# MCom II –Sem IV

# FINANCIAL SERVICES

# Computer Code: 400002

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# Unit-1

# FINANCIAL SERVICES

## ❖ Introduction

Financial services constitute an importance component of the financial system. Financial services through the network of elements such as financial institutions financial markets & financial institutions serve the needs of individuals institutions & corporate. It is through these elements that the functioning of the financial system is facilitated. Considering its nature & importance, financial services are regarded as the fourth element of the financial system. In fact, an orderly functioning of the financial system depends, to great deal on the range & the quality of financial services extended by a host of providers.

## ❖ Meaning of financial services.

In general, all types of activities which are of a financial nature could be brought under the term "financial services". The term "financial services" in a broad sense means mobilizing & allocating savings. Thus, it includes all activities involve in the transformation of saving inter investment. The ' financial service ' can also be called as the financial intermediation. Financial intermediation is a process by which funds are mobilized from a large number of savers & make them available to all those who are in need of it & particularly to corporate customers. Thus, financial service sector is a key area & it is very vital for industrial developments.

A well-developed financial services industry is absolutely necessary to mobilize the saving & to allocate them to various investable channels & thereby to promote industrial developments in a country.

## ❖ NEED FOR FINANCIAL SERVICES

Following are the major factor that helps us to understand the need for financial services.

### 1) Fund raising:-

Financial Services helps to raise the required funds from a host of investors, individuals, institutions and corporate for this purpose, various instruments of finance are used. The funds are demanded by corporate houses, individuals etc.

### 2) Funds deployment:-

An array of financial services is available in the financial markets which help the players to ensure an effective deployment of the funds raised. Financial services assist in the decision making regarding the financial mix. Services such as bill discounting, Factoring of debtors, Parking of short-term funds in the money market, Credit rating, e-commerce and securitization of debts are provides by financial services firms in order to ensure efficient management of funds.

### 3) Specialized services:-

The financial services sector provides specialized services such as credit rating, venture capital financing, Lease financing, Factoring, Mutual funds, Merchant banking, Besides banking and stock lending, Depository, Credit cards, Housing finance, Book building insurance etc. Institutions and agencies such as stock exchanges, Specialized and general financial institutions, Non-banking finance companies, Subsidiaries of Financial Institutions, Banks and insurance companies also provide these services.

### 4) Regulations:-

There are agencies that are involved in the regulation of the financial services activities. In India, agencies such as the Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) and the government of India through a plethora (excessive amount) of legislations, regulate the functioning of the financial service institutions.

### 5) Economic growth:-

Financial service contributes in good measure, to spending up the process of economic growth and development. This takes place through the mobilization of the savings of a cross section of people, for the purpose of channelling them into productive investments, In this connections, it is to be noted that a number of developed and developing countries which have a highly efficient financial market, have witnessed a greater rate of savings and investment.

## ❖ Types or Scope of Financial Services

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

Types of FS

I] Traditional Activities    II] Modern Activities

Fund or Asset based FS    Non-Fund or Fee-based advisory FS

## I] Traditional Activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital & money market activities. These services can be grouped under two heads i.e.

## A. Fund based financial services or Asset based:

The traditional services which come under fund based activities are the following:

1. Underwriting of or investment in shares, bonds etc of new issue (primary market activities)
2. Dealing in secondary market activities.
3. Participating in money market instruments like commercial papers, certificate of deposit, treasonable bills, discounting of bills etc.
4. Involving in equipment leasing, hire purchase, venture capital, seed capital, etc.
5. Dealing in foreign exchange market activities.

Funds based activities are those where there is involvement of funds like?

## 1. Underwriting:

It is an agreement whereby underwriter promises to subscribe to a specified number of shares or debentures or a specific amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed then there is no liability for the underwriter. If the part of share issue remains unsold the underwriter will buy the share. Thus underwriting is the guarantee for market ability of shares. There are two types of underwriters in India: 1) Institutional, 2) Non-Institutional.

## 2. Participating in money market instrument like:

**a. Commercial Paper:**

Commercial paper is an unsecured promissory note issued with a fixed maturity by a company approved by RBI, negotiable by endorsement ad delivery, issued in bearer from & at such discount on the face value as may be determined by the issuing company.

**b. Certificate of Deposit:**

Certificate of deposit is short term negotiable deposit instruments issued by banks & financial institutions to raise large sums of money bearing specific face value & maturity.

**c. Treasury Bills:**

A treasury bills is a short term (up to 90 days) bearer discount security issued by the government as a means of financing its cash requirements.

**d. Discounting of bills:**

Bill discounting is a short tenure financing instrument for companies willing to discount their purchase or sales bills to get funds for the short run & as for the investors in them, it is a good instrument to park their spare funds for a very short duration.

## 3. Involving in

**a. Equipment leasing:**

A lease in an agreement under which a company or firm acquires a right to make use of capital asset like machinery, on payment of prescribed fee called rental charges.

**b. Higher Purchase:**

Higher Purchase is a mode of financing the goods to be sold on future date. In a higher purchase transaction the goods are let on hire, the purchase price is to pay in installment the hirer is allowed an option to purchase the goods by paying the entire installment.

**c. Venture Capital:**

Venture capital provided finance to risky but profitable project. One the project reaches to profitable stage the venture capitalist sells their equity holding at high premium.

**d. Seed Capital:**

The initial capital use to start a business is called as seed capital. If often comes from founder's personal assets or from friends & family. The amount of money received is relatively small because the business is still in the idea or conceptual stage.

### 4. Dealing in securities traded in secondary markets.

### 5. Dealing in foreign exchange market activities:

Large banks & financial institutions are activity involved in large quantities of foreign exchange.

### 6. Other Services:

Mutual funds, factoring, Insurance Services & housing finance.

## B) Non-Fund or Free Based Advisory FS:

Free based income does not involve much risk, but it requires a lot of expertise on the part of a financial company to offer such fee based services.

E.g.; corporate advertiser services, bank guarantees merchant banking, issue management, loan syndication, credit rating, stock broking, M@A capital restricting.

**1) Merchant Banking:**

A merchant banker is the financial intermediary who helps to transfer capital from those who pose it to those who need it.

- Merchant banking services has been statutorily brought under regulatory framework of the Security & Exchange of India (SEBI). Under the SEBI act 1992, no person can act as a merchant banker. Without obtaining a certificate of registration from SEBI. According to SEBI, a merchant banker is a person who is engaged in the business of issue.

- Management either by making arrangement regarding selling, buying or subscribing, to securities as a manager, consultant, advisor rendering corporate advisory service in relation to such issue management.

**2) Loans Syndication:**

- It is taken by the merchant banker as a lead manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a government department. It also enables the member of the syndication to share the credit risk associated with a particular loan among them.

**3) Credit Rating:**

- It evaluates the credit worthiness of a debtor, especially a business company or a government. It is an evaluation made by a credit rating agency of the debtor's ability to pay back the debt & the like hood of default some of the credit rating agencies are ICRA, CRISIL, and S&P MOODYS.

**4) Corporate Advisory Services:**

- These are the activities that combine or consolidate certain enterprise wise needed support services based on specialized knowledge best practices and technology to serve (internal & some time external) customers & business partners.

**5) Letter of Credit:**

- A letter of credit is a document issued by a financial institution or a similar party, assuring payment to a seller of goods & services provided certain documents have been presented to the bank. These are documents that prove that the seller has performed the duties under an underlying contract (e.g. sale of goods contract) & the goods have been supplied as agreed. In return of these documents, the beneficiary's services payment from the financial institution that issued the letter of credit. The letter of credit services as a guarantee to the seller that it will be paid regardless of whether the buyer ultimately fails to pay.

**6) Bank Guarantee:**

- A guarantee from a leading institution ensuring that the liabilities of debtors will be met. In other words, if the debtors to settle a debt, the bank will cover it.
- A bank guarantee enables the customers (debtors) to acquire goods, buy equipment or draw down loans & there by expand business activity.

## ❖ Role and characteristics of financial intermediaries

Following are the roles that the financial intermediaries play in order to develop the economy at large.

### 1. Reduction of poverty:-

Finding innovative ways to provide financial services to poor so that they can improve their productive capacity and quality of life in the role of the financial intermediaries in the 21st century most formal financial intermediaries do not serve the poor because of perceived high risk, low profitability, high cost involved in small transaction, inability to provide the physical collateral generally required by such institutions. About 95% of poor households still have access to institutional financial services most poor and low income households continue to rely on meagre self-finance or informal sources of finance. Providing micro-credit to the poor is important for many reasons.

a) Efficient provision of savings, credit and insurance facilities can enable the poor to smoothen their consumption, manage risks better, gradually build assets, develop micro enterprises, enhance income earning capacity and enjoy an improved quality

b) It will contribute to improvement in resource allocation, development of financial markets and system and ultimately economic growth and development.

c) With improved access to institutional micro-finance, the poor can actively participate in and benefits from development opportunities.

d) Availing small scale loans would introduce them to small-enterprise sector.

e) This would lead to become self-reliant will create employment opportunities, engage women in economic productive activities.

## 2. Financial intermediaries as markets for firms assets:-

a) Financial intermediaries appear to have a key role in the restructuring and liquidation of firms in distress. In particular there is rich evidence that financial intermediaries play an active role in the reallocation of displaces capital, meant both as the piece-meal reallocation of assets (such as the redeployment of individual plants) and more broadly, as the sale of entire bank rapt corporations healthy ones.

b) Financial intermediaries arise as internal, centralized markets where information on machines and buyers is readily available, allowing displaced capital to migrate towards its most productive uses. Financial intermediaries can perform this role by aggregating the information on firms collected in the credit market. The function of financial intermediaries as match makers between savers and firms in the credit market can support their function as internal markets for assets.

## 3. Financial intermediaries as pension funds:-

Pension funds may be defined as forms of institutional investor, which collect pool and invest. Funds contributed by sponsors and beneficiaries to provide for the future pension entitlements of beneficiaries. They thus provide means for individuals to accumulate saving over their consumption needs in retirement, either by means of a lump sum or by provision of an annuity, while also supplying funds to end-users such as corporations, other households or government for investment consumer.

**4. Other roles:-**

**a) Maturity transformation:-**

Converting short-term assets (banks deal with large number of lenders and borrowers and reconcile their conflicting needs).

**b) Risk transformation:-**

Converting risky investments into relatively risky. Free ones (lending to multiple borrowers to spread the risk).

**c) Convenience denomination:-**

Matching small deposits with large loans and large deposits with small loans.

# UNIT II

# INTERNATIONAL CAPITAL FLOW I

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## I. FORIEGN DIRECT INVESTMENT

### ❖ MEANING

- Toyota originally used to export cars to the USA government, USA imposed tariff on cars imported. This increased prices of Toyota cars by 20%. Then the USA customers found that car manufactures in the USA were cheaper than the imported car and the demand for Toyota car declined drastically.
- Then Toyota cars adopted the strategies of locating its manufacturing plant in the USA by direct investment. Thus, direct investment is another mode of business in a foreign country. Company’s investors in foreign countries gain profit and thereby increase sales.
- Market control established by stabilizing control of management decision making via investment in equity share capital.

### ❖ DEFINITION

“The investment made by a company in new manufacturing facilities or marketing facilities in a foreign countries is refers to us FDI”.

### ❖ DETERMINANTS OF FDI

The factors influencing FDI are of three catorgies.

