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**JAGAT GURU NANAK DEV
PUNJAB STATE OPEN UNIVERSITY, PATIALA**

(Established by Act No. 19 of 2019 of the Legislature of State of Punjab)

**CERTIFICATE PROGRAMME IN
STOCK MARKET AND TRADING
OPERATIONS**

Semester-I

**GC-CST1: ELEMENTS OF FINANCIAL
SERVICES AND MARKET**

Head Quarter: C/28, The Lower Mall, Patiala-147001

Website: www.psou.ac.in

SELF-INSTRUCTIONAL STUDY MATERIAL FOR JGND PSOU

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PREFACE

Jagat Guru Nanak Dev Punjab State Open University, Patiala was established in December 2019 by Act 19 of the Legislature of State of Punjab. It is the first and only Open University of the State, entrusted with the responsibility of making higher education accessible to all, especially to those sections of society who do not have the means, time or opportunity to pursue regular education.

In keeping with the nature of an Open University, this University provides a flexible education system to suit every need. The time given to complete a programme is double the duration of a regular mode programme. Well-designed study material has been prepared in consultation with experts in their respective fields.

The University offers programmes which have been designed to provide relevant, skill-based and employability-enhancing education. The study material provided in this booklet is self-instructional, with self-assessment exercises, and recommendations for further readings. The syllabus has been divided in sections, and provided as units for simplification.

The Learner Support Centres/Study Centres are located in the Government and Government aided colleges of Punjab, to enable students to make use of reading facilities, and for curriculumbased counselling and practicals. We, at the University, welcome you to be a part of this institution of knowledge.

Dr. Amitoj Singh
Associate Dean
Academic Affair

SEMESTER -I
GC-CST1 Elements of Financial Services and Market

Max. Marks: 100
External: 70
Internal: 30
Pass: 40%
Credits: 6

SECTION A

Unit I: Introduction to Financial market: Money market and Capital market. Money market: Meaning and instruments under money market. Capital market: Meaning and instruments under Capital market Meaning of the financial services industry;

Unit II: Types of financial services: Mutual funds, factoring, housing finance

Unit III: Leasing: Introduction, Tax, Legal Accounting Aspects, Financial Evaluation: Lessor and Lessee Points of View, Qualitative Factors. Lease structuring, Lease agreement, Funding of Leases.

Unit IV: Merchant Banking: Managing of public Equity/Debenture Issues, Mobilizing Fixed deposits, arranging Inter-corporate loans, Raising term Finance and loan Syndication

SECTION B

Unit V: Underwriting: Concepts and SEBI Regulations.

Unit VI: Hire Purchase and Installment system, consumer Finance, Securitization, Venture Capital: Meaning, Characteristics, SEBI Guidelines, Venture Capital funds in India.

Unit VII: Factoring: Types, Factoring in India.

Unit VIII: Credit rating: Meanings, Significance, types, Rating Methodology, Drawbacks, SEBI Regulations for credit Rating, Credit Rating Agencies in India and in foreign countries.

Suggested Reading:

1. Bhalla. V.K. -Management of Financial Services, Anmol Publications Pvt. Ltd New Delhi.
2. Pathak. Bharati, -Indian Financial System, Pearson Education, New Delhi
3. Peter S. Rose C. Hudgins, Hill. (2010). Bank Management and Financial Services 7/e: New Delhi:Tata Sylvia McGraw
4. Padmalatha Suresh, Justin Paul, (2010). Management of Banking and Financial Services, 2/e; New Delhi: Pearson Education.
5. S Khan. M.Y.(2013). Financial Services, 7/e; New Delhi: Tata McGraw. Hill.
6. Machiraju, H.R (2014). Merchant Banking: Principles and Practice, 4/e: New Ann International.
7. Gurusamy. S.(2013). Merchant Banking and Financial Services, \$/e: New Delhi. Tata McGraw-Hill



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**CERTIFICATE IN STOCK
MARKET AND TRADING
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Semester –I

GC-CST1

Elements of Financial Services and Market

COURSE COORDINATOR AND EDITOR:

Dr. Sulakshna

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CERTIFICATE IN STOCK MARKET AND TRADING OPERATIONS

GC-CST1: ELEMENTS OF FINANCIAL SERVICES AND MARKET

UNIT I: INTRODUCTION TO FINANCIAL MARKET: Money market and capital market. Money market: Meaning and instruments under money market. Capital market: Meaning and instruments under capital market: Meaning of the financial services industry

Structure

- 1.1 INTRODUCTION TO FINANCIAL SYSTEM**
- 1.2 FINANCIAL MARKETS**
- 1.3 TYPES OF FINANCIAL MARKET**
- 1.4 MONEY MARKET**
 - 1.4.1 TYPES OF MONEY MARKET**
 - 1.4.2 MONEY MARKET INSTRUMENTS**
- 1.5 CAPITAL MARKET**
 - 1.5.1 TYPES OF CAPITAL MARKET**
 - 1.5.1.1 PRIMARY CAPITAL MARKET**
 - 1.5.1.2 SECONDARY CAPITAL MARKET**
 - 1.5.2 CAPITAL MARKET INSTRUMENTS**
 - 1.5.3 CAPITAL MARKET INSTRUMENTS WITH PRIMARY & SECONDARY MARKET ROLES**
- 1.6 FINANCIAL SERVICES**
- 1.7 FINANCIAL INSTITUTIONS**
- 1.8 REGULATORY FRAMEWORK OF FINANCIAL MARKETS IN INDIA**
- 1.0 OBJECTIVES**

By the end of this course, students will be able to:

1. Explain the structure and functioning of the financial system and its role in economic growth.
2. Differentiate between various financial markets, including money market and capital market, along with their instruments.
3. Analyze the functioning of primary and secondary capital markets and their contribution to mobilizing funds.
4. Evaluate the role of financial services and institutions in supporting market operations.
5. Interpret the regulatory framework of financial markets in India and assess its impact on financial stability.

6. Apply conceptual knowledge to real-world scenarios for effective financial decision-making.

1.1 INTRODUCTION TO FINANCIAL SYSTEM

A financial system is a framework designed to create and maintain a consistent, seamless, cost-efficient connection between those who deposit their money and those who invest it. The primary role of the financial system is to direct funds from those with excess capital to those in need of it. An effective financial system not only promotes savings and investments but also skillfully distributes resources across various investment opportunities, thereby boosting economic growth. The financial system in a nation holds a vital responsibility in directing limited resources towards productive endeavors, and its effective operation is of paramount significance to the overall economy.

The financial system represents one of the key sectors within an economy. It holds particular significance due to its substantial impact on both society and the overall economy. However, when we demystify its complex façade, it essentially resembles any other industry, comprising a collection of firms that combine the factors of production (such as land, labor, and capital) under the guidance of a management team. These firms produce a product or a range of products intended for sale in the financial market. Unlike tangible goods, the product of the financial industry is intangible in nature.

The financial industry, as a whole, generates a diverse array of services, all of which are directly or indirectly tied to assets and liabilities, essentially representing claims on individuals, organizations, institutions, companies, and governments. These claims are the primary means through which people accumulate a significant portion of their wealth. In simpler terms, we are referring to financial assets such as shares, debentures, deposits, mortgages, and various other securities.

Therefore, the financial system plays several crucial roles in the economy, including the maintenance of a payment system that facilitates the transfer of purchasing power between participants (from buyers to sellers), the collection and allocation of society's savings, and the creation of various forms of wealth storage options to cater to the preferences of savers. This overview of the financial system's functions provides us with its essence.

To understand the financial system and assess its performance, one must recognize its functions within an economy. In reality, the financial system serves the following functions:

Capital formation function:

This refers to the process of redirecting the economy's ability to produce goods towards the creation of capital goods that enhance future production capabilities. Capital formation involves three separate yet interconnected activities: saving, financing, and investing.

Allocation function:

In the process of capital formation, the financial system plays a crucial role in determining the allocation of capital. Making poor choices regarding which economic projects to pursue can result in

the inefficient use of resources. The higher the quality of decision-making in allocating capital, the faster economic advancement will occur.

Service function:

A well-functioning financial system provides various services to different economic sectors by offering secure and convenient wealth-holding opportunities that yield a positive rate of return. The presence of these financial system services significantly, albeit indirectly, enhances consumer satisfaction.

Finance serves as the lifeblood within the framework of the financial system. It acts as the critical link between savings and investments by establishing a mechanism that aggregates the savings (representing claims to resources) of savers and places these resources into the hands of those who are capable and willing to invest, facilitated by financial intermediaries. These intermediaries generate assets that possess the important characteristic of liquidity, or the ability to be readily converted into a fixed amount of money when needed. Liquidity encompasses cash, money, and assets easily convertible to cash. Liquidity is a fundamental aspect of financial intermediation, allowing intermediaries to create liquid assets that can be held by ultimate savers in the economy, even though the intermediaries themselves may primarily hold relatively illiquid assets. Illiquid assets refer to the process of credit creation.

In the Indian economy, the Central Bank (RBI in India) is responsible for cash creation, while financial institutions are instrumental in creating credit. The flow of finance in the system operates between two primary segments: Surplus Units and Deficit Units (Figure 1). Surplus Units, whether they are public or private, have excess income beyond their current consumption needs. Public surplus units save through regular budgetary channels and the retained earnings of public sector enterprises. Private surplus units encompass household savings and savings from the non-corporate sector, with corporate sector savings dominating in terms of volume. Corporate sector savings are heavily influenced by profitability and enterprise distribution policies, while household savings depend on the capacity, ability, and willingness of individuals to save, influenced by various factors like psychological, social, and economic conditions.

On the other end of the fund flow, Deficit Units seek funding for either investment or consumption purposes. Their investment and, at times, consumption patterns are shaped by their strategies concerning future earnings, which in turn are influenced by the existing capital stock, industry and economic conditions, government policies, and the potential opportunities for new investments. Government and the business sector are major borrowers, and their investment needs often exceed their savings. The role of the financial system is, therefore, to encourage savings and channel them into the economy through financial assets that offer greater productivity compared to physical assets.

Another aspect of the financial system in an economy is government intervention. The government establishes the rules governing the financial system, directing how markets operate, specifying

permissible

financial instruments, and setting operational constraints for financial intermediaries. Government intervention serves two primary purposes: ensuring efficiency within the system and providing stability while instilling confidence. An efficient financial system is one where the total gains from lending, payment, and risk management are maximized.

It is essential to recognize the role of the financial system or sector in an economy, particularly as the economy expands. As discussed earlier, its primary role is resource mobilization. An efficient financial system enables the raising of significant amounts of capital through small contributions from a large number of investors. A company, for example, can raise Rs. 100 crore by issuing 10 crore shares, each subscribed to by investors making minimum contributions of Rs. 2000. Alternatively, mutual funds or financial institutions can be used. This allows large sums to be mobilized from small investors. Financial instruments issued to raise funds can have different maturity patterns to suit the needs of investors. To mitigate investment risk, the financial system offers a wide range of investment opportunities, enabling diversification of investments and, consequently, risk reduction.

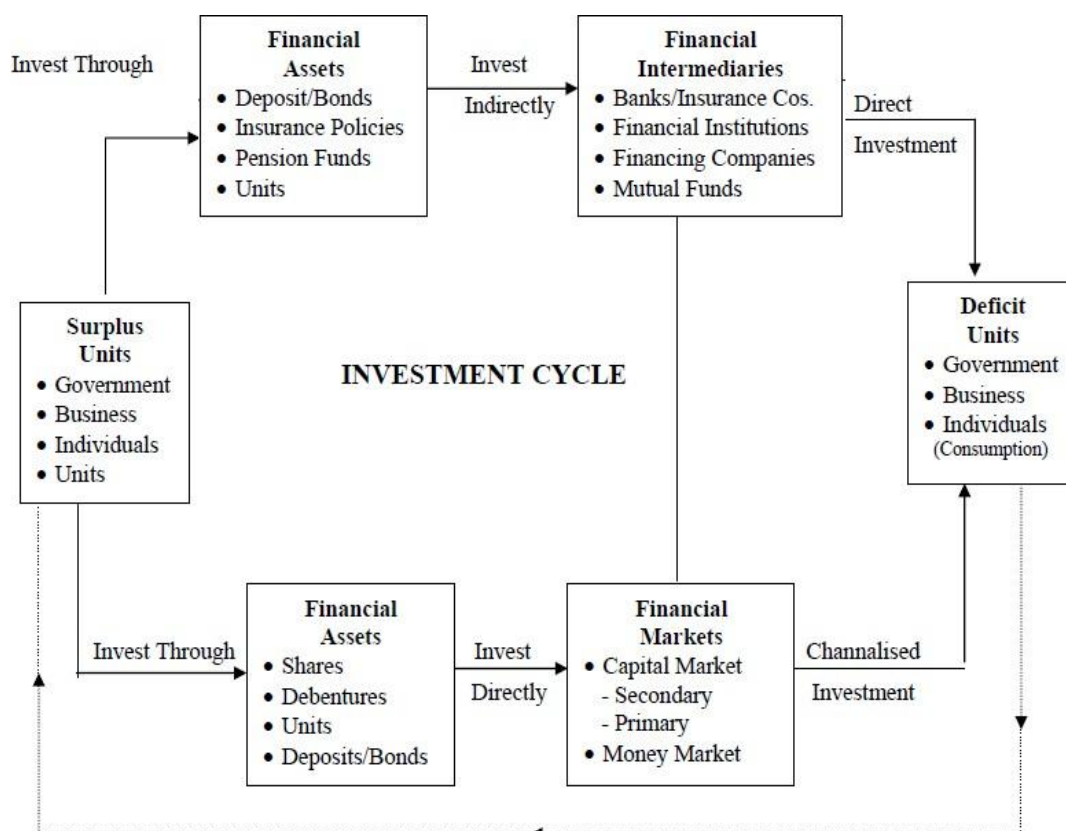


Figure 1

The financial market serves as a platform connecting numerous individuals looking to buy and sell financial products. The prices of these products are determined by the interplay of supply and demand

forces within the market itself.

In essence, the financial market encourages savings within the economy and acts as an efficient conduit for implementing financial policies. In technical terms, it enables:

- Capital generation (in capital markets).
- Risk transfer (in derivatives markets).
- Facilitation of international trade (in currency markets).

A financial system is a framework designed to create and maintain a consistent, seamless, cost-efficient connection between those who deposit their money and those who invest it. The primary role of the financial system is to direct funds from those with excess capital to those in need of it. An effective financial system not only promotes savings and investments but also skillfully distributes resources across various investment opportunities, thereby boosting economic growth. The financial system in a nation holds a vital responsibility in directing limited resources towards productive endeavors, and its effective operation is of paramount significance to the overall economy.

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establishes the rules governing the financial system, directing how markets operate, specifying permissible financial instruments, and setting operational constraints for financial intermediaries. Government intervention serves two primary purposes: ensuring efficiency within the system and providing stability while instilling confidence. An efficient financial system is one where the total gains from lending, payment, and risk management are maximized.

It is essential to recognize the role of the financial system or sector in an economy, particularly as the economy expands. As discussed earlier, its primary role is resource mobilization. An efficient financial system enables the raising of significant amounts of capital through small contributions from a large number of investors. A company, for example, can raise Rs. 100 crore by issuing 10 crore shares, each subscribed to by investors making minimum contributions of Rs. 2000. Alternatively, mutual funds or financial institutions can be used. This allows large sums to be mobilized from small investors. Financial instruments issued to raise funds can have different maturity patterns to suit the needs of investors. To mitigate investment risk, the financial system offers a wide range of investment opportunities, enabling diversification of investments and, consequently, risk reduction.

Check Your Progress

True/False Questions

- Q. I The primary role of the financial system is to channel funds from those with excess capital to those in need of it. **(True/False)**
- Q. II Financial assets such as shares, debentures, and deposits are tangible in nature like physical goods. **(True/False)**
- Q. III In India, the Central Bank (RBI) is responsible for cash creation, while financial institutions create credit. **(True/False)**
- Q. IV Deficit units in the financial system always include households because they spend more than they earn. **(True/False)**
- Q. V Government intervention in the financial system aims to ensure efficiency, stability, and confidence in markets. **(True/False)**

1.2 FINANCIAL MARKETS

The financial market serves as a platform connecting numerous individuals looking to buy and sell financial products. The prices of these products are determined by the interplay of supply and demand forces within the market itself.

In essence, the financial market encourages savings within the economy and acts as an efficient conduit for implementing financial policies. In technical terms, it enables:

- Capital generation (in capital markets).

- Risk transfer (in derivatives markets).
- Facilitation of international trade (in currency markets).

1.3 TYPES OF FINANCIAL MARKET

A Financial Market can be described as the arena where financial assets are either generated or transferred. Unlike tangible transactions that involve the exchange of money for physical goods or services, financial transactions involve the creation or transfer of financial assets. Financial Assets or Financial Instruments represent a future claim to a sum of money and/or periodic payments in the form of interest or dividends.

Money Market: The money market serves as a wholesale debt market for low-risk, highly liquid, short-term instruments. Funds are accessible in this market for periods ranging from a single day to one year. Government entities, banks, and financial institutions primarily dominate this market.

Capital Market: The capital market is designed to provide financing for long-term investments. Transactions in this market typically have durations exceeding one year.

Forex Market: The Forex market handles multicurrency requirements through currency exchange. Funds are transferred in this market based on prevailing exchange rates. It is one of the most developed and globally integrated markets.

Credit Market: The credit market is where banks, financial institutions, and non-banking financial companies (NBFCs) extend short, medium, and long-term loans to both corporations and individuals.

1.4 MONEY MARKET

A money market can be described as a marketplace for short-term debt securities, typically having a maturity period of one year or less, often as short as 30 days. Money market securities are generally considered highly secure investments, offering relatively low interest rates, making them suitable for temporary cash holding or short-term financial goals.

The money market is primarily recognized as a platform where large institutions and governments handle their short-term cash requirements. Nevertheless, individual investors can also participate in this market through various types of securities.

1.4.1 TYPES OF MONEY MARKET

The money market can be categorized into two main types: the organized money market and the unorganized money market.

Organized money market: This segment comprises commercial banks, financial institutions, and all institutions engaged in the trading of short-term assets.

Unorganized money market: In addition to the organized money market, there exists a

robust unorganized money market, particularly in developing countries that have yet to fully develop. In such nations, individuals and small businesses often choose to obtain loans from family members, moneylenders, informal lenders, etc., instead of seeking credit from established institutions regulated by monetary authorities.

1.4.2 MONEY MARKET INSTRUMENTS

The money market can be defined as a market for short-term financial instruments and assets that closely resemble cash. Short-term, in this context, generally refers to a period of up to one year, often as brief as 30

days. The term "near substitutes for money" indicates that these financial assets can be swiftly converted into cash with minimal transaction costs.

Several key money market instruments are briefly discussed below:

- a) **Call/Notice Money:** Call money refers to funds borrowed or lent on demand for very short periods, typically a day, known as "Call (Overnight) Money." If the borrowing or lending period ranges from more than a day up to 14 days, it is termed "Notice Money." These transactions do not require collateral security.
- b) **Treasury Bills:** Treasury Bills are short-term borrowing instruments of the government, with maturities of up to one year. They are issued at a discount to their face value and are repaid at face value upon maturity.
- c) **Certificates of Deposits (CDs):** CDs are negotiable money market instruments issued in dematerialized form or as Promissory Notes for funds deposited with eligible financial institutions for specified time periods. The issuance of CDs is regulated by directives from the Reserve Bank of India, with eligibility criteria for corporate issuers.
- d) **Commercial Papers (CPs):** CPs represents promissory notes evidencing debt obligations issued by corporations. They are issued at a discount to face value and are freely negotiable. Guidelines for issuing CPs are governed by directives from the Reserve Bank of India, including eligibility criteria based on the issuer's financial health, credit rating, and maturity periods.

These money market instruments serve as crucial tools for managing short-term funds and liquidity. Their values in the secondary market may differ from their face values due to fluctuations in interest rates, with bond values rising when interest rates fall and vice versa.

1.5 CAPITAL MARKET

The capital market is the domain for securities trading, enabling companies and governments to secure long-term financing. It functions as a marketplace where funds are borrowed or lent for durations

exceeding one year.

Various categories of financial instruments are actively traded within the capital markets, including equity instruments, credit market instruments, insurance instruments, foreign exchange instruments, hybrid instruments, and derivative instruments.

1.5.1 TYPES OF CAPITAL MARKET

The Capital Market is comprised of two main segments: **The Primary Market and The Secondary Market**. In the Primary Market, newly issued bonds and stocks are transacted, while the secondary market involves the buying and selling of pre-existing bonds and stocks. In its entirety, the Capital Market facilitates the acquisition of capital by enabling the trading of long-term financial assets. In summary, the Capital Market enables the acquisition of funds by engaging in the exchange of extended-term financial assets.

1.5.1.1 PRIMARY CAPITAL MARKET

The primary capital markets, also known as the New Issue Market or NIM, are where newly introduced securities are initially sold to the general public. This market is often referred to as the long-term debt market because the funds raised here are intended for long-term capital purposes.

The process of selling new issues in the primary capital market typically involves a syndicate of securities dealers who play a role in the process and receive a commission for their services. The price of the security offered in the primary capital market includes this dealer commission.

In cases of primary issues, investors directly purchase the issue from the company without the need for intermediaries. To do this, investors send the exact amount of money to the respective company, and upon receiving the funds, the company provides security certificates to the investors.

The funds generated through primary issues in the primary capital market are vital for companies. These funds are utilized by companies for establishing new ventures, expanding existing businesses, and modernizing operations. Additionally, the primary capital market plays a role in capital formation for the overall economy.

There are three methods for offering new issues in the primary capital market:

Initial Public Offering (IPO): An IPO refers to the initial sale of stock by a private company to the public. IPOs are commonly used by smaller, younger companies seeking capital for expansion, but they can also be employed by large privately owned companies looking to become publicly traded. Underwriting firms assist in determining the type of security to issue (common or preferred), the offering price, and the timing of the market entry.

Preferential Issue: A preferential issue involves the issuance of stock available exclusively to designated buyers, such as promoters, their relatives, or institutional investors. This can be likened to a wholesale equity market, as retail investors or shareholders are not invited to participate.

Rights Issue: A rights issue is a unique form of offering for existing companies. Existing shareholders receive the opportunity to purchase a specified number of new shares from the company at a predetermined price within a specific timeframe.

1.5.1.2 SECONDARY CAPITAL MARKET

The secondary capital market pertains to securities that have already been issued through an initial public offering in the primary market. Typically, secondary markets involve the buying and selling of securities that were previously issued.

In the secondary capital market, these securities are generally sold and transferred from one investor to another, highlighting the importance of a high level of liquidity in this market. Additionally, transparency in secondary market transactions is crucial. Advancements in technology have significantly transformed the way trading occurs in the secondary market. In the past, investors had to physically gather at fixed locations to conduct transactions, but now trading in the secondary capital market has become more convenient for investors.

Notes: The secondary bond markets provide a platform for trading bonds that have already been issued in the primary market, while the secondary stock market facilitates the trading of stocks that have already been issued by the respective issuers. Treasury bills in the secondary market are also traded.

Trading in the secondary market holds significant importance within the capital market. An analysis of trends in the secondary market can offer insights into investors' preferences for liquidity. This reflects whether investors intend to invest their money for a short or long duration. It's worth noting that investors in the capital market tend to favor shorter-term investments. However, investors in the secondary market can manage their investments effectively with the right strategy.

The secondary market value of a stock or bond differs from its face value due to fluctuating interest rates. The resale value of bonds in the secondary market depends on prevailing interest rates at the time of the sale. In a typical secondary market scenario, when interest rates decline, bond values rise, but when rates increase, bond values decrease.

