cost, its estimation need not pose major problems since this can be based on competitive quotations. On the other hand, cost of items such as land, site development expenses ancillary facilities like water and power connections, intangibles like preliminary expenses and preoperative expenses necessitate a careful inquiry and assessment. A realistic assessment of project cost with built in cushions for absorbing normal cost escalations, could take care of the consequences of delay and cost overrun.

Means of Financing

There is no ideal pattern concerning means of financing for a project. The means of financing is determined by a variety of factors and considerations like magnitude of funds required, risk associated with the enterprise, nature of industry, prevailing taxation laws and others.

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The following are the sources of finance:

- Share Capital
- Subsidies
- Long term borrowing from financial institutions and banks
- Loans from friends and relatives
- Retained earnings

Financial institutions specify certain debt equity ratios and promoters will have to raise their own finance to match these ratios.

Cost of Production and Profitability

The next step is the assessment of the earning capacity of the project. The unit should be in a position to manufacture the product at a reasonable cost and sell them at a reasonable price which would allow adequate profit margin even in a competitive market. The profitability of an enterprise depends on the total cost of production and the aggregate sale price of the output. The cost of production and sale estimates are also useful in working out the breakeven point. The point at which the income sales would cover the working costs of the project. At this point the unit begins to make profit.

Cash Flow Estimates

The cash flow estimates are essential to ensure availability of cash to meet the requirements of the project from time to time. The cash flows estimates will show funds including repayment of term loan instalments. The debt service coverage ratio is arrived at by dividing cash accruals comprising net profits (after taxes, interest on term loans and depreciation added back) by total interest charges and instalments. This will indicate whether the cash flows would be adequate to meet the debt obligations and also provide sufficient margin of safety. The repayment of term loans being drawn taking into consideration the above aspect.

Proforma Balance Sheets

Proforma balance sheets are drawn for existing concerns doing expansion as well as for new projects. However, in the case of existing concerns going for expansion the balance sheets for the past three years are also analysed and compared with the projections. The projected balance sheets can be drawn for the cash flows estimates and profitability projections. Various ratios are derived from the balance sheets and inferences drawn therefrom.

- 2. Technical Competence:** The technology may be indigenous or imported through foreign collaborations. In the case of indigenous technology, it should be ensured that suitable technical personnel are available. For technology acquired through collaboration tie-ups the key areas to be considered are the following:

- The standing of the collaborators and past experience concerning tie-up arrangements with them.
- Adequacy of the scope and competitiveness of the terms of the collaboration in relation to the requirements of the project, project engineering equipment specifications, drawings, process knowhow, erection and commissioning of the plant trial operations and performance test training facilities.
- Performance guarantee and its adequacy in relation to rated capacity of plant and machinery.
- Reasonableness of financial and other costs by way of down payment royalties and so forth.

The cost of the project should provide for the knowhow fee, training expenses, foreign trips and others.

The project needs to be examined with particular reference to the following points regarding the technical feasibility are as follows:

- **Location:** The success of a project generally depends on its proper location yielding the advantages of nearness to the sources of raw materials, labour availability of power and transport facilities and market. The subsidies and other concessions available at certain specified areas are to be compared with these basic infrastructural aspects.
 - **Land and Building:** The land should necessarily be sufficient to take care of future expansion. If the land is on lease then the terms and conditions of the base should be verified and as well as the municipal laws regarding constructions of building. Actual plant layout is to be studied before deciding the size of the building.
 - **Plant and Machinery:** The important aspect to be noted in examining the list of plant and equipment is to ascertain the appropriateness of the process of technology, capacity and the related sectional balances amongst various assembly lines. It has to be ensured that the cost of equipment is based on proper quotations from suppliers and that suitable provisions have been made for insurance, freight, duty and transportation to site, erection charges and allied expenses. Adequate provision for spare parts is also essential especially if the some have to be imported.
- 3. Economic Feasibility:** Economic feasibility basically deals with the marketability of the product. Basic data regarding demand and supply of a product in the domestic market is needed. Manmade shortages are not to be reckoned as genuine demand and the market analysis is an essential part of a full appraisal. Projection or forecasting of demand is no doubt a complicated matter but is of vital importance. Equally important is to examine the sales promotion proposed by the enterprise and its adequacy.

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Managerial Competence

The success of a business enterprise depends largely on the resourcefulness competence and integrity of its management. However, assessment of managerial competence has to be necessarily qualitative, calling for understanding and judgment. The managerial requirements are the experience and capability of the principal promoters to implement and run the project. The adequacy of the management set up for day to day operations like production, maintenance, marketing, finance and so forth and also the homogeneity of the management set up. For a new entrepreneur it will always advisable to build up a competent team of specialists in the required discipline to join hands with an entrepreneur who has the requisite organizational and managerial expertise in the implementation and operation of the project.

Project approach could be applied for a small investment or a large investment. It is a flexible approach to development wherein each project is considered to be an independent unit having its own costs and benefits. Careful project preparation and analysis is important for efficient use of financial resources. In the liberalized environment and in the wake of financial section reforms, the importance of project approach has increased. Project approach is an important approach in economic and developmental activities. Project basically means an investment activity in which financial resources are expended to create capital assets that produce benefits over an extended period of time and which logically lends itself to planning, financing and implementing as a unit. There are several advantages of project approach including utility in prioritizing resource allocation and ease of monitoring and evaluation. But there are a few limitations of the approach including inability to estimate realistic values of costs and benefits for the future which is uncertain.

3.3 CORPORATE COUNSELLING

Corporate counselling refers to the activities performed by the merchant banks to provide expertise knowledge to a corporate entity to ensure better performance and also to portray a better image to investors resulting from distribution of dividend and ensuring appreciation in market value of its equity shares.

Corporate counselling denotes the advice provided by merchant banking to the corporate unit to ensure better corporate performance in terms of image building among investors steady growth through good working and appreciation in market value of its equity shares. The scope of corporate counselling, capital restructuring and portfolio management and the full range of financial engineering includes venture capital, public issue management and loan syndication, working capital, fixed deposit, lease financing, acceptance credit and so forth. However, counselling is limited to only opinions and suggestions and any detailed analysis would form part of a specific service.

The scope of corporate counselling is restricted to the explanations of concepts, procedures and laws to be observed by the client's company. Requirement of any action to be taken or compliance of statutory formalities to be made for implementation of those suggestions would mean the demand for a specific type of service other than corporate counselling being offered by the merchant bankers. An academic analysis of corporate counselling presents a different picture than that transpires from the literature of the merchant bankers. Firstly, corporate counselling is the beginning of the merchant banking service which every client whether new or existing (separately) for rendering the corporate counselling service or includes the element of fee in the other heads of services but from the angle of priority. Corporate counselling is first in line of the services which a merchant banker offers and other services.

Secondly, the scope of corporate counselling is very vast. Its coverage ranges from the managerial economics investments and financial management to corporate laws and the related legal aspects of the organizational goals, location factors, organizational size and operational scale, choice of product and market survey, forecasting of product, cost reduction and cost analysis, allocation of resources, investment decisions, capital management and expenditure control, pricing methods and marketing strategy. As a financial and investment expert, a merchant banker has to guide the corporate clients in areas covering financial reporting, project measurements, working capital management, financial requirements and the sources of finance, evaluating financial alternatives, rate of return and cost of capital besides basic corporate changes of financial rearrangement. Reorganization, mergers and acquisitions and so forth are the areas to be covered.

3.3.1 Organizational Goals

Organizational goals or objectives are the ends towards which the activities of an organization are directed and the standards against which the performance is assessed. The managerial objectives of an organization can be classified into these major categories.

1. Organizational Objectives

Organizational objectives aim at prosperity and growth of the organization. Generally, it is assured that profit maximization is the main objectives of every organization but it is not true. The managers try to develop and attain variety of objectives in all management areas which reduces cost and brings maximum prosperity for the organization. Drucker was the first to point out the objectives of survival, growth, profit and social objectives. Drucker has suggested the following concrete and meaningful objectives for an organization.

- a) **Market Standing:** It refers to the share and position of the company in the market. The management always aim at maximizing the share and getting control over large share of market in comparison to the competitor by increasing sales in enterprises in the same industry. Concepts of productivity

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of machines and of individual workers have been developed which can measure overall productivity.

- b) Physical and Financial Resources:** The management sets objectives with regard to the use, acquisition and maintenance of capital and monetary resources so that there is sufficient capital available and there is no wastage of financial resources.
- c) Profitability:** Earning adequate amount of profit is one of the important organizational objectives of the management. Managers always assess various investment proposals on the basis of return of each investment proposal for the organization. Every company sets up its profit earning rate, which leads to growth of the organization.
- d) Management Performance and Development:** The management should set up objectives to assess the managerial productivity and growth. The achievement of different objectives of the organization helps in assessing the productivity of managers and developing techniques for performance appraisal of individual managers. Training programmes for developing future managers to replace the existing managers as and when they leave the organization or allied matters would be meaningful and attainable. The success and failure of every company depends upon the managerial efficiency of that company.
- e) Workers performance and attitude:** Workers performance and attitude are vital components for the prosperity and even survival of the organization in the long run. Management make use of statistical information with reference to labour. Turnover absenteeism, accidents, grievances, suggestions and so forth are used to measure attitude of workers towards management. The management develops positive attitude of workers as human resources are one of the most important resources of every company.
- f) Public Responsibility:** The management should set up objectives which fix the responsibility of company towards its customers and society. As organizations are the part of society these cannot exist in isolation. So they must do something for upliftment of society.

2. Social Objectives

Social objectives of the organization deal with the commitment of the organization towards the society. Business organizations are part of society. They earn by using the resources of society, so they must do something for the society as well. The major social objectives of the organization are the following:

- (i) Supply of quality products at reasonable price
- (ii) Contribution towards desirable civic activities
- (iii) Generation of economic wealth
- (iv) Generation of employment opportunities

- (v) Financial support to community
- (vi) Organizing educational, health and vocational training programmes
- (vii) Participating actively in social source projects of government and NGOs

3. Individual Objectives

Individual objectives are related to the employees of the organization. As employees are most important resources of every company consequently, satisfied and motivated employees contribute the maximum for the organizations. The main individual objectives of management are the following:

- (i) Competitive salary
- (ii) Personal growth and development (promotion, training and other factors)
- (iii) Peer recognition, self-respect and respect for colleague
- (iv) Social reorganization
- (v) Good and healthy working conditions

Workers may lose interest in fulfilling the objectives assigned to them. The management must try to integrate the personal objectives with the organizational objectives.

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3.4 LOAN SYNDICATION: MEANING AND SCOPE

A syndicated loan is an essential source of debt financing for corporate loan syndication refers to the services rendered by the financial service expert or firm in procurement of term loans and working capital facilities from financial institutions banks and other financing and investment firms for its clients. It is, thus, availed from a group of lenders include commercial banks, Government Funding Institutions, International Banks and Non-banking Finance Companies (NBFCs) and so forth. They constitute a syndicate to offer loan facility. Syndicated loans provide funding for large scale and capital intensive projects, for instance, infrastructure projects, oil and gas projects, manufacturing projects and so forth. Moreover, banks also participate in this loan syndication transaction to ensure risk mitigation and large exposure.

Syndicated form of raising finance came into existence when the size of individual loans got bigger and banks thought fit to share the risks with other lenders. The concept of sole bankers was no longer feasible when a large amount of funding was involved. Moreover, the syndicated mode of financing has two important features, namely, amount (risks) and administrative saving (documentation to be one principal lender). There will be one principal lender who will finance and the other participant lenders in the syndicate will share the risks in a predetermined share. The government of countries as well as the corporate sector tap the syndicated loan route.

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As the size of the individual loans increased, individual loans found it difficult to take the risk single handedly. Regulatory authorities in most countries limit the size of the individual exposures. Hence, the practice of inviting other banks to participate in the loan, to form a syndicate, came into being, thus, the term syndicated loans. A syndicate is a general term describing any group that is formed to conduct some type of business, for example, a syndicate may be formed by a group of investment bankers who underwrite and distribute new issues of securities or blocks of outstanding issues. Syndicates can be organized as corporation or partnerships. A syndicate only works together temporarily. They are commonly used for large loans or underwritings to reduce the risk that each individual firm must take on.

A loan syndicate refers to the negotiation where borrowers and lenders sit across the table to discuss about the terms and conditions of lending. At present, large groups of banks are forming syndicates to arrange huge amount of loans for corporate borrowers. The need for syndication arises as the size of the loan is huge and a single bank cannot bear the whole risk of lending. Also the corporate going for the issue is not aware about the banks which are willing to lend. Hence, syndication assumes significance. In the case of syndication, the risks get diversified.

A syndicated loan or syndicated bank facility as a large loan, in which a group of banks work together to provide funds for a borrower. There is usually one lead bank that takes a percentage of loan amount and syndicates the rest to other banks. The loan syndication work involves identification of sources from where funds would be arranged. These sources with requisite application and supporting documents and complying with all the formalities involved in the sanction and disbursement of loan. A syndicated loan is the opposite of a bilateral loan, which only involves one borrower and one lender—often a bank or financial institution. Syndicated loans provide borrowers with a more complete menu of financing options. In effect, the syndication market completes a continuum between traditional private bilateral bank loans and publicly traded bond market.

The process of syndication starts with an invitation for bids from the borrower. The borrower mentions the funds requirement, currency, tenor and so forth. The mandate is given to a particular bank or an institution that will take the responsibility of syndicating the loan by arranging for financing the banks. The syndication is given to a particular bank or an institution that will take the responsibility of syndicating the banks. The syndication is available for both, fund-based facilities as well as non-fund based facilities like letters of credit and documentary credits. As the syndicated loans are arranged a little quickly, these are popular with corporate entities. The fees payable on syndicated loans consists of management fees payable by the borrower on signing the loan documents or on first draw down, commitment fees payable, underutilized portion of the loan during the period when the loan was available and fees payable to the principal bank who has arranged for syndication to cover all their administrative expenses.

Benefits of Syndicated Loans

Let us first look at the benefits of syndicated loans for borrowers.

For Borrowers

- The total cost of borrowing is less
- Funding from multiple sources
- New banking relationships
- Ease of documentation
- Flexible Term and Conditions

For Lenders

- Diversified customer base
- Risk allocation among different companies
- Optimize risk and returns
- Limits exposure to a particular corporate group
- Develop new customer base

Parties to a Syndicated Loan Agreement

The parties of the syndicated loan agreement are as follows:

Lead Manager/Arranger

This term refers to those who receive an authority from the borrower to form a syndicate for the required loan. Normally, it is a bank which is mandated by the prospective borrower and is responsible for placing the syndicated loan with other banks and ensuring that the syndication is fully subscribed. This bank charges arrangement fees for undertaking the role of the lead manager. Its reputation matters in that the participating banks would agree or disagree based on the credibility and assessment expertise of this bank. In other words, since the appraisal of the borrower and its proposed venture is primarily carried out by this bank, the onus of default is indirectly on this bank. Thus, bank carries reputation risk in the syndication process.

Underwriters

These banks including the lead bank will underwrite the total amount of the facility and will try to get banks to take up the entire share of loan including them but with no share or even major share. The arranger bank may underwrite to supply the entire unsubscribed portion of the desired loan and in such a case arranger itself plays the role of underwriting bank. Alternatively, a different bank may underwrite (guarantee) the loans or portion percentage of the loan. This bank would be called the underwriting bank. It may be noted that all the syndicated loans may not have this underwriting arrangements. Risk of underwriting is obviously the underwriting risk. It means it will have to carry the credit risk of the larger portion of the loan.

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Co-Manager

They have to participate but with a lesser share than that of the leader. Co-manager takes care of the administrative arrangements over the term of the loan, for example, disbursements, repayments and compliance. It acts for and on behalf of the banks. In many cases, the arranging/underwriting bank itself may undertake this role. In larger syndication's co-arrangers may be used.

Participants

All those banks/lenders who participate in the syndicated programme, as well as the leader/underwriter would try to see that it is fully allocated. These banks charge participation fees. These bank carry mostly the normal credit risk i.e., risk of default by the borrower as like any other normal loan. These banks may also be into passive approval and complacency risk. It means that these banks may not carry rigorous appraisal of the borrower and has proposed project as it is done by the lead manager and may other participating banks. It is this banker's trust that so many high profile banks cannot be wrong. This may be seen in the light of reputation risk of the lead manager.

Creator of Memorandum of Information

Lead Manager/Arranger who will undertake to formulate the memorandum based on the financial and other details of the borrower which function including agreeing to the memorandum publishing and arranging and signing the same and the final documentation.

Principal Documentation Agreement

It is the responsibility of the lead manager to get it drafted and get it approved from all participants and is signed by all the participating banks and the borrower. The agreement gives the details of loan or the facility, its nature, amount purpose, maturity, amortization draw-down arrangement, interest of all types of fees, warranties, undertaking law and its justification, default rules and others.

3.4.1 Steps in Loan Syndication

There are three stages or steps in syndication:

1. Pre-mandate stage

This is initiated by the prospective borrower. It may liaise with a single bank or it may invite competitor's bids from a number of banks. The borrower has to mandate the lead bank and the underwriting bank, if desired. Once the lead bank is selected and mandated by the borrower, the lead bank has to undertake the appraisal process, the lead banks needs to identify the needs of the borrower, design an appropriate loan structure and develop a persuasive credit proposal.

2. Placing the Loan and Disbursement

At this stage, the lead bank can start to sell the loan in the market place, i.e., to prospective participating banks this means that the lead bank needs to prepare a memorandum, prepare a term sheet, prepare legal documents, approach selected banks and write participation. A series of negotiations with the borrower are undertaken, if prospective participants raise concerns. To conclude, at this stage the lead bank must achieve closing of the syndication, including signing. If need be, underwriting bank has to sign the balance portion of the loan. Loan is disbursed in phases as agreed in the loan contract. Loan is disbursed in a bank account created exclusively to disburse loan. This account and its withdrawals are monitored by banks. This is to ensure that the loan is used only for the purpose defined in the loan agreement and that the funds are not diverted to any other purpose.

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3. Post-Closure Stage

This is the monitoring and follow-up phase. Escrow account is the account in which the borrower has to deposit its revenues and the agent ensures that the loan repayment is given due priority before payments to any other parties. Hence, in this stage, the agent handles the day to day running of the loan facility.

Features of Syndicated Loan and its Composition

- The borrower finalizes the amount and the currency of the loan required and invites offers from the banks to arrange for finance.
- Banks who give their quotes for interest rates, fees and so forth and undertakes the responsibility of arranging syndication is normally called the lead bank/Manager/Arranger.
- Borrower will examine the offers of the various banks and will chose the best available offer, which is best suited to its needs. After deciding or selecting the loans, the borrower gives authority to that bank, which acts as the leader to arrange the loan.
- Then the borrower and the arranger bank will formulate a memorandum of information, giving financial and other details of the co-leader. This is the important document on the basis of which the arranger will seek participation of other interested banks/lenders.
- While seeking/inviting banks to participate in the syndication, the arranger will have to give details of sharing of fees, securities and it is expected to share in the proportion of the share to be picked by members in the consortium. In case of any shortfall in the participation of lenders, then such portion of loan is expected to be taken up the leader of the syndicate.
- Once the entire tie-up is done and finalized, the borrower and leader finalize the loan agreement and the borrower executes the same.

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Check Your Progress

1. List the sources of finance.
2. Define corporate counselling.
3. Mention the benefits of syndicated loans.

**3.5 ANSWERS TO CHECK YOUR PROGRESS
QUESTIONS**

1. The sources of finance are the following:
 - Share Capital
 - Subsidies
 - Long term borrowing from Financial Institutions and Banks
 - Loans from Friends and Relatives
 - Retained Earnings
2. Corporate counselling refers to the activities performed by the merchant banks to provide expertise knowledge to a corporate entity to ensure better performance and also to portray a better image to investors resulting from distribution of dividend and ensuring appreciation in market value of its equity shares.
3. The benefits of syndicated loans are the following:
 - The total cost of borrowing is less
 - Funding from multiple sources
 - New banking relationships
 - Ease of documentation
 - Diversified customer base
 - Risk allocation among different companies
 - Optimize risk and returns

3.6 SUMMARY

- The appraisal of a project involves a thorough investigation into the project by a financial institution which is not connected to the entrepreneur. The appraiser would evaluate the objectives of the entrepreneur in the right perspective.

- The project appraisal can be termed as an independent examination of the project concerned by the entrepreneurs. The appraisal of the project is done to make a second look on the assumptions made and to reassess the future projections given by the promoters.
- The financial institutions appraise the project to ensure the technical feasibility, environmental and economic viability, financial and commercial viability, managerial competence of the promoters and their background.
- A realistic assessment of project cost with built in cushions for absorbing normal cost escalations, could take care of the consequences of delay and cost overrun.
- There is no ideal pattern concerning means of financing for a project. The means of financing is determined by a variety of factors and considerations like magnitude of funds required, risk associated with the enterprise, nature of industry, prevailing taxation laws and others.
- The cash flow estimates are essential to ensure availability of cash to meet the requirements of the project from time to time. The cash flows estimates will show funds including repayment of term loan instalments.
- Proforma balance sheets are drawn for existing concerns doing expansion as well as for new projects. However, in the case of existing concerns going for expansion the balance sheets for the past three years are also analysed and compared with the projections.
- The success of a business enterprise depends largely on the resourcefulness competence and integrity of its management. However, assessment of managerial competence has to be necessarily qualitative, calling for understanding and judgment.
- Corporate counselling refers to the activities performed by the merchant banks to provide expertise knowledge to a corporate entity to ensure better performance and also to portray a better image to investors resulting from distribution of dividend and ensuring appreciation in market value of its equity shares.
- Organizational goals or objectives are the ends towards which the activities of an organization are directed and the standards against which the performance is assessed.
- Individual objectives are related to the employees of the organization. As employees are most important resources of every company consequently, satisfied and motivated employees contribute the maximum for the organizations.
- A syndicated loan is an essential source of debt financing for corporate loan syndication refers to the services rendered by the financial service expert or firm in procurement of term loans and working capital facilities from financial institutions banks and other financing and investment firms for its clients.

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- As the size of the individual loans increased, individual loans found it difficult to take the risk single handedly. Regulatory authorities in most countries limit the size of the individual exposures. Hence, the practice of inviting other banks to participate in the loan, to form a syndicate, came into being, thus, the term syndicated loans.
- A loan syndicate refers to the negotiation where borrowers and lenders sit across the table to discuss about the terms and conditions of lending. At present, large groups of banks are forming syndicates to arrange huge amount of loans for corporate borrowers.
- Co-manager takes care of the administrative arrangements over the term of the loan, for example, disbursements, repayments and compliance.
- All those banks/lenders who participate in the syndicated programme, as well as the leader/underwriter would try to see that it is fully allocated. These banks charge participation fees. These banks carry mostly the normal credit risk i.e., risk of default by the borrower as like any other normal loan.
- It is the responsibility of the lead manager to get it drafted and get it approved from all participants and is signed by all the participating banks and the borrower.

3.7 KEY WORDS

- **Project appraisal:** It is an independent examination of the project concerned by the entrepreneurs.
- **Syndicate:** It is a general term describing any group that is formed to promote a common interest.
- **Letter of credit:** It is a document that guarantees the buyer's payment to the sellers.
- **Escrow account:** It is the account in which the borrower has to deposit its revenues and the agent ensures that the loan repayment is given due priority before payments to any other parties.

3.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the project related activities of a rural banker?
2. Mention the factors determining the means of finance.

3. What is the significance of managerial competence?
4. Briefly mention the scope of corporate counselling.
5. Write a short note on the steps involved in loan syndication.

*Project Related Activities
of a Rural Banker*

Long Answer Questions

1. Discuss the various steps involved in project appraisal.
2. Explain the major categories of organizational goals.
3. Examine the meaning and scope of loan syndication.

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3.9 FURTHER READINGS

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BLOCK - II

RURAL BANKING FEATURES

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UNIT 4 CAPITAL ISSUE RELATED ACTIVITIES OF A RURAL BANKER

Structure

- 4.0 Introduction
- 4.1 Objectives
- 4.2 Capital Issues
 - 4.2.1 Changing Structure of Indian Capital Market
- 4.3 Management of Pre-Issue Activities
- 4.4 Answers to Check Your Progress Questions
- 4.5 Summary
- 4.6 Key Words
- 4.7 Self Assessment Questions and Exercises
- 4.8 Further Readings

4.0 INTRODUCTION

Rural banking activities are primarily intended to serve small businesses and communities in rural areas support the implementation of national development in order to improve the welfare of the people, as well as serve the needs of farmers.

Rural banking is not only about a profit motive but also social motive, whose activities include more community development without prejudice to its role as a financial intermediary. This unit discusses the various capital issue related activities of a rural banker.

4.1 OBJECTIVES

After going through this unit, you will be able to:

- Analyse the changing structure of the Indian capital market
- Explain Trade/Settlement Guarantee Fund
- Describe the role of SEBI in rural banking
- Discuss the management of pre-issue activities

4.2 CAPITAL ISSUES

*Capital Issue Related
Activities of a Rural
Banker*

Capital market reforms in India have led to spread of an equity cult even to the rural areas, towns and cities where no stock exchanges or share capital market related institutions are situated. As a corollary to this, new institutions concerning capital markets to strengthen support and regulate the capital markets are emerging. Some of the institutions like OTCEI and NSEI are inculcating the screen based trading cult and are using computer networks in lieu of normal trading floor. The financial markets on the other hand are becoming more complex with increase in trade and competitiveness and transcending the geographical and time limitations of local financial markets. This has necessitated emergence, growth and development of various financial services in India to enable the companies to raise funds at minimum possible cost and the investors to make right investment choices and to trade conveniently. Thus the emerging financial services and new institutions are playing an important role in deepening and widening the capital markets.

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Securities market in India has grown exponentially as measured in terms of amount raised from the market, number of stock exchanges and other intermediaries, the number of listed stocks, market capitalisation, trading volumes and turnover on stock exchanges and investor population. Along with this, the profiles of the investors, issuers, and intermediaries have changed significantly. The market has witnessed fundamental institutional changes resulting in drastic reduction in transaction costs and significant improvements in efficiency transparency and safety. Indian market is now comparable to many developed markets. The number of issues and the amounts mobilised through the primary market is predominantly by financial institutions and banks as opposed to industry. In an institution based financial system, the role of financial intermediaries like banks and financial institutions are prominent in mobilisation and allocation of financial resources. In the current capital market system, the role of banks and financial institutions as intermediary is diluted. In the market based system where the investor and user of funds are expected to come into direct control with the borrowers i.e. the corporates a tendency was developed among the corporate houses to access savings directly through public deposits, commercial paper, equity and debenture issues, external commercial borrowings, ADR/GDR issues, etc. This process of transformation has been further facilitated by the introduction of a set of new financial instruments, with varied degrees of liquidity, risks and returns.

Among the instruments, mutual funds, bonds and derivative instruments are more active which have grasped a substantial share in resource mobilisation giving a challenge to traditional monetary assets such as bank deposits. Similarly instruments like deep discount bonds, zero coupon bonds and other bonds with very long maturity period compete with traditional term saving instruments.

The smooth functioning of the capital market depends on the regulators, participants and investors. Nowadays, the capital market is a far more important

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source of finance than traditional financial intermediaries for the corporate sector. It is poised to dominate the future of corporate finance in India. The process of reforms has led to a pace of growth of markets almost unparalleled in the history of any country. Recent developments which have taken place in the capital market have important implications in the industrial and economic development and the growth of the country.

4.2.1 Changing Structure of Indian Capital Market

The capital market in India is undergoing a process of structural transformation, with a view to improve market efficiency, make stock market transactions more transparent, curb unfair trade practices and to bring capital markets up to international standards. With this objective in mind, several institutional developments have taken place e.g. The National Stock Exchange has been set up with a screen based limit order book market, the National Securities Clearing Corporation Ltd (NSCCL) has been set up to guarantee settlements NSDL has been established to improve settlement process etc. These institutional developments have resulted in a drastic reduction in transaction costs and have made the markets fair and safe for investors. In fact, the process to restructure capital markets began in 1992 with the establishment of SEBI. Persistent efforts have been made since then. An array of capital market reforms encompassing primary and secondary markets, equity and debt and FII have been announced. These reforms have significantly restructured capital markets.

During the last seven/eight years, significant efforts have been made to restructure the Indian capital market. Many of the weaknesses and inefficiencies of the Indian capital market have been removed. Today a sound regulatory framework is in place for floatation of primary issues, operation of stock exchanges and working of market intermediaries like brokers, merchant bankers, registrars and custodians. Screen based trading has been introduced in the stock exchanges. Depository has become a reality and transactions through depository will bring down the cost and risks of trading associated with paper based trading. Cost of transaction has come down. Stock exchanges have strengthened their internal operating practices, surveillance system and infrastructure. Stock brokers and merchant bankers are now better capitalized, more professionally organised and more accountable. Margining system is now better implemented and defaulting members are not allowed to continue trading.

NSE introduced for the first time in India a transparent screen based trading system. Thus, the investor is assured of price which is not vulnerable to manipulation. The national reach of the NSE has enabled it to have a deeper and more liquid market and hence lower costs. The NSE also introduced the concept of novation through clearing house to guarantee trades executed on NEAT (trading system of NSE). All these factors have contributed to reducing the costs of trading.

Fully computerised Stock Exchange Trading was pioneered by NSE in India. This has removed the common investor's biggest complaints viz unfair dealing practices and delays in settlement. It has improved transparency and trading efficiency.

The setting up of depositories and shift to paperless trading has helped to overcome the major problem of handling physical share certificates such as problem of theft, fake and/or forged shares, share transfer delays, particularly due to signature mismatch. Transaction holding costs (Costs of handling, storage, transportation and other back office costs) in the depository environment are cheaper when compared to same in the physical and Demat segments.

The setting up of Trade/Settlement Guarantee Fund by Stock Exchanges

The principal objective of this fund is to provide the necessary finance and ensure timely completion of settlements in cases of failure of member brokers to fulfil their settlement obligations. Establishment of such funds would give greater confidence to investors in the settlement and clearing procedures of the stock exchanges.

The development of the debt market in India is central to the mobilisation of long term funds for infrastructure development. The magnitude of funds required for infrastructure underscores the urgency involved in the development of the debt market.

The government securities segments is the most dominant in debt market. A notable development in the debt market recently has been the significant increase in the amounts raised by the corporate sector through debt instruments, bulk of which were raised through the private placement route. This trend signifies the emergence of a wholesale primary market in debt securities. A number of measures have been initiated to provide depth and increase liquidity in the debt market.

The Indian capital market has exhibited a great measure of dynamism in the recent years with globalisation of the Indian capital market and foreign rating agencies upgrading India on their rating scales, the market is bound to take off in a big way. The gradual process of India's reform has firmly re-established macro-economic stability and public confidence. Several measures were taken to deregulate the rigid financial system and to move toward a more market-determined allocation of credit. Indian capital market has become competitive and efficient and is attracting foreign investment. The reforms measures initiated in the capital market started with SEBI (Securities and Exchange Board of India) repealing Capital Issues Control Act and the abolition of Controller of Capital Issues (CCI) have brought about significant improvements in the functional and regulatory structure for the efficient functioning of the capital market and protecting the interest of the investors have helped in developing the capital market on healthy lines and will in due course bring the functioning of the domestic capital market in line with the international standards.

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A number of policy announcements relating to participants and the methods and procedures of raising finance have been made. The objective is to strengthen the standards of disclosure, introduction of certain prudential norms for the issuers and intermediaries and remove the inadequacies and systematic deficiencies in the issue procedures.

After the abolition of CCI, SEBI as a regulatory authority, issued guidelines for new issues of companies, the clarification to which provided for substantial modifications in respect of promoters contribution for issue of capital at premium by a new company being promoted by existing companies having a track record, minimum promoter contribution from friends/relatives and reservations to various institutions/persons such as mutual funds financial institutions, FIIs, eligible employees etc.

A set of guidelines for development financial institutions for disclosure and investor protection regarding their raising of funds from Capital Market was announced. SEBI brought the merchant bankers under its regulatory framework. The regulations covers among other things registration of merchant bankers, their obligations and responsibilities, procedures for inspection and action to be initiated against defaulting merchant bankers.

SEBI issued regulations relating to registrars to issues and share transfer agents and laid down the capital adequacy requirements, general obligations and responsibilities, procedures for inspection and actions in case of default.

Regulations for underwriters of capital issues were issued included among other things the net worth requirements.

SEBI has also notified the regulations of Mutual Funds which stipulates that they are required to be formed as trust or Trustee Company. It provide for arm's length relationship between the various constituents of the Mutual Funds and thus bring about a structural change which ensure qualitative improvement in the functioning of the Mutual Funds.

Guidelines for stock-brokers and sub-brokers were announced which interalia, cover registration of brokers, their general obligations and responsibilities, procedures for inspection of their operations and actions to be initiated in case of default.

To bring about greater transparency in transactions SEBI has made it mandatory for brokers to maintain separate accounts for their clients and for themselves. They must disclose the transaction price and brokerage separately in the contract notes issued to their clients. They must also have their books audited and audit reports filed with SEBI.

SEBI has also issued directives to stock exchanges (SEs) to ensure that contract notes are issued by brokers to clients within 24 hours of the execution of the contract. They have to see that time limits for payment of sale proceeds and deliveries by brokers and payment of margins by clients to brokers are complied

with. For ensuring the fulfilment of deals in the market and protecting the investors SEBI has introduced capital adequacy norms for the brokers.

SEBI has directed the Stock Exchanges to broad base their governing boards and change the composition of their arbitration, default and disciplinary committee which help stock exchanges to function with greater autonomy and independence so that they become truly self-regulatory organisations.

Another major development in the capital market reforms is the increasing role of banking institutions in the capital market activities by setting up subsidiaries/ mutual funds or contributing to the equity of companies offering financial services. The areas involve leasing, merchant banking, factoring asset management companies, money market, mutual funds, etc.

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4.3 MANAGEMENT OF PRE-ISSUE ACTIVITIES

SEBI has circulated certain proposals for introducing reforms in the primary market. As per the guidelines no compulsory appraisal has been envisaged. Where the appraisal has been made by the choice of the issuer company for the purpose of the issue, such appraisal, of made by financial institution, a banks or one of the lead managers the same may be relied upon to make adequate and appropriate disclosures in the offer documents. The issuer company should also make arrangements in such cases with the concerned financial institution or bank to make available to the lead manager a copy of the appraisal report where the appraisal has been made by a bank, financial institution or any other agency for purposes of grant of term loans, underwriting or any form of financial assistance like guarantee etc. reference to such appraisal in the offer documents shall be made, only of the lead manager has access to financial projection and other relevant conclusions in that report. Thus is necessary for the lead manager to ensure appropriate and adequate disclosures in the offer documents. The offer documents should prominently disclose the name of the agency undertaking the appraisal and the purpose thereof.

Companies will be allowed to raise fresh capital by freely processing their further issues.

The issue price will be determined by the issuer in consultation with the lead managers to the issue.

Disclosers

- (i) The draft prospects will be vetted by SEBI to ensure adequacy of disclosures.
- (ii) The prospectus or offer documents shall contain the net asset value of the company and a justification for the price of the issue.
- (iii) High and low process of the shares for the last 2 years.