**I. SUPPLY FACTORS**

Firms invest capital in foreign countries due to lower cost of business. These include:-

1. **Production cost**

Companies invest in foreign countries in order to get the benefit of lower production cost like labour cost. For example: - Gumsung plastic, a South Korean firm established its manufacturing facilities in Mexico and saved 2/3 times of the labour cost.

2. **Logistics**

If the cost of transportation from the domestic countries to foreign markets is high or the time of transportation of the product to a foreign market is long, then firms undertake FDI. For example: - Coca- Cola selected the FDI strategy as a cost of transportation is heavy because the basic raw material required is water.

3. **Availability of Natural Resources**

Companies locate their production facilities close to the sources of critical import. The US based oil refining companies established gear oil refining facilities in Saudi Arabia and other Gulf countries.

4. **Availability of quality human resources at lower cost.**

If quality human resources are available at low cost, then it attracts FDI. India, South koria, Malaysia, China and Thailand attract FDI as a cost of operation of business, in these countries it is relatively less.

5. **Access to key technology**

Firms go for FDI in order to have access to existing E-technology rather than developing technologies.

**II. DEMAND FACTORS**

Companies also select the FDI strategy in order to increase the total demand for their products these factors include-

1. **Customer access**

Certain business firms particularly fast food service oriented and retail outlet should locate their operations close to customers. For example: - KFC, McDonalds, American Insurance

Company located their operations close to the customer in order to increase the demand for their products and services.

2. **Marketing advantage**

The companies can enjoy a number of market advantages by locating their operations in a host company. These advantages includes:-

a. Lower marketing cost.
b. Accessibility to hand on experience regarding customer and market handling.
c. Improving customer services etc.

For example: - Delta product Taiwan producers battery pack for laptop, computers. They shifted their operations to US to meet the US customers' needs quickly.

3. **Exploitation of competitive advantage**

Companies which enjoy competitive advantages through trademarks, brand name etc. go for FDI in order to exploit its competitive advantages in various foreign markets.

4. **Customer mobility**

Companies also select FDI strategy because of customer mobility in other words the ancillary industrial units locate their production facility in those foreign countries where their parent companies locate their production facilities. For e.g. 6 Korean packs suppliers to Samsung locate their operation in England when Samsung constructed its electronic factory in England.

## III. POLITICAL FACTORS

Companies enter foreign market through FDI in order to overcome the trade barriers imposed by the host country or make use of the incentives offered by the host government.

**a. Avoidance of trade barriers**

Companies establish production facilities in foreign markets in order to avoid trade barriers like high import duties and quotas etc. For example: - Japanese automobile company established their factory in the USA where the US government increased import tariff rates.

**b. Economic development incentives**

The government of different level that is local, national, state level offer incentives to attract domestic as well as foreign investment. Indian government as well as government of Andhra Pradesh offers a number of incentives to FDI. This incentive includes low tax rates, development of infrastructure facility, employee training programme etc.

❖ **ROLE OF FDI**

1. **To increase sales and profit:-**

Companies invest capital directly in various foreign countries in order to increase sales and profits. This is because foreign markets offer more attractive opportunities for business than domestic market. For example: - Toyota and Mercedes increased their sales in the USA, General Motor and Ford increased their sales in Europe. Coca-cola has been earning for more profit in foreign countries than USA.

2. **To enter in growing market:-**

Some international markets grow at a fast rate than other markets. The fast growing markets provide better opportunities to MNC's for their business growth for example: - IBM enters Japan laptop market through FDI during the earlier 1990's as the Japan laptop market had grown by 40% during that period.

3. **To consolidate (strong) trade block:-**

MNCs prefer to do business with other member countries of the trade block; this is because MNCs get preferential treatment in doing business with member countries of their own trade blocks.

4. **To reduce cost:-**

MNC's invest in foreign countries with a view to reduce the cost of production and various other operations. This is due to the availability of various inputs like raw material, human resources, etc. at lower price in foreign countries. Some of the software companies invested in India due to the lower human resources cost in India. Similarly domestic countries invest in foreign market due to lower transportation and energy cost. The Japanese steel firms moved to US due to the lower cost of operation and transportation. The US firms moved to Mexico, India, China etc. in order to utilize the opportunities of lower cost.

5. **To protect domestic market:-**

Some MNCs invest & operate in foreign markets with a view to avoid the competition with the weak domestic firms.

6. **To protect foreign market:-**

Some MNC's invest in foreign countries in order to protect foreign markets. For example: - British petroleum invested in US to protect the declined service station.

7. **To acquire technologic & managerial know-how:-**

Sometimes the technological and managerial know-how in various foreign countries might be superior to those of domestic countries.

In such cases MNC's invest in foreign countries in order to acquire the superior foreign technological and managerial know- how. E.g. The US companies acquired the technological and managerial know- how from Japan.

❖ **BENEFITS FOR HOME COUNTRY**

1. **Positive BOP**

Inflow of foreign currencies in the form of dividend interest etc. E.g. Nissan (Japanese company) profits are sent back to Japan are from its FDI in U.K., helped Japan for positive BOP.

2. **To Increase Industrial Activity**

FDI increases export of machinery, equipment, technology, etc. from the home country to the host country. This in turn increases the industrial activity of the home country.

3. **Increased Employment Opportunity**

The increased industrial activity in the home country increased the employment opportunities.

4. **To Learn To Transfer Skills**

The firm & the other home country firm can learn skills from its exposure to the host country & transfer those skills to the industry in the home country.

❖ **BENEFITS OF THE HOST COUNTRY**

1. **Resources Transfer Effects :-**

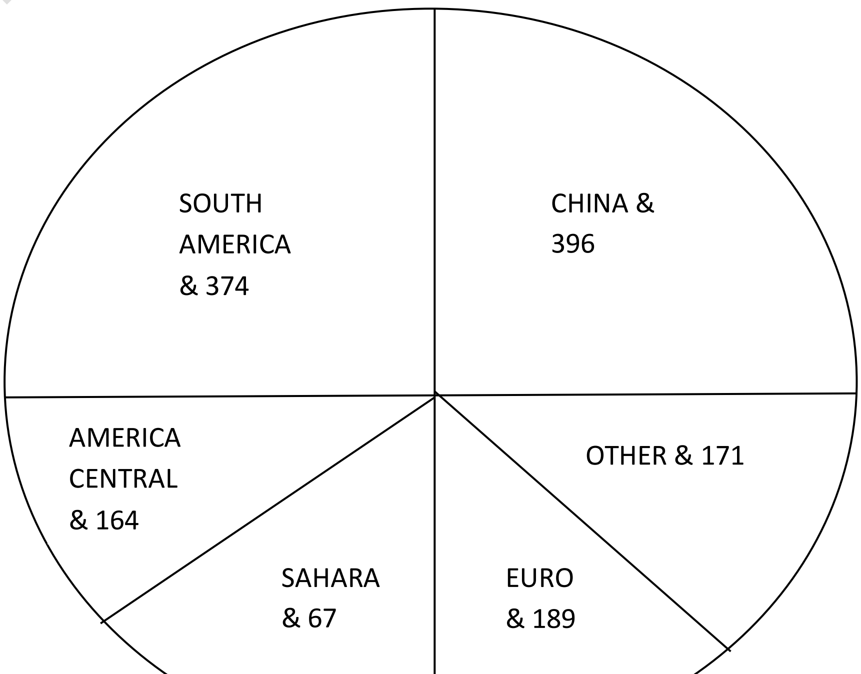
- The resources which are scarce (less) in the host country are transferred from the foreign country.
- These resources include foreign capital, technology, machinery etc.
- Transfer of these resources will develop the host country economically & socially.
- Indian governments have been encouraging the FDI from 1991 which helped in developing the Indian industry, infrastructure & service sectors.

2. **Employment Effects :-**

- The FDI contributes for the establishment of new industries & business directly.
- Further FDI also helps development of ancillary.
- This development will automatically increase employment opportunities for the people of the host country.

3. **Balance Of Payment Effects :-**

- BOP position & foreign exchange resources are very important from the point of view of external situation of a country.
- India faced several foreign exchange shortage problems before July 1991.
- This forced the Indian government to announce economic liberalization in July 1991.
- FDI provides for the production of a number of goods & services domestically.
- This in turn reduces the impact & improves the BOP position of the host country.



- ❖ **CHARACTERISTICS OF FDI**

**FDI SOURCE OF WORLD BANK**

1. In all such transact on to participate in the management of the target company.
2. In most cases it involves a long term commitment i.e. there is no intention to seek quick capital gains.
3. By convention an investment is considered as FDI when it involves acquisition of a minimum of 10% of the paid up equity of the target company.
4. Generally all such investments are accompanied by technology transfers & access to newer markets therefore the partnership involves access to raw materials for the foreign entity & access to technology for the target company.
5. Such investments involve creation of physical assets which generally increase the productive capacity of the target company. This generates employment & consequently economic growth in the host country.
6. Investment by the foreign entity may involve fresh issue of capital or sale of shares held by promoters in the target company. Therefore such transactions are essentially primary market operations in most cases there would be an effect on the balance sheet of the company.

## II. <u>FOREIGN PORTFOLIO INVESTMENT OR FOREIGN INSTITUTIONAL INVESTMENT (FDI OR FII)</u>

- FII means investment by foreign institution such as pension funds, mutual funds, investment trust, asset management companies and certain other specified institutions in all the securities traded on the primary and secondary market in India.
- These securities would include shares, debentures, warrants, other schemes floated by domestic mutual funds and other securities specified by the government from time to time.
- FII is a category of investments, instruments that are more easily traded, may be less permanent and do not represent a controlling stake in an enterprise.

- These include investments via equity instruments (stocks) or debt (bonds) of a foreign enterprise that does not necessarily represent a long term interest.
- In economics, FII or FDI is entry of funds into a country where foreigners make purchase in the countries stock and bond market and sometimes for speculation.
- In short, such investments are made to exploit short-term trading opportunities to make quick capital gains or profit in the foreign countries.

### ❖ MOTIVES OF FII OR FPI

1. To earn higher returns abroad.
2. Residents of one country may purchase stock of another country if they expect the future profitability of the foreign corporation to be greater than that of domestic corporation.
3. Two way capital flows explained by need to reduce risks in investments.
   a. For same level of risk, investors would choose investment with higher returns.
   b. For same level of returns choose the one with lower risk, investment with higher risk level are chosen if returns are high.
4. Diversification of risk between stock in domestic and foreign countries.

### ❖ ROLE OF FPI OR FII/ BENEFITS OF FPI OR FII

**1. Increases the liquidity of domestic capital markets**: -

FPI increases the liquidity of domestic capital market and can help develop market efficiency as well. As market become more liquid, as they become deeper and broader, a wider range of investments can be financed. New enterprise for example have a greater chance of receiving start up financing, savers have more opportunities to invest with the assurance that they will be able to manage their portfolio or sell their financial securities quickly if they need access to their savings. In this way, liquidity market can also make longer term investments more attractive.

**2. Help bring discipline and technical know-how**:-

FPI can also bring discipline and know how into the domestic capital markets. In a deeper, broader market, investors will have greater incentive to expand resources in researching new or emerging investment opportunities as an enterprise compete for financing; they will face demands for better information both in terms of quantity and quality. This press for fuller disclosure will promote transparency, which can have positive spill over into other economic sector. FPI without the advantage of an insider's knowledge of the investment opportunities are specially like to demand a higher level of information disclosure and accounting standards and bring with them experience utilizing these standards and the knowledge of how they function.

