SYNOPSIS

SUBJECT: FINANCIAL SERVICES AND SYSTEMS (ELECTIVE – II)

UNIT – I

The Financial System in India

A financial system is a set of institutions, such as banks, insurance companies, and stock exchanges, that permit the exchange of funds. Financial systems exist on firm, regional, and global levels. Borrowers, lenders, and investors exchange current funds to finance projects, either for consumption or productive investments, and to pursue a return on their financial assets. The financial system also includes sets of rules and practices that borrowers and lenders use to decide which projects get financed, who finances projects, and terms of financial deals.

- A financial system is the set of global, regional, or firm-specific institutions and practices used to facilitate the exchange of funds.
- Financial systems can be organized using market principles, central planning, or a hybrid of both.
- Institutions within a financial system include everything from banks to stock exchanges and government treasuries.

Financial markets **refer broadly to any marketplace where the trading of securities occurs, including the stock** market**, bond** market**, forex** market**, and derivatives** market**, among others.** Financial markets **are vital to the smooth operation of capitalist economies**

Types of Financial Markets

There are so many financial markets, and every country is home to at least one, although they vary in size. Some are small while some others are internationally known, such as the New York Stock Exchange (NYSE) that trades trillions of dollars on a daily basis. Here are some types of financial markets.

1. Stock market

2. Bond market

3. Commodities market.

4. Derivatives market

Primary Market
Secondary Market
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What Is a Derivative?
A derivative is a financial security with a value that is reliant upon or derived from, an underlying asset or group of assets—a benchmark. The derivative itself is a contract between two or more parties, and the derivative derives its price from fluctuations in the underlying asset.

The most common underlying assets for derivatives are stocks, bonds, commodities, currencies, interest rates, and market indexes. These assets are commonly purchased through brokerages.

Common Forms of Derivatives
There are many different types of derivatives that can be used for risk management, for speculation, and to leverage a position. Derivatives is a growing marketplace and offer products to fit nearly any need or risk tolerance.

Futures
Futures contracts—also known simply as futures—are an agreement between two parties for the purchase and delivery of an asset at an agreed upon price at a future date. Futures trade on an exchange, and the contracts are standardized. Traders will use a futures contract to hedge their risk or speculate on the price of an underlying asset. The parties involved in the futures transaction are obligated to fulfill a commitment to buy or sell the underlying asset.

Forwards
Forward contracts—known simply as forwards—are similar to futures, but do not trade on an exchange, only over-the-counter. When a forward contract is created, the buyer and seller may have customized the terms, size and settlement process for the derivative. As OTC products, forward contracts carry a greater degree of counterparty risk for both buyers and sellers.

Counterparty risks are a kind of credit risk in that the buyer or seller may not be able to live up to the obligations outlined in the contract. If one party of the contract becomes insolvent, the other party may have no recourse and could lose the value of its position. Once created, the parties in a forward contract can offset their position with other counterparties, which can increase the potential for counterparty risks as more traders become involved in the same contract.

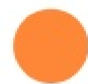
Swaps
Swaps are another common type of derivative, often used to exchange one kind of cash flow with another. For example, a trader might use an interest rate swap to switch from a variable interest rate loan to a fixed interest rate loan, or vice versa.

Options
An options contract is similar to a futures contract in that it is an agreement between two parties to buy or sell an asset at a predetermined future date for a specific price. The key difference between options and futures is that, with an option, the buyer is not obliged to exercise their agreement to buy or sell. It is an opportunity only, not an obligation—futures are obligations. As with futures, options may be used to hedge or speculate on the price of the underlying asset.

Imagine an investor owns 100 shares of a stock worth $50 per share they believe the stock's value will rise in the future. However, this investor is concerned about potential risks and decides to hedge their position with an option. The investor could buy a put option that gives them the right to sell 100 shares of the underlying stock for $50 per share—known as the strike price—until a specific day in the future—known as the expiration date.

MEANING :

- A **government** security is a bond or other type of debt obligation that is issued by a **government** with a promise of repayment upon the security's maturity date. **Government securities** are usually considered low-risk investments because they are backed by the taxing power of a **government**.



Objectives/Features of Govt. Securities :

- Govt. securities are sovereign debt obligations of govt. of India either central or any other authority of govt.
- Govt. securities include central govt. & state govt. securities, Treasury Bill & Govt. guaranteed bonds.
- The terms of govt. securities range from 92 days to 30 years.

Discuss the various types of Government securities that are issued by the RBI. Government securities are referred to as 'gilt-edged securities', as they are absolutely secured RBI, beingthe banker to the Government, issues different types of paper on belhalf of the latter, to cater various requirement.

The Reserve Bank of India (RBI) defines government securities as "tradable instruments issued by the Central Government or State Governments." These securities carry a minimum risk of default and are sometimes called "risk-free gilt-edged instruments." The following are some securities offered by the RBI:

Treasury Bills

Cash Management Bills

Dated Government Securities

State Development Loans

Money market and Capital market

Money market and Capital market are types of financial **markets**. **Money markets** are used for short-term lending or borrowing usually the assets are held for one year or less whereas, **Capital Markets** are used for long-term securities they have a direct or indirect impact on the **capital**.

Following are the types of Money Market Instruments:

Promissory Note:

Bills of exchange or commercial bills

Treasury Bills (T-Bills)

- The Treasury bills are issued by the Central Government and known to be one of the safest money market instruments available. Besides, they carry zero risk, so the returns are not attractive. Also, they come with different maturity periods like 1 year, 6 months or 3 months and are also circulated by primary and secondary markets. The central government issues them at a lesser price than their face-value.

Call and Notice Money

Call and Notice Money exist in the market. With respect to Call Money, the funds are borrowed and lent for one day, whereas in the Notice Market, they are borrowed and

lent up to 14 days, without any collateral security. The commercial banks and cooperative banks borrow and lend funds in this market. However, the all-India financial institutions and mutual funds only participate as lenders of funds.

Inter-bank Term Market

The inter-bank term market is for the cooperative and commercial banks in India who borrow and lend funds for a period of over 14 days and up to 90 days. This is done without any collateral security at the rates determined by markets.

Commercial Papers (CPs)

- Commercial papers can be compared to an unsecured short-term promissory note which is issued by top rated companies with a purpose of raising capital to meet requirements directly from the market.
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Certificate of Deposits (CD’s)

- This functions as a deposit receipt for money which is deposited with a financial organization or bank. The Certificate of Deposit is different from a Fixed Deposit receipt in two ways. i. Certificate of deposits are issued only of the sum of money is huge. ii. Certificate of deposit is freely negotiable.
- Note: CD’s can be issued to individuals (except minors), companies, corporations, funds, non–resident Indians, etc.

Banker’s Acceptance (BA)

- A Banker’s Acceptance is a document that promises future payment which is guaranteed by a commercial bank. Also, it is used in money market funds and will specify the details of repayment like the date of repayment, amount to be paid, and details of the individual to which the repayment is due.
- BA’s features maturity periods that range between 30 days up to 180 days.

Repurchase Agreements (Repo)

- Repo's are also known as Reverse Repo or as Repo. They are loans of short duration which are agreed by buyers and sellers for the purpose of selling and repurchasing.
- However, these transactions can be carried out between RBI approved parties.
- Note: Transactions can only be permitted between securities approved by RBI like the central or state government securities, treasury bills, central or state government securities, and PSU bonds.

Capital market

Capital market is a **market** where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions. ... Generally, this **market** trades mostly in long-term securities

There are two principal types of markets namely,

1. Primary Market
2. Secondary Market

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Functions of Primary Market

Kinds of Capital Markets

There are two principal types of markets namely,

1. Primary Market
2. Secondary Market

Unit -2

Financial Institutions

Evolution of Banking in India

The banking sector in India plays a vital role in this country's economic development. Over the centuries, numerous changes have occurred within this industry, from technological advancement to the diversification of financial services and products.

Currently, the Indian banking system includes commercial banks, small finance banks, and cooperative banks.

Banks operating within the boundaries of India abide by the Banking Regulation Act 1949.

- **Phase 1 (1786-1969)**

This is the pre-independence phase, which lasted nearly 200 years. During this period, there were close to 600 banks. At the same time, some significant developments in the banking industry also took place.

Bank of Hindustan is the first bank to exist, marking the foundation of India's banking system. But it ceased to exist in 1932.

- Presidency Banks

The East India Company founded three key presidency banks. These include the Bank of Bombay (1840), Bank of Madras (1843) and Bank of Calcutta (1806).

These three banks merged and became the Imperial Bank of India. In 1955, it was renamed the State Bank of India. Besides these, more banks, including Punjab National Bank and Allahabad Bank, came into existence.

Between 1913 and 1948, there was stagnation in India’s banking space as growth was slow. Multiple banks encountered periodic failures. The lack of confidence in the country’s banking system played a part in the slow mobilisation of funds and the growth of this sector. There were around 1100 banks during this period.

To streamline these banks' operations, the Indian Government introduced the Banking Regulation Act 1949.

- **Phase 2 (1969-1991)**

Post-independence, Indians were doubtful about the private ownership of banks. Instead, they preferred to rely on moneylenders for necessary financial assistance. To combat this issue, the Indian Government nationalised 14 commercial banks in 1969.

The main objective of this move was to reduce the concentration of power and wealth of certain families that owned and controlled these financial institutions.

There were other reasons too for nationalisation:

- To support India’s agricultural sector
- Mobilise savings among individuals
- Facilitate the expansion of India’s banking network by opening more branches
- Boost the priority sectors through banking services

Some of the banks that were nationalised in 1961 include:

- Central Bank of India
- United Bank
- Canara Bank
- Indian Overseas Bank
- Dena Bank
- Union Bank of India
- Bank of Baroda
- Bank of India
- Allahabad Bank

The evolution of India's banking system continued in this trajectory.

In 1980, the Government nationalised six more banks, including:

- Corporation Bank
- Punjab & Sind Bank
- New Bank of India
- Vijaya Bank
- Andhra Bank
- Oriental Bank of Commerce

  - Financial Institutions

Besides nationalising private banks, the Indian Government established a few financial institutions (between 1982 and 1990) to fulfil specific objectives.

- EXIM Bank – for promoting import as well as export

- National Housing Board- for funding housing projects
- National Bank for Agriculture and Rural Development (NABARD) – for supporting agricultural activities
- Small Industries Development Bank of India (SIDBI) – for providing financial assistance to small-scale Indian industries

Benefits of Nationalisation

- Increased efficiency in the industry
- Empowered small-scale industries
- Provided a massive boost to India’s agricultural sector
- Increased public deposits
- Ensured better outreach
- Provided employment opportunities

- **Phase 3 (1991- Present)**

Since 1991, the Indian banking system has been evolving. The Indian Government encouraged foreign investment, which opened the economy to foreign and private investors, which has led to the introduction of mobile banking, internet banking, ATMs, and more.

Some foreign banks in India include:

- HSBC
- Citibank
- Bank of America
- Standard Chartered Bank

- DBS Bank
- Royal Bank of Scotland

To stabilise the nationalised public sector banks, the Indian Government formed the Narasimham Committee in 1991 to manage reforms in the banking sector. During this time, the Government approved various private banks. These include Axis Bank, IndusInd Bank, and ICICI Bank.

Other noteworthy developments or changes:

- Small finance banks became eligible to open new branches anywhere in India
- The Government and RBI began to treat both private and public sector banks equally
- Banks started digitising transactions along with other banking operations
- Payments banks were established

Different Types of Banks in India

Currently, there are four types of banks in India:

- Commercial Banks

  These banks adhere to the provisions of the Banking Regulations Act 1949. Commercial banks accept deposits from the public and give out loans to generate profits. They are segregated into four types: Private sector banks, public sector banks, regional rural banks and foreign banks.