1.5.2 CAPITAL MARKET INSTRUMENTS

1. Equity Instruments (Ownership Instruments)

- These represent ownership in a company and give investors voting rights and a share in profits.
- Equity shares provide variable returns through dividends and capital gains depending on performance.
- Preference shares offer fixed dividends and priority over equity holders during liquidation.
- Warrants and Depository Receipts allow future purchase of shares or investment from foreign markets.

2. Debt Instruments (Borrowing Instruments)

- These represent funds borrowed by companies or governments from investors, repayable with interest.
- Debentures and corporate bonds are common forms, offering fixed coupon rates and maturity.
- Government securities (G-Secs) like dated bonds are considered the safest with steady returns.
- Such instruments are ideal for investors seeking stable, low-risk, long-term income.

3. Hybrid Instruments

- These combine features of both equity and debt, offering balanced risk and return.
- Convertible debentures allow investors to convert debt into equity after a fixed period.
- Preference shares may be structured as convertible or non-convertible, depending on the terms.
- Derivative-linked instruments also act as hybrids, giving flexibility in investment.

4. Other Instruments

- Mutual fund units pool money from investors and diversify across equity and debt securities.

- Exchange Traded Funds (ETFs) are listed on stock exchanges and track indices or commodities.
- Derivatives like futures and options help investors hedge risks or speculate on price movements.
- These instruments provide indirect, diversified, and flexible ways to participate in capital markets.

1.5.3 CAPITAL MARKET INSTRUMENTS WITH PRIMARY & SECONDARY MARKET ROLES

Instrument Type	Primary Market Role	Secondary Market Role	Example
Equity Shares	Companies raise funds through IPOs/FPOs by issuing shares to investors.	Shares are traded on stock exchanges, providing liquidity to investors.	Infosys IPO (1993), Reliance shares on NSE/BSE
Preference Shares	Issued by companies to raise capital with fixed dividend obligations.	Can be traded or redeemed in the secondary market if listed.	ICICI Bank preference issue
Warrants & Depository Receipts	Warrants allow future purchase of shares; DRs help firms raise capital abroad.	Traded in global or domestic exchanges after issuance.	HDFC Bank GDRs
Debentures / Corporate Bonds	Issued by companies to borrow long-term funds from investors.	Traded in bond markets, allowing investors to sell before maturity.	Tata Motors debentures
Government Securities (G-Secs)	Government raises funds by issuing dated securities and bonds.	G-Secs are traded in debt markets, often through RBI platforms.	10-year Indian G-Sec
Hybrid Instruments	Issued to provide	Can be converted into	Reliance convertible

(Convertible Debentures, Preference Shares)	both fixed returns and future conversion options.	equity or traded as per terms.	debentures
Mutual Funds Units (NFOs)	AMCs launch New Fund Offers (NFOs) for investors to subscribe.	Close-ended funds & ETFs can be traded on stock exchanges.	SBI Nifty 50 ETF
Exchange Traded Funds (ETFs)	Introduced in the primary market through initial offerings.	Bought and sold like shares on stock exchanges.	Nippon India ETF Nifty BeES
Derivatives (Futures, Options)	Not typically issued in the primary market; contracts are created by exchanges.	Traded actively in secondary markets for hedging and speculation.	Nifty 50 Options, Crude Oil Futures

CHECK YOUR PROGRESS

QVI. Which of the following best describes the money market?

- a) A market for long-term securities
- b) A market for short-term, highly liquid, low-risk debt instruments
- c) A market for trading equities and derivatives
- d) A market for multicurrency exchange

Q VII In the primary capital market, securities are:

- a) Traded between investors for liquidity
- b) Initially issued by companies directly to investors
- c) Redeemed by the government
- d) Always issued through the stock exchange

Q VIII Treasury Bills (T-Bills) are:

- a) Long-term borrowing instruments issued by private corporations
- b) Short-term government borrowing instruments issued at a discount
- c) Negotiable certificates of deposits issued by NBFCs
- d) Promissory notes issued by commercial banks

Q IX Which of the following instruments is a hybrid of debt and equity?

- a) Treasury Bills
- b) Convertible Debentures
- c) Commercial Papers
- d) Certificates of Deposit

Q X In the secondary capital market, the primary function is:

- a) Raising fresh funds for companies
- b) Providing liquidity through the trading of already issued securities
- c) Directly funding government projects
- d) Selling securities exclusively to promoters

1.6 FINANCIAL SERVICES

Financial services encompass the array of products and offerings provided by financial institutions, such as various types of banks, to facilitate a wide range of financial transactions and related activities within the finance sector. These activities include services like loans, insurance, credit cards, investment opportunities, money management, and the provision of information on topics like the stock market and market trends. The Gramm-Leach-Bliley Act, which was passed in the late 1990s, played a pivotal role in bringing the term "financial services" to the forefront. This act repealed previous laws that prohibited banks and financial institutions from entering sectors like insurance and investment. Consequently, numerous organizations offering these financial services merged under a unified banner, giving rise to a new category known as Commercial Banking. Entities like Citibank emerged primarily as service providers in this transformed landscape.

While the financial services industry is highly profitable in terms of earnings, it does not constitute a substantial portion of the market, and it employs fewer people compared to some other industries. Some of the prominent service providers and commercial banks in this field include:

- Citibank
- HSBC
- Standard Chartered
- Citigroup
- Merrill Lynch
- Morgan Stanley
- ING (Investment)
- American Express (Credit Card)

- VISA (Credit Card)
- Allianz (Insurance)

Objectives or Functions of Financial Services

Fund Raising:

Financial Services play a crucial role in securing the necessary capital from a diverse range of investors, including individuals, institutions, and corporations. To achieve this goal, a variety of financial instruments are employed. Corporate entities, as well as individuals and other entities, seek these funds to meet their financial needs.

Funds Deployment:

A variety of financial services are accessible within financial markets, aiding participants in optimizing the profitable utilization of the capital they've raised. These services contribute to informed decision-making concerning the financing combination. Banking and financial service companies offer services such as bill discounting, debtor factoring, short-term fund placement in the money market, credit assessment, e-commerce, and debt securitization to facilitate effective fund management.

Specialized Services:

The financial services industry offers specialized offerings like credit assessment, venture capital investment, lease financing, factoring, mutual funds, merchant banking, stock lending, depository services, credit cards, housing finance, book building, and more. Additionally, these services are not limited to traditional banking and insurance entities; stock exchanges, specialized and general financial institutions, non-banking finance companies, subsidiaries of financial institutions, banks, and insurance firms also participate in providing these services.

Regulation:

Various regulatory bodies oversee financial services activities. In India, entities like the Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI), and the Department of Banking and Insurance, Government of India, utilize a wide range of legislative measures to govern the operations of financial service institutions. The primary aim is to maintain an organized operation of the financial markets.

Economic Growth:

Financial services significantly contribute to expediting the pace of economic growth and development by efficiently gathering savings from a diverse group of individuals and directing these funds into productive investments.

1.7 FINANCIAL INSTITUTIONS

The financial sector plays a crucial role in the overall progress of a nation. At the heart of this sector are financial institutions that serve as intermediaries, facilitating the movement of resources from individuals and entities who save more than they spend to those who spend more than they earn.

These financial institutions have historically been the primary source of long-term capital for the economy. They offer a diverse range of financial products and services to cater to the diverse requirements of the business sector.

Additionally, they extend support to emerging businesses, small and medium-sized enterprises, and industries located in underdeveloped regions.

A financial institution is an establishment that offers financial services to its customers or members. Any organization that gathers funds and invests them in assets like stocks, bonds, bank deposits, or loans qualifies as a financial institution.

There are primarily two categories of financial institutions:

Depository institutions: These institutions not only receive deposits from customers but also provide interest on those deposits. They utilize these deposits to extend loans.

Non-depository institutions: These institutions, on the other hand, do not pay interest on deposits and may have different mechanisms for funding their operations and investment activities.

Examples: Banks, Credit unions, Trust companies, Mortgage loan companies.

In contrast, non-depository institutions primarily engage in the sale of financial products. To clarify, these can be government or private entities that act as intermediaries between individuals who save and those who borrow, but they do not accept time deposits. These institutions finance their lending operations by either selling securities or offering insurance policies to the general public. Depending on the level of liquidity associated with their liabilities, these liabilities may fall into one or more definitions of money supply or may be categorized as near-money equivalents.

Examples: Insurance companies, Pension funds, Brokerage firms, Underwriting firms, Mutual fund companies, Investment trust.

Numerous financial institutions offer a combination of depository and non-depository services. Serving as financial intermediaries is arguably the most crucial financial service provided by these institutions. Government authorities usually subject most financial institutions to stringent regulatory oversight.

Finance companies, in particular, often benefit from excellent credit ratings, enabling them to secure loans at highly competitive market rates. Consequently, they can extend loans at interest rates not significantly higher than those offered by banks. Despite serving customers who typically don't meet bank credit criteria, these companies have a track record of low default rates. Finance companies, in general, tend to be sensitive to fluctuations in interest rates, as shifts in market interest rates directly impact their profitability.

Types of Financial Institutions

Financial institutions come in various forms, reflecting the diversity of financial systems across different economies. In India, the financial system encompasses the following categories of institutions:

- Financial Authorities
- Commercial Banks
- Regional Rural Banks
- Non-banking Financial Companies
- Co-operative Societies, etc.

Let us discuss these in detail:

Financial Authorities: Also known as financial regulators, they include:

- Central Board of Direct Taxes (CBDT)
- Central Board of Excise & Customs (CBE&C)
- Reserve Bank of India (RBI)
- Securities and Exchanges Board of India (SEBI)
- Insurance Regulatory and Development Authority (IRDA).

Commercial Banks: The main commercial banks in India include:

State Bank of India (SBI) - State Bank of India is the largest and oldest commercial bank in India, with a vast network of branches and ATMs across the country.

HDFC Bank - HDFC Bank is one of the largest private sector banks in India, known for its strong retail and corporate banking services.

ICICI Bank - ICICI Bank is another prominent private sector bank in India, offering a wide range of financial services.

Punjab National Bank (PNB) - Punjab National Bank is one of the leading public sector banks in India, with a significant presence both nationally and internationally.

Bank of Baroda (BOB) - Bank of Baroda is another major public sector bank in India, known for its global presence and a wide range of banking products and services.

Regional Rural Banks (RRBs): On October 2, 1975, the Government of India established Regional Rural Banks (RRBs). These banks extend credit primarily to the economically disadvantaged segments in rural areas, including small and marginal farmers, agricultural laborers, artisans, and small entrepreneurs.

Initially, there were five RRBs, each sponsored by a different bank: Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank, and United Bank of India. RRBs enjoy several concessions provided by the Reserve Bank of India, such as lower interest rates on notes,

refinancing facilities from NABARD (National Bank for Agriculture and Rural Development), reduced cash reserve ratio, lower statutory liquidity ratio, lower interest rates on loans from sponsoring banks, managerial and staff support from the sponsoring bank, and reimbursement of staff training expenses.

NABARD has the oversight and control of RRBs. It is responsible for setting policies, monitoring operations, providing refinancing facilities, assessing performance, and addressing any issues related to RRBs.

Non-banking Financial Companies: Non-Banking Financial Companies (NBFCs) are rapidly gaining significance within the Indian financial system. This diverse group of institutions, distinct from commercial and cooperative banks, engages in various forms of financial intermediation. These activities encompass receiving deposits, providing loans and advances, offering leasing and hire-purchase services, among others. NBFCs source funds directly or indirectly from the public and subsequently lend them to end consumers. They extend credit to a wide array of clients, including wholesalers, retailers, small-scale industries, and self-employed individuals. Consequently, NBFCs have expanded and diversified the array of financial products and services available in the financial sector.

The RBI registers various types of NBFCs, which include:

- Equipment leasing company
- Hire-purchase company
- Loan company
- Investment company.

Now, these NBFCs have been reclassified into three categories:

- Asset Finance Company (AFC)
- Investment Company (IC) and
- Loan Company (LC).

Co-operative Societies: The overarching strategy concerning rural and agricultural credit revolves around ensuring farmers receive prompt and sufficient financing to enhance agricultural output and efficiency. The primary objective is to facilitate enhanced access to institutional credit for small-scale and

marginalized farmers, as well as other vulnerable segments of society, enabling them to embrace modern technology and improved farming practices. This has been a central focus of the policy.

India's Cooperative Movement boasts a rich historical legacy, and currently these societies consist of the following components:

- The Primary Agricultural Co-operative Societies
- District Central Co-operative Banks
- State Co-operative Banks
- National Co-operative Development Corporation (NCDC)
- National Co-operative Union of India (NCUI)
- National Agricultural Co-operative Marketing Federation of India (NAFED)
- Tribal Co-operative Marketing Development Federation of India Ltd.
- Indian Farmers Fertiliser Cooperative Limited (IFFCO)
- Krishak Bharati Co-operative Limited (KRIBHCO)
- National Bank for Agriculture and Rural Development (NABARD)
- National Federation of State Co-operative Banks Limited (NAFSCOB)
- Gujarat Cooperatives Milk Marketing Federation Ltd. (AMUL)
- National Dairy Development Board (NDDB).

Credit Reporting and Debt Collection Companies: While Credit Reporting and Debt Collection may be somewhat fragmented, it encompasses businesses such as:

Trustman Credit Management Services

Pankaj Saraf

Insurance Companies: Numerous insurance companies operate in the Indian market, with the primary ones being:

General Insurance Corporation of India Ltd.

Life Insurance Corporation

New India Assurance Company

United India Insurance Company.

Merchant Banks: Merchant banks are institutions like:

Citibank

Bajaj Capital Limited

Standard Chartered Bank

Mutual Funds: It is a trust that collects money from a number of investors who share a common investment objective and invests the same in equities, bonds, money market instruments and/or other securities. And the income / gains generated from this collective investment is distributed proportionately amongst the investors after deducting applicable expenses and levies, by calculating a scheme's "Net Asset Value" or NAV. Simply put, the money pooled in by a large number of investors is what makes up a Mutual Fund.

Specialized Financial Institutions: These government enterprises are established to provide both financial and technical support to Indian industries. The roster of specialized financial institutions in India principally comprises:

Export-Import Bank of India

Board for Industrial & Financial Reconstruction

Small Industries Development Bank of India

National Housing Bank.

Venture Capitalists: Venture capitalists are entities specializing in venture capital investment. Venture capital, often referred to as VC, is a form of private equity funding primarily directed towards early-stage, promising, high-growth enterprises, with the goal of achieving returns through future events like an initial public offering (IPO) or the sale of the company.

Examples: Sequoia Capital India, Accel Partners, Matrix Partners India, Nexus Venture Partners, Lightspeed India Partners.

1.8 REGULATORY FRAMEWORK OF FINANCIAL MARKETS IN INDIA

Reserve Bank of India (RBI):

The RBI is the central bank of India and plays a pivotal role in regulating the country's monetary policy. It regulates and supervises banks, non-banking financial companies (NBFCs), and payment systems. The RBI also oversees foreign exchange control and manages the nation's foreign exchange reserves.

Securities and Exchange Board of India (SEBI):

SEBI is the primary regulator for securities markets in India. It oversees stock exchanges, brokers, mutual funds, and other market intermediaries. SEBI enforces regulations to protect investors and maintain market integrity.

Insurance Regulatory and Development Authority of India (IRDAI):

IRDAI regulates and supervises the insurance industry in India, ensuring fair practices, solvency, and consumer protection. It approves insurance products, licenses insurers, and sets capital adequacy standards.

Pension Fund Regulatory and Development Authority (PFRDA):

PFRDA regulates and promotes the pension sector in India. It oversees pension funds, administrators, and other entities involved in the National Pension System (NPS).

Ministry of Finance:

The Ministry of Finance is responsible for formulating fiscal policies and overseeing public finance management. It plays a key role in shaping the regulatory landscape through budgetary allocations and policy decisions.

Market Segments Covered:

Banking and Financial Services:

The RBI regulates commercial banks, co-operative banks, NBFCs, and other financial institutions. It sets capital adequacy, liquidity, and lending standards to maintain financial stability.

Securities Markets:

SEBI regulates stock exchanges, securities brokers, mutual funds, and depositories. It enforces listing and disclosure norms to protect investor interests.

Insurance:

IRDAI oversees life and non-life insurance companies, ensuring they comply with underwriting and solvency regulations. It approves insurance products and premium rates.

Pension:

PFRDA regulates and promotes the NPS, which is a voluntary long-term retirement savings scheme. It ensures transparency, portability, and choice for pension subscribers.

Q XI Which Act brought the term “financial services” into prominence by allowing banks to enter insurance and investment sectors?

- a) Banking Regulation Act
- b) Securities Contract Regulation Act
- c) Gramm-Leach-Bliley Act
- d) Companies Act

Q XII Which of the following regulates the insurance industry in India?

- a) SEBI

- b) RBI
- c) IRDAI
- d) PFRDA

Q XIII Regional Rural Banks (RRBs) were established mainly to:

- a) Provide short-term trade finance to exporters
- b) Extend credit to small and marginal farmers, artisans, and rural entrepreneurs
- c) Offer high-value credit facilities to corporations
- d) Supervise cooperative banks at the state level

QXIV Which of the following is responsible for regulating pension funds and the National Pension System (NPS) in India?

- a) SEBI
- b) PFRDA
- c) Ministry of Finance
- d) NABARD

QXV The primary regulator of the securities market in India is:

- a) SEBI
- b) RBI
- c) IRDAI
- d) Ministry of Finance

1.8 ANSWERS FOR CHECK YOUR PROGRESS

Question No.	Answer	Question No.	Answer	Question No.	Answer
I	T	VI	b	XI	c
II	F	VII	b	XII	c
III	T	VIII	b	XIII	b
IV	F	IX	b	XIV	b
V	T	X	b	XV	a

Terminal Questions

- Q1 What are the three primary functions of the financial system within an economy?
- Q2 Discuss the role of government intervention in the financial system. How does government intervention contribute to both efficiency and stability within the financial sector?
- Q3 Explain the role of the primary capital market in the financial system. What are the three methods for offering new issues in the primary capital market?
- Q4 Explain the role of financial institutions in the movement of resources within an economy, and why are they considered a vital source of long-term capital?
- Q5 State the objectives of the Financial Services
- Q6 What is the primary role of the Reserve Bank of India (RBI) in the Indian financial regulatory framework?
- Q7 Which regulatory authority oversees the securities markets in India, including stock exchanges and mutual funds?

Suggested Readings:

- Khan, M. Y. (2019). *Indian financial system*. Tata McGraw Hill.
- Bhole, M. K. (2017). *Financial markets and institutions*. Macmillan Publishing Co. Inc.
- Madura, J. (2015). *Financial markets and institutions*. West Publishing Company.

CERTIFICATE COURSE IN STOCK MARKET AND TRADING OPERATIONS

GC-CST1: ELEMENTS OF FINANCIAL SERVICES AND MARKET

UNIT II – Types of Financial Services – Mutual Funds, Factoring, Housing Finance

Structure

- 2.0 Introduction to Financial Services
- 2.1 Characteristics of Financial Services
- 2.2 Evolution of Financial Services in India
- 2.3 Significance of Financial Services
- 2.4 Types of Financial Services
- 2.5 Impact of Technology On The Financial Services Sector
- 2.6 Challenges before the Financial Services Sector
- 2.7 Conclusion

Objectives

After studying this unit, you will be able to:

1. Understand the concept, scope, and importance of financial services in an economy.
2. Explain how financial services contribute to economic growth and stability.
3. Trace the evolution of financial services in India from its regulated infancy stage to today's technology-driven era.
4. Describe the unique characteristics that differentiate financial services from physical products.
5. Classify and analyze various types of financial services (Fee-Based, Fund-Based, Insurance) with practical examples.

2.0 INTRODUCTION TO FINANCIAL SERVICES

Financial services are an essential component of any modern economy, acting as a facilitator for the smooth functioning of money, credit, and investments. While the term “financial services” has gained significant prominence over the past 25–30 years, its roots can be traced back centuries, evolving alongside trade, commerce, and economic development. In countries like the UK, the financial services industry broadly includes banking, insurance, stockbroking, investment advisory, venture capital, leasing, mutual funds, and a wide range of professional services. In simpler terms, financial services can be defined as activities, processes, and services that ensure the effective flow of money, financial instruments, and investment opportunities within an economy.

The financial services sector plays a crucial role in supporting **financial institutions, markets, and instruments**. It provides individuals and organizations with solutions to save, invest, borrow, and manage their funds. It is regarded as the **fourth pillar of the financial system**, alongside financial institutions, markets, and instruments. Without financial services, the other three pillars cannot operate efficiently, as services bridge the gap between savers and borrowers, thereby ensuring capital flows smoothly through the economy.

Over the last few decades, rapid globalization, liberalization, and technological advancement have transformed financial services into a highly competitive and innovative industry. Traditionally, services like bill discounting, leasing, and factoring dominated this sector, but now, **digital payment systems, mutual funds, venture capital, and insurance solutions** have gained significant importance.

Financial service providers can be broadly divided into two categories:

1. **Asset Management Companies** – Firms that manage and invest client funds, such as mutual funds, merchant bankers, leasing firms, and portfolio managers.
2. **Liability Management Companies** – Firms focusing on financing activities such as acceptance houses and bill discounting firms.

Furthermore, convergence in the industry has blurred the boundaries between financial institutions. For instance, banks now provide insurance (bancassurance), investment management, and wealth advisory services, while non-banking financial companies (NBFCs)

offer loans, leasing, and fintech-driven solutions.

Financial services are not merely about raising funds but also about ensuring **optimal utilization of resources**, investment planning, and risk management. For example, bill discounting allows businesses to access immediate cash by selling bills of exchange, while venture capital supports start-ups with high growth potential.

This sector's significance cannot be overstated because it ensures economic development by mobilizing savings, facilitating investments, and maintaining liquidity in the system. Additionally, **regulatory bodies such as SEBI, RBI, and IRDA** play a critical role in monitoring transparency and ensuring investor protection.

In today's fast-paced financial environment, financial services have become indispensable, contributing not just to individual wealth creation but also to **nation-building by creating a robust financial ecosystem**.

2.1 CHARACTERISTICS OF FINANCIAL SERVICES

Financial services differ significantly from tangible products because they are **intangible, customer-focused, dynamic, and time-sensitive**. Their success depends on trust, expertise, and adaptability rather than physical attributes. Following are the characteristics of Financial Services

2.1.1 Customer-Specific Services

One of the most defining features of financial services is their **customer-centric nature**. Unlike physical products, which are standardized, financial services are designed and customized to match individual customer needs, risk appetite, and financial goals. Providers of these services — whether banks, insurance companies, or NBFCs — begin by thoroughly analyzing client requirements through financial assessments and market surveys. Factors such as the **cost of service, liquidity needs, maturity period, and future returns** are carefully considered before suggesting a solution.

For example, a high-net-worth individual (HNI) may need **wealth management services** that include tax planning, estate management, and equity investment portfolios, while a salaried middle-class person may prefer **systematic investment plans (SIPs)** and affordable insurance products. Similarly, a business may seek working capital financing or venture capital, whereas a rural farmer might need a crop insurance policy or agricultural loan.

Technology plays a crucial role in tailoring services. For instance, **Robo-advisory platforms** such as Groww and Zerodha use AI-based algorithms to design investment plans for customers based on their risk profiles and goals. Thus, financial services are inherently **relationship-driven**, requiring a deep understanding of client expectations and market trends. Regular feedback loops, CRM (Customer Relationship Management) systems, and constant innovation are used to create **personalized financial solutions**. This focus on customization differentiates financial services from mass-market goods.

