

FINANCIAL SERVICES ON 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 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

Write a brief note about the meaning and regulations of NBFCs in India.

Answer

Meaning of NBFC's: An NBFC is a company or an institution basically engaged in acceptance of deposits under different schemes and to invest these monies in any manner. NBFC may be registered as a Company under Companies Act, 1956, or may be other form of organization. The Reserve Bank of India Act defines an NBFC as (1) a financial institution which is a company. (ii) a non-banking institution which is a company having its principal business the receiving of deposits under any scheme or lending in any manner (iii) such other non-banking institution as the RBI may specify with the approval of Central Government. Non-banking financial companies, normally, provides supplementary finance to the corporate sector. For the purpose of growing economy the role of NBFC's is important. The finance and related services is the major activity of NBFC's.

Regulation of NBFCs – RBI Act

The RBI Act regulates different types of NBFCs under the provisions of Chapter III – B & Chapter C.

Silent features of Chapter III – B

The two compulsory prerequisites as per Chapter III- B are

- (a) The NBFC should obtain a certificate of registration.
- (b) It must have NOF (Net Operating Funds) of Rs. 200 lacs.

These two requirements are cumulative.

Computation of NOF (Net Operating Funds) will be as follows

NOF is defined in the Section 45, I-A of the Act. The basis of computation is the latest Balance Sheet of the Company. Following items are considered for NOF.

- Paid up equity capital and free reserves.
- Accumulated losses, deferred revenues expenditure and intangible assets.
- Investment in shares of subsidiaries, companies in the same group and other NBFCs.
- Book value of Debentures, bonds made in subsidiaries or companies in the same group.
- Deposit with subsidiaries and companies in the same group.

The calculation of NOF is

$$X = 1 + 2$$

$$Y = 3 + 4 + 5.$$

If 10% of Y exceeds the X then excess to be find out.

The NOF of the NBFC will be X - the excess amount.

Procedure for obtaining registration

Application must be in the form prescribed by RBI and should be submitted to the Regional Office of the RBI.

Processing of application by RBI

RBI ensures capacity of the NBFC to meet the creditors claim in full, general character of the management and the capital structure. The activity of NBFC shall not be prejudicial to the operation and consolidation of the financial sector and also shall not be prejudicial to the public interest.

Cancellation of registration

Registration can be cancelled under section 44IA (6) wherein certain conditions are prescribed under the section such as

- § Non-compliance of directions issued by the RBI.
- § Fails to maintain accounts in accordance with any law or order issued by RBI.
- § Failed to submit or offer for inspection its books of accounts or other relevant documents when demanded by RBI.
- § Failed to comply with any conditions specified by RBI while granting certificate of registration.

Procedure for cancellation of registration

NBFC should be given a reasonable opportunity of being heard. NBFC must generally be given an opportunity by RBI for taking necessary steps to comply with the conditions, except in cases where RBI is of the opinion that the delay in canceling the certificate of registration shall be prejudicial to public interest or to the interest of the depositors of the NBFC.

Appellate Remedy

The NBFC can prefer and appeal to Central Government within 30 days from the date on which the cancellation order was communicated to it. If no appeal has been prescribed then the decision of RBI shall be final.

Question 2

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 3

A Ltd. has a total sales of Rs. 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 Rs. 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

	Rs.
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

Strategic Financial Management

Factoring reserve = $80,00,000 \times 10/100$ 8,00,000

Amount available for advance =

Rs. $80,00,000 - (1,60,000 + 8,00,000)$ 70,40,000

Factor will deduct his interest @ 18%:-

Interest = $\frac{\text{Rs. } 70,40,000 \times 18 \times 90}{100 \times 360}$ = Rs. 3,16,800

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

Annual Cost of Factoring to the Firm: Rs.

Factoring commission (Rs. $1,60,000 \times 360/90$) 6,40,000

Interest charges (Rs. $3,16,800 \times 360/90$) 12,67,200

Total 19,07,200

Firm's Savings on taking Factoring Service: Rs.

Cost of credit administration saved 5,00,000

Cost of Bad Debts (Rs. $3,20,00,000 \times 1.5/100$) avoided 4,80,000

Total 9,80,000

Net cost to the Firm (Rs. $19,07,200 - \text{Rs. } 9,80,000$) 9,27,200

Effective rate of interest to the firm = $\frac{\text{Rs. } 9,27,200 \times 100}{67,23,200}$ 13.79%

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

Question 4

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

- (i) 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.
- (ii) The annual charge for the factoring is 2% of turnover payable annually in arrears. Administration cost saving is likely to be Rs.1,00,000 per annum.
- (iii) Annual sales, all on credit, are Rs.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:

(Amount in Rs.)

Savings

Administration cost saved		1,00,000
Existing average debtors	21,91,781	
[Rs.1,00,00,000/365) x 80 days]		
Average New Debtors	16,43,836	
[(Rs.100,00,000/365) x 60 days]		
Reduction in debtors	5,47,945	
Cost there of @80%	4,38,356	
Add: Interest saving @15% P.A on.	Rs.4,38,356	65,753
Add: Bad Debts saved @.005 of	Rs.1,00,00,000	50,000
	Total	2,15,753
Less: Annual charges @2% of	Rs.1,00,00,000	2,00,000

Net annual benefits of factoring 15,753

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

Question 5

MSN Ltd. has total sales of Rs.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 Rs.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	$45000000 \times 120 / 360$	15000000
Factoring commission	$15000000 \times 2\%$	300000
Factoring Reserve	$15000000 \times 10\%$	1500000

Strategic Financial Management

Amount available for advance	$15000000 - (300000 + 1500000)$	13200000
Factor will deduct interest @ 18%		
Interest $(13200000 \times 18 \times 120) / 100 \times 360$		792000
Advance to be paid = Rs.13200000 – 792000		12408000
Annual cost of factoring to the firm:		
Factoring commission $(Rs.300000 \times 360 / 1320)$		900000
Factoring commission $(Rs.300000 \times 360 / 120)$		2376000
		3276000
Firms savings on taking factoring service:		
Cost of credit administration saved		600000
Cost of bad debts $(45000000 \times 2\%)$		900000
Total savings		1500000
Net cost to the firm = Rs.3276000 – 1500000 = Rs.1776000		
Effective rate of interest to the firm = $1776000 \times 100 / 12408000 = 14.31\%$		

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

EXERCISES

Question

The following financial information related to Norwason India Ltd.:

	2009	2008
	Rs. 000	Rs. 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>

Financial Services on India

	2009		2008	
	Rs. 000	Rs. 000	Rs. 000	Rs. 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 Rs.1,00,000 per year in administration costs and Rs. 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.)