- Small Finance Banks

Small finance banks provide financial assistance to those segments of society that other banks do not serve. The customer base of such banks includes small business units, micro industries, and more.

- Cooperative Banks

A managing committee controls the operations of these banks. Cooperative banks are not designed to make a profit, and the customers of these banks are their owners. These banks are categorised into state cooperative banks and urban cooperative banks.

- Payments Banks

This new type of bank in India can accept limited deposits. These banks are allowed to provide savings and current account services. They can also issue debit cards. But as per RBI norms, they are not eligible to offer credit cards or loans.

That said, Payment Banks are said to play a vital role in the growth of e-banking in India. Airtel Payments Bank and Fino Payments Bank are a few examples of payment banks in the country.

Reserve Bank of India (RBI) And Its Functions

RBI (Reserve Bank of India) is the central bank of India and a statutory body responsible for multiple tasks like printing the currency notes, controlling monetary policy and acting as a custodian to other primary banks of the nation. The RBI was established on April 1, 1935 under the Reserve Bank of India Act, 1934 on the recommendation of the Hilton-Yong-Commission or commonly referred to as Royal Commission on Indian currency and finance. It is headquartered in Mumbai. The main motive behind setting up RBI was to separate the currency control from the government and provide other banking facilities. The Reserve Bank of India was nationalized with effect from 1st January, 1949 on the basis of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948. The working of RBI is regulated by the RBI governor appointed by the central government of India and the Governor acts as the main decision-maker in RBI.

Main Functions of RBI

Issue Currency Notes:

The issue and printing of currency notes are one of the primary functions of the RBI. The Reserve Bank of India prints notes of all denominations except 1 rupee and that's because the one rupee note is issued by the Indian Ministry of Finance. The issue and printing of currency notes in India are regulated under the Minimum Reserve System (MRS). As per the MRS, the Reserve Bank of India keeps a reserve asset of Rs 200 crore out of which INR 120 crore would be in form of Gold and the rest in the form of foreign currency. Also, the addition of any new denomination or discontinuation of any existing denomination is being done by RBI. For example, during demonetization in November 2016, RBI discontinued old 500 and 1000 rupee notes and added new 2000 and 500 rupee notes.

Central Bank for other Banks (Lender of the Last Resort):

The Reserve Bank of India acts as a parent bank to all the primary banks operating in India. However hereby RBI plays a role as lender (acting as the lender of the last resort for all banks when they are in financial crisis situation)

that lends money to the primary banks of India on certain interests. Also, it keeps an eye on the financial transactions of the banks so that amount of account holders remain secured in the banks.

Keeping a Track of Foreign Exchange Reserve:

Buying and selling foreign currencies and thus making sure a stable foreign exchange in India comes into RBI's account. Reserve Bank of India holds the right to buy and sell foreign currencies in the international foreign exchange market. Also, RBI makes sure that turbulence in the foreign exchange market does not affect the economy of the nation.

Acting as a Banker to the Government:

The RBI acts as a banker to the central and the state governments of India and fulfills all the banking necessities of the government. Also, RBI plays a crucial role as an advisor to the central government of India and assists the government in framing economic policies for the nation.

Controlling Credit Flow:

The credit made by the primary commercial banks of India is being controlled by the RBI. Also, RBI is responsible for regulating the flow of money in the market. RBI adopts both quantitative and qualitative methods to regulate the cash flow in the market. RBI increases or decreases the repo rate to control inflation and regulate the cash flow in the market.

Other Important Functions:

The RBI acts as a representative of India in the IMF (International Monetary Fund), and also in many other major international financial organizations. The Reserve Bank of India is also responsible for looking after government treasures, available securities, foreign reserves, etc. The RBI also plays a major role in the development program run by the central government of India and finances some of these programs. Also, other activities like presenting the economic data of the nation, GDP growth, and the inflation rate is also done by the RBI.

The scheduled commercial banks are those banks which are included in the second schedule of

RBI Act 1934 and which carry out the normal business of banking such as accepting deposits,

giving out loans and other banking services. The major difference between Scheduled

Commercial Banks and Scheduled Cooperative Banks is their holding pattern, since cooperatives

are registered under the Cooperative Societies Act as cooperative credit institutions.

Scheduled Commercial Banks can be further divided into four groups:

- Public Sector Banks: This includes:
- SBI & Associates
- Nationalized Banks
- Other Public Sector Banks
- Private Banks
- Foreign Banks
- Regional Rural Banks

Nationalized Banks

1. Allahabad Bank
2. Andhra Bank
3. Bank of Baroda

4. Bank of India

5. Bank of Maharashtra

6. Canara Bank

7. Central Bank of India

8. Corporation Bank

9. Dena Bank

10. Indian Bank

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11. Indian Overseas Bank

12. Oriental Bank of Commerce

13. Punjab & Sind Bank

14. Punjab National Bank

15. Syndicate Bank

16. UCO Bank

17. Union Bank of India

18. United Bank of India

19. Vijaya Bank

Importance of Commercial Banks

Commercial banks are vital to a nation’s economy. They offer essential banking services to end users and help create market capital and liquidity by taking consumers’ funds and lending them to others.

Commercial banks play a role in credit creation, which increases production, employment, and consumer spending, thereby boosting the economy. These banks are heavily regulated by the central bank of that country, the RBI, in India. For example, central banks impose reserve requirements on commercial banks, which means that they would need to hold a certain percentage of their consumer deposits at the central bank in case of a rush to withdraw funds from the general public. These entities help markets thrive and, if their influence is used well, can foster development so that more people can access essential services and consumer goods.

Types of Commercial Banks

Commercial banks are classified into two categories, i.e., scheduled commercial banks and non-scheduled commercial banks. Furthermore, scheduled commercial banks are classified into three types:

Private Banks

When individuals own more than 51% of the share capital, that banking company is private. However, these banks are companies on the stock market on a recognized stock exchange. Below are the private banks in India –

- Axis Bank
- Bandhan Bank
- City Union Bank
- DCB Bank
- Dhanlaxmi Bank
- Federal Bank
- HDFC Bank
- ICICI Bank
- IDBI Bank
- IDFC Bank
- IndusInd Bank
- Jammu and Kashmir Bank
- Karnataka Bank
- Karur Vysya Bank
- Kotak Mahindra Bank
- Lakshmi Vilas Bank
- Nainital Bank
- RBL Bank
- South Indian Bank
- Tamilnad Mercantile Bank

- YES Bank

Public Banks

When the Government owns more than 51% of the share capital of a listed banking company, that bank is called a public sector bank. SBI is the largest public sector bank in India and is ranked among the top 50 banks in the world. Listed below are the public banks in India.

- Bank of Baroda
- Bank of India
- Bank of Maharashtra
- Canara Bank
- Central Bank of India
- Indian Bank
- Indian Overseas Bank
- Punjab & Sind Bank
- Punjab National Bank
- State Bank of India
- UCO Bank
- Union Bank of India

Foreign Banks: Banks established in foreign countries and branches in the home country are called foreign banks. Some of the top foreign banks operating in India are –

- American Express Banking Corporation
- Bank of America
- Barclays Bank Plc.
- BNP Paribas
- Citibank
- DBS Bank India Limited
- Deutsche Bank
- HSBC Bank
- J.P. Morgan Chase Bank N.A
- Standard Chartered Bank
- The Royal Bank of Scotland
- United Overseas Bank Ltd

Functions of Commercial Banks

Among the roles played by commercial banks in modern economies are:

1. Mobilize savings for capital creation

Commercial banks help mobilize savings through a banking network. People in developing economies have low incomes, but banks can induce them to save by introducing a variety of deposit schemes to suit individual needs. Banks also mobilize the savings of the wealthy few. By mobilizing these people's savings, banks can channel them to carry out productive and investment activities. Therefore, commercial banks are crucial to help capital formation in a developing country, creating jobs and markets, and boosting capitalism.

2. Finance the industry

Commercial banks finance the industrial sector in multiple ways. They provide short-term, medium-term, and long-term loans and three-year or even multi-year loans to help the industry, which is very rudimentary, particularly in the case of some developing nations, and help them grow and flourish. Commercial banks provide manufacturing activities and entrepreneurs with the confidence they need to grow their businesses on a large scale. In the same way, commercial banks can finance the actions and ventures of large companies that go public.

3. Finance trade

Commercial banks help in the financing of both internal and external trade. Banks provide loans to retailers and superstores to store the goods they trade. They also help the movement of goods from one place to another by providing all kinds of facilities such as discounts and accepting letters or promissory notes to provide resources. However, they finance exports and imports of developing countries by providing currency exchange facilities to exporters and importers of goods.

4. Finance agriculture

Commercial banks help finance the agricultural sector in developing countries in multiple ways. They provide loans to traders in agricultural commodities. They also open a network of branches in rural areas by providing agricultural credit. Commercial banks provide direct financing to farmers for the commercialization of their products, modernization, and technification of their farms by providing irrigation technologies, resources for land development, etc.

These banks also provide financial assistance for industrial-scale animal husbandry, cattle raising, sheep farming, chicken farming, fish farming, and horticulture. Sometimes, small farmers are also reached by microcredit tools from commercial or microfinance institutions. Commercial banks, in theory, are prepared to provide financial assistance for all economic activities in rural areas.

5. Financing of consumer goods

In developing countries, commercial banks help buyers to invest in durable consumer goods like home appliances, cars, etc. These banks can give consumers credit to buy movable and immovable goods. They also help people improve their living standards by providing the necessary resources.

6. Finance activities that generate employment

Commercial banks help finance employment-generating activities in developing and developed countries in multiple ways. They provide loans for young people to pursue higher education in engineering, medicine, and other high-skilled vocational pursuits. They also grant credits for young entrepreneurs, engineering and medical students, and others seeking technical training to establish their businesses. All commercial banks provide such credit facilities. Thus, help form human capital for start-ups and foreign companies that establish themselves in a country. Still, they also help finance entrepreneurial activities and new talents, brands, inventions, etc.

7. Help the government and central banks in monetary policy

Commercial banks help the economic development of a country by faithfully following the central bank's monetary policy. Central banks depend on commercial banks to successfully implement monetary policy by following their dictates to drive the development of the economy.

These banks contribute so much to the growth of economies by granting loans for agriculture, for industry, helping the formation of physical and human capital, and by following the monetary policy of the monetary authorities of a country.

NBFCs –role and Functions

The full form of NBFC is Non-Banking Financial Companies. NBFCs like us have played a significant role in the development of the Indian economy in the areas of credit and finance.

An NBFC offers a wide range of financial services to salaried individuals, businesses, and other self-employed professionals. These services include lending, investment, asset management, and financial advisory services. In this blog, we will go through the meaning, types, scope, and role of NBFCs. An NBFC is a type of financial institution registered under the Companies Act, 1956. It deals with several financial services, including lending and investment. With NBFCs, borrowers can apply for loans with affordable interest rates online.

NBFCs have emerged as key participants in the present financial landscape. The sector has also introduced cutting-edge credit distribution strategies for MSMEs, which has had a substantial positive impact on the Indian economy and the financial system as a whole.

Services Offered by NBFCs

NBFCs offer a wide range of financial services, including:

1. Personal loans
2. Home loans
3. Vehicle loans

4. Gold loans
5. Microfinance
6. Leasing and hire-purchase services
7. Credit card services
8. Insurance services
9. Investment and asset management services

Importance of NBFCs in the Indian Economy

NBFCs have emerged as an important component of the Indian financial system. They have played a crucial role in providing credit and finance to various sectors of the economy, including agriculture, infrastructure, and small and medium-sized enterprises (SMEs).