2.1.2 Intangibility

Financial services are **intangible**, meaning they cannot be physically seen, touched, or stored like tangible goods. This creates a unique challenge: customers cannot evaluate the “quality” of a financial service before purchase. Instead, they rely on **brand reputation, trust, reviews, and service experience**.

For example, when an individual deposits money in a bank, they cannot physically “see” their money grow but trust that the bank will safeguard funds and provide interest. Similarly, buying insurance is purchasing a **promise** of future protection, not a tangible product.

Financial institutions overcome this challenge by building a **strong brand image** and investing in customer trust. For example, **HDFC Bank, LIC, and SBI** are popular in India because of their credibility and long-standing performance. Institutions also use **advertising, transparent policies, and customer-friendly apps** to bridge the gap created by intangibility. In today’s fintech era, trust-building also involves **digital transparency**. Payment apps like Paytm and PhonePe use instant transaction notifications, monthly statements, and two-factor authentication to assure customers about safety and reliability. The intangible nature of financial services

requires institutions to focus heavily on **service quality, security, and reputation**, as these factors drive customer loyalty.

2.1.3 Concomitant Nature

Financial services are **produced and delivered simultaneously**, unlike physical goods that can be manufactured, stored, and distributed later. For instance, when a bank approves a home loan, the service is “created” and “delivered” at the same moment the loan is disbursed. Similarly, online stock trading platforms provide **real-time services**, where the moment a customer clicks “buy,” the trade is executed instantly. This simultaneity makes **timely service delivery critical**. Delays or errors can result in **financial losses, reputational damage, and customer dissatisfaction**. For example, a delay in processing a loan for a business client could result in missed investment opportunities. To handle this, financial institutions adopt **automation, AI-powered chatbots, and real-time tracking systems**. Apps like Zerodha, Groww, and ICICI Direct allow customers to buy and sell securities instantly without human intervention. Since financial services cannot be stockpiled, institutions must continuously invest in **skilled employees and advanced technology infrastructure** to ensure smooth, quick, and error-free delivery. This characteristic highlights the importance of agility and real-time responsiveness in the financial services industry.

2.1.4 Tendency to Perish

Unlike physical goods that can be stored for later use, financial services **cannot be inventoried**. If a service is not consumed at a particular moment, the opportunity is lost. For example, if a bank loan officer is idle during work hours, the time cannot be stored or resold later. Similarly, if a credit card is not used during a reward campaign, the opportunity for benefits is lost forever. This perishability increases the **cost of idle resources** in the sector, such as unused employee hours, underutilized technology, or unexecuted trades. Financial institutions, therefore, focus on **demand forecasting, capacity planning, and resource optimization**.

For example, banks and NBFCs launch **promotional loan schemes** during festive seasons to drive customer activity. Stockbrokers often incentivize trading during market hours with cashback or reduced brokerage fees. Similarly, insurers use **limited-time offers** to ensure

customers act promptly. In a competitive environment, perishability forces financial institutions to adopt **lean operations** and advanced **customer engagement strategies** to maximize service utilization and profitability.

2.1.5 People-Based Services

Financial services rely heavily on human expertise and customer interaction, making them **people-intensive**. Employees act as brand ambassadors of financial institutions because customers often judge a service by the professionalism and knowledge of staff. For example, a poorly trained insurance agent may miscommunicate policies, leading to customer dissatisfaction. To address this, banks and financial institutions invest in **employee training, soft skills development, and financial certifications**. For instance, the **Indian Institute of Banking & Finance (IIBF)** offers professional certifications to bankers, ensuring standard knowledge levels. In India, private banks like **HDFC Bank and Kotak Mahindra Bank** are known for superior service quality, which gives them an edge over public-sector banks. Wealth management services, investment advisory, and credit risk evaluation are all highly **people-driven**, requiring expertise, trust-building, and personalized communication. Even in the era of automation, the human element remains critical in **relationship management and decision-making**. For example, while robo-advisors provide data-driven investment advice, high-net-worth clients still rely on human wealth managers for personalized guidance. This characteristic emphasizes the importance of **skilled human resources** and strong customer service culture in financial institutions.

2.1.6 Market Dynamics

Financial services are highly influenced by **social, economic, and demographic factors**. Demand for services changes based on customer income levels, lifestyle trends, and macroeconomic conditions. For example, rising disposable incomes and urbanization have boosted demand for **credit cards, insurance, and wealth management products** in India. Financial institutions must constantly adapt to these market changes. They can be **proactive**, predicting future demand (e.g., fintech apps like Paytm anticipated the digital

payments boom before demonetization), or **reactive**, responding to customer demand trends (e.g., banks introducing buy-now-pay-later schemes after observing consumer credit needs).

Another example is **microfinance institutions (MFIs)**, which emerged to cater to rural and low-income households who were previously excluded from banking. Similarly, the increasing focus on sustainability has given rise to **green bonds** and ESG (Environmental, Social, Governance) funds. This characteristic demonstrates that financial services are **dynamic and demand-driven**, requiring companies to constantly innovate, rebrand, and introduce new offerings to remain competitive.

2.2 EVOLUTION OF FINANCIAL SERVICES IN INDIA

The Indian financial services sector has evolved tremendously over the last six decades, transitioning from a heavily regulated and government-driven system to a dynamic, technology-enabled, and globally integrated industry. Its development can be divided into **four distinct phases**:

2.2.1 Stage of Infancy (1960–1980)

The period from **1960 to 1980** marked the infancy stage of financial services in India. This was a time when the country was emerging from colonial rule, and the primary focus was on nation-building, industrial development, and financial stability. During this period, financial services were largely controlled by the **government and public-sector enterprises**, with minimal private sector participation.

1. Merchant Banking Beginnings

Merchant banking services were relatively unknown in India during the early 1960s. The Industrial Credit and Investment Corporation of India (ICICI) was the first to start merchant banking activities in 1972, offering services like:

- **Project identification and feasibility studies**
- **Financial and marketing analysis**
- **Capital structuring and underwriting support**

- **Legal advice for mergers and acquisitions**

These services created a link between **capital markets and companies** seeking funds, laying the groundwork for future growth.

2. **Nationalisation of Insurance**

Insurance became a central part of financial services during this stage:

- In **1956**, the **Life Insurance Corporation of India (LIC)** was established by nationalizing over 240 private insurance companies.
- In the **early 1970s**, the general insurance sector was also nationalized. A holding company and four subsidiaries — National Insurance, New India Assurance, Oriental Insurance, and United India Insurance — were formed. This step ensured wider insurance coverage for citizens, especially in rural areas.

3. **Leasing Services Growth**

Leasing emerged as an innovative financing option in the late 1970s. Companies began leasing equipment and machinery instead of purchasing them outright, helping businesses save capital and reduce risks. By the late 1970s, there were almost **400 leasing companies** operating in India, though many were later restructured due to non-viability.

4. **Economic Context**

This phase coincided with the **License Raj**, where the government strictly regulated industries. Financial services were limited to traditional banking, insurance, and equipment financing. Private sector participation was minimal, and innovation was slow. However, this stage laid the foundation for future reforms.

Example:

A medium-sized manufacturing company in 1975 could approach LIC for insurance, a public-sector bank for term loans, and ICICI for project financing, showing that all financial services were concentrated in **public-sector hands**.

2.2.2 Modern Financial Services (Late 1980s)

The late 1980s marked a **turning point** in India's financial services sector. The demand for innovative financial products and services grew as the Indian economy gradually liberalized. This era saw the introduction of **modern services, credit rating agencies, mutual funds, and venture capital.**

1. Rise of Mutual Funds

Mutual funds became a popular instrument for small investors, allowing them to invest in a diversified portfolio managed by professionals.

- The **Unit Trust of India (UTI)**, established in 1963, dominated the mutual fund industry.
- By the late 1980s, other public sector institutions such as **State Bank of India (SBI), LIC, and GIC** also entered this market.

Mutual funds gave retail investors a safer, transparent way to invest in equities and bonds.

2. Credit Rating Introduction

Credit rating was introduced in the mid-1980s to enhance investor confidence and prevent fraudulent fundraising by companies.

- **CRISIL** was established in 1987 as India's first credit rating agency, followed by **ICRA (1991)** and **CARE (1993)**.
- Initially, these agencies rated debt instruments like debentures but later expanded to commercial papers and fixed deposits.

3. Factoring and Discounting

Factoring companies like **SBI Factors** and **Canbank Factors** started offering receivable financing services to companies, helping them manage working capital effectively.

4. Venture Capital

Venture capital financing was introduced in this period, largely dominated by public sector financial institutions like ICICI and IFCI. It provided funding for high-risk, innovative ventures, especially in technology-driven industries.

5. Shift Toward Professionalization

The 1980s marked a transition toward **professional, service-oriented financial offerings**. Employees were trained in specialized domains, leading to better customer support and higher efficiency.

Example:

A small investor in 1989 could invest ₹1,000 in a mutual fund managed by UTI and benefit from diversification, something that was previously only available to wealthy individuals.

2.2.3 The Third Flush (1990s Onwards)

The **economic liberalization of 1991** brought a seismic shift in the Indian financial services sector. Government control reduced significantly, foreign investments were encouraged, and private players entered the market, resulting in unprecedented growth.

1. Dematerialisation and Online Trading

The introduction of **demat accounts** and online trading platforms revolutionized the capital markets. Investors no longer needed physical share certificates, reducing fraud and delays.

- **National Securities Depository Limited (NSDL)** was established in 1996, making shareholding paperless.
- **Bombay Stock Exchange (BSE)** and **National Stock Exchange (NSE)** launched electronic trading platforms, increasing transparency and reducing costs.

2. Regulatory Reforms

The **Securities and Exchange Board of India (SEBI)** emerged as a powerful regulator, introducing norms for investor protection, corporate governance, and merchant banker regulation.

- Reforms in the **Companies Act (1956)** and **Income Tax Act** streamlined business regulations.

3. **Global Investments and MNC Entry**

Foreign institutional investors (FIIs) were allowed to invest in Indian markets, leading to a surge in foreign capital inflows. Firms like **Goldman Sachs and Lehman Brothers** began collaborating with Indian players, globalizing Indian finance.

4. **Insurance Sector Reforms**

The establishment of the **Insurance Regulatory and Development Authority (IRDA) in 1999** opened the insurance sector to private and foreign players. Banks were also permitted to sell insurance products, leading to **bancassurance models**.

5. **Disinvestment of Public Sector Enterprises**

The privatization and disinvestment of PSUs created new opportunities for merchant bankers and equity analysts to manage public offerings.

Example:

An investor in 1998 could purchase shares online through NSE, invest in private insurance products like ICICI Prudential, and use foreign brokerage firms to diversify globally.

2.2.4 Introduction of New Financial Instruments (2000s–Present)

The post-2000 era is characterized by **rapid innovation, technology integration, and the creation of new financial instruments**. India embraced globalization, fintech startups flourished, and the financial ecosystem became highly competitive.

1. **Securitisation**

Banks started converting loans and receivables into marketable securities to raise funds. For example, housing loans were pooled and sold as mortgage-backed securities, increasing liquidity.

2. **Derivatives Market Growth**

Instruments like **futures, options, swaps, and forward contracts** gained traction, helping investors hedge against interest rate, currency, and commodity risks. Today, NSE's derivatives segment is among the largest in the world.

3. **Fintech Revolution**

Fintech companies such as **Paytm, PhonePe, Zerodha, and Razorpay** have disrupted

traditional services by offering **digital wallets, UPI-based transactions, robo-advisory platforms, and automated lending services.**

4. **Global Capital Access**

Indian firms now raise funds globally through **Global Depository Receipts (GDRs), American Depository Receipts (ADRs), and External Commercial Borrowings (ECBs)**, integrating India with global capital markets.

5. **ESG and Sustainable Finance**

With growing focus on sustainability, financial institutions now issue **green bonds** and ESG-linked investment products, attracting environmentally conscious investors.

6. **Digital Inclusion**

Government initiatives like **Jan Dhan Yojana** and UPI (Unified Payments Interface) have enabled millions of unbanked Indians to access formal banking, further deepening financial inclusion.

Example:

In 2023, a small business owner can use a mobile app to get instant working capital through fintech lenders, hedge currency risk through futures contracts, and raise funds by securitizing invoices.

CHECK YOUR PROGRES

EXERCISE-1

1. **Which of the following best defines financial services?**
 - a) Services that involve manufacturing goods
 - b) Services provided by the finance industry to manage money
 - c) Services related to agriculture
 - d) None of these
2. **Financial services are mainly concerned with:**
 - a) Tangible goods
 - b) Production of goods
 - c) Creation and transfer of financial assets
 - d) Import of machinery
3. **Which of the following is *not* a characteristic of financial services?**
 - a) Intangibility

- b) Customer-specific services
 - c) Standardized and identical for all
 - d) Involves risk and uncertainty
4. **The evolution of financial services in India gained momentum after:**
- a) 1947
 - b) 1969
 - c) 1991 economic reforms
 - d) 2000
5. **True or False:** Financial services act as an intermediary between savers and investors.
6. **True or False:** The Indian financial sector was completely liberalized before 1980.
7. **Which of the following played a key role in the modernization of financial services in India?**
- a) Industrial Revolution
 - b) Liberalization, Privatization, and Globalization (LPG)
 - c) Independence Movement
 - d) Green Revolution

2.3 SIGNIFICANCE OF FINANCIAL SERVICES

Financial services play a critical role in driving economic growth and development by mobilizing savings, channelizing investments, managing risks, and supporting trade and industry. They serve as the backbone of a country's financial system, enabling individuals, businesses, and governments to efficiently allocate resources, manage funds, and achieve financial goals. Below are the key areas highlighting their significance:

2.31. Economic Growth and Development

Financial services stimulate economic growth by mobilizing savings from households and channeling them into productive investments. Banks, mutual funds, insurance companies, and capital markets act as intermediaries, ensuring that idle funds are directed towards sectors like infrastructure, manufacturing, and services, boosting employment opportunities and GDP growth. A robust financial services sector also attracts foreign investment, improving capital inflow and supporting economic stability.

2.3.2. Capital Formation

Capital formation is essential for industrialization and business expansion. Financial services encourage savings by providing safe and diverse investment avenues such as fixed deposits, bonds, mutual funds, and pension plans. These mobilized savings are converted into capital for entrepreneurs and corporates through loans, share issuance, and other instruments, strengthening the foundation of a nation's economy.

2.3.3. Efficient Intermediation

Financial services act as a bridge between surplus and deficit units in an economy. By efficiently allocating funds from savers to borrowers, they ensure that resources are not left idle. Banks, stock markets, and NBFCs (Non-Banking Financial Companies) facilitate this flow of funds, thereby enhancing liquidity, promoting investment, and ensuring smooth functioning of economic activities.

2.3.4. Promotion of Entrepreneurship

Entrepreneurs often require timely financial support to transform ideas into reality. Financial services provide venture capital, working capital loans, and credit facilities to entrepreneurs and startups. Moreover, they offer advisory services, portfolio management, and risk assessment, empowering new businesses to scale operations and compete globally.

2.3.5. Credit Creation

Financial services facilitate credit creation, which fuels consumption and investment. Banks lend money in excess of their reserves, helping businesses to expand, purchase machinery, or invest in technology. This multiplier effect of credit creation accelerates economic growth, fosters innovation, and encourages production.

2.3.6. Risk Management

Risk is an inherent part of financial transactions. Financial services such as insurance, hedging, and derivatives provide tools to manage financial risks arising from unforeseen events, currency

fluctuations, or market volatility. Insurance companies, for instance, help individuals and businesses secure themselves against life, property, or liability risks, ensuring economic resilience.

2.3.7. Financial Inclusion and Social Welfare

Financial services promote financial inclusion by offering banking, microfinance, and digital payment services to marginalized communities. This reduces economic disparities and empowers individuals to save, invest, and plan for emergencies. Government schemes such as Jan Dhan Yojana in India have further highlighted the role of financial services in bringing the unbanked population into the formal economy.

2.3.8. Globalization and Trade Facilitation

Financial services support international trade through foreign exchange services, trade credit, export financing, and letters of credit. This promotes globalization, strengthens foreign relations, and ensures that businesses can compete in global markets.

CHECK YOUR PROGRES

EXERCISE-2

Questions:

1. **Financial services contribute to economic growth by:**
 - a) Reducing financial literacy
 - b) Mobilizing savings and facilitating investments
 - c) Increasing inflation
 - d) Promoting only public sector
2. **Which of the following is a *fund-based* financial service?**
 - a) Merchant banking
 - b) Leasing and hire purchase
 - c) Credit rating
 - d) Advisory services
3. **Which of the following is a *non-fund-based* financial service?**
 - a) Factoring
 - b) Venture capital

- c) Underwriting
- d) Leasing
- 4. **True or False:** Financial services promote employment opportunities by supporting new business ventures.
- 5. **True or False:** Only banks provide all types of financial services in an economy.
- 6. **Which of the following is *not* a type of financial service?**
 - a) Insurance
 - b) Investment management
 - c) Manufacturing services
 - d) Asset management
- 7. **The significance of financial services includes:**
 - a) Enhancing liquidity in the economy
 - b) Creating financial instability
 - c) Restricting savings
 - d) None of these

2.4 TYPES OF FINANCIAL SERVICES

Financial services form the backbone of any economy, enabling smooth functioning of businesses, governments, and households. These services can broadly be categorized into **fee-based services, fund-based services, and insurance services**. Each category plays a unique role in mobilizing resources, facilitating transactions, and managing financial risks. Let's explore them in depth.

2.4.1. Fee-Based Financial Services

Fee-based services refer to those financial services where financial institutions, banks, or intermediaries earn a **fee or commission** for providing advisory, facilitation, or expertise without directly committing their own funds. Here, the primary role of the financial institution is **advisory or intermediary**, not investing.

Key Features

- The institution earns **fees, commissions, or consultancy charges** instead of interest income.

- These services involve **expert knowledge and skills** in structuring deals, raising funds, or managing risks.
- There is **low financial risk** for the service provider because they are not deploying their own funds.
- Widely used in corporate finance, capital markets, and investment advisory.

Examples of Fee-Based Services

1. Merchant Banking:

Merchant bankers provide services such as raising funds through equity or debt issues, underwriting, and advisory for mergers and acquisitions.

Example: A merchant banker helps a startup raise ₹50 crores through a private placement of shares, charging a 2% commission.

2. Portfolio Management Services (PMS):

Portfolio managers invest clients' funds in equity, debt, or mutual funds and charge a management fee.

Example: HDFC Securities offers PMS to high-net-worth individuals, charging an annual fee of around 1-2% of assets under management.

3. Credit Rating:

Rating agencies evaluate the creditworthiness of a company or government bond issue.

Example: CRISIL rating a corporate bond issue AAA, indicating low risk, and charging the issuer for the rating service.

4. Investment Banking and Advisory:

Investment banks provide M&A (mergers and acquisitions) advisory and strategic consulting.

Example: Goldman Sachs advising Reliance Industries on its acquisition of a global business.

5. Stockbroking and Underwriting:

Stockbrokers facilitate buying and selling of securities, earning brokerage fees, while underwriters guarantee subscription of shares or debentures for a fee.

Example: Zerodha earns brokerage fees from investors for trading stocks.

6. Leasing Advisory and Consultancy:

Financial institutions offer guidance on leasing arrangements, tax implications, and legal structure.

Example: A bank advises a company on leasing industrial machinery instead of purchasing it.

Importance of Fee-Based Services

- Enable **corporate growth** by helping firms raise capital efficiently.
- Provide **specialized expertise** that small and medium enterprises often lack in-house.
- Low risk for service providers as they are not lending their own funds.
- Facilitate **financial market development** by connecting investors and issuers.

2.4.2. Fund-Based Financial Services

Fund-based services are those where financial institutions deploy **their own funds** or borrowed funds to earn returns in the form of **interest, lease rentals, or capital gains**. Here, the financial institution takes on more **risk** because it invests or lends its own resources.

Key Features

- The institution **uses its own capital** or borrowed funds to earn income.
- Revenue is primarily from **interest, dividends, rentals, or appreciation of assets**.
- There is **higher risk** as funds are committed.
- Involves **direct financing** of clients.

Examples of Fund-Based Services

1. Term Loans and Working Capital Finance:

Banks provide loans to businesses for capital expenditure, expansion, or working capital needs.

Example: SBI provides a ₹100 crore term loan to a manufacturing company at 9% interest.

2. **Leasing and Hire Purchase:**

Leasing involves financing an asset while retaining ownership, whereas hire purchase allows ownership transfer after payment of installments.

Example: A bank leases an aircraft to an airline, earning regular lease rentals.

3. **Venture Capital and Private Equity Funding:**

Venture capital firms invest in startups, taking equity stakes in return.

Example: Sequoia Capital invests ₹100 crore in a fintech startup for a 20% stake.

4. **Factoring and Forfaiting:**

Factoring involves purchasing a company's receivables at a discount, while forfaiting deals with international receivables.

Example: SBI Factors buys ₹5 crore worth of receivables from an exporter, paying them upfront.

5. **Housing Finance:**

Financial institutions provide loans for purchasing or constructing homes.

Example: HDFC Bank offers a ₹50 lakh home loan at a fixed or floating interest rate.

6. **Equipment Financing:**

Banks and NBFCs provide loans for purchase of heavy machinery or vehicles.

Example: A logistics firm purchases trucks using loans from Tata Capital.

7. **Mutual Funds:**

Asset management companies (AMCs) pool investor funds and invest in diversified securities, charging management fees.

Example: SBI Mutual Fund invests pooled investor funds in equity and debt instruments.

Importance of Fund-Based Services

- Provide **capital access** to businesses for growth and expansion.
- Help individuals achieve financial goals like home ownership or education.
- Promote **industrial and infrastructure development** by funding large projects.
- Encourage **investment culture** through products like mutual funds and venture capital.

2.4.3. Insurance Services

Insurance services protect individuals and businesses against financial losses due to unforeseen risks. By pooling risk and charging premiums, insurance companies provide **financial security and risk management solutions**.

Key Features

- Involves **risk pooling** and spreading losses among policyholders.
- Provides **financial compensation** in case of adverse events.
- Includes both **life insurance** (human life risk) and **general insurance** (property, health, liability risks).
- Encourages **savings and investments** through certain products like endowment plans and ULIPs.

Types of Insurance Services

1. Life Insurance:

Offers financial protection against the death of the insured person.

Example: LIC's term insurance plan provides ₹1 crore coverage for a yearly premium of ₹10,000.

2. Health Insurance:

Covers medical expenses for illnesses, surgeries, or hospital stays.

Example: Star Health Insurance covers up to ₹5 lakh per person per year.

3. Property and Motor Insurance:

Protects homes, vehicles, or industrial assets from risks like fire, theft, and accidents.

Example: ICICI Lombard offers motor insurance that covers damages due to accidents.

4. Business Interruption Insurance:

Provides coverage for losses due to events that halt business operations.

Example: A hotel takes a business interruption policy to cover losses due to a natural disaster.

5. Reinsurance:

Insurance companies transfer part of their risks to other insurers.

Example: GIC Re (General Insurance Corporation of India) reinsures risks for Indian insurers.

Importance of Insurance Services

- Provides **financial stability** for individuals and families.
- Helps businesses manage risks and protect assets.
- Encourages **savings and investments** via life insurance policies.
- Promotes **economic growth** by reducing uncertainty and encouraging entrepreneurship.

