FINANCIAL MARKETS AND SERVICES

UNIT - II

FINANCIAL SERVICES

Since 1990's there has been an upsurge in the financial services provided by various banks and financial institutions. Efficiency of financial system largely depends upon the quality and variety of financial services provided by the banking and non-banking financial companies.

Meaning :- All types of activities which are of a financial nature could be brought under the term 'financial services'. The term "financial services" in a broad sense means "mobilisation and allocating savings". Thus, it includes all activities involved in the transformation of savings into investment.

Definition :- The term 'Financial Services' can be defined as "activities, benefits and satisfactions, connected with the sale of money, that offer to users and customers, financial related value".

Features / Characteristics / Nature of Financial Services

i, Intangible :- FS cannot appeal to a buyer's sense of touch, taste, smell, sight or hear. So they cannot be standardised or reproduced in the same form. Hence, there is a need to have a track record of integrity, reputation & good image and timely delivery of services. Service organisations depend on feedback from public.

ii, Direct Sale :- It is the only possible channel of distribution. There are no middlemen. Simultaneous production and distribution of services is undertaken by service Orgs.

iii, Customer-Oriented :- Customer is the king and his requirements must be satisfied in full. It calls for designing innovative products suitable to varied risk-return requirements of customers. Timely delivery of services is important.

iv, Fluctuations in Demand :- The demand for certain services eg:- life insurance, fluctuate according to the level of general economic activity.

v, Information Based :- It involves creation, dissemination and use of information. Information is essential in production of fin. services.

vi, Geographical Dispersion :- Service providing Orgs. must have massive branch network so that benefits of convienience are enjoyed by international, national and local customers.

vii, Labour Intensive :- FS sector is highly labour intensive. It leads to increase in the costs of production & affects the price of fin. services.

viii, Require quality labour :- FS require huge amounts of high quality labour to deal with information and communication with the market. The role of human inputs in FS production can be realised from the salaries paid in the industry.

ix. Perishability :- FS are immediately consumed and so inventories cannot be created. There is a greater need for balancing demand and supply properly.

SCOPE OF FINANCIAL SERVICES

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

i, Traditional Activities & ii, Modern Activities.

I Traditional activities can be grouped under two heads, namely

a Fund based or Asset based services

i, Underwriting of or investment in shares, debentures, bonds etc.

ii, Participating in money market instruments like CPs, CDs, TBs etc.

iii. Involving in equipment leasing, hire purchase, venture capital, etc.

v, Dealing in foreign exchange market activities.

b, Non-Fund or Fee based Services

i, Managing the capital issues in accordance with SEBI guidelines

ii, Making arrangement for placement of various instruments with investment institutions

iii. Arrangement of funds from FIs.

iv. Assisting in the process of getting all Govt. clearances.

II Modern Activities :- Most of the modern services are in the nature of non-fund based or advisory services.

- Rendering project advisory services
- Planning for mergers & acquisitions
- Guiding corporate customers in capital restructuring
- Recommending changes in Mgt. structure & style
- Structuring financial collaboration / Joint ventures
- Hedging of risks
- Undertaking risk mgt services

Overall, Financial Services can be classified into two types.

1, Fund Based (Asset Baded)
2, Fee based (Advisory).

Fund Based Services

- Equipment leasing
- Hire purchase & Consumer Credit
- Bill Discounting
- Venture Capital
- Housing Finance
- Insurance Services
- Factoring etc.