Here are some of the key reasons why NBFCs are important:

1. **Promoting Financial Inclusion**
   NBFCs have been instrumental in promoting financial inclusion in India. They provide credit to borrowers who are unable to obtain loans from banks due to various reasons, such as lack of collateral, credit history, and documentation. NBFCs have played a significant role in enabling access to credit for individuals and small businesses in rural and semi-urban areas of India.

2. **Supporting SMEs**
   NBFCs play a vital role in supporting the growth of SMEs. They offer a range of financial products, such as Business Loans, Working Capital Loans to SMEs for machinery and trade finance, which in turn helps them to expand their business operations.

3. **Boosting Consumer Spending**
   NBFCs provide loans for the purchase of popular consumer expenses such as vehicles, education, travel, two-wheelers, and homes. These loans help boost consumer spending, which in turn drives economic growth.

Now that you know what NBFC stands for, its importance, let's dive deeper into its scope and types.

Types of NBFCs

There are various types of NBFCs in India, catering to different sectors and needs. Here are

some of the commonly known NBFCs:

1. **Asset Finance Company (AFC)**
   These NBFCs finance the purchase of physical assets for companies, such as machinery, equipment, and vehicles.

2. **Investment Company (IC)**
   These NBFCs wholly deal in investing in securities, such as shares, bonds, and other debt instruments.

3. **Loan Company (LC)**
   These NBFCs provide loans and credit facilities to individuals and businesses. The various loans can be Personal Loans, Car Loans, Business Loans, etc.

4. **Infrastructure Finance Company (IFC)**
   These NBFCs finance infrastructure projects like power, telecom, and transportation.

5. **Microfinance Company (MFC)**
   These NBFCs provide microfinance services, such as small loans, to individuals and groups in semi-urban or rural areas.

Now that we have discussed the meaning and types of NBFCs, let's look at their role and scope in the financial system.

Role of NBFCs

NBFCs play a crucial role in the Indian financial system, especially in providing credit to sectors that are not served by traditional banks. They cater to the needs of small businesses, low-income households, and other underserved markets, filling the gap left by banks. NBFCs also play a significant role in the growth of the economy by providing funds for investment and infrastructure projects.

Scope of NBFCs

The scope of NBFCs in India is vast and growing, given the increasing demand for credit and

financial services. They offer a wide range of financial products and services, such as Personal Loans, Business Loans, Vehicle Loans, Loan Against Property, and other credit facilities. NBFCs also provide investment opportunities, such as mutual funds, fixed deposits, and other investment products.

What are the Differences Between NBFCs and Banks?

Despite lending money and investing like banks, NBFCs have notable differences that set them apart.

- NBFCs are not authorized to accept demand deposits.
- Issuing self-drawn cheques is not permitted for NBFCs.
- Unlike banks, deposit insurance coverage from the Deposit Insurance and Credit Guarantee Corporation is unavailable for NBFC depositors.
- NBFCs are not included in the payment and settlement system.

Conclusion

Now that you know all about NBFCs, their scope, roles and types. We can summarise that NBFCs like us indeed play an important role in the economy. They assist borrowers and businesses with instant capital by providing credit and financial services. The major products offered by NBFCs are Retail Loans and Corporate Loans.

An an NBFC, we have been assisting professionals and entrepreneurs with various **cash credit** and loan requirements, like instant Personal Loans, Business Loans, Home Loans, Two-Wheeler Loans, etc.

Financial Institutions in India

NABARD

National Bank for Agriculture and Rural Development or NABARD is the main regulatory body in the country's rural banking system and is considered as the peak development finance institution which is established and owned by the government of India. This bank aims to provide and regulate credit to the rural areas, which will be a first step towards enhancing the rural development in the country.

NABARD has been given many responsibilities related to the formulation of policies, planning, and operations in agriculture and financial development. NABARD carries these responsibilities efficiently and works towards promoting and developing man industries in the rural areas like the agriculture industry, cottage industries, other small scale industries, and rural crafts in an effort to create better infrastructure and better employment opportunities for the people living in these regions.

The Government of India established this bank considering all the guidelines of the National Bank for Agriculture and Development Act of 1981. To put it in simple terms, you can say that the National Bank for Agriculture and Rural Development or NABARD is the main and specific bank of the country for agriculture and rural development.

Functions of NABARD

Now that we have seen what NABARD stands for and the roles that it has to perform, let us go through the functions performed by the bank. In an effort to keep up with its roles, the National Bank for Agriculture and Rural Development undergoes four central functions. These four central functions performed by the NABARD are—credit functions, financial functions, supervisory functions, and development functions. To understand all these four functions performed by the NABARD, let’s go through all of them one by one.

1. Credit functions As the main provider of credit facilities in rural areas, the National Bank for Agriculture and Rural Development or NABARD performs the credit functions. Under these functions, the bank provides, regulates, and monitors the credit flow in the rural parts of the nation.

2. Financial functions NABARD has many client banks and institutions that help and assist in the developmental activities in rural areas. By performing the financial functions, the National Bank for Agriculture and Rural Development or NABARD provides loans to these client banks and institutions like handicraft industries, food parks, processing units, artisans and many more.

3. Supervisory functions As already discussed above, NABARD is the apex institution that looks after agriculture and rural development. This is why the responsibility of monitoring and regulating all the development activities and projects fall on this institution. Given this role, the NABARD performs supervisory functions in which it has to keep a check on all the client banks, institutions, credits and non-credits societies that are a part of the developmental tasks taking place in the rural areas.

4. Development Functions As you must be pretty much aware by now that the primary role of the National Bank for Agriculture and Rural Development or NABARD is to focus on developing sustainable agriculture and promote rural development, the bank performs development functions in an effort to stay true to this role. Under developmental functions, the NABARD helps rural banks prepare action plans for the developmental activities.

The National Bank for Agriculture or Rural Development or NABARD performs all the above roles and functions efficiently and has a great impact on the agricultural progress and rural development in the country.

SIDBI

What is Small Industries Development Bank of India (SIDBI)?

Small Industries Development Bank of India (SIDBI) is an independent financial institution aimed at aiding the growth and development of Micro, Small and Medium Enterprises (MSMEs) which contribute significantly to the national economy in terms of production, employment and exports.

- SIDBI was established with the mission of facilitating and strengthening the flow of credit to Micro, Small and Medium Enterprises and for addressing the developmental and financial gaps in the ecosystem of MSMEs.
- It is a statutory body set up under an act of the Indian Parliament in 1990.

Functions of SIDBI

- It aims at emerging as a single-window to meet the developmental and financial needs of MSMEs in order to make them globally competitive, strong, vibrant and to protect the institution as a customer-friendly financial body.
- It also aims at enhancing the wealth of shareholders through the modern technology platform.
- It is involved in the promotion and development of the MSME sector.
- It is the principal institution for the development, promotion and financing of the MSME sector and for coordination of functions of the institutions engaged in similar activities.
- SIDBI retained its position in the top 30 Development Banks of the World in the ranking of The Banker, London.
- SIDBI also functions as a Nodal/Implementing Agency to various ministries of the Government of India viz., Ministry of MSME, Ministry of Textiles, Ministry of Commerce and Industry, Ministry of Food Processing and Industry, etc.

Financial Support of SIDBI to MSMEs

SIDBI provides financial support to MSMEs in the following ways:

1. Indirect financing by way of refinancing the banks, refinancing financial institutions for onward lending to MSMEs.
2. Direct financing by way of service sector financing, receivable financing, risk capital and sustainable financing, etc.

Apart from providing financial assistance, SIDBI focuses on the “credit plus approach” under which it facilitates technology modernisation & upgradation, cluster development, enterprise development, upgrading the skills and support marketing activities.

EXIM Bank – Overview

The EXIM Bank of India is considered as a rare case of a banking institution wherein both the concept and the need for such an institution had been questioned for more than 20 years before it was finally established in the year 1982. In a rapidly shifting paradigm of finance, the EXIM Bank acts as a key player in the promotion of cross border trade and investment.

Objectives

The objective of the EXIM Bank had been to import technology and export marketing and product development, export production, pre-shipment and post-shipment, and overseas investment. Given below are some more objectives of the EXIM Bank of India:

- Providing financial assistance to importers and exporters, and functioning as the financial institution for coordinating the work of institutions engaged in financing import and export of goods and services with a view to promote India's international trade.
- The EXIM Bank of India is encrusted to act on business principles in the best regards of the public interest.
- The EXIM bank's vision has transformed from being product-centric with Export Capability Creation and Export Credits, to a more customer-centric approach by providing a wide array of products and services to empower businesses at all stages of a company's business operations.
- The bank aims to develop commercially cordial relationships with a target set of externally oriented companies by way of a wide array of products and services that are aimed at improving their internationalization efforts.
- It aims to utilize the leadership and expertise in Export Finance to strike a lasting difference to India-based companies with global aspirations. The bank also aims to facilitate globalization of the Indian businesses.

Importance

The EXIM Bank of India is primarily responsible for providing financial assistance to the exporters and importers of the country. It also supervises and coordinates the working of the other bodies that work in the import-export sector in India.

Besides, the EXIM Bank also strives to promote the foreign trade sector in India. In the early 1990s, the Bank had introduced the Clusters of Excellence in the country. Its aim was to enhance the quality standards of the imports as well as exports. For that, the EXIM Bank also has a tie-up with the European Bank for Reconstruction and Development.

In order to promote the exports, the EXIM Bank has also devised schemes such as production equipment finance program, vendor development finance, export marketing finance, and so on.

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EXIM Bank – Financial Products

The EXIM Bank functions take place through its various financial products. Let us have a quick look at the EXIM Bank's financial products in brief as below:

- **Buyer's Credit:** With this credit facility, the overseas buyer can open a "letter of credit" in favour of the Indian exporter and can import goods and services from India on the terms of deferred payment.
- **Corporate Banking:** Under this one, the EXIM Bank offers a myriad of financing programs to enhance the exports competitiveness of the Indian companies. It also caters to their working capital and supervises the investment requirements.
- **Lines of Credit:** Through the Lines of Credit (LOC) the Indian exporters are able to enter new geographies or expand their business in the existing markets without any risk of payment from the overseas importers.
- **Overseas Investment Finance:** The EXIM Bank extends term loans to Indian companies for the purpose of equity investments in their foregin joint ventures with a view to enhance export opportunities.

Functions of the EXIM Bank

Now that we are aware of the meaning, importance, objectives, and financial products concerning the EXIM bank, one of the prime Regulators of Banks and Financial Institutions, let us also take a look at some of its prime functions. The major functions of the EXIM Bank include:

- Financing exports and imports of goods and services from India
- Financing the import and export of goods and services other countries as well
- Underwriting shares/ stocks/ debentures/ bonds of companies that carry out foreign trade
- Financing the import and/ or export of machinery and equipments on lease or hire-purchase basis
- Undertaking functions of a merchant bank for the importer or exporter in transactions of foreign trade
- Providing refinancing services to banks and other financial institutions for their capital requirements of foreign trade
- Offering short-term loans or lines of credit to foreign banks and governments

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As we have seen, the EXIM Bank plays a key role in assisting the Indian companies to carry out businesses abroad and earn foreign exchange. Hence, it is a prominent part of the Indian economy as well as of the UPSC syllabus as regards to the General Studies. Candidates preparing for UPSC or bank exams must be thorough with the finance study notes as the one above. For more such information, check out the Testbook App regularly.

UNIT-3

Merchant Banking

Merchant Banking is a combination of **Banking** and consultancy services. It provides consultancy to its clients for financial, marketing, managerial and legal matters. Consultancy means to provide advice, guidance and service for a fee. It helps a businessman to start a business. It helps to raise (collect) finance.