Comparison of Fee-Based, Fund-Based, and Insurance Services

Feature	Fee-Based Services	Fund-Based Services	Insurance Services
Primary Revenue Source	Fees, commissions, advisory charges	Interest, rentals, capital gains	Premiums
Risk to Provider	Low	High	Moderate
Role	Advisory, intermediation	Direct financing, investing	Risk pooling, protection
Examples	Merchant banking, stockbroking	Loans, leasing, mutual funds	Life insurance, health cover

Financial services are vital for the smooth functioning of economies, enabling capital formation, efficient intermediation, and risk management. **Fee-based services** leverage expertise and advisory roles, **fund-based services** focus on deploying capital for income, and **insurance services** safeguard against unforeseen losses. Together, they form a robust financial ecosystem that drives economic growth, supports individuals and businesses, and promotes stability.

2.5 IMPACT OF TECHNOLOGY ON THE FINANCIAL SERVICES SECTOR

The financial services industry, both in India and globally, is one of the **fastest-growing sectors** of the economy. It plays a **vital role** in ensuring the health of the global economy and also affects businesses and consumers on a daily basis.

Technology—particularly **Information Technology (IT)**—has transformed the way financial services are delivered, making them faster, cheaper, and more customer-friendly. This transformation is often called the "**Information Revolution**". Let's explore the impact of technology **from both service providers' and customers' perspectives**.

2.5.1 From the Service Providers' Point of View

Financial institutions such as banks, insurance companies, NBFCs (Non-Banking Financial Companies), and fintech firms benefit immensely from IT. Here's how:

Cost Savings

Technology has drastically reduced the **cost of transactions**.

- A single banking transaction costs:
 - ₹50 when done **through a branch** (manual process).
 - ₹15 when done **through an ATM**.
 - ₹4 when done **online or through mobile banking**.

This shows that by using technology, banks can save costs and pass these savings to customers, offering them cheaper services and gaining a **competitive advantage**.

Example:

If a bank shifts 10 lakh transactions from branches to online platforms, it can save **₹46 per transaction**. This totals savings of ₹46 crores, improving profitability and allowing banks to invest in better services.

Labour Cost Reduction

Before computerisation, banks needed many clerks and officers for tasks like updating passbooks, handling deposits, or issuing cheques.

- With **networking and automation**, one employee can now do the work of many.

- **Single Window Systems** allow customers to complete multiple tasks at one counter, reducing queues and manpower needs.

Example:

Previously, a bank branch may have required **10 staff members** for various counters. Today, with automation, the same branch can run efficiently with **4-5 staff members**, reducing costs significantly.

Product Development and Innovation

Technology enables banks to **create new financial products** or provide traditional services in **new ways**:

- Debit cards and credit cards replace cash or cheques.
- Online share-trading platforms simplify stock buying and selling.
- ATMs now offer railway ticket bookings, bill payments, and even mini statements.

Example:

Internet banking isn't a "new" service but an **online version of traditional banking**. Similarly, mobile wallets like **Paytm or Google Pay** let users send money instantly—replacing the need for physical cash transfers.

Marketing Tool

Marketing in financial services is complex and people-intensive. Technology simplifies this:

- **Database technology** allows banks to analyse customer data and offer personalised services.
- **INFINET** (Indian Financial Network) uses satellite-based VSAT technology, enabling banks to operate nationwide and enter **new markets**.

Example:

If a customer frequently books travel tickets using their debit card, banks can market **travel insurance** or **holiday loan offers** to that customer.

Delivery Channels

Technology has introduced "**Anytime, Anywhere Banking**":

- Customers can use **ATMs, internet banking, mobile apps, or call centres**.
- **SWIFT** network allows **instant cross-border transactions**.
- Banks provide services through multiple devices—PCs, mobile phones, and even smartwatches.

Example:

An NRI in the US can transfer funds to India via SWIFT in minutes without visiting a bank branch.

Decision-Making Aid

Financial institutions use **Artificial Intelligence (AI)** and **Expert Systems** for repetitive decision-making, such as loan approvals.

- AI ensures **consistency** and saves time.
- Managers still make final decisions, but technology improves **speed and accuracy**.

Example:

AI tools can analyse a borrower's credit history and decide whether they are eligible for a loan within seconds.

Globalisation

Technology has broken geographical barriers, making finance a **global industry**:

- Internet banking allows customers worldwide to access Indian bank services.
- Indian banks can market services globally, competing with international players.

Example:

Today, Indian fintech companies like **Razorpay and PayU** serve clients across multiple countries, thanks to tech-driven globalisation.

2.5.2 From the Customers' Point of View

Technology has transformed customer experiences, making financial services **faster, simpler, and more transparent**:

Accessibility

Customers can easily access details about financial products and compare services online.

Example:

Before choosing a credit card, a customer can compare fees, interest rates, and rewards across different banks using comparison websites.

Convenience

- Customers no longer need to visit banks to withdraw cash or check balances.
- **ATMs** and **mobile apps** allow 24/7 access.
- Call centres and online chat support make problem resolution quicker.

Example:

A customer can transfer money from their smartphone while sitting at home, instead of standing in bank queues.

Speedier Transactions

- **Real-Time Gross Settlement (RTGS)** and **NEFT** enable instant fund transfers.
- NRIs can send money to India anytime using online remittance services.
- Depository systems (like **NSDL/CDSL**) make share trading and settlement much faster.

Example:

Earlier, selling shares and getting payment took **7-10 days**. Today, it's settled within **T+1 (next working day)**.

2.6 CHALLENGES BEFORE THE FINANCIAL SERVICES SECTOR

Despite these benefits, technology has also created **new challenges**:

1. Need for a Flexible Organisational Structure

- Financial institutions must redesign their structure to handle competition and rapid growth.
- This requires **decentralisation, clear delegation of powers, and constant monitoring.**

2. Continuous Training of Employees

- Staff must be trained in **IT systems**, online transactions, and customer service.
- Regular skill upgrades are necessary to keep up with rapid tech changes.

Example: Many public sector banks have retrained thousands of employees to adapt to **mobile banking and UPI payments.**

3. Global Competition

- India signed the **Financial Services Agreement (FSA)**, allowing foreign players into India.
- Indian banks now compete globally and must adopt international practices.

4. Size and Consolidation Challenges

- Indian banks are small compared to global giants.
- Consolidation and mergers are essential for survival.

Example: The **merger of SBI with its associate banks** strengthened its position in global rankings.

5. Need for Product Innovation

- Firms must create **customer-friendly and cost-effective products.**
- Tech helps lower transaction costs but demands constant innovation.

6. Integrated Delivery Channels

Banks must develop **multi-channel platforms** that provide seamless services (online, ATM, mobile apps, etc.).

7. Security Risks

- Online fraud, hacking, and phishing are major threats.
- Banks must adopt global standards like **ISO 17799** or **BS 7799** to ensure data security.

Example: Banks now use **OTP verification, biometric logins, and AI fraud detection**.

8. Rural Penetration

- Most IT benefits are limited to cities.
- Banks must create **multi-lingual platforms** and invest in rural infrastructure.

Example: Payment apps like **BHIM UPI** support multiple regional languages to encourage rural adoption.

CHECK YOUR PROGRES

EXERCISE-3

Questions:

1. **Which of the following technological innovations has revolutionized financial services?**
 - a) Artificial Intelligence and FinTech
 - b) Typewriters
 - c) Steam engines
 - d) Manual record-keeping
2. **Digital banking primarily aims to:**
 - a) Increase paperwork
 - b) Provide faster and convenient services to customers
 - c) Reduce customer access to accounts
 - d) Eliminate all banking services

3. **One major challenge faced by financial services today is:**
 - a) Increasing digital security threats
 - b) Lack of customer awareness
 - c) Regulatory compliance issues
 - d) All of the above
4. **True or False:** Blockchain technology improves transparency and reduces fraud in financial transactions.
5. **True or False:** Cybersecurity is not a concern in financial services.
6. **FinTech companies have contributed to:**
 - a) Slowing down digital payments
 - b) Enhancing innovation and competition
 - c) Reducing financial inclusion
 - d) None of these
7. **Which of the following is a key technological impact on the financial sector?**
 - a) Mobile banking and UPI payments
 - b) Barter system
 - c) Manual cash transactions only
 - d) Paper-based systems

2.7 CONCLUSION

Financial services form the backbone of a nation's economic development. They play a crucial role in mobilizing savings, facilitating investments, and ensuring efficient allocation of financial resources.

Over time, financial services in India have evolved significantly — from traditional banking and insurance models to a diverse, technology-driven ecosystem that includes FinTech, digital payments, online trading, and innovative investment platforms.

The significance of financial services lies in their contribution to economic growth, employment generation, wealth creation, and financial inclusion. By offering a wide range of fund-based and non-fund-based services, the sector supports both individuals and businesses in managing their financial needs efficiently.

With the advent of technology, the financial sector has become more customer-centric, efficient, and transparent, though it also faces new challenges such as cybersecurity risks, regulatory compliance, and maintaining trust in digital systems.

In conclusion, the financial services sector in India continues to evolve as a dynamic and vital pillar of the economy, integrating innovation, technology, and inclusive growth to meet the changing needs of a modern society.

Keyword	
Financial Services	Economic services provided by the finance industry to manage money, including banking, insurance, and investment.
Fund-Based Services	Services involving direct use of funds, e.g., loans, leasing, hire purchase.
Non-Fund-Based Services	Advisory or fee-based services like underwriting, credit rating, or financial consultancy.
Financial Inclusion	Ensuring access to financial products and services for all sections of society.
LPG Reforms (1991)	Liberalization, Privatization, and Globalization – reforms that modernized India’s financial sector.
FinTech	Financial Technology that integrates digital innovations with financial services.
Digital Banking	Use of online and mobile platforms to offer banking services conveniently.
Blockchain	A secure digital ledger technology improving transparency in financial transactions.
Cybersecurity	Protection of digital financial systems from data breaches and cyber threats.
Liquidity	The ease with which assets can be converted into cash.
Investment	Allocation of funds into assets with the expectation of earning a return.
Economic Growth	Increase in a country’s output and income, supported by efficient financial services.
Financial Market	A platform for trading financial assets such as stocks, bonds, and derivatives.
Risk Management	Identifying and minimizing financial losses through diversification or insurance.
Customer-Centric Services	Financial products designed specifically to meet individual customer needs.

ANSWERS TO CHECK YOUR PROGRESS

Question No.	Exercise 1	Exercise 2	Exercise 3
1	b	b	a
2	c	b	b
3	c	c	d
4	c	True	True
5	True	False	False
6	False	c	b
7	b	a	a

Terminal Questions

1. Explain the role of financial services in promoting economic development.
2. Describe the major changes that took place in the evolution of financial services in India after the 1991 economic reforms.
3. Discuss the significance and types of financial services available in India.
4. Evaluate the impact of technology on the financial services sector.
5. Identify and explain the key challenges faced by the financial services sector in the present scenario.

Suggested Readings

- Suresh, P. and Paul, J., Management of Banking and financial Services, Pearson Education
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CERTIFICATE COURSE IN STOCK MARKET AND TRADING OPERATIONS

GC-CST1: ELEMENTS OF FINANCIAL SERVICES AND MARKET

UNIT IV – MERCHANT BANKING

Structure:

- 4.0 Objectives
- 4.1 Introduction
- 4.2 Merchant Banking
- 4.3 Distinction from Commercial and Investment Banking
- 4.4 Managing Public Equity/ Debenture Issues
- 4.5 Mobilizing Fixed Deposits
- 4.6 Arranging Inter-Corporate Loans
- 4.7 Raising Term Finance
- 4.8 Loan Syndication
- 4.9 Other Functions of Merchant Banking
- 4.10 Future Trends and Challenges in Merchant Banking
- 4.11 Conclusion
- 4.12 Key Words
- 4.13 answers to check your progress
- 4.14 Terminal Questions

4.0 Objectives

After studying this unit, you would be able to:

- Understand the role of merchant banking and its core functions
- Explore issues related to the public equity and debenture issue management
- Understand different techniques and incentives for mobilizing the funds through fixed deposits

- Understand the concept and evaluate the dynamics of arranging inter-corporate loans
 - Understand and analyses the approaches involved in raising term finance
- understand the concept, fundamentals and intricacies of loan syndication

4.1 INTRODUCTION

Merchant banking serves as a distinctive niche practice in modern corporate finance. Whereas mass retail banks are typically concerned with taking deposits and making short-term loans, merchant banks serve their corporate, institutional and high-net worth clients with customized and complex financing solutions and advisory services. Merchant banking has come a long way from its historical role in trade finance to one that not just raises capital for companies through public equity and debenture issues but also structures inter-corporate loans, term finance, loan syndication, and more. To fill this gap for specialized financial services, many corporates have contracted with merchant bankers to navigate public issues, debt and equity placements, and strategic advisory services. Merchant bankers play an essential role in connecting financial markets to corporates, which in turn enables effective capital deployment that drives economic development. They execute a variety of roles essential to the success of mass fundraising and restructuring campaigns. It may vary from acting as underwriter or issue manager to the one who helps in mobilizing interoperate loans, and fixed deposits etc. It also offers other ancillary services like advisory, portfolio management, restructuring, and treasury management that substantiate merchant banking's diverse roles.

4.2 MERCHANT BANKING

Merchant banking is an important branch of the financial services industry that helps businesses meet their financial needs and achieve growth. It creates an ecosystem where business can apparently easily find access to funding and as a result grow. This is because whereas ordinary banks are primarily concerned with deposits and loans, merchant banks specialize in services like raising capital, advising on mergers and acquisitions, and restructuring. Simply put, merchant banks are intermediaries between firms and investors and provide the financial expertise to back dramatic corporate moves. The roots of the merchant banking lie in merchants who capitalized international trade historically. These initial moneylenders financed big trade ventures, not only taking a risk, but also taking a percentage of the profits. These evolved over time into modern

merchant banks which expand beyond simple money lending into a variety of services. If a business requires money to grow, to open up a new location, or to purchase new technology, it can go to a merchant bank, who will raise this money by issuing stocks or bonds. The bank will scrutinize the company's financial soundness, analyses the risks and create a marketing strategy to draw investors.

Merchant banks also play a significant role in assisting companies in mergers, acquisitions, and other major transactions. Merchant banks are all over the process when two companies agree to merge or when a company wants to buy another company. They research, they go through the books and reports, they find out how the market will enable profits for all participants. This inspection allows for a more confident transaction between the two parties and eliminates any possible future issues. They develop good networks by having relationships with many types of investors which could include venture capitalists, private equity and institutional investors among others. This proximity improves access to these funds at a quicker pace and on better terms. Plus, the recommendations for risk management and strategic planning also offered by the merchant banks remain relevant in our increasingly volatile economic environment. Merchant banks, through observing the market and monitoring economic changes are able to assist businesses to think ahead and manage risk. The origins of merchant banking date to the Middle Ages when merchants engaged in international trade began offering lines of credit, financing journeys, and making capital contributions to finance their enterprises. These early merchant bankers served as financial intermediaries, connecting buyers to sellers and ensuring the fluidity of trade-not unlike today's bankers, but without the language of today's globalized capitalism. The functions of merchant bankers would evolve and expand dramatically over the centuries as financial markets developed and economies diversified.

Today, a merchant bank is described as a specialized bank providing various financial and advisory services to corporate clients such as issue management, underwriting, project finance, mergers and acquisitions, and portfolio management. Merchant banks provide corporate clients with issuer services to raise capital for business development needs through public and private equity and debt offerings. Their work is also strategic; they may offer expert advice on capital market transactions, risk management, and corporate restructuring.

4.3 DISTINCTION FROM COMMERCIAL AND INVESTMENT BANKING

Commercial banks are focused on deposit mobilization, retail lending, and liquid financial transactions; and the investment banks are focused on the deep end of capital markets, but merchant banks are engaged rendering different types of services. The major differences can be highlighted as follows:

- 4.3.1 Emphasis on advisory services:** Merchant bankers prioritize personalized advisory services and strategic planning over regular banking services.
- 4.3.2 Fee based business model:** They are primarily fee-based, collecting commissions and advisory fees not interest income from loans and deposits.
- 4.3.3 Capital market specialist:** Unlike regular banks that engage in short-term lending, merchant banks are capital market specialists, assisting in underwriting and issue structure.
- 4.3.4 Equity stakes:** They frequently participate in minority equity investments in the companies they consult, sharing in the client companies' interests.

These attributes make merchant banks trusted strategic partners that add value guiding a company through the complexities of raising capital and managing large-scale finance operations. Some of the most functions performed by merchant banks for their customers are elaborated in the coming sections of this lesson plan.

CHECK YOUR PROGRESS

- I. What is a core service offered by merchant banks?
 - a) Personal loans
 - b) Fixed deposit accounts
 - c) Strategic advisory services
 - d) Internet banking
- II. Which of the following is NOT a role of merchant bankers?
 - a) Issuing public equity

- b) Providing treasury management
 - c) Offering retail banking services
 - d) Conducting foreign exchange
- III. What type of clients do merchant banks typically serve?
- a) Small businesses
 - b) Individual retail customers
 - c) Corporate, institutional, and high-net-worth clients
 - d) Government entities
- IV. Merchant banks are involved in the digital transformation of financial services **(True/ False)**.
- V. Merchant banks primarily focus on short-term loans **(True/ False)**.

4.4 MANAGING PUBLIC EQUITY / DEBENTURE ISSUES

Merchant banking's traditional and flagship services include handling public equity and debenture issues. It is a system made up of detailed steps that help companies raise funds from public markets. These funds may be raised through issuing the public shares of the companies and also the debentures, depending upon the requirements of the clients. While managing the public issues and issue of debentures, generally following types of assistive functions are performed by the merchant bankers:

4.4.1 Underwriting and Issue Management:

Underwriting is the essential role of the merchant banker to ensure the securities a company plans to issue will be sold. So, the merchant banker frequently agrees to buy any remaining unsold portion of the new issue, effectively serving as an insurance policy for the issuing company. This is important for instilling investor confidence and achieving a successful capital raise. The merchant bankers also help in issue management. The merchant banker helps design the offer document and issue structure so that it meets the regulations set by the Securities and Exchange Board of India (SEBI), among others. They collaborate with legal teams to draft a prospectus, establish valuations, and structure the deal in a way that balances the interests of the issuer and investors. When a company goes public, merchant bankers perform broad due diligence on the company's financial health, business model, and growth potential.

4.4.2 Preparing Prospectuses and Regulatory Compliance:

Prior to any public offering, a prospectus is created, which discloses pertinent financial, operational, and legal information about the company. Merchant bankers are central to shepherding the prospectus through detailed, thorough, and regulation-compliant procedures. They collaborate with attorneys, auditors, and regulators to substantiate information and insert all required disclosures to safeguard prospective investors. It also includes seeking regulatory approvals, scheduling roadshows for investors, and fielding questions from both underwriters and exchange authorities. Each part of it is carefully organized and acted in order to secure and realize the issue.

4.4.3 Pricing and Marketing the Issue:

After drafting the prospectus and ensuring proper disclosures, the merchant banker sets the final price of the public issue. This requires assessing market conditions, investor sentiment, comparable valuations of companies, etc. Correct pricing is essential as it should be reflective of valuation yet cheap enough to entice investors. During the marketing phase, merchant bankers use their market knowledge and relationships to push the issue. They coordinate presentations, investor meetings, and partake in the roadshow, which is when the company's management travel to meet prospective investors. The objective is to achieve the maximum subscriptions, not just complete subscriptions, for the issue so that the capital is not only fully subscribed, but done so efficiently and expeditiously.

4.4.4 Post-Issue Activities and Investor Relations:

After the issue is successfully placed, merchant bankers remain involved in post-issue activities. This can involve stabilizing the share price, aiding in compliance reporting, and overseeing investor relations. Regular updates to shareholders and due diligence of market progress will inspire market confidence in the company going forward and lessen the transition.

In sum, overseeing public equity and debenture issues necessitates sophisticated market knowledge, regulatory insight, and financial strategy. Throughout this process, the merchant banker serves as a custodian of sorts, guiding the company to achieve its capital formation objective with the least amount of risk possible for all principal parties.

4.5 MOBILIZING FIXED DEPOSITS

Fixed deposits are a core product for commercial banking, but for merchant banks, attracting

fixed deposits are part of a strategy to diversify a company's sources of financing and to increase its liquidity. FDs are a low-risk source of long-term funds. In a hybrid financing model as a complement to market-based funding, merchant banking may also include efforts at mobilizing fixed deposits as a strategy to access capital. For corporates, fixed deposits serve not just the function of parking idle cash but a tool of financial strategy to tide over a difficult market for equity or debentures by accessing short-term capital. Merchant bankers use fixed deposits to harvest a deep pool of capital domestic institutional investors, non-resident Indians (NRIs), and even high-net-worth individuals who may chose debt-based instruments in pursuit of more stable returns.

The process commences by determining the funding needs and structuring a fixed deposit program to fit the company. Then merchant bankers assist in structuring the offer document which details the interest rate, tenure, and otherwise essential features of the deposit scheme. They must also oversee that the scheme is compliant with regulations and market practice relating to transparency and investor protection. After the scheme is approved, merchant bankers work to market the offering to compatible investors. This includes tapping into their relationships with institutional investors, utilizing digital technologies for marketing, and, at times, hosting investment roadshows targeted for fixed income instruments. A successful mobilization of fixed deposits does not only inject immediate liquidity, it also strengthens the company's balance sheet, given that FDs are perceived to be secure and predictable funding sources. For many corporates, fixed deposits were a counter-cyclical constituent to other market-oriented types of financing. With a relatively lower cost of and fixed interest rate on these deposits, the average cost of capital decreases, making the corporate funding picture less expensive. By thus channelling and disciplining fixed deposits, merchant bankers help to systematize a sound capitalization as well as to secure a robust pool of long-term funds for companies.

4.6 ARRANGING INTER-CORPORATE LOANS

Inter-corporate loans are loans that are made by one company to another company and usually form part of the borrowing company's short- or medium-term financial requirements. Such arrangements assist companies in liquidity management, cash flow efficiency, or in some cases, long-term strategic objectives such as investments in allied businesses or joint ventures. Unlike regular bank loans, inter-company loans are loans that take place between corporations. Such

loans are often at competitive rates relative to commercial banks, undergirded by mutual business interests and strategic alliances. In this regard, merchant bankers help to arrange and structure these loans. They serve as the go-between to guarantee that the inter-corporate loans' stipulations are reciprocal, reflect the current market rates, and are legal and regulatory compliant.

The borrowing company receives a needs assessment. The borrowing entity's liquidity needs, ability to repay and risk are assessed by merchant bankers. Then, they target prospective lending companies seeking non-traditional investment options or have surplus cash. Merchant bankers are also responsible for finding interested parties, then bargaining the loan's interest rate, length, collateral, and payment schedule. This is followed by the creation of a comprehensive memorandum of understanding (MOU) or term sheet that delineates all the agreed terms. Merchant bankers see to it that the documentation details every aspect of the deal-from compliance issue, to tax consequences, to conflict resolution provisions-so that the lender and borrower are protected. An essential function in the inter-corporate loan brokerage is risk assessment and due diligence. Merchant bankers perform a rigorous assessment of the borrowing company's financial status, market standing, and prospects. They scrutinize cash flow statements, debt-equity ratios, and operational performance to assess whether the loan is viable. This is important in limiting credit risk and guaranteeing the loan is made on sound financial analysis. Merchant bankers thus help remodel the corporate borrowing environment, establishing them as new opportunities for borrowers and lenders in fixed-income securities.