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Undertaking

- (a) Underwriting is mandatory for the full issue and minimum requirement of 90% subscription is also mandatory for each issue of capital to public. Number of underwriting would be decided by the issues.
- (b) If the company does not receive 90% of issued amount from public subscription plus accepted development from underwriters, within 120 days from the date of opening of the issue the company shall refund the amount of subscription. In case of disputed development, the company should refund the amount of subscription of the above conditions are not met.
- (c) The lead manager(s) must satisfy themselves about the net worth of the underwriters and the outstanding commitments and disclose the same to SEBI.

Underwriting should be only for issue to the public which will exclude reserved/preferential allotment to reserved categories. Underwriting is mandatory only to the extent of net offer to the public minimum subscription clause is applicable for both public and rights issue with a right of renunciation.

Check Your Progress

1. On what factors does the smooth functioning of the capital market depend on?
2. Who pioneered fully computerized stock exchange trading?
3. State the principle objective of Trade/Settlement Guarantee Fund.
4. How does SEBI bring about transparency in transactions?

4.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The smooth functioning of the capital market depends on the regulators, participants and investors.
2. Fully computerised stock exchange trading was pioneered by NSE in India.
3. The principal objective of this fund is to provide the necessary finance and ensure timely completion of settlements in cases of failure of member brokers to fulfil their settlement obligations.
4. To bring about greater transparency in transactions SEBI has made it mandatory for brokers to maintain separate accounts for their clients and for themselves. They must disclose the transaction price and brokerage separately in the contract notes issued to their clients. They must also have their books audited and audit reports filed with SEBI.

4.5 SUMMARY

- Capital market reforms in India have led to spread of equity cult even to the rural areas, towns and cities where no stock exchanges or share capital market related institutions are situated. As a corollary to this, new institutions concerning capital markets to strengthen support and regulate the capital markets are emerging.
- The financial markets on the other hand are becoming more complex with increase in trade and competitiveness and transcending the geographical and time limitations of local financial markets. This has necessitated emergence, growth and development of various financial services in India to enable the companies to raise funds at minimum possible cost and the investors to make right investment choices and to trade conveniently.
- Securities market in India has grown exponentially as measured in terms of amount raised from the market, number of stock exchanges and other intermediaries, the number of listed stocks, market capitalisation, trading volumes and turnover on stock exchanges and investor population. Along with this, the profiles of the investors, issuers, and intermediaries have changed significantly.
- In an institution based financial system, the role of financial intermediaries like banks and financial institutions are prominent in mobilisation and allocation of financial resources. In the current capital market system, the role of banks and financial institutions as intermediary is diluted.
- The capital market in India is undergoing a process of structural transformation, with a view to improve market efficiency, make stock market transactions more transparent, curb unfair trade practices and to bring capital markets up to international standards.
- During the last seven/eight years, significant efforts have been made to restructure Indian capital market. Many of the weaknesses and inefficiencies of the Indian capital market have been removed.
- Today a sound regulatory framework is in place for floatation of primary issues, operation of stock exchanges and working of market intermediaries like brokers, merchant bankers, registrars and custodians.
- The principal objective of this fund is to provide the necessary funds and ensure timely completion of settlements in cases of failure of member brokers to fulfil their settlement obligations. Establishment of such funds would give greater confidence to investors in the settlement and clearing procedures of the stock exchanges.
- The Indian capital market has exhibited a great measure of dynamism in the recent years with globalisation of Indian Capital market and foreign rating

NOTES

NOTES

agencies upgrading India on their rating scales, the market is bound to take off in a big way. The gradual process of India's reform has firmly re-established macro-economic stability and public confidence.

- A number of policy announcements relating to participants and the methods and procedures of raising finance have been made. The objective is to strengthen the standards of disclosure, introduction of certain prudential norms for the issuers and intermediaries and remove the inadequacies and systematic deficiencies in the issue procedures.
- SEBI has also notified the regulations of Mutual Funds which stipulates that they are required to be formed as trust or Trustee Company. It provide for arm's length relationship between the various constituents of the Mutual Funds and thus bring about a structural change which ensure qualitative improvement in the functioning of the Mutual Funds.
- Another major development in the capital market reforms is the increasing role of banking institutions in the capital market activities by setting up subsidiaries/mutual funds or contributing to the equity of companies offering financial services. The areas involve leasing, merchant banking, factoring asset management companies, money market, mutual funds, etc.

4.6 KEY WORDS

- **SEBI:** The Securities and Exchange Board of India is the regulator for the securities market in India. It was established in 1988 and given statutory powers on 30 January 1992 through the SEBI Act, 1992.
- **NSE:** The National Stock Exchange of India Limited is the leading stock exchange of India, located in Mumbai. The NSE was established in 1992 as the first demutualized electronic exchange in the country.

4.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short note on capital issues.
2. How was the debt market developed in India?

Long Answer Questions

1. Analyse the changing structure of Indian capital market.
2. How are pre-issue activities managed? Discuss.

4.8 FURTHER READING

- Ram Jitendra. 2015. *Regional Rural Banks of India: Evolution, Performance and Management*. Gurgaon: Partridge Publishing.
- Acharya S.C. and A. K. Mohanty. *Operational Analysis of Regional Rural Banks*. New Delhi: Gyan Publishing House
- Agrawal Meenu. 2009. *Regional Rural Banks (RRBs) in India*. New Delhi: New Century Publications.
- Ahmad Rais and Mahmudur Rahman. 1998. *Rural Banking and Economic Development*. New Delhi: Mittal Publications.
- Reddy, Ranga. 2004. *Rural Banking and Overdues Management*. New Delhi: Mittal Publications.

*Capital Issue Related
Activities of a Rural
Banker*

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UNIT 5 CORPORATE SECURITIES

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Structure

- 5.0 Introduction
- 5.1 Objectives
- 5.2 Types and Characteristics of Securities
- 5.3 Marketing of Corporate Securities
- 5.4 Steps to be taken by the Issuing Company
 - 5.4.1 Lead Manager and Underwriting
- 5.5 Answers to Check Your Progress Questions
- 5.6 Summary
- 5.7 Key Words
- 5.8 Self Assessment Questions and Exercises
- 5.9 Further Readings

5.0 INTRODUCTION

Corporate securities can be termed as – shares, debentures, public deposits and loans from institutions. For the purpose of building fixed capital, joint stock companies mobilize funds from the public in the form of equity or ordinary shares or preference shares.

Ordinary shares are not preferred shares and they do not have any predetermined dividend amount. The dividend payable to the ordinary shareholders may be high when the company performs well and it may be low or nil when the performance of the company is found to be poor. This unit will examine the types and characteristics of securities in detail.

5.1 OBJECTIVES

After going through this unit, you will be able to:

- Describe the different types of securities
- Discuss the characteristics of securities
- Explain the process of marketing of corporate securities
- Describe the steps taken by the issuing company and the lead manager
- Discuss the process of underwriting of shares

5.2 TYPES AND CHARACTERISTICS OF SECURITIES

Various types of securities are traded in the market. Securities broadly represent evidence to property rights. A security provides a claim on an asset and any future cash flows the asset may generate. We commonly think of securities as shares and bonds. According to the Securities Contracts Regulation Act 1956, securities include shares, scrips, stocks, bonds, debentures and other marketable products like securities of incorporated companies, other body corporates or the government. Securities are classified on the basis of return and the source of issue. On the basis of income, they may be classified as fixed or variable income securities. In the case of fixed income security, the income is fixed at the time of the issue itself. Bonds, debentures and preference shares fall into this category. Sources of issue may be government, semi-government and corporate. The incomes of variable securities change from one year to another. Dividends of companies' equity shares can be cited as an example of this. Corporates generally raise funds through fixed and variable income securities like equity shares, preference shares and debentures.

Equity Shares

Equity shares are commonly referred to as common stock or ordinary shares. Even though the terms 'shares' and 'stocks' are interchangeably used, there is a difference between them. The share capital of a company is divided into a number of small units of equal value called shares. The term 'stock' means the aggregate of a member's fully paid-up shares of equal value merged into one fund. It is a set of shares put together in a bundle. The 'stock' is expressed in terms of money and not as many shares. Stock can be divided into fractions of any amount and such fractions may be transferred like shares.

Share certificate means a certificate under the common seal of the company specifying the number of shares held by any member. A share certificate provides the *prima facie* evidence of title of the members to such shares. This helps the shareholder to deal easily in the market. It enables him to sell his shares by showing marketable title.

The share certificate is available in two forms.

- Physical form – share certificates are issued in the physical form.
- Demat form – share certificates are issued in the electronic form.

Equity shareholders have the following rights according to Section 85 (2) of the Companies Act, 1956.

- Right to vote at the general body meetings of the company.
- Right to control the management of the company.
- Right to share in profits in the form of dividends and bonus shares.

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- Right to claim on the residual after repayment of all claims in case of winding up of the company.
- Right of pre-emption in the matter of issue of new capital.
- Right to apply to court in case of any discrepancy in the rights set aside.
- Right to receive a copy of the statutory report, copies of annual accounts along with audited report.
- Right to apply to the central government to call an annual meeting when a company fails to call such a meeting.
- Right to apply the Company Law Board for calling an extraordinary general meeting.

In a limited company, the equity shareholders are liable to pay the company's debt only to the extent of their share in the paid up capital. Equity shares have certain advantages. The main advantages are:

- Capital appreciation
- Limited liability
- Free tradability
- Tax advantages (in certain cases)
- Hedge against inflation

Sweat Equity

Sweat equity is a new equity instrument introduced in the Companies (Amendment) Ordinance, 1998. The newly inserted Section 79A of the Companies Act, 1956 allows the issue of sweat equity. However, it should be issued out of a class of equity shares already issued by the company. It cannot form a new class of equity shares. Section 79A (2) explains that all limitations, restrictions and provisions applicable to equity shares are applicable to sweat equity. Thus, sweat equity forms a part of the equity share capital.

Non-voting Shares

Non-voting shares carry no voting rights. They carry additional dividends instead of voting rights. Even though the idea was widely discussed in 1987, it was only in the year 1994 that the Finance Ministry announced certain broad guidelines for the issue of non-voting shares.

Shareholders in possession of non-voting shares have the right to participate in bonus issues. Non-voting shares can also be listed and traded in stock exchanges. If non-voting shares are not paid dividends for two years, shares would automatically get voting rights. The company can issue this to a maximum of 25 per cent of the voting stock. The dividend on non-voting shares would have to be 20 per cent higher than the dividend on voting shares. All rights and bonus shares for non-voting shares have to be issued in the form of non-voting shares only.

Right Shares

Shares offered to existing shareholders at a price by the company are called right shares. They are offered to shareholders as a matter of legal right. If a public company wants to increase its subscribed capital by way of issuing shares after two years from its date of formation or one year from the date of first allotment, whichever is earlier, such shares should be offered first to existing shareholders in proportion to the capital paid up on the shares held by them at the date of such offer. This pre-emptive right can be forfeited by shareholders through a special resolution. The shareholder can renounce right shares in favour of his nominee. He may renounce all or part of the shares offered to him. Right shares may be partly paid. The minimum subscription limit is prescribed for right issues. In the event of the company failing to receive 90 per cent subscription, the company has to return the entire money received. SEBI has, at present, removed this limit. Right issues are regulated under the provisions of the Companies Act and SEBI.

Bonus Shares

A bonus share is the distribution of shares in addition to cash dividends to existing shareholders. Bonus shares are issued to existing shareholders without any payment of cash. The aim of a bonus share is to capitalize the free reserves. The bonus issue is made out of free reserves built from genuine profit or share premium collected in cash only. The bonus issue can be made only when all partly paid shares are fully paid-up.

The declaration of the bonus issue has a favourable impact on the psychology of shareholders. They take it as an indication of high future profits. Bonus shares are declared by directors only when they expect a rise in the profitability of the concern. The issue of bonus shares enables shareholders to sell shares and get capital gains while retaining their original shares.

Preference Stock

The characters of the preferred stock are hybrid in nature. Some of its features resemble the bond and others the equity shares. Like the bonds, their claims on the company's income are limited, and they receive a fixed dividend. In the event of liquidation of the company, their claims on the assets of the firm are also fixed. At the same time, like the equity, it is a perpetual liability of the corporate. The decision to pay a dividend on the preferred stock is at the discretion of the Board of Directors. In the case of bonds, payment of interest rate is mandatory.

The dividend received by the preferred stock is treated on par with the dividend received from the equity share for tax purposes. These shareholders do not enjoy any of the voting powers, except when any resolution affects their rights.

Cumulative preference shares: Here, the cumulative total of all unpaid preferred dividends must be paid before dividends are paid on the common equity. Unpaid dividends are known as arrearages—these do not earn interest. The non-

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payment of dividend only continues to grow. The arrearages accrue only for a limited number of years and not indefinitely. Generally three years of arrears accrue and the accumulative feature ceases after three years. But the dividends in arrears continue if no such provision is given in the Articles of Association. In case of liquidation, no arrears of dividends are payable unless a provision is made in the Articles of Association.

Non-cumulative shares: As the name suggests, the dividend does not accumulate. If the company earns no profit or inadequate profit in a particular year, the company does not pay a dividend. If the preference and equity shares are fully paid while winding up a company, non-cumulative shareholders have no further rights to have claims in the surplus. If a provision is made in the Articles of Association for such claims, they have the right to claim.

Convertible preference shares: The convertibility feature makes the preference share a more attractive investment security. The conversion feature is almost identical to that of the bonds. These preference shares are convertible as equity shares at the end of the specified period and are quasi-equity shares. This gives the additional privilege of sharing the potential increase in equity value, along with the security and stability of income.

Redeemable preference shares: If a provision in the Articles of Association to issue redeemable preference shares is available, it can be issued. However, redemption of the shares can be done only in the following conditions:

- The partly paid-up shares are made fully paid-up.
- The fund for redemption is created from profits, which would otherwise be available for distribution of dividends or out of the proceeds of a fresh issue of shares for the purpose.
- If a premium has to be paid on redemption, it should be paid out of the profits or out of the company's share premium account.
- When redemption is made out of profits, a sum equal to the nominal value of the redeemed shares should be transferred to the capital redemption reserve account.

Irredeemable preference shares: These shares are not redeemable except on occasions like winding up of the business. In India, these shares were permitted till 15 June 1988. The introduction of Section 80A in the Companies Act, 1956 put an end to them.

Cumulative convertible preference shares (CCPS): These were introduced by the government in 1984. This preference share gives a regular return of 10 per cent during the gestation period from three years to five years and is then converted into equity as per the agreement. According to guidelines, CCPS can be issued for any of the following purposes: (a) setting up of new projects, (b) expansion or diversification of existing projects, (c) normal capital expenditure for modernization, and (d) working capital requirements. CCPS failed to attract the

interest of investors because the rate of interest was very low and the gain that could be received from the conversion into equity also depended upon profitable functioning of the equity.

Debenture

According to the Companies Act 1956, 'Debenture includes debenture stock, bonds and any other securities of the company, whether constituting a charge on the assets of the company or not'. Debentures are generally issued by the private sector companies as a long-term promissory note for raising loan capital. The company promises to pay interest and principal as stipulated. A bond is an alternative form of debenture in India. Public sector companies and financial institutions issue bonds. The characteristic features of debentures are as follows:

- **Form:** It is given as a certificate of indebtedness by the company, specifying the date of redemption and rate of interest.
- **Interest:** Rate of interest is fixed at the time of the issue itself, which is known as the contractual or coupon rate of interest. Interest is paid as a percentage of the par value of the debenture and may be paid annually, semi-annually or quarterly. The company is legally bound to pay the interest rate.
- **Redemption:** As stated earlier, the redemption date would be specified in the issue itself. The maturity period may range from 5 to 10 years in India. They may be redeemed in instalments. Redemption is done through the creation of a sinking fund by the company. A trustee in charge of the fund buys the debentures either from the market or from owners. Creation of the sinking fund eliminates the risk of facing financial difficulty at the time of redemption because redemption requires a huge sum. Buy-back provisions help the company to redeem debentures at a special price before the maturity date. The special price is usually higher than the par value of the debenture.
- **Indenture:** An indenture is a trust deed between the company issuing debentures and the debenture trustee who represents the debenture holders. The trustee takes the responsibility of protecting the interest of the debenture holders and ensures that the company fulfils contractual obligations. Financial institutions, banks, insurance companies or firm attorneys act as trustees to the investors. In the indenture, the terms of agreement, description of debentures, rights of the debenture holders, those of the issuing company and responsibilities of the company are clearly specified.

Types of Debentures

Debentures are classified on the basis of security and convertibility:

- Secured or unsecured debenture
- Fully convertible debenture

NOTES

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- Partly convertible debenture
- Non-convertible debenture

Secured or unsecured debenture: A secured debenture is secured by a lien on the company's specific assets. In the case of default, the trustee can take hold of the specific asset on behalf of the debenture holders. Secured debentures in the Indian market include a charge on present and future immovable assets of the company.

When the debentures are not protected by a security, they are known as unsecured or naked debentures. Debentures in the American capital market mean unsecured bonds, while bonds could be secured or unsecured. Unsecured debentures find it difficult to attract investors because of the risk involved in them. Debentures are generally rated by credit rating agencies.

Fully convertible debenture: This type of debenture is converted into equity shares of the company on the expiry of a specific period. The conversion is carried out according to the guidelines issued by SEBI. The FCD carries a lower rate of interest than other types of debentures because of the attractive feature of convertibility into equity shares.

Partly convertible debenture: This debenture consists of two parts, namely convertible and non-convertible. The convertible portion can be converted into shares after a specific period. Here, the investor has the advantage of convertible and non-convertible debentures blended into one debenture. For example, Procter and Gamble had issued fully convertible debenture (FCD) of ₹200 each to its existing shareholders. The investor can get a share for ₹65 with the face value of ₹10 after 18 months from allotment (as in August 1997).

Non-convertible debenture: Non-convertible debentures do not confer any option on the holder to convert the debentures into equity shares and are redeemed at the expiry of the specified period.

Bond

A bond is a long-term debt instrument that promises to pay a fixed annual sum as interest for a specified period of time. The basic features of the bonds are given below:

- Bonds have face a value. This is known as par value. The bonds may be issued at par, or at a discount.
- The interest rate is fixed. It may sometimes vary as in the case of a floating rate bond. The interest is paid semi-annually or annually and is known as the coupon rate. The interest rate is specified in the certificate.
- The maturity date of the bond is usually specified at the time of issue, except in the case of perpetual bonds.

- The redemption value is also stated in the bonds. It may be at par value or at a premium.
- Bonds are traded in the stock market. When they are traded, the market value may be at par, at a premium or discounted. The market value and redemption value need not be the same.

Secured bonds and unsecured bonds: The secured bond is secured by the real assets of the issuer. In case of the unsecured bond, the name and fame of an issuer may be the only security.

Perpetual bonds and redeemable bonds: Bonds that do not mature or never mature are called perpetual bonds. The interest alone would be paid. In redeemable bonds, the bond is redeemed after a specific period of time. The redemption value is specified by the issuer.

Fixed interest rate bonds and floating interest rate bonds: In fixed interest rate bonds, the interest rate is fixed at the time of the issue, whereas in the floating interest rate bonds, the interest rates change according to already fixed norms. For example, in December 1993 the State Bank of India issued floating interest rate bonds worth ₹500 crore, pegging the interest rate with its three and five years' fixed deposit rates to provide built-in yield flexibility to the investors.

Zero coupon bonds: These bonds sell at a discount and the face value is repaid at maturity. The origin of this type of bond can be traced to the US Security Market. The high value of the US government security prevented investors from investing their money in government security. Big brokerage companies like Merrill Lynch, Pierce and others purchased government securities in large quantities and sold them in smaller denominations—at a discounted rate. The difference between the purchase cost and face value of the bond is the gain for the investor. Since the investor does not receive any interest on the bond, the conversion price is suitably arranged to protect the loss of interest to the investor. The discounted value is calculated using the formula:

$$\text{Present Value} = \frac{\text{Face Value of the Bond}}{(1 + R)^n}$$

R = interest rate and n = number of years.

For example, a zero coupon bond with a face value of ₹50,000 that matures in 20 years' time would be sold at ₹5,185 to give a return of 12 per cent per annum.

The merit of this bond is that the company does not have the burden of servicing the debt during the execution period of the project. The repayment could be adjusted to fall after the completion of the project. This could result in considerable cost savings for the company.

Deep discount bonds: A deep discount bond is another form of zero coupon bond. The bonds are sold at a large discount on their nominal value and

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interest is not paid on them. Also, they mature at par value. The difference between the maturity value and the issue price serves as an interest return. The deep discount bonds' maturity period may range from three years to 25 years or more. IDBI first issued deep discount bonds in India in 1992 with varying maturity period options. Later, ICICI in 1997 issued deep discount bonds with four optional maturity periods. Early redemption option is provided at the end of the 6th, 12th and 18th year.

Capital indexed bonds: In the capital indexed bond, the principal amount of the bond is adjusted for inflation for every year. For example, an investment of ₹1000 in inflation indexed bonds earns the investor a semi-annual interest income for a five-years' period. The re-selling of the principal amount is done semi-annually based on the wholesale price index (WPI) movements. The principal amount of the bond is adjusted for inflation for each of the years. A coupon rate of 6 per cent is worked on the inflation-adjusted principal.

The bond is advantageous because it gives the investor more returns by taking inflation into account. The investor enjoys the benefit of a return on his principal, which is equal to the average inflation between the issue (purchase) and maturity period of the instrument. The investor has to keep the instrument for the entire five-year period, to avail the benefit of inflated principal amount.

If the investor wants to exit early, he can do it through the secondary market. The value of the principal repayment is adjusted by the Index Rate (IR), which is announced by the RBI two weeks prior to the repayment of the principal. The IR is worked out as follows:

$$\text{IR} = \text{Reference WPI as in Aug 2002/Base WPI}$$

Financial institutions, banks, insurance companies or firm attorneys act as trustees to the investors. In the indenture, the terms of agreement, description of debentures, rights of debenture holders and of the issuing company, and responsibilities of the company are specified clearly. Rates change according to already fixed norms.

Warrants

A warrant is a bearer document of title to buy a specified number of equity shares at a specified price. Warrants can usually be exercised over a number of years. The life periods of warrants are long. Warrants are offered to make the bond or preferred stock offering more attractive. Bonds may have a low interest rate but the warrants offered along with them help the investor enjoy the equity appreciation value. Warrants are detachable—the investor can sell them separately to be traded in the market.

The person who holds the warrant cannot enjoy the benefits of the equity holder before the conversion of the warrant. The price at which the warrants are converted is called exercise price. The exercise price is always greater than the current market price of the respective equity at the time of issue of the warrant.

When warrants are issued along with host securities and are detachable, they are known as detachable warrants. In some cases, the warrants can be sold back to the company before the expiry date. These are known as puttable warrants. Naked warrants are issued separately and not with host securities. The investor has the option to convert them into bonds or equities.

Advantages of Warrants

- Warrants make non-convertible debentures and other debentures more attractive and acceptable.
- Debentures, along with warrants, are able to create their own market and reduce the company's dependence on financial institutions and mutual funds.
- As the exercise of warrants takes place at a future date, cash flow and the capital structure of the company can be planned accordingly.
- The cost of debt is reduced if warrants are attached to it. Investors are willing to accept a lower interest rate in anticipation of enjoying capital appreciation of equity value at a later date.
- Warrants provide a high degree of leverage to the investor. He can sell the warrant in the market, convert it into stocks or allow it to lapse. But if the conversion is compulsory, investors have to shell out money from their pockets even if the price of the share falls.
- Warrants are liquid and they are traded in stock exchanges. Hence, the investor can sell the warrants before exercising them.

Table 5.1 Difference between Share Warrants and Share Certificates

Share Warrants	Share Certificates
Issued by a public limited company	Issued by public and private companies
Need for the provision in the Articles of Association	No need to be contained in the Articles of Association
Should be approved by the central government	Central government approval is not needed
Share warrants are issued to fully paid-up shares	Share certificates are issued to fully and partly paid-up shares
Transfer of share warrants requires no registration	Transfer of share certificates would be complete only if registered
Share warrants are negotiable instruments	Share certificates are not considered negotiable instruments

Stock Derivatives

A stock derivative is an instrument whose value is derived from the value of one or more underlying securities. It can be bonds, stocks, stocks indices, etc. Common examples of derivative instruments are futures and options.

Index futures are future contracts where the underlying asset is an index. Index futures are traded in the Sensex and Nifty.

Options are contracts that confer on the buyer of the contract certain rights (rights to buy or sell an asset) for a predetermined price on or before a pre-

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specified date. The buyer of the option has the right but not the obligation to exercise the option.

The popular stock options are:

- Equity – index options and options on individual stocks
- Interest rates – bond options, interest rate futures options, options embedded in bonds, caps and floors, etc.

5.3 MARKETING OF CORPORATE SECURITIES

Market makers are those who quote rates for buying and selling the securities they deal in. This is to ensure adequate liquidity for both buyers and sellers in the securities market.

A market maker is a firm or an individual prepared to buy and sell a particular security throughout the trading session to maintain liquidity and a fair and orderly market in that security. Market makers are essential for the success of both the primary and secondary markets.

Market makers maintain inventory levels depending on demand and supply situation just like any other commodity. As per SEBI guidelines, the requirements for market makers are:

1. The market maker is required to provide a two-way quote on a continuous basis for 75 per cent of the time in a day.
2. The minimum depth of the quote should be ₹5,000 or one market lot, whichever is higher. In case of demat shares, for which there is no market lot, the same market lot as existed in the physical segment would be applicable for this purpose.
3. There will not be more than five market makers for each scrip; these would be selected by each exchange on the basis of selected objective criteria.
4. Each market maker may compete with other market makers for better quotes to the investors.
5. Once registered as a market maker, an individual has to start providing quotes within five trading days of registration.
6. The quote shall be provided in such a way that the quotes are not absent from the screen for more than 30 minutes at a time.
7. Execution of the order on a continuous basis at the quoted price and quantity must be guaranteed by the market maker.
8. Once registered as a market maker, an individual has to mandatorily act in that capacity for a minimum period of three months.

Capital Issue Management

Management of capital issues in India is a professional service rendered by merchant bankers. In fact, issue management is a major function for merchant bankers. The role of merchant bankers has increased due to the tremendous growth of public listed companies in number, size and complexity, SEBI's guidelines and requirements increase.

Capital issue management relates to the management of issues for raising funds through various instruments by companies.

The issue can be a public issue through a prospectus, rights issue, private placement and institutional placement programme. Issue management, in the case of issues through prospectus, involves the following functions:

- Obtaining an observation letter for the issue from SEBI.
- Arranging underwriting for the proposed issue.
- Drafting and finalizing the prospectus and obtaining its clearance from the various agencies concerned.
- Drafting and finalizing other documents, such as applications, forms, newspaper advertisements and other statutory requirements.
- Selecting the registrar to the issues; the printing press; the advertising agencies; the brokers and bankers to the issue and finalizing the fees and charges to be paid to them.
- Arranging for the press conference and investors' conferences.
- Coordinating printing, publicity and other work, to get everything ready at the time of the public issue.
- Complying with the SEBI guidelines before and after the issue is over (both in case of over-subscription or devolpment), by sending the various reports as required by the authorities.

The procedures and practices for managing public issues fall under two phases:

- Pre-issue management begins with the structuring of issues and ends with the opening of a subscription list;
- Post-issue management continues until the securities are listed on the stock exchange.

The management of capital issues in both phases is regulated and monitored by SEBI.

SEBI's objective in capital issue management is to protect the interests of investors through regulations and guidelines, establishing transparency in market dealings.

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Check Your Progress

1. State some advantages of equity shares.
2. What are the two forms of share certificate?
3. What are the procedures and practices for managing public issues?

5.4 STEPS TO BE TAKEN BY THE ISSUING COMPANY

Primarily, issues can be classified into the following categories:

- Public issue
- Rights issue
- Bonus issue
- Stock option/Employees stock option scheme
- Private placement

While public and rights issues involve a detailed procedure, private placements are relatively simpler.

Types of Issues

The following are the different types of issues:

1. Public issue

Public issues can be further classified into initial public offerings (IPOs) and follow-on public offerings.

(a) Initial public offering: An initial public offer (IPO) is selling of securities to the public in the primary market for the first time.

An IPO is the selling of securities to the public in the primary market, which can be either fresh issues, an offer of its existing securities or both, by its promoters to the public for the first time. An IPO is, historically, considered high-risk in nature.

In other words, the entire emphasis is on an issue to the public for the first time, which can be either by the company or its existing shareholders, including promoters. The issuer makes an offer for new investors to enter into its shareholding family. The company involved in the issue makes detailed disclosures as per SEBI's Disclosure and Investor Protection guidelines (DIP) in its offer document and offers it for subscription. This paves the way for the listing and trading of the issuer's securities.

For example, Google's IPO included both a primary offering (the issuance of Google stock by Google) and a secondary offering the sale of Google stock held by shareholders, including the founders.

To make a public issue, it is necessary for every company to obtain a credit rating from at least one credit rating agency, registered with SEBI, before the date of registering its prospectus or red herring prospectus with the Registrar of Companies.

- (b) A follow-on public offering:** A follow-on public offering (FPO) is an issuance of shares by the existing company, subsequent to its initial public offering. This is an issuance of additional shares offered to the public by the existing company. By the time an FPO is initiated, new shares are created by the existing company to raise funds.

A follow-on public offering means the issuance of additional shares by an existing company, after the IPO, through an offer document.

A follow-on offering can be made in any one of the following ways:

- Promoters dilute their stake by offering some of their shares to the public.
- The company issues fresh shares.
- Both these approaches are combined.

The basic difference between an IPO and an FPO is simple. An IPO is made by a company for the first time to the public, while an FPO is a subsequent issue to the public with an intention to raise additional capital.

2. Rights issue

A rights issue (RI) is one when a listed company proposes to issue fresh securities to its existing shareholders on any specified date, known as a record date. The rights are normally offered in a particular ratio to the existing security holders, prior to the issue. This route is the most suitable for companies, which would like to raise capital, without diluting the stake of its existing shareholders, provided the existing shareholders subscribe to their entitlements.

3. Bonus issue

A bonus issue is a free issue of shares to the existing shareholders. A company may decide to distribute free shares, known as bonus shares, as an alternative to increasing the dividend payout. With the bonus issue, new shares would be issued to existing shareholders in proportion to their holdings. For example, the company may give one bonus share for every five shares held.

When bonus shares are announced, the market price of existing shares may flare up as buyers would be eligible to get additional shares without payment. Of course, this action depends on market expectations.

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Sometimes, the market price goes down after the announcement of a bonus issue, when market expectations are not fulfilled. For example, the market expected a bonus issue of 1:1, but the company announces one bonus share for two shares held.

4. Stock option or employees' stock option scheme

An employees' stock option scheme (ESOP) is a common option given to employees to purchase shares at a lower price, compared to the market price. This is issued to existing employees, who provide valuable services, to retain their loyalty.

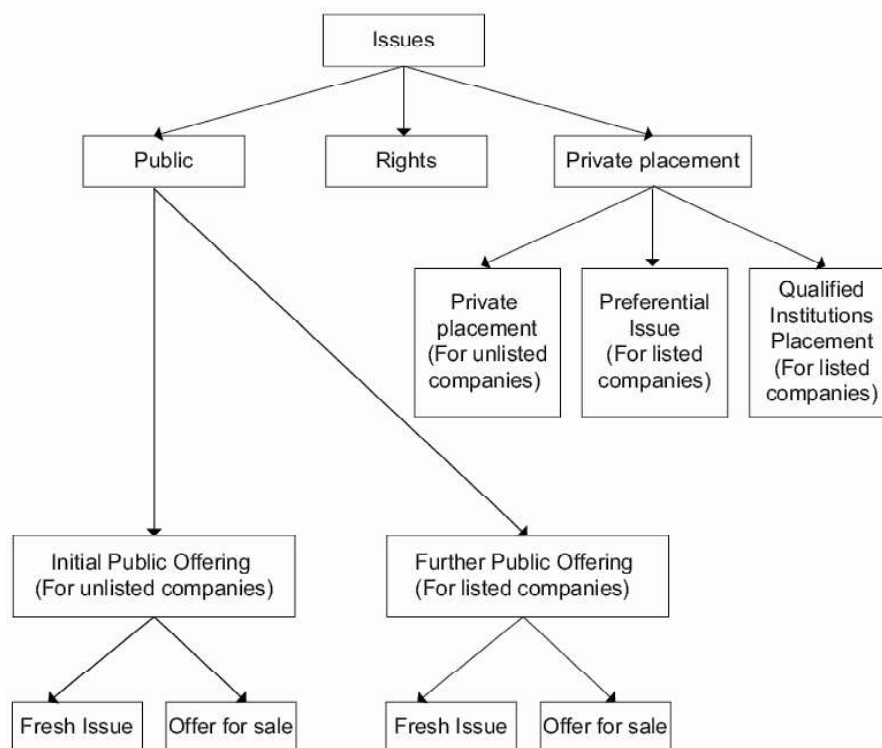


Fig. 5.1 Types of Issues

This differs from sweat equity shares. Sweat equity is usually given to directors or employees as consideration for some knowhow or knowledge obtained from them, which is useful for the organization. Both employees stock option scheme and sweat equity are similar but not the same (Table 5.2).

Table 5.2 Difference between Stock Option and Sweat Equity

Basis of Difference	Stock Option	Sweat Equity
Price	At a predetermined price, usually, at a lower price than the market price.	At a discount or without monetary consideration (free)
To whom issued	Employees and promoters	Only employees
Lock in period	No lock in period	3 years

5. Private placement

The main purpose of private placement is to enable the company to speedily issue shares and raise equity capital with minimal costs. Private placement can be of the following types:

- Preferential allotment
- Qualified institutions placement

To go for private placement, there are certain regulations and criteria that a company has to follow. The first thing is that the company has to be listed on a stock exchange. It must meet the requirement of minimum public shareholding as per the listing agreement.

Private placement consists of two kinds preferential allotment and qualified institutional placement. Under the preferential allotment, a listed company issues securities to a select group of entities not exceeding 49, which may be institutions or promoters, at a particular price. The eligibility of investors is as per Chapter XIII of SEBI (DIP) guidelines.

Under the SEBI rules and Companies Act, a private placement is defined as issuance of shares or other securities to a select group of persons not exceeding 49, which is neither a rights issue nor a public issue. An issue that involves 50 or more investors is considered a public offer.

5.4.1 Lead Manager and Underwriting

In the 1960s and 1970s, a public issue was managed by the company and its personnel. Now, a public issue involves a number of agencies. The rules and regulations and the changing scenario of the capital market have made it necessary for companies to seek the support of various agencies to make the public issue a success. As a student of investment management, one should know the agencies involved and their respective roles in the public issue. The promoters should also have a clear idea about the agencies so that their activities can be coordinated effectively in the public issue. The main agencies involved in the public issue are:

- Managers to the issue
- Registrars to the issue
- Underwriters
- Bankers
- Advertising agencies
- Financial institutions
- Government/statutory agencies

Managers to the Issue

Companies appoint lead managers to manage a public issue. Their main duties are as follows:

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- Drafting the prospectus
- Preparing a budget of expenses related to the issue
- Suggesting the appropriate timing of the public issue
- Assisting in marketing the public issue successfully
- Advising the company in the appointment of registrars to the issue, underwriters, brokers, bankers to the issue, advertising agents, etc.
- Directing the various agencies involved in the public issue

Many agencies perform the role of lead managers to the issue. The merchant banking divisions of financial institutions, subsidiaries of commercial banks, foreign banks, private sector banks, and private agencies are available to act as lead managers. Some of them are SBI Capital Markets Ltd, Bank of Baroda, Canara Bank, DSP Financial Consultants Ltd, and ICICI Securities & Finance Company Ltd. The company negotiates with the prospective managers to its issue and settles their selection and terms of appointment. Usually, companies appoint lead managers with a successful background. There may be more than one manager to the issue. Sometimes the banks or financial institutions impose a condition, while sanctioning a term loan or underwriting assistance, that they be appointed as one of the lead managers to the issue. The fee payable to the lead managers is negotiated between the company and the lead manager. The amount agreed upon is revealed in the memorandum of understanding filed along with the offer document.