Definition: Merchant banking can be defined as a skill-oriented professional service provided by merchant banks to their clients, concerning their financial needs, for adequate consideration, in the form of fee.

Merchant banks are a specialist in international trade and thus, excel in transacting with large enterprises.

Services offered by Merchant Banks

Merchant Banks offers a range of financial and consultancy services, to the customers, which are related to:

- Marketing and underwriting of the new issue.
- Merger and acquisition related services.
- Advisory services, for raising funds.
- Management of customer security.
- Project promotion and project finance.
- Investment banking
- Portfolio Services
- Insurance Services.

Merchant banking helps in reinforcing the economic development of the country, by acting as a source of funds and information to the business entities

Merchant Banker

Any person, indulged in issue management business by making arrangements with respect to trade and subscription of securities or by playing the role of manager/consultant or by providing advisory services, is known as a merchant banker. The activities carried out by merchant bankers are:

- Private placement of securities.
- Managing public issue of securities
- Satellite dealership of government securities
- Management of international offerings like Depository Receipts, bonds, etc.
- Syndication of rupee term loans
- Stock broking
- International financial advisory services.

In India, the functions of the merchant bankers are governed by the Securities and Exchange Board of India (SEBI) Regulations, 1992.

Functions of Merchant Banking Organization

1. **Portfolio Management**
2. **Raising funds for client**.
3. **Promotional Activities**:
4. **Loan Syndication**:
5. **Leasing Services**

The Evolution of Merchant Banking in the Indian Scenario

With the advent of the industrial boom in India, there has been a growing need of Merchant Bankers. Businesses often require specialised banking services which are concentrated in nature. Hence, commercial bankers set up their merchant banking subsidiaries to cater financial services for the corporate sector.

The first Merchant Banker was set up in 1967 by Grindlay's Bank, after that there were a number of merchant banks incorporated. There are multiple factors that have accelerated the importance of Merchant Banking in the country. These could be enlisted in the following pointers:

Globalisation of Economy: Post the 1991 reforms, the Indian economy opened its gates to overseas organisations. This encouraged fundings coming in from abroad and thereby pivoting the importance of Merchant Bankers.

Increased Competition: With favourable business options and lucrative market scenarios, the Indian corporates buckled up their games and were on an expansion spree. This encouraged the Merchant Bankers to play substantial roles with their specialised services towards Corporates.

Change in Consumer Trends: With multiple foreign players setting shop on Indian soil, there has been a boost in the quality of products that were being offered to the Indian masses. This in turn transformed the strategies of the Indian counterparts. Financial products and instruments became more prominent in the prevailing environments.

Government Reforms: With reduction in Government intervention and privatisation, there was a boost in the private corporate sector. Also, increasing the limits on investments and reduction in direct interventions proved to be a lucrative proposition of foreign players.

These factors, along with the enhancement on the ease of doing business has paved the way for Merchant Bankers to gain a considerable position. In addition, SEBI has served to be an effective watchdog for **merchant banking** activities. We, at Resurgent India are a Category I Merchant Banker, registered under SEBI. We are a one point stop towards catering all merchant banking activities. Do write to us at corporate@resurgentindia.com

Regulations by SEBI on Merchant Banking

Reforms for the merchant bankers

SEBI has made the following reforms for the merchant banker

1. Multiple categories of merchant banker will be abolished and there will be only one equity merchant banker.

2. 2. The merchant banker is allowed to perform underwriting activity. For performing portfolio manager, the merchant banker has to seek separate registration from SEBI.
3. 3. A merchant banker cannot undertake the function of a non banking financial company, such as accepting deposits, financing others' business, etc.

4. A merchant banker has to confine himself only to capital market activities.

Recognition by SEBI on merchant bankers

SEBI will grant recognition a merchant banker after taking into account the following aspects

1. Considering how much the merchant are professionally competent.

2. Whether they have adequate capital

3. Track record, experience and general reputation of merchant bankers.

4. Quality of staff employed by merchant bankers, their adequacy and available infrastructure are taken into account. After considering the above aspects, SEBI will grant permission for the merchant banker to start functioning.

Conditions by SEBI for merchant bankers

SEBI has laid the following conditions on the merchant bankers, for conducting their operations. They are

1. SEBI will give authorization for a merchant banker to operate for 3 years only. Without SEBI's authorization, merchant bankers cannot operate.

2.The minimum net worth of merchant banker should be Rs. 1 crore.

3. Merchant banker has to pay authorization fee, annual fee and renewal fee.

4. All issue of shares must be managed by one authorized merchant banker. It should be the lead manager.

5. The responsibility of the lead manager will be clearly indicated by SEBI.

6. Lead managers are responsible for allotment of securities, refunds, etc.

7. Merchant banker will submit to SEBI all returns and send reports regarding the issue of shares.

8. A code of conduct for merchant bankers will be given by SEBI, which has to be followed by them

UNDERWRITING SERVICES PROVIDED BY MERCHANT BANKERS

Underwriting means an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them.

A **merchant bank** is a company that conducts underwriting, loan services, financial advising, and fundraising services for large corporations and high net worth individuals. Unlike retail or commercial **banks**, **merchant banks do** not provide services to the general public

We can explain underwriting in merchant banking as under in simple terms

- Underwriting is the process through which an individual or institution takes on financial risk for a fee.
- Underwriters assess the degree of risk of insurers' business.
- Underwriting helps to set fair borrowing rates for loans, establishes appropriate premiums, and creates a market for securities by accurately pricing investment risk.
- Underwriting ensures that an IPO company will raise the amount of capital needed and provides the underwriters with a premium or profit for their services.
- Investors benefit from the vetting process that underwriting provides and helps them to make informed investment decisions.
- Risk is the underlying factor in all underwriting. In the case of a loan, the risk has to do with whether the borrower will repay the loan as agreed, or will default. With insurance, the risk involves the likelihood that too many policyholders will file claims at once. With securities, the risk is that the underwritten investments would not be profitable.

Underwriters evaluate loans, particularly mortgages, to determine the likelihood that a borrower will pay as promised and that enough collateral is available in the event of default. In the case of insurance, underwriters seek to assess a policyholder's health and other factors and to spread the potential risk among as many people as possible. Underwriting securities, most often done via initial public offerings (IPOs), helps to determine the value of the underlying company compared to the risk of funding the IPO.

Three Types of Underwriting

Loan underwriting

All loans undergo some form of underwriting. In many cases, underwriting is automated and involves appraising an applicant's credit history, financial records, and the value of any collateral offered, along with other factors that depend on the size and purpose of the loan. Depending on the process and whether a human underwriter is involved, the appraisal process can be almost instant or take a few hours, days, or even weeks.

The most common type of loan underwriting that involves a human underwriter is for mortgages and is the type of loan underwriting that most people face during their lifetime. The underwriter assesses income, liabilities (debt), savings, credit history, credit score, and more depending on an individual's financial circumstances. Mortgage underwriting typically has a “turn time” of a week or less.

Refinancing often takes longer because buyers who face deadlines get preferential treatment. Although loan applications can be approved, denied, or suspended, most are “approved with conditions,” meaning the underwriter wants clarification or additional documentation.

Insurance underwriting

With insurancpre-existing conditions. Beginning in 2014, under the Affordable Care Act, insurers were no longer allowed to deny coverage or impose limitations based on pre-existing conditions.

Life-insurance underwriting seeks to assess the risk of insuring a potential policyholder based on their age, health, lifestyle, occupation, family medical history, hobbies, and other factors as determined by the underwriter. Unlike health insurance, life-insurance underwriting is not restricted for pre-existing conditions or any other health factors. Life-insurance underwriting can result in approval—along with a whole range of coverage amounts, prices, exclusions, and conditions—or outright rejection.

Securities underwriting

Securities underwriting, which seeks to assess risk and the appropriate price of a particular security—most often as it relates to an IPO—is performed on behalf of a potential investor, often an investment bank.

Merchant Banker and Portfolio Manager

Under the SEBI (Merchant. Bankers) Regulations I992, merchant bankers placed in category I and category II alone can work as portfolio managers. The merchant bankers belonging to category III and IV cannot act as portfolio managers.

However, any person can work as a portfolio manager provided he is registered under the SEBI (Portfolio Manager) Regulations 1993. So, merchant bankers of categories I and II need not have a separate registration to act as a portfolio manager.

SEBI takes into account the following Procedure for Registration to act as Portfolio Manager

particulars while considering the application for registration to act as a portfolio managers.

1. Basic infrastructure such as manpower, equipment, optimum amount of staff to discharge his works.

2.Minimum of 2 persons with enough experience should be employed to manage portfolio.

3. A person directly or indirectly connected with applicant, that is, associate, subsidiary, inter-connected group or group company that has not been grantedregistration.

4. Adequate capital, not less than a net worth of Rs. 50 lakh in terms of capital plus free reserves excluding revaluation reserves minus accumulated losses as deferred expenditure not written off.

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4. He should not derive any direct on indirect benefit out of the clients funds or securities.

5. He, cannot pledge or lend securities held on behalf of clients, to a third person without client’s permission.

6. It is the responsibility of a Portfolio Manager to attend to the clients complaints in a proper and timely manner. He should also ensure that proper action is taken immediately.

Code of conduct for portfolio managers

A portfolio manager should

1. Be fair in all dealings with clients and staff with higher standard of integrity.

2. Deploy as soon as possible the money received by him from a client.

3. Render at all times high standards of services, exercise due diligence.

4. Ensure proper care and exercise independent professional judgement.

5. Avoid any conflict of interest in his investment or disinvestment decision.

6. Ensure fair treatment to all his customers.

Services offered by Merchant Banks

Merchant Banks offers a range of financial and consultancy services, to the customers, which are related to:

- Marketing and underwriting of the new issue.
- Merger and acquisition related services.
- Advisory services, for raising funds.
- Management of customer security.
- Project promotion and project finance.
- Investment banking
- Portfolio Services
- Insurance Services.

Merchant banking helps in reinforcing the economic development of the country, by acting as a source of funds and information to the business entities.

Unit -4

Venture Capital Financing

Venture capital financing is a type of private equity investing specific to earlier-stage businesses that require capital. In return, the investor receives an equity stake in the business through the issuance of some type of security instrument.

Venture capital firms have a variety of different securities they use depending on the nature of the investment. The most common securities are convertible debt (often called convertible debentures), SAFE notes, and preferred stock.

The kind of instrument an investor chooses depends on a variety of factors related to the company and the investor's own risk tolerance.

- Venture Capital firms make private equity investments in disruptive companies with high potential returns over a long time horizon.
- The three most common securities used by venture capital investors are convertible notes, SAFE notes, and preferred equity.
- The securities a venture capital investor chooses will depend on the stage of the business and its specific capital requirements.
- Different securities present different levels of risk for investors depending on their position in the capital stack.

Types of Venture Capital Financing

1. Convertible Debt

One of the most common instruments used by venture capital investors is convertible notes.

Convertible notes are short-term debt instruments designed to convert to equity at a predetermined conversion event, typically a future financing or liquidation event like an IPO (Initial Public offering) or acquisition. Furthermore, since convertible notes are loans, they also have a maturity date and an interest rate.

If a conversion event occurs in the future, the total amount converting into equity will include the original principal amount on the convertible note and any interest accrued to date. The price at which the convertible note converts to equity will be determined by one of the following:

- **Valuation Cap**: Refers to the maximum valuation at which a convertible note will convert.
- **Discount Rate**: Refers to the discounted (percentage) rate at which the note will convert during the business' next priced round (e.g., 85% of share price).