**3. Help promote development of equity markets: -**

FPI can also help to promote development of equity markets and the shareholders voice in corporate governance. As companies come compete for finances, the market will reward better performance, better prospects for future performance and better corporate governance. As the market liquidity and functionality improves, equity prices will increasingly reflect the underlying values of the firm, enhancing the more efficient allocation of capital flows well-functioning equity market will also facilitate take overs a point where portfolio and direct investment overlap. Take overs can turn a poorly functioning firm into an efficient and more profitable firm. It strengthens the firm and the domestic economy.

**4. Help introduce more sophisticated instruments and technology:-**

FPI's may also help the domestic capital markets by introducing more sophisticated instruments and technology for managing portfolio. For instance, they may bring with them a facility in using futures, options, swaps and other hedging instruments to manage portfolio risk. Increased demand for these instruments would be conducive in developing this function in domestic markets, improving risk management opportunities for both foreign and domestic investors.

❖ **CHARACTERISTICS OF THE FPI**

1. The primary intention is not to control a foreign business enterprise but to gain from profit making opportunities available in foreign markets.
2. FPI is represented by monetary flows from individuals, mutual funds, portfolio management companies, pension funds, equity funds etc.
3. Due to the short term nature of such investments the funds flow are less predictable. This may result in volatility in both the foreign exchange and capital markets.

4. There is no interface between the management and the foreign investors. The transactions represent a change in ownership of existing equity from one investor to another. It has no impact on the balance sheet of the company.
5. Conventionally, all such investments represent secondary market transactions. However, regulations may permit investments through the primary market with quantitative restrictions.
6. FPI transactions result in replacement of existing investors. Thus, they do not directly contribute to economic growth. However, the greater demand for shares of the target company increased their market price leading to a higher profit earnings ratio. This helps the target company to raise capital at a lower cost.
7. Due to the presence of such investors secondary markets grow deeper and broader.
8. FPI helps capital market acquire an institutional character since global liquidity is channelled into local markets in a planned manner through research and analytical studies. These funds translate into diversified investment against predefined risk parameters.
9. These investments increase demand for the shares of target companies thereby increasing their profit earnings ratios. This helps such companies to raise capital at lower cost.
10. International investors are provided with an avenue for investment in diversification, wealth protection and at a macro level an opportunity for cross country hedging in terms of currencies, industries and geographical location.
11. The growth in FPI in recent years can be attributed to better investor protection regulations in developing countries liberalization in terms of access to such market and better macro-economic fundamental of emerging economics.
12. They provide a buffer for financing the BOP deficits thereby helping to preserve the foreign currency reserve of the host country.

## ❖ DETERMINANTS OF FPI

a) Inflation rate
b) Real exchange rate
c) Index of economic activity
d) Share of domestic capital market in the world stock and market capitalization.

These are the four statistically significant determinants of FII or FPI. Other determinants are listed below:

1. Institutionalization of savings- pension funds, investment trust, life insurance companies etc. in developed countries.
2. Diversification strategies led to cross border investments.
3. Removal of exchange control in the 1980's by the industrialized countries.
4. Full capital convertibility by early 1990's
5. Relaxation of exchange controls in emerging economies
6. Opening of capital account in 1980's and early 1990's
7. Modern portfolio theory- Risk/Return trade off same return- lower risk, same risk- high returns, variability of return significance
8. Developing countries expected to grow faster due to higher returns and increased shares prices
9. Worldwide wave of privatization
10. Emerging markets accounting for rising proportion of international investment by mutual funds
11. Funds originating from pension funds less volatile than mutual funds
12. Challenges of economic growth of receiving countries:
    a) Policy dilemmas for macro-eco 'management'
    - ✓ Over valuation of currency
    - ✓ Excessive expansion of money

    b) Capital reversal- with sharp domestic and international changes, securitized flows become more volatile than medium term bank loan as they can leave the country fast speed increased with computerization.
    c) Speculative flows cause abnormal fluctuation of share prices
    d) Flows of hot money- movement of FPIs i.e. investments only for profits with high volatility, distort the exchange rates and disrupt the capital market both when entering and existing market. These monetary flows are called 'Hot money'. Therefore to safeguard against ill effects of such fund movements, most government, introduced exchange control regulations.
13. Regional Factors- Portfolio flow to different country in a region has a high correlation.

14. Determinants with reference to India- The good fundamentals of the Indian economy under the present government like controlled inflation and a comfortable foreign exchange reserve situation has enhanced FIIs confidence most money managers from abroad believe that investors will tolerate a great degree of political disturbance so long the fundamentals of the economy stay on track and companies can continue to expand and increase earnings.
15. Returns on Investments- India are one of the major hot markets around the globe for investors to look at in 1994. It forecasts a rate of return at 30% to 50% much higher than any other investing countries like, France, Mexico, and South Korea.
16. Bright Prospects of Growth- India has an immense amount of industrial growth. This has been attributed to the ability of the Indian industries to withstand the dismantling of tariff barriers, delicensing and convertibility and still makes profit.
17. Vibrant Capital markets and investor's participation- Indian market can be compared with markets of developed countries. It has high number of investors, companies and the size of its private sectors.

❖ **TRENDS IN FII**

- FIIs are allowed to enter into the Indian market only in 1992 and since then there has been a tremendous response.
- As on the end of December 1993, foreign portfolio investment into the Indian stock markets has crossed more than $1 billion mark.
- The total investments by FIIs are understood to be around $1.055 billion according to the custodian.
- The official figure with the SEBI is more than $ 762 million.
- However, SEBI has quoted that there could be a difference in the figures because of the time log in reporting the data.
- This $ 1 billion mark is indeed more than double the $500 million a year that most analysts were predicting only for few months.
- Following this trend the BSE index has jumped nearly 30% to cross the covered 4000 points mark during the first week of January 1994 due to heavy buying by FIIs.
- So unexpected has been the surge of foreign portfolio investment that the only two custodians for foreign investor shares in the country like Hong Kong Bank and Citi Bank were finding it increasingly difficult to handle the mounting volume of business.

- In the last two settlements on the BSE, they are said to have handled upward of more of more than1, 50,000 pieces of paper.
- Morgan Stanley did better than all other FIIs openings in India by floating its own domestic mutual fund.
- Some reports say that instead of Rs 300 crores, they were hoping to collect and they have managed to pick more than Rs 1000 crores.
- The reputation that the fund has built up in the country must be tremendous because ICICI which came out with an issue at around the same time was struggling to collect Rs. 100 crores.

## ❖ TRENDS IN FDI

- FDI flows have increased dramatically during the last 25 years, with a rapid growth during 1990s. The outflow of FDI was more than 15 times after 1990s compared to that during 1970s. It increased from US $64 billion in 1980 to US $981 billion in 2007. The flow of FDI is expected to increase further once the recent recession in advanced countries decreases.
- "Advanced countries were the major players in the flow of FDI. They were the predominant providers and recipients of FDI as 84% of FDI was provided by advanced countries and they received 69% of the FDI in 2007. It indicated that developing countries provided only 16% of total FDI and received 31% of total global FDI in 2007. The USA was the largest provider as well as recipient of FDI followed by the UK in 2007.
- Emerging economies are now receiving high FDI than what they received in 1980's. However, a few countries like China, Hong Kong, Brazil, México, India and Singapore are receiving over 50% of FDI among developing countries.
- The UK is the world's second largest provider of FDI. Investment in overseas securities accounted for nearly 25% of the UK pension funds' assets under management in 2007. UK was also a major recipient of FDI and it was the 2$^{nd}$ largest in the world and the largest among European Union Countries.
- US direct investment abroad was US $ 1,72,0905 million in 2007 out of which it invested US $5,678 million in India in 2007. While US received an investment of US $ 1,520,965 million from other countries in 2007.

## ❖ Foreign Direct Investment in India:

The policy of the government of India towards the foreign direct investment has been positive due to the shortage of domestic capital. This is evident from various industrial policy resolutions and the declaration issued by the government from time to time. However foreign investor did not show keen interest in investing in India until 1991 due to the type of economic system of our country. The economic liberalization of 1991 have given greater fillip to the foreign direct investment the government of India with regard to FDI announced significant measures since 1991 include-

1. Granting of automatic permission for foreign equity participation up to 51% in high technology and high investment priority industries.
2. Allowing foreign equity participation up to 51% in international trading companies, hotel industry and tourist industry.
3. Constitution of specialized Empowered Board in order to attract FDI by negotiating with multinational corporations.
4. Depressing with the bureaucratic rules and regulation which caused and created hurdles for the FDI.
5. Allowing the MNC to use their trademark in India with effect from 14th may 1992.
6. Allowing 100% foreign equity for setting up of power with free repatriation of profits.
7. Allowing 100% equity contribution by the NRL and the corporate bodies owned by NRL in high priority industries with automatic approval and capital repatriation benefit.
8. Foreign investors can disinvest at market rate on stock exchange from September 15th 1992. However they should repatriate the proceeds of disinvestments.
9. Foreign companies can use that trademark in India w.e.f 14th May 1992.
10. According to the finance minister FII portfolio investment not subject to sectorial limit for foreign direct investment except in specialized sectors however various factors including exchange rate effects investment of FII to be hard.
11. The holding of non-banking financial companies can pull foreign equity up to 100%.
12. Foreign investors are allowed to establish 100% operating subsidiaries and should bring at least US $ 50 million for this purpose.
13. Private sector firms can have FDI up to 49% in automatic route subject to conformity to Reserve Bank of India guidelines.

14. 100% FDI is permitted in business to business, E –Commerce, power sector and oil refining.
15. Manufacturing activities in all special economic zones can have 100% automatic route except for arms, ammunition, explosive, allied defence equipment and warships, narcotics hazardous, chemicals, distillation brewing of alcoholic drinks, cigarettes and manufactured tobacco substitutes.
16. 74% FDI is allowed as subject to licensing and security norms (with the prior government approval for project beyond 49%) in internet service provider with the gateways, radio paging and end to end bandwidth. However, 100% FDI is allowed in other telecommunication project.
17. Offshore venture capital funds/companies can use automatic route subject to SEBI regulations.
18. Insurance companies can have FDIs up to 26% under the automatic route subject to the licensing requirements of Insurance Regulatory and Development Authority.
19. 100% FDI is permitted in airports (with prior government approval in case of beyond 74% FDI requirements), courier services (subject to the existing laws and exclusion of activities relating to distributing of letters), development of integrated township (including housing, commercial premises, hotels, resorts, roads and bridges etc.), hotel and tourism sector, drugs and pharmaceuticals (except some lines).

## III. MNC (Multinational Corporation)

### ❖ Meaning

- MNC is an organization doing business in more than one country.
- In modern times, the growth of the MNCs has contributed significantly to the development of global trade and economy at large.
- MNCs and expanding trade are two sides of the same coin- says Peter Ducker.
- Developing countries are today widely opening the doors, for the entry of the MNCs by encouraging foreign collaboration as well as foreign investment with a view to increase or to accelerate the growth process.
- It has been realized that external assistance in the form of foreign investment is necessary for rapid economic growth in a developing country.
- In fact, the rise of MNCs has been the most remarkable phenomena of post war era.

- MNCs produce, market, invest and operate across the world.
- They integrate global resources with global market to make profit.
- These companies have sales office and manufacturing facilities in many countries.
- MNC engage in various activities like exporting, importing, manufacturing in different countries.
- International Labour Organization finds MNC as, "essential of MNC lies in the fact i.e. their managerial headquarters are located in home country while the enterprise carries out operation in the number of host country.
- Thus, MNCs have become very powerful driving forces in the world economy.