Fee Based Services

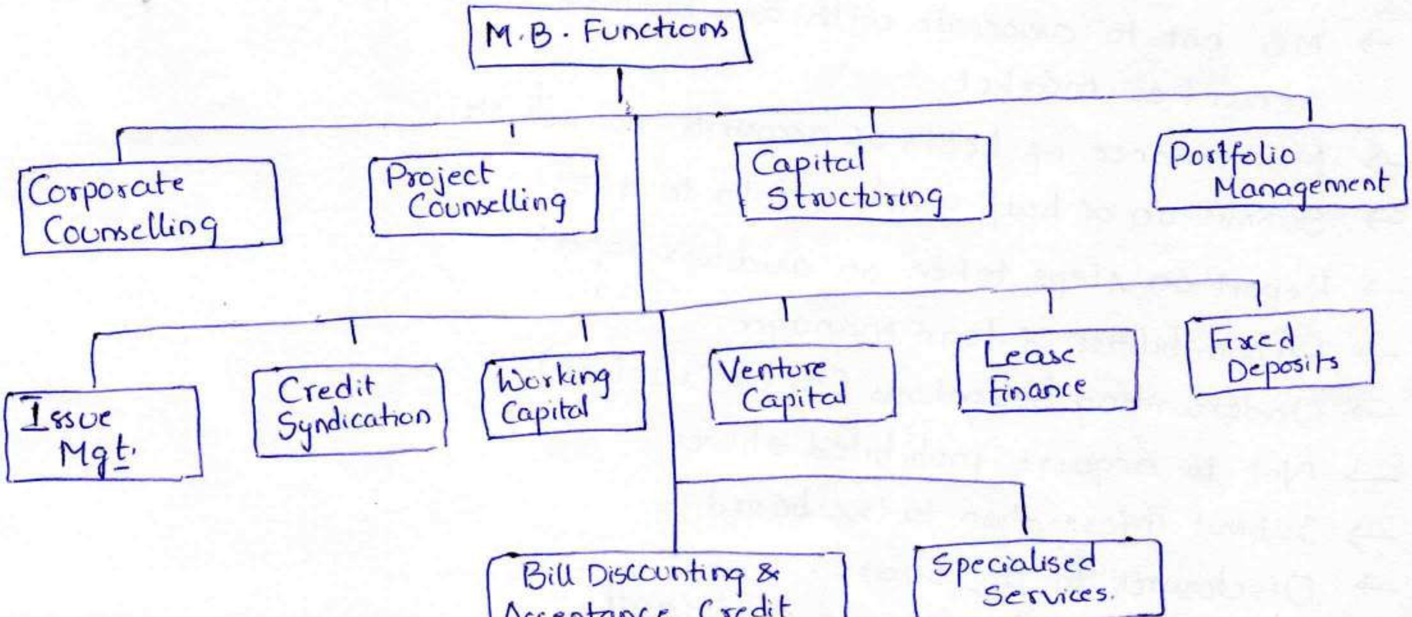
- Issue Management
- Portfolio Management
- Corporate Counselling
- Loan Syndication
- Mergers & Acquisitions
- Capital Restructuring
- Credit Rating
- Stock Broking etc.

MERCHANT BANKING

The need for specialised merchant banking service was felt in India with the rapid growth in the number and size of the issues made in the primary market. The M.B services were started by foreign banks namely, the National Grindleys Bank in 1967, the Citibank in 1970. The Banking Commission in its report in 1972 recommended the setting up of Merchant Banking institutions by commercial banks and financial institutions. This marked the beginning of MB in India.

Definitions:- "Merchant Banking may be defined as an institution which covers a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counselling etc.

The Notification of Ministry of Finance defines Merchant Banker as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, advisor, or rendering corporate advisory service in relation to such issue management."



TYPES (OR) CLASSIFICATION OF MERCHANT BANKERS

The SEBI has classified M.B under four categories for the purpose of registration.

1. Category I Merchant Bankers :- These M.B can i, Carry on any activity which consists of preparation of prospectus & other information relating to the issue, determining financial structure, final allotment and refund and ii, to act as advisor, consultant, underwriter and portfolio manager.

2. Category II Merchant Bankers :- Such M.B can act as advisor, consultant, co-manager, underwriter and portfolio manager. They can'tact (cannot) as issue manager of their own but can act as co-manager

3. Category III Merchant Bankers :- They are allowed to act as underwriter, advisor and consultant only. They can neither undertake issue mgt. of their own nor they can'act as co-manager. They cannot undertake the activities of portfolio mgt. also.

4. Category IV Merchant Bankers :- A category IV M.B can merely act as a consultant or advisor to an issue of capital.

RESPONSIBILITIES OF MERCHANT BANKERS

→ MB not to associate with any business other than that of the securities market
→ Maintenance of books of accounts, records etc.
→ Submission of half-yearly results to SEBI
→ Report on steps taken on auditor's report
→ Responsibilities of lead manager
→ Underwriting obligations (5% or Rs 25 lacs)
→ Not to acquire prohibited shares
→ Submit information to the board
→ Disclosures to the board.
→ Liability for action in case of default.

