

Financial Services In India

BASIC CONCEPTS

1. Introduction

Financial Services has a broad definition and it can be defined as the products and services offered by institutions like banks of various kinds for the facilitation of various financial transactions and other related activities in the world of finance like Investment Banking, Credit Rating, Consumer Finance, Housing Finance, Asset Restructuring, Mutual Fund Management Company, Depository Services, Debit Card etc.

2. Investment Banking

This term is mainly used to describe the business of raising capital for companies. Major players in global scenario include Goldman Sach, Merrill Lynch, and Morgan Stanley etc.

The main difference between traditional commercial banking system and investment banking system is that while commercial bank takes deposits for current and savings accounts from customers while an investment bank does not.

3. Credit Rating

Credit Rating means an assessment made from credit-risk evaluation, translated into current opinion as on a specific date on the quality of specific debt security issued. Credit Rating is a long process involving a series of chronological steps. In India Credit Rating Agencies started to be set up in 1990s. Major agencies are CRISIL, ICRA, and CARE etc.

Different agencies use different scores for rating. Although Credit Rating is very advantageous for users as well as investors, but it also suffers from some serious limitations like credit quality may not be constant, information usually provided by the company to be assessed, etc.

4. Consumer Finance

Consequent upon the globalisation of Indian economy, a spurt increase in employment opportunities has been resulted. This has lead to steady increase in demand of durable consumer goods such as electronic and automobile goods. Consumers can now easily purchase the goods by way of consumer finance.

Basically consumer finance is concerned with providing short term/medium term loans

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to finance purchase of goods or services for personal use by consumers.

Consumer Finance is provided by Non-Banking Financial Companies (NBFCs) which are governed by RBI's regulations and other banking regulations.

5. Housing Finance

With the globalisation of economy level of housing sector activity has also increased. Main purpose is to cover loans to promoters as well as to users. Equated monthly installments (EMI) are an important concept in Housing Finance.

6. Asset Restructuring/Mutual Fund Management Company

These types of companies make investment decisions according to the investment policy indicated in the mutual funds scheme.

7. Depository Services

Depository Services may be defined as an organisation where the securities of a shareholder are held in the form of electronic accounts, in the same way as a bank holds money.

There are only two depositories in India:

- National Securities Depository Limited (NSDL): It was registered by SEBI on June 7, 1996 as India's first depository to facilitate trading and settlement of securities in the dematerialized form.
- Central Depository Service (India) limited (CSDL): It commenced its operations in February 1999. It was promoted by Stock Exchange, Mumbai in association with Bank of Baroda, Bank of India, State Bank of India and HDFC Bank.

8. Debit Cards

Although debit cards appear like credit cards but they operate like cash or personal cheques. The main difference between credit card and debit card is that, while credit card means to "pay later", a debit card means to "pay now". The money is instantly deducted from the user's account on the use of debit card.

9. Online Share Trading

Online Share Trading is basically Internet based trading and services. By using internet trading, any client sitting anywhere in the country would be able to trade through brokers' Internet Trading System. Online trading offers many advantages. NSE became the first exchange to grant approval to its members for providing Internet based trading services.

Question 1*What is Credit rating?***Answer**

Credit rating: Credit rating is a symbolic indication of the current opinion regarding the relative capability of a corporate entity to service its debt obligations in time with reference to the instrument being rated. It enables the investor to differentiate between instruments on the basis of their underlying credit quality. To facilitate simple and easy understanding, credit rating is expressed in alphabetical or alphanumerical symbols.

Credit rating aims to (i) provide superior information to the investors at a low cost; (ii) provide a sound basis for proper risk-return structure; (iii) subject borrowers to a healthy discipline and (iv) assist in the framing of public policy guidelines on institutional investment. Thus, credit rating financial services represent an exercise in faith building for the development of a healthy financial system. In India the rating coverage is of fairly recent origin, beginning 1988 when the first rating agency CRISIL was established. At present there are few other rating agencies like:

- (i) Credit Rating Information Services of India Ltd. (CRISIL).
- (ii) Investment Information and Credit Rating Agency of India (ICRA).
- (iii) Credit Analysis and Research Limited (CARE).
- (iv) Duff & Phelps Credit Rating India Pvt. Ltd. (DCR I)
- (v) ONICRA Credit Rating Agency of India Ltd.