4.7 RAISING TERM FINANCE

Raising term finance is the process of obtaining long-term debt for capital investments, expansion, or refinancing. Term finance is typically intermediated by merchant bankers who source corporates to institutional lenders and structure transactions in alignment with a company's long-term strategic objectives. Unlike short-term loans, term finance is characterized by a longer maturity period, sometimes years. It usually consists of long-term loans, bonds, debentures, or other debt securities. The goal of term finance is to establish a certain, reliable reservoir of fixed debt capital for the funding of long-term assets, project, or investment need. Merchant bankers generally use following strategies to arrange obtain term finance for their clients:

- **Direct Negotiations with Institutional Lenders:** They negotiate with banks, financial institutions, and non-banking financial companies (NBFCs) relationships for terms characterized by lower than market interest rates and flexible repayment schedules.
- **Public Debt Instrument Issue:** Merchant bankers help and underwrite issues of debentures or bonds providing access to public debt markets for long term funds for corporates. These securities develop and attract long-term investors for the issuing company.
- **Hybrid Instruments and Structured Finance:** Sometimes, merchant bankers recommend hybrid instruments, with debt and equity features, to deliver more innovative financing solutions better suited for a company's risk profile and growth prospects.

Negotiation is a vital part of raising term finance. Merchant bankers serve as agents for the borrowing company in its solicitation of lenders. They negotiate the specific terms of the term loan including interest rates, amortization schedules, covenants, and other contractual terms to be in line with the company's cash flow projections and strategic objectives. The negotiation process likewise requires extensive due diligence and market analysis to benchmark terms against what market conditions will bear. Ultimately, a merchant banker's successful mobilization of term finance permits firms to finance long-term investment projects and mitigate potential risk from that financing.

4.8 LOAN SYNDICATION

Loan syndication refers to the practice of aggregating capital contributions from multiple lenders for a single large loan facility, which is usually needed for significant corporate ventures or significant capitalization requirements. This feature is especially useful for loans that are beyond the risk appetite or lending capacity of an individual financial institution.

For significant financing, a single bank may not be able or willing to provide the entire sum. Syndication mitigates this problem by sharing the credit risk among a group of lenders. On the behalf of their clients, merchant bankers coordinate, structure, and oversee the syndication. They mediate negotiations between the banks involved, set the conditions of the syndicated loan, and get everyone on the same page regarding risk sharing and the method of repayment.

During the process of loan syndication, merchant bankers perform the following activities/ functions:

- **Mandate and structuring** - The borrowing company appoints a lead merchant banker to serve as the arranger or syndicate manager. The manager determines how much financing is needed and then structures the loan so that it is divided into smaller portions that multiple lenders can handle.
- **Due diligence and offering memorandum preparation** - An offering memorandum is prepared containing comprehensive financial information, risk analysis and loan use. This is an important piece for both attracting and reassuring prospective lenders.
- **Invitation to participate** - The lead arranger invites other banks and financial institutions to participate in the syndicate. Then comes negotiation over funding allocations, interest rates, and other terms.
- **Agreements and documentation** - After the syndicate is established, a syndicated loan agreement is prepared. The document defines the roles and responsibilities of each lender, risk distribution, repayment schedule, and default or early repayment procedures.
- **Disbursement and ongoing administration** - Following final agreement, funds are disbursed to the borrower. The lead merchant banker servicing the loan coordinates administration, manages repayments, restructuring, or amendments necessary during the life of the loan.

Merchant bankers play a critical role in the process of loan syndication. They oversee the initial structuring, negotiate and draft the loan terms, arrange due diligence, and help the successful closing of the syndicated loan agreement. Their knowledge not only optimizes the borrowing terms for the borrowing company, but also reduces risks for participating lenders, improving market confidence in commodifying such massive debt.

CHECK YOUR PROGRESS

- VI. What is a common goal of term finance arranged by merchant banks?
 - a) Short-term cash flow
 - b) Long-term investment funding
 - c) Daily operational expenses
 - d) none of the above
- VII. Which of the following describes merchant banks' involvement in foreign exchange?
 - a) Setting up local retail stores

- b) Providing hedging strategies and treasury management
 - c) Offering educational classes regarding foreign exchange
 - d) Coordinating local activities
- VIII. Merchant banks are known for providing personalized advisory services (**True/ False**).
- IX. Merchant banks engage in the restructuring of companies during financial crises (**True/ False**).
- X. Merchant banks play a critical role in loan syndication (**True/ False**).

4.9 OTHER FUNCTIONS OF MERCHANT BANKING

In addition to the aforementioned core functions, merchant banking practice has developed several ancillary, specialized services which serve as valuable ingredients to the financial management of the corporate sector. Some of the other important functions of merchant banks are highlighted in Figure-1 and are also explained below:

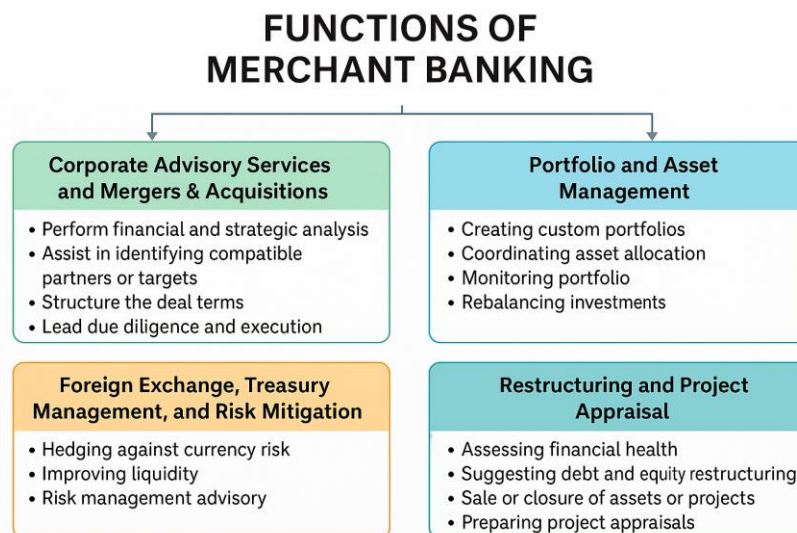


Figure – 1

4.9.1 Corporate Advisory Services and Mergers & Acquisitions: Merchant bankers offer a wide range of corporate advisory services willing to under strategic planning, business valuation, and capital restructuring. One of the most critical is mergers and acquisitions (M&A) advisory. During an M&A deal, merchant bankers:

- Perform financial and strategic analysis,
- Assist in identifying compatible merger partners or acquisition targets,

- Structure the deal terms, and
- Lead due diligence, negotiation, and final execution.

Their role is to enable a smooth transition during mergers or acquisitions, with a fair evaluation of the risks and advantages to both parties.

4.9.2 Portfolio and Asset Management: Many merchant banks provide specialized portfolio and asset management services targeted for institutional, high-net-worth clients. This function includes:

- Creating custom portfolios,
- Coordinating asset allocation for a diversified mix of securities,
- Monitoring portfolio, and
- Rebalancing investments to market conditions and investor goals.

These services help clients maximize their returns and navigate risk.

4.9.3 Foreign Exchange, Treasury Management, and Risk Mitigation: The foreign exchange (FX) market is a core component of corporate finance amid growing globalization. A merchant banker typically offers:

- Hedging strategies to protect against currency risk,
- Treasury management to improve liquidity, and
- A risk management advisory protecting companies from market volatility.

These functions are critical for MNCs or corporates conducting transactions across borders to have to navigate international markets.

4.9.4 Restructuring and Project Appraisal: A critical function through which merchant bankers provide value is corporate restructuring. In times of financial crisis or when businesses require restructuring to achieve new strategic goals, merchant bankers may:

- Assess the company's financial health and operational efficiency,
- Suggest restructure of debt and equity,
- Suggest the sale of assets or closure of projects, and
- Prepare detailed project appraisals.

Their advisory assists companies in regaining financial stability and preparing for future growth.

4.10 FUTURE TRENDS AND CHALLENGES IN MERCHANT BANKING

The market for merchant banking is dynamic as a function of market forces, technology, and regulation. Some future trends and challenges of note include:

- Digital Transformation - Technology is changing the financial services industry. Fintech and artificial intelligence (AI) driven data analytics solutions are rapidly being integrated into the due diligence, risk assessment, and customer service process by merchant bankers. This transformation is driving operational efficiency and better client experiences.
- Regulation Evolution - Under pressure to ensure transparency and protect investors, regulators are revising merchant banking rules further in that direction. Merchant bankers would thus have to continue to navigate and find new ways to innovate within the changing rules.
- Global Integration - As markets become more integrated, merchant bankers are at the forefront in the orchestration of cross border transactions, foreign direct investments, and global capital market integration. This calls for more knowledge and experience in international finance, foreign exchange, and geopolitical risk management.
- Growing competition - Alternative business financing sources-principally fintech companies, private equity funds, and new start-up financing tools-are competing with traditional merchant bankers, and the new products that these alternative financing sources offer are well and broadly used. Such competition is driving merchant banks to improve service offerings and become more client-focused.
- Sustainability and ESG Focus - Environmental, social, and governance (ESG) criteria are growing influential as parameters in investment decisions. These considerations are being incorporated into merchant bankers' advice, guiding companies to deploy investment and capital that can support sustainable and responsible business practice.

CHECK YOUR PROGRESS

- XI. Which service is NOT typically offered by merchant banks?
- a. Mergers and acquisitions
 - b. Issuing debit cards
 - c. Asset management
 - d. Corporate restructuring
- XII. What is a major challenge faced by merchant banks today?
- a) Decreasing demand for corporate advisory services
 - b) Growing competition from fintech and alternative business financing sources
 - c) Lack of interest in global integration
 - d) Shortage of capital
- XIII. What is one of the future trends in merchant banking?
- a) Decrease in global trade
 - b) Digital transformation
 - c) Increase in manual processing
 - d) Reduction in advisory services
- XIV. What type of financing model do merchant banks use regarding fixed deposits?
- e) Hybrid financing model
 - f) Solely equity-based model
 - g) Only loan-based model
 - h) Barter system
- XV. Which sector do merchant banks NOT typically serve?
- i) Corporate finance
 - j) Institutional clients
 - k) Retail banking
 - l) High-net-worth individuals

4.11 CONCLUSION

Today, merchant banking has evolved from its origins in the financing of medieval trade to an indispensable function within the architecture of contemporary finance. Merchant banking services cover full spectrum of corporate financing activities from handling public equity and

debenture issues, raising fixed deposits, brokering inter-corporate loans, securing term finance, and organizing multi-lender loan syndication. Both provide some specialized expertise and some strategic advice. For example, when facilitating public issues, merchant bankers perform the tasks of underwriting, regulatory compliance, pricing, and post-issue investor relations to help ensure efficient capital raising. For the mobilization of fixed deposits, they design instruments that entice stable, long-term investment in uncertain markets. They provide inter-corporate loans for corporates to secure discounted financing on mutual terms and term finance for long-term growth capital. Equally, merchant banks function in loan syndication to spread out risk and satisfy a large capital needed by organizing a consortium of lenders for a borrower.

Beyond these core functions, merchant bankers provide a suite of ancillary services that include corporate advisory, mergers and acquisitions guidance, portfolio management, treasury management, risk mitigation, and restructuring. These multi-dimensional roles not only assist companies in optimizing their capital structures but also drive strategic growth and sustainability. To sum up, merchant banking represents a critical strategic partnership that empowers companies to access global capital, mitigate financial risks, and achieve sustainable growth. The ongoing evolution of its functions—ranging from public issue management to intricate loan syndication—demonstrates the enduring importance of specialized financial advisory services in shaping the future of commerce and industry.

4.12 Keywords

Issue Management	Overseeing a public offering by preparing the prospectus, marketing the issue (road show), and finalizing the offering's terms and price.
Inter-Corporate Loan	A loan made by one corporation to another (often for short- or medium-term funding), which merchant bankers arrange and structure to meet both companies' needs
Loan Syndication	Combining multiple lenders to provide a single large loan to a

borrower, which spreads credit risk among the group (syndicate) for big corporate financing needs.

Mergers & Acquisitions

The process of combining companies or transferring ownership of one company's assets or shares to another, often involving negotiation of deal terms and due diligence.

Treasury Management

Managing a company's cash, liquidity, investments, and financing to ensure funds are available for operations while controlling financial risk.

Fixed Deposit

A bank-issued time deposit with a fixed interest rate and maturity date; companies can use FDs as a low-risk way to raise or park funds over the long term.

4.13 Answers to Check your Progress

Q. No.	Answer	Q. No.	Answer	Q. No.	Answer
I	C	VI	B	XI	B
II	C	VII	B	XII	B
III	C	VIII	True	XIII	B
IV	True	IX	True	XIV	D
V	False	X	True	XV	C

4.14 Terminal Questions

- Discuss the role and functions of merchant banks in corporate finance.
- Analyses the process and complexities involved in managing public equity issues.
- Examine the key aspects of debenture issues, including pricing, risk, and investor perception.

- Compare and contrast the strategies employed for mobilizing fixed deposits in financial institutions.
- Elaborate on the comparative advantages and challenges of arranging inter-corporate loans versus traditional bank loans.
- Discuss the framework for raising term finance for medium to long-term projects.
- Examine the process of loan syndication and its significance for large-scale financing.
- Discuss the impact of regulatory and compliance aspects on merchant banking and issuance processes.
- Investigate emerging trends and innovations in merchant banking and related financing mechanisms.

Suggested Readings

- Suresh, P. and Paul, J., Management of Banking and financial Services, Pearson Education
- Goel, S, Financial Markets, Financial Institutions and Financial Services, PHI Learning
- Ramagopal, C, Management of Financial Services, Vikas Publishing House
- Bansal, L.K., Merchant Banking and Financial Services, Tata McGraw Hill
- Khan, M.Y., Management of Financial Services, Tata McGraw-Hill
- Padmalatha, S., Management of banking and financial services, Sultan Chand and Sons.
- Rose, P. S. and Hudgins, S. C., Bank management and financial services, Tata McGraw Hill

CERTIFICATE COURSE IN STOCK MARKET AND TRADING OPERATIONS

GC-CST1: ELEMENTS OF FINANCIAL SERVICES AND MARKET

UNIT V – UNDERWRITING

Structure:

- 5.0 Objectives
- 5.1 Introduction
- 5.2 Underwriting
- 5.3 Types of Underwriting
- 5.4 Objectives of Underwriting
- 5.5 Parties involved in Underwriting
- 5.6 Advantages of Underwriting
- 5.7 Disadvantages of Underwriting
- 5.8 SEBI Regulations on Underwriting in India
- 5.9 Futures trends in Underwriting
- 5.10 Conclusion
- 5.11 Key Words
- 5.12 Answers to check your progress
- 5.13 Terminal Questions

5.0 Objectives

After studying this unit, you would be able to:

- Understand the concept and significance of the underwriting
- Analyse the primary objectives of the underwriting
- Identify the key parties involved in the process of underwriting
- Explore SEBI regulations governing the underwriting contracts in India
- Evaluate the impact of underwriting practices on market efficiency, investor confidence and overall financial stability
- Apply regulatory insights to real-world scenarios

5.1 INTRODUCTION

India's capital market has grown significantly in the last few decades. As businesses of all stripes look to drive expansion and tap into public markets, issuing securities and capitalizing on the ability to raise capital has become a staple. But this route is beset with difficulties, from establishing the right valuation to navigating unpredictable market conditions. Underwriting offers a way to address these problems, it instils confidence in investor, and helps effectively raise capital. Underwriting is a complex procedure through which a financial intermediary, most commonly an investment bank or group of banks, takes on the obligation of buying new securities from the issuer and then reselling them to the public. This shifts the natural risk from the issuing company to the underwriter and helps establish market credibility through the demonstration of serious underwriting and disclosure practices. Underwriting in India is a heavily regulated practice and is subject to close supervision by the Securities and Exchange Board of India (SEBI), as market conditions can change quickly with both domestic and global events. The transparency of underwriters and the provision of full and accurate information to investors support market integrity, which is ultimately the goal of SEBI regulation. The report is a deep dive into underwriting in India, from multiple angles. The document describes all the relevant information- the principles, different underwriting models (with fewer examples provided), goals, steps (simplified), related actors, and a fair evaluation of pros and cons for businesses. Finally, it provides a detailed examination of SEBI's regulation and its effect on India's underwriting procedures.

5.2 UNDERWRITING

Underwriting is central to the modus operandi of modern finance, operating at the critical crossroads of risk management, market assurance, and capitalization. Its significance lies in its function to help companies raise large sums of capital via public issues in the context of market uncertainty. An intermediary (usually a bank or financial institution) commits to buying a company's newly issued securities and then resells those securities to public or institutional investors is known as underwriting. The term "underwriting" itself comes from insurance, where people would physically write their names under a risk statement indicating they were willing to take on some risk for a premium. Underwriting has changed dramatically since its beginning, and has transformed apace with the expansion of world and domestic capital markets. Underwriting

began with single merchants or banks conducting simple assessments. As industrialization and subsequent market growth grew the need for increased underwriting complexity, these increasingly became specialized, requiring focused expertise, and hence the creation of separate investment banking divisions began. Underwriting in the Indian market today is a well-structured, disciplined, and closely regulated exercise.

It is fundamentally a technique to transfer the risk which a company may have to face during a public issue. In any public issue of capital by a company, there is an element of unknown demand for the security and thus price. An underwriter effectively assumes the risk on behalf of the issuer that the full issue may not be sold. In exchange, the underwriter earns a fee to offset the risk. This risk transfer mechanism serves a two-fold purpose. it secures the company a certain amount of capital (especially under a firm commitment underwriting model) and provides a positive signal in the marketplace. The participation of a well-known underwriter is usually taken as a vote of confidence carried by the offer proceeding through careful diligence and vetting, providing a de facto endorsement of the issue that already primes investors when the security becomes available. Such a mechanism is crucial in the capricious economic setting of India, in which markets surprises regular disrupt a fast reported line of growth. It not only reduces corporate risk but also helps create a stable and predictable market environment.

5.3 TYPES OF UNDERWRITING

There are a variety of underwriting techniques to use depending on the issuer's financials objectives, market conditions, and general risk appetite. Each kind of underwriting specifies how much risk is to be divided between the issuer and the underwriter. Following are some of the widely used types of the underwriting:

5.3.1 Firm Commitment Underwriting

Under a firm commitment underwriting, the underwriter purchases all of the securities being issued from the issuer at a set price and resells them to the public. This model ensures the issuer will receive the total capital amount no matter how many of these securities are actually sold. The underwriter, however, bears all risk of unsold securities. Companies for which certainty of capital to be raised is important often choose this method. The fixed nature of the deal requires

that the underwriter prop up demand when reselling the securities. In a bullish market, this arrangement allows for not only quick capital but also an unequivocal statement of market confidence.

5.3.2 Best Efforts Underwriting

In a best effort underwriting, the underwriter agrees to use its best effort to sell the securities but does not fully purchase the issue. The issuer is only paid for the securities successfully sold to investors. This type is generally would be considered by the underwriter as more conservative due to a reduced risk exposure. This method is employed in uncertain markets or if the issuing company is in a growth face with less market credit. The built-in flexibility of best efforts underwriting makes sense when the expected pricing discovery varies significantly on existing market conditions.

5.3.3 All-or-None (AON) Underwriting

The all-or-none underwriting provision applies to the entire issue. This suggests that if the aggregate subscription fails to reach the stated minimum, then the entire issue is cancelled and no funds are procured. This method is used by companies that need full capital commitments to begin projects and would otherwise function on incomplete funding. The AON model also guarantees companies will not be stranded with less than the needed resources as a byproduct of underperformance in investor turnout. This serves to restrict qualifying issues that may proceed, but also incentivizes the underwriter to market the issue such that investors accept the offered terms.

5.3.4 Standby Underwriting

Standby underwriting is most common with rights offerings (when existing shareholders have the opportunity to purchase additional securities). In this structure, the underwriter commits to purchase any shares not purchased at the end of the rights issue process. This setup serves as a reserve to guarantee the full capital target is achieved. Standby underwriting further guarantees that the company will successfully raise the necessary capital, regardless of whether the market fully takes up the shares offered via the rights issue.

CHECK YOUR PROGRESS

- I. Underwriting is best defined as:
 - a) A company insuring physical assets
 - b) A process of issuing bonds to foreign investors
 - c) A financial intermediary committing to purchase an issuer's new securities and resell them to the public
 - d) A government body setting stock prices
- II. The term "underwriting" originated from:
 - a) Early stock exchange trading practices
 - b) Underwriters signing insurance risk statements (writing their names beneath them)
 - c) 17th-century banking regulations
 - d) Government treasury auctions
- III. In a firm commitment underwriting, the underwriter
 - a) Uses only "best efforts" to sell the issue
 - b) Purchases all securities from the issuer at a set price and bears all unsold risk
 - c) Pays the issuer only for the portion of shares that it can sell
 - d) Cancels the issue if demand is low
- IV. Underwriting eliminates all market risk for the issuing company. **(True/ False)**
- V. Having an underwriting agreement guarantees that an issue will proceed regardless of demand. **(True/ False)**

5.4 OBJECTIVES OF UNDERWRITING

Underwriting is pursued by both issuers and underwriters, though the goals for each party differ. The objectives for the issuer focus on ensuring a smooth capital raise and leveraging market credibility, whereas for the underwriter, the emphasis is on revenue generation, risk diversification, and market positioning. This section details the principal objectives on each side and the strategic synergy achieved when these objectives align.

5.4.1 Issuer-Centric Objectives

The underwriting process is critical for companies looking to raise capital to meet various financial and strategic objectives:

- a) **Capital Certainty** - One of the main goals is raising the necessary capital. Especially under firm commitment underwriting, businesses can anticipate a predetermined cash injection for desired projects, the reorganization of debt, and prospective expansion. The certainty creates predictability, which in turn enables some long-term strategic decision making.
- b) **Market Credibility and Enhanced Visibility** - Attaching a well-known underwriter gives an issuing company a level of credibility. It also signals a strong measure of due diligence and risk assessment behind the offering. This added confidence is critical in contexts where investor confidence can dictate subscription rate and broader market reception.
- c) **Optimal Pricing and Valuation** - Reliable underwriters apply tested pricing models and market data to produce a price that accurately represents the company's value and market appetite. The former can reduce the risk of dilution and ensure that the funds raised fulfill their maximum value relative to the market's current sentiment.
- d) **Risk Transfer** - As it transfers part of the market risk of issuing public offerings to the financial institution. They allow companies to prioritize their business operations without distraction from capital market uncertainty.
- e) **Facilitation of Future Capital Market Access** - A successful underwriting process may set a positive precedent for future capital fundraising. A successful and well-received public offering tends to endear companies to future funding rounds, which translates to long-term access to capital markets.

5.4.2 Underwriter-Centric Objectives

To the underwriters the major concerns are creating business value, earning fees, and garnering a good name for the next deal:

- a) **Revenue Generation** - The underwriter's fees and commissions are based on the size and success of the offering. Compensation schemes can be flexibly tailored to mimic the degree of risk. With the bigger and more difficult issues, there is greater money to be made, so the underwriters have an incentive to try to get the pricing and the marketing right.

- b) **Enhanced Reputation and Market Positioning** - By handling a high-profile or sought after offering well, an underwriter burnishes its reputation in the market. In a financial world that is only going to get more crowded and competitive, where it will be harder not easier to make outsized profits, such a reputation will be more important than ever: It will help you win more assignments and make some real money over the long term.
- c) **Risk Diversification** - Underwriters can limit their risk by diversifying into a large number of underwriting deals in a wide array of industries. Dealing with different issuers spreads the risk and reduces the idiosyncratic threat of a local market dislocation or a disaster specific to one sector.
- d) **Data Collection and Model Refinement** - Every underwriting provides more data to improve the model. With new data, underwriters can adjust their pricing models and risk approaches, making them more accurate and thus better poised to service future issues.