ROLE OF MERCHANT BANKER IN ISSUE MANAGEMENT

Management of public issue of shares/debentures has been the traditional service rendered by merchant bankers in India. The issue function may be broadly divided into pre-issue work and post-issue work.

Pre-Issue Work :-

i, Appointment of underwriters, brokers, bankers, registrars and advisors

ii, Preparation of draf prospectus and obtaining clearance from stock-exchange authorities.

iii, Getting the prospectus signed by the Board of Directors and filing it with stock exchanges.

iv, Printing and distributing the prospectus all over the country & abroad.

Work during the Issue :- This comprises launching advertising campaigns in print & electronic media, hoardings posters etc.

i, Organising investor conferences and broker conferences at leading centres

ii, Deciding on the opening and closing dates of the issue

iii, Obtaining collection reports

iv, Closing the issue

v, Organising necessary press releases

Post-Issue Work :-

i, If the issue is over-subscribed, the basis of allotment has to be finalised in consultation with the SE authorities

ii, If under subscribed, the underwriting liability has to be determined

iii, After allotment, shares to be credited to respective D-mat accounts

iv, The listing agreement should be concluded with the stock exchanges and the shares should get listed.

REGULATION OF MERCHANT BANKERS

M.B has be statutorily brought within the framework of SEBI under SEBI (Merchant Bankers) Regulation, 1992.

1, All MBs should have qualification in finance, law or business management.

2, They should have adequate office space, equipment and manpower

3, Two persons who have experience to conduct business of MB be appointed

4, A MB should be fair in all transactions.

MBs are classified into four categories. Minimum networth for I category is Rs 1 Crore, II category is Rs 50 lacks, III 20 lacs & IV nil.

5, An initial authorisation fee, an annual fee and renewal fee may be collected by SEBI

6, All issues must be managed atleast by one authorised MB as the lead manager. For issues over 100 crores, the number may go to 4 or 5.

7, SEBI will supervise the activities of MBs

8, SEBI has the power to suspend or cancel the authorisation of MBs in case of any violation of the guidelines.

9, The MB should abide by the code of conduct prescribed by SEBI

10, The MB should make an agreement with Corporate bodies about their mutual rights, liabilities and obligations etc.

LEASE FINANCING

Leasing is effectively a sourse of finance but it always relates to a specific asset. Under a lease contract, the ownership of the assets remains with the lessor whilst the use of the assets is available to the lessee in return for the payment of a fixed rental. Lease finance is very similar to debt in that the lease rent is a fixed contractual obligation. Leasing will therefore, increase the level of gearing and financial risk of the company.

A lease is a contractual arrangement whereby one party (i.e the owner of the asset) grants the other party the right to use the asset in return for a periodic payment. A lease is essentially the renting of an asset for some specified period. The owner of the asset is called the "lessor" while the other party that uses the assets is known as the "lessee". A lessee can be an individual, a firm or a company, interested in the use of the assets without owning it, while the lessor may be the sellor, supplier, a finance company or the manufacturer who can finance the purchase of the assets. Under the lease contract, the ownership of the asset remains with the lessor whereas the use of the asset is available to the lessee. In return, the lessee has to pay a fixed pericdical amount to the lessor. This periodic payment is known as "Lease rental".

The terms and conditions regulating the lease arrangement are given in the lease contract. At the end of the lease period the asset generally revert to the lessor, who is the real owner of the asset. As a legal owner, the lessor is entitiled to claim depreciation on the assets.

Lease:-

* The ownership and the title to the assets remain with the lessor.
* The lessor recovers the cost of the asset as well as reasonable return in the form of rental income.
* The lessor also gets the deduction in taxable income for the depreciation of the assets.
* The lessee gets the opportunity of using the asset in its entirity without owning it
* The rental paid by the lessee gets fully deducted from the taxable income of the lessee.

TYPES OF LEASE ARRANGEMENTS

As the lease is basically a contract between the lessor and the lessee and so can agree for any set of terms & conditions. There can be different types of lease arrangements.