## ❖ FEATURES OF MNCs

1. MNCs have managerial headquarters in the home country while they carry out operation in a number of countries.
2. A large part of the assets of the parent company is owned by the citizens of the home country.
3. The majority of the members of the board of director are the citizens of the home country.
4. Decision on the new investment and the local objects are taken by the parent company.
5. MNCs are large in size and exercise a great degree of economic dominance.
6. MNCs are oligopolistic in character.

## ❖ MOTIVES OF MNCS

Domestic companies become MNCs for the number of reasons. The main motive includes:

**1. Protection:**

To protect themselves from the uncertainty and risk of business cycle, political policies and social uncertainty of the domestic country. Expand the operations to a number of foreign countries can reduce the uncertainty.

**2. To Tap The Global Market**

To tap the growing global market for various goods and services, Many MNCs have targeted India & China during the 21st century because of their large population and increase in per capita income. Some MNCs have targeted Japanese and European market in view of their rich and sophisticated market.

3. **To increase Market Share**

Firms become MNCs in order to increase their market share by expanding their operation to number of countries.

4. **To Reduce Cost**

Companies become MNCs by locating their manufacturing facilities close to their foreign customers. This in turn reduces cost of transportation, warehousing, etc.

5. **To Overcome Tariff**

Many countries charge tariff if the companies import goods from other countries. In contrast company need not pay tariff if they locate their manufacturing facilities in foreign countries. Therefore, companies become MNCs by locating their manufacturing facilities in foreign countries.

6. **To Have Technological Advantage**

Companies become MNCs in order to take the advantages of technological enterprise by producing goods directly in foreign countries rather than through licensing.

7. **Expansion of Market Territory**

The growth of the various economies along with a growth of GDP and per capita income resulted in the rise in living standard. These factors contributed towards the expansion of market territory. Added to this, the large operation of the MNCS builds the image which contributes to the expansion of market territory.

8. **Market Superiority**

MNCs enjoy a number of market superiorities over the domestic companies. They include:

a) Availability of more reliable and updated data and information.
b) They enjoy market reputation
c) They face less difficulty in marketing their products.
d) They adopt more effective advertising and sales promotion techniques.
e) They enjoy with transportation and warehousing facility.

For example: World's major corporations are Wal-Mart store, General Motor, General Electronic Company and Citi group etc.

9. **Financial Superiority.**

MNCs enjoy financial superiority over national companies. They have

a) Huge financial resources at the disposal of the MNCs.
b) They have easy access to the external capital market.
c) They can mobilize different types of resources of high quality easily.
d) They can have access to internal banks and financial institutions.

**10. Technological Superiority.**

MNCs are allowed if not invited by the developing countries mostly due to the technological backwardness of these countries. In fact, MNCs are rich in advanced technology. They develop the technology through continuous R&D. The developing economies regard the transfer of the technology from the MNCs as useful due to the following reasons.

a) Industrialization is on a backward state in developing countries and the resources available in developing countries are insufficient to develop the technology and thereby industrialization.
b) Developing countries are rich in minerals and natural resources. They are unable to explore it fully due to shortage of financial resources and low level of technology.
c) Local manpower, capital etc. cannot be optimally utilized by the developing countries on their own. Therefore, MNC are invited by the developing countries to help them in exploiting the resources.
d) Developing countries would be required to import raw material, capital equipment, technology etc. on their own. This in turn needs large foreign exchange resources. Developing countries which suffer from shortage of foreign exchange resources invite MNCs in their regards.
e) Developing countries though they produce goods and services on their own importing technology and material, they fail in marketing the products, due to severe competition. This forces them to invite MNCs.
f) Production innovation:

   MNCs because of their wide spread operation in many countries collect information regarding customers tastes and preferences. Further, the MNCs switch their strong research and development, invent new product and develop the existing product. Developing countries suffer from limitation in this regard; therefore they invite MNCs to their countries.

## ❖ PROBLEMS OF MNCS TO THE HOST COUNTRY

Critics have pointed out several problems of MNCs such as:

**1. Drain of resources for profit maximization:**

The basic objective of MNCs is profit maximization through exploitation of host country resources. It is least concerned with developmental areas, growth of the poor host country.

**2. Drain of scare foreign exchange resources:**

These days MNCs belonging to the developed countries are usually making huge investment in the developing countries for the benefits of their home country. Thus, they transfer a huge amount of the country's foreign exchange resources by way of profit, dividend etc. to their home country. This may hold to the problem of BOP deficit which the country may face.

**3. Minimum transfer of technology:**

It has observed that the MNC's generally do not transfer their advanced technology to the host countries. They carry out R&D in the home alone. Further, technologies supplied by the MNCs, the less developed countries are capital intensive & which may not suit their real need of these countries. Moreover, they are mostly outdated.

**4. Insignificant employment potential:**

The MNCs mostly operate in the capital intensive industries because of these employment generations out of their investment are not very large in a less developed country. Moreover they are not interested in employing local, national (people) for high level technical & managerial post.

**5. Influence on culture:**

MNCs bring their cultural values & attribute to the host country. This causes destruction of the original culture in various ways.

**6. Interference in state sovereignty:**

The MNC's interference in the host countries political policy matter & try to shape their policy for the advantage of the MNC's. Thus they misuse their financial power on the host government. They may also play their power game in getting a politician party of their own choice elected to the government.

**7. Ill- effects of advertisement:**

The MNC's spend large amount on competitive advertisement which may lead to high price of the products. They also try to change the lifestyle of the people in the developing countries through advertisements.

**8. Monopoly growth:**

The MNCs may create their monopoly in the market & remove local competitors.

**9. Depletion of non- renewable resources:**

The MNCs exploit the host countries non- renewable natural resources to their advantage. This results in decrease of non-renewable resources in the host country.

**10. Evasion of taxes:**

The MNCs may manipulate their account in order to erode taxes.

**11. Unconcern for environmental pollution and eco- logical balance**:

It is widely criticized that the MNC's in India did not invest in environmental pollution, controlling equipment as they normally do in their home country. This in turn resulted in environmental pollution in a number of places in the country. E.g. Bhopal gas tragedy

**12. Business but not social justice:**

MNCs are in business but not in social service. They believe in superiority of free market economies. The MNCs distribute their investment in such a way in order to maximize profits; wide gap between rich & poor has become characteristic of Indian since long back. A section of Indian economy enjoy higher standard of living. MNCs in India have been concentrating only on the rich section. They leave the poor section to the local business. Thus, the more profitable business is grabbed by the MNCs & the less profitable business is left to locals

❖ **PROBLEMS OF MNCS TO THE HOME COUNTRY**

1. Unfavorable BOP

   Transfer of capital to other countries from the home country causes unfavorable BOP.
2. Unemployment increases

MNCs may not create employment opportunities to domestic people in the home country because of outsourcing their business operations in various countries. E.g. USA software companies outsource business operations in India.

3. Neglect of industrial development

   MNCs may neglect the industrial development of the home country.

4. Culture

   MNCs may cost erosion of the domestic culture.

5. Excessive exploitation of natural resources

   MNCs may exploit the natural resources in the home country resulting in excessive exploitation of natural resources.

# I. FACTORING

## INTRODUCTION:

- As stated earlier, a lot of working capital is tied up in the form of trade debts.
- Collection of debts, especially for the small-scale & medium scale company is the biggest problem.
- The average collection period has been on the increase.
- Delays in collection process in turn load to liquidity problems & consequently to delay in production & supplies. The peculiar situation in India is that a number of small scale units are catering to the requirements of a single large buyer.
- This large buyer is always known for his procrastination in paying his small suppliers.
- The creed of the problem is not so much the failure to pay altogether as the failure to pay on time.
- As a result, the interest cost of financing book debts is quite heavy.
- This increase in cost of capital reduces profit and competitiveness of a company particularly the small ones in the market.
- Ultimately, the small unit may become even sick.
- To overcome this situation, the factoring service has been conceived.
- In India, the financial services sector is developing at a faster rate so as to meet the emerging needs of the economy.
- Many innovative schemes have been introduced by this sector.

## MEANING AND DEFINITION:

- The word factor has been derived from the Latin word 'Facere' which means to make or to do.
- Factor means to get things done.
- Factor is an agent, as a banking or insurance company engaged in financing the operations of certain company or in financing wholesale or retail trade, through purchase of accounts receivables.
- Thus, factoring is nothing but financing through purchase of accounts receivables.
- Factoring is a method of financing whereby a company sells its trade debts at a discount to financing institution.

- Thus, it is a continuous arrangement between financial institution & a company which sells goods & services to trade customers.
- Prof. S. P. Singh, a member of study group appointed by RBI defines "factoring which traditionally meant buying of book debts for cash does not merely involve discounting or credit insurance"

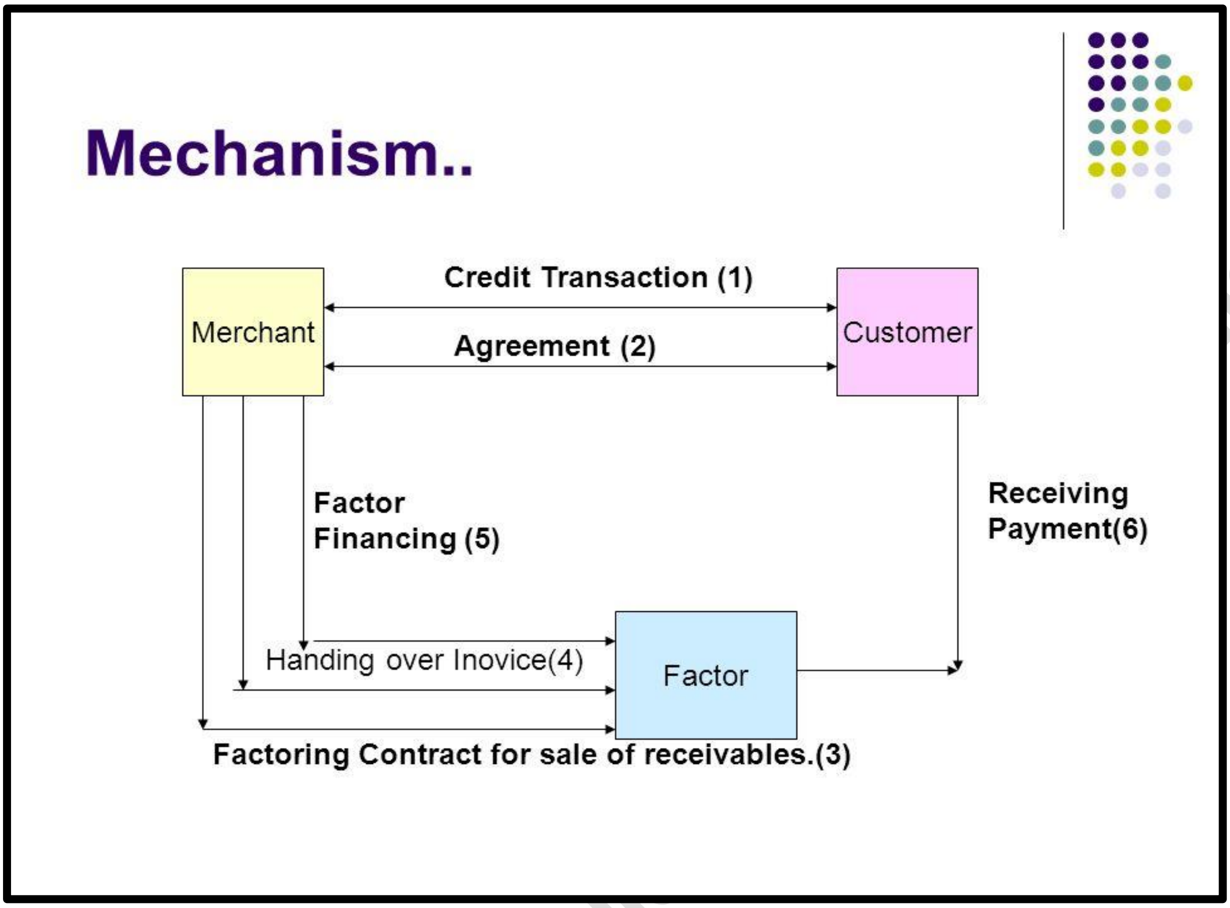
**ORIGIN OF FACTORING:-**

- Modern factoring came into existence in 1920s.
- Factoring as financing against receivable got a boost in 1930s, but there was no comprehensive framework of statutory law for a factoring arrangement.
- In the UK, factoring came into existence in the form of invoice discounting.
- The factoring market grew there in the late 1960s.
- In 1976, the leading factoring companies of the UK formed the Association of British Factors (ABF).
- The factoring business has now thrived in Italy & Asia- pacific countries.
- They are also experiencing a tremendous growth in the factoring business.