Question 2*What are the limitations of Credit Rating?***Answer**

Credit rating is a very important indicator for prudence but it suffers from certain limitations. Some of the limitations are:

- (i) **Conflict of Interest** – The rating agency collects fees from the entity it rates leading to a conflict of interest. Since the rating market is very competitive, there is a distant possibility of such conflict entering into the rating system.
- (ii) **Industry Specific rather than Company Specific** – Downgrades are linked to industry rather than company performance. Agencies give importance to macro aspects and not to micro ones; overreact to existing conditions which come from optimistic / pessimistic views arising out of up / down turns. At times, value judgments are not ruled out.
- (iii) **Rating Changes** – Ratings given to instruments can change over a period of time. They have to be kept under constant watch. Downgrading of an instrument may not be timely

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enough to keep investors educated over such matters.

(iv) Corporate Governance Issues – Special attention is paid to:

- (a) Rating agencies getting more of their revenues from a single service or group.
- (b) Rating agencies enjoying a dominant market position. They may engage in aggressive competitive practices by refusing to rate a collateralized / securitized instrument or compel an issuer to pay for services rendered.
- (c) Greater transparency in the rating process viz. in the disclosure of assumptions leading to a specific public rating.

(v) Basis of Rating – Ratings are based on 'point of time' concept rather than on 'period of time' concept and thus do not provide a dynamic assessment.

(vi) Cost Benefit Analysis – Since rating is mandatory, it becomes essential for entities to get themselves rated without carrying out cost benefit analysis.

Question 3

List and briefly explain the main functions of an investment bank.

Answer

The following are, briefly, a summary of investment banking functions:

- **Managing an IPO (Initial Public Offering):** This includes hiring managers to the issue, due diligence and marketing the issue.
- **Issue of debt:** When a company requires capital, it sometimes chooses to issue public debt instead of equity.
- **Mergers and Acquisitions:** Acting as intermediary between Acquirer and target company
- **Private Placement:** A private placement differs little from a public offering aside from the fact that a private placement involves a firm selling stock or equity to private investors rather than to public investors.
- **Financial Restructuring:** When a company cannot pay its cash obligations - it goes bankrupt. In this situation, a company can, of course, choose to simply shut down operations and walk away or, it can also restructure and remain in business.

Question 4

- (i) *What is the meaning of NBFC?*
- (ii) *What are the different categories of NBFCs?*
- (iii) *Explain briefly the regulation of NBFCs under RBI Act.*

Answer

- (i) Meaning of NBFC (Non Banking Financial Companies)

NBFC stands for Non-Banking financial institutions, and these are regulated by the Reserve Bank of India under RBI Act, 1934. NBFC's principal business is receiving of deposits under any scheme or arrangement or in any other manner or lending on any other manner. They normally provide supplementary finance to the corporate sector.

(ii) Different categories of NBFC are

1. Loan companies
2. Investment Companies.
3. Hire Purchase Finance Companies.
4. Equipment Leasing Companies.
5. Mutual Benefit Finance Companies.
6. Housing Finance Companies
7. Miscellaneous Finance Companies

(iii) Regulation of NBFCs-RBI Act

RBI regulates the NBFC through the following measures:

- (a) Mandatory Registration.
- (b) Minimum owned funds.
- (c) Only RBI authorized NBFCs can accept public deposits.
- (d) RBI prescribes the ceiling of interest rate.
- (e) RBI prescribes the period of deposit.
- (f) RBI prescribes the prudential norms regarding utilization of funds.
- (g) RBI directs their investment policies.
- (h) RBI inspectors conduct inspections of such companies.
- (i) RBI prescribes the points which should be examined and reported by the auditors of such companies.
- (j) RBI prescribes the norms for preparation of Accounts particularly provisioning of possible losses.
- (k) If any of interest or principal or both is/ are due from any customer for more than 6 months, the amount is receivable (interest or principal or both) is termed as non-performing asset.

Question 5

Explain CAMEL model in credit rating.

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Answer

CAMEL Model in Credit Rating

Camel stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the rating agencies deserves special attention, it focuses on the following aspects-

- (i) *Capital*- Composition of external funds raised and retained earnings, fixed dividends component for preference shares and fluctuating dividends component for equity shares and adequacy of long term funds adjusted to gearing levels, ability of issuer to raise further borrowings.
- (ii) *Assets*- Revenue generating capacity of existing/proposed assets, fair values, technological/physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues, size, ageing and recoverability of monetary assets like receivables and its linkage with turnover.
- (iii) *Management*- Extent of involvement of management personnel, team-work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.
- (iv) *Earnings*- Absolute levels, trends, stability, adaptability to cyclical fluctuations, ability of the entity to service existing and additional debts proposed.
- (v) *Liquidity*- Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive/negative aspects under each of these five categories and these are factored in for making the overall rating decision.