5.5 PARTIES INVOLVED IN UNDERWRITING

Achieving successful underwriting requires the coordinated effort of several parties. Every actor involved specializes in a particular aspect, which cumulatively construct a system that accommodates financial risk, all the while building trust in a market.

5.3.1 The Issuer

The issuer is the company or other organization issuing securities in order to raise money from the public. It is responsible for providing full financial reporting transparency as well as operational and strategic transparency and for communicating with underwriters and submitting required documentation in a timely manner. It needs to establish concise capital goals and harmonizing business plans with market desires. As a central participant, the issuer's ability to provide accurate and substantive information influences every other component of the underwriting process.

5.3.2 Underwriters and Investment Banks

Underwriters serve as the principal intermediaries between the issuer and the public markets. They need to act with due diligence and to prepare all the necessary documentation. Their job

includes assisting with pricing and executing the book building process. They are responsible for managing market stabilization activities in the post-issue phase also. In India, many established financial institutions with deep market penetration serve as underwriters, ensuring that the process functions efficiently and maintains the trust of investors.

5.3.3 Brokers, Dealers, and Distribution Channels

These participants are the critical links that allow securities to be channeled to the end investors. Brokers and dealers solicit orders, help consolidate bids during the book building process, and distribute information on the offering. Electronic platforms and traditional networks serve as distribution channels to retail and institutional investors. They are critical to achieving full market reach and a healthy, broadly distributed total subscription.

5.3.4 Legal Advisors, Auditors, and External Consultants

Legal advisors and auditors are tasked with confirming and certifying that the prospectus contains accurate and complete disclosure that does not violate statutory disclosure requirements. Financial statements are audited and present a true and fair view of the issuer's performance. They are the external consultants who provide third-party opinions on complex strategic or market issues requiring specialized knowledge. These professionals help establish market confidence through compliance to regulations and best practices.

5.3.5 Regulatory Bodies

Underwriting in India is regulated primarily by the Securities and Exchange Board of India (SEBI). SEBI's role in this ecosystem involves to examine the prospectus and validating disclosures against exacting standards. It is also responsible for supervising pricing and allocation to prevent market manipulation. It also tracks post-issue stabilization and monitoring for compliance with subsequent reporting. SEBI's intervention is essential to protect investors and to ensure the integrity and transparency of all players in the market.

5.6 ADVANTAGES OF UNDERWRITING

Following are the major advantages of underwriting:

5.6.1 Certainty of Capital:

Underwriting provides a degree of assured capital. Under a firm commitment underwriting, the full amount of capital is guaranteed, regardless of the market's temporary vagaries, for the issuing company. Such capital certainty is essential for repeating large projects, deleveraging, or following expansion plans confidently.

5.6.2 Enhanced Market Credibility:

A reputable underwriting institution gives credibility to the public issue. Due diligence, pricing, and risk assessment all serve to increase investor confidence. When perception often drives participation in the market, a trusted underwriter is a big advantage.

5.6.3 Availability of Pricing Expertise and Distribution Networks:

Underwriters have the modeling power to price an issue correctly. Their experience guarantees that the securities are not priced too high nor too low, to the benefit of all involved. Also, their massive distribution networks serve to draw a wide swath of investors.

5.6.4 Risk Mitigation:

Underwriters assume the risk of unsold securities, allowing companies to remain focused on their core operations. This risk transfer is most advantageous in an unstable market as the company is protected should the market unexpectedly worsen.

5.6.5 Long term access to Capital markets:

An effectively conducted underwriting can set the stage for future capital raises. Good public offerings forge deep relationships between the issuer and finance capital, simplifying future rounds of financing and burnishing market standing.

An overview of the different advantages and disadvantages associated with the underwriting is presented in a very Crips manner with the help of following Figure – 1

ADVANTAGES	DISADVANTAGES
• Certainty of Capital • Enhanced Market Credibility • Availability of Pricing Expertise • Availability of Distribution Networks • Risk Mitigation	• High Cost • Dilution of Control Extensive Disclosure Requirements • Market Dependency • Reputational and Brand Risk • Reliance on external expertise

Figure – 1

5.7 DISADVANTAGES OF THE UNDERWRITING

Following are the major disadvantages of underwriting:

5.7.1 High Cost:

One of the main disadvantages of underwriting is the costs. The net proceeds can be significantly affected by underwriting fees, legal fees, advisory fees, and other costs associated with the offering. For low margin businesses, these costs must be carefully measured against the benefits of accessing guaranteed capital.

5.7.2 Dilution of Control and Extensive Disclosure Requirements:

The issuance of equity for capital results in dilution of control for existing shareholders. Second, the detailed financial and strategic information companies are required to disclose could potentially provide unwanted insights into their operations for competitors.

5.7.3 Market Dependency:

Good underwriting support notwithstanding, prospects of a public issue are largely dependent on current market conditions. Economic uncertainty or changes in investor sentiment can negatively impact subscription levels. The value realized in the offering may then stray from expectations.

5.7.4 Reputational and Brand Risk:

If a public issue does not perform as expected may be due to improper pricing or being influenced by general economic conditions, the issuer and underwriter's reputation suffers. In

India's interconnected financial ecosystem, such reputational setbacks can influence future dealings and affect overall brand value.

5.7.5 Reliance on external expertise:

Companies that sow the bulk of their expertise in external underwriters for market assessments and pricing decisions can grow dependent and constraining on internal strategic decision making. Over time, this over-reliance can weaken the company's capacity to independently navigate complex market dynamics.

CHECK YOUR PROGRESS

- VI. Underwriter primarily engage in underwriting to:
 - a) Provide free advisory services to companies
 - b) Earn fees and commissions tied to the size and success of the offering
 - c) Minimize their market reputation
 - d) Eliminate competition among banks
- VII. During the underwriting process, brokers and dealers typically:
 - a) Perform legal due diligence on the issuer
 - b) Gather investor orders (book-building) and help distribute the new issue
 - c) Set the minimum subscription levels
 - d) Audit the underwriter's financial statement
- VIII. Which of the following is an advantage of underwriting for issuers?
 - a) Guaranteed perpetual rise in share price
 - b) Enhanced market credibility and investor confidence thanks to a reputable underwriter
 - c) Complete avoidance of issuance costs
 - d) No need for a prospectus
- IX. The participation of a reputable underwriter signals investor confidence in an issue. **(True/ False)**
- X. The main goal of underwriting is to allow the underwriter to take over the issuer's operations. **(True/ False)**

5.8 SEBI REGULATIONS ON UNDERWRITING IN INDIA

SEBI is the principal institution responsible for developing and regulating India's capital

markets. To keep the practice of underwriting transparent, efficient and investor- friendly, Securities and Exchange Board of India (SEBI) has formulated the SEBI (Underwriters) Regulations, 1993 and subsequent amendments covering the range of underwriting activities. No person shall act or continue to act as an underwriter unless it is in possession of a certificate of registration whilst under Rule 3(1), the certificate of registration is to be obtained by the applicant from the SEBI. This provides a quality control where only firms who meet high financial and operational standards are allowed to underwrite public issues therefore protecting investors and market integrity. In addition to this the structure is intended to encourage best practices through systematic standards that protect the market and capital.

An important exemption is provided under Rule 3(2) which clarifies that a merchant banker or a stock broker who holds a valid certificate of registration under the SEBI Act is exempted from obtaining ‘registration’ of underwriter for carrying on this work of underwriting. And this is yet another place where the promise of a streamlined ecosystem for underwriters will be kept, because those professionals also fall under tight regulation. Rule 4(b) also stipulates that each underwriter must have a bona fide underwriting agreement with the issuer. All responsibilities, duties, liabilities are very clearly stated in this agreement. The underwriting agreement acts as a legal security, in that it clarifies the terms of the deal agreed to by each side, eliminates confusion and potential disputes, and affords an enforceable system for tracking obligations at each stage of the underwriting process.

The accompanying regulation of capital adequacy standards for the underwriters is also significant in SEBI’s underwriting regulations. According to Regulation 7(1), underwriters must have a certain minimum net worth originally stipulated at ₹20 lakhs, indicating that the underwriter firm should have a requisite financial strength to be able to underwrite large public issues and to bear the associated risks. That capital need is the risk-bearing or risk absorbing component that insulates the investor(s) from financial exposure in the event of insolvency or financial distress at the underwriting facility. On top of that underwriters are bound by a rigid code of conduct regarding transparency and conflicts of interest. Also, handpicked agents and auditors perform routine inspections as ordered by SEBI, guaranteeing the qualitative application of these ethics and thus perpetuating the unimpeachable integrity of the process of underwriting.

Aside from the financial and moral obligations, underwriting regulations by the SEBI also carry with them stringent disclosure requirements on the part of the issuers. Public stock issuers must file prospectuses containing important facts; this information can be in the form of audited financial information, past financial performance, and future financial indications that allow potential investors to fully understand the company's financial position and abilities. The disclosures must also describe the risks including but not limited to market risk, operating risk, regulatory risk and economic risk factors. This type of transparency is critical for informed investing relevant to those who want to evaluate both the risk and the reward of placing monies within a particular fund. Under the new regulations underwriting agreements, including capping techniques such as the green shoe option, need to be completely public information to provide investors with a further sense of security and an open market.

SEBI ensures market integrity, once securities are floated, through a carefully laid out post issue disclosures and compliance norms. Issuers must report continuously on their market interventions including stabilization activity and the use of the greenshoe option- as must the underwriters, so that a step toward remedial action can be taken and so that the secondary market does not go haywire. Such post-issuance responsibilities provide the transparency and accountability necessary for ensuring that investors have information about the health and growth potential for public issues. On top of that, in the event that an underwriter does not comply with these standards, either by means of poor financial record keeping, violation of the underwriting contract or dereliction of reporting norms, SEBI mandates stringent inspection measures and levies "heavy" fines. This type of immediate reaction acts as a deterrent to malpractice and ultimately strengthens the credibility of the underwriting system.

In addition to the norms some of the procedures related to registration and ongoing compliance are also explicitly laid down by SEBI. The FORM A and FORM B, which are considered as proofs that the underwriter has fulfilled the requirements, must accompany the application. The underwriters shall also report to SEBI any major developments in the corporate form or control of such underwriting entity due to any reasons like mergers, demergers, or any other restructuring events within the framework of "Change of control", as is applicable and disseminate the information immediately. This on-going requirement allows SEBI to keep tabs on the financial and operational well-being of underwriters and ultimately to revoke registration

if need be. These regulations have also been subject to periodic revision and improved by incorporating international standards and best practices, strengthening capital requirements, adding ethics requirements, and allowing for electronic filings and use of electronic documents instead of physical paper documents. So, these changes have resulted in keeping India's underwriting framework updated and efficient as well as in line with the underwriting frameworks of other countries.

5.9 FUTURE TRENDS IN UNDERWRITING

Following trends are anticipated to influence the future development of underwriting in India going forward:

5.9.1 Digital Transformation:

Technology will continue to make preprocessing, pricing, and risk analysis more efficient, with block chain, artificial intelligence, and big data analytics offering greater benefits. The use of automation promises to drive down operational costs and enhance the transparency of the underwriting process.

5.9.2 ESG Integration:

Growing global attention to environmental, social, and governance (ESG) factors suggests that future underwriting evaluations may include ESG performance as a critical risk factor. ESG strong issuers may receive more favourable underwriting terms.

5.9.3 Improved Regulatory Flexibility:

SEBI's current regulatory review, which balances investor protection with the need for market dynamism, will likely result in more flexible frameworks that can accommodate innovation while maintaining transparency.

5.9.4 Global Integration:

As the Indian market continues to integrate more deeply into global capital markets, there will be increasing pressure to align local underwriting practices to world practice. This will further attract foreign investments and the general credibility of India's capital markets.

5.9.5 Advanced Data Analytics:

Underwriters will use advanced data analytics for pricing refinement and enhanced risk management in real-time. Proactive adjustments made possible by improved monitoring systems will allow for greater stability even in the most volatile market conditions.

CHECK YOUR PROGRESS

- XI. According to SEBI (Underwriters) Regulations, an underwriter in India must:
- a) Be appointed by the stock exchange
 - b) Obtain a certificate of registration from SEBI
 - c) Be a government institution
 - d) Keep all underwriting agreements secret
- XII. Under SEBI rules, which entity is exempt from obtaining a separate underwriting registration?
- a) A merchant banker or stock broker holding a valid SEBI registration
 - b) Any foreign bank participating in an IPO
 - c) The issuing company itself
 - d) Retail individual investors
- XIII. The “green shoe option” in underwriting agreements _____.
- a) Is a price stabilization mechanism and must be fully disclosed to the public
 - b) Prohibits any sale above the issue price
 - c) Is unrelated to underwriting
 - d) Automatically cancels the issue if oversubscribed
- XIV. Underwriters can diversify risk by engaging in many deals across industries. **(True/ False)**
- XV. Underwriting agreements in India do not need to be made public. **(True/ False)**

5.10 CONCLUSION

Indian underwriting developed as a tightly disciplined and heavily regulated practice critical to the country’s capital markets. Underwriting accomplishes these objectives by transferring risk, supplying market confidence, and establishing an organized process for pricing and distribution, all critical functions for public offerings. SEBI’s pro-active regulation not only define those rules-the rules control every step between the opening decision to raise public capital and the post-hop manipulation of market stabilization with transparency, integrity, and investors protection. This complex but supported network of issuers, underwriters, legal and financial advisors, brokers, and regulators is tasked to ensure frictionless flows of capital. As emerging technologies, sustainability goals, and deepening global relationships continue to reshape the field, the underwriting process is likely to grow even more dynamic and evolving. Those

companies and financial institutions that adjust will not simply find the funding tools they need to achieve their near-term growth goals, but they will establish relationships that will provide reliable future access to capital markets.

The march of progress in underwriting goes on, more efficient, more transparent, and better risk management. As the industry adjusts its practices to global best standards and adopts emerging digital technologies, the function of underwriting will continue to determine the business development and economic security of India. Finally, the knowledge of underwriting and regulation behind it will be critical to negotiating the current complexity of capital markets. Its systematic risk assessment, precise pricing, and market stabilization plan under robust SEBI rules is exemplary for the generation of capital. Strategically setting goals, financing technology, and adaptive engagement with emerging regulation lay the foundation for a bright, smart, and honest capital market place for companies and underwriters to come.

5.11 Keywords

Underwriting	A process in which a financial intermediary (typically an investment bank) agrees to buy all or part of a new securities issue from an issuer and resell it to investors.
Underwriter	The financial institution (such as an investment bank) that conducts the underwriting; it purchases securities from issuers, assumes the risk of unsold shares, and assists in pricing and marketing.
Firm Commitment Underwriting	An underwriting arrangement where the underwriter buys the entire issue from the issuer at a set price and guarantees the issuer a fixed amount of capital, bearing all the risk of any unsold shares.
Standby Underwriting	A form of underwriting often used in rights issues, where the underwriter commits to purchase any unsubscribed shares at the end of the offering period.

Prospectus	A legal document filed by the issuer that provides detailed information about the company, its financial performance, and the risks of the offering, which must be furnished to potential investors.
Underwriting Agreement	A legal contract between the issuer and the underwriter specifying each party's responsibilities, duties, fees, and liabilities in the underwriting process.
Book Building	A mechanism used during an offering where the underwriter gauges investor demand at various price levels and helps determine the issue price based on these bids.

5.12 Answers to check your progress

Q. No.	Answer	Q. No.	Answer	Q. No.	Answer
I	C	VI	B	XI	B
II	B	VII	B	XII	A
III	B	VIII	B	XIII	A
IV	False	IX	True	XIV	True
V	False	X	False	XV	False

5.13 Terminal Questions

- Discuss the concept of underwriting by defining its role and significance in capital markets.
- Critically examine the primary objectives of underwriting.
- Identify the key participants in the underwriting process. Describe in detail the functions and responsibilities of each party.

- Discuss the regulatory framework set by SEBI for underwriting practices in India.
- Analyses how effective underwriting practices influence overall market stability and investor confidence.
- Compare and contrast various underwriting models such as firm commitment, best efforts, and standby underwriting. Discuss the benefits and limitations inherent in each model.
- Explore the challenges faced by underwriters when managing large-scale public issues.
- Analyses how advancements in technology, such as digitization, data analytics, and fintech innovations etc., are reshaping the underwriting process.

Suggested Readings

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CERTIFICATE COURSE IN STOCK MARKET AND TRADING OPERATIONS

GC-CST1: ELEMENTS OF FINANCIAL SERVICES AND MARKET

UNIT VI – HIRE PURCHASE AND INSTALMENT SYSTEM

Structure:

- 6.0 Objectives
- 6.1 Introduction
- 6.2 Hire Purchase and Installment System
- 6.3 Features of Hire Purchase and Installment System
- 6.4 Advantages of Hire Purchase and Installment System
- 6.5 Disadvantages of Hire Purchase and Installment System
- 6.6 Consumer Finance
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- 6.8 Sources of Consumer Finance in India
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- 6.13 Characteristics of Venture Capital
- 6.14 SEBI Guidelines for Venture Capital
- 6.15 Present status of Venture Capital Funds in India
- 6.16 Conclusion
- 6.17 Key Words
- 6.18 Answers to Check your progress
- 6.19 Terminal Questions

6.0 Objectives

After studying this unit, you would be able to:

- Explain the concept of hire purchase and Installment system

- Grasp that how these financing methods facilitate consumer access to goods and services while managing risk and cash flow.
- Identify and evaluate types and sources of consumer finance in India
- Understand the concept of securitization and the parties involved in the process
- Understand the concept and characteristics of venture capital
- Analyse SEBI guidelines for venture capital operations
- Evaluate the structure and functioning of venture capital funds in India
-

6.1 INTRODUCTION

Modern forms of finance are those that empower the individual and give rise to entrepreneurial innovation through the different services such as the hire purchase and installment system, consumer finance, securitization and venture capital. Availability of durable goods on credit can make it easier for more people to access and use such goods, removing many social and economic barriers. Not only does this allow customers to take immediate advantage of the asset, but it also allows them to justify the transfer costs of an asset to themselves more easily; as this model also has the added benefit of a delayed payment scheme, it is especially attractive for items deemed necessary, like cars, appliances, or electronics. At the same time, consumer finance refers more generally to the variety of credit products and loans that support individual spending needs and quality of life. This can include everything from individual loans to lines of credit, again offering some flexibility and a way to connect the gap between financial capacity and immediate demands. In addition, venture capital is essential in developing new and nascent businesses by giving them funding in exchange for specified equity interests. These sorts of investments lead to new, cutting-edge technology and projects, generate local jobs and help the local economy to grow. This combination of services and funding sources then creates a financial ecosystem that serves not only contemporary consumer needs, but also the long-term financing demands of growing capital investment which supports a strong, vibrant marketplace that can continually adjust to the changing needs of a modern economy. This highlights the commitment of the financial world in offering more flexible and better solutions for the customer but also allowing for more investment alternatives and more efficient ways to manage risk that allow for win-win solutions for both lenders and borrowers and allow for a financial structure

that can drive economic development and financial empowerment.

6.2 HIRE PURCHASE AND INSTALLMENT SYSTEM

The hire purchase and installment system is an option to acquire products without the immediate payment of their full purchase price. It allows the purchase of consumer and durables goods by individuals as well as businesses, before full ownership is transferred. The hire purchase system is fundamentally a contract, in which the ‘buyer’ or ‘hirer’ or ‘hire purchaser’ takes possession of the good and agrees to pay for it in installments. But unlike the outright sale, which can only materialize when payment is made in full and the title is transferred, in the hire purchase the buyer takes the asset with immediate benefits and pays for it over time. The item is owned by the seller or financier, and only becomes the property of the buyer after the last payment is made. Ownership of the asset is only transferred to the buyer once all the installments including principal amount, interest and related charges are paid by the hire purchase. The logic of the system is to expand access to high-priced items such as cars or electronics products. In practice, the deal is struck between the seller (or finance company) and the hirer regarding the payment schedule, the interest rate (or hire charge), the delivery, service, the right to cancel, the right to terminate, the right to default. It is a set of guaranteed payments and contracts that comes with artificial value. The product is “hired” by the buyer and “paid for” in monthly installments. It is commonly viewed in opposition to other forms of credit, for example installment sales, where ownership may transfer earlier in the purchase process.

6.3 FEATURES OF HIRE PURCHASE AND INSTALLMENT SYSTEM

The hire purchase and installment system are unlike the normal norm of buying due to the following features:

6.3.1 Delayed Transfer of Ownership:

The legal title of the asset is transferred to the buyer only after the payment of after the installments as per the contract. Till this date, the legal title is retained by the seller and buyer only has the physical possession of the goods along with the rights to use them but buyer has no right to sell or transfer the goods to any third party till the date he makes all the payments and the title is transferred to his name.

6.3.2 Regular payment of Installment:

Payments occur on a fixed periodic basis such as monthly, quarterly, or an agreed upon frequency by both parties. Each payment consists of a payment towards principal and an interest charge, fee or hire charge which increases the ultimate cost of the item above a cash price.

6.3.3 Provision of pre-payment:

The contract always carries a provision whereby buyer at any time can pay all the future installments at once and can claim the transfer of the ownership. In such a situation, buyer does not need to pay the interest on the principal amount due on the date of full and final pre-payment.

6.3.4 Possession vs. Ownership:

Possession and ownership are explicitly separated in this system. The buyer has right to use the property but is not the legal title holder until all the terms of the contract are satisfied. In the other hand the seller bears the risk for the asset, even in most cases the maintenance and repair of the asset based on the agreement.

6.3.5 Pre-decided terms regarding payment:

Length of time and interest rates and how payments will be made are agreed to when the hire-purchase agreement is signed initially. It allows the buyers to budget it because it becomes a known financial purchase.

6.3.6 Repossession of goods:

In the case of failure of payments, the financial institution has the right to repossess the asset. It has this self-protection because the seller as far as possible tries to inoculate their deals against non-payments / defaults and therefore also towards possible financial losses.

6.4 ADVANTAGES OF HIRE PURCHASE AND INSTALLMENT SYSTEM

Hire purchase and installment systems allow individuals to own the items immediately, by breaking the total cost into easily payable smaller payments. This approach requires much less capital to get started, allowing more people to have access to and insure themselves in this way. More than just a practical form of financing, hire purchase also encourages the growth of markets, as it allows people to purchase valuable goods who would otherwise be excluded. Following are some of the advantages of these kind of systems:

- Hire purchase renders expensive goods like cars, electronics and furniture more accessible. Individuals unable to make a large up-front investment now have access and can pay for it over a period of time.
- An individual or business can more easily manage their cash flow by turning a large, one-time, outlay into continual and manageable payments.
- It gives an escape clause for the buyer to abandon the contract before the final payment is made. It allows the buyer, in a changing environment, to opt to return the asset instead of being forced to take ownership.
- It helps in general to the people in increase their standard of living.
- Risk of seller is covered as he remains the owner till the time all the payments are made.

6.5 DISADVANTAGES OF HIRE PURCHASE AND INSTALLMENT SYSTEM

As every coin has a other side too, hire purchase and installment systems also have some drawbacks like costs in financing these loans are high, as interest and fees add up, forcing buyers to pay more. Longer payment schedules can keep debt obligations a long-term issue and for many this can result in cash-flow difficulties. Following are some of the disadvantages of Hire Purchase systems:

- Buyer ends up paying more than the actual price of the goods as he pays not only for the principal amount, but also the interest and other charges. The rate of interest in such a kind of contracts are generally high.
- If buyer is not able to pay the installments on time, he has a risk of goods being repossessed by the seller. This may further lead to loss of all the payment made by him.
- These types of contracts are very specific and contracted legally. The fine print can often times include minimum or no clauses regarding maintenance of goods by the seller or termination fees etc. as to deter the buyer.
- The ownership of the goods does not technically transfer to the borrower until the entire payment has been made, and as a result, he or she may not be able to offer it as collateral for other credit opportunities. This may inhibit financial flexibility when additional liquidity is needed to the buyer.