Both valuation caps and discount rates allow noteholders to receive cheaper equity by converting at a discounted valuation. The result of this is that note holders end up with a larger percentage of the company than they otherwise would.

The better equity price helps compensate early investors for the higher amount of risk they take on by investing in the business earlier.

Benefits of Using Convertible Debt

Convertible debt is used by investors because it is simple and can be issued quickly. Unlike other securities, investors and founders aren't required to agree on a valuation of the business when negotiating the terms of a convertible note which is typically an intensive diligence process with high legal fees.

Additionally, since convertible notes are recorded as debt on the balance sheet up until the conversion event, The venture capital investor is going to have a senior liquidation preference if there is no future financing. This means that if the company exits at a lower amount than expected, the noteholders will be paid out before the equity investors.

2. “SAFE” Notes

A SAFE (Simple Agreement for Future Equity) is a kind of convertible security that allows note holders to purchase a specified number of shares for an agreed-upon price at some point in the future.

SAFE notes are similar to convertible notes in that they convert at a future financing event such as a series A. They also usually have a valuation cap or discount rate to give venture capital investors a favorable valuation when buying their equity.

The biggest difference between a convertible note and a SAFE note is that there is no debt component and, as a result, no interest rate or maturity date associated with the security.

Benefits of Using SAFE Notes

SAFE notes were popularized by the now famous start-up accelerator Y-Combinator, which wanted access to a more founder-friendly security than convertible debt.

In addition to being advantageous to founders, SAFE notes are relatively easy to issue because no current company valuation is required, and there are fewer other components to the instrument that must be negotiated.

3. Preferred Equity

Preferred equity refers to a share class within a company’s shareholder equity. This kind of stock is commonly used by venture capital investors in later-stage deals and has a number of advantages in comparison to common shares.

Benefits of Using Preferred Equity

The two main reasons venture capital investors would opt for preferred equity instead of common equity are: 1) its seniority to common shares, and 2)

preferred equity may include negotiable provisions like additional voting rights and/or anti-dilution clauses.

Preferred shares are considered senior to common shares in the case of a liquidation or sale of the company. This means that if the company a VC firm has invested in is forced into a liquidation scenario (or it exits at a lower price than anticipated), owners of preferred shares will be paid out before common shareholders (although still behind creditors).

This limits the risk inve **Advantages and Disadvantages of VC**

Advantages –

- Help gain business expertise

One of the primary advantages of venture capital is that it helps new entrepreneurs gather business expertise. Those supplying VC have significant experience to help the owners in decision making, especially human resource and financial management.

- Business owners do not have to repay

Entrepreneurs or business owners are not obligated to repay the invested sum. Even if the company fails, it will not be liable for repayment.

- Helps in making valuable connections

Owing to their expertise and network, VC providers can help build connections for the business owners. This can be of immense help in terms of marketing and promotion.

- Helps to raise additional capital

VC investors seek to infuse more capital into a company for increasing its valuation. To do that, they can bring in other investors at later stages. In some cases, the additional rounds of funding in the future are reserved by the investing entity itself.

- Aids in upgrading technology

VC can supply the necessary funding for small businesses to upgrade or integrate new technology, which can assist them to remain competitive.

Disadvantages –

- Reduction of ownership stake

The primary disadvantage of VC is that entrepreneurs give up an ownership stake in their business. Many a time, it may so happen that a company requires additional funding that is higher than the initial estimates. In such situations, the owners may end up losing their majority stake in the company, and with that, the power to make decisions.

- Give rise to a conflict of interest

Investors not only hold a controlling stake in a start-up but also a chair among the board members. As a result, conflict of interest may arise between the owners and investors, which can hinder decision making.

- Receiving approval can be time-consuming

VC investors will have to conduct due diligence and assess the feasibility of a start-up before going ahead with the investment. This process can be time-consuming as it requires excessive market analysis and financial forecasting, which can delay the funding.

- Availing VC can be challenging

Approaching a venture capital firm or investor can be challenging for those who have no network.

In 2019, the total value of venture capital deployed throughout India was worth $10 billion. This is an increase of 55% compared to the previous year and is currently the highest.

VC was introduced in the country back in 1988, after economic liberalisation. IFC, ICICI, and IDBI were the few organisations that established venture capital funds and targeted large corporations. The formalisation of the Indian VC market started only after 1993.

stors take on since there is a higher likelihood that they will be paid than if they owned common shares in the company, which fall at the bottom of the capital stack.

The Stages of Venture Capital Financing

The Seed Stage

Venture capital financing starts with the **seed-stage** when the company is often little more than an idea for a product or service that has the potential to develop into a successful business down the road. Entrepreneurs spend most of this stage convincing investors that their ideas represent a viable investment opportunity. Funding amounts in the seed stage are generally small, and are largely used for things like marketing research, product development, and business expansion, with the goal of creating a prototype to attract additional investors in later funding rounds.

The Startup Stage

In the startup stage, companies have typically completed research and development and devised a business plan, and are now ready to begin advertising and marketing their product or service to potential customers. Typically, the company has a prototype to show investors, but has not yet sold any products. At this stage, businesses need a larger infusion of cash to fine tune their products and services, expand their personnel, and conducting any remaining research necessary to support an official business launch.

The First Stage

Sometimes also called the "emerging stage," first stage financing typically coincides with the company's market launch, when the company is finally about to start seeing a profit. Funds from this phase of a venture capital financing typically go to actual product manufacturing and sales, as well as increased marketing. To achieve an official launch, businesses usually need a much bigger capital investment, so the funding amounts in this stage tend to be much higher than in previous stages.

The Expansion Stage

Also commonly referred to as the second or third stages, the expansion stage is when the company is seeing exponential growth and needs additional funding to keep up with the demands. Because the business likely already has a commercially viable product and is starting to see some profitability, venture capital funding in the emerging stage is largely used to grow the business even further through market expansion and product diversification.

The Bridge Stage

The final stage of venture capital financing, the bridge stage is when companies have reached maturity. Funding obtained here is typically used to support activities like mergers, acquisitions, or IPOs. The bridge state is essentially a transition to the company being a full-fledged, viable business. At this time, many investors choose to sell their shares and end their relationship with the company, often receiving a significant return on their investments.

An experienced business attorney can guide you through the different stages of venture capital financing and advise you on the best ways to secure funding for your company in its current stage.

Different Types of Venture Capital Fund Performance Metrics

1. Gross IRR

The internal rate of return (IRR) is a popular metric that investors use to predict the profitability of their investment. The IRR is the expected rate of growth for an investment. Specifically, the IRR of a project shows you the annual growth the investment will experience.

IRRs help investors and companies analyze investment returns and predict yearly returns, even if cash flow varies throughout the course of the project.

2. Invested Amount

Self-explanatory, the invested amount is the amount of money you put into a certain investment. While this number is meaningless on its own, it's particularly helpful compared with other metrics, like return on investment (ROI) and IRR.

Ownership

Ownership refers to the proportion of ownership your fund owns in a company. For example, high ownership in a portfolio company may mean more decision-making authority than other investors.

You can calculate ownership by multiplying the price per share by the number of shares your ownership percentage corresponds to.

Most commonly, VCs calculate the total number of shares in a portfolio company on a fully diluted basis (includes, for example, ESOP and convertible notes assuming they are converted).

3. Multiple

Multiple of Invested Capital – MOIC (or Total Value to Paid-in Capital), also known simply as "multiple," is a metric that tells investors how much money they're getting from an investment. Multiples don't consider time in the equation, so it's crucial to compare multiples to other metrics.

4. ROI

One of the most popular VC fund metrics, ROI stands for Return on Investment. ROI tells you the profitability of an investment and compares the amount of an investment's return to the investment cost. ROIs are expressed either as percentages or ratios. Positive

percentage ROIs usually indicate that a project is profitable, while negative percentage ROIs indicate a loss.

5. Total Cash Realized

Many VC metrics predict returns on investments without those returns taking place. There's a system behind each one, but it's important to note that any metric predicting a future gain is unrealized. Total cash realized is the number of gains that an investor received as a return in cash.

6. Fair Value

Fair value is the estimated value of a company or investment, or the estimated amount of money that a company or investment can be sold for.

For example, VCs use discounted cash flow (DCF) analysis to calculate a company's fair value or investment. This formula assumes that the value of an investment is the total value of its future cash flows at today's prices. In other words, this valuation demonstrates the cash that a company's shareholders can distribute upon selling the company.

Exit Strategies for Venture Capital Funds

An important aspect of venture capital investing is the exit strategies. Venture capital funds primarily invest with an exit in mind after a few years. After successfully funding at seed, pre-production, production and expansion stages, a venture capitalist will start assessing exit strategies. The exit in the form of disinvestment or liquidation is the last and final stage of the venture capital funding. The key types of liquidation/disinvestment are trade sales, sale of quoted equity post initial public offering (IPO), and write-offs. Let's look at each of these in detail:

Trade Sales: In this type of strategy the private company is sold or merged with an acquirer for stocks, cash, or a combination of both.

IPO: If the company has done well, the venture capital investors will take the IPO route, by issuing shares registered for public offering. An example is the upcoming Facebook IPO, which is expecting to raise about $15 billion through IPO and is valued at approx. 100 billion. The

venture capital investors and other private investors will get their portion of shares who can put them in the open marketplace for trading after an initial lock-in period.

Write-offs: These are voluntary liquidations that may or may not result in any proceeds.

Apart from the above three types of disinvestment, there are a few other options:

Bankruptcy: The company may just go bankrupt.

Buy-back: In this method the entrepreneur buys-back the investment share from the venture capitalists and takes it back to being a privately held company.

Investors who invest in a venture capital fund get distributions of public stock or cash from realized venture capital investments. Sometimes the fund may require further investments from limited partners. At other times, they may make cash or share distributions at random times during the lifetime of the fund. Investors can sell their interests to another buyer if they find one.

In a bad case scenario, some funds find themselves with highly illiquid, barely there companies. In a good scenario, they have good investments, which they disinvest from at a stage and find new investments to fund.

Venture capital is a form of financing that provides startups and high-growth companies with funds and expertise to scale and innovate. However, venture capital also comes with many challenges, such as finding the right investors, negotiating fair terms, managing expectations, and achieving milestones. How do you overcome these common venture capital challenges and secure a successful partnership with your backers? Here are some tips and best practices to help you navigate the venture capital landscape.

Top experts in this article

1 Find the right fit

One of the most important steps in raising venture capital is finding the right investors for your business. You want to look for investors who share your vision, values, and goals, and who can offer more than just money, such as industry insights, connections, and mentorship. To find the right fit, you need to do your homework and research potential investors, their portfolio, their track record, and their reputation. You also need to network and build

relationships with investors who are interested in your sector, stage, and geography, and who can add value to your business.

> This is so aptly said. Finding the right set of investors for the future growth of your company can make or break the company. There have been innumerable examples of network-effects being amplified due to a right sectoral fit of VC investors. The vision alignment will fairly fall in place once you have the right fit of investors alongside in the company.

2Negotiate fair terms

Another common challenge in venture capital is negotiating fair and favorable terms for your deal. You want to secure a valuation that reflects your potential and growth, but also leaves room for future rounds and exits. You also want to avoid terms that limit your control, flexibility, or autonomy, such as excessive liquidation preferences, anti-dilution clauses, or board seats. To negotiate fair terms, you need to understand the market and the standard terms for your industry and stage, and be prepared to justify your valuation and projections with data and evidence. You also need to be willing to walk away from a deal that is not aligned with your interests or values.