Registrar to the Issue

The registrar to the issue is appointed in consultation with the lead managers. Quotations with details of the various functions they will be performing and charges for them are invited. The most suitable one is then selected. It is always ensured that the registrar to the issue has the necessary logistical support such as access to a computer, internet and a telephone.

The registrars usually receive the share applications from various collection centres. They recommend the basis of allotment in consultation with the stock exchange of listing the shares. They arrange for the despatch of the share certificates. They hand over the details of the share allocation and other related documents to the company. Usually, registrars to the issue retain the issue records for at least six months from the last date of despatch of letters of allotment, to enable investors to approach the registrars for redressal of their complaints.

Underwriters

Underwriting is a contract in which an underwriter gives an assurance to the issuer that he will subscribe to the securities offered in the event of non-subscription by the persons to whom they are offered. The person who gives this assurance is called an underwriter. Underwriters do not buy and sell securities. They stand as back-up supporters, and underwriting is done for a commission. Underwriting

provides insurance against the possibility of inadequate subscription. Underwriters are divided into two categories:

- Financial institutions and banks
- Brokers and approved investment companies

Some examples of underwriters are financial institutions, commercial banks, merchant bankers, members of the stock exchange, Export and Import Bank of India and State Bank of India. The underwriters are exposed to the risk of non-subscription, and for such risk exposure, they are paid an underwriting commission.

The underwriter's financial strength is considered before appointing him, because he has to undertake the agreed non-subscribed portion of the public issue. The other aspects considered are the following:

- Experience in the primary market
- Past underwriting performance and default
- Outstanding underwriting commitment
- Network of investor clientele
- Overall reputation

The company, after the closure of the subscription list, communicates in writing to the underwriter the total number of shares/debentures that remain unsubscribed and the number of shares/debentures required to be taken up by the underwriter. The underwriter will then take up the agreed portion. If the underwriter fails to pay, the company is free to allot the shares to others or take up proceedings against the underwriter to claim damages for any loss suffered by the company for his denial.

Bankers to the Issue

Bankers to the issue are responsible for collecting the application money along with the application form. They charge commission besides the brokerage, if any. Depending upon the size of the public issue more than one banker to the issue is appointed. When the size of the issue is large, three or four banks are appointed as bankers to the issue. The number of collection centres is specified by the central government. The bankers to the issue should have branches in the specified collection centres. In metropolitan cities, more than one branch of the various bankers to the issue is designated as the collecting branch for acceptance of money. To create investment awareness among the people, collecting branches are designated in the different towns of the state where the project is being set up. If the collection centres for application money are located nearby, people are likely to invest their money in company shares.

Advertising Agents

Advertising plays a key role in promoting a public issue. Hence, the past track record of an advertising agency is studied carefully. Advertising agencies submit

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their tentative programmes and the estimated cost. The issuer selects a suitable advertising agency after comparing the effectiveness and cost of each programme in consultation with the lead managers. The advertising agencies take responsibility for giving publicity to the issue through appropriate platforms. These could be newspapers, magazines, hoardings, press releases or a combination of all.

Financial Institutions

Financial institutions underwrite the issue and extend term loans to the companies. Usually, they will scrutinize the draft prospectus, study the proposed programme for public issue, and approve them. IDBI, IFCI and ICICI, LIC, GIC and UTI are some of the financial institutions that underwrite and give financial assistance. The lead manager will send a copy of the draft prospectus to the financial institutions and include their comments, if any, in the revised draft.

Government and Statutory Agencies

The various regulatory bodies associated with a public issue are listed below:

- SEBI
- Registrar of Companies
- Reserve Bank of India (if the project involves foreign investment)
- Stock exchanges of the place where the issue is going to be listed
- Industrial licensing authorities
- Pollution control authorities (clearance for the project has to be stated in the prospectus)

Check Your Progress

4. How can public issues be further classified?
5. What are the different ways in which a follow-on offering can be made?
6. What are the two types of private placement?

5.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Equity shares have certain advantages. The main advantages are:
 - Capital appreciation
 - Limited liability
 - Free tradability
 - Tax advantages (in certain cases)
 - Hedge against inflation

2. The share certificate is available in two forms.
 - Physical form – share certificates are issued in the physical form.
 - Demat form – share certificates are issued in the electronic form.
3. The procedures and practices for managing public issues fall under two phases:
 - Pre-issue management begins with the structuring of issues and ends with the opening of a subscription list;
 - Post-issue management continues until the securities are listed on the stock exchange.
4. Public issues can be further classified into initial public offerings (IPOs) and follow-on public offerings.
5. A follow-on offering can be made in any one of the following ways:
 - Promoters dilute their stake by offering some of their shares to the public.
 - The company issues fresh shares.
 - Both these approaches are combined.
6. Private placement can be of the following types:
 - Preferential allotment
 - Qualified institutions placement

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5.6 SUMMARY

- Various types of securities are traded in the market. Securities broadly represent evidence to property rights. A security provides a claim on an asset and any future cash flows the asset may generate.
- Corporates generally raise funds through fixed and variable income securities like equity shares, preference shares and debentures.
- Equity shares are commonly referred to as common stock or ordinary shares. Even though the terms ‘shares’ and ‘stocks’ are interchangeably used, there is a difference between them.
- Share certificate means a certificate under the common seal of the company specifying the number of shares held by any member. A share certificate provides the *prima facie* evidence of title of the members to such shares.
- Sweat equity is a new equity instrument introduced in the Companies (Amendment) Ordinance, 1998. The newly inserted Section 79A of the Companies Act, 1956 allows the issue of sweat equity.
- Non-voting shares carry no voting rights. They carry additional dividends instead of voting rights. Even though the idea was widely discussed in 1987, it was only in the year 1994 that the Finance Ministry announced certain broad guidelines for the issue of non-voting shares.

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- A bonus share is the distribution of shares in addition to cash dividends to existing shareholders. Bonus shares are issued to existing shareholders without any payment of cash. The aim of a bonus share is to capitalize the free reserves.
- The characters of the preferred stock are hybrid in nature. Some of its features resemble the bond and others the equity shares. Like the bonds, their claims on the company's income are limited, and they receive a fixed dividend.
- A bond is a long-term debt instrument that promises to pay a fixed annual sum as interest for a specified period of time.
- A warrant is a bearer document of title to buy a specified number of equity shares at a specified price. Warrants can usually be exercised over a number of years. The life periods of warrants are long. Warrants are offered to make the bond or preferred stock offering more attractive.
- Market makers are those who quote rates for buying and selling the securities they deal in. This is to ensure adequate liquidity for both buyers and sellers in the securities market.
- Management of capital issues in India is a professional service rendered by merchant bankers. In fact, issue management is a major function for merchant bankers.

5.7 KEY WORDS

- **Sweat equity:** It is a party's contribution to a project in the form of labour, as opposed to financial equity such as paying others to perform the task.
- **Non-voting share:** A non-voting share is a share in the capital of a company which belongs to a class that has no voting rights. This is distinct from, for example, an ordinary share which gives the shareholder standard rights to vote at shareholder meetings in proportion to their shareholding.

5.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Differentiate between right shares and bonus shares.
2. What are the different types of preference stock?
3. Write a short note on stock derivatives.

Long Answer Questions

1. How is marketing of corporate securities done? Discuss in detail.
2. What are the different types of issues? Analyse the different types of steps to be taken by the issuing company?
3. Describe the role of lead managers and underwriters.

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5.9 FURTHER READINGS

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UNIT 6 MANAGEMENT OF POST- ISSUE ACTIVITIES

NOTES

Structure

- 6.0 Introduction
- 6.1 Objectives
- 6.2 Processing of Data and Allotment of Shares
 - 6.2.1 Under Subscription
 - 6.2.2 Bridge Loans
- 6.3 Reporting to SEBI
- 6.4 Listing on Stock Exchanges
- 6.5 Answers to Check Your Progress Questions
- 6.6 Summary
- 6.7 Key Words
- 6.8 Self Assessment Questions and Exercises
- 6.9 Further Readings

6.0 INTRODUCTION

In post-issue management, generally, the relative success or failure of public issue mostly depends on response received for the issues. Thus, in a public issue, all the players associated with are very much eager to know about the number of applications received for subscription and also the amount collected thereon.

The market intermediaries who take part in the primary market to provide specialised services in capital issue management are (a) merchant bankers, (b) registrars, (c) underwrites, (d) brokers to the issue, (e) advisors to the issue, (f) bankers to the issue, (g) advertising agencies, etc. This unit will examine various post-issue management activities.

6.1 OBJECTIVES

After going through this unit, you will be able to:

- Describe the management of post-issue activities
- Analyse the processing on data and allotment of shares
- Discuss the process of listing of securities
- Define bridge loans and under subscription

6.2 PROCESSING OF DATA AND ALLOTMENT OF SHARES

Corporates can raise funds through a fixed price issue, book building or a combination of both. Free pricing of issues was introduced by SEBI in 1992. SEBI gave a free hand to companies to set the issue price based on market dynamics and no longer plays a role in price fixing. The issuer consults the merchant banker and sets the price based on market demand. The offer document contains full disclosures of the parameters that are taken into account by the merchant banker and issuer to settle the price. The parameters include EPS, PE multiple, return on net worth and comparison of these parameters with other companies in the same industry. Based on comparative parameters, companies fix the price while issuing shares.

An IPO can be made through the fixed price method, book building method or a combination of both.

Fixed Price Issue

In a fixed price issue, the issuer decides the issue price at the outset and mentions it in the offer document. The companies are free to price their equity shares. However, they have to justify the price in the offer document / letter of offer.

The issue price can be the face value of the instrument, discounted price or premium price, which is determined by the company. The allotment of securities to different categories of investors in a fixed price issue is to be made on a proportionate basis and the conditions are as below:

- A minimum 50 per cent of the net offer of securities to retail individual investors.
- The remainder to:
 - o Individual applicants other than retail individual investors.
 - o Other investors, including corporate bodies/ institutions.

If shares set aside for either category remain unsubscribed, it would be assigned to the other category, where there are more subscriptions. The issue remains open for a minimum of three days and for a maximum of 10 days.

Book Building

SEBI introduced the practice of issuing shares through the book building process in 1998—this was an important reform of the Indian market. The aim of book building is to elicit demand and efficient price discovery for the issue of securities. The book building process is undertaken, to determine investor appetite for a share at a particular price.

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Book building refers to the collection of bids from investors, based on an indicative price range, to fix the issue price after the bid closing date. Book building is a process of demand and price discovery of securities. SEBI Guidelines define book building as a process undertaken by a corporate body to elicit the demand and assess the price for the quantum of securities issued.

Types of Book Building

There are two types of book building 75 per cent book building and 100 per cent book building.

Seventy-five per cent book building–allotment procedure: In case of 75 per cent book building, the balance 25 per cent of the net issue is allotted to the public at the same price, determined through the book-building process.

Why is it called book building? The book building method provides an opportunity to the market to discover the price for the securities offered, based on the bids received. The process is so named because the investors can watch the book being built in the form of a chart, indicating the price and the number of bids received, which is updated at periodical intervals, not exceeding thirty minutes.

Book building is seen as an alternative to a fixed price issue mechanism. The issuing company can issue the shares at a predetermined price or arrive at a price through the book building process. The purpose of book building is to elicit and build up the price of securities for the quantum offered by the issuing company.

In book building, the issuing company defines a price range, i.e., floor (lower) price and cap (upper) price. The issuer will notify the floor price or a price band by way of an advertisement. After subscription, the company decides the basis of allotment depending upon under or over subscription. On this basis, an applicant may or may not get allotment of shares.

Floor price In case of book building, the floor price (base price) is the minimum price at which bids can be made.

Band price The issuer sets a band within which the investors are allowed to bid for shares. The cap in the price band should not be more than 20 per cent of the floor price. Take the example of the recent issue of Yes Bank IPO; the floor price was ₹38 and the band was ₹38–45.

Cut-off price In a book building issue, the issuer is required to indicate either the price band or a floor price in the red herring prospectus. The actual discovered issue price can be any price in the price band.

The issue price discovered in the book building process is the cut-off price.

Only an individual retail investor can apply at the cut off price, while submitting the application. It means that the investor is ready to pay the price determined by the company at the end of the book building process. An individual investor applies for securities worth up to ₹2 lakh. SEBI has increased the earlier limit from ₹1–2 lakh in October 2010.

When retail investors bid at the cut-off price, it indicates their willingness to accept the shares at any price within the price band. In such a case, they need not indicate the price specifically. A retail investor has to pay the highest price along with the application, while placing the bid at the cut-off price. They are required to pay the margin amount calculated at the number of shares applied for multiplied by the ceiling price. Those retail individual investors who have applied at the cut-off price are eligible to be considered for allotment, irrespective of the issue price finally determined through the price discovery process.

If the company settles on a final price lower than the highest price asked for in the IPO, the remaining amount is returned to the retail investor.

The first 100 per cent book building issue was undertaken by Bharti Televentures in 2001.

In 100 per cent book building process, the entire issue price is determined through the book building process.

Red herring prospectus (RHP) A red herring prospectus does not contain the details of either the price or the number of shares being offered or the amount of issue. In other words, the full details of issue are not available. In case the price is not disclosed, the number of shares and the upper and lower price bands are disclosed. On the other hand, an issuer can state the issue size and the number of shares are determined later. The issue size relates to the total amount that the company wants to raise. In case, the final issue price is more than the minimum price, the number of shares would be reduced as the issue size is fixed.

An RHP would be filed with the Registrar of Companies (RoC) without the price band. In such a case, the issuer notifies the floor price or a price band by way of an advertisement one day before the opening of the issue. The details of the final price are included in the offer document only on completion of the bidding process. The offer document, filed thereafter with the RoC, is called a prospectus.

Is book building compulsory? A company has the option to come out with a fixed price issue or a book built issue. However, if the company does not satisfy any of the conditions stipulated in Chapter III Part I Clause 26 (I) of the SEBI ICDR Regulations 2009, then it has to go through the book built route.

Working mechanism of the book building process Book building is a new buzzword in the capital markets. It is aimed to aid price and demand discovery. The red herring prospectus may contain either the floor price for the securities or a price band within which the investors can bid. The spread between the floor and the cap of the price band shall not be more than 20 per cent. In other words, the cap should not be more than 120 per cent of the floor price.

Book building is like a public auction. The process is as under:

Bidding takes place through an electronically linked transparent bidding facility, provided by recognized stock exchange/s.

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The issuer who is planning an offer nominates lead merchant banker(s) as 'book runners'.

A red herring prospectus has to be filed with the registrar of companies, before the bidding process begins.

The issuer also appoints syndicate members with whom orders are to be placed by the investors.

The syndicate members input the orders into an 'electronic book'. This process is called 'bidding' and is similar to open auction.

The book remains open for a minimum of three days for all categories of applicants, which can be extended to ten days, in case of a revision in the price band.

Investors who desire to participate in book building issues are required to fill up a bid-cum-application form and deposit it with one of the designated bidding centres along with the margin payment.

The issuer specifies the number of securities to be issued and the price band for the bids.

Bids have to be entered within the specified price band.

Bids can be revised by the bidders any number of times, before the book closes.

To maintain transparency in the bidding process, at the end of every bidding session, the demand for the issue is shown in the graph format on the terminals at periodical intervals.

On the close of the book building period, the book runners evaluate the bids on the basis of the demand at various price levels.

The book runner and the company conclude the pricing and decide the basis of allotment.

As the number of shares is fixed, the issue size gets frozen, based on the final price per share.

Allocation of securities is made to the successful bidders and the rest get refund orders.

Allotment is to be made within a period of 15 days from closure of the issue, failing which the issuer will be liable to pay interest at the rate of 15 per cent p.a. till the date of allotment.

The details of the final price are included in the offer document only on completion of the bidding process. The offer document filed thereafter with ROC is called a prospectus.

SEBI has not fixed any formula for arriving at the issue (price fixation), which is left to the company to decide, depending on market dynamics.

The issue price is the same for all who are allotted shares. Even if an applicant bidder has quoted a price higher than the final price, the excess amount is refunded.

Objective of case The objective of the following imaginary case is to explain how allotment of shares is made, when the issue is oversubscribed, to please the investors as well as derive benefit from the issue.

Company XYZ Ltd issues 1,00,000 shares through book building. It has fixed a price band of ₹60–72. The final demand is provided in Table 6.1.

Table 6.1 Final Demand

No. of Shares Subscribed (in thousands)	Cumulative Quantity (in thousands)	Price at Which Allotment can be Made (₹)
10	10	72
15	25	71
30	55	70
45	100	68
90	190	65
100	290	62
105	395	60

The issue is 1,00,000 shares, which the company wants to allot at the best possible price in the price band. In the above example, all the 1,00,000 shares are being subscribed at a price of ₹68 by investors. If the company wishes, it can fix the price at ₹68 and allot all the shares offered to the public. The issuing company can secure the maximum benefit, if it fixes the cut-off price at ₹68. However, the company, in consultation with the lead manager, has decided to fix an issue price at ₹65 and allot on a lottery basis as the number of eligible applicants are (1,90,000), more than the number of shares (1,00,000) issued to the public. There would be several disappointed applicants, at least 90,000 who have quoted a higher price but would not get the allotment and may be keen to buy in the stock market, after listing. So, the price may not fall below ₹65, at least for some time after the listing. In this process, the issuing company receives some benefit and also leaves some juice to the investors to satisfy their appetite, after listing. This action of company establishes a good brand image that it cares for the investors, even after the issue is fully subscribed at a price of ₹68.

Generally, when the issue is heavily oversubscribed, the issuing company has the opportunity to allot the full issue at the top end of the price band. However, there have been exceptions in the past where the issuers have fixed the issue price at less than the cap price, despite the heavy oversubscription from the investors. While determining the final issue price, the issuer as well as the book running lead manager (BRLM) will take into account the likely price at which the issue will be listed and traded.

The success of an issue is based on the market price, after being listed and its stability, at least, for a reasonable period. This is the litmus test for the success of an issue.

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Most book running lead managers (BRLMs) and issuers take this aspect into account and allow a little bit of juice to the investors so that there is sufficient liquidity for the shares post-listing. After initial listing, the market price may not remain stable and may fall below the issue price. The strategy of fixing a lower price does not allow the market price to fall below the issue price, at least, for a reasonable period.

SEBI, as regulator, does not participate in setting the price for issues. It is up to the company to decide on the price or the price band, in consultation with merchant bankers.

Listing: In case of book building, listing has to be completed within 12 days of the closure of the issue, which facilitates early trading.

Open outcry system for book building: Open outcry system for book building is not permitted. As per SEBI, only an electronically linked transparent facility is to be used in case of book building.

Quoting a price above the band will not in any way improve the purchaser's chances of getting an allotment.

Demat account for investors: As per the requirement, all the public issues of size in excess of ₹10 crore are to be made compulsorily in demat mode.

Guidelines for book building: The rules governing book building are covered in Chapter XI of the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines 2000.

In a public issue, which follows the book building process, retail investors have to deposit the application money based on the maximum price within the price band, if they choose the cut-off option.

Rights of investors: The following are the rights of investors in book building process:

1. An individual investor can revise his own bid at any time, before the closure of the issue, using the book building facility.
2. A bidder can ask for a transaction registration slip as the proof of having entered the bid. Whenever a bid is entered by trading members into the system, a unique transaction registration slip is automatically generated. The transaction registration slip gives details, such as the number of shares in the bid, the price, the client's name, etc.
3. An investor cannot enter a bid below the floor price. The system automatically rejects the bids, if the price is less than the floor price.
4. Individual investors are certain to be eligible for an allotment, when they exercise the option of a cut-off price. This privilege is only extended to retail investors.

Allotment: Allotment is to be made in case of book built issue as under:

The other alternative is 100% book-building process. If the company makes 100% of the issue through the book-building process, the basis of allocation of the issue should be as shown in Table 6.2.

Table 6.2 Basis of Allocation of the Issue

Category to Whom Allotment is to be Made	% of Issue
Retail investors	35% minimum
Non-institutional investors i.e., other than retail investors and qualified institutional buyers (QIBs)	15% minimum
Qualified institutional buyers (QIBs)	Not more than 50%

In a book built issue, allocation to individual retail investors, non-institutional investors and QIBs is in the ratio of 35:15: 50 respectively. All allottees are allotted shares on a proportionate basis within their respective investor categories.

Issue of share capital through book-building has been made compulsory for those companies, which do not have a profitable track record. Book-building is compulsory for those companies that do not have distributable profits for a minimum period of three years. Such non-profit making companies have to allot at least 50 per cent of the net offer to the QIBs, failing which the full subscription monies shall be refunded.

The media has commended the initiative taken by the SEBI, which will enable retail investors to make a well informed decision (Box 6.1), while investing in IPOs:

Box 6.1 SEBI Notifies IPO Reforms

Steps include keeping a strict vigil on issue proceeds and allotting a minimum number of shares to retail investors.

The company would also have to open the issue at least three working days from the date of registering the red herring prospectus with the Registrar of Companies.

The companies would have to disclose the price band at least five days before the opening of the offer period, as against the current provision of two days. This will give the investors more time to analyse the IPO.

The minimum application size for all investors has also been increased to ₹10,000–15,000, as against the existing ₹5,000–7,000.

In another step aimed at helping retail investors, SEBI has allowed retail individual investors to either withdraw or revise their bids until finalization of the allotment, but institutional buyers and non-institutional investors can neither withdraw nor lower the size of their bids at any stage. The move is aimed at avoiding any misleading signals to retail investors about the extent of the issue subscription.

Source: Live Mint, 15 October 2012

The applications supported by blocked amount (ASBA) process The ASBA process is available in all public issues made through the book building

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route. ASBA is an application containing an authorization to block the application money in a bank account for subscribing to an issue. If an investor is applying through ASBA, his application money will be debited from the bank account only if his application is selected for allotment after the basis of allotment is finalized. In this process, banks block the amount in the bank account and funds continue to remain in the same account till allotment by the issuer.

6.2.1 Under Subscription

Undersubscribed is a situation in which the demand for an initial public offering of securities is less than the number of shares issued. An offering is undersubscribed when the underwriter is not able to get enough interest in the shares for sale. Because there may not be a firm offering price at the time, purchasers usually subscribe for a certain number of shares. This process allows the underwriter to gauge demand for the offering and determine whether a given price is fair.

6.2.2 Bridge Loans

A bridge home loan is a short-term loan when the owner of an existing house wants to sell it and buy another, without waiting for the sale proceeds of the existing house. The new home is normally bigger or located elsewhere to suit the changed requirements of the person concerned.

If one is planning to move into a bigger, better and more convenient house from the existing small home, without waiting for its sale proceeds, a short-term bridge loan is the ideal choice.

Here, the individual owns a small house and wants to buy a bigger house. But he does not want to sell the existing house before buying the bigger one. This creates a mismatch in the cash flow. The short-term bridge loan helps him in the interim period between the sale of the existing house and the purchase of a new one.

The procedure is very similar to that of applying for a normal home loan in terms of the eligibility criteria and the documents to be furnished. However, it is mandatory for the borrower to identify the new house that is to be purchased before going to a bank. The application for a bridge loan is generally considered only after ensuring that the prospective borrower has entered into an agreement for the sale of his property. On the negative side, the interest rates on bridge loans are higher than those on home loans because it is a short-term loan, and also, costs and fees are also involved in it.

Check Your Progress

1. How can an IPO be made?
2. What are the two types of book building?
3. What is the situation of under subscription?

6.3 REPORTING TO SEBI

The eligibility norms for public issue as issued by the SEBI are as follows:

1. Unlisted company

An unlisted company needs to satisfy all the following criteria to be eligible for making a public issue, which is popularly known as the profitability route. It should have the following:

- Net tangible assets of at least ₹3 crore for three full years, out of which 50 per cent is held in monetary assets
- Distributable profits in at least three years out of the past five years in terms of section 205
- Net worth of at least ₹1 crore in each of the preceding three years
- If it has changed its name, at least 50 per cent of revenue for the preceding one year should be from the new activity
- The issue size should not exceed five times the pre-issue net worth

The unlisted company has to comply with all the above five conditions to make a public issue.

Alternative eligibility norms for public issue To provide sufficient flexibility and also ensure that genuine entrepreneurs do not suffer on account of the rigidity of the above parameters, SEBI has provided two alternative routes for unlisted companies:

QIB route: The total issue has to be made through the book building process (100 per cent), out of which at least 50 per cent of the net offer should be allotted to QIBs, otherwise the full subscription money is to be refunded.

Appraisal route: The project should be appraised by public financial institutions and scheduled commercial banks, who would be prepared to participate to the extent of 15 per cent, 10 per cent of which will come from the appraisers. In addition, 10 per cent of the issue size must be allotted to QIBs. Otherwise, the subscription money has to be refunded.

- The post-issue size shall be a minimum of ₹10 crore or there must be market making for at least two years subject to the following conditions:
- Market makers undertake to buy and sell for a minimum depth of 300 specified securities
- The spread in the bid-ask difference for sale and purchase is not to exceed 10 per cent
- The inventory holding of market makers as on the date of allotment of securities shall be at least 5 per cent of the proposed issue

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The unlisted company can adopt any one of the above alternative routes to make a public issue. In addition to the compliance of any one of the above eligibility conditions, the company that makes the issue shall have at least 1,000 prospective allottees in the issue.

Minimum promoter's contribution and lock-in: In a public issue by an unlisted issuer, the promoters shall contribute not less than 20 per cent of the post-issue capital, which should be locked in for three years. A lock-in indicates a freeze on the shares. The remaining pre-issue capital should also be locked in for a period of one year from the date of listing. In case of a public issue by a listed issuer (i.e., FPO), the promoters shall contribute not less than 20 per cent of the post-issue capital or 20 per cent of the issue size. This provision ensures that promoters of the company have some minimum stake in the company for a minimum period after the issue or after the project for which funds have been raised from the public, commences.

2. Listed company

A listed company is eligible to make a public issue of equity shares or any other security that can be converted into or exchanged into equity shares at a later date, provided it complies with the following conditions:

- The issue size does not exceed five times its pre-issue net worth as per the audited balance sheet of the last year.
- If the company has changed its name, at least 50 per cent of the revenue for the preceding one year should be from the new activity.

If the issue size exceeds five times the company's net worth, prior to the issue, the listed company has to make the issue through the book building process and allot 50 per cent of shares to QIBs; otherwise, the subscription money collected has to be refunded.

3. Fast track issue

To enable listed companies to access the Indian primary market quickly, SEBI has specified the requirements to make fast track issues (FTIs). The listed companies can make a follow-on public offer/rights issue by filing a copy of their red herring prospectus (in case their issue is made through book building) or a prospectus (in case their issue is made through fixed price) with the Registrar of Companies. The provisions relating to filing of offer documents are not applicable to a listed company that wants to make a public issue of securities via a follow-on public offer/rights issue, where the aggregate value of the securities, including premium, if any, exceeds ₹50 lakh.

The applicable conditions are as under:

Listing: The shares of the company have been listed on any stock exchange that has nationwide terminals for a period of at least three years, immediately

preceding the reference date. In case of non-compliance, adequate disclosure has been made in the offer document in respect of non-compliance.

Market capitalization: The average market capitalization of public shareholding of the company is at least ₹5,000 crore (reduced from ₹10,000 crore earlier) for a period of one year up to the end of the quarter, preceding the month of issue. The average market capitalization of public shareholding means the sum of the daily market capitalization of public shareholding divided by the number of trading days.

Annualized trading turnover: The annualized trading turnover of the shares of the company is 2 per cent of the weighted average of the number of shares listed during the six months period, preceding the month of the reference date.

Grievances/complaints: The company has redressed at least 95 per cent of the grievances/complaints of the shareholders/investors received till the end of the quarter, immediately preceding the month of issue.

Auditors' qualifications: When the accounting treatment adopted by the company is not acceptable, the statutory auditor makes qualifications in its audit report. Further, the auditor also has to quantify the impact of qualification on profits for the benefit of the readers. In the absence of quantification, the significance may not be known. The impact of the auditors' qualifications, if any, on the audited accounts has not exceeded 5 per cent of the net profits/loss after tax for the respective years.

Prosecution proceedings: No prosecution proceedings or show cause notice has been issued by the SEBI against the company or the promoters or full-time directors on the reference date.

Dematerialized shareholding: The entire shareholding of the promoters group has been held in dematerialized form on the reference date.

Is the Book-building Process Compulsory for all Companies?

The book-building process is compulsory for those companies without an established track record of profits. It is optional for profitability route companies, which have to comply with specific conditions, including distributable profits for a period of three years, before issue of share capital. As per SEBI's guidelines, this book building process is not compulsory for those IPOs that comply with all the conditions in the profitability route. In case companies do not have a track record of profitability and the required net worth as per SEBI guidelines, the book-building process is compulsory in the QIB route. SEBI has tightened the entry norms for IPOs to enhance the quality of issues in the primary market. Depending on the entry route, the book-building process can be voluntary or compulsory. However, infrastructure companies are exempt from the book building requirement.

The book-building process is not compulsory for those companies which have an established track record of profits. Those companies have the option to

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issue shares either at a predetermined fixed price or through the book building process.

Exempted Category of Entities

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SEBI (Disclosure and Investor Protection) guidelines have provided certain exemptions from the eligibility norms. The following are eligible for exemption from entry norms.

- Private sector banks
- Public sector banks
- An infrastructure company, whose project has been appraised by approved institutions
- Rights issue by a listed company

6.4 LISTING ON STOCK EXCHANGES

Listing means admission of securities to dealings on a recognized stock exchange. The securities may be of any public limited company, central or state government, quasi-governmental and other financial institutions/corporations, municipalities, etc.

The following are the reasons why a company may seek listing for its shares:

- **Access to a wider pool of finance:** Listing on the stock market provides greater access to a number of potential investors. Listing also improves the credit rating of a company, making debt finance easier and cheaper to obtain.
- **Improved marketability:** Securities that are traded on the stock market can be bought and sold in relatively small quantities at any time with greater ease.
- **Transfer of capital to other uses:** Founder owners can sell part of their holdings either for personal reasons or for investment in other business opportunities.
- **Enhancement of company image:** Quoted companies are commonly believed to be more financially stable. Listing improves the image of the company with its customers and suppliers, allowing it to gain additional business and improve its buying power.
- **Offer for acquisition:** A listed company is in a better position to make a paper offer for a target company than an unlisted one.

Check Your Progress

4. State the full form of FTI?
5. What categories of entities are exempted from entry norms?

6.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. An IPO can be made through the fixed price method, book building method or a combination of both.
2. There are two types of book building— 75 per cent book building and 100 per cent book building.
3. Undersubscribed is a situation in which the demand for an initial public offering of securities is less than the number of shares issued. An offering is undersubscribed when the underwriter is not able to get enough interest in the shares for sale.
4. The full form of FTI is Fast Track Issues.
5. The following are eligible for exemption from entry norms.
 - (a) Private sector banks
 - (b) Public sector banks
 - (c) An infrastructure company, whose project has been appraised by approved institutions
 - (d) Rights issue by a listed company

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6.6 SUMMARY

- Corporates can raise funds through a fixed price issue, book building or a combination of both. Free pricing of issues was introduced by SEBI in 1992.
- SEBI gave a free hand to companies to set the issue price based on market dynamics and no longer plays a role in price fixing. The issuer consults the merchant banker and sets the price based on market demand.
- In a fixed price issue, the issuer decides the issue price at the outset and mentions it in the offer document. The companies are free to price their equity shares.
- The issue price can be the face value of the instrument, discounted price or premium price, which is determined by the company.
- Book building refers to the collection of bids from investors, based on an indicative price range, to fix the issue price after the bid closing date. Book building is a process of demand and price discovery of securities.
- SEBI Guidelines define book building as a process undertaken by a corporate body to elicit the demand and assess the price for the quantum of securities issued.

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- Book building is seen as an alternative to a fixed price issue mechanism. The issuing company can issue the shares at a predetermined price or arrive at a price through the book building process.
- The purpose of book building is to elicit and build up the price of securities for the quantum offered by the issuing company.
- When retail investors bid at the cut-off price, it indicates their willingness to accept the shares at any price within the price band. In such a case, they need not indicate the price specifically.
- A red herring prospectus does not contain the details of either the price or the number of shares being offered or the amount of issue.
- Undersubscribed is a situation in which the demand for an initial public offering of securities is less than the number of shares issued. An offering is undersubscribed when the underwriter is not able to get enough interest in the shares for sale.
- A bridge home loan is a short-term loan when the owner of an existing house wants to sell it and buy another, without waiting for the sale proceeds of the existing house. The new home is normally bigger or located elsewhere to suit the changed requirements of the person concerned.
- Listing means admission of securities to dealings on a recognized stock exchange. The securities may be of any public limited company, central or state government, quasi-governmental and other financial institutions/corporations, municipalities, etc.

6.7 KEY WORDS

- **Red herring prospectus:** A red herring prospectus, as a first or preliminary prospectus, is a document submitted by a company as part of a public offering of securities.
- **Bridge loan:** A sum of money lent by a bank to cover an interval between two transactions, typically the buying of one house and the selling of another; a bridging loan.

6.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. Write a short note on fixed price issue.
2. What is a red herring prospectus?
3. Write a short note on allotment of shares.

Long-Answer Questions

1. Describe the different types of book building.
2. Analyse the different eligibility norms for public issue.
3. How is listing on stock exchanges done? Describe the process.

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6.9 FURTHER READINGS

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UNIT 7 SERVICE ORIENTED ACTIVITIES OF A RURAL BANKER

Structure

- 7.0 Introduction
- 7.1 Objectives
- 7.2 Merger and Amalgamation: Meaning and Purpose
 - 7.2.1 Types of Merger
- 7.3 Answers to Check Your Progress Questions
- 7.4 Summary
- 7.5 Key Words
- 7.6 Self Assessment Questions and Exercises
- 7.7 Further Readings

7.0 INTRODUCTION

As you have learnt previously, rural banks in India were established in the country under RRB Act, 1976 with a view to develop the rural economy by providing for the purpose of development of agriculture, trade commerce, industry and other production activities in the rural areas, credit and other facilities particularly to small and marginal farmers agricultural labourers artisans and small entrepreneurs and for matters connected there with and incidental thereto. In the initial stages during the 1970s and 1980s, RRBs were seen as primarily catering to the BPL population by lending to them towards meeting their investment needs. The recapitalization of RRBs during 1994-2000 along with a reorientation towards profitable function helped to restore the fortunes of RRBs. Thereafter the process of amalgamation which was started in 2005 has resulted in the number of RRBs being brought down. The amendment to the RRBs Act passed in April 2015 facilitates the raising of share capital of RRBs. These changes have paved way for their part privatisation and pure commercialisation and given access to institutional credit. RRBs have been repositioned as development oriented banks in the service of the poor as well as to be in harmony with the objectives and programmes of financial credit.