Question 6

A Ltd. has a total sales of ₹ 3.2 crores and its average collection period is 90 days. The past experience indicates that bad-debt losses are 1.5% on Sales. The expenditure incurred by the firm in administering its receivable collection efforts are ₹ 5,00,000. A factor is prepared to buy the firm's receivables by charging 2% Commission. The factor will pay advance on receivables to the firm at an interest rate of 18% p.a. after withholding 10% as reserve.

Calculate the effective cost of factoring to the Firm.

Answer

	₹
Average level of Receivables = $3,20,00,000 \times 90/360$	80,00,000
Factoring commission = $80,00,000 \times 2/100$	1,60,000
Factoring reserve = $80,00,000 \times 10/100$	8,00,000
Amount available for advance = ₹ $80,00,000 - (1,60,000 + 8,00,000)$	70,40,000
Factor will deduct his interest @ 18%:- Interest = $\frac{\text{Rs. } 70,40,000 \times 18 \times 90}{100 \times 360}$	= ₹ 3,16,800

\ Advance to be paid = ₹ 70,40,000 - ₹ 3,16,800 = ₹ 67,23,200

Annual Cost of Factoring to the Firm:	₹
Factoring commission (₹ $1,60,000 \times 360/90$)	6,40,000
Interest charges (₹ $3,16,800 \times 360/90$)	<u>12,67,200</u>
Total	<u>19,07,200</u>
Firm's Savings on taking Factoring Service:	₹
Cost of credit administration saved	5,00,000
Cost of Bad Debts (₹ $3,20,00,000 \times 1.5/100$) avoided	<u>4,80,000</u>
Total	<u>9,80,000</u>
Net cost to the Firm (₹ $19,07,200 - ₹ 9,80,000$)	<u>9,27,200</u>
Effective rate of interest to the firm = $\frac{₹ 9,27,200 \times 100}{67,23,200}$	13.79%

Note: The number of days in a year has been assumed to be 360 days.

Question 7

A company is considering engaging a factor, the following information is available:

- The current average collection period for the Company's debtors is 80 days and $\frac{1}{2}\%$ of debtors default. The factor has agreed to pay money due after 60 days and will take the responsibility of any loss on account of bad debts.
- The annual charge for the factoring is 2% of turnover payable annually in arrears. Administration cost saving is likely to be ₹1,00,000 per annum.

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- (iii) Annual sales, all on credit, are ₹1,00,00,000. Variable cost is 80% of sales price. The Company's cost of borrowing is 15% per annum. Assume the year is consisting of 365 days.

Should the Company enter into a factoring agreement?

Answer

The annual change in cash flows through entering into a factoring agreement is:

Savings		(Amount in ₹)
Administration cost saved		1,00,000
Existing average debtors [₹ 1,00,00,000/365) x 80 days]	21,91,781	
Average New Debtors [(₹ 1,00,00,000/365) x 60 days]	16,43,836	
Reduction in debtors	5,47,945	
Cost there of @80%	4,38,356	
Add: Interest saving @15% p.a on. ₹ 4,38,356		65,753
Add: Bad Debts saved @.005 of ₹ 1,00,00,000		<u>50,000</u>
	Total	2,15,753
Less: Annual charges @2% of ₹ 1,00,00,000		<u>2,00,000</u>
Net annual benefits of factoring		<u>15,753</u>

Therefore, the factoring agreement is worthwhile and should be undertaken.

Question 8

MSN Ltd. has total sales of ₹ 4.50 crores and its average collection period is 120 days. The past experience indicates that bad debt losses are 2 percent on sales. The expenditure incurred by the company in administering its receivable collection efforts are ₹ 6,00,000. A Factor is prepared to buy the company's receivables by charging 2 percent commission. The factor will pay advance on receivables to the company at an interest rate of 18 percent per annum after withholding 10 percent as reserve.

You are required to calculate effective cost of factoring to the company.