**FACTORING MECHANISM**:

The mechanism of factoring can be explained with the help of the following flowchart:-

1. Customers place an order with the client for goods & /or service on credit, client delivers the goods & sends an invoice to customers.
2. Client assigns invoice to factor.
3. Factor makes prepayment upto 80 per cent & sends periodical statements.
4. Monthly statement of accounts to customers is sent & follow up is done.
5. Customer makes payment to factor.
6. Factor makes balance 20 per cent payment on realization to the client




-The client sends an invoice to his customers in the usual way but adds a notification that the invoice is assigned to & must be paid to the factor with whom he has made on arrangement.

- The client then submits copies of invoices to the factor with a schedule of offer accompanied by the receipt, delivery, challan, or any other valid proof of dispatch.

- The factor provides prepayment up to 80% of the invoice value & follows up with customers for realization of payment due.

**BENEFITS:**

Factoring offers a number of benefits to the clients some of the important benefits are:

1. **Financial Service:**

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. This has been a great handicap to the small and medium scale manufacturers because they have to wait for months to realise their debts. In the meantime, the business may suffer due to want of funds. Infact many business concerns fail as a result of inadequate cash flow than anything else. The key to successful working capital management lies in the ability of converting credit sales into cash immediately which is possible through factoring.

2. **Collection Service:**

It is found that over 60% of the total sales of the SSI sector and over 50% of the total sales of the medium and large sector are made on credit. Due the delays in collection of debts, industrialists cannot concentrate on production. It leads to delays in production and supplies and ultimately affects the profitability of the company; now this collection work is completely taken up by the factoring organization.

3. **"Credit Risk" Service:**

In the absence of a factor, the entire credit risk has to be borne by the client himself. Bad debts eat away the profits of a concern and in some cases; it may lead to the closure of a business. But, once the factoring relationship is established the client need not bother about the loss due to bad debts. The factor assumes the risk of default in payment by customers and thus, the clients is assumed of complete realization of his book debts.

4. **Provision of Expertise "Sales Ledger Management" Service :**

Administration of sales ledger is purely an accounting function which can be performed efficiently only by a few. In fact, the success of any organization depends upon the efficiency with which the sales ledger is managed. It requires a specialized knowledge which the client may not possess. But, the client can receive services like maintenance of accounting records, monthly sales analysis, and overdue invoice analysis and customer payment statement from the factor. Besides, he maintains contact with customers to ensure that they repay their dues promptly. Thus, it offers an excellent credit control for the client.

5. **Consultancy Service:**

Apart from the above, the factor also provides consultancy services to the client.

6. **Economy in Servicing:**

Factors are able to render very economic service to their clients because their overhead cost is spread over a number of clients. Moreover their service charges are also reasonable. Factoring is a cheap source of finance to the client because the interest rate is charged only on the amount actually provided to the client, say e.g., 80% of his total invoices and not on the total amount of the invoices. Thus, clients are able to get factoring services at economic rates.

7. **Off-Balance Sheet Financing:**

Factoring is an off-balance sheet means of financing. When the factor purchases the book debts of the client, these debts no longer exist on the current asset side of the balance sheet. It leads to reduction in debts and less collection problems. The client can utilize the money so received to reduce his current liabilities.

## ❖ FACTORING COMPANIES IN INDIA:

- Can bank Factors Ltd.
- SBI factors and Commercial Services Pvt. Ltd.
- The Hong Kong and Shanghai Banking Corp. Ltd.
- Foremost Factors Ltd.
- Global Trade Finance Ltd.
- Export Credit Guarantee Corp. Of India Ltd.
- Citi Bank NA, India.
- SIDBI.
- Standard Chartered Bank.

## ❖ SBI FACTORS AND COMMERCIAL SERVICES PVT. LTD.

- Subsidiary of SBI.
- Asset base of Rs.919.36 crores.
- As on March 31, 2006.
- First factoring co. in India

## ❖ GLOBAL TRADE FINANCE LIMITED.

- Only provide of international factoring.
- Commenced in Sep 2001.
- Joint Venture between West LB, Germany [40%], Export-Import Bank of India [35%] and International Finance Corporation, Washington [25%].

❖ **TYPES OF FACTORING**

The types of factoring services depend on the business nature of the clients. In general, factoring services can be classified as follows:-

1) **Full service factoring :**

It is also known as without resources factoring. Hence factor provides all kind of services such as providing of finance, maintenance of sales ledger, consultancy services, collect debt at his risk etc.

2) **With resource factoring :**

As the name suggests, under this type, the factor does not assume the credit risk. It simply means that, if the debtors do not repay their dues on time, such debts are automatically aligned back to take up work for collections. If he fails to pay on time in extra charge is charged which is called as “Refactoring Charges”.

3) **Maturity Factoring :**

Under this type factor does cash payment to the client at the time of assignment of debts. Hence, it is also called as “Collection Factoring”. As no financing is involved but all other services are available.

4) **Bulk Factoring :**

Here the factor provides finance assignment of debts to the debtor concerned. Hence, the factor simply collects the debts on behalf of the client. It is also known as the “Disclosed Factoring” or “Notified Factoring”.

5) **Invoice Factoring :**

Here, the factor simply provides the finance against invoices without understanding any other factor. It is very confidential in nature and thus is called an “Undisclosed Factoring”.

6) **Agency Factoring :**

Here, there is no connection of agency as far as factoring is concerned. Here factor and client share the work of each other.

7) **International Factoring:**

Here, factoring services are extended to international markets. Factoring is purely done on the basic of invoice prepared by the exporter. The exporter here is able to get 80% cash of the export invoice immediately.

**8) Limited Factoring :**

Under this type, the factor does not take up all the invoice of a client. He discounts only selected invoice on mail basis and convert credit bills into cash in respect of those bills only.

**9) Buyer Based Factoring :**

Here, the initiatives come from the buyers end. This facility is available only for limited, reputed credit worthy buyers and it is also called as "Selected Buyer Based Factoring".

**10) Seller Based Factoring :**

Under this type, the seller instead of discounting his bills sells all his A/c's receivables to the factor, after invoicing the customers. Hence, it is called as "Seller Based Factoring".

**11) Suppliers Guarantee Factoring :**

This is suitable for business establishment which sells goods through middlemen. Generally goods are sold through wholesalers, retailers, through middlemen. This enables the suppliers to earn profits without much financial involvement.

❖ **INTERNATIONAL FACTORING**

International factoring facilitates international trade. It is a comprehensive range of receivable management & financing service wherein a factor provides an exporter with at least two of the following services.

- Credit management & bad debt protection
- Credit guarantee.
- Finance up to 90% of the value on shipment to approved debtor.
- Collection services.
- Professional sales ledger & analysis.

  International factoring cases much of the credit & collection burden created by international sales.

Export receivables that can be factored have the following characteristics.

- The buyer's country should be covered by the factor.
- The exporter's performance obligation should be completed at the time the exporters present an invoice for prepayment.
- There should be multiple shipments or a continuous sales flow on an ongoing basis with the same buyer or buyers. There should be assignment of the whole turnover with a buyer on a continuous basis.

**Need for International Factoring**

An exporter requires international factoring services to relieve him of the problems of collecting receivables in a foreign country & the tensions arising from the unfamiliarity with the customers' credit worthiness. Moreover, the demand for open account trading has expanded globally & Indian exporters are also required to offer similar terms to importers in order to remain competitive. This has created a demand for better credit risk protection service arising out to remain competitive. International factoring provides credit assessment & protection, financing & collection services to exporters for regular sales in open account terms. International factoring requires no collateral or letter of credit (LC). A letter from a bank to a foreign bank authorizing the payment of a specified sum to the person or company named is known as letter of credit (LC). Letters of credit are widely used as a means of payments for goods in foreign trade.

An export factor in India pays 90% as advance on the approved invoice & also gives a 100% risk protection on the receivable in the event of the buyer's failure to pay including insolvency.

**BENEFITS OF INTERNATIONAL FACTORING**

Exporters deal with only one factor even if his exports are spread across different countries. He can experience of the correspondent factors not only in terms of getting an access to the buyers but also in laws & business practices of these countries. The risks & bad debts are reduced. He can expand his exporting new markets.

The importer also benefits as he pays the invoice amount to a factoring company in his own country. This is similar to making payments to domestic suppliers. The importer gets an access to open account terms. In the absence of this, he would have to open letter of credit (LC), thereby blocking his bank limits.

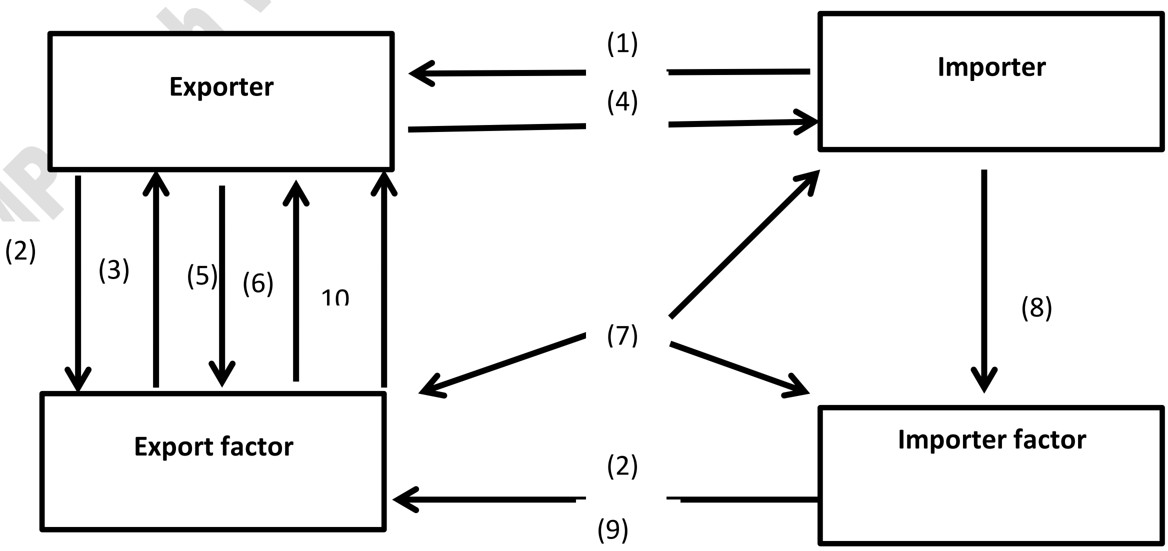
## FLOWS CHART OF INTERNATIONAL FACTORING TRANSACTION

In international factoring, there are four parties that is the exporter (client), the importer (customers), the export factors & the import factor. International factoring is a two factor system. The export factor serves the needs of clients in India while the import factor undertakes the credit assessment of customers keeping in view the macro-conditions of the country specific factors. It also undertakes collections & follow-up required for realization on maturity.