CHECK YOUR PROGRESS

- I. In a hire purchase agreement, ownership of the asset is transferred:
 - a) On signing the contract
 - b) After the first Installment
 - c) Only after all installments are paid
 - d) After receiving possession
- II. In an Installment system, the buyer:
 - a) Owns the item immediately
 - b) Gets possession after final payment
 - c) Does not pay any interest
 - d) Never gets ownership
- III. In case of payment default in hire purchase:
 - a) Ownership is transferred anyway
 - b) Buyer keeps the asset
 - c) Goods may be repossessed
 - d) No legal consequence
- IV. What separates possession from ownership?
 - a) Consumer loan
 - b) Installment scheme
 - c) Hire purchase system
 - d) Trade credit
- V. Buyers pay more than the actual cost in a hire purchase deal. **(True/ False)**

6.6 CONSUMER FINANCE

The term consumer finance broadly includes all types of financial services available to individuals for the acquisition of consumer goods and services. Consumer finance is the provision of credit to individuals for the purchase of goods for personal consumption. These products include everything from home appliances to high-priced items. Consumer finance, in essence, allows for consumers to buy items on credit, or to buy on time instead of having to pay up front in full. Consumer finance basically closes the gap between the consumer's purchasing needs now and the cash they have to spend. It can be done using different facilities like hire

purchase, revolving funds like credit cards, personal loans and installment loans. Consumer credit products are built around this fact since they assume that costs can be systematically repaid, and provide the consumer with the ability to budget while enjoying the pleasures of modern products and services.

There are several factors behind the reasons consumer finance has grown. Rapid technological changes, growing digitalization, and a more competitive financial services industry has enabled better access to a variety of consumer financial products. This transition also strengthens customers, and a rippling effect to the economy leads to stimulate demand in other parts of the economy. The concept of consumer finance can be understood better with the help of following characteristics:

6.6.1 Accessibility of Credit:

At a fundamental level consumer finance is about making credit accessible. Oftentimes, customers lack the liquid cash needed to buy a high-value good or product at once. Finance providers help to soften the blow by breaking the cost down into smaller payments, or with the use of revolving credit options.

6.6.2 Deferred Payment:

One of the important components to note is that of deferred payment. Consumers are able to obtain access to the product immediately, the payment is then made on a weekly, monthly or some schedule even a yearly. The deferred payment may be in the form of hire-purchase, Installment loans or credit card facilities.

6.6.3 Risk Sharing:

Trust and risk sharing with lenders and borrowers. Risk is determined by lenders through credit scores, job history and income so that borrowers can afford to periodically meet obligations.

6.6.4 Products of Consumer Finance:

There is a very wide range of different products which can be bought using the consumer finance. It has commonly been used to buy the goods like phones, home, appliances, automobile etc. but also is now used in regard to daily consumables and services. This variety is enabled by new financial products and digital creditors that customize loan products to the individual.

6.7 TYPES OF CONSUMER FINANCE

Contemporary consumer finance products take many forms and accommodate a variety of

consumer needs. The majority of the types of consumer finance which are commonly recognized include:

6.7.1 Revolving Credit (Credit Cards):

Credit cards are one of the most flexible consumer finance options. A LOC is an open-ended line of credit that can be drawn on demand and repaid, and redrawn again, up to a credit limit that the bank extends depending upon the profile of the customer. Consumers are able to buy things and then make partial or full payments during the billing cycle when they are able.

6.7.2 Fixed Credit (Personal Loans):

Fixed credit is a loan where the borrower receives a fixed amount of money and repays that money in even installments over a specified time frame. The terms of repayment are also deterministic unlike for credit cards in the sense that both the principal and the interest portion, are known ex-ante. It is also a loan commonly associated with the financing of durables such as cars, electronics and other high value items.

6.7.3 Consumer Durable Loans:

These are loans which would be used to buy durable goods and consumer durables. These types of loans are especially common in a market of consumers looking to upgrade household appliances, television sets, or other electronics in which the loans frequently include warranties and service repairs.

Each type of consumer finance product is tailored to particular financial needs and consumption patterns. The development of these products is really an indication of a better understanding of consumer behavior, of risk management and of the larger economic picture.

6.8 SOURCES OF CONSUMER FINANCE IN INDIA

Ultimately this is possible through various channels of a healthy consumer finance market in India. These sources are both typical financial institutions and informal lenders. The major ones are as follows:

6.8.1 Commercial Banks:

Consumer finance is majorly sourced through commercial banks in the Indian case. They offer products such as personal loans and lines of revolving credit, as well as consumer durables finance. Credit Unions provide loans but not always at a structured interest rate, or with a

structured formula to determine the credit worthiness of the consumer. The finance provided by these institutions are responsible and sustainable, and are closely regulated.

6.8.2 Non-Banking Financial Companies (NBFCs):

NBFCs are found to be major agents within personal lending. Some of the banks are companies like Bajaj Finance and Muthoot Finance and they often target populations not served by mainstream banks. NBFCs are also generally known as being nimbler in handling and granting loans, and often serve niche markets. While they may adjust their interest rates slightly to account for the higher risk, this service is becoming popular among the clientele due to its flexibility and quickness.

6.8.3 Credit Card Institutions:

The Indian credit card industry is a centre of consumer finance. Consumers are able to purchase items on credit via credit cards made available through traditional banks as well as specialized financial service providers. These are revolving cards, which allows for flexible spending. Also, working in tandem with retailers, credit card companies tend to offer bonus rewards points and discounts when purchases are made using their cards thus also providing an additional incentive for consumers to use credit cards.

6.8.4 Traders and Sales Finance Companies:

In some cases, retailers or traders themselves are the direct source of consumer finance. In India, many of the large retail outlets and sales financing companies provide in-store financing. This form of fund-raising gives people a direct way of funding a project without having to go through a late-stage capital institution such as a bank. These can include hire purchase and installment schemes that make consumer durables more accessible.

6.8.5 Credit Unions and Co-operative Credit Societies:

Credit unions and co-operative credit societies are more local community focused. Generally, NGOs encourage savings and lend to their members at lower interest rates. Smaller in scale than commercial banks, these banks often cater to rural or semi-urban areas and are clearly seen as a safety net for their members.

6.8.6 Digital Lending Platforms:

Due to the quick or rising popularity of fintech, digital lending platforms now also constitute very major kinds of consumer finance. These digital platforms make use of “non-traditional data and modern algorithms” to make rapid assessments of creditworthiness, and offer small personal

loans or small amounts of installment credit with little documentation. They are extra attractive to the tech savvy millennial and those that like a simpler process and would rather not have to do everything on paper.

All of the sources are part of the larger consumer finance scene in India. Besides providing a variety of products to cater for different consumer needs, they also promote financial inclusion among different groups of people. These sources have enabled the massive uptake of consumer credit in the country, providing transparent products with competitive pricing, and customized service. An overview regarding types and sources of consumer finance in India is presented in the Figure – 1 below:

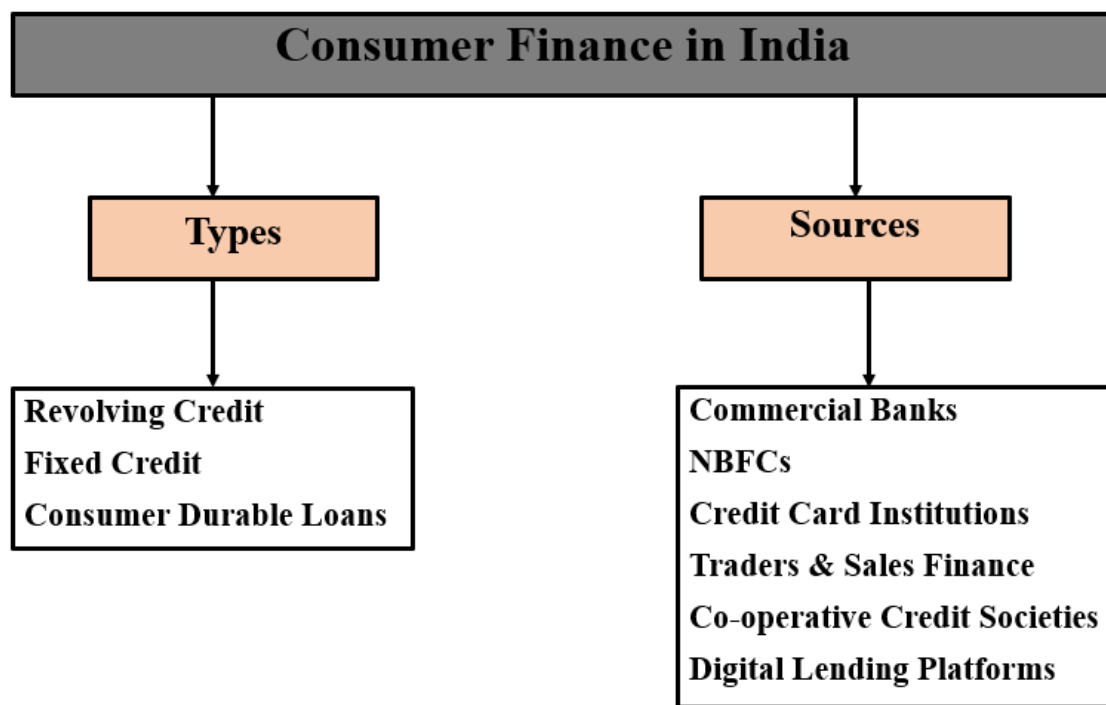


Figure – 1

6.9 SECURITIZATION

Securitization is a complex financial process that facilitates the increasing shift of focus on liquidity and risk dispersion in modern markets. It is the process by which typically inefficient liquid able assets are turned into productive funds available for lending. Securitization is the process by which a common pool of assets, usually loans, receivables, or other income-generating assets, are transformed into securities which can be offered to investors. At the actual

moment of the up-front loan, the underlying assets are combined, future cash-flows on these are supposed to pay the interest and the principal on the security notes sold to the investors. Basically, it transforms traditionally non-market commodities into such that are both liquid and tradable. The main principle of securitization is to enhance liquidity and release capital. The result is that banks and other financial institutions are struggling to stay profitable as they have increasingly been forced to deleverage to conform to new regulatory mandates. Through this process, they are able to transform a set of loans into what are known as asset-backed securities (ABS) or mortgage-backed securities (MBS) at the same time simultaneously unloading risk, obtaining immediate cash liquidity, while satisfying regulators' demands for additional capital cushions against risk. Thus, securitization is responsible for the credit cycle as it provides an uninterrupted mechanism by which capital can be provided for the "promising entrepreneur and the ready borrower". Securitization has also been extended to items beyond things like auto, home, or credit card receivables in the traditional form of loans. These range from securitization of intellectual property rights, music royalties, even cryptocurrency-based assets to be some of the most recent developments. Nonetheless, the core mechanism does not change, and that is the packaging of future cash flows into tradable securities that will attract a broad range of investors.

6.10 TYPES OF SECURITIZATIONS

Forms of securitization vary with the underlying assets and the characteristics of securities thus produced. Some of more common types include the following:

6.10.1 Asset Backed Securities (ABS):

ABS are securities backed by pools of non-mortgage assets such as auto loans, credit card receivables, or personal loans. Lenders make loans to a large number of borrowers, queuing them and freeing up the flow of credit from the bank's balance sheet. Instead, they choose to securitize the loans by selling bonds or notes secured by the loans. This puts the onus of risk on the bond holders and note owners. These securities allow a number of debt instruments backed by the various cash flows in the pool to be created in order to provide investors with cash flows that are diversified.

6.10.2 Mortgage-Backed Securities (MBS):

Probably the most widely known among these types of securitizations, mortgage-backed securities are financial instruments that contain residential or commercial mortgage loans.

Monthly payments made by borrowers on the loans make up the income stream which pays investors in MBS. The MBS market has significantly changed and now tranches are part of the investment design that is available based on the different levels of risk that have been packaged into MBS's.

6.10.3 Collateralized Debt Obligations (CDOs):

CDOs are an even more abstract form of securitization, which does not restrict the collateral to one asset type. Instead, they are made up of different types of loans or receivables, often cut into pieces or 'tranches' by risk and return. Riskier segments can be pursued for higher return, or investors can select safer, lower yield tranches.

6.10.4 Future Flow Securitization:

In other cases, securities are based on the future projected revenue of an enterprise, rather than its loans or receivables at present. This securitization makes best sense for companies which have good business models and future cash flows that are predictable. This then allows the company to obtain working capital today by selling an expected stream of future receipts.

This categorization is important because each type of securitization target unique financial risk profiles and investor preferences. Improved securitization models, like trenching and credit enhancements allow for segmentation of even more complex pools of assets to suit particular markets. The different securitization constructs are a key link to understand market liquidity and investor participation.

6.11 BENEFITS OF SECURITIZATION

The securitization benefits our financial markets in the following ways:

- By transforming fewer liquid assets into tradable securities financial institutions are able to create capital otherwise locked. This form of liquidity can of course be utilized for on lending or other productive activities.
- The risk of investments can be distributed among a wide array of investors via securitization.
- It can help in balance sheet enhancement by moving loans and receivables off the books exposing impaired credit and can positively impact financial ratios such as debt to equity and return on assets.
- Originators can often access capital at cheaper rates than borrowing from banks in the capital markets.

- It gives greater confidence to investors as the process takes place under very stringent regulatory conditions for the disclosure of asset quality and risk parameters.

These benefits combined show that how securitization has become a core feature in contemporary financial markets. It is not only good for liquidity and flexibility in managing risk, but also reminds us of the basic ideas of capital efficiency in an ever more fluid financial world.

CHECK YOUR PROGRESS

- VI. Consumer finance primarily supports:
 - a) Government purchases
 - b) Institutional investments
 - c) Individual consumption
 - d) Business exports
- VII. Revolving credit includes:
 - a) Credit cards
 - b) Fixed deposits
 - c) Term loans
 - d) Debentures
- VIII. Consumer durable loans are used to purchase:
 - a) Office buildings
 - b) Gold or stocks
 - c) Household appliances
 - d) Factory land
- IX. Which of these is not a source of consumer finance?
 - a) NBFCs
 - b) Digital lending platforms
 - c) Central government
 - d) Traders
- X. Securitization involves converting:
 - a) Shares to bonds
 - b) Assets into marketable securities
 - c) Loans into equity
 - d) Expenses into revenue

6.12 VENTURE CAPITAL

Venture capital is a type of private equity capital that investors provide to young, high growth potential, companies and small businesses. In contrast to standard bank loans, venture capital is not usually secured by assets. Rather, the idea is that the venture capital is buying into the company in return for ownership, so if the business fails, the venture capital firm also participates in the risk of the outcome, but if the business is successful, they are heavily rewarded. At its core, venture capital is a form of investment that takes risks on uncertain/unproven business models with the hope of making outsized returns. venture capital firms not only connect the start-up to funding, but also around providing advice, mentoring and putting companies in their various industry networks. The growth of venture capital has been fuelled by an entrepreneurial drive in India along with advancing government support policies for entrepreneurs specifically. Venture capital is often characterized as important to filling the gap between a good idea and achieving full market potential. As a result of the surging startup world in India, venture capital is synonymous with opportunities and is a great enabler for a shift in long term economic transformation.

6.13 CHARACTERISTICS OF VENTURE CAPITAL

Venture capital is quite distinct from other forms of finance. Identifying those characteristics sheds light on how it operates and why it continues to be the most prominent method of financing start-up companies:

6.13.1 High-Risk, High-Reward Proposition:

Venture capital is the business of investing in companies too early in their lifespan to secure public capital, making it a very risky business indeed. If they do get through, the returns are huge but. This tendency for venture capital firms to distribute their investments in more than one startup is aimed at reducing the risks that come with venture capital investing.

6.13.2 Equity Structure:

Venture capitalists receive equity ownership in the company in exchange for their investment capital. This has to do with a long-term perspective of investing which includes being actively part of the effort to lead the company to growth and profit.

6.13.3 Active participation:

Venture capitalists are generally more active than banks in the daily operations of the business. Startups receive not only money but also management assistance, and guidance from mentors who often take a position on the board of the company.

6.13.4 Exit Focused Investment:

The goal with venture capital investing is almost always to achieve a liquidity event such as an IPO or acquisition by a larger company. This exit is coupled with the need to capture their investment and take high return for the investors.

6.13.5 Horizon of Investment:

Venture capital investment tends to have longer term horizons. In contrast with debt which must be repaid instantly, venture capital commitments are long term investments that will pay out over a period of time, typically anywhere from 5- 10 years.

These elements make venture capital not just a matter of money or capital, but a partnership aligned with growth and innovation.

6.14 SEBI GUIDELINES FOR VENTURE CAPITAL

The venture capital financing industry is regulated by the Securities and Exchange Board of India (SEBI). Said regulation is provided by the SEBI- Venture Capital Funds - Regulations 1996 as amended from time to time. These rules are designed to protect investment while fostering fair competition and market transparency. Key aspects of the SEBI guidelines include:

6.14.1 Registration and eligibility:

Venture capital funds must be registered with SEBI. It involves a strict examination to the fund manager expertise and financial strength to filter only professionals that exhibit these characteristics. The criteria also help to ensure the investors in these funds are educated to the risks of high growth companies.

6.14.2 Investment conditions and restrictions:

These ceilings and thresholds required by SEBI are enforced; presumably keep investors, as well as entrepreneurs, relatively safe. These conditions are to encourage diversification and prevent being exposed to the failure of one type of business. Further, the regulations also stipulate the terms under which such securities may be issued and traded.

6.14.3 Disclosure and reporting requirements:

Under the SEBI regulation there are very strict disclosure norms for venture capital funds. Such reports include regular investor reports, offering memorandum detailed fund descriptions, portfolio company valuations and conflict of interest statements. This kind of transparency is necessary in order to build confidence among investors and to stabilize the markets.

6.14.4 Prohibition on public fundraising:

The participation of the general public in the subscription of a venture capital fund is not allowed by the regulation. Instead, they may only be private placements, which fits the highly risky and high return model of venture capital and ensures that the investors are sophisticated and able to understand and handle risk.

These regulations are a means by which SEBI tries to regulate a fair transparent and efficient regime in order to ensure the growth of the venture capital industry in India over the long term. For investors and startups this environment is beneficial because risks are adequately managed and the probabilities of high returns are still great.

6.15 PRESENT STATUS OF VENTURE CAPITAL FUNDS IN INDIA

Venture capital in India has been growing like a mushroom over the past few decades. All of this together means multiple things, Central to all this is that today India is no doubt one of world's largest startup ecosystems and is also one of the most vibrant places of venture capital funding. In the past decade, there has been considerable growth of the venture funding ecosystem in India, as signs of the Indian economy moving beyond seed stage funding towards large rounds are attracting both foreign and domestic venture investors. This has been driven, in large part, by the rapidly growing technology industry and government policies focused on promoting innovation. Startups in fintech, health tech, edtech, e-commerce etc., many of which have also become unicorns, often dominate the scene for multi- core investments.

There is still a lot of pent-up energy among investors in the venture capital market. This has been largely driven by the exits via both IPOs and strategic acquisitions that have consistently occurred. The high risk is certainly there but so is the possibility for very high returns, which makes institutional and personal investors to keep an interest on it. This optimism is reinforced by the developing legislative offer of transparent, accountable usage. SEBI's stringent regulations have been key in the process of institutionalizing venture capital in India. These guidelines

developed have provided more transparency in the valuation process, the ability to track what is happening with portfolio companies, quantifying and creating a new way to look at measuring risk. This has made venture capital funds in India much more mature as well. The support structure outside of the markets themselves, such as professional fund managers, industry-specific events, and access to mentors and advisors help foster the environment for innovation and growth.

In the future, the venture capital market in India seems to be growing. Future startup financing is posited to be propelled by new advancements in technology, by a supportive government, and by a growing appetite for investment in India. In addition, industries that traditionally had low levels of investments are now being targeted, thus changing the whole risk profile of venture capital portfolios in the country. Having these dynamics in place, it is venture capital which will continue to drive the shift in the economy and the technological transformation of the country.

CHECK YOUR PROGRESS

- I.Consumer finance supports business expansion more than personal needs. **(True/ False)**
- II.Securitization turns liquid assets into fixed investments. **(True/ False)**
- III.NBFCs often serve clients ignored by commercial banks. **(True/ False)**
- IV.Consumer durable loans are used to fund industrial infrastructure. **(True/ False)**
- V.Securitization increases liquidity in financial markets. **(True/ False)**
- VI.Fixed credit loans have defined repayment terms. **(True/ False)**
- VII.Venture capital guarantees fixed returns to investors. **(True/ False)**
- VIII.Venture capitalists are usually passive investors. **(True/ False)**

6.16 CONCLUSION

The modern financial services ranging from the hire purchase and Installment systems to consumer finance, securitization, and venture capital etc. together create a robust ecosystem that empowers both individuals and enterprises to meet immediate consumption needs and long-term growth objectives. The hire purchase and Installment mechanism democratizes access to durable goods by separating possession from ownership and spreading payments over time, while clearly defined contractual terms and repossession rights balance lender protection with consumer flexibility. Complementing this, a diverse array of consumer finance products ranging from

revolving credit and personal loans to digital lending platforms, bridges the gap between purchasing power and demand, fostering greater financial inclusion. Securitization further amplifies market liquidity by transforming pools of loans and receivables into tradable securities, dispersing risk among investors and unlocking capital for productive deployment. Finally, venture capital fuels innovation and job creation by providing high-risk, equity-based funding and strategic guidance to startups, underpinned by stringent SEBI regulations that safeguard investor interests and ensure market transparency. Together, these interlinked services not only enhance individual living standards and consumer choice but also drive entrepreneurial activity, economic development, and capital efficiency in an evolving marketplace. As technology and regulatory frameworks continue to advance, the synergy among these financial instruments will remain central to fostering sustainable growth, mitigating risk, and expanding opportunities for all market participants.

6.17 Keywords

Hire Purchase	A contract allowing users to buy goods through instalments with ownership transferred after final payment.
Instalment System	A method where buyers gain immediate ownership and repay the cost over time in parts.
Consumer Finance	Financial services that enable individuals to purchase goods for personal use on credit.
Revolving Credit	Credit like credit cards where the borrower can reuse credit as they repay.
Digital Lending Platforms	Tech-based services that offer instant loans using digital credit scoring.
Securitization	Converting pooled financial assets into tradable securities for liquidity and risk sharing.

Venture Capital High-risk investment in early-stage companies in exchange for equity.

1.18 Answers to check your progress

Q. No.	Answer	Q. No.	Answer	Q. No.	Answer
I	C	VII	A	XIII	True
II	A	VIII	C	XIV	False
III	C	IX	C	XV	True
IV	C	X	B	XVI	True
V	True	XI	False	XVII	False
VI	A	XII	False	XVIII	False

1.19 Terminal Questions

- Discuss the basic principles underlying hire purchase and Installment arrangements.
- Discuss the range and characteristics of consumer finance options in India. Examine the various types of consumer finance products available in India.
- Identify and compare the primary sources of consumer finance in India.
- Define securitization and explain its importance in the financial markets.
- Identify the key participants in the securitization process. Describe the role and responsibilities of each party also.
- Explore the concept of venture capital by defining its role in the financing ecosystem. Highlight the distinctive characteristics that set it apart from other forms of financing.
- Analyses the regulatory framework provided by SEBI for venture capital operations in India.
- Describe the internal organization, investment process, and exit strategies involved in managing venture capital funds.