7.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning and types of mergers
- Describe amalgamations and consolidation

7.2 MERGER AND AMALGAMATION: MEANING AND PURPOSE

*Service Oriented
Activities of a Rural
Banker*

Restructuring has become the compelling necessity to survive in this fiercely competitive environment. Restructuring is required primarily to maintain status quo and secondly for growth. Corporate houses are redefining their mission statements by focusing on core competence and competitive advantage in a bid to achieve market leadership.

The term corporate restructuring encompasses business portfolio restructuring by the process of mergers, demergers, takeovers, acquisitions, foreign franchise purchase of brands and hiring of unrelated businesses, strategic alliances and joint ventures and above all internal financial restructuring and organizational restructuring.

Restructuring is a process by which a firm does an analysis of itself at a point of time and alters what it owes and owns, refocuses itself to specific tasks of performance improvements. Restructuring would radically alter a firm's capital structure, asset mix and organization to enhance the firm's value. Corporate restructuring refers to episodic exercise in the life of a business firm involving a significant change in its pattern of ownership and contract, or structure of assets and liabilities or both. Corporate restructuring may lead to (a) expansion and (b) change in ownership and contract.

Corporate restructuring has become very vital for achieving all the ultimate managerial objectives.

Corporate restructuring through mergers and acquisitions, takeovers, control and change in ownership structure is undertaken by companies for enlarging their size and for being benefited by the concept of economies of scale. Mergers and acquisitions are crucial in ensuring a healthy expansion of organizations as they evolve.

Various stages of developmental growth mergers and amalgamations may facilitate entry into new services or product market.

Many experts feel that corporate restructuring is neither a panacea nor a palliative for curing the problem of global competition. Corporate restructuring is not an easy process to manage. It is a difficult task demanding strong management skills, imagination, leadership attitude and also finance. Corporate restructuring may be termed as a process of self-transformation of the promoters, managers and the employees. Each corporation should re-examine itself to know whether it has the willingness and ability to reorient itself to withstand the pains of restructuring including adaptability to new processes and technologies and also the different demands of the customers.

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Forms of Restructuring Business Firms

1. Expansion
 - Mergers
 - Acquisitions
 - Amalgamations
 - Consolidation
 - Compromise
 - Tender offers
 - Arrangement
 - Joint Ventures
 - Reconstruction
2. Sell-offs
3. Spin-offs
4. Split-offs
5. Split-ups
6. Divestures
7. Equity carve-outs
8. Corporate control
 - Premium buybacks
 - Standstill agreements
 - Anti-takeover amendments
 - Proxy contests
9. Change in ownership structure
 - Exchange offers
 - Share repurchases
 - Going private
 - Leveraged buyout

Merger

A number of strategic imperatives have been driving companies towards mergers and acquisitions. They include globalization, consolidation, product differentiation, and customer demands, vertical integration, deregulation, technology requirements and refashioning. There has been a substantial increase in acquisitions and mergers by the corporate sector in India. This trend started in 1991, with the scrapping of

the relevant sections of Monopolies and Restrictive Trade Practices (MRTP) Act and Foreign Exchange Regulation (FERA) Act which required companies to get prior permission from the government for mergers.

The terms merger, amalgamation and acquisition are often used interchangeably to denote the situation where two or more companies combine into one economic entity to share risks, keeping in view their long-term business interest.

Amalgamation, merger and acquisition of undertakings are tools for materializing several objectives of the organization. These tools have been in use from a long time in one form or the other. At present, there are statutory requirements to be complied with by a company under the Companies Act, 2013 for merger, amalgamation and acquisition.

Meaning

If we go by the literal meaning of the words merger, acquisition or amalgamation, they mean the blending of one undertaking with another which may either be existing or new. It is a tool by which one or two undertakings come under the umbrella of one undertaking.

The Income Tax Act provides that for taking benefits of carrying forward losses and depreciation of the amalgamating undertakings, the following 'conditions must be fulfilled.

- All the assets and liabilities of the amalgamating companies must be transferred to the amalgamated company.
- At least 90 per cent members of the amalgamating companies must become the members of the amalgamated company.
- The shareholders of the amalgamated company must be given shares of the amalgamated company in exchange.

According to M.A. Weinberg, 'A merger may be defined as an arrangement whereby the assets of two companies become vested in, or under the control of one company, (which may or may not be one of the original two companies) which has its shareholders all or substantially all the shareholders 'of the two companies'.

A merger involves the fusion of two or more separate companies into one. It is a special case of combining companies where one survives and the other loses its identity. The company that acquires the other company acquires the assets, stock as well as liabilities of the merged company/companies in the form of equity shares of the. Transferee Company. The shareholders of the transferor company become shareholders in the' transferee company. Merger generally means that one company that is of less importance opts to become non-existent after the merger, for example, TOMCO after the merger with Hindustan Lever.

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Amalgamation

The word amalgamation is not defined by the Companies Act. The word has no precise legal meaning. In commercial parlance, the word amalgamation is used when two or more independent companies combine to form a new business. In case of amalgamation, a new company is formed and all the amalgamating companies are liquidated.

In Halsbury's Laws of England, amalgamation is stated as the blending together of two or more undertakings into one undertaking and in such an act, the shareholders of each blending company becomes the shareholders of the blended undertaking. Amalgamation may take place either by transfer of two or more undertakings to a new company or by the transfer of one or more undertakings to an existing 'company.

Incorporation of a new company to effect amalgamation is permissible. So a new company may be formed for amalgamation and takeover of an old company. However, it involves the formation of a new company to carry on the business of the old company.

Generally, amalgamation paves the way for better and more efficient control in running the operations and leads to saving costs and improved profitability.

Amalgamation is a legal process by which two or more companies are joined together to form a new entity or one or more companies are absorbed or blended with another, which will result in the amalgamating companies to lose its existence and its shareholders to become the shareholders of the new company or the amalgamated company. In an amalgamation, a new company may come into existence or an old company may survive while the amalgamating company may lose its existence.

Amalgamation signifies an arrangement to bring together the assets of two companies under a single company's control, which may or may not be one of the original two companies.

Examples of mergers and amalgamations

Indian banks have adopted the merger strategy to compete with foreign banks, since after the merger, the growth rate of deposits, income, total expenditure, profit, capital, number of employees and the number of branches increase considerably. Mergers help banks to increase asset size, strengthen their presence, optimize resources and diversify the range of products and services. The following is the list of mergers which has taken place in the last few years in our country.

- Times Bank (Bennett Coleman & Company) has been merged with HDFC Bank.
- ICICI a leading development bank was merged with ICICI Bank in 2002.

- Global Trust Bank was amalgamated with the Oriental Bank of Commerce in 2004.
- IDBI Bank was merged with its parent institution IDBI a development bank on 2 April 2005.
- Lord Krishna Bank was merged with Centurion Bank of Punjab in 2007.
- Centurion Bank of Punjab was merged with HDFC Bank.

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Acquisition

Acquisition implies that one of the firms loses its identity and that it has been purchased by the firm that continues its existence. According to the *Collins Business Dictionary* an acquisition is the act of getting or buying something.

In the context of business combinations, an acquisition means purchase of share capital of an existing company by another company. Theoretically, more than 50 per cent of the paid-up quality capital of the acquired company should be bought by the acquirer for enjoying complete control. However, in practice, even with 10-40 per cent shareholding, effective control can be exercised. Since the remaining shareholders are usually scattered and ill-organized, they are not likely to challenge the control of the acquirer.

An asset acquisition is an acquisition of all or part of the assets of a company pursuant to a contract entered into between the buyer and the seller. Asset acquisition requires that specific instruments of title must be delivered by the seller for transferring, the legal title to the buyer.

A share acquisition or takeover is an acquisition in which all or part of the outstanding shares of the seller is acquired from the shareholders of the seller company. A takeover is defined as a transaction or series of transactions in which a person (individual, group of individuals or company), acquires control of a company's assets either directly by becoming the owner of those assets or indirectly by obtaining control of the company's management where shares are closely held (by a small number of persons). A takeover will come into effect by an agreement with the holders of those shares. In case the shares are held by the public, a takeover may come into effect by an agreement between the acquirers and the controllers of the acquired company by purchasing shares on the stock exchange.

A takeover or acquisition may be effected by the following:

- An agreement between the acquirer and the majority
- Purchase of shares in the open market as in the case of Genelec Ltd and Spencer Ltd
- A public offer to all the shareholders as in the case of Tata Tea Ltd and Consolidated Coffee Ltd
- Private treaty for purchasing new shares
- By means of a takeover bid

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Distinction between merger and acquisition

The word merger is commonly used as an alternative to acquisition or takeover. However, there are some differences between the two also. The differences are as follows:

- (i) In takeover, the companies involved continue their corporate existence without interruption, whereas in a merger only one company survives and the other loses its existence.
- (ii) The consideration payable in a takeover is generally in the form of cash though it may also be paid in the form of equity shares or debentures or a mix of the various modes available.

Consideration in a merger paid for or received in shares. All shareholders receive money in future periods of time in the form of future dividends and/or capital appreciation.

- (iii) Takeover generally takes longer than mergers because in a takeover the bid for controlling the stake in the target company is frequently against the wishes of the management of the target company, whereas in the case of a merger the bid is generally by the consent of the management of both the companies.
- (iv) The legal routes to mergers and acquisitions are different in the Indian context. Sections 230 to 240 of the Companies Act 2013 require consent of shareholders, creditors and approval of the courts in case of mergers, whereas takeovers/ acquisitions are governed by the Securities and Exchange Board of India (SEBI) regulations.

Consolidation

Consolidation implies a completely new form that is created from the merged firms. Consolidation represents a combination of two or more business firms into a new business firm. The essence of consolidation is that all the combining firms lose their identity.

Consolidation is preferred because when a large firms combine with small firms, normally the smaller firms are merged into the larger firm. However, when two firms of the -same size combine, it is very difficult to make one of the firms agree to lose its identity and merge with the other firm. In such situations, consolidations desired. Another reason is that the combining firms get an opportunity to obtain a new corporate charter with more favourable features than that present in the charter of the existing firms.

Compromise

If there is a dispute between two parties, say, between the company and its creditor or between secured and unsecured creditors of a company or preference shareholders and equity shareholders of a company, it can be resolved through a

compromise. A compromise is a term which implies the existence of a dispute, such as relating to rights (Sheath Valley Gold Ltd (1893) ICH 477). It means settlement or adjustment of claims in a dispute by mutual concession by the parties to the disputes or differences. It is a mode of terminating a controversy by the method of making mutual concessions. In compromise, the parties propose to arrive at a settlement of an existing dispute which could relate to some kind of rights, duties or powers, between themselves by a give and take arrangement. Each party should be empowered to make the necessary concessions. A company has the same right to compromise claims 'brought against it as an individual person has. A reasonable compromise must be a compromise which is reasonable and beneficial to both sides making it. If the members have to give up their rights entirely, it will not be a compromise. Similarly, a claimant who abandons his claims not compromising it. A compromise pre-supposes the existence of a dispute for there can be no compromise unless there is some dispute.

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Arrangement

The Companies Act, 2013 defines arrangement as something analogous to compromise and includes reorganization of share capital of the company by consolidation of shares of different classes or by division of shares into share of different classes or by both methods.

The word arrangement as defined under Section 230 of the Companies Act, 2013 covers a wide range of arrangements, for example:

- For restarting a company that is being wound up
- For reconstruction of an existing company by winding up and sale of its undertaking for share in foreign company
- For transfer of shares to another company
- For debenture holders giving their consent for advancing the re-payment period or for reducing the rate of interest
- Preference shareholders may reduce the rate of dividend or accept equity share instead of preference shares
- Many other such arrangements

In the *Oxford Law Dictionary*, the expression 'scheme of arrangement' is explained as follows:

1. An agreement between a debtor and his creditors to arrange the debtors' offer to satisfy the creditors. The debtor usually agrees to such an arrangement in order to avoid bankruptcy. If the arrangement is agreed upon when no bankruptcy order has been made, it is governed primarily by the ordinary law of contract.
2. An agreement between a company and its creditors or members when the company is in financial difficulties. To effect a takeover arrangement

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implies rearrangement of rights or of liabilities without the existence of any dispute where under a scheme each shareholder of a company has to transfer some of his shares to another company and some to the shareholders of his own company.

An arrangement can be resorted to even in the absence of any dispute and includes agreements which modify rights about which there is no dispute and which can be enforced upon without difficulty. Section 230 of the Companies Act provides that the expression arrangement includes a reorganization of the share capital of the company by consolidation of shares of different classes or by division of shares into shares of different classes or by both those methods.

Reconstruction

The term reconstruction has not been defined anywhere in the Companies Act, but it generally means reconstruction of the company as a whole or of the share capital of the company which also includes varying rights of the shareholders in the event of reconstruction. In reconstruction, the management of the company desires to preserve the undertaking in some form. Management decides not to sell the undertaking but to carry it on, may be in a modified form. It means that persons now managing the firm will continue to manage the undertaking in substantially the same manner as in the past and also the same business shall be carried on.

Reverse Merger

In reverse merger a smaller company acquires the larger company and is motivated by tax benefits available wherever at least one of the companies in deal has accumulated loss or unabsorbed expenses/allowance that can be earned forward and set-off against future profit of the amalgamated, company. If the smaller firm has better record and more promising future it is more appropriate to go for a takeover. In some cases, the smaller company which may be listed may acquire a larger company which is not listed in order to cover costs to keep the listing. In normal practice, in corporate merger, the relative size in terms of either capital employed or turnover of the companies determines which firm will be acquired. However, in reverse merger a smaller company acquires a larger one. Restructuring through reverse merger process is carried out by following the steps below:

- Capital reduction of the losing company to write off the share capital not represented by assets
- Consolidation of shares after capital reduction to make face value of shares of the acquirer at par with that of the target
- Change of name after merger

The basic philosophy of the reverse merger is to take advantage of the provisions of the Income Tax Act, 1961. The Gujarat High Court has clarified in a judgement that the basic principles of reverse merger should satisfy the following conditions:

- The net assets of the amalgamating companies are greater than the net assets of the amalgamated company.
- Equity capital to be issued by the amalgamated company pursuant to the acquisition exceeds its original issued capital.
- The control of the amalgamated company goes into the hands of the management of the amalgamated company.

When a healthy company amalgamates with a financially weak company, it is reverse merger. In the context of the provisions of the Companies Act, 1956 there is no difference between a regular merger and ~reverse merger. It is like any other amalgamation.

If one of the merging companies is a sick industrial company under the Sick Industrial Companies (Special Provisions) Act (SICA), it is also possible to carry out the reverse merger through the High Court route. Such a merger must take through the Board for Industrial and Financial Reconstruction (BIFR). The sick company may get the name of the healthy company after amalgamation.

Reverse merger automatically makes the transferor company entitled to the benefit of carry forward and set-off of loss and unabsorbed depreciation of the transferee company according to Section 72 of the Income Tax Act.

Demerger

When for strategic reasons a conglomerate is split into two or more independent bodies and assets are transferred to such bodies, it is known as demerger. Demerger is not just the opposite to merger; it is also called spin-off or hiving-off. Demerger refers to the situation where an undertaking is separated and transferred to a separate company and decided to run as an independent unit from the earlier enterprise. ABC Ltd, for example, carries on the business of chemicals and textile; if the textile unit is not doing well or is doing exceptionally well, in either case, it may be found desirable to split-off textiles business into a separate company to have sharp focus. By demerging the business activities, a corporate body splits into two or more corporate bodies with separation of management and accountability. The main reason for making each division a profit centred organization may be to make each head of the division accountable for profitability of their respective divisions.

The provisions of the Income Tax Act, 1961 recognizes demerger only if restructuring is pursuant to Sections 230 to 240 the Companies Act, 2013 and to avail the tax advantage of demerger it should be in the spirit of Section. 2(19AA) of the Income Tax Act. The tax benefits available to the resulting company is that accumulated loss and unabsorbed depreciation of the demerged company will be allowed to be carried forward and set-off in the hands of the resulting company and the resulting company can carry the losses forward only for the remaining period out of the permissible assessment year.

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Reasons for demerger

The strategic reasons for demerger are as follows:

- To restructure the existing business by segregating uncommon activities into different corporate bodies
- Separation of management of different undertakings
- Introduction of the concept of responsibility and accountability
- Protection of business from high-risk activities and undertakings which are continuously incurring cash losses
- Bringing clear lines of management
- Protection of crown jewel from the predator through hostile takeover
- Avoidance of frequent interference of government and its agencies in business
- Division of familiar managed business
- Tapping more opportunities
- Separation of unwanted activities and to concentrate on core activities
- Enable management buyouts

The potential disadvantages of demergers are as follows:

- Loss of economies of scale
- Increase in overhead cost
- Loss of ability to raise extra finances
- Lower turnover and profitability
- Loss of benefits from synergy.

Modes of demerger

There are three ways of demerger.

- Demerger by arrangement between promoters
- Demerger under the scheme of arrangement with approval from the rest Under Section 238 of the Companies Act, 2013
- Demerger under voluntary winding up

The promoters of the company can enter into an agreement for division of the company and in that case the company is wound up after division. The assets are distributed after paying off the liabilities.

Similarly, a company which has been split up into several companies after division could be wound up voluntarily pursuant to the provisions of Sections 304 to 323 of the Companies Act, 2013

Example of Grasim Demerger

Grasim Industries Limited decided to separate its cement division. Grasim's cement related assets were to be transferred to a wholly-owned subsidiary Samruddhi Cement Limited and Grasim shareholders were to get one share of Samruddhi for each share they hold. Grasim will hold 65 per cent of Samruddhi and Grasim's shareholders will hold 35 per cent shares. Grasim took this decision because it wanted to continue to have a stake in the cement business and Grasim's cash flows from viscose staple fibre have contented to the expansion of the cement business and in the cement operations many continue to need these cash flows. The company gave only 35 per cent shares to Grasim shareholders in Samruddhi and not 100 per cent because Grasim holds 55 per cent of Ultra Tech and so when the merger with Grasim will take place, Grasim will hold between 55 per cent and 65 per cent of the new company which will enable it to reuse more resources if necessary by selling equity. A higher direct share to Grasim shareholders in Samruddhi could mean Grasim shareholding slipping below 55 per cent in Ultra Tech when Samruddhi is merged with it. Similarly, directly giving Ultra Tech shares to Grasim shareholders would mean a lower share for Grasim in Ultra Tech. The promoters hold just 25 per cent of equity in Grasim and the entire promoters' stake in Ultra Tech is through Grasim. Grasim shareholders have got a 35 per cent direct share in Samruddhi. If Grasim shareholders were directly given 100 per cent of Samruddhi, minority shareholders would have got full exposure to the cement assets. Now they will get only 35 per cent of the assets directly and 65 per cent indirectly through their shareholding in Grasim. The company will however have to pay stamp duty twice-first for the demerger and second for the proposed merger of Samruddhi with Ultra Tech.

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Strategic alliance

An increasing number of companies find alliances a more efficient means of using limited resources and with an alliance one can know where the greatest value creation potential lies and form the partnership around those specific areas only where the value created by the partnership will be greater than the sum of the value provided by each industrial partner. According to Gones-Cassers, a management expert, a successful partnership does not require two similar cultures. For example, the Fuji-Xerox partnership is more than 45 years old partner; when the differences are marked it becomes essential for the partners to communicate closely. According to BMC Garvie, president of a consultancy firm, the success of alliance depends upon the consistency in the two organizations' values and involvement of all the persons who will implement the alliance.

7.2.1 Types of Merger

Mergers may be classified into several types viz.

1. Horizontal
2. Vertical
3. Conglomerate

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A horizontal merger represents a merger of firms engaged in the same line of business. Most of the mergers were of this type. For example, the merger of Punjab Communications with Siemens.

A vertical merger is one which the buyer expands backward towards the source of raw materials or forward in the direction of the ultimate consume. For example, the vertical merger of Arihant Industries with Arihant Cotsyn.

A conglomerate merger represents a merger of firms engaged in unrelated line of activities. Conglomerate mergers have become common in the recent years. For example, TOMCO with Hindustan Lever.

Motives of merger

The principal economic rational of a merger is that the value of the combined entry is expected to be greater than the sum of the independent values of the merging entities.

A variety of reasons like growth diversification, economies of scale, managerial effectiveness, utilization of tax sheets, lower financing costs, strategic benefits etc., are cited in support of merger proposals.

Check Your Progress

1. Why do companies require restructuring?
2. Define arrangement.
3. What is a horizontal merger?

7.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Restructuring is required by companies primarily to maintain status quo and secondly for growth.
2. The Companies Act, 2013 defines arrangement as something analogous to compromise and includes reorganization of share capital of the company by consolidation of shares of different classes or by division of shares into share of different classes or by both methods.
3. A horizontal merger represents a merger of firms engaged in the same line of business.

7.4 SUMMARY

- Restructuring has become the compelling necessity to survive in this fiercely competitive environment.

- Restructuring is a process by which a firm does an analysis of itself at a point of time and alters what it owes and owns, refocuses itself to specific tasks of performance improvements.
- A number of strategic imperatives have been driving companies towards mergers and acquisitions. They include globalization, consolidation, product differentiation, and customer demands, vertical integration, deregulation, technology requirements and refashioning.
- A merger involves the fusion of two or more separate companies into one. It is a special case of combining companies where one survives and the other loses its identity.
- Amalgamation is a legal process by which two or more companies are joined together to form a new entity or one or more companies are absorbed or blended with another, which will result in the amalgamating companies to lose its existence and its shareholders to become the shareholders of the new company or the amalgamated company.
- Acquisition implies that one of the firms loses its identity and that it has been purchased by the firm that continues its existence. According to the Collins Business Dictionary an acquisition is the act of getting or buying something.
- Compromise means settlement or adjustment of claims in a dispute by mutual concession by the parties to the disputes or differences.
- Mergers may be classified into several types viz.
 1. Horizontal
 2. Vertical
 3. Conglomerate
- A horizontal merger represents a merger of firms engaged in the same line of business. Most of the mergers were of this type. A vertical merger is one which the buyer expands backward towards the source of raw materials or forward in the direction of the ultimate consume. A conglomerate merger represents a merger of firms engaged in unrelated line of activities. Conglomerate mergers have become common in the recent years.

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7.5 KEY WORDS

- **Merger:** It means a combination of two things, especially companies, into one.
- **Consolidation:** It represents a combination of two or more business firms into a new business firm. The essence of consolidation is that all the combining firms lose their identity.
- **Amalgamation:** It is the action, process, or result of combining or uniting.

7.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short Answer Questions

1. Why is restructuring necessary?
2. List the forms of restructuring in a business.
3. What is acquisition?

Long Answer Questions

1. What is a merger? Differentiate between merger and amalgamation.
2. What is demerger? Discuss the reasons for demerger.
3. Describe the various types of mergers.

7.7 FURTHER READINGS

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BLOCK - III
VENTURE CAPITAL AND MISCELLANEOUS

*Overview of Role of Rural
Bankers in Mergers and
Portfolio Management*

**UNIT 8 OVERVIEW OF ROLE OF
RURAL BANKERS IN
MERGERS AND
PORTFOLIO
MANAGEMENT**

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Structure

- 8.0 Introduction
- 8.1 Objectives
- 8.2 Role of Rural Bankers in Mergers
- 8.3 Portfolio Management
 - 8.3.1 Functions of Portfolio Managers
 - 8.3.2 Capital Asset Pricing Model (CAPM)
- 8.4 Answers to Check Your Progress Questions
- 8.5 Summary
- 8.6 Key Words
- 8.7 Self Assessment Questions and Exercises
- 8.8 Further Readings

8.0 INTRODUCTION

Banking services have extended beyond that of merely being a money lending institution. It has evolved through the ages and its activities have diversified over the years. Today, banking companies assist other companies in their mergers through their services like investment and merchant banking. The RBI too plays a crucial role when it comes to mergers. Further, just like non-banking companies, banking companies too have since long back in history, taken part in mergers for various reasons including the interest of the creditors, better management or simply saving itself from losses or poor operations. Rural banking in India, through the Regional Rural Banks has also been ordered compulsory merger by the Central Government over the years and time and again there have been arguments for and against the move.

Another area where banking services have expanded is that of portfolio management. The bankers simply the investment management of their customers by providing advice as well as helping them achieve a portfolio with minimal risk and increased profits.

In this unit, you will learn about the banking legislations and services in the context of mergers and portfolio management.

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8.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the role of rural bankers in mergers
- Describe the concept of portfolio management
- Explain the functions of portfolio managers and explanation to risk
- Discuss the CAPM Approach to market operations

8.2 ROLE OF RURAL BANKERS IN MERGERS

Banks get and derive power from Banking Regulation Act, 1949 regarding merger and amalgamation. The merger of banking companies is contained under Sections 44A, 44B and 45 under Part III of the Banking Regulation Act 1949. Voluntary amalgamation is contained under Section 44 A of the Act. As per this Section, RBI has the power to merge two or more banking companies, however the RBI does not have the power to do so for merging of banking company with a non-banking company. This case is handled by the Tribunal under the relevant applicable sections of the Companies Act, 2013. As per Section 44A the High Court is not given the powers to grant its approval to the merger of banking companies. RBI is given such powers. The Central Government has the powers to order compulsory amalgamation of banking companies similar to any other company under the Companies Act as per Section 237 of the Act. However, the exercise of such powers should be only after consultation with the RBI. As per Section 45, the Reserve bank has the power to prepare a scheme of amalgamation of a banking company with other institution (the transferee bank) under subsection 15 of the same section. Under this Section, banks can be reconstructed or amalgamated compulsorily without the consent of its members or creditors.

Legal Considerations in Case of Merger of Private Banking Companies

As per Reserve Bank of India (Amalgamation of Private Sector Banks) Directions, 2016, the following points are important:

1. Approval from at least a two-third majority of the total Board member of the involved companies.
2. The scheme for merger needs to be approved majority in number i.e. two-thirds in value of the shareholders, present in person or by proxy at a meeting, of each banking company.
3. An application needs to be made to Reserve Bank of India, along with the lists of information required.

4. The note also provides that a dissenting shareholder is entitled to claim within 3 months from the date of sanction, the value of shares held by him in the company and its determination by the Reserve bank of India.

The directions also provide considerations for an amalgamation of an NBFC with a banking company, which differs slightly from the aforementioned considerations.

After the approval, the scheme should be submitted to RBI. Broadly RBI will examine the following objectives to be achieved by the merger what impact the merger could have on the financial markets:

- The impact that the merger might have on the overall structure of the industry.
- The possible costs and benefits to customer and to small and medium size businesses including the impact on bank branches the availability of financing price, quality and the availability of services.
- The timing and the socio-economic impact of any branch closure resulting from the merger.
- The manner in which the proposal will contribute to the international competitiveness of the financial services sector.
- The manner in which the proposal would indirectly effect employment and the quality of life in the sector with a distinction made between transitional and permanent effects.
- The manner in which the proposal would increase the ability of the banks to develop and adopt new technologies.
- Remedial steps that the merger applicants would be willing to take to mitigate the adverse effects identified to arise from the merger.

Legal Procedure of Mergers of the Companies

A merger is a complicated transaction involving fairly complex legal, tax and accounting considerations. The following are the same:

1. Check the Memorandum of Association and the Articles of Association of both the companies about the enabling provisions for the proposed merger, and if there is no provision, then the provision should be made first for the proposed merger.
2. Drafting of scheme including Valuation/Revaluation of Assets and determination of exchange ratio by independent expert and decide cut-off rate.
3. Approvals from Banks/Financial institutions etc., if any.
4. Hold the Board meeting for approval of the Draft Scheme of amalgamation, cut-off date, exchange ratio and appointment of Advocate/Solicitor/Attorney etc.

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5. Applications to be made to the respective High Court(s) by each of the companies.
6. High Court to order the following:
 - (a) Appointment of chairman for each of the meeting and fix their remuneration
 - (b) Fix date, time and venue for separate meetings of shareholders/creditors of each of the companies
 - (c) Quorum of each meeting is to be fixed
 - (d) Prescribe mode of despatch and publication of notice of each meeting
7. Chairman has to make arrangements for notice, dispatch of notice, draft scheme, proxy form, publication of notice in newspaper, file compliance report with High Court.
8. Hold meeting of shareholders/creditors
9. Chairman has to file report of meetings with the High Court
10. Submit the application to the Regional Office of the Registrar of Companies, regional director and to the official liquidator
11. Final petition is to be made to the respective High Court(s) for confirmation of the Scheme of Amalgamation
12. High Court to issue notice to:
 - (a) Official liquidation (in case company to be dissolved without winding up)
 - (b) Public notice in the newspaper
13. High Court to receive report from the Registrar of Companies, Regional Director and from official liquidator about the affairs of the companies concerned.
14. Final hearing before the High Court
15. High Court to order the confirmation of the scheme
16. Draft (format) orders to be submitted to the registry attached to the respective High Court giving schedule of property to be transferred for the transferor company
17. Filing of certified copy of order with the offices of the respective registrar of companies
18. Transferee company to fix record date for the purpose of issue of shares to the shareholders of the transferor company. (ies)
19. Transferee company to issue circular to the shareholders of the transferor company as on the record date requesting for surrender of the share certificate of the transferor company

20. Finalise the allotment of shares to the shareholders of the transferor company and despatch share certificates in exchange of the share certificate of transferor company.

Managing Mergers

As the chances of failure in a merger programme can be high, it should be planned carefully. It pays to develop a disciplined merger programme consisting of the following steps:

1. **Manage the pre-merger phase:** A good starting point of merger programme is to institute a thorough valuation of the company itself. This will enable the acquiring company to understand well its strengths and weakness and deepen the acquirer's insights into the structure of its industry. Opportunities that strengthen or leverage the core business, or provide functional economies of scale or transfer of skill or technology need to be identified.
2. Screen Candidates
3. **Evaluate the remaining candidates:** A comprehensive evaluation must cover in great detail the following aspects, operations, plant facilities, distribution network, sales, personal and finances (including hidden and contingent liabilities) special attention should be paid to the quality of the management experienced, competent and dedicated management is a scarce resource. Each candidate ought to be valued as realistically as possible.
4. Determine the mode of the merger/amalgamation.
5. **Negotiate and consummate the deal:** Negotiation requires considerable skill. The acquiring firm should identify not only the synergies that it would derive but also what other acquires may obtain further the acquiring firm should assess the financial condition of the existing owner and other potential acquires.
6. **Manage post-merger integration:** Many competent professional managers believe that managing a complex multi-product, multi-technology enterprise requires a culture and set of values which may be alien to the new group to make adjustments in their values and styles and introduce changes which are worked over cooperatively. Mutual trust and confidence should be the bedrock for introducing changes meant to galvanise the enterprise to reach greater heights of achievements. In this context, the two basic guidelines are borne in mind:
 - (a) **Anticipate and solve problems early:** A thoughtful attempt has to be made to think through the implications of the merger, anticipate problems that may arise understand the nature of these problems, and hammer out a sensible and mutually acceptable way to handle these problems.

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(b) Treat people with dignity and concern: It has been said that making a merger work is the art of taking over a company without overtaking it. Efforts should be made to rock the best as little as possible. If some changes are envisaged, disseminate information effectively. Clarity is the most potent antidote against morbid imagination.

Check Your Progress

1. Mention the sections and the act under which contains the provisions related to merger of banking companies.
2. Who appoints a chairman for meeting in case of merger of companies?
3. Mention the approval quorum needed from the board members in case of merger of banking companies.

8.3 PORTFOLIO MANAGEMENT

Portfolio management leads with the selection of optimal portfolios by rational risk averse investors i.e. by investors who attempt to maximise the expected return consistent with individually acceptable portfolio risk.

The term investment portfolio refers to various assets of an investor which are to be considered as a unit. An investment portfolio is merely a collection of unrelated assets but a carefully blended asset combination within a unified framework.

Investment Portfolio Management involves maintaining a proper combination of securities, which comprise the investor's portfolio in a manner that they give maximum return with minimum risk.

Portfolio management is the investment of funds in such combinations of different securities in which total risk of portfolio is minimised while expecting maximum return from it. An investor will invest his total funds in not just one type of security but a combination of securities. This is diversification and every investor prefers diversification. This is due to, every diversification reduces variability of returns and this reduces total risk. "The basic principles of portfolio selection fall down to a common sense statement that investors try to increase expected return on their portfolio's and reduce risk of that return. The portfolio that gives the highest expected return known as efficient portfolio. To work out which portfolio, are efficient an investor must be able to state the expected returns and risk of each asset."

Traditional vs Modern Portfolio Analysis

Traditional portfolio analysis has been subjective in nature, since it analysis individual securities through evaluation of risk and return conditions in each security. In fact

the investor has been able to get the maximum return of the minimum risk. The normal method of calculating the return on an individual security was by finding out the amounts of hundreds that have been given by the company, the price earnings ratio, and by an estimation of the market value of shares.

The modern portfolio theory believes in the maximization of return through a combination of securities. It discusses the relationship between different securities and draws inter-relationships of risk between them. The theory states that by combining a security of high risk, success can be achieved by an investor in making a choice of investment outlets.

Traditional theory was based on the fact that risk could be measured on each individual security through the process of finding out the standard deviation and that security whose deviation was the lowest should be chosen. Greater variability and higher deviations showed more risk than those securities, which has lower variations.

The modern theory is of the view that by diversification risk can be reduced. Diversification can be made by the investor either by having a large number of shares of companies in different regions, in different industries or those producing different types of product lines. But the modern theory states that there cannot be only diversification to achieve the maximum return. The securities have to be evaluated extent within which the maximum achievement can be sought by the investor.

Thus traditional theory and modern theory are both framed under the constraints of risk and return, the former analysing individual securities and the better believing in the combination of securities. Traditional theory believes that the market is inefficient and the fundamental analyst can take advantage of the solution. By analysing internal financial statements of the company he can make superior profits through higher returns. The technical analyst believed in the market behaviours and past trends to forecast the future of securities. Modern portfolio theory as brought out by Markowitz and Sharpe is the combination of securities to get the most efficient portfolio.

Objectives of Portfolio Management

The key objective of the portfolio management is to ensure appreciation of wealth creation based on financial goals. It is a process that requires regular monitoring and analysis to make the most of one's investment with the borated investment at hand, managing an investment portfolio through a proper channel ensures an optimal distribution of those funds to generate the best possible returns.

For many individuals an investment portfolio is a source of fixed or supplementary income. In order to achieve this, it is important to invest in the right assets classes and periodically after the investment portfolio based on its performance. It is always important to jot down one's short, medium and long-term objectives based on one's desired goals and then invests in those investment

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avenues that would fulfil those goals. All forms of investment have an inherent risk which changes from time to time, while equity and derivatives are high risk high returns investment avenues, mutual funds offer a moderate risk return ratio. On the other hand instruments such as FDs, RDs, PPFs etc. offer low risk lower return investment options. The key is to have a balanced portfolio that hedges the overall risk.