In international factoring there is no bank involved in the transaction. All the necessary documentations & the RBI formalities are completed by the export factor who is an authorized dealer.

- The exporter receives an order or regularly receives orders from an importer or importers & is able to estimate the financing requirements.
- The exporter provides the export factors with contact details of its customers along with estimates of the credit limits. The export factor forwards these details to correspondent import factors in the relevant country.
- On approval of the exporters credit limits the exporters enters into a factoring agreement with the export factors.
- The exporters ship the goods to his customers (importer).
- The export factors scrutinize the documents & make a pre-payment as agreed upon to the exporters.

**Figure: International Factoring Transactions**



1. Receives order
2. Credit limit request
3. Approval
4. Delivers goods
5. Submits documents
6. Pre-payments
7. Documents
8. Collections
9. Payments remittance
10. Balance payments

- The export factor directly forwards the documents to the customers under advice to the correspondent factors.
- The correspondent factor (import factor) follows up with the customers & collects payments from export factors.
- On collection, the export factor credits the balance payments to the exporters account.
- Factoring is most suitable for manufacturing & trading companies. It is also suitable for advertising agencies, Solicitors & legal firms, architect firms, medical firms, construction & engineering contracts & software firms.

**INTERNATIONAL FACTORING CHARGES**

In international factoring, there are two types of charges; discount charge & service charge. The factor levies discount charge for pre-payment & service charge for allied services which includes 100% risk protection. The charge is generally calculated as a percentage on a flat basis on the gross invoice value.

## II INTERNATIONAL FINANCE CORPORATION

The International Finance Corporation, an affiliate of the World Bank, was established in1956. Although membership in the World Bank is a pre-requisite for membership in the IFC, legally and financially, the IFC is a separate entity. The corporation has its own operating and legal staff, but draws upon the Bank for administrative and other services.

**Mission and Objectives**

The mission of IFC is to contribute to World Bank Group's overall purpose of reducing poverty and improving living standards by playing a leading role in the development of a sustainable private sector. The goal of IFC, in partnership with others, is to deliver development impact.

IFC's basic tools to achieve this goal remain loan and equity financing of private enterprises, mobilization of external capital alongside its own resources, and provision of related advisory and technical assistance services. But the context of the corporation's work has dramatically altered, opening many new areas of activity.

The objective of IFC is to assist the economic development of less developed countries by promoting growth in the private sector of their economies and helping mobilise domestic and foreign capital for this purpose.

The IFC's role is to stimulate the flow of private capital into productive private, mixed private/public enterprises. It acts as a catalyst in bringing together entrepreneurship, investment capital and production.

The origin of the IFC lays in the recognition by the industrial countries that the provision of essential infrastructure for development alone would not be enough to attract private investment flows to countries where underdevelopment was pronounced. It was necessary, in addition, to encourage the growth of productive private investment and saving in the developing world. These board objectives were translated into specific objectives that were embodied in the IFC's Articles of Agreement.

**Performance of IMF**

The main features of IFC's assistance are:

1. The IFC makes its investments in partnership with private investors from the capital-exporting country or from the country in which the enterprise is located, or both.
2. It is envisaged that the Corporation's investments will never be more than that of the capital requirements of the enterprise.
3. The minimum investment that the IFC will make in an enterprise is fixed at $ 1,00,000 or its equivalent, but no upper limit is fixed.
4. The enterprise eligible for loans from the Corporation should be predominantly industrial and countribute to the the economic development of the country.
5. The rate of interest in each case would be a matter of negotiation depending on the risks and other investments.
6. The IFC will not seek or accept a government guarantee for the repayment of any its investments, nor will it seek formal government approval of any proposed financing. Except when such approval is required by law in any country.

One important feature that distinguishes the IFC from commercial financial institutions is its commitment to provide project sponsors with the necessary technical, assistance that will help ensure that their ventures are potentially productive and financially sound. In addition, the Corporation provides policy assistance to its member governments in support of their efforts to develop the necessary investment climate that will encourage productive as well as beneficial domestic and foreign investment.

Recognizing the important contributions of financial markets to economic development, the IFC has a specialised department that is the focal point of the capital market development activities of the IFC and the World Bank. The Department provides specialised resources for addressing the financial market needs and problems of developing countries. In response to the economic situation, in 1984 the IFC began to expand its operation in a new area- assisting in the physical and financial restructuring of existing firms (corporate restructuring). In addition to corporate restricting, IFC expanded is activity into several other new areas. For example, it helped create a bonding facility for construction firms operating outside their own country, helped establish a secondary mortgage marketing institution, and provided financing for a regionally oriented venture capital company.

The privatization trend all around the world has greatly increased the role of the IFC.

**IFC and India**

The IFC has assisted a number a number of projects in India. The New economic policy of India which has substantially enhanced the role of the private sector implies a greater role for the IFC in the industrial development of the country.

The Corporation has identified five priority areas in India where it plans to beef up its activities. The five identified area for strengthened activities include capital markets development, direct foreign investment, access to foreign markets, equity investments in new and expanding companies to finance capital investments and infrastructure. The IFC opened a mission in Bombay to speed up the assessment of the project proposals. India is the first of the IFC's member countries to benefit from such decentralization.

First, IFC will invest in a range of financial service companies and provide technical assistance to help develop India's capital market. Secondly, with its global network of contacts, IFC could act as a catalyst in bringing together Indian and foreign companies, stimulating the flow of foreign investment and technology into India.

Thirdly, IFC will intensify its efforts to help Indian companies gain access to funding in the international financial market through loan syndications and underwriting of securities issues.

Fourthly, Indian companies need to strengthen their balance sheets by increasing equity and reducing debt levels if they were to survive in a more competitive market. The IFC is giving special emphasis to equity investments in companies that are internationally competitive.

## III INTERNATIONAL MONITORY FUND (IMF)

**Introduction:**

The "International Monitory and Financial Conference" was held at Bretton woods in 1944. The global trade mechanism was severally affected due to Second World War. The conference has given birth to the twin International Financial Institution namely-IMF (International Monitory Fund) and IBRD.(International Bank for Reconstruction and Development).

**International Monitory Fund (IMF)**

The IMF is a post war International Monitory Institution. After the world war, nation of the world felt the need for international co-operation in economic trade and balance of payment affairs. "The United State Treasury" in 1943 published a proposal of the establishment of an International Stabilization Fund. "UK around the same time proposed the establishment of International clearing union". The USA proposal is known as "White plan" (Mr. White is the Author) and UK proposal is known as "Keynes plan". (The author is Lord Keynes). The joint plan was prepared in 1944 in the form of joint statement by experts for the establishment of IMF. This became the basis for IMF established in the Financial Conference at Bretton Woods in 1944. An agreement was reached to establish an International Monitory Fund by 44 nations during this conference.

-Thus IMF was formed to promote economic planning and financial co-operation among the member countries to facilitate expansion and balanced growth of world trade with effect from 1947. The number of members of IMF has increased from 44 in 1947 to 185 in 2008. It is for short term loan and to correct disequilibrium in BOP.

**Objectives of IMF**

1) To avoid competitive devaluation.

2) To establish stable exchange rate.

3) To develop multi-lateral trade and development.

4) To promote international monitory co-operation- a permanent institution –consultation and

collaboration of International Monitory problems.

5) To facilitate expansion of balanced growth of international trade.

6) To provide exchange stability.

**Functions of IMF**

i. To avoid competitive devaluation & exchange control.
ii. To establish & maintain currency convertibility with stable exchange rate.
iii. To provide exchange stability & to maintain orderly exchange arrangement among members to avoid competitive exchange devaluation.
iv. To develop multilateral trade & payment. To assist in the establishment of multilateral system of payment between members & in the removal of foreign exchange transaction which hampers the growth of international world trade.
v. Promote International monitory co-operation through a permanent institution which provides machinery for consultation & collaboration of international monitory problem.
vi. To facilitate the expansion of balanced growth of international trade and to contribute to the promotion and maintain high level of employment and real income.
vii. To also contribute to the development of productive resources of all members as a primary objective of economic policy.
viii. Provide exchange stability – IMF aims at reducing tariff and other trade restrictions by the member countries. IMF wants to lessen the degree of disequilibrium in the International BOP of members.
ix. One of the main objectives is to level confidence to the members by making the funds resources available to them to conduct mal-adjustment in their BOPs the IMF is thus regarded as garden of “the good conduct” in the area of BOP.
x. One of the objectives of IMF is to provide technical advice to its members regarding monitory and fiscal policy. It also provides machinery for international consultancy.
xi. IMF aims to provide machinery for orderly adjustment of exchange rate.
xii. IMF aims to provide short term financial assistance to its member to get rid of BOP problems.

xiii. It also conducts short term training course on fiscal, monetary and BOP for employees of Member County. It provides this training through it's:

a) Central Bank Services department.
b) The fiscal affairs department.
**c)** The IMF institution.

**Performance of IMF**

1) IMF has played an important role in providing international liquidity and in the structural adjustment programmes. There is however a wide gap between aspiration (hope) and achievement.
2) A criticism often made is that these institutions which are dominated by the developed countries have not been paying enough attention to the needs of the development country.
3) Another criticism is about the size of the funds available to the member countries. The availability of fund depends on the willingness of the developed countries to contribute.
4) Inspite of all these problems, IMF has played a very important role in the world economy. The increase in the membership of this institution is a clear evidence of their utility.

## IV IBRD

**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD)**

### Introduction:

The International Monetory and Financial Conference was held at Bretton woods in 1944. The conference has given birth to the twin international institution namely IMF and IBRD. IBRD is popularly known as World Bank. The global trade mechanism was severely affects due to the Second World War. The war also affected the manufacturing facility and infrastructural facilities. Germany, France, UK, Japan and other countries were the worst victim of the world war. There was a fear of another world war due to the western countries, Asian countries and Africa countries after the Second World War. The third world countries felt the need for development of agricultural and industrial sector of their economics. Most of the countries felt the need for reconstruction of their economics. The participant countries at Bretton woods conference felt that only IMF cannot be achieved this objective. The conference resolved to establish another institution for reconstruction of weak countries and establishment of World Bank. IMF was established to provide short term assistance to correct the BOP disequilibrium, while the IBRD was established to provide long term assistance for the reconstruction and development of the economy of the member countries. IBRD is an inter-governmental institution .its capital is entirely owned by its member government.

### Objectives of IBRD

The main objectives of World Bank are:-

1) To assist in the reconstruction and development of territories of its members

2) To promote private foreign investment

3) To promote long term balance growth of interaction of trade and maintain equilibrium in the BOP of member countries

4) The World Bank also encourages international investment for the development of their productive resources this increase standard of living and conditions of workers in their member countries.

**Funding Objectives of Bank**

IBRD has the following funding objectives:-

1) To make sure the availability of funds in the market

2) To provide funds to the borrowers at the possible lowest cost .They choose the time when the interest rate in the market is low

3) To provide an appropriate degree of maturity transformation between borrowing and lending.