Answer**MSN Ltd.**

	₹
Average level of Receivables $\text{₹ } 4,50,00,000 \times 120 / 360$	1,50,00,000
Factoring commission $\text{₹ } 1,50,00,000 \times 2\%$	3,00,000
Factoring Reserve $\text{₹ } 1,50,00,000 \times 10\%$	15,00,000
Amount available for advance $\text{₹ } 1,50,00,000 - (3,00,000 + 15,00,000)$	1,32,00,000
Factor will deduct interest @ 18%	
Interest $(\text{₹ } 1,32,00,000 \times 18 \times 120) / 100 \times 360$	7,92,000
Advance to be paid = $\text{₹ } 1,32,00,000 - 7,92,000$	1,24,08,000
Annual cost of factoring to the firm:	
Factoring commission $(\text{₹ } 300000 \times 360 / 120)$	9,00,000
Interest Charges $(\text{₹ } 792,000 \times 360 / 120)$	23,76,000
	32,76,000
Firms savings on taking factoring service:	
Cost of credit administration saved	6,00,000
Cost of bad debts $(\text{₹ } 4,50,00,000 \times 2\%)$	9,00,000
Total savings	15,00,000

Net cost to the firm = $\text{₹ } 32,76,000 - \text{₹ } 15,00,000 = \text{₹ } 17,76,000$

Effective rate of interest to the firm = $\text{₹ } 17,76,000 \times 100 / \text{₹ } 1,24,08,000 = 14.31\%$

Note: The number of days in a year is assumed to be 360 days.

Question 9

The credit sales and receivables of M/s M Ltd. at the end of the year are estimated at ₹ 3,74,00,000 and ₹ 46,00,000 respectively.

The average variable overdraft interest rate is 5%. M Ltd. is considering a proposal for factoring its debts on a non-recourse basis at an annual fee of 3% on credit sales. As a result, M Ltd. will save ₹ 1,00,000 per year in administrative cost and ₹ 3,50,000 as bad debts. The factor will maintain a receivables collection period of 30 days and advance 80% of the face value thereof at an annual interest rate of 7%. Evaluate the viability of the proposal.

Note: 365 days are to be taken in a year for the purpose of calculation of receivables.

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Answer

	₹
Estimated Receivables	46,00,000
Estimated Receivables under Factor $\frac{30}{365} \div \frac{0}{0}$	30,73,973
Reduction in Receivables (₹ 46,00,000 – ₹ 30,73,973)	15,26,027

Total Savings (A)

Reduction in finance costs ₹ 15,26,027 @ 5%	76,301
Saving of Administration costs	1,00,000
Saving of Bad debts	3,50,000
Total	5,26,301

Total Cost of Factoring (B)

Interest on advances by Factor	
Advances 30,73,973 @ 80% ₹ 24,59,178	
Interest on ₹ 24,59,178 @ 7%	₹ 1,72,142
Overdraft Interest rate 5%	(₹ 1,22,959)
Charges payable to Factor (Rs 3,74,00,000 @ 3%)	<u>11,22,000</u>
Total	<u>11,71,183</u>

Net Saving (A) – (B) (6,44,882)

Since Net Saving is negative the proposal is not viable and cannot be accepted

EXERCISES

Question

The following financial information related to Norwason India Ltd.:

	2009	2008
	₹ 000	₹ 000
Sales (all on credit)	37,400	26,720
Cost of sales	<u>34,408</u>	<u>23,781</u>
Operating profit	2,992	2,939
Finance costs (interest payments)	<u>355</u>	<u>274</u>
Profit before taxation	<u>2,637</u>	<u>2,665</u>

	2009		2008	
	₹ 000	₹ 000	₹ 000	₹ 000
Non-current assets		13,632		12,750
Current assets				
Inventory	4,600		2,400	
Trade receivables	<u>4,600</u>		<u>2,200</u>	
	9,200		4,600	
Current liabilities				
Trade payables	4,750		2,000	
Overdraft	<u>3,225</u>		<u>1,600</u>	
	7,975		3,600	
Net current assets		<u>1,225</u>		<u>1,000</u>
		14,857		13,750
8% Bonds		<u>2,425</u>		<u>2,425</u>
		<u>12,432</u>		<u>11,325</u>
Capital and reserves				
Share capital		6,000		6,000
Reserves		<u>6,432</u>		<u>5,325</u>
		12,432		11,325

The average variable overdraft interest rate in each year was 5%. The 8% bonds are redeemable in ten years' time.

A factor has offered to take over the administration of trade receivables on a non-recourse basis for an annual fee of 3% of credit sales. The factor will maintain a trade receivables collection period of 30 days and Norwason India Ltd will save ₹ 1,00,000 per year in administration costs and ₹ 3,50,000 per year in bad debts. A condition of the factoring agreement is that the factor would advance 80% of the face value of receivables at an annual interest rate of 7%.

Evaluate whether the proposal to factor trade receivables is financially acceptable.

(Answer: Net cost of factoring is 6,44,884 and hence factor's offer not recommended.)