Suggested Readings

- Suresh, P. and Paul, J., Management of Banking and financial Services, Pearson Education
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CERTIFICATE COURSE IN STOCK MARKET AND TRADING OPERATIONS

GC-CST1: ELEMENTS OF FINANCIAL SERVICES AND MARKET

UNIT VII – FACTORING

Structure:

- 7.0 Introduction
- 7.1 Factoring
- 7.2 Meaning and Definition of Factoring
- 7.3 Objectives of Factoring
- 7.4 Types of Factoring
- 7.5 Process of Factoring (Factoring Mechanism)
- 7.6 Features (Nature) of Factoring
- 7.7 Functions of a Factor
- 7.8 Advantages of Factoring
- 7.9 Limitations of Factoring
- 7.10 Factoring in India

Objectives:

After studying this unit, students will be able to:

1. Understand the concept, meaning, and objectives of factoring in business finance.
2. Explain the process, features, and mechanism of factoring.
3. Identify and describe the key functions performed by a factor.
4. Evaluate the advantages and limitations of factoring for businesses.

7.0 INTRODUCTION

The deregulation of the various markets, globalization and cut throat competition both in domestic and international markets have posed serious challenges to the banks and Financial Institutions, and NBFCs like how to manage various risks, improve capital adequacy ratio,

manage portfolio of earning assets, improve spread and non-interest income etc. These challenges can be converted into opportunities by using innovative business strategies. In this regard, banks and financial institutions can make use of Factoring, Forfaiting, Bill discounting, Asset Securitization, etc. as a part of business strategy to manage both liquidity and credit risks of loan assets. With the help of such product, lending institutions can sell receivables, loan assets, etc. thereby improving their liquidity position. The various aspects of these products as well as developments in global and Indian markets are discussed in this unit.

7.1 FACTORING

When a firm sells goods on credit, cash is not received immediately. This means there is a time gap between sale of goods/services and receipt of cash out of such sale. The outstanding amounts get blocked for a period. This period depends upon the credit period allowed to buyers. The outstanding amounts are called 'Debtors' or 'Accounts Receivables'. If the debts are not collected in time, the firm will be handicapped due to lack of sufficient working capital. The other side is that if the debts were collected speedily the amount could be used productively. Further, it is very difficult to collect debts. Moreover, there is the problem of defaults (i.e. bad debts). In short, debtors or accounts receivables involve risks. So, business enterprises are always looking for selling the debtors for cash, even at a discount. This is possible through a financial service. Such a financial service is known as factoring. Factoring is one of the oldest forms of commercial finance. Some scholars trace its origin to the Roman Empire. Some others trace its origin even further back to Hammurabi, 4000 years ago.

7.2 MEANING OF FACTORING

Like securitisation factoring also is a financial innovation. Factoring provides resources to finance receivables. It also facilitates the collection of receivables. The word factor is derived from the Latin word facere. It means to make or do or to get things done. Factoring simply refers to selling the receivables by a firm to another party. The buyer of the receivables is called the factor. Thus factoring refers to the agreement in which the receivables are sold by a firm (client) to the factor (financial intermediary). The factor can be a commercial bank or a finance company. When receivables are factored, the factor takes possession of the receivables and generally becomes responsible for its collection. It also undertakes administration of credit i.e.

credit control, sales accounting etc. Thus, factoring may be defined as selling the receivables of a firm at a discount to a financial organisation (factor). The cash from the sale of the receivables provides finance to the selling company (client). Out of the difference between the face value of the receivables and what the factor pays the selling company (i.e. discount), it meets its expenses (collection, accounting etc.). The balance is the profit of the factor for the factoring services. Factoring can take the form of either a factoring agreement or an assignment (pledging) agreement. The factoring agreement involves outright sale of the firm's receivables to a finance company (factor) without recourse. According to this agreement the factor undertakes the receivables, the credit, the collection task, and the risk of bad debt. The firm selling its receivables (client) receives the value of the receivables minus a commission charge as compensation for the risks the factor assumes. Thereafter, customers make direct payments to the factor. In some cases receivables are sold to factor at a discount. In this case factor does not get commission. The discount is its commission. From this its expenses and losses (collection, bad debt etc.) are met. The balance represents the profit of the factor. In an assignment (pledging) agreement, the ownership of the receivables is not transferred; the receivables are given to a finance company (factor) with recourse. The factor advances some portion of the receivables value, generally in the range of 50 – 80%. The firm (client) is responsible for service charges and interest on the advance (due to the factor) and losses due to bad debts. According to this arrangement, customers make direct payment to the client. It should be noted that both factoring and securitisation provide financing source for receivables. In factoring, the financing source is the factor. But in securitisation, the public (investors) who buys the securities is the factoring source.

7.3 OBJECTIVES OF FACTORING

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.
2. To minimize the risk of bad debts arising on account of non-realisation of credit sales.
3. To adopt better credit control policy.

4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

CHECK YOUR PROGRESS

Exercise 1

MCQs

1. Factoring is primarily concerned with:
 - a) Long-term investment
 - b) Conversion of receivables into cash
 - c) Stock market trading
 - d) Insurance services
2. Who bears the credit risk in **non-recourse factoring**?
 - a) Business
 - b) Factor
 - c) Bank
 - d) Customer
3. The main objective of factoring is to:
 - a) Increase inventory
 - b) Improve liquidity
 - c) Reduce employee costs
 - d) Expand market share

True/False

4. Factoring helps a company reduce its administrative burden. (True/False)
5. Recourse factoring means the factor bears all credit risk. (True/False)
6. Factoring is only used by large businesses. (True/False)
7. Full-service factoring includes collection of receivables. (True/False)

7.4 Types of Factoring

Factoring is not a “one-size-fits-all” service. Different businesses have different needs, so factors (the companies providing factoring services) offer various types of factoring arrangements.

1. Recourse Factoring

Meaning: In recourse factoring, the factor (the financial company) only **manages the receivables** of the client. The factor **does not bear the risk** of bad debts if customers fail to pay.

Responsibility: The client (business) **bears all the credit risk**. If a customer defaults, the client has to repay the factor.

Example: Suppose Company A sells goods worth ₹1,00,000 to its customers on credit. It assigns these receivables to a factor. If a customer worth ₹10,000 does not pay, the factor can claim this ₹10,000 from Company A.

Factor provides collection service but not risk coverage.

2. Non-Recourse Factoring (Full Factoring)

Meaning: Here, the factor **takes full credit risk**. Even if some customers default, the client is fully protected. The factor assumes the responsibility for bad debts.

Responsibility: Factor bears all the risk of non-payment by customers.

Cash Advance: Client usually gets **100% cash** (minus service fees/commission) against receivables.

Example: Company B assigns receivables of ₹2,00,000 to a factor under non-recourse factoring. If customers worth ₹20,000 default, Company B still receives full payment from the factor (after deducting commission).

Client gets risk-free cash but pays a higher commission for factoring services.

3. Maturity Factoring

Meaning: The factor **does not pay cash in advance**. The client gets payment **only when the factor collects money from the customers** or when the customers guarantee payment.

Use Case: Useful for businesses that want outsourcing of collection without immediate cash need.

Example: Company C sells goods and assigns ₹1,50,000 receivables to a factor. The factor will collect payment from customers. Only **after receiving cash from customers**, the factor pays Company C.

Factor mainly provides **collection services**; no upfront cash is given.

4. Advance Factoring

Meaning: The factor **advances a portion of the invoice value** to the client immediately (usually about **70–90% of invoice value**). Remaining balance is paid after collecting from customers.

Use Case: Helps businesses improve **cash flow** quickly.

Example: Company D has invoices **worth ₹5,00,000**. The factor gives **₹4,00,000 immediately** (80% advance). Once customers pay, the factor remits remaining ₹1,00,000 (minus commission). Client gets **quick cash** to meet working capital needs.

5. Invoice Discounting

Meaning: Similar to advance factoring, but the factor's involvement is usually **hidden**, and the client **remains responsible for collection**. The factor charges **interest/service charge** for the period between advance and collection.

Example: Company E assigns ₹2,50,000 receivables to a factor and gets ₹2,00,000 advance. The factor charges **interest for 30 days** until payment is collected from customers.

Client retains control over collection; factor mainly provides **finance against receivables**.

6. Undisclosed Factoring

Meaning: Customers are **not informed** about the factoring arrangement. Factor works behind the scenes but performs **all usual factoring functions**.

Use Case: Keeps factoring arrangement **confidential**, often used in UK.

Example: Company F assigns ₹1,00,000 receivables to a factor. Customers continue to make payments directly to Company F, unaware that a factor is involved. Factor handles bookkeeping and payments in the background.

Key point: Factoring is **invisible to customers**; client's image remains intact.

7. Cross-Border Factoring (International Factoring)

Meaning: Similar to domestic factoring, but **involves exporters, importers, and factors in different countries**. Often called **two-factor system**.

Parties Involved:

1. Exporter (client)
2. Export Factor (in exporter's country)
3. Import Factor (in importer's country)
4. Importer (customer)

Process:

- Exporter sells goods on credit and assigns receivables to Export Factor.
- Export Factor coordinates with Import Factor for collection and credit evaluation.
- Importer pays Import Factor, who remits money to Export Factor after deducting advance and fees.

Example: An Indian exporter sells machinery worth \$50,000 to a German importer. Indian factor (Export Factor) assigns this to German factor (Import Factor), who collects payment in Germany and transfers proceeds to the Indian exporter.

Used for **international trade**, ensures credit protection and smooth cash flow for exporters.

Types of Factoring

Type	Risk Borne By	Advance Cash	Customer Informed	Key Feature
Recourse Factoring	Client	No	Yes	Only collection service
Non-Recourse Factoring	Factor	Yes	Yes	Full credit protection
Maturity Factoring	Factor	No	Yes	Payment after collection
Advance Factoring	Factor	Yes (~80%)	Yes	Quick cash
Invoice Discounting	Client	Yes	Yes	Factor charges interest; client collects
Undisclosed Factoring	Factor	Yes	No	Confidential factoring
Cross-Border Factoring	Factor	Varies	Yes	International factoring

7.5 PROCESS OF FACTORING (FACTORING MECHANISM)

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

CHECK YOUR PROGRESS

Exercise 2

MCQs

1. **Maturity factoring** means:
 - a) Factor collects receivables only on due date
 - b) Factor provides immediate cash payment
 - c) Factor bears full risk
 - d) Factor finances only short-term loans
2. The first step in factoring process is:
 - a) Collection of payments
 - b) Approval of receivables
 - c) Agreement between business and factor
 - d) Payment of factor's fees

True/False

3. In **full-service factoring**, the factor manages both finance and collection. (True/False)
4. Factoring can be done on selective invoices. (True/False)
5. The business remains responsible for customer credit evaluation in recourse factoring. (True/False)
6. Non-recourse factoring protects the business from credit risk. (True/False)
7. Factoring mechanism begins after the sale of goods on credit. (True/False)

7.6 FEATURES (NATURE) OF FACTORING

Factoring is a specialized financial service that helps businesses manage their **credit sales** and **accounts receivables** efficiently. Its main purpose is to **convert credit sales into cash** while also handling risks associated with receivables. The following are the key features of factoring:

1. Financial Service Nature

Factoring is essentially a **financial service**. It involves the **conversion of credit bills or receivables into cash**. Businesses that sell goods on credit often have money tied up in accounts receivable, which can affect their cash flow. By selling these receivables to a factor, a firm can obtain **immediate liquidity**, which can be used for day-to-day operations or expansion.

Example: A company has ₹5,00,000 in credit sales due in 60 days. By factoring, it can receive immediate cash from the factor instead of waiting for two months.

2. Purchase and Collection of Receivables

A key feature of factoring is that the **factor purchases the receivables** from the client (business) and is responsible for **collecting payments** from the customers on the due date. The factor may assume **the risk of bad debts** depending on whether the factoring is recourse or non-recourse. This reduces the burden on the business to chase payments and manage overdue accounts.

Example: If a customer defaults under non-recourse factoring, the factor bears the loss, not the client.

3. Factor as a Financial Institution

A factor is usually a **financial institution**, such as a commercial bank, finance company, or specialized factoring company. It acts as a **financial intermediary** between the seller (client) and the buyer (client's customer), providing both **financing** and **management services**. The

factor is equipped to handle financial processes professionally and efficiently, which many businesses may not have the resources to do themselves.

Example: SBI, ICICI Bank, and HDFC Bank in India provide factoring services to businesses.

4. Specialization in Receivables Management

Factors are **experts in managing receivables**. They handle tasks such as:

- **Credit monitoring:** Assessing the creditworthiness of the client's customers.
- **Collection:** Ensuring payments are collected on time.
- **Sales accounting:** Keeping proper records of invoices and receipts.
- **Credit protection:** Offering protection against bad debts in certain types of factoring.

This specialization allows businesses to **focus on core operations** while leaving receivables management to the factor.

5. Advisory Services

Apart from finance and collection, factors often provide **advisory services** to clients. They may guide businesses on **credit policies, debtor management, and risk minimization**. This helps businesses improve their **financial efficiency and decision-making**.

Example: A factor may advise a client to limit credit to customers with a high risk of default.

6. Technique of Receivables Management

Factoring is more than just financing; it is a **technique of managing receivables**. It helps businesses:

- Release funds tied up in credit sales.
- Avoid delays and defaults in payments.
- Reduce administrative burden related to debt collection.

Example: A company selling on credit to multiple customers can streamline its accounts receivable operations through factoring.

7.7 FUNCTIONS OF A FACTOR

Factor is a financial institution that specialises in buying accounts receivables from business firms. A factor performs some important functions. These may be discussed as follows:

1. **Provision of finance:** Receivables or book debts is the subject matter of factoring. A factor buys the book debts of his client. Generally, a factor gives about 80% of the value of

receivables as advance to the client. Thus, the nonproductive and inactive current assets i.e. receivables are converted into productive and active assets i.e. cash.

2. **Administration of sales ledger:** The factor maintains the sales ledger of every client. When the credit sales take place, the firm prepares the invoice in two copies. One copy is sent to the customers. The other copy is sent to the factor. Entries are made in the ledger under open-item method. In this method each receipt is matched against the specific invoice. The customer's account clearly shows the various open invoices outstanding on any given date. The factor also gives periodic reports to the client on the current status of his receivables and the amount received from customers. Thus, the factor undertakes the responsibility of entire sales administration of the client.
3. **Collection of receivables:** The main function of a factor is to collect the credit or receivables on behalf of the client and to relieve him from all tensions/problems associated with the credit collection. This enables the client to concentrate on other important areas of business. This also helps the client to reduce cost of collection.
4. **Protection against risk:** If the debts are factored without resource, all risks relating to receivables (e.g., bad debts or defaults by customers) will be assumed by the factor. The factor relieves the client from the trouble of credit collection. It also advises the client on the creditworthiness of potential customers. In short, the factor protects the clients from risks such as defaults and bad debts.
5. **Credit management:** The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to buy all trade debts of the customer. Factor assesses the credit standing of the customer. This is done on the basis of information collected from credit relating reports, bank reports etc. In this way the factor advocates the best credit and collection policies suitable for the firm (client). In short, it helps the client in efficient credit management.
6. **Advisory services:** These services arise out of the close relationship between a factor and a client. The factor has better knowledge and wide experience in the field of finance. It is a specialised institution for managing account receivables. It possesses extensive credit information about customer's creditworthiness and track record. With all these, a factor can provide various advisory services to the client. Besides, the factor helps the client in raising finance from banks/financial institutions.

7.8 ADVANTAGES OF FACTORING

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

1. **Improves efficiency:** Factoring is an important tool for efficient receivables management. Factors provide specialised services with regard to sales ledger administration, credit control etc. Factoring relieves the clients from botheration of debt collection.
2. **Higher credit standing:** Factoring generates cash for the selling firm. It can use this cash for other purposes. With the advance payment made by factor, it is possible for the client to pay off his liabilities in time. This improves the credit standing of the client before the public.
3. **Reduces cost:** The client need not have a special administrative setup to look after credit control. Hence it can save manpower, time and effort. Since the factoring facilitates steady and reliable cash flows, client can cut costs and expenses. It can avail cash discounts. Further, it can avoid production delays.
4. **Additional source:** Funds from a factor is an additional source of finance for the client.

Factoring releases the funds tied up in credit extended to customers and solves problems relating to collection, delays and defaults of the receivables.

5. **Advisory service:** A factor firm is a specialised agency for better management of receivables.

The factor assesses the financial, operational and managerial capabilities of customers. In this way the factor analyses whether the debts are collectable. It collects valuable information about customers and supplies the same for the benefits of its clients. It provides all management and administrative support from the stage of deciding credit extension to the customers to the final stage of debt collection. It advocates the best credit policy suitable for the firm.

6. **Acceleration of production cycle:** With cash available for credit sales, client firm's liquidity will improve. In this way its production cycle will be accelerated.
7. **Adequate credit period for customers:** Customers get adequate credit period for payment of assigned debts.
8. **Competitive terms to offer:** The client firm will be able to offer competitive terms to its buyers. This will improve its sales and profits.

7.9 LIMITATIONS OF FACTORING

1. Factoring may lead to over-confidence in the behaviour of the client. This results in overtrading or mismanagement.
2. There are chances of fraudulent acts on the part of the client. Invoicing against non-existent goods, duplicate invoicing etc. are some commonly found frauds. These would create problems to the factors.
3. Lack of professionalism and competence, resistance to change etc. are some of the problems which have made factoring services unpopular.
4. Factoring is not suitable for small companies with lesser turnover, companies with speculative business, companies having large number of debtors for small amounts etc.
5. Factoring may impose constraints on the way to do business. For non - recourse factoring most factors will want to pre- approve customers. This may cause delays. Further, the factor will apply credit limits to individual customers.

7.10 FACTORING IN INDIA

Factoring is a financial service that has gradually gained importance in India over the last few decades, providing businesses with a solution for managing their receivables and improving liquidity. In India, factoring is defined as a system where a business sells its accounts receivable, arising from credit sales, to a financial institution known as a factor in exchange for immediate cash. The factor may be a commercial bank, a non-banking finance company (NBFC), or a specialized factoring company. This arrangement helps businesses focus on their core operations rather than worrying about debt collection or delayed payments. In India, factoring has evolved in response to the needs of small and medium enterprises (SMEs), which often face challenges in maintaining cash flow due to delayed payments from customers. The **Factoring Regulation Act, 2011**, was enacted to formalize and regulate factoring operations in India. This act defines the rights and duties of factors and assignors, establishes legal procedures for factoring agreements, and ensures the protection of businesses against default risks. The act also encourages the use of both recourse and non-recourse factoring, giving businesses flexibility in managing credit risk. The process of factoring in India typically begins with a business entering into an agreement with a factor. Once invoices are submitted, the factor evaluates the creditworthiness of the business's customers. Depending on the type of factoring chosen—**recourse factoring**, where the business retains credit risk, or **non-recourse factoring**, where the factor assumes the risk—

the factor advances a percentage of the invoice value to the business immediately. The factor then collects payments from the customers on the due date. Factoring in India offers several advantages. It provides immediate liquidity, reduces the burden of credit management, and protects businesses from bad debts in non-recourse arrangements. Additionally, factoring allows businesses to access professional debt collection services and strengthens their working capital position, enabling them to expand operations or invest in growth opportunities. However, factoring in India also has some limitations. It can be costly due to service fees and interest charged by the factor, and businesses may become dependent on factors for cash flow. Moreover, not all types of receivables may be eligible for factoring, and some small businesses may find it difficult to meet the documentation and credit evaluation requirements. Despite these challenges, factoring has become a valuable financial service in India, particularly for SMEs and businesses with large volumes of credit sales. With regulatory support, increasing awareness, and growth in trade finance, factoring continues to play a significant role in enhancing liquidity, minimizing credit risk, and supporting the overall growth of Indian businesses.

CHECK YOUR PROGRESS

Exercise 3

MCQs

1. Which of the following is a key feature of factoring?
 - a) Only long-term financing
 - b) Immediate cash against receivables
 - c) Fixed asset financing
 - d) Equity investment
2. A major advantage of factoring is:
 - a) Reduced credit risk
 - b) Increase in debt burden
 - c) Requirement of collateral
 - d) Restriction on sales

True/False

3. Factoring provides professional collection services. (True/False)
4. Factoring increases liquidity for the business. (True/False)
5. A limitation of factoring is that it may be costly. (True/False)
6. Factoring can be used by small and medium enterprises. (True/False)
7. Factoring eliminates all financial risks for a business. (True/False)

Conclusion

Factoring is an important financial service that plays a vital role in managing the working capital of businesses. It refers to the process where a company sells its accounts receivable, or credit sales, to a financial institution known as a factor in exchange for immediate cash. This service not only ensures quick liquidity for the business but also reduces the risks associated with credit sales. By transferring receivables to a factor, companies can focus more on their core business operations without worrying about the collection of debts or potential defaults by customers. The objectives of factoring are multifaceted. Primarily, it aims to improve cash flow, minimize credit risk, and reduce the administrative burden of managing receivables. This allows businesses, especially small and medium enterprises, to maintain smooth operations without interruptions caused by delayed payments. Factors may provide full-service factoring, handling both the finance and collection aspects, or limited services such as maturity factoring or invoice discounting, depending on the requirements of the business. Factoring can be classified into several types, including recourse and non-recourse factoring. In recourse factoring, the business assumes the credit risk, while in non-recourse factoring, the factor bears the risk of customer default. This flexibility makes factoring suitable for businesses of different sizes and risk appetites. The advantages of factoring include immediate access to funds, professional management of receivables, reduction in bad debts, and strengthened liquidity. However, factoring also has some limitations, such as high costs, dependency on the factor, and limited control over customer interactions. Despite these drawbacks, factoring remains an effective tool for managing short-term financing needs, ensuring steady cash flow, and safeguarding businesses from uncertainties associated with credit sales. In conclusion, factoring is a strategic financial solution that provides both liquidity and credit management, enabling businesses to

grow efficiently and focus on long-term objectives while minimizing financial risks.

Keyword	
Factoring	A financial service where receivables are sold to a factor for immediate cash.
Factor	Financial institution or company that provides factoring services.
Receivables	Amounts due from customers arising from credit sales.
Credit Risk	Risk that a customer may default in payment.
Full-Service Factoring	Factor provides both finance and collection services.
Maturity Factoring	Factor collects receivables only on the due date.
Non-Recourse Factoring	Factor assumes credit risk in case of customer default.
Recourse Factoring	Business retains credit risk; factor can claim back losses.
Liquidity	Availability of cash or cash equivalents.
Invoice Discounting	Financing against invoices without selling receivables.

ANSWERS TO CHECK YOUR PROGRESS

Question No.	Exercise 1	Exercise 2	Exercise 3
1	b	b	b
2	b	b	d
3	True	False	True
4	b	c	c
5	c	b	c
6	False	True	True
7	d	b	b

TERMINAL QUESTIONS

1. Define factoring and explain its main purpose in business finance.
2. What are the main types of factoring? Explain the difference between recourse and non-recourse factoring.
3. Describe the key features and functions of a factor in the factoring process.
4. Explain how factoring operates in India. Include its regulatory framework and benefits for businesses.
5. Discuss the advantages and limitations of factoring in India, giving examples where appropriate.

Suggested Readings

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