**Bank Borrowing**

**-**One of the important activities of the World Bank is borrowing.

**-**In order to lend the funds it borrows the money.

**-**It borrows in the international capital market both on medium and long term.

**-**It also borrows on currency swap agreement.

**-**It also borrows under the objectives Discount net program me.

**-**The World bank borrows from the central bank of the member countries .This borrowing instruments includes central bank facility and us dollar dominated facility.

**-**Another instrument is floating note. The World Bank borrows from the commercial bank and other financial institution under the help of these instruments.

**Bank Lending Activity**

-The, World Bank grants loan to the member countries.

-Granting loan from its own funds.

-Granting loans from the funds borrowed by the bank in the market of the members countries.

-Guaranteeing the loans raised by the members from various other sources.

**Conditions for Granting Loan**

1) If the borrowers are unable to raise loan under reasonable circumstances.

2) If the loan is for reconstruction and development

3) When central bank guaranties the repayment of the loan raised by the company.

4) If the competent committee, recommends a loan in the form of written Project report.

**Structural Adjustment Facility**

1) In order to help the member country suffering from BOP disequilibrium.

2) IBRD introduced the structural adjustment –facilities this funds are used to finance general import but not imports of luxury and military goods.

3) Technical and advisory assistance; -

The IBRD provides technical and advisory assistance to its member countries. In addition to financial assistance includes.

**a**) Assessing the economic sources of the members and set up priorities to be followed in the developmental programme.

**b**) Sending survey missions to member countries to conduct intensive study of national resources to formulate policy for long term development of the country.

❖ **Performance of IBRD Or World Bank**

1) Inadequate financial aid.

2) Dis-crimination treatment.

3) Interest and commission charges.

4) Insistence on repaying capacities.

5) Loan for agriculture.

1) Inadequate Financial Aid

_ The capital and other financial resources of the World Bank are not adequate to meet the increasing requirement of the member countries.

_ The financial assistance given by the bank to the developing countries amount to just a drop in the ocean.

2) Discriminatory Treatment

_ In its day to day functioning banks have discriminated against a poorer count and has benefited more the richer countries.

3) Interest and Commission Charges

World Bank has also been accrued (Put Blame) of charging high interest and commission from the borrowing countries which mostly happened to be developing countries. This practice is highly unjust inequitable and opposite to the bank charters.

4) Insistence on Repaying Capacities;

Another criticism is that the World Bank insists on knowing the repaying capacities before granting of loans to member countries.

5) Loans for Agriculture

It has extended loan to developing countries mostly for agriculture and the ratio of granting the loan to agriculture is more than the heavy and basic industries.

# Unit IV

## CREDIT RATING

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### ➢ MEANING & DEFINITION OF CREDIT RATING:

- Credit rating means giving an expert opinion by a rating agency on the relative willingness & ability of the issuer of a debt instrument to meet the debt servicing obligations in time & in full.
- Credit ratings are judgements about a firm's financial & business prospects.
- It is the assessment of borrower's credit quality.
- Credit rating performs the function of Credit risk evaluation reflecting the borrower's expected capability to repay the debts as per terms of issue.
- Credit rating is merely an indicator of the current opinion of the relative capacity of a borrowing entity to service its debt obligations within a specified time & with particular reference to the debt instrument being rated.
- Credit rating is not a recommendation to buy.
- It is a well-informed opinion made available to the public & might influence their investment decisions.
- An agency that performs the rating of debt instruments is known as Credit rating agency.
- According to John Moody "Ratings are designed exclusively for the purpose of grading bonds according to their investment qualities".
- According to CRISIL (Credit Rating Information Service Ltd), "Credit Rating is an unbiased & independent opinion as to issuer's capacity to meet its financial obligation. It does not constitute a recommendation to buy/sell or hold a particular security".

- **ORIGIN OF CREDIT RATING:**

  - The origin of Credit rating can be traced to the $1840_s$ when following the financial crisis of 1837, the first mercantile Credit agency was set up in New York by Louis Tappan in 1841.
  - The agency rated the ability of merchants to pay their financial obligations Lates on, it was taken over by Robert Dun.
  - The first rating guide was published in 1859 by this agency.
  - John Bradstreet set up a similar agency in 1857.
  - These two agencies were later merged to inform Dun & Brad sheet in 1933, which acquired the 'Moody's' investors service' in 1962.
  - It is interesting to note that Moody's have a long story in the railing business. Spanning over a period of more than a hundred years.
  - In 1990 John Moody founded Moody's investor service & in 1909 published his ' Manual of Railroad securities.
  - Presently rating agencies exist in Canada, Australia, Japan, UK, France, Sweden, portages, South Korea, Philippines, Spain, & Chile.
  - The history of credit rating in India is very short.
  - It started with the establishment of the credit rating information services of India Ltd. (CRISIL) in Jan 1988.
  - It was followed by the establishment of the investment information & credit rating agency of India (IICRA) in 1991, promoted by the industrial finance corporation of India (IFCI).
  - In 1993, the credit analysis & Research ltd. was established as a subsidiary of IDBI.
  - The DUFFs & Phelps credit rating (India) (DCRI) was established for rating Non- banking financial companies for fixed deposits.

➢ **IMPORTANCE OF CREDIT RATING:**

– Credit rating is an important service for both investors & issuers it offers, the following advantages or benefits to the investors & issuers.

**I. Importance of credit rating to investors:**

**1. Low cost information: -**

Credit rating is a source of low cost information the collection, processing & analysis of relevant information is done by specialized agency which a group of investors can trust.

**2. Independent investment decision: -**

For related instruments, investors need not depend upon the advice of the financial intermediaries the rating symbol suggests the credit worthiness of the instrument & indicates the degree of risk involved in it, the investor can make direct investment decision.

**3. Quick Investment Decisions: -**

In the present day, complex world ratings enable investor to take quickest possible decisions on associated ratings.

**4. Investor Protection: -**

Hiring of credit agency implies that the management of the company is ready to show its operations for independent scouting so, the investors who are not provided with confidential information can have overall assessment based on ratings. The creditable & objective rating agency can provide & disclosure, better akg std & improved investor protection.

**5. Other Benefits: -**

The investors' community, in general, also benefits from the other services offered by credit rating agencies, namely, research, in the form of industry reports, corporate reports, seminars, & open access to the analysis of the agencies.

## II. Importance of Credit Rating to the Issuers:

1. **Sources of Additional Certification: -**

   Credit rating agency provides additional information to the issuers of debit /financial instruments. A highly rated firm can enter the market with great confidence Indian experience shows that use of rating, benefit a great deal by getting larger amount of money from a wider audience at a lower cost.

2. **Increase the Investor Protection: -**

   A sound credit rating system give an alternative method to name recognition as a determining factor in making investment & help increase the population of those investing in debt obligation of the company.

3. **Forewarns Risks: -**

   Credit Rating acts as a guide to company which gate a lower rating. It forewarns the management of the perception of risk in the market & prompts to take steps on their operating & marketing risks & thereby changes the perception in the markets.

4. **Encourages Financial Discipline: -**

   Rating also encourages discipline among corporate borrowers to improve their financial structure & performance to obtain better rating for their debt obligation.

5. **Merchant Bankers Job Made Easy: -**

   Merchant bankers & brokers will be relieved of the responsibility of guiding investors as to the risk of a particular investment. Merchant bankers & brokers in the absence of objective information, go on the basis of name recognition in guiding their Clients.

6. **Foreign Collaboration Made Easy: -**

   The foreign collaboration always asks for credit rating while negotiating with an Indian company. Credit rating enables to identify instantly the relative credit standing of the company. The important of credit rating is being increasingly recognized in the euro marketing.

7. **Low cost of Borrowing: -**

A co. with highly rated instrument has the opportunity to reduce the cost of borrowing by quoting lesser interest rate on fixed deposit or debenture as the investors with low risk preference would invest in safe securities through yielding low rate of return.

8. **Rating as Marketing Tools: -**

Companies with rated instruments, use rating as a marketing tool to credit better image in dealing with their customers, lenders & creditors.

- **RATING METHODOLOGY**: -
  - In India, the rating exercise starts at the request of the company.
  - The process of obtaining a rating is quite lengthy & time consuming.
  - The rating of a financial instrument requires a thorough analysis of relevant factors that affect the credit worthiness of the issuer.
  - Ratings are assigned after an in-depth study of both objective & subjective factors related to business.
  - Ratings are based on an in-depth study of the industry & an evaluation of the strength & weakness of the company.
  - The analytical framework of rating agencies consists of the following four broad areas.

A. **Business Analysis: -**

- This covers an analysis of industry risk, market position in the country, operating efficiency of the company & legal position.

i. Industry risk covers an analysis of actual & estimated demand or supply, number of the performance of the industry, its future potentiality & other factors.

ii. Market position in the industry, covers the study of market share, market arrangements, products and customers.

iii. Operating efficiency is a study of production processes of the firm, its cost structure, locational advantages, labour relationships, input availability & prices.

iv. Legal position covers a study of prospectus, accuracy & so on with proper regulatory austerities.

B. **Financial Analysis: -**

– Financial analysis includes an analysis of accounting quality, earning protections, cash flow adequacy & financial flexibility

i. Accounting quality is known by the study of method of income recognition, inventory valuation, depreciation policies, and auditor's remarks & off balance liabilities.
ii. Earnings protection is examined with reference to profitability ratios, earning growth & projected earnings, among others
iii. Adequacy of cash flow includes a study of future cash flows, working capital needs & capital budgets
iv. Financial flexibility is examined in terms of whether alternative financing plans have been developed & the feasibility of such plans, among other prospects.

**C. Management Evaluation: -**

– This includes a study of the track record of the management, the management capacity to overcome adverse situation, goals, philosophy & strategies.

**D. Fundamental Analysis: -**

– This covers an analysis of liquidity management, asset quality, profitability & interest & tax sensitivity.

i. Liquidity management can be known through a study of capital structure, matching of assets & liabilities, liquid assets, maturing deposits among others.
ii. Asset quality includes the company's credit management, policies for monitoring credit, composition of assets & sector risk
iii. Profitability is examined through a study of profitability ratios, spreads, reserves & non- business income
iv. Interest & tax sensitivity is in terms of exposure to interest rate charges hedge against interest rate, tax provision & impact of tax law changes

– The above information is collected & analyzed by a term of professionals in an agency.

– Companies are asked to fill up the forms & provide the required data.

- If necessary meeting with top management suppliers & dealers & a visit to the plant and proposed sites are arranged to collect & confirm additional data & issues relating to credit evaluation of a firm.
- This team of professionals or analysis submits their recommendations to the rating committee.
- The committee discusses this report & their assigns rating.
- Once the quantitative data is analysed, it is seasoned judgment of the rating committee which makes rating of an agency unique & sometimes controversial.
- Rating involves a lot of subjectivity in the process for instance in case of bond ratings, besides a quantitative analysis of past performance it is the future debt servicing capacity of a company that is relevant.
- An analysis of the estimate of this capacity is subjective & subjectivity cannot be rule out.
- The rating assigned is then notified to the issue & only on his acceptance the rating is published.
- A rating agency assures strict confidentiality of information to its client.
- If the client wants to furnish additions information, he can do so & get the rating reviewed again.
- Once the issuer decides to use & publish the rating, the agency has to continuously monitor it over the entire life of the instrument.
- The rating agency continuously monitors the corporate the rating is monitored till the life of the instrument.
- This process is known as surveillance.
- Rating may be upgraded, downgraded, or continue unchanged depending upon new information or developments & their resultant effect on the debt instrument being rated.