Types of leases

- Finance lease
  - Direct lease
  - leveraged lease
  - Sale and lease back.
- Operating lease

I <u>Finance</u> <u>lease</u> (<u>Capital</u> <u>lease</u>) :- It is one which usually covers the full useful economic life of the asset. The lessor receives the lease rentals during the lease period so as to recover fully not only the cost of the assets but also a reasonable return on the funds used to buy the asset. The finance lease is usually a non-cancellable and the lessee provides for the maintenance of the assets. The lease payment is for the use of the asset only and the responsibility for the repair and maintenance generally lies with the lessee. The leesses position is quite similar to that of an owner and the cost of maintaining is in his hands. At the end of the lease period, the asset may be returned to the lessor or handled as per the lease contract.

<u>Lessee's point of View</u>

→ The F.L ensures him an uninterrupted use of the asset

→ A F.L is essentially a form of borrowing for the purpose of acquiring an asset

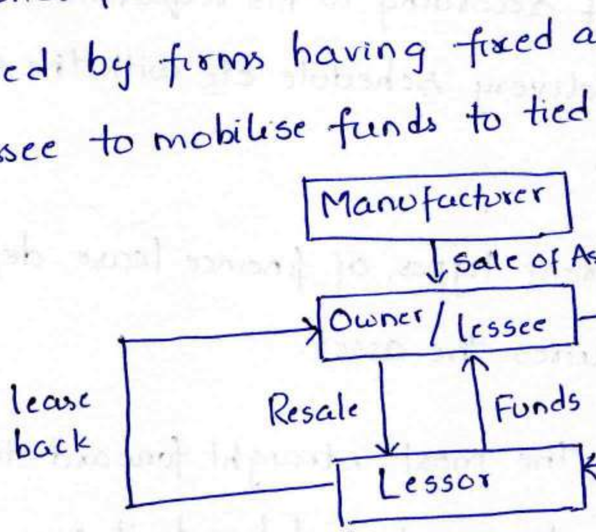
→ He may select the asset according to his requirement, may even negotiate the price, the delivery schedule etc with the supplier and get the delivery also.

There may be different types of finance lease depending upon how the lessee acquires the asset.

i, <u>Direct</u> <u>lease</u> :- This is the most straight forward type of F.L. The lessor itself purchases the asset and hands it over to the lessee. A manufacturer can also act as a lessor and can deliver the assets to the lessee under the lease agreement (instead of delivery under the sale agreement). In other words, the lessee will normally specifies the manufactorer, the model number and other features of the asset it whishes to lease and the lessor will produce/procure for the lease.

ii, Leveraged lease :- A L.L is an arrangement where the lessor borrows a portion of the purchase price from some lender & FI. This loan is secured by the assets and the lease rentals are first distributed to the lender ; any surplus goes to the lessor. The lease payment must be large enough to meet the debt repayment, interest payment to the lender as well as provide a return to the lessor. The L.L is generally adopted in case of costly assets.

iii, Sale and Lease Back :- In this case, the lessee is already the owner of the asset. He, under the lease agreement sell the asset to the lessor, who, in turn leases the asset back to the owner (now the lessee). The lessee not only retains the use of the asset but also gets funds from the sale of the asset to the lessor. This is usually preferred by firms having fixed assets but shortage of funds. It helps the lessee to mobilise funds to tied over the liquidity position.



II <u>Operating lease</u> :- It is an agreement in which the lessee acquires the use of an asset on a periodic basis. It is a lease arrangement for a period considerably shorter than the life of the asset. The lessor may lease the asset to different lessees one after the other. The present value of the lease payment is generally much lower than the actual price of the asset. At the end of the lease, the asset reverts back to the lessor, who can either offer it to sell to the lessee or somebody else or lease it to some other lessee. The OL nomally include a maintenance cost requiring the lessor to maintain the assel. The lessor ofcourse, will include in the lease rentals, a sufficient compensation for the expected maintenance of the asset.

The OL is cancellable, by the either party and is more expensive than a finance lease because the lessee has to compensate the lessor (owner) as the latter assumes the ownership risk and the lessee bearing no risk of asset becoming obsolete. Vehicles, amusement equipment, display fixtures and furniture etc are some of the assets which may be acquired on O.L basis.