Portfolio Management Process

Building and managing an investment portfolio is one of the most critical and perhaps the most complex tasks of financial planning while it requires planning and projecting scenario at the beginning, it is an ongoing journey that requires attention and as you go along in this section, we look at a four step portfolio management process to help with one's planning:

- **Step I- Assessing finances and projecting future goals:** The first step in the process is to assess one's current financial situation. This means listing one's current assets and liabilities as well as projecting one's future goals. The objective of this step is to identify the gaps between the current cash flows and the future requirements.
- **Step II- Creating an investment policy statement:** The next step is to create a formal investment policy statement based on the future goals and one's risk return profile. It takes into account various constraints and limitations and the preferred approach to investments as well as the modalities of managing the portfolio. This includes guidelines to investing, establishing measurement benchmarks, reporting methodology as well as means to review and rebalance the portfolio periodically. An investment policy statement is a document that determines the rules of engagement between oneself and his portfolio manager, hence it is important to be as clear and detailed as possible.
- **Step III- Developing an asset allocation strategy:** Based on one's risk return profile the next step is to choose and assign allocation weightage to investments and assets from the available options. This needs to be done in alignment with the investment objectives and in a manner so as to ensure optimal utilisation of available funds. A key element of this step is also to diversify the portfolio to reduce risk while yielding the best possible returns. An asset an investor's financial situation and goals as well as the risk profile at a given point in time.
- **Step IV- Establishing a monitoring and feedback method:** Like any process managing a portfolio also needs to be monitored and measured from time to time. This requires setting up milestones and benchmarks to compare the performance of the entire portfolio against the market. This also enables to track changes in one's financial goals and risk profile to recommend ways to rebalance one's portfolio at a given point. For example, selling off underperforming assets or reducing the weightage of market-

related investments as one approach retirement to reduce the volatility and overall risk.

Wealth creation is a lifelong and dynamic process that is influenced by various internal and external factors such as marriage and childbirth, changes in one's financial situation on a market downturn. While one may or may not be able to control these factors, a robust portfolio management process and strategy enables one to manage his investments better and make it work for one different stages of life.

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Portfolio diversification

Minimizing risk is a cornerstone of any investment portfolio and the most basic way to do it is by diversifying one's portfolio. A diversified portfolio consists of different types of assets that have varying degrees of inherent risk. While it is not a sure short way to hedge risks, it is among the most effective methods to help one achieve one's financial goals.

Below are some common ways in which one can diversify portfolio company diversification.

The old adage do not put all your eggs in one basket holds true for investment portfolios as well ensure that a person does not invest large portion of one corpus in a single company else a drop in the performance of that stock could drag the portfolio down. Investing in multiple companies hedges that risk and protects the portfolio against market related risks.

Sector diversification

Different industries and sectors follow different business cycles, for example, a bad monsoon may have an adverse effect on the agricultural stocks while it may not have as much impact on the pharmaceuticals or it companies. So it is worthwhile to consider and monitor the overall market conditions while one invest to capitalise on emerging investment opportunities.

Asset class diversification

Different asset classes possess different risks and offer variable returns while investments in equities and derivatives are inherently riskier than bonds and government securities, they do often higher returns. Additionally, the performance of each of these classes may also vary based on the economic and business environment as well as factors specific to those assets. For example equity investments can yield higher returns during a bull run, while debt instruments like bonds or debentures are more productive during a bear phase.

Portfolio Rebalancing

A combinations of internal and external forces determines the performance of any asset class. The process of adjusting one portfolio across different asset classes in light of the portfolio performance is known as portfolio rebalancing.

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For example, the investments in the technology sector may be growing by leaps and bounds while pharms stocks might be severely underperforming due to prevalent market conditions. If it is a cyclical stock, it would be worth transferring some funds from the high performing due to prevalent market conditions. If it is a cyclical stock, it would be worth transferring some funds from the high performing stocks to stocks performing moderately and which may be on its way up as the business cycles changes. This will allow one to invest in a stock that is likely to yield a better return during the next business cycle.

Approaches to Rebalancing

There are three common approaches to rebalancing:

- Redirecting funds from within the portfolio to under performing asset classes to match their original allocation in the investment portfolio.
- Infusing fresh investments to the lagging asset classes to normalise their weightage in the overall portfolio.
- Selling off a portion of the investments from within the better performing asset class to convert in the underperforming asset classes.

It is important to map asset allocation with one's financial objectives and the current performance of one's portfolio. The key here is to take a long term view and prospects of ones investments, remember that it needs to be a financial decision and not an emotional one.

8.3.1 Functions of Portfolio Managers

In managing the investment portfolio effectively, the Portfolio Manager must have the competence to make spot decisions. He should have thorough knowledge about the stock market, movement of script prices, track record and working results of companies opportunities available for companies to expand and diversify, move towards mergers, acquisitions, takeover, etc. his decisions must match with the investment objective of his client. He must keep track of the record dates, timing of rights issue, bonus issue etc. It is important that he makes an analysis so as to gather knowledge on net profit, earnings per share/dividend payout ratio and rate of dividend of at least previous three years. He may adopt detailed analysis of the company about its products, technology, performance management etc. Prospects of each industrial segment also are to be assessed to decide on the investments to be made undue concentration of investments in one particular industry will not be advisable even if it is doing well at the time of the investment decision. A good portfolio manager should consider all these aspects and take investment decisions on behalf of his clients.

Regulations

1. The portfolio managers have to enter into an agreement with clients setting out their mutual obligations and liabilities.

2. The Discretionary Portfolio Manager is required to manage the funds of each client individually and independently in accordance with the needs of the client in a manner, which does not partake the character of a mutual fund.
3. The Non-discretionary Portfolio Manager is required to manage the funds in accordance with the discretions of his clients, restrictions have been imposed on the number of investment.
4. Portfolio Manager is debarred from deploying the clients funds in bill discounting, bill financing or for lending with corporate and non-corporate bodies.
5. Portfolio Manager has been debarred from accepting money or securities from his clients for a period of less than one year.
6. The transaction is to be affected at prevailing market price only.
7. Every portfolio manager is required to observe a high standard of integrity and fairness in all his dealings.
8. A portfolio manager should not be a party to the creation of false market in securities price ragging or manipulation of securities and passing of price sensitive information to a broken on any other intermediary in the capital market.
9. There must be proper maintenance of Books of Accounts and these are to be kept open for inspection by the authority appointed by SEBI.
10. SEBI is empowered to suspend or cancel the registration after holding an enquiry.

Portfolio manager has been brought under regulatory framework and organisations carrying on portfolio management services are to be compulsory registered with SEBI satisfying certain conditions. No person should carry on any activity as portfolio manager unless he holds a certificate of registration granted by SEBI under SEBI (Portfolio Managers) Rules, 1993. The intention of the regulation is to ensure that organisations with the requisite background and expertise only undertake such services and the investor gets professional services.

8.3.2 Capital Asset Pricing Model (CAPM)

Harry Markowitz developed an approach that helps an investor to achieve his optimal portfolio position. Hence, portfolio theory, in essence, has a normative character as it prescribes what a rational investor should do.

Markowitz theory determines for the investor the efficient set of portfolio through three important variables i.e. return standard deviation and coefficient of correlation. This is also called the full covariance model. Through this method, the investor can find out the efficient set of portfolio by finding out the trade-off between risk and return between the limits of zero and infinity. According to this theory, the

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effects of one security, purchase over the effects of the other security purchase is taken into consideration and then the results are evaluated.

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Assumptions

The CAPM is based on the following assumptions:

1. Individuals are risk averse.
2. Individuals seek to maximise the expected utility of their portfolios over a single period planning horizon.
3. Individuals have homogeneous expectations they have identical subjective estimates of the means, variances and covariance among returns.
4. Individuals can borrow and lend freely at a riskless rate of interest.
5. The market is perfect, there are no taxes, there are no transaction costs, securities are completely visible, the market is competitive.
6. The quantity of risky securities in the market is given.

Check Your Progress

4. What was the method used for calculating return on an individual security under the traditional portfolio analysis?
5. Mention examples of high, moderate and low risk investments.

8.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The merger of banking companies is contained under Sections 44A, 44B and 45 under Part III of the Banking Regulation Act 1949.
2. The High Court appoints the chairman for each of the meeting and fix their remuneration in case of merger of companies.
3. Approval from at least a two-third majority of the total Board member of the involved companies is needed in case of merger of banking companies.
4. The normal method of calculating the return on an individual security under traditional portfolio analysis by finding out the amounts of hundreds that have been given by the company, the price earnings ratio, and by an estimation of the market value of shares.
5. All forms of investment have an inherent risk which changes from time to time, while equity and derivatives are high risk high returns investment avenues, mutual funds offer a moderate risk return ratio. On the other hand, instruments such as FDs, RDs, PPFs etc. offer low risk lower return investment options.

8.5 SUMMARY

- The banks get and derive power from Banking Regulation Act, 1949 regarding merger and amalgamation. The merger of banking companies is contained under Sections 44A, 44B and 45 under Part III of the Banking Regulation Act 1949.
- Voluntary amalgamation is contained under Section 44 A of the Act. As per this Section, RBI has the power to for merging two or more banking companies, however the RBI does not have the power to do so for merging of banking company with a non-banking company. This case is handled by the Tribunal under the relevant applicable sections of the Companies Act, 2013.
- The Central Government has the powers to order compulsory amalgamation of banking companies similar to any other company under the Companies Act as per Section 237 of the Act. However, the exercise of such powers should be only after consultation with the RBI.
- As per Section 45, the Reserve bank has the power to prepare a scheme of amalgamation of a banking company with other institution (the transferee bank) under subsection 15 of the same section. Under this Section, banks can be reconstructed or amalgamated compulsorily without the consent of its members or creditors.
- After the approval, the scheme should be submitted to RBI. Broadly RBI will examine the following the objectives to be achieved by the merger what impact the merger could have on the financial markets.
- Legal procedure of mergers of the non-banking companies are slightly different and the provisions related to it are contained in the Companies Act, 2013.
- As the chances of failure in a merger programme can be high, it should be planned carefully. It pays to develop a disciplined merger programme consisting of the following steps: manage the pre-merger phase, evaluate the remaining candidates, determine the mode of the merger/amalgamation, negotiate and consummate the deal and manage post-merger integration.
- Portfolio management leads with the selection of optimal portfolios by rational risk averse investors i.e. by investors who attempt to maximise the expected return consistent with individually acceptable portfolio risk.
- Traditional portfolio analysis has been subjective in nature, since it analysis individual securities through evaluation of risk and return conditions in each security. In fact the investor has been able to get the maximum return of the minimum risk.

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- The modern portfolio theory believes in the maximization of return through a combination of securities. It discusses the relationship between different securities and draws inter-relationships of risk between them.
- The key objective of the portfolio management is to ensure appreciation of wealth creation based on financial goals.
- Portfolio management process includes the following steps: assessing finances and projecting future goals, creating an investment policy statement, developing an asset allocation strategy, and establishing a monitoring and feedback method.
- Minimizing risk is a cornerstone of any investment portfolio and the most basic way to do it is by diversifying one's portfolio. A diversified portfolio consists of different types of assets that have varying degrees of inherent risk.
- A combination of internal and external forces determines the performance of any asset class. The process of adjusting one portfolio across different asset classes in light of the portfolio performance is known as portfolio rebalancing.
- In managing the investment portfolio effectively, the Portfolio Manager must have the competence to make spot decisions. He should have thorough knowledge about the stock market, movement of script prices, track record and working results of companies opportunities available for companies to expand and diversify, move towards mergers, acquisitions, takeover, etc. his decisions must match with the investment objective of his client.
- Markowitz theory determines for the investor the efficient set of portfolio through three important variables i.e. return standard deviation and coefficient of correlation. This is also called the full covariance model. Through the CAPM method, the investor can find out the efficient set of portfolio by finding out the trade-off between risk and return between the limits of zero and infinity.

8.6 KEY WORDS

- **Investment portfolio:** It is merely a collection of unrelated assets but a carefully blended asset combination within a unified framework.
- **Portfolio management:** It is the investment of funds in such combinations of different securities in which total risk of portfolio is minimised while expecting maximum return from it.
- **Portfolio rebalancing:** It refers to the process of adjusting one portfolio across different asset classes in light of the portfolio performance.

8.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Name the Act under whose purview comes the amalgamation of a banking and a non-banking company.
2. What are the factors which are examined by the RBI incase it receives an application for merger?
3. Write a short note on the basic guidelines that are two be borne in mind which managing post-merger integration.
4. Differentiate between traditional and modern portfolio analysis.
5. Briefly explain the objectives of portfolio management.
6. What is Capital Asset Pricing Model?

Long Answer Questions

1. Discuss the legal considerations in case of merger of private banking companies along with that of mergers of non-banking companies.
2. Explain the portfolio management process, portfolio diversification and rebalancing.
3. Describe the functions of portfolio managers.

8.8 FURTHER READINGS

Ram Jitendra. 2015. *Regional Rural Banks of India: Evolution, Performance and Management*. Gurgaon: Partridge Publishing.

Acharya S.C. and A. K. Mohanty. *Operational Analysis of Regional Rural Banks*. New Delhi: Gyan Publishing House

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UNIT 9 MISCELLANEOUS ACTIVITIES OF A RURAL BANKER

Structure

- 9.0 Introduction
- 9.1 Objectives
- 9.2 Venture Capital and its Administration
 - 9.2.1 Origin
 - 9.2.2 Types of Venture Capital Financing
- 9.3 Mutual Funds
 - 9.3.1 Kinds of Mutual Fund Schemes
- 9.4 Answers to Check Your Progress Questions
- 9.5 Summary
- 9.6 Key Words
- 9.7 Self Assessment Questions and Exercises
- 9.8 Further Readings

9.0 INTRODUCTION

The rural banks were established with a need to develop the rural economy, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs and for matters connected therewith and incidental thereto. You have already learnt about the scope of work of rural banks in the economy. The institution of Regional Rural Banks (RRBs) was created to meet the excess demand for institutional credit in the rural areas, particularly among the economically and socially marginalized sections. In order to provide access to low-cost banking facilities to the poor, the Narasimhan Working Group proposed the establishment of a new set of banks, as institutions which confine the local feel and the familiarity with rural problems which the cooperative possess and the degree of business organisations, ability to mobilise deposits, access to control money markets and modernised outlook which the commercial banks have. The multi-agency approach to rural credit was also to sub serve the needs of the input-intensive agricultural strategy (Green Revolution) which had initially focussed on betting on the strong but by the mid-seventies was ready to spread widely through the Indian countryside. In addition, the potential and the need for diversification of economic activities in the rural areas had begun to be recognised and this was a sector where the RRBs could play a meaningful role.

There has been an unprecedented growth and diversification of banking industry. The banking industry has experienced a series of significant transformations in the last few decades. Banks have increased the scope and scale of their activities and several banks have become very large institutions with a presence in multiple regions of the country. You have already learnt about the concepts of mergers and portfolio management in the context of banking in Unit 8.

The banking sector has immensely benefitted from the implementation of superior technology. Productivity enhancement innovative products, speedy transactions, seamless transfer of funds, real time information system and efficient risk management are some of the advantage derived through the technology. Information technology has also improved the efficiency and robustness of business, process across banking sector, India's banking environment. Indian banking industry in the midst of an IT revolution. Technological infrastructure has become an indispensable part of the reforms process in the banking system, with the gradual development of sophisticated instruments and innovations in market practices.

Real Time Gross Settlement system introduced in India since March 2004, is a system through which electronics instructions can be given by banks to transfer funds from their account to the account of another bank. The RTGS system is maintained and operated by the RBI and provides a means of efficient and faster funds transfer among banks facilitating their financial operations. Funds transfer between banks takes place on a Real Time basis. Therefore, money can reach the beneficiary instantaneously and the beneficiary's bank has the responsibility to credit the beneficiary's account within two hours.

Electronic Funds Transfer (EFT) is a system whereby anyone who wants to make payment to another person/company etc. can approach his bank and make cash payment or given instructions/authorisation to transfer funds directly from his own account to the bank account of the receiver/beneficiary. RBI is the service provider of EFT.

Electronics Clearing Service is a retail payment system that can be used to make bulk payments/receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller amount. This facility is meant for companies and government departments to make/receive large volumes of payments rather than for funds transfer by individual.

Telebanking facilitates the customer to do entire non-cash related banking on phone. Under this device Automotive Voice Recorder is used for simpler queries and transactions for complicated queries and transactions, manned phone terminals are used.

Electronic Data Interchange is the electronic exchange of business documents like purchase order, invoices shipping notices, receiving advices etc. in a standard, computer processed, universally accepted format between trading partners. EDI can also be used to transmit financial information and payments in electronic form.

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The banking today is re-defined and re-engineered with the use of Information Technology and it is sure that the future of banking will offer more sophisticated services to the customers with the continuous product and process innovations. Thus, there is a paradigm shift from the seller's market to buyer's market in the industry and finally it effected at the bankers level to change their approach from conventional banking to convenience banking and mass banking to class banking the shift has also increased the degree of accessibility of a common man.

In this unit, you will learn about some of the miscellaneous banking services pertaining to venture capital and mutual funds.

9.1 OBJECTIVES

After going through this unit, you will be able to:

- Describe the concept of venture capital
- Discuss the origin of venture capital
- Explain the significance of mutual funds

9.2 VENTURE CAPITAL AND ITS ADMINISTRATION

The term venture capital means different things to different people. Most commonly it is used to mean risk capital. By definition venture capital is thought of as creative capital and is expected to perform economic functions different from other investment vehicles which primarily serve. Expansion capital in practice, venture capital is equated to long term funds in equity or semi-equity form to finance hi-tech projects involving high-risk and yet having strong potential of high profitability.

A venture capital company makes a very thorough and critical evaluation of all investment proposals it receives like the banks or financial institutions. But the extent of risk analysis carried out by a venture fund is more than that of other lenders whose loans are secured.

In case of other financial institutions, they extend loans which are covered by assets of the borrowing units. The escape route for such lenders is much easier. For the venture capitalist, it is a question of swimming or sinking within main promoter.

There is high mortality risk and the long gestation period in the area of venture capital finances. The experience of the United States, where this concept has most successfully operated shows that 40 per cent of the firms promoted through venture capital fail with the loss of capital, 30 per cent just break even and only 30 per cent become profitable ventures.

Venture capitalists also provide substantial management inputs including seats on the Board to the assisted companies in the early years of the project once the venture has reached the stage of profitability, they sell equity interest at the market price to others thereby making millions or one-deploy their resources in new ventures.

Venture capital companies/funds which avail concessional treatment of capital gains have to employ the guidelines as prescribed. Approval is given for the establishment of the venture capital companies/funds by the Department of Economic Affairs, Ministry of Finance or such authority as may be nominated by the government and the application for such approval is made with suitable explanatory notes and details of the proposal is addressed to the department of economic affairs.

All India Public Sector Institutions, State Bank of India and other scheduled banks including foreign banks operative in India, the subsidiaries of the above are eligible to start Venture Capital Fund companies subject to approval as may be required from Reserve Bank of India.

It is required that the Venture Capital Funds/Companies are managed by professionals such as bankers, managers and administrators and persons with adequate experience of industry, finance accounts etc.

It is intended that venture capital assistance should go mainly to enterprise where the risk element is comparatively high due to the technology involved being relatively new and not efficient though otherwise qualified and the size being modest. For successful units, the possibility of high returns would exist, but the projects would initially find it difficult to raise equity from the market, especially when public issues are no longer readily available for small green field companies. The assistance should mainly be for equity support, though loan support to supplement this also be done.

Venture capital assistance cover those enterprises which fulfil the following parameters:

- (a) **Size:** Total investment not to exceed 10 crores
- (b) **Technology:** New on relatively introduced or very closely held or being taken from pilot to commercial stage, or which incorporates some significant improvement over the existing one in India.
- (c) Promoters/entrepreneurs relatively new professionally or technically qualified with inadequate resources or backing to finance the project.

Investment in enterprises engaged in trading, broking, investment or financial service, agency or liaison work, shall not be permitted. Further investment in assisted units for their expansion or strengthening, or investments for the revival of sick units, would be permitted as a part of venture capital activity and the above parameters will not apply. The recipient venture is established as a limited company and must employ professionally qualified persons to maintain its accounts. Funds

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may be raised through public issues and/or promote placement of finance. The venture capital company may be listed according to the prescribed norms. Its issue may be underwritten at the discretion of the promoters.

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9.2.1 Origin

The origin of venture capital goes back to one General Dariot, who in 1946 established the American Research and Development (ARD) at the Massachusetts Institute of Technology, USA (MIT) in order to finance the commercial promotion of new technologies developed in universities in the United States. The growth of Venture Capital Companies (VCC's) received a fillip in 1958 when the US Congress passed the Small Business Act and the US Government set up the Small Business Administration (SBA). The SBA licenses small business investment companies which are private sector firms and also provides them long term loans.

Although in the early days of Indian industry, private sector provided the funding for industry and in a way some of the managing agency houses were sort of venture capitalist providing both finance and management for many new and high-risk areas. The Tata Group Investment Corporate of India successfully promoted a number of enterprises like Associated Bearings, National Rayon and CEAT Tyres and these enterprises are example of formal venture capital type of financing in India.

Today in India public sector financial institutions at the national and state levels take care of the bulk of project financing in the private sector primarily through concessional term loans and to a limited extent through equity financing. These term bonding government institutions in discharging their role also meet a part of the venture capital requirement of hi-tech and hi-risk industries. Conditions in the India economy at present seem favourable for the development of venture capital.

9.2.2 Types of Venture Capital Financing

Venture capital companies invest their corpus in the form of equity purchase, conditional loans, income notes and participating debentures.

- (i) **Equity participation:** It is the basic avenue of investment in the assisted firms. Equity holding does not generally exceed 49% of the total equity of the assisted firms. As a result, overall control over the venture remains in the hands of entrepreneurs.
- (ii) **Conditional loan:** Loan is another form of investment, it is repayable by the assisted firms in the form of royalty after the venture is able to generate sales. Royalty charges normally range between 2 to 15 per cent as the cost of financing.

(iii) **Income notes:** It is a form of investment which is a compromise between conventional loans and conditional loans. The assisted firms are to pay both interest and royalty on sales but at substantially low rate.

(iv) **Participating debenture:** Venture capitalists charge interest in these phases under the scheme of investment through participating debentures. No interest is charged before the assisted firms attain operations on a minimum level, a low rate of interest is charged after the firms attain operations up to a particular level and a high rate of interest is charged once the venture operates commercially in full swing. The terms and conditions of financing are decided by mutual agreement between the entrepreneurs launching the ventures and the venture capital funds.

Forms of venture capital assistance in India: Venture capital in India is available in three forms viz. equity, conditional loans and income notes. All Venture Capital Funds (VCFs) in India provide equity up to a maximum participation of 49 per cent of total equity capital of the firm, under which the ownership of the firm remains with the entrepreneur.

A conditional loan is repayable in the form of royalty, ranging between 2 per cent and 15 per cent, after the venture is able to generate sales and no interest is paid on such loans. Income note has combinational features of conventional and conditional loans. The entrepreneur has to pay both interest and royalty on sales at lower rates.

Investment by VCFs: VCFs are interested to invest at three stages in a company's development (i) start-up, (ii) money to finance the launching of an enterprise and (iii) growth capital for major expansion of the company. Among the three, the first is the most risky but promises high returns. During the second stage, the Venture Capital Company (VCC) helps the entrepreneur to develop his company to a stage where he/she can secure capital or loans from various external sources. Finally, in the growth stage, the VCC helps the company in major expansion to enjoy the benefits of economies of scale.

Venture capital activity is regulated by three sets of regulations. First, the SEBI (Venture Capital) Regulations, 1996; secondly, Guidelines for Overseas Venture Capital Investments issued by MOF in 1995 and thirdly, CBDT Guidelines for Venture Capital Companies in 1995, which were notified in 1999.

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Check Your Progress

1. Whose approval is needed for the starting of venture capital by All India Public Sector Institutions and State Bank of India?
2. Where can the origin of venture capital in the world be traced back to?
3. What is a conditional loan?

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9.3 MUTUAL FUNDS

According to Association of Mutual Funds in India (AMFI), “A mutual fund is a trust that pools the savings of a number of investors who share common financial goal. Anybody with an investible surplus of a little as a few thousand rupees can invest in mutual funds scheme that has a defined investment objective and strategy.”

According to SEBI Regulations, 1996, “Mutual Fund means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of public under one or more schemes for investing in securities, in accordance with regulations.”

Unit Trust of India was the first mutual fund set up in India in the year 1963. In early 1990's government allowed public sector banks and institutions to set up mutual funds. SEBI formulates policies and regulates the mutual funds to protect the interest of the investors.

A mutual fund is set up in the form of a trust, which has Sponsor, Trustees, Asset Management Company (AMC) and Custodian. The trust is established by a sponsor or more than one sponsor who is like promoter of a company.

- The trustees of the mutual fund hold its property for the benefits of the court holders.
- Asset Management Company (AMC) approved by SEBI manager the funds by making investments in various types of securities.
- Custodian who is registered with SEBI holds the securities of various schemes of the fund in its custody.

The trustees are vested with the general power of superintendence and directions over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund. All mutual funds are required to be registered with SEBI before they launch any scheme.

9.3.1 Kinds of Mutual Fund Schemes

A mutual fund scheme can be classified into open-ended or close-ended scheme depending on its maturity period.

(i) Open-ended schemes

These schemes do not have a fixed maturity period. These schemes are available for subscription and repurchase on a continuous basis. Investors can conveniently buy and sell units at NAV related prices which are declared on a daily basis. The key feature of these schemes is liquidity.

(ii) Close-ended schemes

A close ended fund or scheme has a stipulated maturity period, e.g. 5-7 years. The fund is open for subscription only during a specified period at the time of

launch of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices.

(iii) Interval schemes

These combine the features of open ended and close ended schemes, which may be traded on the stock exchange any time as will be open for sale or redemption during predetermined intervals at NAV related prices.

Mutual funds collect money from individuals and organizations and pool it to invest in stocks, bonds and other types of securities in financial markets. In mutual funds there is simple and easy entry and exit options and tax benefits available on certain schemes. Mutual fund units can be held in dematerialised form and can be converted into statement form (paper form) to demat form.

Check Your Progress

4. Name the first mutual fund set up in India.
5. What is the key feature of open-ended mutual schemes?

9.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. All India Public Sector Institutions, State Bank of India and other scheduled banks including foreign banks operative in India, the subsidiaries of the above are eligible to start Venture Capital Fund companies subject to approval as may be required from Reserve Bank of India.
2. The origin of venture capital goes back to one General Dariot, who in 1946 established the American Research and Development (ARD) at the Massachusetts Institute of Technology, USA (MIT) in order to finance the commercial promotion of new technologies developed in universities in the United States.
3. A conditional loan is another form of investment, it is repayable by the assisted firms in the form of royalty after the venture is able to generate sales. Royalty charges normally range between 2 to 15 per cent as the cost of financing.
4. Unit Trust of India was the first mutual fund set up in India in the year 1963.
5. The key feature of open-ended schemes is liquidity.

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9.5 SUMMARY

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- The rural banks were established with a need to develop the rural economy, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs and for matters connected therewith and incidental thereto.
- In the banking field, there has been an unprecedented growth and diversification of banking industry. The banking industry has experienced a series of significant transformations in the last few decades. Banks have increased the scope and scale of their activities and several banks have become very large institutions with a presence in multiple regions of the country.
- The banking sector has immensely benefitted from the implementation of superior technology. Productivity enhancement innovative products, speedy transactions, seamless transfer of funds, real time information system and efficient risk management are some of the advantage derived through the technology.
- The term venture capital means different things to different people. Most commonly it is used to mean risk capital. By definition venture capital is thought of as creative capital and is expected to perform economic functions different from other investment vehicles which primarily serve.
- A venture capital company makes a very thorough and critical evaluation of all investment proposals it receives like the banks or financial institutions. But the extent of risk analysis carried out by a venture fund is more than that of other lenders whose loans are secured.
- There is high mortality risk and the long gestation period in the area of venture capital finances.
- Venture capitalists also provide substantial management inputs including seats on the Board to the assisted companies in the early years of the project once the venture has reached the stage of profitability, they sell equity interest at the market price to others thereby making millions or one-deploy their resources in new ventures.
- Venture capital companies/funds which avail concessional treatment of capital gains have to employ the guidelines as prescribed. Approval is given for the establishment of the venture capital companies/funds by the Department of Economic Affairs, Ministry of Finance or such authority as may be nominated by the government and the application for such approval is made with suitable explanatory notes and details of the proposal is addressed to the department of economic affairs.

- It is required that the Venture Capital Funds/Companies are managed by professionals such as bankers, managers and administrators and persons with adequate experience of industry, finance accounts etc.
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- The origin of venture capital goes back to one General Dariot, who in 1946 established the American Research and Development (ARD) at the Massachusetts Institute of Technology, USA (MIT) in order to finance the commercial promotion of new technologies developed in universities in the United States.
- Although in the early days of Indian industry, private sector provided the funding for industry and in a way some of the managing agency houses were sort of venture capitalist providing both finance and management for many new and high-risk areas.
- Venture capital companies invest their corpus in the form of equity purchase, conditional loans, income notes and participating debentures.
- VCFs are interested to invest at three stages in a company's development (i) start-up, (ii) money to finance the launching of an enterprise and (iii) growth capital for major expansion of the company.
- According to SEBI Regulations, 1996, "Mutual Fund means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of public under one or more schemes for investing in securities, in accordance with regulations."
- A mutual fund is set up in the form of a trust, which has Sponsor, Trustees, Asset Management Company (AMC) and Custodian. The trust is established by a sponsor or more than one sponsor who is like promoter of a company.
- A mutual fund scheme can be classified into open-ended or close-ended scheme depending on its maturity period.

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9.6 KEY WORDS

- **Venture capital:** It is used to mean risk capital. By definition venture capital is thought of as creative capital and is expected to perform economic functions different from other investment vehicles which primarily serve.
- **Debenture:** It is a long-term security yielding a fixed rate of interest, issued by a company and secured against assets.
- **Mutual Fund:** It means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of public under

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one or more schemes for investing in securities, in accordance with regulations.

- **Demat account:** It is an account that allows investors to hold their shares in an electronic form.

9.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. List the parameters of enterprises which are covered by venture capital assistance.
2. What are the different types of venture capital financing?
3. Mention the stages of a company's development in which VCF's are interested in.
4. What constitutes the form of a mutual fund set-up?

Long Answer Questions

1. Discuss the concept of venture funds and its form in India. Also mention the regulations which govern its administration in India.
2. Explain the concept and types of mutual funds.

9.8 FURTHER READINGS

Ram Jitendra. 2015. *Regional Rural Banks of India: Evolution, Performance and Management*. Gurgaon: Partridge Publishing.

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UNIT 10 CLASSIFICATION OF MUTUAL FUNDS

NOTES

Structure

- 10.0 Introduction
- 10.1 Objectives
- 10.2 Types of Mutual Funds
- 10.3 Factoring: Mechanism and Types of Factoring
- 10.4 Cash Management: Meaning, Importance and Objectives
 - 10.4.1 ST/MT Funding
- 10.5 Answers to Check Your Progress Questions
- 10.6 Summary
- 10.7 Key Words
- 10.8 Self Assessment Questions and Exercises
- 10.9 Further Readings

10.0 INTRODUCTION

Most investment companies are structured as open-ended mutual funds in terms of both sheer number and assets under management. When an investor wants to buy shares of a mutual fund, the mutual fund issues and sells them shares at net asset value. Similarly, investors selling shares sell them at net asset value back to the fund. These types of funds are known as open-end funds since they don't restrict the number of shares issued.

Closed-end funds (CEFs) are investment companies that issue a fixed number of shares that trade intraday on stock exchanges at market prices. Since the market price is determined by investors, the price does not necessarily reflect the underlying value of the assets.

10.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the different types of mutual funds
- Analyse the mechanism and types of factoring
- Describe the meaning and importance of cash management
- Discuss the concept of ST and MT funding

10.2 TYPES OF MUTUAL FUNDS

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Mutual fund is a mechanism for pooling resources by issuing units in securities to the investors and investing funds in accordance with the objectives disclosed in the offer document. A mutual fund is a corporation, trust or partnership, which manages the collected money with the help of professional expertise. Different persons have defined mutual funds different ways. 'A mutual fund is almost like a cooperative society of investors. That is why the word 'mutual' is used. It collects money from investors by issuing mutual fund units, invests it in securities, and divides whatever dividend or interest is received among its members.' (A. John Halin)

The SEBI Mutual Fund Regulations, 1993 defines mutual fund as 'a fund established in the form of a trust by a sponsor, to raise money by the trustees through sale of units to the public, under one or more schemes, for investing in securities in accordance with the regulations'. Mutual funds are financial intermediaries which bring a wide variety of securities within the reach of the most modest investors. The financial intermediary is known as 'investment company' in the US and most other countries. They are called 'investment trusts' in the United Kingdom. In India, they are known by the term 'mutual funds'.

Classification of Mutual Funds

A mutual fund scheme can be classified into close ended or open ended depending on its maturity period.

Close-ended scheme

It has a prefixed maturity period, e.g., five to seven years. Both the corpus amount and the number of units are prefixed. The fund is open for subscription only for a specified period after the launch of the scheme. Mutual funds are required to despatch certificates or statements of accounts within six weeks from the date of closure of the initial subscriptions of the schemes. The investors can invest in the scheme during this period. After the closure of the subscription period, investors can buy and sell the units of the scheme at the stock exchanges where the units are listed. They would either get a demat account statement or unit certificates as traded in the stock exchanges.

According to SEBI regulations, one or two exit routes should be provided to the investors. It may either be in the form of regular repurchase or by listing them in stock exchanges. Some of the close-ended mutual funds provide the option of selling back of the units to the mutual funds. The prices are fixed on the basis of net asset value. The NAV of the schemes is disclosed on a weekly basis.

The entire corpus is disinvested after the maturity period and the proceeds are distributed among the investors in proportion to their unit holdings.

Open-ended schemes

These are available for subscription and repurchase on a continuous basis. These schemes do not have a maturity period. Investors can buy and sell units at prices fixed by a mutual fund. Prices are fixed on the basis of NAV. The NAVs of these schemes are declared daily. Liquidity is the main advantage of the open-ended scheme. The main difference between the open-ended and the close-ended schemes is that the latter is traded on stock exchanges, whereas the former is not. Also, open ended schemes are available at all times, whereas the close-ended schemes are available only for a prescribed period.

Schemes on the basis of investment objectives

Schemes are classified as growth scheme, income scheme or balanced scheme as per the investment objectives. These schemes may either be open-ended or close-ended. Some of them are given below.

Index funds

These are equity funds that passively mimic a market index. The portfolio of the index fund is designed to reflect the composition of some stock market index. The index funds avoid the risk of poor stock selection by the fund manager. The aspects that are in favour of index funds are:

- low costs
- predictability
- diversification

All the index funds, which are currently in operation, are modelled either on the Nifty or the Sensex. Several fund houses have launched passive index funds in the past. Some of them are Franklin Templeton India Index fund (formerly Pioneer ITI Index fund, offering both Sensex and Nifty Plans), UTI Nifty Index fund, UTI Master Index fund and IDBI Principal Index fund.

These funds suffer because of tracking error. This error is the percentage by which returns from the funds deviate from the underlying index. If the error is positive, the funds generate higher returns than that of the index. One of the reasons cited for the tracking error is the transaction cost. Index funds have to incur brokerage and other costs to make changes in their portfolios in line with those in the index. This results in increase in cost. Besides this, the lack of depth in the Indian stock market also affects the index funds.

Investment management fee affects the return and recurring expenses such as advertisement, investor communication costs and administration costs. Though these expenses form a small portion of the returns each year, the compounding effect over the years becomes quite significant.

It is felt that if the index funds could track down broad based market indices such as S&P CNX 500 and BSE 200, it would help the investors to capture

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broad market trends more accurately. However, lack of liquidity of many small and mid-cap stocks would result in high transaction costs.