- The revised ratings are also published & made public in financial dailies & newspaper.
-

## ➢ CREDIT RATING AGENCIES IN INDIA:

Following are the Credit Rating Agencies in India: -

1. **Credit Rating Information Services Limited (CRISI): -**
    - CRISIL is the first credit rating agency established in India.
    - It was promoted jointly by ICICI (18%) & UTI (18%) in 1987 with a capital of 4 crores.
    - There are a number other shareholders such as Asian Development Bank (ADB) (15%), LIC GIC each 5%, SBI (5%), HDFC (6.2%), GIC, nine public sector & private sector banks (19.25%) & 10 foreign banks (7.55%).
    - It commenced its operations on 1st Jan.1988.
    - CRISIL has five offices one each in Mumbai, Delhi, Kolkata, Chennai & Bangalore.
    - The principal obj. of CRISIL is to rate the debt obligation of Indian cos.
    - Its rating guides investors about the risk of timely payment of investment… & principal on a particular debt instrument.
    - It provides the following services to corporates:
        - i) Rating services
        - ii) Information services
        - iii) Advisory services
    - Among the credit rating agencies, CRISIL is the most dominant player in the field.

2. **Investment Information & Credit Rating Agency of India (IICRA): -**
    - IICRA was set up by Industrial Finance Corporation of India on 16th Jan.1991.
    - It is a public limited co. with an authorised share capital of Rs. 101 crores.
    - The initial paid capital of Rs. 350 crores are subscribed by IFC, UTI, GIC, SBI & 17 other banks.
    - IICRA started its operations from 15th Mar.1991.

- It was established to meet the requirements of cos. based in the north.
- It is the second most important credit rating agency in India after CRISIL.
- It provides the following services: -
    1. Rating of credit instruments
    2. Equity rating – (earning prospects & risk analysis)
    3. Credit Assessment
    4. General Assessment

**3. CARE Ltd. (The credit Analysis & Research Ltd.): -**

- The CARE Ltd. is promoted by Industrial Development Bank of India (IDBI) jointly with investment institutions, banks & other finance cos.
- It is a credit rating & information services co. which commenced its operations in October 1993.
- The instruments credit – rated by CARE Ltd. are debentures, fixed deposits, certificates of deposits, commercial paper & structured obligations.
- Services offered by CARE Ltd. are: -
    i) Credit rating
    ii) Information service
    iii) Equity research
    iv) Rating of paralleled market of LPG & Kerosene.
- Since its inception till the end of March 1995, CARE has rated 249 debt instruments covering a total debt volume of Rs. 9,729 crores.

**4. Duffs & Phelps Credit Rating India Pvt. Ltd. (DCRI): -**

- The Duffs & Phelps Credit Rating India Pvt. Ltd. is the latest entrant in credit rating business in the country.
- It is also a leading international credit rating agency.
- It is a joint venture between the international credit rating agency Duffs & Phelps & M. J. financial & Allianze group.
- It renders rating service of the following: -
    i) Debt Instruments
    ii) Cos. & countries on their request
    iii) Commercial papers

- In Aug. 1996, the RBI approved this agency for rating commercial papers in India.

5. **Onida Individual Credit Rating Agency Ltd. (ONICRA): -**
    - The ONICRA is the first rating agency established in India to rate the credit worthiness of non- corporate or individual borrowers established in 1993.
    - It is sponsored by Onida Finance Ltd.
    - It does not rate the individual, but it analyses the risk associated with entering into a transaction with a particular individual at a particular point of time.
    - This kind of credit rating is useful while considering the application for the issue of credit cards, granting of housing loans, leasing or hire purchase, rental agreements, personal loans, bank finance, etc.

➢ **CREDIT RATING SYMBOLS:**

The following table shows the investment – wise rating symbols assigned by various credit rating agencies & the meaning of each rating from the angle of safety to the investors:

**ICRA (Investment Information and Credit Rating Agency of India Limited)**

a. Long-term Debt-Debenture, Bonds and Preference shares

| Symbol | Indicator | Profile |
|---|---|---|
| LAAA | Highest safety | • Indicates fundamentally strong position<br>• Risk factors are negligible<br>• Visualization of any circumstances adversely affecting the degree of safety<br>• Timely payment of principal and interest as per terms will not be affected |
| LAA+<br>LAA<br>LAA- | High safety | • Modest and slightly varying risk factors<br>• Strong protective factors<br>• Prospect of timely payment of principal and interest as per terms under adverse circumstances, as may be visualized |

| | | |
|---|---|---|
| LA+<br>LA<br>LA- | Adequate safety | • Risk factors are more variable and greater in periods of economic stress<br>• Provide factors are average<br>• Any adverse change in circumstances although and could be visualized, may alter the fundamental strength and affect the timely payment of principal and interest as per terms |
| LBBB+<br>LBBB<br>LBBB- | Moderate safety | • Considerable variability in risk factors<br>• Protective factors are below average<br>• Adverse changes in business/economic circumstances are likely to affect the timely payment of principal and interest as per terms |
| LBB+<br>LBB<br>LBB- | Inadequate safety | • Timely payment of interest and principal are more likely to be affected by present or prospective changes in business/economic circumstances<br>• Protective factors fluctuate in case of changes in economic/business conditions |
| LB+<br>LB<br>LB- | Risk prone | • Risk factors indicates that the obligations may not be met when due<br>• Adverse changes in business/economic conditions could result in inability/unwillingness to service debts on time as per terms |
| LC+<br>LC<br>LC- | Substantial risk | • Presence of inherent elements of risk and timely servicing of debts/obligations could be possible only in case of continued existence of favourable circumstances |
| LD | Default extremely speculative | • Either already default in payment of interest and/or principal as per terms or expected to |

| | | |
|---|---|---|
| | | default<br>• Recovery is likely only on liquidation or reorganization |

b. Medium-term Debt-including Fixed Deposit Programs

| Symbol | Indicator | Profile |
|---|---|---|
| MAAA | Highest safety | • Best prospect of timely servicing of interest and principal as per terms |
| MAA+<br>MAA<br>MAA- | High safety | • Prospect of timely servicing of the interest and principal as per terms is high, not as high as in MAAA rating |
| MA+<br>MA<br>MA- | Adequate safety | • Adequate prospect of timely servicing of the interest and principal<br>• Debt servicing may however, be affected by adverse changes in the business/economic conditions |
| MB+<br>MB<br>MB- | Moderate safety | • Timely payment of interest and principal are more likely to be affected by future uncertainties |
| MC+<br>MC<br>MC- | Risk prone | • High susceptibility to default<br>• Adverse changes in business/economic conditions could result in inability/unwillingness to service debts on time and as per terms |
| MD | Default | • Either already default or expected to default |

c. Short-term Debt-including Commercial Paper

| Symbol | Indicator | Profile |
|---|---|---|
| A1+<br>A1 | Highest safety | • Best prospect of timely payment of debt/obligation |
| A2+<br>A2 | High safety | • Relative safety is marginally lower than A1rating |
| A3+<br>A3 | Adequate safety | • Prospect of timely payment of interest and instalment is adequate, but any adverse changes in business/economic conditions may affect the fundamental strength |
| A4+ | Risk prone | • Degree of safety is low. Likely to default in case of adverse changes in business/economic conditions |
| A5 | Default | • Either already on default or expected to default |

- **CRISIL (Credit Rating and Information Services if India Limited)**

a. Debenture Rating Symbols

| Symbol | Indicator | Profile |
|---|---|---|
| AAA<br>(Triple A) | Highest safety | • Offers highest safety of timely payment of interest and principal<br>• Any change in circumstances, providing this degree of safety can be envisaged, and is most unlikely to affect adversely the fundamentally strong position of such issues |
| AA<br>(Double A) | High safety | • Offers adequate safety of timely payment of interest and principal<br>• Differs in safety from ‘AAA’ issues only marginally |

| | | |
|---|---|---|
| A | Adequate safety | • Offers adequate safety of timely payment of interest and principal<br>• However, changes in circumstances can adversely affect such issues more than those in the highest rated categorises |
| BBB<br>(Triple b) | Moderate safety | • Offers sufficient safety of timely payment of interest and principal for present<br>• Changing circumstances are, however, more likely to lead to a weakened capacity to pay interest and repay principal than for debentures in higher rated categories |
| BB<br>(Double B) | Inadequate safety | • Carriers inadequate safety of timely payment of interest and principal<br>• Less susceptible to default than others speculative grade debentures in the immediate future<br>• However, the uncertainties that the issuer faces could lead to inadequate capacity to make timely interest and principal repayments |
| B | High Risk | • Have greater susceptible to default<br>• Although current interest and principal repayment are met, adverse business or economic conditions would lead to lack of ability or willingness to pay interest or principal |
| C | Substantial risk | • Presence of highly vulnerable factors<br>• Timely payment of interest and principal is possible only if favourable circumstances continue |
| D | Moderate safety | • Interest or principal payments are expected to default and maturity speculative nature of debentures and returns from these debentures may be realized only on reorganization or liquidation |

**Note:**

1. CRISIL may apply '+'(plus) or '-' (minus) signs for ratings from AA to C reflect comparative standing within the category
2. The contents within parentheses are a guide to the pronunciation of the rating symbols
3. Preference share rating symbols are identical to debenture rating symbols except that the letters 'pf' are prefixed to the rating symbols in, e.g. 'pfAAA'

➢ **CRISIL Fixed Deposit Rating Symbols**

| Symbol | Indicator | Profile |
|---|---|---|
| FAAA(F Triple A) | Highest safety | • Degree of safety regarding timely payment of interest and principal is very strong |
| FAA(F Double A) | High safety | • Degree of safety regarding timely payment of interest and principal is very strong<br>• However, the relative degree safety is not as high as for Fixed Deposits of 'FAAA' rating |
| FA | Adequate safety | • Degree of safety regarding timely payment of interest and principal is satisfactory<br>• Changes in circumstances can affect such issues more than those in the higher rated categories |
| FB | Inadequate safety | • Inadequate safety of timely payment of interest and principal<br>• Such issues are less susceptible to default than fixed deposits rated below this category<br>• The uncertainties that the issuer might face could lead to inadequate capacity to make timely interest and principal payments |
| FC | High Risk | • Degree of safety regarding timely payment of interest and principal is doubtful<br>• Such issues have factors present that make them vulnerable to default<br>• Adverse business or economic conditions would |

| | | |
|---|---|---|
| | | lead to lack of ability or willingness to pay interest or principal |
| FD | Default | • Indicates that the issue is either in default or is expected to be in default upon maturity |

**Note:** CRISIL may apply '+' (plus) '-' (minus) signs for rating from FAA to FC to indicate the relative position within the rating category.

- **CRISIL RATINGS FOR SHORT-TERM INSTRUMENTS**

| Symbol | Indicator | Profile |
|---|---|---|
| P-1 | Highest safety | • Degree of safety regarding timely payment on instruments is very strong |
| P-2 | High safety | • Degree of safety regarding timely payment on instruments is very strong<br>• However, the relative degree of safety is lower than that for instruments 'P-1' |
| P-3 | Adequate safety | • Degree of safety regarding timely payment on instrument is adequate<br>• However, the instrument is more vulnerable to adverse effects due to changing circumstances than an instrument rated in the two higher categories |
| P-4 | High Risk | • Degree of safety regarding timely payment on the instrument is minimal and is likely to be adversely affected by short-term adversity or less favourable conditions |
| P-5 | Default | • Instrument is expected to default on maturity or is already in default |

**Note:** CRISIL may apply '+' (plus) '-' (minus) signs for rating from P-1 to P3 to reflect comparative within category.