> Founders should consider that the eventual exiting valuation outcome is far more important than the highest valuation in the current round. Raising at too high of a valuation is a risk that the Company may not grow into that lofty valuation. And if taking money from a less reputable firm, that risk compounds as there are fewer investors interested in leading flat or down rounds. Who you take money from and their track records should be part of the calculation when determining fair terms.

3Manage expectations

Once you have secured venture capital, you need to manage the expectations of your investors and keep them informed and engaged. You want to establish a clear and regular communication channel with your investors, and update them on your progress, challenges, and achievements. You also want

to be transparent and honest about your performance, and address any issues or concerns as soon as possible. You also need to balance the feedback and advice from your investors with your own vision and judgment, and make sure that you are aligned on the key metrics and milestones that measure your success.

> In our experience working with Founders, Owners, and CEOs, unrealistic expectations abound, and are the toughest to manage. But manage them FOC must, by keeping coming back to it, share the facts, discuss the underlying assumptions and beliefs, and gently confront sometimes the emotions and wishful thinking driving these expectations.

4Achieve milestones

The final challenge in venture capital is achieving the milestones that you have set for your business and that your investors expect from you. You want to deliver on your promises and show that you are using the funds wisely and effectively. You also want to demonstrate that you are growing and scaling your business, and that you are creating value for your customers and stakeholders. To achieve milestones, you need to have a clear and realistic roadmap and strategy, and execute it with focus and discipline. You also need to monitor and measure your performance and results, and adjust your plans and tactics as needed.

8 SUGGESTIONS FOR ENTREPRENEURS PREPARING TO RAISE VENTURE CAPITAL.

1. ***Ready for prime time*** Is your story compelling enough to interest venture capital investors? Some businesses, even if they succeed, simply will not deliver the kinds of returns that venture investors seek. Do you have demonstrable results? Customer traction? Patented intellectual property? Consider raising a small amount of money from angels or from friends & family first in order to reach important milestones that will make your business more marketable to venture firms.

2. ***Documents***. Prepare three documents: (i) a thoughtfully reasoned business plan; (ii) a one to two page executive summary of the business plan; and (iii) a presentation. A business plan should include a business model, detailed information on your target market, financial projections and assumptions, and the team. Even if most investors do not read the full plan, the process of writing it will help you better tell your story and prepare for questions from investors. Be sure that you can defend each fact, assumption, projection and conclusion that you include in these documents. If you are not confident in your writing skill, then be sure to run at least the executive summary by someone who has experience in fundraising to make sure that it does a good job of conveying your story.

3. ***Build your core team***. This is critical to investors, and it is important to articulate clearly your background and experience, who has joined the team and who will likely join the team. Do the founders have money or meaningful “sweat equity” in the company? You want to impress upon investors that you have the committed team members necessary to take the next steps toward your vision.

4. ***Build your team of advisors***. Surround yourself with good advisors who are experienced in raising venture capital and building companies, whether board members, attorneys, accountants, professional investors, technologists or industry executives.

5. ***Target list***. Create a target investor list using key criteria including: (a) industry sector; (b) investment stage (i.e., Seed, Series A, B, C, etc.); (c) amount to be raised; (d) comparable/competitive portfolio companies; and (e) geography. Find out as much information as you can about the current investment status or activity level of your target investors.

6. ***Practice your pitch***. Find a friendly audience (including at least one experienced investor) who can help identify gaps and weaknesses in your pitch. Practice out loud. Be sure to have a 30-second version, a three minute version and a fifteen minute version. You must be able to articulate your vision succinctly and in plain English. When you make your actual presentations, space them so that you can incorporate feedback and suggestions in subsequent pitches.

7. ***Competition***. Know your competition and be prepared to distinguish your business model. Saying that you do not have competition is the wrong answer.

8. ***Understand your capitalization table***. If you don't understand the basics of a corporation's capitalization, then ask someone to explain it to you (*e.g.*, authorized vs. issued stock; reserved option pool vs. granted options; preferred stock vs. common stock). Prepare a detailed capitalization table. Know exactly who owns each share of stock in your company. Document options and stock issuances right away, and avoid vague, open-ended or ambiguous equity promises, such as offering someone a percentage of the company—be clear that you are offering them a percentage of the company as of a particular date or event.

Growth Of Venture Capital Financing In India

he purpose of this research paper is to analyse the development and growth of venture capital funds in India. The venture capital industry in India has been in operation in some form since 1973. It is now has successfully emerged for all the business firms that take up risky projects and have high growth prospects. The venture capital investment assist in fostering innovative entrepreneurship in India.

The private organization which does not want to take finance from the society may have their view on venture capital. It has potential to become an important source for financing of small-scale enterprises (SSEs). Venture capital finance is often thought of as 'the early stage financing of new and young enterprises seeking to grow rapidly.

With the increased foreign rivalry, a variety of growth-oriented businesses have venture capital as a solution. Due to the lack of autonomy and lengthy and complex process, venture capital investment is usually made by accredited, high-net worth individuals or other financial institutional investors. This paper focuses on the challenges and opportunities that entrepreneurs face when it comes to venture capital investing.

Introduction

India has emerged as one of the world's fastest developing economies in the 21st century. It is among the most lucrative investment opportunities. India's economic advantage over other emerging countries is due to its large trained people capital and knowledge imprisoned in research laboratories. There should be a type of financing that connects all available resources for effective

exploration and usage.

This relationship is accessible in a variety of forms, including bank loans, private debt, equities, bonds, and so on. However, each has advantages and disadvantages that make them inapplicable in certain situations. Development in a high-growth field needs not just advanced technology and large sums of money, but also the willingness to take significant risks.[1]

It contributes significantly to the life cycle of developing businesses by investing in high-risk, growth-oriented projects. It bridges the gap between high-quality ideas and available funding. Whereas traditional ways of finance, such as bank loans, government subsidies, and so on, are costly and time-consuming for new entrepreneurs, venture capital funds have evolved as a savior, offering required help to cash-strapped creative businesses in return for shares.[2]

"Venture capital funding" can also refer to "initial stage investment by small and emerging enterprises wanting to develop swiftly." It is an investment that will help to encourage creative enterprise in India. It arose as a result of the need to give unconventional, risky financing to new companies based on creative entrepreneurship.

Venture capital is an investment in new companies promoted by a technically or professionally competent entrepreneur in the form of stock, quasi-equity, and at times debt- direct or conditional. It consists of capital investment, including stock and debt, which entails significant risk and uncertainty.[3]

The venture capital business in India is growing. The slow and arduous evolution of India's integrated venture capital sector has been constrained by resource constraints imposed by the overarching framework of socialistic economic ideologies. While banks and government-owned development finance institutions provided funding for new businesses, it was only available as collateral-based money on a project-financing basis, making it difficult for most new entrepreneurs, particularly those in the technology and services sectors, to raise funds for their ideas and businesses.

Most entrepreneurs had to rely on their own financial capital, as well as that of their family, well-wishers, and private lenders, to accomplish their business dreams. In 1972, the Small and Medium Enterprise Development Commission proposed that venture capital be supported as a form of financing for emerging entrepreneurs and technology. As a result, during the next decade and a half, various incremental steps will be taken to assist needy technology-based small and medium companies (SMEs) in gaining access to venture capital funding.[4]

Venture Capital Funding

According to section 2(m)[5] of SEBI Venture Capital Funds (VCFs) Regulations, 1996, A Venture Capital Fund means a fund established in the form of a trust/company; including a body corporate, and registered with SEBI which (i) has a dedicated pool of capital raised in a manner specified in the regulations and (ii) invests in venture capital undertakings (VCUs) in accordance with these regulations.

Venture capital funds (VCFs) are investment vehicles that allow individuals to put their money into freshly created start-ups as well as small and medium-sized businesses in exchange for ownership in such businesses. These are investment funds that typically target companies that have the potential to provide significant profits but also carry a high level of risk.[

Types Of Venture Capital Funding

Venture Capital Funds are classified on the basis of their utilisation at different stages of a business. The 3 main types are early stage financing , expansion financing , and acquisition/buyout financing.[10]

A. **Early Stage financing:**

- Early stage financing has three sub divisions seed financing, start up financing and first stage financing.
- Seed funding is a small sum of money provided to an individual in order for him or her to be available for a start-up loan.
- Start up financing is given to companies for the purpose of finishing the development of products and services.
- Financing for the first stage of a business: who have exhausted all of their initial funds and need funding to continue full-scale operations are the primary beneficiaries of First Stage Financing.

B. **Expansion Financing:**
Expansion financing may be categorized into second-stage financing, bridge financing and third stage financing or mezzanine financing.

- Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way.

- Bridge financing may be provided as a short-term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers as a major business strategy.

C. **Acquisition or Buyout Financing:**
Acquisition or buyout financing is categorized into acquisition finance and management or leveraged buyout financing. Acquisition financing assists a company to acquire certain parts or an entire company. Management or leveraged buyout financing helps a particular management group to obtain a particular product of another company.[11]

Structure Of Venture Capital Fund

The Structure Of Venture Capital Fund Is As Follows:

Management company:

A management company is a business entity created by a venture firm's general partners (GPs). It's responsible for managing a venture firm's operations across its funds. The management company collects fees and pays expenses. It also typically owns the fund's trademark and brand. Single-member companies, which are most common for new GPs, are treated as "disregarded entities" under U.S. tax code, while multi-member companies are treated as partnerships.[12]

General partner (GP):

The manager of a venture capital fund is called a "general partner" (GP). A GP is responsible for raising money from a network of investors, selecting investments, and overseeing all of the operational, accounting, and legal aspects of the fund. A GP often follows an investment thesis to select investments, targeting a specific segment of the market and/or stage of investment. A general partner has unlimited liability for the partnership.

Limited partners (LPs):

They are passive investors in the fund. Examples of LPs include pension funds, insurance companies, high-net-worth individuals or other financial institutions. The liability of limited partners is capped at the amount of capital the limited partner contributed to the fund. Investors in a venture capital fund are called "limited partners" (LPs).
Portfolio companies. Companies the fund invests in.

Operation Of Venture Capital Fund

Venture capital investments can be classified as early-stage capital, seed capital, or expansion-stage finance based on the maturity of the firm at the time of investment. However, the stage of investment has little bearing on how venture capital firms work.

Funds start with a capital-raising period during which the venture capital company seeks investors for the new fund.[13] Potential investors are provided a prospectus for the fund before committing funds. Following a commitment, the fund's operators contact all possible investors to settle individual investment amounts. Following that, the venture capital fund seeks private equity investments that have the potential to provide favorable returns for its investors. This procedure entails the fund's manager or managers analyzing hundreds of business plans in search of possibly high-growth enterprises. Fund managers make investment decisions based on the prospectus and the expectations of the investors. Once an investment is placed, the fund will incur an annual management fee of around 2%.

When a venture capital fund's portfolio firm leaves, investors get returns through a merger and acquisition or an IPO. The revenues will subsequently be divided pro rata among the fund's investors. In addition to the yearly management charge, the fund will keep a share of the earnings if the investment is profitable.[14]

Method Of Venture Capital Funding

Funds can be raised from investors in exchange for the following:

1. **Share in equity of the Company:**
   In exchange for a share in the equity of the company

2. **Participating in Debentures:**
   A type of debt instrument that is not backed by any collateral but gives the investor a right to participate in the profit of the company.

3. **Conditional Loan:**
   These loans do not carry interest and are repayable to the investor in the form of royalty after the company seeking investment starts generating revenue.

4. **Income Notes:**
   It is a hybrid of both; traditional loans and conditional loans, wherein the entrepreneur will have to pay both royalties and interest at a very minimal rate. [15]

Benefits And Challenges Of Venture Capital Funds

Benefits:

- **Assist in the acquisition of business knowledge:**
  One of the key benefits of venture capital is that it assists new entrepreneurs in the acquisition of business skills. Those providing VC have extensive knowledge to assist owners in decision making, particularly in human resource and financial management.