Exchange traded funds (ETFs)

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These are passively managed funds that track a particular index and have the flexibility to trade like a common stock. These types of funds combine the attributes of mutual funds with those of the stocks. Without large investment, an average investor can have an entire range of index stocks. It is different from the index funds where units are issued in return for cash and redeemed as per the net asset value in cash. However, ETF issues units in lieu of shares and vice versa.

The ETFs are priced throughout the day. They can be bought and sold at any time during a trading day just like a stock. The fund may either represent market index or a specific industry sector or an international sector. An investor can buy it on a margin. Short selling can be carried out. The expense ratio is similar to the open end mutual funds. They range from 0.18 per cent of the value of the fund to 0.84 per cent.

ETFs came into existence in the US in 1993. The first ETFs were based on the S & P 500 and were popularly known as spiders. Presently, diamonds are the other type of ETFs representing all thirty stocks in the Dow Jones Industrial Average and traded in American stock exchange. The Benchmark Asset Management Company (BAMC) has launched Nifty BeEs. It was listed on the capital market segment of the NSE on 8 January 2002. Nifty BeEs tracks the Standard Poor (S&P) CNX Nifty index. The minimum investment for taking the index exposure through Nifty BeEs is just one unit (around 1/10 of the Nifty).

Balanced funds

These funds invest both in equity and fixed income securities. They are also called 'income-cum-growth' funds. They aim at regular income and capital appreciation. They have the equity and debt portfolios to fulfil this objective. The portfolio beta is less than one and the price of units does not rise in proportion to the aggregate stock market price because of the debt component in the portfolio. Some of the balanced funds are: Prudential ICICI Balanced fund, Kothari Balanced fund, Alliance 95 fund and DSP Merrill Lynch Balanced fund. The performance of the balanced funds differs due to the ratio of stocks to the fixed income securities that varies from fund to fund and their different levels of exposure to individual sectors like IT, media or telecom. The weightage of individual stock in funds differs. Hence, an investor has to go through the portfolios before investing in the funds.

Money market funds or liquid funds

These funds were initiated during 1973 in the US when interest rates on short term money market securities were high. They are also income funds and attempt to provide current income and safety of principal by investing in short term securities such as treasury bills, bank certificates of deposits, bank acceptances, commercial

papers and inter bank call money. Returns on these schemes fluctuate much less as compared to the other funds. These funds are appropriate for corporate and individual investors to invest their surplus cash for a short period.

Gilt funds

These are also known as G-Sec funds. These invest in the Government of India securities, and have gained popularity in the Indian market. The Securities Exchange Board of India has issued new guidelines in 2002 with an aim to provide better checks and balances for the mutual funds. The following are the salient features of the new requirements:

- Mutual funds have to reconcile their balance with the monthly RBI report
- Internal audit, continuous checks by the auditors and reports to audit committees form a part of the requirements
- The same report must also be placed before the boards of the asset management company and the trustee company
- Mutual funds will have to submit a compliance certificate to the RBI on a quarterly basis, indicating their adherence to the norms
- Public debt offices of the RBI will issue monthly statements to mutual funds maintaining SGL/CSGL accounts

Growth funds

The main objective of these funds is to provide capital appreciation over medium to long term. They invest a major portion of their collected money in equity. This makes them prone to risk. As per their preference, the investors may either choose the option of dividend or the option of capital appreciation. Investors have to specify their choice while applying for units. However, if they want to change at a later date, they are permitted to do so. The year 1999–2000 was one of the best periods for growth funds in the Indian market. Fresh sales by growth schemes were about 1000 crore. Growth funds outperform bench mark index in bull phase and underperform in bearish times. Another common problem cited by the fund managers is that investors put more money when the NAVs are high and sell when NAVs are low, making the managers busier in redemption than in managing the funds.

Income/Debt-oriented funds

The objective of these funds is to provide regular and steady income to investors. A major part of the funds corpus is invested in fixed-income securities such as bonds, corporate debentures, government securities and money market instruments. The scope for capital appreciation is limited in these schemes. These funds carry only modest risks as compared to equity funds.

The NAVs of debt funds are affected because of change in interest rate in the country. If the interest rates increase, NAVs of such funds are likely to fall in

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the short run and vice-versa. For instance, debt funds lost heavily in July 2000, when the RBI raised the interest rate to defend the rupee. Thus, the debt funds are prone to risk because of changes in the rate of interest. The NAV is calculated based on the market price and not just the income earned from holding from the bonds. The NAV fluctuates with the volatility of the bond prices.

Like all instruments, the bond price is based on demand and supply. This means that the bond prices will fall when supply is relatively more than the demand. This happens when rupee is falling sharply against the dollar or when the call rates are very high. During this period, banks generate resource by selling the bonds. The excessive supply of bonds in the market pulls down the price.

Fall in the prices of bonds leads to fall in NAVs of the debt funds. Thus the debt funds are also prone to market risk. However, long-term investors prefer these funds. Some of the debt funds/income funds include Birla Income Plus, Prudential ICICI Income plan, SBI LiquiBond, UTI Bond fund and DSP Merrill Lynch Bond fund.

Reinvestment risk is defined as the risk of having to reinvest the intermediate cash flows (coupon payments at a lower interest rate). In falling interest climate, the mutual funds may earn a lower return by reinvesting the coupon payment. To understand this, the funds should provide two distinct NAVs—one inclusive of the coupon payments, and other exclusive of the coupons. This would give an idea about the reinvestment risk to the investors.

Sector specific funds

These funds/schemes invest in securities of those sectors or industries specified in the offer documents, e.g., information technology, pharmaceuticals, fast moving consumer goods (FMCG) and petroleum, etc. The returns on these funds depend on the performance of these sectors. Since they are investing in a particular sector, the risk is high as compared to the other funds. The performance of the sector should be closely followed in order to take the entry and exit decisions.

A complaint often levelled against these funds is that they invest in sectors other than the ones suggested by their name. This is because most offer documents spell out the investment strategy in vague terms and this allows the funds to move away completely from the nature of the scheme as indicated by its name. For example, Tata Core sector fund was designed to invest in the core sector (steel, cement, power and infrastructure) in 1999, but it shifted out of cyclicals into technology stocks. By Nov 1999, 71 per cent of its assets were invested in technology stocks.

Tax saving schemes

These schemes provide tax rebates to the investors under the supervision of the Income Tax Act 1961. The government offers tax incentives for investment in specified avenues. Equity linked savings schemes and pension schemes offered

by mutual funds offer tax benefits. These schemes resemble the equity-oriented schemes and invest mostly in equities.

Load and no load funds

In load funds, a fee is charged for the entry and exit. The charge is a percentage of NAV. Whenever an investor buys or sells units in the fund, he has to pay a charge. If the entry as well as exit load is one per cent to buy a unit worth ₹ 10, he has to pay ₹ 10.10. Likewise if he sells a unit, he will get ₹ 9.90 per unit. The load factor affects the return and the investor has to consider the load factor before investing in a mutual fund.

No load funds do not charge a fee for entry or exit. No additional charges are levied on the purchase or sale of units. However, SEBI regulations allow no load funds to hike the investment management fees by up to one per cent per annum until they recover their initial expenses.

Check Your Progress

1. How does the SEBI Mutual Fund Regulations, 1993 defines mutual fund?
2. State some of the aspects which are in favour of index funds.
3. What is the main objective of growth funds?

10.3 FACTORING: MECHANISM AND TYPES OF FACTORING

Factoring is a type of financial service provided by specialist organizations. In factoring, a financial institution (factor) buys the debts or accounts receivables of a company (client) and pays up to 80 per cent (rarely up to 90 per cent) of the amount immediately to credit sales, once agreement with the factor is entered into. The factoring company pays the remaining amount (the balance 10 per cent or 20 per cent) to the client when the collections are made from debts. Factoring is a great boon to firms that sell on a credit basis as the collection of receivables poses a problem to them. Several small and medium-sized organizations cannot afford to have a separate credit department. For such organizations, factoring is ideal, as factors play an important role in the collection of debts and other services connected with credit management. As this is a specialist organization that provides factoring services, even big organizations too may prefer to avail of their services from the cost-benefit analysis viewpoint.

A factor is an institution that offers credit against receivables and provides managerial services relating to management of debts arising from credit sales. Factoring is a financial innovation that provides financial and managerial support to a client.

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The factoring business is defined as ‘the business of acquisition of receivables of an assignor by accepting assignment of such receivables or financing, whether by way of making loans or advances or in any other manner against the security interest over any receivables’. However, the credit facilities provided by banks in the ordinary course of business against the security of receivables and any activity undertaken as a commission agent or otherwise for sale of agricultural produce or goods of any kind whatsoever and related activities are expressly excluded from the definition of factoring business. The Factoring Act has laid down the basic legal framework for factoring in India.

Factoring is an arrangement under which a financial institution (called a factor) undertakes the task of collecting the book debts of its client in return for a service charge. Factoring involves the sale of receivables to a specialized firm, called factors. Factors collect receivables and also advance cash against receivables to solve the client firm’s liquidity problem. They charge interest on the amount advanced for providing their services and charge a commission for other services. Management services, which relate to maintenance of a sales ledger, the collection of book debts (accounts receivable), rendering advisory services to their clients and protection from bad debts, are also provided by factors. The factoring institution eliminates the client’s risk of bad debts by taking over the responsibility of book debts due to the client. The factoring institution advances a proportion of the value of book debts of the client immediately, and the balance on the realization of book debts.

The factoring service is more comprehensive, compared to a cash credit limit from a bank or the discounting of bills. A bank looks at the total assets of a borrower while a factor considers only the book debts.

Factoring differs from a bank loan. The emphasis in factoring is on the value of the receivables (essentially a financial asset), whereas a bank focuses more on the value of the borrower’s total assets.

Parties in Factoring

There are three parties involved in a factoring transaction:

- The buyer of the goods
- The seller of the goods
- The factor, i.e., financial institution

Under the Factoring Regulation Act, 2011, the factor is referred to as the ‘assignee’, the industry selling the accounts receivable to the factor as the ‘assignor’, and the person liable to the industry as the ‘debtor’.

Factoring Services

The purchase of receivables is fundamental to the functioning of factoring. The following basic services are provided in factoring:

- Financial accommodation
- Sales ledger administration and credit management
- Credit collection
- Protection to seller against default and bad-debt losses of buyers

Credit sales are common in most businesses. Factoring involves the outsourcing of debt collection along with the option of bearing risk for bad debts. Bad debts eat the profitability of business. Factoring provides an option to cover the default risk that may arise in respect of credit sales to business organizations.

Factoring Procedure

Normally, the credit evaluation of potential buyers, the maintenance of a sales ledger, follow-up with debtors and collections from them are handled by a separate credit department in an organization; its role is vital in improving liquidity and profitability. The maintenance of a separate department is expensive; moreover, this department may not have the professional expertise that is normally available with an exclusive organization, such as a factoring agency, which specializes only in this type of activity.

In factoring, receivables created out of the sale of goods or services are sold to a factor. To benefit from professional expertise and receive services in a cost effective manner, organizations may avail of factoring services.

The agreement between the supplier and the factor specifies the factoring procedure and spells out the detailed conditions between the two parties.

To perform the functions of credit evaluation and collection for a large number of clients, a factor may maintain a credit department with specialists on the staff. Once the factor has purchased a firm's receivables, receivables disappear from the balance sheet of the supplier and ownership rests with the factor.

The factoring procedure is as follows:

- The buyers' creditworthiness is appraised by the factor, based on market assessment, and the factor then fixes credit limits for potential buyers of the client to whom goods are sold or services provided on credit.
- Once the factor is satisfied about the customer's creditworthiness and agrees to buy receivables, the client firm dispatches goods to the buyers and sends a copy to the factor.
- The sales documents given to buyers contain the instruction to make the payment to the factor directly.
- The factor remits the agreed amount to the client.
- Once the full amount is collected from debtors, the balance invoice amount is paid, after deducting interest and commission as per the terms of agreement.

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- Factoring may be on recourse basis, where the risk of bad debts is borne by the client firm or on a non-recourse basis where the risk of bad debts is borne by the factor.
- When the factor assumes the responsibility for bearing loss and the risk of bad debts, the service charges would increase, compared to a situation where losses due to bad debt are borne by the client.

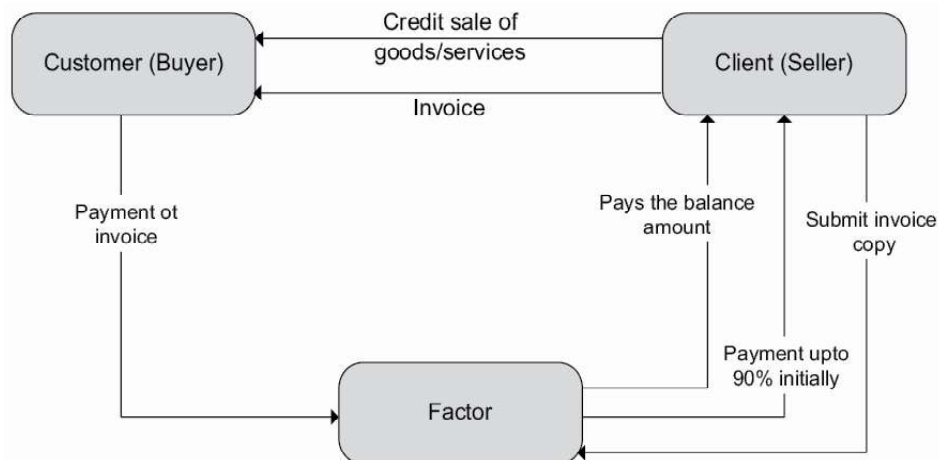


Fig. 10.1 Factoring Process

Types of Factoring

Different types of factoring are:

- Disclosed and undisclosed factoring
- Recourse and non-recourse factoring

Disclosed factoring: Disclosed factoring means that the customer (i.e., the debtor), who is liable to make the payment to the client on credit sales, must be informed by way of intimation in writing that receivables from the customer are being factorized. Prior to the commencement of the Factoring Act 2011, the assignment of receivables was governed by the Transfer of Property Act 1882, which does not make prior notice to the debtor compulsory before the assignment of receivables. Thus, it was open to the parties to decide whether they wanted to undertake disclosed or undisclosed factoring. However, as per the provisions of the Factoring Act 2011, prior notice to the debtor is now mandatory for the assignment of receivables to the factor.

Factoring, as envisaged under the Factoring Act, must be disclosed factoring. Earlier, it was open to the parties to decide. Prior notice to the debtor before the assignment of receivables has become mandatory now under the Factoring Regulation Act 2011. Disclosed factoring can either be on recourse or non-recourse basis.

Undisclosed factoring: In undisclosed factoring, a seller's customers are not notified of the factoring arrangement. Sales ledger administration and collection of debts are undertaken by the client (seller). In this type, factoring is limited to the provision of finance by the factor—no other services are provided. Factoring services, such as undisclosed factoring, are confidential in nature, as the debtors are not aware of the factoring arrangement. This practice is not possible now.

Recourse factoring: In recourse factoring, if buyers do not pay the amount on maturity, the factor recovers the amount from the client (seller) as the buyer has paid an advance to the seller at the time of credit sales reporting. Recourse factoring is offered at a lower cost since the risk to the factor is low. This is the most common type of factoring and very popular in the UK and US, where factoring is advanced.

In recourse factoring, the factor does not take on the risk of bad debts. Put another way, the factor reclaims its money from the client if the customer (buyer) does not pay the debt.

Example: The factoring agreement requires payment to be made within three months. It also states that 80 per cent of each invoice will be advanced. On 30 April 2012, an invoice for ₹1,000,000 is issued and the factor advances ₹80,000 immediately. On 31 July, if the buyer has defaulted in payment, ₹80,000 must be repaid to the factor. There is no refund of the factoring fees relating to the debt.

Non-recourse factoring: In non-recourse factoring, the factor undertakes the risk of bad debts from customers. This is an advantageous situation for the client who is burdened with the risk of bad debts. Non-recourse factoring is popular in developing countries, including India.

In non-recourse factoring, the factor takes on the risk of bad debts. The factor accepts specified risks of the debtor's failure to pay, but it does not insure against debts that are unpaid because of genuine disputes. Non-recourse factoring is more expensive than recourse factoring, because in the former, the factor accepts the risk of bad debts.

A factor's commission depends on the services provided including acceptance of risk for bad debts or otherwise.

10.4 CASH MANAGEMENT: MEANING, IMPORTANCE AND OBJECTIVES

Cash management is concerned with the managing of: (i) cash flows into and out of the firm, (ii) cash flows within the firm, and (iii) cash balances held by the firm at a point of time by financing deficit or investing surplus cash. It can be represented by a **cash management cycle** as shown in Figure 10.2.

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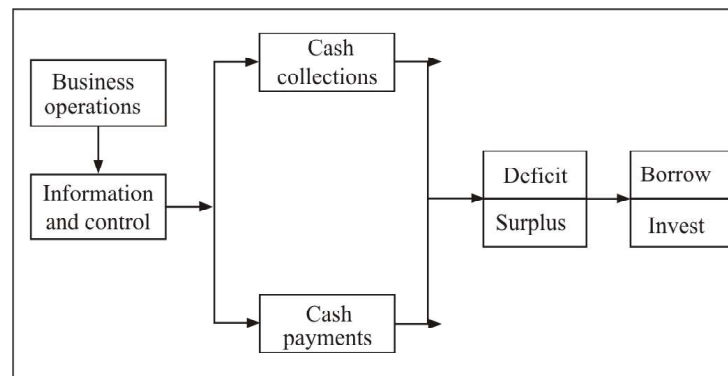


Fig. 10.2 Cash Management Cycle

Management of cash is also important as it is difficult to predict cash flows accurately, particularly the inflows, and there is no perfect agreement between the inflows and outflows of cash. Sometimes, cash outflows will exceed cash inflows (as payments for taxes, dividends or seasonal inventory build up), while at other times, cash inflow will be more than cash payments (as there may be large cash sales and debtors may be realized in large sums promptly). Management of cash is also critical since cash constitutes the smallest portion of the total current assets, yet the management's precious time is devoted in managing it. A lot of innovations have been done in cash management techniques recently. An obvious aim of the firm these days is to manage its cash affairs in such a way as to keep cash balance at a minimum level and to invest the surplus cash in profitable investment opportunities.

A firm should chart out strategies concerning the facets of cash management, which are as follows:

- **Cash planning:** Cash inflows and outflows must be drawn out to project cash surplus or deficit for each part of the planning period, and for this purpose, a cash budget must be prepared.
- **Managing the cash flows:** The management of a firm should ensure proper and uninterrupted flow of cash. The cash inflows should be accelerated, while the cash outflows should be slowed down as far as possible.
- **Optimum cash level:** The firm must take a decision regarding the suitable level of cash balances. The cost of excess cash and danger of cash deficiency need to be compared to figure out the appropriate level of cash balances. The firm should decide about the division of such cash balance between alternative short-term investment opportunities such as bank deposits, marketable securities or inter-corporate lending.

The ideal cash management system will depend on the firm's products, organization structure, competition, culture and options available. The task is complex, and decisions taken can affect important areas of the firm. For example, to improve collections if the credit period is reduced, it may affect sales. However, in certain cases, even without fundamental changes, it is possible to significantly reduce cost of cash management system by choosing the right bank and controlling the collections properly.

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Motives for Holding Cash

Just like the motives for holding inventory the firm's need to hold cash may be attributed to the following three motives:

- The transactions motive
- The precautionary motive
- The speculative motive

1. Transaction motive: The **transactions motive** requires a firm to hold cash to conduct its business in the ordinary course. The firm needs cash primarily to make payments for purchases, wages and salaries, other operating expenses, taxes, dividends, etc. The need to hold cash would not arise if there were perfect synchronization between cash receipts and cash payments, i.e., enough cash is received when the payment has to be made. But cash receipts and payments are not perfectly synchronized. For those periods, when cash payments exceed cash receipts, the firm should maintain some cash balance to be able to make required payments. For transactions purpose, a firm may invest its cash in marketable securities. Usually, the firm will purchase securities whose maturity corresponds with some anticipated payments, such as dividends, or taxes in the future. Notice that the transactions motive mainly refers to holding cash to meet anticipated payments whose timing is not perfectly matched with cash receipts.

2. Precautionary motive: The **precautionary motive** is the need to hold cash to meet contingencies in the future. It provides a cushion or buffer to withstand some unexpected emergency. The precautionary amount of cash depends upon the predictability of cash flows. If cash flows can be predicted with accuracy, less cash will be maintained for an emergency. The amount of precautionary cash is also influenced by the firm's ability to borrow at short notice when the need arises. Stronger the ability of the firm to borrow at short notice, the lesser the need for precautionary balance.

3. Speculative motive: The **speculative motive** relates to the holding of cash for investing in profit-making opportunities as and when they arise. The opportunity to make profit may arise when security prices change. The firm will hold cash,

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when it is expected that interest rates will rise and security prices will fall. Securities can be purchased when the interest rate is expected to fall; the firm will benefit by the subsequent fall in interest rates and increase in security prices. The firm may also speculate on materials' prices. If it is expected that materials' prices will fall, the firm can postpone materials' purchasing and make purchases in future when price actually falls. Some firms may hold cash for speculative purposes.

Cash Planning

Cash flows are inseparable parts of the business operations of firms. A firm needs cash to invest in inventory, receivable and fixed assets and to make payment for operating expenses in order to maintain growth in sales and earnings. It is possible that the firm may be making adequate profits but may suffer from the shortage of cash as its growing needs may be consuming cash very fast. The 'cash-poor' position of the firm can be corrected if its cash needs are planned in advance. At times, a firm can have excess cash with it if its cash inflows exceed cash outflows. Such excess cash may remain idle. Again, such excess cash flows can be anticipated and properly invested if cash planning is resorted to. **Cash planning** is a technique to plan and control the use of cash. It helps to anticipate the future cash flows and needs of the firm and reduces the possibility of idle cash balances (which lowers firm's profitability) and cash deficits (which can cause the firm's failure).

Cash planning protects the financial condition of the firm by developing a projected cash statement from a forecast of expected cash inflows and outflows for a given period. The forecasts may be based on the present operations or the anticipated future operations. Cash plans are very crucial in developing the overall operating plans of the firm.

Cash planning may be done on daily, weekly or monthly basis. The period and frequency of cash planning generally depends upon the size of the firm and philosophy of management. Large firms prepare daily and weekly forecasts. Medium-sized firms usually prepare weekly and monthly forecasts. Small firms may not prepare formal cash forecasts because of the non-availability of information and small-scale operations. However, if the small firms prepare cash projections, it is done on monthly basis.

Cash Forecasting and Budgeting

Cash budget is the most significant device to plan for and control cash receipts and payments. A cash budget is a summary statement of the firm's expected cash inflows and outflows over a projected time period. It gives information on the timing and magnitude of expected cash flows and cash balances over the projected period. This information helps the financial manager to determine the future cash needs of the firm, plan for the financing of these needs and exercise control over the cash and liquidity of the firm.

The time horizon of a cash budget may differ from firm to firm. A firm whose business is affected by seasonal variations may prepare monthly cash budgets. Daily or weekly cash budgets should be prepared for determining cash requirements if cash flows show extreme fluctuations. Cash budgets for a longer intervals may be prepared if cash flows are relatively stable.

Cash forecasts are needed to prepare cash budgets. Cash forecasting may be done on short-or long-term basis. Generally, forecasts covering periods of one year or less are considered short-term forecasts and those extending beyond one year are considered long-term forecasts.

1. Short-term cash forecasts

It is comparatively easy to make short-term cash forecasts. The important functions of carefully developed short-term cash forecasts are as follows:

- To determine operating cash requirements
- To anticipate short-term financing
- To manage investment of surplus cash

Short-run cash forecasts serve many other purposes. For example, multi-divisional firms use them as a tool to coordinate the flow of funds between their various divisions as well as to make financing arrangements for these operations. These forecasts may also be useful in determining the margins or minimum balances to be maintained with banks. Still other uses of these forecasts are as follows:

- Planning reductions of short- and long-term debt
- Scheduling payments in connection with capital expenditures programmes
- Planning forward purchases of inventories
- Checking accuracy of long-range cash forecasts
- Taking advantage of cash discounts offered by suppliers
- Guiding credit policies

2. Short-term forecasting methods

Two most commonly-used methods of short-term cash forecasting are as follows:

- The receipt and disbursements method
- The adjusted net income method

The receipts and disbursements method is generally employed to forecast for limited periods, such as a week or a month. The adjusted net income method, on the other hand, is preferred for longer durations, ranging between a few months to a year. Both methods have their pros and cons. The cash flows can be compared with budgeted income and expense items if the receipts and disbursements approach is followed. On the other hand, the adjusted income approach is appropriate in showing a company's working capital and future financing needs.

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10.4.1 ST/MT Funding

External funds available for a period of one year or less are called short-term finance. In India, short-term funds are used to finance working capital. Two most significant short-term sources of finance for working capital are trade credit and bank borrowing.

Short-term Sources of Finance

External funds available for a period of one year or less are called short-term finance. Two most significant short-term sources of finance for working capital are trade credit and bank borrowing. Let us go through the short-term sources of finance.

Trade Credit

Trade credit refers to the credit that a customer gets from suppliers of goods in the normal course of business. In practice, the buying firms do not have to pay cash immediately for the purchases made. This deferral of payments is a short-term financing called trade credit. It is a major source of financing for firms. In India, it contributes to about one-third of the short-term financing. Particularly, small firms are heavily dependent on trade credit as a source of finance since they find it difficult to raise funds from banks or other sources in the capital markets.

Trade credit is mostly an informal arrangement, and is granted on an **open account** basis. A supplier sends goods to the buyer on credit which the buyer accepts, and thus, in effect, agrees to pay the amount due, as per sales terms in the invoice. However, he does not formally acknowledge it as a debt; he does not sign any legal instrument. Once the trade links have been established between the buyer and the seller, they have each other's mutual confidence, and trade credit becomes a routine activity which may be periodically reviewed by the supplier. Open account trade credit appears as **sundry creditors** (known as **accounts payable** in USA) on the buyer's balance sheet.

Trade credit may also take the form of **bills payable**. When the buyer signs a bill—a negotiable instrument—to obtain trade credit, it appears on the buyer's balance sheet as bills payable. The bill has a specified future date, and is usually used when the supplier is less sure about the buyer's willingness and ability to pay, or when the supplier wants cash by discounting the bill from a bank. A bill is formal acknowledgement of an obligation to repay the outstanding amount. In USA, **promissory notes**—a formal acknowledgement of an obligation with a promise to pay on a specified date—are used as an alternative to the open account, and they appear as **notes payable** in the buyer's balance sheet.

Bank Finance for Working Capital

Banks are the main institutional sources of working capital finance in India. After trade credit, bank credit is the most important source of financing working capital

requirements. A bank considers a firm's sales and production plans and the desirable levels of current assets in determining its working capital requirements. The amount approved by the bank for the firm's working capital is called **credit limit**. Credit limit is the maximum amount of funds which a firm can obtain from the banking system. In the case of firms with seasonal businesses, banks may fix separate limits for the **peak level credit** requirement and normal, **non-peak level credit** requirement indicating the periods during which the separate limits will be utilized by the borrower. In practice, banks do not lend 100 per cent of the credit limit; they deduct **margin money**. Margin requirement is based on the principle of conservatism and is meant to ensure security. If the margin requirement is 30 per cent, bank will lend only up to 70 per cent of the value of the asset. This implies that the security of bank's lending should be maintained even if the asset's value falls by 30 per cent.

Forms of Bank Finance

A firm can draw funds from its bank within the maximum credit limit sanctioned. It can draw funds in the following forms: (a) overdraft, (b) cash credit, (c) bills purchasing or discounting, and (d) working capital loan.

Overdraft: Under the overdraft facility, the borrower is allowed to withdraw funds in excess of the balance in his current account, up to a certain specified limit, during a stipulated period. Though overdrawn amount is repayable on demand, it generally continues for a long period by annual renewals of the limits. It is a very flexible arrangement from the borrower's point of view since he can withdraw and repay funds whenever he desires within the overall stipulations. Interest is charged on daily balances—on the amount actually withdrawn—subject to some minimum charges. The borrower operates the account through cheques.

Cash credit: The cash credit facility is similar to the overdraft arrangement. It is the most popular method of bank finance for working capital in India. Under the cash credit facility, a borrower is allowed to withdraw funds from the bank upto the sanctioned credit limit. He is not required to borrow the entire sanctioned credit at once, rather, he can draw periodically to the extent of his requirements and repay it by depositing surplus funds in his cash credit account. There is no commitment charge; therefore, interest is payable on the amount actually utilized by the borrower. Cash credit limits are sanctioned against the security of current assets. Though funds borrowed are repayable on demand, banks usually do not recall such advances unless they are compelled by adverse circumstances. Cash credit is a most flexible arrangement from the borrower's point of view.

Purchase or discounting of bills: Under the purchase or discounting of bills, a borrower can obtain credit from a bank against its bills. The bank purchases or discounts the borrower's bills. The amount provided under this agreement is covered within the overall cash credit or overdraft limit. Before purchasing or discounting the bills, the bank satisfies itself as to the creditworthiness of the drawer. Though the term 'bills purchased' implies that the bank becomes owner of the

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bills, in practice, bank holds bills as security for the credit. When a bill is discounted, the borrower is paid the discounted amount of the bill (viz., full amount of bill minus the discount charged by the bank). The bank collects the full amount on maturity.

Letter of credit: Suppliers, particularly the foreign suppliers, insist that the buyer should ensure that his bank will make the payment if he fails to honour its obligation. This is ensured through a letter of credit (L/C) arrangement. A bank opens an L/C in favour of a customer to facilitate his purchase of goods. If the customer does not pay to the supplier within the credit period, the bank makes the payment under the L/C arrangement. This arrangement passes the risk of the supplier to the bank. Bank charges the customer for opening the L/C. It will extend such facility to financially sound customers. Unlike cash credit or overdraft facility, the L/C arrangement is an indirect financing; the bank will make payment to the supplier on behalf of the customer only when he fails to meet the obligation.

Working capital loan: A borrower may sometimes require ad hoc or temporary accommodation, in excess of the sanctioned credit limit, to meet unforeseen contingencies. Banks provide such accommodation through a **demand loan** account or a separate **non-operable cash credit account**. The borrower is required to pay a higher rate of interest above the normal rate of interest on such additional credit.

Long-term/Medium-term Sources of Finance

Long-term sources of finance are those that are needed over a longer period of time - generally over a year. The reasons for needing long-term finance are generally different to those relating to short term finance. Long term finance may be needed to fund expansion projects or buy new premises. It is important to remember that in most cases, a firm will not use just one source of finance but a number of sources. There might be a dominant source of funds but when you are raising hundreds of millions of pounds it is unlikely to come from just one source. Let us go through the various long-term source of finance.

1. Shares

Ordinary shares (referred to as common shares in the US) represent the ownership position in a company. The holders of ordinary shares, called shareholders (or stockholders in the US), are the legal owners of the company. Ordinary shares are the source of permanent capital since they do not have a maturity date. For the capital contributed by shareholders by purchasing ordinary shares, they are entitled to dividends. The amount or rate of dividend is not fixed; the company's board of directors decides it. An ordinary share is, therefore, known as a variable income security. Being the owners of the company, shareholders bear the risk of ownership; they are entitled to dividends after the income claims of others have been satisfied.

Similarly, when the company is wound up, they can exercise their claims on assets after the claims of other suppliers of capital have been met.

2. Debentures

A debenture is a long-term promissory note for raising loan capital. The firm promises to pay interest and principal as stipulated. The purchasers of debentures are called debenture holders. An alternative form of debenture in India is bond. Mostly public sector companies in India issue bonds. In the USA, the term debenture is generally understood to mean the unsecured bond.

3. Venture Capital Financing: Concept

Venture capital (VC) is a significant financial innovation of the twentieth century. It is generally considered as a synonym of **risky capital**. Venture capital finance is often thought of as ‘the early stage financing of new and young enterprises seeking to grow rapidly.’ It usually implies an involvement by the venture capitalist in the management of the client enterprises. It has also come to be associated with the financing of high and new technology based enterprises. The conventional financiers generally support proven technologies with established markets. Venture capital focuses on high technology, but it is not a necessary condition for venture financing. According to Pratt:

There is a popular misconception that high-technology is the principal driving factor behind the investment decision of a US venture capitalist. Only a small minority of venture capital investments are in new concepts of technology where potential technical problems add a significant amount of risk to the new business development.

There is, however, no doubt that young, high-tech companies would look forward to the venture capitalists for making risky capital available to them. In broad terms, venture capital is the investment of long-term equity finance where the venture capitalist earns his return primarily in the form of capital gains. The underlying assumption is that the entrepreneur and the venture capitalist would act together in the interest of the enterprise as ‘partners’. The true venture capital finances any risky idea. In fact, venture capital can prove to be a powerful mechanism to institutionalize innovative entrepreneurship. It is a commitment of capital for the formation and setting up of small-scale enterprises specializing in new ideas or new technologies. The venture capitalist focuses on growth; he would like to see small business growing into larger ones.

Check Your Progress

4. State the parties involved in factoring.
5. What are the three motives for holding cash?
6. Why are cash forecasts needed?

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10.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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1. The SEBI Mutual Fund Regulations, 1993 defines mutual fund as ‘a fund established in the form of a trust by a sponsor, to raise money by the trustees through sale of units to the public, under one or more schemes, for investing in securities in accordance with the regulations’.
2. The aspects that are in favour of index funds are:
 - Low costs
 - Predictability
 - Diversification
3. The main objective of growth funds is to provide capital appreciation over medium to long term. They invest a major portion of their collected money in equity. This makes them prone to risk. As per their preference, the investors may either choose the option of dividend or the option of capital appreciation.
4. There are three parties involved in a factoring transaction:
 - The buyer of the goods
 - The seller of the goods
 - The factor, i.e., financial institution
5. The following basic services are provided in factoring:
 - Financial accommodation
 - Sales ledger administration and credit management
 - Credit collection
 - Protection to seller against default and bad-debt losses of buyers
6. Cash forecasts are needed to prepare cash budgets. Cash forecasting may be done on short-or long-term basis. Generally, forecasts covering periods of one year or less are considered short-term forecasts and those extending beyond one year are considered long-term forecasts.

10.6 SUMMARY

- Mutual fund is a mechanism for pooling resources by issuing units in securities to the investors and investing funds in accordance with the objectives disclosed in the offer document. A mutual fund is a corporation, trust or partnership, which manages the collected money with the help of professional expertise.