Differences between Finance Lease & Operating lease

Basis.	FL	OL
i, Life of Contract	Approximates the economic life of the asset	Shorter than the economic life of the asset.
ii, Maintenance.	Provided by the lessee	Provided by the lessor & included in lease rentals.
iii, Lease Payments	Return the cost of the asset and allow a profit to the lessor	Not sufficient to cover the cost of the asset.
iv, Cancellation.	May be cancelled only if both the lessor and lessee agrees.	May be cancelled before Expiry date.

Although, the differences between the finance and the operating lease are obvious, some lease arrangements may not fit neatly into one or another of these extremes. They may have features of both types of leases and may be called a combination lease.

ADVANTAGES OF LEASING TO THE LESSEE

→ Avoidance of Initial Cash Outlay
→ Minimum Delay
→ Easy source of finance
→ Shifting the risk of Obsolescence
→ Enhanced Liquidity
→ Conserving borrowing capacity
→ Tax planning & Tax advantage
→ Higher Return on Capital Employed
→ Convenience and Flexibility
→ Certainity
→ No Floatation Costs
→ No Disposal Problem
→ Lesser administrative & maintenance Costs.

DISADVATAGES TO LESSEE

→ Higher Cost
→ Loss of Moratorium Period
→ Risk of being deprived of the Use of asset
→ No alteration or Change in Asset
→ Loss of Ownership incentives
→ Penalities on Termination of Lease
→ Loss of Salvage value of the asset

LEASE VS BUY - The Basic Decision

Lease is a source of financing provided by the lessor to the lessee. If not lease, the only other way, the lessee could obtain the services of the given asset would be to purchase it outright, which would require ~~sufficient~~ funds. The lessee might have these funds to purchase the assets without borrowing, but the funds would not be free as there is always an opportunity cost of the funds. (atleast equal to prevailing rate of interest).

Two mutually exclusive situations
- Should the asset be purchased and become the owner of the asset.
- Should the asset be acquired on lease basis.

So, the firm has to decide whether it should lease the asset or borrow the funds and buy the asset. This is known as lease-buy decision and is a financing decision - which involves a choice between debt financing and lease financing.

The firm should compare leasing to borrowing the amount of purchase price and then buying the asset. In the lease-buy decision, the choice upon the PV of the two series of after tax cash flows to the lessee and to evaluate the decision, the finance manager has to consider only the relavant CFs i.e consider only those CFs that differ under the two alternatives.

The lease decision may be evaluated as an alternative to financing the asset purchase by 100% debt financing. What is needed is an after tax PV comparisons of the two options.

EVALUATION OF LEASE-BUY DECISION

I Identification of relevant Cash Flows :- The CFs emanating from the lease option as well as the buying option are to be identified.

In case of lease, the lessee has to make lease payments and also maintenance expenses. These payments are tax-deductable for lessee.

In case of buying the asset, the firm assumes all the risk and benefits associated with the ownership like salvage value, if any. It incurs maintenance costs. The firm also has to pay the interest on funds borrowed to finance the asset, along with repayment.

The after tax CFs of lease rent may be taken as equal to the difference between lease rental and tax benefit.

CFs associated with borrowing are more difficult to obtain due to the need to identify both interest and depreciation associated with the asset.

The CFs associated with the buying option are :-

→ Interest payment on debt, which is tax deductable

→ Principal repayment of debt, which is not tax deductable

→ Tax savings accruing from the depreciation of the asset

→ Any other operating expenses arising as a consequence of buying asset

→ Any Salvage value at the end of assets life

II Analysis of Incremental Cash Flows :-

After identification, the CFs are to be analysed for each year for tax shield under both the options. Present Value of the stream of after-tax CFs associated with each option must be calculated. This is because CFs occur at different point of time.

There is difference of opinion about the rate of discount being used to find out the PVs.

a) The discount rate used to evaluate the CFs should be the after-tax cost of debt. It may be noted that the lease payment and interest create similar commitment for the firm. So, they should be treated similarly, in terms of risk to estimate discount rates. Because the D.R for debt is the after tax cost of borrowings for the firm, the D.R for lease payment should also be after-tax.

b) However, it is argued that the after tax WACC (k_o) and not after tax cost of debt (k_d) should be used to discount the net CFs under the buying option because funding for the purchase option in fact comes from mingled funds raised from different sources and cannot be associated with any one particular type of security. The same overall WACC should be used to discount the CFs of the leasing option.