- **Business owners are not required to repay:**
  Entrepreneurs or business owners are not required to reimburse the invested amount. Even if the business fails, it will not be required to return the loan.

- **Assists in the formation of important connections:**
  Because of their knowledge and network, VC providers may assist business owners in the formation of valuable connections. This may be really advantageous in terms of marketing and promotion.

- **Aids in the raising of additional Capital:**
  VC investors strive to inject more capital into a firm in order to increase its valuation. They can do so by bringing in additional investors at a later time. In certain circumstances, the investing company reserves more rounds of money in the future.

- **Assists with technology update:**
  VC may provide the required capital for small enterprises to upgrade or incorporate new technology, allowing them to remain competitive.[16]

Challenges:

- **Reduction of ownership stake:**
  The primary disadvantage of VC is that entrepreneurs give up an ownership stake in their business. Many a time, it may so happen that a company requires additional funding that is higher than the initial estimates. In such situations, the owners may end up losing their majority stake in the company, and with that, the power to make decisions.

- **Give rise to a conflict of interest:**
  Investors not only hold a controlling stake in a start-up but also a chair among the board members. As a result, conflict of interest may arise between the owners and investors, which can hinder decision making.

- **Receiving approval can be time-consuming:**
  VC investors will have to conduct due diligence and assess the feasibility of a start-up before going ahead with the investment. This process can be time-consuming as it requires excessive market analysis and financial forecasting, which can delay the funding.

- **Availing VC can be challenging:**
  Approaching a venture capital firm or investor can be challenging for those who have no network. [17]

Growth Of Venture Capital Financing In India

The present venture capital financing climate is significantly different. In India, there has been a venture capital business since 1990. It has now effectively developed for all organizations that undertake risky endeavors while yet having tremendous growth possibilities. Bonds, seed capital, and other forms of risk capital are issued as venture capital in India. In 1988, ICICI formed a venture capital fund with the Unit Trust of India. There are already a number of venture capital businesses in India.

Finance institutions, such as ICICI Bank, have entered the industry and established their own venture capital sections. Aside from Indian investors, multinational firms have established themselves in India as a financial institution that invests in huge corporations. International investors are accountable for India's large-scale capital market development. India's economy is thriving, owing to considerable changes in the financial investment structure throughout time.

Examples Of Venture Capital Funding In India

Kohlberg Kravis & Roberts (KKR), one of the world's leading alternative investment asset managers, has agreed to invest USD150 million (Rs 962 crore) in Mumbai-based listed polyester producer JBF Industries Ltd. The company will invest in zero-coupon compulsorily convertible preference shares with 14.5% voting rights in its Singapore-based fully owned subsidiary JBF Global Pte Ltd. KKR money will assist JBF in completing ongoing initiatives. [20]

Pepperfry.com, India's largest furniture e-marketplace has secured USD 100 million in a new round of fundraising spearheaded by Goldman Sachs and Zodius Technology Fund. Pepperfry will utilize the funding to increase its presence in Tier III and Tier IV cities by adding to its increasing fleet of delivery vans. It will also build additional distribution centers and extend its carpentry and assembly service network. This is the greatest volume of investment raised by a sector-focused e-commerce

business in India. [21]

Conclusion
Venture capital is a vital source of funding for high-growth startups in India and plays an important role in spurring job creation and economic productivity. It was introduced in India back in 1988, after economic liberalisation. IFC, ICICI, and IDBI were the few organisations that established Venture Capital funds and targeted large corporations. The formalisation of the Indian Venture Capital market started only after 1993.[22]

This paper examines the challenges and opportunities that entrepreneurs face while working with venture capital assets, as well as the importance of venture capital funding in the corporate world. An entrepreneur may benefit from the assistance of a venture capitalist in a number of ways.

The desirability of venture capital funding is largely based on the venture capitalists ability to make managerial contributions to the firm. Long-term funding is not the same as venture capital. A venture capitalist, on the other hand, invests in an entrepreneur's idea, nurtures it for a set period of time, and then exits with the help of an investment banker.

According to the findings, every entrepreneur is ready to approach Venture Capitalists but is unable to complete all of the necessary paperwork. Despite the fact that venture capital is scarce, it is critical to the development of innovative creative ideas.[23] Venture capital financing has become a part of the popular business in India. These Investments are growing at an exponential rate and one who is starting his business can look it as a good option of financing its venture.

Features Of Venture Capital

The characteristics of venture capital are as follows:

1. It mainly focuses on financing young businesses that are having trouble entering the capital market in their initial stages of growth.
2. To provide a fixed return for the venture capital sources, this financing may also be loan-based or in the form of inconvertible debt securities.
3. Investors in venture capital seek to profit financially from the success of the business that borrows.
4. It is an investment for the long term and is placed in businesses with strong growth prospects. The allocation of venture capital will result in the company's quick expansion.
5. The venture capital provider will also participate in the borrowing business; in doing so, they will provide financial support and managerial expertise.

Advantages Of Venture Capital

- Venture capitalists present a chance for growth
- Venture capitalists facilitate networking.
- Businesses can raise a significant amount of money.

- Guidance, advice, and knowledge can be found in venture capital.
- No commitment to pay back the capital investment
- Generally speaking, venture capitalists are reliable.
- Venture capitalists can aid in team building and hiring.

Disadvantages Of Venture Capital

- It can be challenging to approach a venture capitalist.
- A decision from a venture capitalist is typically made slowly.
- The search for investors may divert an entrepreneur's focus.
- The founder's ownership interest is diminished.
- It is necessary to exercise extensive due diligence.
- Rapid growth for the business is anticipated.
- A performance schedule is used to release fund

UNIT-5

Factoring and credit Rating

FACTORING

Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs.

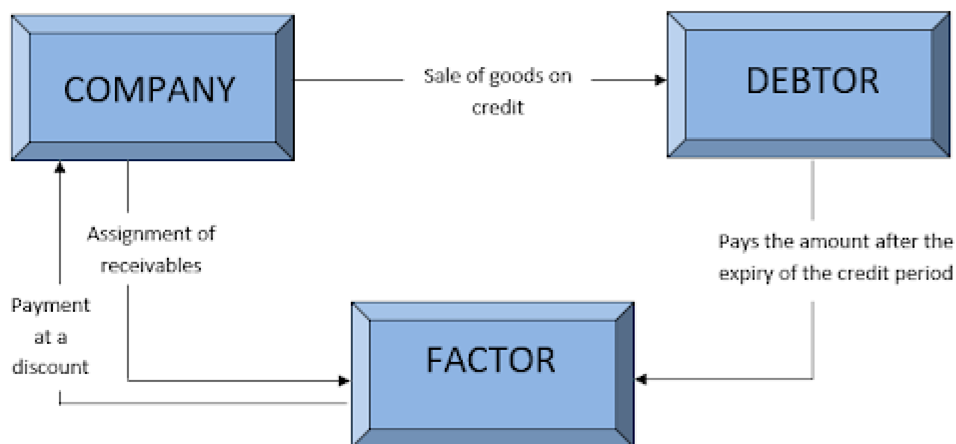
Factoring

Definition: Factoring implies a financial arrangement between the factor and client, in which the firm (client) gets advances in return for receivables, from a financial institution (factor). It is a financing technique, in which there is an **outright selling of trade debts by a firm to a third party, i.e. factor, at discounted prices**

8 most important Types of Factoring

- Full **Factoring**.
- Recourse **Factoring**.
- Maturity **Factoring**.
- Advance **Factoring**.
- Undisclosed **Factoring**.
- Invoice Discounting.
- Bulk **Factoring**.
- Agency **Factoring**.

Factoring Process



Functions of Factor:

A factor performs a number of functions for his client.

These functions are:

1. Maintenance of Sales Ledger:

2. Collection of Accounts Receivables:

3. Credit Control and Credit Protection:

4. Advisory Functions:

10 Legal aspects of factoring

The growth of a company depends largely on its liquidity. Many business projects, sales and credit expansion are hindered by lack of immediate cash. Today, the companies which are increasingly exporting face the risk of insolvency of its customers in addition to affecting the margin of the company. This weakens the results and becomes a permanent menace in achieving financial balance. So finding different financial variants is necessary which includes **factoring**.

Factoring in its traditional conception includes the management and collection of loans granted by the client and accepted by the factor, which assumes according to the contract the risk of insolvency of debtors. However there are certain **legal aspects of factoring** which you need to be aware of before you consider it as another financial variant.

The following are the **legal aspects of factoring**:

1. The sale is taking place on a credit basis and the factor takes the responsibility for collecting payment from the buyer. For this purpose, the agreement between the seller and the factor should clearly state the role of each party involved in the sale.

- 2. The seller should give due authority to the factor for collecting money from the buyer.
- 3. Legally, the claim on the buyer is assigned by the seller to the factor. For this, a letter of authority is given by the seller to the factor.
- 4. The buyer is also informed by the seller that he should make payment only to the factor.
- 5. All the rights of the seller on the buyer now get transferred to the factor in his capacity as an assignee.
- 6. In case of default by the buyer, it is the factor who will take action against the buyer in his capacity as an assignee.
- 7. No other creditor can have any claim settled with the buyer towards the sale of goods except the factor.
- 8. The banker will be informed that he should not finance the seller for any post sales requirements or accounts receivable discount, as it is the factor who has been assigned with the bills.
- 9. Disputes arising between the seller and buyer should be settled by the parties concerned and they should not affect the factor.
- 10. The factor must have the right to take legal action against the buyer in the case of default.

Benefits

Even after efficient cash flow management, **business entities** regularly face a cash crunch. Thus, factoring is crucial in fulfilling an urgent need for **capital**.

Given below are the various advantages of factoring in finance:

- **Facilitates Short-Term Financial Needs**: By utilizing this provision, businesses meet numerous operational expenses such as salary disbursement, bill settlement, payment to **creditors**, inventory purchase, etc.
- **Provides Liquidity**: It allows companies to convert their **trade receivables** into cash in an emergency.
- **Non-recourse Factoring Protects Against Bad Debts**: The non-recourse option transfers the credit risk and the receivables. This way, clients insulate themselves from bad debts.
- **Boosts Working Capital**: When companies run out of working capital, they can raise additional funds quickly.
- **No Collateral Required**: Since the factor extends funds in exchange for the receivables, the client firm is not required to submit any **collateral**.
- **Easily Available**: Compared to business loans, factoring is easier to avail. Business loans require thorough background checks and credit rating checks.

Drawbacks

Factoring also has certain drawbacks that cannot be overlooked.

- Primarily, it reduces the **profit margin** for client firms.
- Also, the factor's decision depends upon the debtors' credibility.

- Some customers may not prefer factoring addition; the factor directly deals with the debtor (customer), which may hinder the relationship between the client firm and the debtor (customer).
- Also, desperate firms end up incurring hidden costs. It further increases the financial burden of a struggling firm.

Types of Factoring

On the basis of default risk:

Recourse Factoring	**Non-Recourse Factoring**
In this type of factoring, the factor does not take on the risk of default. If the debtor fails to repay the invoice, the liability falls on the business firm itself.	The liability of bad debt remains with the factor, and they cannot reclaim the money from the business in case the debtor defaults.

On the basis of disclosure:

Disclosed Factoring	**Undisclosed Factoring**
When the factor's name is mentioned in the invoice by the debtor, and the debtor is fully aware that the invoice is being prefinanced by the factor.	The name of the factor is not mentioned, and the debt is repaid to the business – but the invoice and control is with the factor.