- The SEBI Mutual Fund Regulations, 1993 defines mutual fund as ‘a fund established in the form of a trust by a sponsor, to raise money by the trustees through sale of units to the public, under one or more schemes, for investing in securities in accordance with the regulations’.
- A mutual fund scheme can be classified into close ended or open ended depending on its maturity period.
- Gift funds are also known as G-Sec funds. These invest in the Government of India securities, and have gained popularity in the Indian market. The Securities Exchange Board of India has issued new guidelines in 2002 with an aim to provide better checks and balances for the mutual funds.
- The main objective of growth funds is to provide capital appreciation over medium to long term. They invest a major portion of their collected money in equity. This makes them prone to risk. As per their preference, the investors may either choose the option of dividend or the option of capital appreciation. Investors have to specify their choice while applying for units.
- Sector specific funds/schemes invest in securities of those sectors or industries specified in the offer documents, e.g., information technology, pharmaceuticals, fast moving consumer goods (FMCG) and petroleum, etc.
- The returns on these funds depend on the performance of these sectors. Since they are investing in a particular sector, the risk is high as compared to the other funds.
- Factoring is a type of financial service provided by specialist organizations. In factoring, a financial institution (factor) buys the debts or accounts receivables of a company (client) and pays up to 80 per cent (rarely up to 90 per cent) of the amount immediately to credit sales, once agreement with the factor is entered into.
- Factoring is an arrangement under which a financial institution (called a factor) undertakes the task of collecting the book debts of its client in return for a service charge. Factoring involves the sale of receivables to a specialized firm, called factors.
- Normally, the credit evaluation of potential buyers, the maintenance of a sales ledger, follow-up with debtors and collections from them are handled by a separate credit department in an organization; its role is vital in improving liquidity and profitability.
- Cash management is concerned with the managing of: (i) cash flows into and out of the firm, (ii) cash flows within the firm, and (iii) cash balances held by the firm at a point of time by financing deficit or investing surplus cash.

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- Management of cash is also important as it is difficult to predict cash flows accurately, particularly the inflows, and there is no perfect agreement between the inflows and outflows of cash.
- Cash budget is the most significant device to plan for and control cash receipts and payments. A cash budget is a summary statement of the firm's expected cash inflows and outflows over a projected time period. It gives information on the timing and magnitude of expected cash flows and cash balances over the projected period.
- Cash forecasts are needed to prepare cash budgets. Cash forecasting may be done on short-or long-term basis. Generally, forecasts covering periods of one year or less are considered short-term forecasts and those extending beyond one year are considered long-term forecasts.
- Trade credit refers to the credit that a customer gets from suppliers of goods in the normal course of business. In practice, the buying firms do not have to pay cash immediately for the purchases made. This deferral of payments is a short-term financing called trade credit. It is a major source of financing for firms.

10.7 KEY WORDS

- **Exchange-traded fund:** An exchange-traded fund is an investment fund traded on stock exchanges, much like stocks. An ETF holds assets such as stocks, commodities, or bonds and generally operates with an arbitrage mechanism designed to keep it trading close to its net asset value, although deviations can occasionally occur.
- **Factoring:** Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable to a third party at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs.

10.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What are load and no load funds?
2. Write a short note on factoring services.
3. What are the different short-term sources of finance?
4. State the different forms of bank finance.

Long-Answer Questions

1. Describe the different types of mutual funds.
2. Discuss the procedure of factoring.
3. Explain the methods of factoring.
4. Analyse the meaning and importance of cash management.
5. Describe the long-term sources of finance.

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10.9 FURTHER READINGS

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BLOCK - IV
LRR AND CRR

NOTES

UNIT 11 CASH FLOW CYCLE

Structure

- 11.0 Introduction
- 11.1 Objectives
- 11.2 Cash Flow Budgeting and Forecasting
 - 11.2.1 Electronic Cash Management
- 11.3 Securitization
 - 11.3.1 Term Loans
- 11.4 Capital Budgeting
- 11.5 Profit and Cost Centre
- 11.6 Answers to Check Your Progress Questions
- 11.7 Summary
- 11.8 Key Words
- 11.9 Self Assessment Questions and Exercises
- 11.10 Further Readings

11.0 INTRODUCTION

In the previous unit, you learnt about how mutual funds are classified. In this unit, the discussion will turn towards cash flow cycle. In a business, cash flow cycle attempts to measure the time it takes a company to convert its investment in inventory and other resource inputs into cash. In other words, the calculation measures how long cash is tied up in inventory before the inventory is sold and cash is collected from customers. Just like any other business, the cash flow is extremely important for banks to maintain their working capital. This unit will discuss cash flow budgeting, forecasting, cost and profit centre and capital budgeting in detail.

11.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain cash flow forecasting
- Describe the ways in which a banker secures his advances
- Discuss capital budgeting, cost and profit centre

11.2 CASH FLOW BUDGETING AND FORECASTING

Three basic principles are followed in forecasting project cash flow: (a) relevant or incremental cash flow principle, (b) 'independent of financing' principle, (c) long-term fund principle.

The relevant or incremental cash flow principle

Only those cash flows, which are relevant to making investment decisions, should be considered in estimating project cash flows. A net change in a firm's cash flow due to acceptance of a project is relevant in making decision. An acceptance of a new project may cause changes in the fixed assets and working capital, and in the operating cash flows. An acceptance of a project of one department may affect cash flows of other departments, which is relevant for the project. For example, a powder detergent company sets up a plant for manufacturing liquid detergents. It may result in a loss of sales of powder detergent due to cannibalization effect. Therefore, it is relevant to the liquid detergent project. Some points related to the relevant cash flow principle are explained later in this section. But those readers who want to read in detail about relevant cash flow are advised to read a suitable book on management accounting.

The 'independent of financing' principle

Investment and financing decisions are considered to be completely independent of each other, according to this principle. Therefore, interest expense together with tax savings on it is not considered as part of project cash flow. Project cash flow is calculated as per Equation 11.1.

$$\text{Project cash flow} = \text{PAT} + \text{Depreciation} \pm \text{Working capital change} + \text{Interest} \times (1 - t) \quad (11.1)$$

Interest on debt, together with a tax shield is added back to the net profit for calculating the yearly cash flow of the project. Repayment of the principal sum of loan is not considered as project cash flow. According to the same logic dividend payment by the firm is not considered as part of the project cash flow. Project cash flow is discounted by a discount rate, which comprises the interest, tax shield on interest and dividend components related to financing of a project. Therefore, it is excluded from the project cash flow.

The long-term funds principle

This principle is rather an exception to the previous principle of 'independence of financing'. Only long term financing is kept separate from the project cash flow. Long term financing is necessary for investment in fixed assets and permanent portion of working capital. Short term fluctuation in working capital and its financing are combined with the project cash flow. Therefore, the working capital loan

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schedule and its interest schedule are prepared and the cash flows associated with it is included in the project cash flow.

Salient Points about Basic Principles

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The principle of relevant cash flow can be easy to understand after the perusal of pertinent issues. Some of these issues are enumerated below:

Incremental cash flow

This is the basic principle; only the incremental cash flow is relevant to a project. Some important points to be remembered are:

- (a) **Sunk costs are not relevant:** Costs incurred in the past are historical cost. A part of historical cost is realizable, which is relevant. The remaining part, which cannot be realized, is a sunk cost. The sunk portion of historical cost is not relevant. For example, in a replacement project, a new machine is bought and the old one is discarded. The book value (say ₹5,000) of an old machine is the 'historical cost'. If this old machine can be sold at say ₹1,000 then ₹4,000 is unrealizable and therefore 'sunk' but ₹1,000 is realizable and therefore 'relevant' or 'incremental' or 'future' or 'opportunity' cash flow. This cash flow *will* occur if the replacement project is accepted, and therefore ₹1,000 is a part of the project cash flow.
- (b) **Overheads may not be relevant:** If a firm's overheads are unlikely to change with the acceptance of a particular investment plan, then it is irrelevant irrespective of policy of overhead allocation. But, if some overheads are likely to change with the acceptance of a project then amount of change is a relevant cash flow.
- (c) **Any cost can be relevant or irrelevant:** No particular cost is automatically relevant or otherwise. Therefore, costs classified into direct cost and indirect costs (or overheads), or variable costs and fixed costs cannot be generalized as either relevant or irrelevant costs. Only future cash flows are relevant, irrespective where they occur in the whole organization.
- (d) **The project cash flow may occur anywhere in the firm:** It often happens that the acceptance of a proposed project may have effects somewhere in the firm. Any cash flow that occurs anywhere in the firm as a result of the acceptance of a project is the 'project cash flow'. For example, if a firm builds a new division for the production of a new product and as a result if the sales of one of the existing division are expected to reduce then the expected loss of cash flow from the existing division is the cash flow of the project of building a new division.

Salvage value must be considered

The salvage value of assets on the date of project termination must be included as the terminal cash flow, which becomes the part of project cash flow. The tax

implications on salvage value are also considered. Similarly, if the acceptance of an investment plan requires the salvaging of some assets held now, then that salvage value is considered as cash inflow in the initial period.

Working capital must be considered

Working capital is the net investment in circulating assets (like cash, raw material, semi finished goods, finished goods and receivables) minus current liabilities (like accounts payables and other payables). In most cases capital investment proposals require an additional (incremental) working capital, without which wheels of fixed assets cannot operate.

Any increase (decrease) in the core or permanent (or core) working capital is an initial cash outflow (inflow). This core working capital is held through the project life (no effect on operating cash flow), and upon the termination of the project the working capital change back to original and therefore result into the decrease (increase) of the working capital, incurring cash inflow (outflow) as the terminal cash flow. That means the change in working capital affects initial cash flow as well as terminal cash flow, but with opposite sign (inflow vs. outflow).

However, note that as per the 'long-term funds principle' fluctuating working capital requirements during the life of the project, together with its source of funds and cost of funds, is considered as the part of operating cash flow of the project.

Tax implications

Incremental tax is usually a largest single component in cash flow estimates. The government provides incentives and disincentives for investment in selected areas of business and location. Central and State tax structure (direct and indirect both) must be appropriately considered at a realistic level. A realistic level means the extent to which it can be availed to a firm.

Cash Flow Classification

Cash flow can be classified from various angles as below:

1. Timing of occurrence basis
2. Type of cash flow
3. Pattern of cash flow
4. Inter-dependence basis

Timing of occurrence basis

Project cash flow is usually classified into three parts on the basis of the timing of occurrence; namely, (a) initial cash flow, (b) operating cash flow and (c) terminal cash flow.

- (a) Initial cash flow** It is the cash flow of the capital type, which is usually an outflow for a typical project¹. This cash flow would remain invested for the

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life of the project, during which it would generate operating cash flow as return. All capital assets, pre-operative expenditure, preliminary expenditure, as well as core working capital are included in the initial cash flow.

- (b) **Operating cash flow** The *Operating cash flow* starts coming in once the project is commissioned and the initial teething problems are over. The operating cash flow is generated from regular cash receipts and cash payments during routine operations. Tax implications are also considered here.
- (c) **Terminal cash flow** The *terminal cash flow* is important for the internal evaluation of projects. At the end of the project life, salvage value is received and working capital is recovered in cash. These items together with tax implications, if any, form part of the terminal cash flow.

Types of cash flow

Cash flows are also classified three groups on the basis of the type. These groups are (a) absolute cash flow, (b) relative cash flow and (c) incremental cash flow.

- (a) **Absolute cash flow** It occurs in the case of green field projects, because all the cash flows of such projects are incremental over zero. Any investment, which does not change the existing assets, is likely to have absolute cash flow. For example, if a new business is set up, all the cash flows of that business is absolute cash flow because they occur additionally over no existing cash flows.
- (b) **Relative cash flow** occurs when two mutually exclusive investment alternatives are evaluated. The difference in the cash flow of the two alternatives is termed as the relative cash flow. If a company wants to add a new machine in its shop floor, and two alternative machines are evaluated, then the cash flow estimates of both alternative machines give a relative cash flow on comparison.
- (c) **Incremental cash flow** is obtained when an investment proposal is meant for replacement of some existing assets. Modernization, new product development, replacement of machine and such investment opportunities involve the projection of incremental cash flow. The excess of cash flow from the proposed investment plan over that of existing alternative is called the incremental cash flow.

The classification of cash flow on these lines follows the same basic principles of cash flow projection. The awareness of this classification would change the context of understanding. One has to be careful, particularly in the incremental cash flow, as a mechanical process of evaluation may lead to a wrong decision. An investment option involving incremental cash flow may not have an investment pattern, but may have a financing pattern. The divestment option would generate financing pattern, which can be accepted if IRR is less than discount rate, which is just opposite to the IRR-based decision rule.

Table 11.1 Summary List of Cash Flow Classification

Timing of Occurrence basis	Types of Cash Flow	Pattern of Cash Flow	Interdependence basis
Initial investment	Absolute cash flow	Investment vs. Financing pattern	Independent Dependent
Operating cash flow	Relative cash flow	Other patterns;	Dependent on;
Terminal cash flow	Incremental cash flow	* conventional vs. non-conventional * Annuity * Mixed	* Other cash flow streams * Cash flow of previous period Perfectly correlated Partially correlated

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Pattern of cash flow

Cash flow pattern are described in two ways:

- (a) **Investment vs financing pattern** In the investment pattern of cash flow, an outflow occurs initially followed by a stream of inflow, whereas in financing pattern the initial inflow occurs followed by a stream of outflow. For example,

	Y_0	Y_1	Y_2	Y_3	Y_n
Investment pattern →	-1000	+200	+300	+400	+ 300
Financing pattern →	+1000	-200	-300	-400	-300

Initial and subsequent signs of cash flow create the distinction of investment and financing pattern of cash flow.

- (b) **Other patterns** The timing of cash flow gives the following patterns:

- **Conventional vs. non-conventional cash flow:** In the conventional cash flow either initial inflow is followed by outflow, or initial outflow is followed by inflow; and sign changes only once in the cash flow stream over the time line. In the non-conventional cash flow, inflows and the outflows occur alternatively though not with regularity and sign changes more than once during the period of cash flows.
- **Annuity cash flow:** The annuity cash flow implies that the subsequent series of cash flow (inflow in case of the investment pattern, and outflow in case of the financing pattern) is uniform in amount.

Table 11.2 Examples of various patterns of cash flows

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_n
Conventional → (a)	-1000	+200	+300	+400	+450	+300
or (b)	+1000	-200	-300	-400	-450	-300
Non conventional ®	-1000	+500	+300	-400	+500	+300
Annuity → (c)	-1000	+300	+300	+300	+300	+300
or (d)	+1000	-300	-300	-300	-300	-300
Mixed →	-1000	+500	+300	+100	+300	+200

Mixed cash flow: It is the opposite of annuity cash flow. An uneven stream of cash flow is called a mixed cash flow. Table 11.2 gives examples of each of these patterns. A conventional stream can be either in annuity form or in mixed form.

NOTES

It is essential to know the pattern in which cash is received from investments so that terms for the funds for financing of the project can be suitably determined. The cost of funds usually comes down where project cash flow matches in terms of amount and timing with the capital servicing commitments. A mismatch between the two may require further funds for bridging the gap and increase the cost of project.

Interdependence basis

This classification is applied to risky cash flow. Cash flows may be independent or inter-dependent. Cash flow can be inter-dependent in two ways: (a) different streams of cash flow during a single period may be dependent on each other, and (b) cash flow of two different periods may be dependent on each other. The price of raw material and price of output, quality cost and price of output, price of product and sales quantity are dependent on each other. They are examples of the former type of inter-dependence. Whereas, in case of a new product launch the cash flow of the first year of commissioning will depend on the project completion time, in the case of a research project the cash flow estimate in, say, year-3 will depend upon the actual cash flow of year-2. Inter-dependence of cash flow may change the risk profile of the complete cash flow stream of the project.

If cash flows are related then they may be in (a) perfect correlation, either positive or negative, or (b) partial correlation, either positive or negative. Since risk is an important element in the endeavour to attain the objective of shareholder wealth maximization the interdependence of cash flow assumes greater significance in investment analysis.

11.2.1 Electronic Cash Management

Electronic cash management refers to the set of procedures and practices of integrated management of cash with the developments in the technologies of the information. Electronic cash management systems are becoming popular with companies as they help deter fraud. This is because electronic cash management solutions deter money handlers from pocketing money, they provide a proper paper trail throughout the entire process as well as they provide easy access to oversight.

11.3 SECURITIZATION

A banker secures the advances by means of:

- (a) Lien
- (b) Pledge
- (c) Mortgage
- (d) Hypothecation

Banker's Lien

Legal aspects relating to 'Banker's Lien' have already been discussed in detail in the chapter 'Banker and Customer' under the heading 'Banker's Lien'. Reader's attention is invited to that section. It may briefly be repeated here that a lien is a right to retain properties belonging to the debtor until he has discharged the debt due to the retainer of the properties. A banker's lien is a general lien, which confers a right to retain properties in respect of any general balance due by the debtor to the banker. Bankers have a general lien on all securities deposited with the bankers in their capacity as bankers by a customer unless there be an express contract or circumstances that show an implied contract inconsistent with the lien as has been held in *Brandao vs Barnett*. In the case of lien, banker's right of sale extends to only fully negotiable securities. As far as such securities as concerned, the banker may exercise his right of sale after serving reasonable notice to the customer. In the case of securities other than fully negotiable securities, the banker is well advised to realize them only after getting sanction from a Court of Law.

Pledge

A pledge is a contract whereby an article is deposited with a lender or a promise as security for the repayment of a loan or performance of a promise. To complete a contract of pledge, delivery of the goods to the banker is necessary. Delivery of the documents of title relating to the goods, or the key of the godown where the goods are stored, may be sufficient to create a valid pledge. Strictly speaking, where no possession is given, it is known as 'hypothecation', which is elaborated in the next section. Legal aspects relating to pledges in this section cover 'documents of title' also.

It has been observed in *Shatzadi Begum Saheba and others vs Girdharilal Sanghi and others* that there are three essential features of a pledge, namely:

- (a) there must be a bailment of goods, i.e., delivery of goods;
- (b) the bailment must be by way of security and
- (c) the security must be for payment of a debt or performance of a promise.

A pledge gives the pledgee no right of ownership. But under Section 173 of the Indian Contract Act, he gets a special interest to retain possession even against the true owner until the payment of the debt, and any other expenses incurred in respect of the possession or preservation of the goods. In case of a pledge a special interest and not the special property is transferred to the pledgee who is impliedly authorized to sell the goods pledged in case of default in accordance with the provisions of the Contract Act as has been held in *Kunhunni Elaya Nayar vs Krishna Pattar*. The pledgee's right of disposition is governed by the terms of the pledge and is limited to the recovery of the amount due under the pledge as has been held in the above referred case of *Shatzadi Begum Saheba and others vs Girdharilal Sanghi and others*.

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NOTES

Mortgage

Section 58 of the Transfer of Property Act defines a ‘mortgage’ thus:

‘A mortgage is the transfer of an interest in a specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to pecuniary liability.’

In terms of the above definition, the essentials of a mortgage are:

1. There must be a transfer of interest in an immovable property.
2. The immovable property must be a specific one.
3. The consideration of a mortgage may be either money advanced or to be advanced by way of a loan, or the performance of a contract.

What is ‘Immovable Property’?

When the banker is securing the advances on the security of collaterals, the point whether a particular collateral is a movable property or an immovable property assumes significance. It may be recalled here that a mortgage can be created only by a transfer of interest in an immovable property. Besides, this point is relevant for determining the period of limitation for a suit for declaration of the title to the property, or for recovery of possession of the property. If the property is a movable property, then such a suit is required to be filed within three years. But if it is an immovable property, then such a suit can be filed within twelve years.

In *Ramadev Panigrahi vs Smt Manorama Raj*, the question whether machinery embedded or installed in the earth, by constructing foundations for the purpose, was movable or immovable came up for consideration. The High Court the statutory definitions of the terms ‘movable property’ and ‘immovable property’ and stated that movable property would become immovable property if it was attached to the earth or permanently fastened to anything attached to the earth. The enquiry should not be whether the attachment is direct or indirect; but what the nature and character of the attachment and the intention and object of such attachment were. The High Court considered several English and Indian decided cases on the subject and felt that the tests enunciated by these cases to determine the character and nature of the property were:

- (a) What was the intendment, object and purpose of installing the machinery—whether it was the beneficial enjoyment of the building, land or structure, or the enjoyment of the very machinery?
- (b) The degree and manner of attachment or annexation of the machinery to the earth.

In order to determine the intendment, object and purpose of installing the machinery, the High Court observed:

‘Where the machinery and the building or land on which it is installed are owned by one and the same person normally it should be inferred, unless the contrary is proved, that the object and purpose of installing the machinery is to have beneficial enjoyment of the entire building or land but not the sole enjoyment of the very machinery itself. However, where the machinery imbedded or installed and the building or land belong to two different persons, the intendment and object of the person who is in possession and enjoyment of the property in installing or annexing the machinery must normally be presumed, until the contrary is proved, to be to exploit the benefit of machinery alone, as he is not interested in the building or land.’

Thus, it has to be inferred that the object and purpose of installation of the machinery by a lessee or a tenant in possession of a building, factory or land, was for the beneficial enjoyment of the very machinery during the period of lease or tenancy and not for making any permanent improvement of the building, factory or land, as the case may be. Again, where the building in which machinery has been installed was not a pucca or permanent one, but was only a temporary shed, the intention and purpose of the owner could only be the beneficial enjoyment of the very machinery but not the building.

Hypothecation—Mortgage of Movable

A ‘mortgage of movables’ may be defined as a transfer, by way of security of the general ownership of the chattel, subject to the equity of redemption of the mortgagor. Mortgage of movables can be made by mere parole and without transfer of possession. However, a subsequent mortgagee with possession, in the absence of notice of the previous mortgage, will get priority over a prior mortgage without possession. *In the strict sense, the term ‘mortgage’ is used only in connection with immovables.* In the case of movables, the terms ‘pledge’ and ‘hypothecation’ are used generally. Where a mortgage of movables is created by delivery of possession of goods, it is known as a ‘pledge’, and where no possession is given it is known as ‘hypothecation’.

Letter of Hypothecation

In the case of hypothecation, a document known as ‘Letter of Hypothecation’ is executed. This document details the terms under which the relevant goods are hypothecated. Briefly, the following are the main contents of the letter of hypothecation:

- (a) affirmation by the borrower that the goods are free from encumbrances, that further encumbrances will not be created on them and that he is the absolute owner of the goods;
- (b) undertaking by the borrower that proceeds arising from the sale of the hypothecated goods will be utilized for the repayment of the advance;

NOTES

NOTES

- (c) undertaking by the borrower to meet all expenses relating to the safe custody of the hypothecated goods and that sufficient margin acceptable to the banker will be maintained at all times; and
- (d) provision to the effect that the banker has the right to take possession of the hypothecated goods and to realize them in the event of the borrower making default in the repayment of the advance.

11.3.1 Term Loans

Term loans are short-term loans offered to businesses for capital expenditure and expansion among others. Generally having a tenor up to 5 years, these loans are tailor-made to suit the various financial needs of businesses. Minimal documentation, quick disbursement of funds, and flexibility in repayment are some of the major benefits of these loans.

MT and LT Funding

We have already discussed the various sources of medium and long-term funding in the previous unit.

11.4 CAPITAL BUDGETING

The **investment decisions** of a firm are generally known as the capital budgeting, or capital expenditure decisions. A **capital budgeting decision** may be defined as the firm's decision to invest its current funds most efficiently in the long-term assets in anticipation of an expected flow of benefits over a series of years. The long-term assets are those that affect the firm's operations beyond the one-year period. The firm's investment decisions would generally include expansion, acquisition, modernization and replacement of the long-term assets. Sale of a division or business (divestment) is also an investment decision. Decisions like the change in the methods of sales distribution, or an advertisement campaign or a research and development programme have long-term implications for the firm's expenditures and benefits, and therefore, they should also be evaluated as investment decisions. It is important to note that investment in the long-term assets invariably requires large funds to be tied up in the current assets such as inventories and receivables. As such, investment in fixed and current assets is one single activity.

The following are the features of investment decisions:

- The exchange of current funds for future benefits
- The funds are invested in long-term assets
- The future benefits will occur to the firm over a series of years

It is significant to emphasize that expenditures and benefits of an investment should be measured in cash. In the investment analysis, it is cash flow, which is important, and not the accounting profit. It may also be pointed out that investment

decisions affect the firm's value. The firm's value will increase if investments are profitable and add to the shareholders' wealth. Thus, investments should be evaluated on the basis of a criterion, which is compatible with the objective of the Shareholder Wealth Maximization. An investment will add to the shareholders' wealth if it yields benefits in excess of the minimum benefits, as per the **opportunity cost of capital**.

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11.5 PROFIT AND COST CENTRE

For the purpose of ascertaining cost, the whole organization is divided into small parts or sections. Each small section is treated as a cost centre of which cost is ascertained. A cost centre is defined by CIMA, London as '*a location, person, or item of equipment (or group of these), for which costs may be ascertained and used for the purpose of control.*' Thus, a cost centre refers to a section of the business to which costs can be charged. It may be a location (a department, a sales area), an item of equipment (a machine, a delivery van), a person (a salesman, a machine operator) or a group of these (two automatic machines operated by one workman). The main purpose of ascertaining the cost of a cost centre is control of cost.

Cost centres are primarily of two types:

- (a) **Personal cost centre**—which consists of a person or a group of persons.
- (b) **Impersonal cost centre**—which consists of a location or an item of equipment or group of these.

From a *functional* point of view, cost centres may be of the following two types:

- (a) **Production cost centre:** These are those cost centres where actual production work takes place. Examples are, weaving department in a textile mill, melting shop in a steel mill and cane crushing shop in a sugarmill.
- (b) **Service cost centre:** These are those cost centres which are ancillary to and render services to production cost centres. Examples of service cost centres are power house, tool room, stores department, repair shop and canteen.

A cost accountant sets up cost centres to enable himself to ascertain the costs he needs to know. A cost centre is charged with all the costs that relate to it, *e.g.*, if a cost centre is a machine, it will be charged with the costs of power, light, depreciation and its share of rent, etc. The purpose of ascertaining the cost of a cost centre is cost control. The person in charge of a cost centre is held responsible for the control of cost of that centre.

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Profit Center

A profit center is a section of a company treated as a separate business. Thus profits or losses for a profit center are calculated separately.

Business organizations may be organized in terms of profit centers where the profit center's revenues and expenses are held separate from the main company's in order to determine their profitability. Usually different profit centers are separated for accounting purposes so that the management can follow how much profit each center makes and compare their relative efficiency and profit. Examples of typical profit centers are a store, a sales organization and a consulting organization whose profitability can be measured.

A profit center manager is held accountable for both revenues, and costs (expenses), and therefore, profits. What this means in terms of managerial responsibilities is that the manager has to drive the sales revenue generating activities which leads to cash inflows and at the same time control the cost (cash outflows) causing activities.

This makes the profit center management more challenging than cost center management. Profit center management is equivalent to running an independent business because a profit center business unit or department is treated as a distinct entity enabling revenues and expenses to be determined and its profitability to be measured.

Peter Drucker originally coined the term profit center around 1945. He later recanted, calling it 'One of the biggest mistakes I have made.' He later asserted that there are only cost centers within a business, and 'The only profit center is a customer whose cheque hasn't bounced.'

Cost Unit

"Cost unit is a form of measurement of volume of production or service. This unit is generally adopted on the basis of convenience and practice in the industry concerned." CAS-I.

A cost unit is defined by CIMA, London as a '*unit of product or service in relation to which costs are ascertained.*' For example, in a sugar mill, the cost per tonne of sugar may be ascertained, in a textile mill the cost per metre of cloth may be ascertained. Thus 'a tonne' of sugar and 'a metre' of cloth are cost units. In short, cost unit is unit of measurement of cost.

All sorts of cost units are adopted, the criterion for adoption being the applicability of a particular cost unit to the circumstances under consideration. Broadly, cost units may be of two types as explained below:

- (i) **Units of production**, e.g., a ream of paper, a tonne of steel or a metre of cable.

- (ii) **Units of service**, e.g., passenger miles, cinema seats or consulting hours.

The cost units and cost centres should be those which are natural to the business and which are readily understood and accepted by all concerned.

Cost Object

Cost object may be defined as ‘*anything for which a separate measurement of cost may be desired.*’ A cost accountant may want to know the cost of a particular ‘thing’ and such a ‘thing’ is called a cost object. A cost object may be a product, service, activity, department or process, etc.

Planning and Control

Financial planning and control defines as a combination of strategies it supports the entire financial management process for an organization. The process begins at financial planning, many times in the form of cash flow and forecasting balance sheet. This information will be use of various reasons, in order to calculate your business ratios and financial indicators as a basis for the calculation otherwise in order to illustrate risk calculation or repayment purposes.

Check Your Progress

1. What is working capital?
2. What are the ways of classifying cash flow?
3. What is a pledge?
4. What is profit centre?

11.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Working capital is the net investment in circulating assets (like cash, raw material, semi-finished goods, finished goods and receivables) minus current liabilities (like accounts payables and other payables). In most cases capital investment proposals require an additional (incremental) working capital, without which wheels of fixed assets cannot operate.
2. Cash flow can be classified from various angles as below:
 - (i) Timing of occurrence basis
 - (ii) Type of cash flow
 - (iii) Pattern of cash flow
 - (iv) Inter-dependence basis

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3. A pledge is a contract whereby an article is deposited with a lender or a promise as security for the repayment of a loan or performance of a promise. To complete a contract of pledge, delivery of the goods to the banker is necessary.
4. A profit center is a section of a company treated as a separate business.

11.7 SUMMARY

- Three basic principles are followed in forecasting project cash flow: (a) relevant or incremental cash flow principle, (b) 'independent of financing' principle, (c) long-term fund principle.
- The salvage value of assets on the date of project termination must be included as the terminal cash flow, which becomes the part of project cash flow. The tax implications on salvage value are also considered.
- Incremental tax is usually a largest single component in cash flow estimates. The government provides incentives and disincentives for investment in selected areas of business and location. Central and State tax structure (direct and indirect both) must be appropriately considered at a realistic level.
- Project cash flow is usually classified into three parts on the basis of the timing of occurrence; namely, (a) initial cash flow, (b) operating cash flow and (c) terminal cash flow.
- Electronic cash management refers to the set of procedures and practices of integrated management of cash with the developments in the technologies of the information.
- A banker secures the advances by means of:
 - (a) Lien
 - (b) Pledge
 - (c) Mortgage
 - (d) Hypothecation
- A capital budgeting decision may be defined as the firm's decision to invest its current funds most efficiently in the long-term assets in anticipation of an expected flow of benefits over a series of years.
- A cost centre refers to a section of the business to which costs can be charged. It may be a location (a department, a sales area), an item of equipment (a machine, a delivery van), a person (a salesman, a machine operator) or a group of these (two automatic machines operated by one workman). The main purpose of ascertaining the cost of a cost centre is control of cost.

- Cost object may be defined as ‘anything for which a separate measurement of cost may be desired.’

11.8 KEY WORDS

- **Cost Unit:** It is a form of measurement of volume of production or service. This unit is generally adopted on the basis of convenience and practice in the industry concerned.
- **Capital Budgeting:** It is the planning process used to determine whether an organization’s long term investments such as new machinery, replacement of machinery, new plants, new products, and research development projects are worth the funding of cash through the firm’s capitalization structure
- **Mortgage:** It is a legal agreement by which a bank, building society, etc. lends money at interest in exchange for taking title of the debtor’s property, with the condition that the conveyance of title becomes void upon the payment of the debt.
- **Hypothecation:** It is the practice where a debtor pledges collateral to secure a debt or as a condition precedent to the debt, or a third party pledges collateral for the debtor.

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11.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What is a banker’s lien?
2. What is capital budgeting?
3. What are the two types of cost centres?

Long-Answer Questions

1. Discuss the principles for forecasting cash flow.
2. Describe the various types of cash flow.
3. Examine how a banker secures his advances.

11.10 FURTHER READINGS

Ram Jitendra. 2015. *Regional Rural Banks of India: Evolution, Performance and Management*. Gurgaon: Partridge Publishing.

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Acharya S.C. and A. K. Mohanty. *Operational Analysis of Regional Rural Banks*. New Delhi: Gyan Publishing House

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UNIT 12 LIQUIDITY MANAGEMENT

Structure

- 12.0 Introduction
- 12.1 Objectives
- 12.2 Objectives and Sources
 - 12.2.1 Projected Cash and Core Sources
 - 12.2.2 Maturity Ladder
- 12.3 Contingency Plans
- 12.4 Answers to Check Your Progress Questions
- 12.5 Summary
- 12.6 Key Words
- 12.7 Self Assessment Questions and Exercises
- 12.8 Further Readings

NOTES

12.0 INTRODUCTION

In the previous unit, you learnt about cash flow budgeting, forecasting, capital budgeting and cash management.

Liquidity means the capacity to meet one's financial commitments. Banks are often evaluated on their liquidity, or their ability to meet cash and collateral obligations without incurring substantial losses. Liquidity management then describes the effort of bank managers to decrease liquidity risk exposure. This unit will discuss the objectives and sources of liquidity management. It will also discuss contingency plans, maturity ladder, information and internal control.

12.1 OBJECTIVES

After going through this unit, you will be able to:

- Describe the objectives and sources of liquidity management
- Discuss contingency plans and maturity ladder

12.2 OBJECTIVES AND SOURCES

Liquidity refers to a company's cash position and its ability to meet obligations when due. A key role of all cash managers in ensuring liquidity is the daily monitoring of working capital and to optimally manage the company's resources by accelerating inflows and controlling outflows. If there is an excess of cash in the daily position, the cash manager has to determine the best use for that surplus. If there is a deficit, the cash manager must find a source of funds.

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There are three major sources and uses of liquidity. The sources are:

1. Business flows: Cash generated by the business
2. Internal sources: Cash on deposit or invested in liquid instruments
3. External sources: Cash raised from sources such as the Commercial Paper market or from banks

The uses are:

1. Business flows: Outflows generated by the business
2. Internal uses: Investments or purchase of assets
3. External uses: Repayment of debt

Maturity Concerns

Liquidity problems arise on account of the mismatches in the timing of inflows and outflows. Per se, the liabilities being the sources of funds are inflows while the assets being application of funds are outflows. However, in the context of liquidity risk management, we need to look at this issue from the point of maturing liabilities and maturing assets; a maturing liability is an outflow while a maturing asset is an inflow. The need for liquidity risk management arises on account of the mismatches in maturing assets and maturing liabilities.

12.2.1 Projected Cash and Core Sources

Cash forecasting is used to estimate the liquidity position of the company for periods ranging from the current day up to one year. Short-term forecasts (0 - 3 months) are used primarily for managing liquidity. Operational forecasts (1 – 12 months) are used for medium term working capital and financing requirements. The long-term forecasts (1 – 5 years) are used for planning strategic financial goals. Some of the forecasting methods used by cash managers are:

- Cash Budgeting
- The Distribution Method
- Cash Modelling

12.2.2 Maturity Ladder

A maturity ladder refers to a strategy of purchasing equal amounts of bonds maturing at equal intervals, for example every six months or every year. This is also called laddering maturities.

Strategy

When interest rates are low, it pays to keep maturities short in order to take advantage of future rate increases. When interest rates are high, it pays to go with the longest maturities to lock in the high rates before they drop. An investor with a

ladder can apply this strategy as his bonds mature one by one. If no changes in interest rates have occurred, he can reinvest the maturing bond into a new one that matures after the last bond in the ladder.

12.3 CONTINGENCY PLANS

A contingency funding plan (CFP) is, at its core, a liquidity crisis management instrument. The document is prepared as a directive for a future emergency and stands ready to be referenced, someday, as a response plan and potential forecast of how a distant liquidity event may unfold. But then, the scenarios presented in the CFP may not occur. The next liquidity crisis may be an event that not a single bank management team could have ever imagined. After all, clairvoyance is not typically listed as a required banking skill.

Luckily, the objective of the contingency planning process is not to predict the future. Rather, the CFP's great value lies in its utility both as a crisis management document and a regular deep dive into the bank's liquidity profile. As an assessment tool, the contingency planning process provides additional insight into the community bank's liquidity strengths and weaknesses beyond the bank's normal reporting activities. In this role, the CFP serves as a comprehensive evaluation, similar to a person's annual health examination, which complements ongoing asset/liability monitoring. This endeavour can provide new risk mitigation knowledge that management can use to protect the bank both in an emergency and in the day-to-day competitive arena.

Netting

Netting entails offsetting the value of multiple positions or payments due to be exchanged between two or more parties. It can be used to determine which party is owed remuneration in a multiparty agreement. Netting is a general concept that has a number of more specific uses, specifically in financial markets.

Netting is used in trading, where an investor can offset a position in one security or currency with another position either in the same security or another one. The goal in netting is to offset losses in one position with gains in another. For example, if an investor is short 40 shares of a security and long 100 shares of the same security, he is net long 60 shares.

Also, when a company files for bankruptcy, parties tend to net the balances owed to each other. This is also called a set-off clause or set-off law. That is, a company doing business with a defaulting company will offset any money they owe the defaulting company with money that's owed them. The remainder represents the total amount owed by them or to them, which can be used in bankruptcy proceedings.

NOTES

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Companies can also use netting to simplify third-party invoices, ultimately reducing multiple invoices into a single one. For example, several divisions in a large transport corporation purchase paper supplies from a single supplier, but the paper supplier also uses the same transport company to ship its products to others. By netting how much each party owes the other, a single invoice can be created for the company that has the outstanding bill. This technique can also be used when transferring funds between subsidiaries.

Information and Internal Control

A system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations. A system of strong internal controls can help to ensure that the goals and objectives of a banking organisation will be met, that the bank will achieve long-term profitability targets, and maintain reliable financial and managerial reporting. Such a system can also help to ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures, and decrease the risk of unexpected losses or damage to the bank's reputation.

Check Your Progress

1. What is liquidity?
2. Why does the need for liquidity risk management arise?
3. What does netting entail?

12.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Liquidity refers to a company's cash position and its ability to meet obligations when due.
2. The need for liquidity risk management arises on account of the mismatches in maturing assets and maturing liabilities.
3. Netting entails offsetting the value of multiple positions or payments due to be exchanged between two or more parties.

12.5 SUMMARY

- A key role of all cash managers in ensuring liquidity is the daily monitoring of working capital and to optimally manage the organization's resources by accelerating inflows and controlling outflows.
- Liquidity problems arise on account of the mismatches in the timing of inflows and outflows.

- Cash forecasting is used to estimate the liquidity position of the company for periods ranging from the current day up to one year.
- Short-term forecasts (0 - 3 months) are used primarily for managing liquidity. Operational forecasts (1 – 12 months) are used for medium term working capital and financing requirements. The long-term forecasts (1 – 5 years) are used for planning strategic financial goals.
- A contingency funding plan (CFP) is, at its core, a liquidity crisis management instrument. The document is prepared as a directive for a future emergency and stands ready to be referenced, someday, as a response plan and potential forecast of how a distant liquidity event may unfold.
- Netting is used in trading, where an investor can offset a position in one security or currency with another position either in the same security or another one. The goal in netting is to offset losses in one position with gains in another.
- A system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations.
- A system of strong internal controls can help to ensure that the goals and objectives of a banking organisation will be met, that the bank will achieve long-term profitability targets, and maintain reliable financial and managerial reporting.

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12.6 KEY WORDS

- **Maturity Ladder:** It refers to a strategy of purchasing equal amounts of bonds maturing at equal intervals, for example every six months or every year.
- **Cash Budgeting:** It is an estimation of the cash inflows and outflows for a business over a specific period of time.

12.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. What are the sources of liquidity?
2. State the uses of liquidity.

Long-Answer Questions

1. Discuss cash forecasting.
2. Describe the role of contingency plans in liquidity management.

12.8 FURTHER READINGS

NOTES

Ram Jitendra. 2015. *Regional Rural Banks of India: Evolution, Performance and Management*. Gurgaon: Partridge Publishing.

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UNIT 13 REGULATION, SUPERVISION AND COMPLIANCE

NOTES

Structure

- 13.0 Introduction
- 13.1 Objectives
- 13.2 Need and Significance of Internal and External Audit
 - 13.2.1 Objectives and Scope of an Audit
 - 13.2.2 Advantages of an Audit
 - 13.2.3 Classification of Audit: External and Internal Audit
- 13.3 Answers to Check Your Progress Questions
- 13.4 Summary
- 13.5 Key Words
- 13.6 Self Assessment Questions and Exercises
- 13.7 Further Readings

13.0 INTRODUCTION

The purpose of the work of the auditors is to enable them to express an opinion as to whether the accounts presented show a true and fair view. It is the sacred duty of an auditor to extend his procedures even at the slightest indication of the existence of fraud or error which may result in material misstatement so that he can confirm or dispel his suspicions. According to the observations made by the International Auditing Practices Committee: 'The responsibility for the prevention and detection of fraud and errors rests with management through the implementation and continued operation of an adequate system of internal control. Such a system reduces but does not eliminate the possibility of fraud or error.' It continues to state that the object of an audit is to enable the auditor to express an opinion on the financial statements subjected to his audit. In this unit, we will learn about the meaning of audit, with especial focus on internal and external audit.

13.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the need of internal and external auditing
- Describe the significance of internal and external auditing

13.2 NEED AND SIGNIFICANCE OF INTERNAL AND EXTERNAL AUDIT

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According to Montgomery, a prominent American accountant

“Auditing is a systematic examination of the books and records of a business or other organisation, in order to ascertain or verify, and to report upon the facts regarding its financial operations and the results thereof.”

According to Spicer and Pegler

“An audit may be said to be such an examination of the books, accounts and vouchers of a business, as will enable the auditor to report whether he is satisfied that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business, and that the profit and loss account gives a true and fair view of the profit or loss for the financial period, according to the best of the information and explanations given to him, and as shown by the books; and if not, to report in what respects he is not satisfied.”

Ronald Irish states

“Auditing in its modern concept, is a scientific and systematic examination of books, vouchers and other financial and legal records in order to verify and report upon the facts regarding the financial condition disclosed by the balance sheet and the net income revealed by the profit and loss account.”

An Introduction to Indian Government Accounts and Audit considers audit as an instrument of financial control. It continues to state that

“It (audit) acts as a safeguard on behalf of the proprietor (whether an individual or a group of persons) against extravagance, carelessness or fraud on the part of the proprietor’s agents or servants in the realisation and utilisation of his money or other assets, and it ensures on the proprietor’s behalf that the accounts maintained truly represent facts and that expenditure has been incurred with due regularity and propriety.”

According to L.R.Dicksee

“An audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate. In some instances it may be necessary to ascertain whether the transactions themselves are supported by proper authority.”

L.R.Howard describes an audit as

“An examination by an auditor of the evidence from which the final revenue accounts and balance sheet of an organisation have been prepared, in order to ascertain that they present a true and fair view of the summarised transactions for the period under review and of the financial state of the organisation at the end date, thus enabling the auditor to report thereon.”

Preface to International Auditing Guidelines of the International Federation of Accountants describes an audit as

“the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.”

The Institute of Chartered Accountants in England and Wales in its ‘statement on Auditing’ has stated that the essential features of an audit are

- (a) to make a critical review of the system of book keeping, accounting and internal control;
- (b) to make such tests and enquiries as the auditors consider necessary to form an opinion as to the reliability of the records as a basis for the preparation of accounts;
- (c) to compare the profit and loss account and the balance sheet with the underlying records in order to see whether they are in accordance therewith;
- (d) to make a critical review of the profit and loss account and the balance sheet in order that a report may be made to the members stating whether, in the opinion of the auditors, the accounts are presented and the items are described in such a way that they show not only a true but also a fair view and give in the prescribed manner the information required by the Act.

The features covered by (d) above are subsequently explained in more clear terms as follows:

...In addition, the auditors will make a critical review of the profit and loss account and the balance sheet in relation to the following matters:

- (a) whether the accounts have been prepared on sound accounting principles consistent with those applied in the previous period; the distinction between capital and revenue is particularly important to prevent the overstatement of profits by charging revenue expenditure to capital or their understatement by charging capital expenditure to revenue;

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NOTES

- (b) the items in the balance sheet with particular reference to the basis on which they are stated and:
 - (i) the existence, ownership and proper custody of assets,
 - (ii) the existence of liabilities,
 - (iii) their relation to the corresponding items at the end of the previous year, and where necessary, earlier years,
 - (iv) the suitability of the descriptions used,
 - (v) an adequate disclosure of information;
- (c) the items in the profit and loss account with particular reference to adequate description, disclosure of information and the significance of variations as compared with previous periods;
- (d) compliance with the requirements of the Act.

The purpose of the work of the auditors is to enable them to express an opinion as to whether the accounts presented show a true and fair view. The purpose should govern their whole approach and if with respect to any material they are unable to satisfy themselves, it will be their duty to include appropriate reservations in their report, to the extent, if necessary, of stating that they are not able to express the opinion that the accounts show a true and fair view.

13.2.1 Objectives and Scope of an Audit

The above definitions and observations throw light on the objectives and scope of an audit. The primary objectives of an audit is to enable the auditor to express an opinion on the financial statements which have been subject to such audit. This opinion is then embodied in what is known as “audit report”, addressed to those interested parties who commissioned the audit, or to whom the auditor is responsible under the relevant statute. It may be noted here that the terminology used in different countries by the auditor in expressing his opinion varies. The actual wording used reflects concepts determined by local legislation, by rules issued by professional bodies, or by the development of general practice within the country. Phrases often used to reflect these concepts are: “present fairly in accordance with generally accepted accounting principles”, “give a true and fair view”, and “in conformity with the law”. In expressing the opinion, the auditor has to carry out such procedures and take such steps as designed to obtain reasonable assurance that the financial statements are properly stated in all material respects. It is true that there are certain inherent limitations present in any kind of examination where the person carrying out his examination will have to use his judgment. Also, much of the evidence available to auditors is persuasive rather than conclusive in nature. Hence there is an unavoidable risk that even some material misstatements may remain undiscovered, and absolute certainty in auditing is rarely attainable. However, it is the sacred duty of an auditor to extend his procedures even at the slightest indication of the existence of fraud or error which may result in material

misstatement so that he can confirm or dispel his suspicions. And wherever it is not possible to give an affirmative opinion whether or not the financial statements give a true and fair view, the auditor has to express a qualified opinion or disclaimer of opinion, as appropriate. Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such statements should also be set out in the audit report, making it clear in what respect and to what extent the financial statements are considered to be misstated.

Thus the opinion expressed by the auditor helps to establish the extent of credibility of the financial statements. Of course, such an opinion should not be construed as an assurance as to the future viability of the organisation or as to the efficiency or effectiveness with which the management has conducted the affairs of that unit.

Scope of an Audit

The scope of an audit is dependent on the terms of agreement between the auditor and the client and on statutory requirements and the requirements of the relevant professional bodies. A properly conducted audit is organised to cover adequately all aspects of the organisation as far as they are relevant to the financial statements subject to examination. The auditor has to ensure that information contained in the underlying accounting data and other source data is reliable and sufficient as the basis for the preparation of the financial statements. To achieve this the auditor makes a study and evaluation of accounting system and the related internal controls on which he intends to rely, and tests these internal controls to decide on the nature, extent and timing of other audit procedures. This is reinforced by carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as are considered appropriate in the circumstances of each case.

As to the point whether the relevant information is properly communicated, the auditor bases his opinion by:

- (i) comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarise the transactions and events recorded therein; and
- (ii) considering the judgments that management has made in preparing the financial statements; accordingly he assesses the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

It may be noted in this connection that the auditor is not responsible for the preparation of the financial statements on which he has to form and express an opinion. This is the responsibility of the management of the particular organisation concerned which, inter alia, also covers the maintenance of adequate accounting records and internal controls, the selection and application of appropriate accounting

NOTES

NOTES

policies and the safeguarding of the assets of the organisation. As observed by the Council of Chartered Accountants in England and Wales, the directors are responsible for the accounts and financial control of a company. Their statutory duties include responsibility for ensuring the maintenance of adequate records and the preparation of annual accounts showing a true and fair view required by the Act. They are responsible for safeguarding the assets of the company and are not entitled to rely upon the auditor to protect them from any shortcomings in carrying out their responsibilities. The Research Committee of the Institute of Chartered Accountants of India has specifically stated that the duty of safeguarding the assets of a company is primarily that of the management, and the auditor is entitled to rely upon the safeguards and internal controls instituted by the management. Of course, in forming and expressing professional opinion on the financial statements the auditor has his own independent responsibility. This responsibility is heavy and cannot be discharged without a full realisation of the professional skill and judgment which need to be exercised in carrying out his duties. If the directors have not carried out their duty properly this will have a material bearing on the terms of the audit report and may well involve the auditor in extensive checking; but it is not his function to act as a substitute for proper management control.

13.2.2 Advantages of an Audit

The advantages of an audit are as follows:

1. Detection and prevention of errors and frauds

It has already been mentioned that incidental to the primary objective, an audit facilitates the detection and prevention of fraud and errors.

In this connection a brief mention of the various types of errors and frauds would be enlightening. Errors may be classified into:

- (a) An **ERROR OF OMISSION** arises from omitting to record a transaction fully or partially in the book of accounts. The omission to record a sales invoice while writing up the sales book is an example. Partial omission by recording only one aspect of the transaction will affect the balancing of the trial balance and hence can easily be detected. On the other hand, complete omission will not affect the arithmetical accuracy of the trial balance.
- (b) An **ERROR OF COMMISSION** arises as a result of recording a transaction incorrectly, either partially or wholly. For instance, posting an incorrect amount to the ledger. Where the transaction is wholly incorrectly recorded, the trial balance may not be affected. Where the recording is only partially incorrect, it will affect the arithmetical accuracy of the trial balance.
- (c) An **ERROR OF PRINCIPLE** arises from the failure to observe fundamental principles of accounting in recording the transactions. Incorrect allocation of expenditure between capital and revenue,

incorrect bases of valuation of current assets and fixed assets, incorrect adjustment of prepaid expenses and accrued income, incorrect provision for depreciation, etc. are some of the examples of errors of principle. Such errors will not affect the arithmetical accuracy of the trial balance. They are, however, often serious in the sense that they may affect the true and fair view of the financial statements.

- (d) An ERROR OF DUPLICATION arises from recording a transaction twice and posting the same twice to the ledger. Such errors do not affect the arithmetical accuracy of the trial balance.
- (e) A COMPENSATING ERROR arises from an error being offset by another error or errors. Such errors also do not affect the arithmetical accuracy of the trial balance.

Fraud may involve either misappropriation of money, goods or any property; or falsification of accounts not involving any misappropriation as such. Examples of the former include:

- (i) entering fictitious credit notes;
- (ii) writing off good debts as bad;
- (iii) failure to record all cash received;
- (iv) entering higher discounts than was actually allowed;
- (v) inclusion of fictitious payments;
- (vi) wages defalcation;
- (vii) under invoicing; etc.

Examples of the latter include:

- (i) overvaluation or undervaluation of stock in trade and work in progress;
- (ii) over provision or under provision for depreciation and bad debts;
- (iii) treating revenue items as capital and vice versa;
- (iv) ante dating or post dating of purchase invoices and sales invoices, etc.

The object of the latter type of fraud is not immediate misappropriation of money as such. The object is usually to show a different picture of the earning capacity and the state of affairs of the business than what actually is the case. For instance, a higher profit may be shown through the falsification of accounts with the following objectives:

- (i) increasing the remuneration payable to the people at the top where such remuneration is expressed as a percentage of net profits;
- (ii) obtaining credit facilities by showing a rosy picture of the business;
- (iii) maintaining the confidence of the shareholders in the management;
- (iv) declaring higher dividends in order to facilitate the sale of securities of the company at higher prices; etc.

NOTES

NOTES

On the other hand a lower profit may be shown through falsification of accounts with the following objectives:

- (i) misleading trade competitors about the state of the business;
- (ii) facilitating tax evasion;
- (iii) declaring lower dividends in order to facilitate the purchase of the securities of the company at low prices; etc.

Besides facilitating the detection and prevention of fraud and errors, the following advantages also arise from subjecting financial statements to an independent audit:

2. In the case of large organisations, the interests of many parties are protected. For example, in the case of limited companies the interests of shareholders, who do not take part in the day to day management of the companies and who thereby are divorced from management, are protected. In addition, as mentioned earlier, audited accounts helps to establish the credibility of annual accounts. As a result even in cases where accounts have not been specifically prepared for use by third parties, it would be possible for them to make use of such accounts in order to take decisions based on them. It is with these objectives that statutory provisions are in force for the compulsory audit of accounts by suitably qualified auditors in many cases.
3. Audited accounts will be more acceptable to banks and other financial institutions in extending financial accommodation.
4. Audited accounts will carry greater authority for tax assessment by tax authorities.
5. In the case of partnership organisations audited accounts will help in avoiding disputes between the partners especially where profit sharing arrangements are complex. So also, the admission of a new partner or the death, retirement, etc. of an existing partner or the sale of the business as a going concern may require revaluation of assets and liabilities and the computation of goodwill. In such cases, audited accounts will be a more suitable basis.

13.2.3 Classification of Audit: External and Internal Audit

On the basis of nature of work undertaken, audit may be classified into following sections:

Private audit

Although there is no statutory provision for the audit of the accounts of individuals and partnership firms, the advantages arising from subjecting the accounts to an independent examination of properly qualified persons have already been pointed out. A point of importance to be noted in this connection is that the duties, rights and responsibilities of an auditor undertaking such a work are not defined statutorily.

As indicated earlier, the accountant, in many cases, may be required to write up the accounts besides being required to carry out an audit. The client may not be fully aware of the distinction between the work of an accountant in doing the accounting work and in carrying out the work of audit and the full implications of each. Consequently it is quite possible that the client and the accountant might have quite different ideas in mind as to the nature and purpose of the appointment of the accountant. Besides, the client might have, on the grounds of expenses or otherwise, limited the scope of work to be done; it is also dependent on the records maintained by the client. These could have far reaching consequences which may involve issues of negligence and breach of trust on the part of the auditor.

This indicates the necessity of getting the terms of appointment defined in writing whenever an auditor is taking up an appointment in respect of a private audit. The rights, duties and responsibilities of the auditor together with the nature and scope of work should be clearly specified. Even where the auditor is appointed to carry out work in accordance with the rules and regulations of an entity, as in the case of clubs, charitable organisations, etc., it would be advisable to obtain a letter of engagement, the details of which are discussed in detail elsewhere.

In those cases where a practising accountant is appointed only to prepare the accounts and not in the capacity of an auditor, the position should be made clear either by means of a note placed at the foot of the accounts or by means of a separate covering letter accompanying the accounts in which it should be stated:

- (i) the source or sources of information from which the accounts have been prepared; and
- (ii) that an audit or verification of assets and liabilities has not been carried out.

When the information is given in a covering letter accompanying the accounts, the accounts should include a specific statement referring to the covering letter.

Audit under statute

In many cases the relevant statutes will specify detailed provisions relating to the appointment, remuneration, removal, rights, duties, responsibilities, etc. of auditors for the independent audit of the financial statements of the undertakings covered by the respective statutes. For instance, the Companies Act contains such provisions relating to company audit. In such cases the position of the auditor is clear and any restrictions on his work specified in the statutes concerned will be ultra vires. Thus the main difference between private audits and statutory audits arises from the fact that while in the former case the scope of the audit may be determined as narrowly or as broadly as the client wishes, according to his requirements, in the case of statutory audits their scope and depth are largely determined by the governing legislation, which neither the directors nor the members of the client organisation or other persons have authority to restrict.

NOTES

NOTES

Internal audit

As the every name implies, this is an examination carried out by the employees specially appointed for the purpose by an organisation. It is defined as an appraisal activity, independent of other activities, within an organisation, for the review of operations, as a service to all levels of management. It differs from an independent audit, otherwise known as external audit, in scope, approach, responsibility and independence.

On the basis of the methods of approach to work, audit may be classified into:

I. Final audit or completed audit: A final audit, otherwise known as completed audit, is one that is carried through to completion in one continuous session. Normally it is commenced immediately after the end of the accounting period. In certain cases it is commenced towards the end of the accounting period but completed after the end of such period.

Advantages

1. The expenses involved is considerably less and hence this type of audit is suitable for small organisations.
2. Since work is carried through completion in one session, possibilities of alteration of figures after the completion of work up to a certain stage can be eliminated.
3. As an extension to the above, it obviates the necessity of taking down notes and balances on the completion of work at each stage for subsequent comparison.
4. It facilitates the drawing up of a more simplified time table for audit assistants.

Disadvantages

1. In the case of large organisations it would not be practicable to have a completed audit because of the large volume of work to be done. This would mean undue delay in the presentation of final accounts.
2. Where there are a number of clients whose accounting dates are the same, the pressure of work will be heavy. This may cause delay in the completion of work.
3. Limitation in time for the completion of work may lead the audit staff overlooking some of the detailed aspects.

II. Continuous Audit: In the case of a continuous audit, work of audit is carried out throughout the accounting period by the audit staff engaged continuously on the audit.

Advantages

1. Since the audit staff are engaged in the work continuously, fraud and errors are detected sufficiently early with the result that the amount of defalcations, irregularities and errors will be less than would be the case otherwise.
2. It is possible to carry out a more detailed checking. Such detailed checking reveals more about the functioning or malfunctioning of the client's system of accounting and related internal controls.
3. The work of audit assistants can be arranged more effectively, giving due consideration to the pressure of work in different client organisations.
4. It acts as a moral check on client staff in that they will give particular importance to keep the work up to date because of the frequent visits by the auditor.
5. Continuous engagement on the work enables the auditor to understand better the technical details of the client organisation.
6. Since most of the detailed checking will be over by the end of the accounting period, it facilitates the completion of final work more quickly with the result that the final accounts can be presented without much delay after the end of the financial year.
7. Because of the constant contact which the audit staff have with the work, audit programmes can be reviewed according to the developing circumstances.
8. Wherever possible and feasible, closer cooperation and coordination of work between the external auditor and internal auditor can be achieved.

Disadvantages

1. There are possibilities of the client staff altering the figures either innocently or fraudulently once the auditor has completed checking a part of the work.
2. Periodical checking of the books and records may cause inconvenience to the client staff through interruption of their work.
3. Similarly, attendance by audit staff at intervals may lead to their failure to follow up unfinished work during the previous visit.
4. Audit staff will find it necessary to maintain detailed notes on accounts and balances, especially in respect of unfinished work during any visit.
5. There is the danger that the audit staff might lose the impartiality of outlook when they are allowed to remain on a continuous audit over a long period of time because of the possibility that they tend to regard themselves as a part of client staff.
6. It is an expensive system of audit.

NOTES

NOTES

In spite of the above disadvantages, big business organisations generally prefer continuous audit. This is all the more so in the case of organisations which require their final accounts to be presented immediately after the end of the accounting period.

Certain precautions may be taken to overcome most of the disadvantages mentioned above. The client staff should be given strict instructions that no alteration, however, genuine it may be, should be made once the auditor has examined the books and records and that, if necessary, rectification of an error should be made only through an adjusting entry. The auditor should use special ticks while passing altered figures. When ticking an altered figure, the amount should be inserted in ink in small figures to prevent any misunderstanding as to the figure which has been accepted. Similarly, client staff should be instructed to enter periodical totals in ink or in any other permanent form to guard against alteration.

Inconvenience to the client staff can be avoided to a great extent through a judicious selection of work completed up to a particular date.

Proper follow up by the audit staff can be ensured through extensive note taking, properly planned audit programmes and proper supervision. The audit working papers should include:

- (a) notes of important totals taken from the books of account up to the stage to which they have been checked;
- (b) details of any alterations that have been made in figures checked earlier;
- (c) details of transactions which appear to be unusual or exceptional and which therefore call for special treatment;
- (d) notes of any verification tests carried out; and
- (e) particulars of errors discovered.

The audit programme should be so drafted as to show clearly:

- (a) the work to be done during the course of each quarter or month; and
- (b) the work to be performed at the final stages.

III. Interim audit: This is an audit conducted in between two final audits. The object may be to complete detailed procedural or vouching tests with a view to assisting the speeding up of the final audit, or to make available interim results to the management to declare an interim dividend through the preparation of interim accounts. It is important to note in this connection that an interim audit does not take into account such matters as verification of assets and liabilities, provision for depreciation, bad debts, etc.

Advantages

1. It enables the management to get an idea about the overall performance of the organisation periodically.
2. It facilitates the discovery of errors and frauds sooner.

3. It aids the completion of the final audit without much delay.
4. It facilitates the declaration of interim dividends.
5. It acts as a moral check on the client staff in keeping the work upto date.

Disadvantages

The main disadvantage is, as in the case of a continuous audit, the possibility of alteration of figures after the same have been passed by the auditor. The precautions enumerated in connection with a continuous audit are applicable in this case also.

IV. Partial audit: Partial audit is one which covers only a part of the accounts. For instance, a sole trader may require his cash book to be audited without involving any verification or valuation of assets or liabilities. As already indicated, partial audits should be undertaken only after getting the terms of such assignments clearly in writing as otherwise the auditor may be held liable for work which he was not supposed to do.

V. Procedural audit or systems audit: This is in fact a part of the audit work as a whole. It is an examination, assessment and review of the internal control procedures and records of an entity with a view to ensuring their reliability as a basis for the preparation of its final accounts. In other words, it consists of those audit steps which are designed to test whether the procedures laid down are in fact being followed, thus establishing independently the accuracy of the information supplied by the client staff. As observed by Skinner and Anderson, the system audit approach attempts to 'explore inside the system and discover exactly how it produces results. If the mechanics of the system were analysed intensively and detailed survey showed it to be designed with appropriate control, checks and balances to forestall errors, then this too would be a good indication that the results produced by the system were accurate.' The increased attention given by auditors to the internal control procedures existing in the client organisation has naturally resulted in the increased importance of procedural audit. More about this is dealt in the chapter "Internal Control".

VI. Balance sheet audit: Balance sheet audit operates in the opposite direction to audit procedures normally carried out. It commences with a detailed examination of the draft balance sheet and works back to the books of original entry and their documentary evidence. This type of audit need not necessarily be considered as strange in view of the fact that every single transaction has a direct effect on the balance sheet.

Balance sheet audit is of more recent origin and is popular in the United States of America. It is appropriate under the following circumstances:

- Where the client organisation is very large with a complex economic unit employing qualified accounting staff and having an internal audit department.

NOTES

NOTES

- Where the auditor has acted in that capacity for the client organisation during the last few years.
- Where the internal control system in operation is efficient and effective in every material aspects, this having been proved to the entire satisfaction of the auditor.
- Where an interim audit has already covered basic tests of routine procedures in each department of the client organisation.

Following is given a broad outline of the procedures to be followed in the case of a balance sheet audit.

- Verify all assets and liabilities, with special reference to documents of title, agreements, correspondence and valuation.
- Examine the minute books, noting carefully any matters of importance relating to the accounts and the balance sheet items, e.g., capital commitments, pending law suits, capital and loan issues, etc.
- Compare each item in the balance sheet with the corresponding item for the previous year and ascertain the reason for any material variations and their effect on the profits for the year.
- Compare the profit and loss account with that for the previous year and ascertain the reasons for any material variations.
- Examine whether variations for wages, materials consumed and other variable expenses are fairly consistent with the variation in turnover. Ascertain the quantities of turnover where the monetary value thereof has been affected by price or other variations.
- Verify the quantitative details of purchases, production, turnover, and opening and closing stock.
- Ascertain the reasons for any material variations in the rate of gross profits.
- Compare the values of stock on hand with those adopted for insurance purpose.
- Examine transactions of an exceptional nature and items of non recurring nature such as exceptional profits, capital profits, etc. These may have resulted in charges or credits of a material amount to the profit of the period under review.
- Compare the values of stock on hand with the cost of turnover, ascertaining the reason for any material variations in this ratio, which indicates the average rate of stockturn during the period.

- Consider the changes in the position disclosed by the balance sheet. For instance, does this reveal increased liquidity, a proportionate reduction in capital or long term liabilities, or increase in fixed assets?
- Examine the schedules showing the composition of each item in the balance sheet. Study the changes comparing them with the schedules relating to the previous year.
- Examine the values placed on the current assets, with particular reference to the basis of valuation of stock and work in progress.
- Ascertain any material variation in current assets as compared with the previous year. Accounting ratios may be usefully applied in this regard. For example, if the debtors-turnover ratio indicates that the customers are taking longer period to settle their accounts, particular attention should be paid to the provision for bad and doubtful debts. Similarly possibility that remittances have not been accounted for should be considered.
- Scrutinise the schedules for provisions, accruals and prepayments, comparing them with those for the previous period and enquiring into any material variations.
- Ascertain whether the provisions made for depreciation are reasonable and the amounts set aside for the increased cost of replacement are reasonable.
- Consider the effect of any changes in the basis of accounting on material variation in profits.
- Examine the nature and amount of contingent liabilities and commitments for capital expenditure not provided for in the accounts.
- Consider any forward contracts for forward purchases or sales, ascertaining whether any provision for losses is required at the balance sheet date.
- Examine the statement of sources and application of funds, comparing it with that of the previous year.
- Where appropriate, compare the accounts concerned with the figures shown by certificates and returns made to trade associations, insurance companies and Government departments in respect of wages and salaries paid, declarations for insurance purposes, returns to the customs and excise authorities and similar documents.
- Examine all remaining balance sheet items ascertaining that these are in order in the light of the prevailing audit requirements.
- Ascertain that all statutory requirements have been complied with in every detail.

NOTES

NOTES

VII. Social audit or social responsibility audit: Social audit takes into consideration the relationship of an entity's activities in relation to its employees, the community in general, and the customers in the context of social considerations. The concept of social audit arises from the modern conception that an entity owes certain duties, besides its duties to the shareholders who have put their capital in the entity, towards the employees who are putting their labour and their lives into the business, and towards its customers and the general public. As Lord Denning has observed:

“.....the directors of a great company should owe a duty to those who are employed by the company to see that their conditions of service are proper. They should owe a duty to the consumers, to the people to whom the goods are supplied, a public duty perhaps, not to expect excessive prices. They should owe a duty also to the community in which they live, not to make the place of production hideous or a nuisance to those who live around.”

In relation to employees, social audit will ascertain, assess and review whether the people who put their labour and lives into the company get fair wages, continuity of employment, and a recognition of their right to their jobs, as well as recreation and welfare facilities, retirement arrangements, etc.

In relation to the general public, social audit will take into consideration the question of environment, pollution, ecology, and other factors of the entity's activities in the light of their immediate and long term effects. Other considerations involving the welfare of the general public who are affected by the operations and actions of the entity will also be reviewed under social audit.

In relation to the customers, social audit will take into consideration such factors as the entity's pricing policy, maintenance of quality control, methods of redressing the grievances of the customers, honesty in advertising, etc.

VIII. Operational audit: Operational audit is concerned with the operating propriety and efficiency of the functional areas of an organisation. It takes into consideration (i) inefficient operations both from the time and cost angles; and (ii) wastage of resources through lack of propriety in expenses. It is aimed at improving the profitability of the organisation and simultaneously at achieving the other organisational objectives.

IX. Management audit: This is a total audit of every area of operation of an organisation with a view to identifying the inefficiencies and/or ineffectiveness of the management and setting up criteria for efficiency. According to the Association of Consulting Management Engineers Inc., U.S.A.:

“Just as the public accountant examines the books and records of a company, the management auditors study a business as a whole. They consider its policies, organisation, operating methods, financial

procedures and physical facilities and report on its overall position. Whereas the accounting audit is concerned with past transactions and (operational audit) with the present conditions, management audit studies the present and looks into the future.”

Again, William P. Leonard defines management audit as

“a comprehensive and constructive examination of an organisational structure of a company, institution or branch of a Government or any component thereof, such as a division or department, and its plans and objectives, its means of operation, and its use of human and physical facilities.”

In short, management audit is an investigation to ascertain whether every level of management and staff is functioning at its optimum, and a set of recommendations is issued to the management after the review, keeping it alert against internal and external changes which may have a bearing on the growth plans of the organisation.

X. Cost audit: Cost audit involves an examination of the cost records and cost performance of an organisation just as financial audit is concerned with the financial records and performance. The Institute of Cost and Management Accountants, U.K. defines it as the verification of cost accounts and a check on adherence to cost accounting plan. Thus cost audit is an examination of the cost accounting records to ensure that the cost statements are properly drawn up so as to show a true and fair view of the cost of production and marketing of various goods dealt with by the organisation.

XI. Special audit under the companies act: In terms of section 233A of the Indian Companies Act, the Central Government is empowered to order a special audit of the accounts of a company for a specified period where it is of the opinion that -

- (a) the affairs of the company are not being managed in accordance with sound business principles or prudent commercial principles; or
- (b) any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
- (c) that the financial position of any company is such as to endanger its solvency.

Special audit under the Act is conducted by professionally qualified accountants in the same manner as any company audit with the main difference that the special auditor submits his report to the Central Government instead of to the shareholders as in the case of a company auditor in the ordinary course. On receipt of the report, the Central Government shall take such action as is necessary. But if the Government does not take any action on the report within four months from the date of its receipt, it shall send a copy of the report with its comments to

NOTES

the company concerned for circulation among the members. The expense of this kind of audit including the remuneration to the special auditor, as determined by the Central Government, shall be paid by the company.

NOTES

Check Your Progress

1. What is the primary objective of an audit?
2. In which kind of audit, the terms of appointment of an auditor need to be defined in writing?
3. What is the main difference between private audits and statutory audits?
4. Define internal audit.

13.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The primary objective of an audit is to enable the auditor to express an opinion on the financial statements, which have been subject to such audit.
2. In private audit, the terms of appointment of an auditor need to be defined in writing.
3. The main difference between private audits and statutory audits arises from the fact that while in the former case the scope of the audit may be determined as narrowly or as broadly as the client wishes, according to his requirements, in the case of statutory audits their scope and depth are largely determined by the governing legislation, which neither the directors nor the members of the client organisation or other persons have authority to restrict.
4. An internal audit is defined as an appraisal activity, independent of other activities, within an organisation, for the review of operations, as a service to all levels of management.

13.4 SUMMARY

- The purpose of the work of the auditors is to enable them to express an opinion as to whether the accounts presented show a true and fair view.
- The primary objective of an audit is to enable the auditor to express an opinion on the financial statements, which have been subject to such audit.

This opinion is then embodied in what is known as ‘audit report’, addressed to those interested parties who commissioned the audit, or to whom the auditor is responsible under the relevant statute.

- The scope of an audit is dependent on the terms of agreement between the auditor and the client and on statutory requirements and the requirements of the relevant professional bodies.
- On the basis of nature of work undertaken, audit may be classified into private audit, internal audit, and audit under statute.
- On the basis of the methods of approach to work, audit may be classified into: final audit or completed audit; continuous audit; interim audit; partial audit; procedural audit or systems audit; balance sheet audit; social audit; operational audit; management audit; cost audit; and special audit under the Companies Act.

NOTES

13.5 KEY WORDS

- **Statute:** It is a written law passed by a legislative body.
- **Audit:** It is to conduct an official financial inspection of (a company or its accounts).

13.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the essential features of an audit according to the Institute of Chartered Accountants in England and Wales?
2. How would you describe the scope of an audit?
3. Why should an auditor’s role be defined in case of the private audit?

Long Answer Questions

1. Describe the various meanings of audit in detail.
2. Discuss the classification of an audit on the basis of methods of approach to work.
3. Explain the advantages of an audit.

13.7 FURTHER READINGS

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