On the basis of trade:

Domestic Factoring	**Export Factoring**

When all three parties (factor, firm and debtor) reside and operate in the same country.	Where one or more parties operate or reside overseas. In export factoring, there are four parties involved: exporter/seller, importer/buyer, export factor and import factor.

On the basis of payment:

Advance Factoring	**Maturity Factoring**
The factor gives the business an advance payment in exchange for the accounts receivable.	The factor makes the payment only on the date of maturity of the invoice. Businesses opt for this method to insulate themselves from credit risk.

Why Financial Management is So Important

Factoring helps business improve inflow of cash and reduces credit risk – two important parts of an overall financial management strategy.

Having a solid financial management strategy is key – especially for young businesses and startups. Here's a few other strategies that make a high-growth financial management strategy.

- A solid investment strategy and a well-diversified portfolio
- Well-thought out budget and forecast plan for each quarter
- Top talent to facilitate and support growth – and employee retention plans to keep them
- Automated financial management for minimal errors and smooth finances

Credit Rating Agencies in India

A **credit rating** is an essential assessment of a person's or an organization's **creditworthiness**, showing their capacity to pay back debts and fulfill financial obligations. These evaluations are carried out by credit rating companies, who offer a free evaluation of credit risk. Making wise financial decisions requires having a solid understanding of the significance of credit ratings. Credit ratings are crucial in determining financial opportunities, whether for companies looking for investment or for governments looking to achieve favorable borrowing terms. Individuals and organizations can try to increase their creditworthiness and access better financial options by understanding the elements affecting credit ratings and actively managing financial responsibilities.

Types of Credit Ratings

There are two broad categories of credit ratings used by different credit rating agencies. Credit rating agencies may use slightly different terminology to classify credit ratings within these two broad categories, but the underlying concept remains the same.

- **Investment Grade:** Credit ratings in the investment grade category indicate that the corporate entity has demonstrated prudent financial management and is considered relatively low risk. These ratings suggest that the borrower is likely to fulfil their financial obligations and repay debts on time. Companies with investment grade ratings can easily access loans at favourable interest rates.
- **Speculative Grade:** Credit ratings in the speculative grade category imply a higher level of risk associated with the corporate borrower. These ratings indicate that the entity has engaged in riskier investments or may have financial challenges that could affect its ability to repay debts. Borrowers with speculative grade ratings may face difficulties in accessing loans and may be charged higher interest rates due to the perceived higher risk.

Users of Credit Ratings

Credit ratings of companies are considered by various entities or users and organisations, including:

- **Investment Banks:** Investment banks utilise credit ratings when underwriting and pricing debt instruments or equity shares before they are offered to the market. Credit ratings help determine the risk associated with the securities being issued.
- **Lenders:** Lenders such as banks or financial institutions assess credit ratings to evaluate the borrowing company's ability to repay loans. A favourable credit rating indicates a lower risk of default and increases the likelihood of loan approval.
- **Retail/Institutional Investors:** Retail and institutional investors analyse credit ratings to gauge the risk and potential returns of investing in a company's securities, such as stocks or bonds. Credit ratings influence investment decisions and assist investors in assessing the reliability of their investments.
- **Debt Issuers:** Companies themselves monitor their credit ratings to assess their creditworthiness and evaluate how their borrowing costs may be affected. This self-

assessment assists them in managing their financial strategies and making informed decisions.
- **Other Businesses/Corporations:** When entering into business transactions or partnerships, companies often review the credit ratings of other organisations involved. This evaluation helps them assess the financial stability and creditworthiness of potential partners or counterparties.

Importance of Credit Rating

Credit ratings play a crucial role for lenders, borrowing companies, and other entities involved in investment decisions. Here's a more detailed elaboration on their importance:

- **Lenders:**Lenders such as banks and financial institutions heavily rely on credit ratings to evaluate the creditworthiness of borrowing companies. The credit rating provides a standardized assessment of the company's ability to repay its debts. Lenders use this information to make informed decisions regarding loan approvals, loan terms, and interest rates. A higher credit rating indicates a lower risk of default, increasing the likelihood of loan approval. Lenders can assess the company's financial health and repayment capacity through its credit rating.
- **Borrowing Companies:**Credit ratings are of significant importance to borrowing companies. The credit rating affects their ability to obtain loans for various purposes, such as operational needs, expansion plans, or capital investments. A good credit rating enhances the company's reputation and credibility in the financial market, making it easier to secure loans at favourable terms and interest rates. On the other hand, lower credit ratings can limit borrowing options and result in higher borrowing costs.
- **Individual and Institutional Investors:**Credit ratings are valuable information for investors who are considering investing in equity shares or bonds of a company. Investors use credit ratings to assess the risk associated with their investments. A higher credit rating indicates a lower risk of default and suggests a higher level of confidence in the company's financial stability. Investors can evaluate the potential risks and returns associated with investing in a particular company based on its credit rating. This information helps investors make informed investment decisions aligned with their risk appetite and investment goals.

What is Credit Rating Agency

An entity's creditworthiness is evaluated by a credit rating agency (CRA) in general terms or in relation to a specific debt or financial obligation. Like a person's credit score, a company's or government entity's credit rating indicates how creditworthy they are. These organisations assist investors and lenders in assessing the possible risk of providing money to a specific borrower and assessing the borrower's ability to repay the loan based on previous credit behaviour.

According to SEBI Regulations, 1999 of the SEBI Act, 1992, Securities and Exchange Board of India (SEBI) has the jurisdiction to authorise and control credit rating agencies.

Who evaluates credit ratings in India?

Credit rating agencies (CRAs) play a crucial role in evaluating and determining the creditworthiness of individuals and companies. By analysing factors such as income,

credit history, and financial obligations, CRAs assess the debtor's ability to repay debts and identify potential credit risks.

The list below comprises some of the prominent credit rating agencies in India:

1. CRISIL (Credit Rating Information Services of India Limited)
2. ICRA (Investment Information and Credit Rating Agency) Limited
3. CARE (Credit Analysis and Research Limited)
4. India Ratings and Research Pvt. Ltd.
5. Brickwork Ratings India Pvt Ltd.
6. Acuite Ratings and Research Limited
7. SMERA Ratings Limited
8. Infometrics Valuation and Rating Pvt Ltd

Different credit rating scales

Credit rating scales used by various credit rating agencies in India are an essential tool for assessing the creditworthiness of entities. Credit ratings use alphabetical symbols (AAA, AA, A, B, etc.) to assess the creditworthiness of corporate financial instruments. Higher ratings suggest a lower risk of default, with AAA being highly favourable, indicating strong financial capability. Ratings below BB are considered indicative of poor creditworthiness.

The three tables presented highlight different rating categories and their associated default risks. These credit rating scales serve as valuable tools for investors, lenders, and other stakeholders in evaluating the financial health and repayment capabilities of entities in India.

Table 1: Credit Rating Scale - High Safety, High Safety, and Low Risk

Credit Rating Scale	High Safety: Lowest Risk of Default	
ICRA	AAA	AA
BrickWork	AAA	AA
CRISIL	AAA	AA
CARE	AAA	AA
India Ratings and Research	AAA	AA

This table represents the credit rating scale for entities, ranging from high safety to low risk. It includes credit ratings from agencies like ICRA, BrickWork, CRISIL, CARE, and

India Ratings and Research, providing an assessment of the default risk associated with each rating category.

Table 2: Credit Rating Scale - Moderate Safety and Moderate Default Risk

Credit Rating Scale	Moderate safety: moderate credit risk	
ICRA	BBB	BB
BrickWork	BBB	BB
CRISIL	BBB	BB
CARE	BBB	BB
India Ratings and Research	BBB	BB

In this table, the credit rating scale focuses on moderate safety and credit risk levels. The credit ratings assigned by ICRA, BrickWork, CRISIL, CARE, and India Ratings and Research reflect the agencies' evaluation of entities' creditworthiness in terms of moderate credit risk and moderate default risk.

Table 3: Credit Rating Scale - High Risk, Very High Default Risk, and Defaulted Instruments

Credit Rating Scale	High risk: High default risk	High risk: Very high default risk	
ICRA	B	C	D
BrickWork	B	C	D
CRISIL	B	C	D
CARE	B	C	D
India Ratings and Research	B	C	D

This table presents the credit rating scale for entities with high risk and very high default risk, along with a category for defaulted or about-to-default instruments. The credit

ratings assigned by ICRA, BrickWork, CRISIL, CARE, and India Ratings and Research indicate the increasing levels of default risk associated with different rating categories.

Factors affecting Credit Ratings in India

The credit ratings of corporate entities in India are influenced by several factors. These factors collectively provide credit rating agencies with insights into the financial health, repayment capability, and overall creditworthiness of corporate entities in India.

Factors that influence Credit Rating in India are described below:

- **Past repayment behaviour:**The repayment history of previous loans is an important consideration for credit rating agencies. Timely repayment of debts demonstrates good financial management skills and enhances the borrower's creditworthiness, while a track record of late payments or defaults can negatively impact the credit rating.
- **Loan portfolio:**The composition of a corporate entity's loan portfolio significantly affects its credit rating. Having a higher proportion of secured loans compared to unsecured loans is viewed favourably, whereas a significant reliance on unsecured loans can have a negative impact on the credit rating.
- **Market reputation:** The market reputation and perception of the borrowing firm also influence its credit rating. A positive reputation can contribute to higher income and better loan repayment capability, thus enhancing the credit rating. Conversely, a negative reputation or poor market perception may lead to a lower credit rating.
- **Future prospects of the business:**The growth potential and projected earnings of the business play a crucial role in determining its credit rating. If the company demonstrates robust expansion plans and a promising outlook for future income based on strong fundamentals, it is likely to receive a higher credit rating. Conversely, if the outlook appears uncertain or lacks growth prospects, it may result in a lower rating.

Some of the Top Credit Rating Agencies in India are:

1.Credit Rating Information Services of India Limited (CRISIL)

CRISIL is a leading global analytics firm considered to be a top supplier of ratings, data, research, analytics, and solutions in India. The rating agency is owned by S&P Global Inc., a global leader in providing fair and unbiased ratings, benchmarks, analytics, and data to the capital and commodity markets.

2.Credit Analysis and Research (CARE) Limited

In less than three decades after it began operations in April 1993, CareEdge Ratings (CARE Ratings Ltd.) has made a name for itself as one of India's top credit rating companies.

CareEdge is a knowledge-based organisation that offers almost real-time research on all national and international economic trends. The industry research team continuously monitors and produces sector reports.

3.Brickwork Ratings India Private Limited

Brickwork Ratings (BWR), a Credit Rating Agency registered with SEBI and authorised by the RBI, provides ratings for NCDs, Bank Loans, Fixed Deposits, Security Receipts, Commercial Paper, Securitized Paper, and other financial instruments.

Canara Bank, a prominent public sector bank, is the promoter and strategic partner of Brickwork Ratings.

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

ICRA Limited (formerly known as Investment Information and Credit Rating Agency of India Limited) was founded by leading financial institutions, commercial banks, and financial services firms in 1991 to serve as an independent and expert investment information and credit rating agency.

The ICRA Group of Companies is made up of ICRA and its subsidiaries (Group ICRA). ICRA is a public limited company, and the National Stock Exchange and the Bombay Stock Exchange both list its shares.

5.Acuite Ratings & Research (earlier SMERA Ratings Limited)

The aim of Acuite Ratings and Researcg is to pursue their mission to unleash the development potential of financial markets and give their clients the insights they need to make wise and informed decisions as India's leading credit rating and research organisation.

The company is supported by the largest and most potent public and private sector banks in the nation and is also a SEBI registered and RBI authorised credit rating agency. The agency benefits from Dun & Bradstreet's co-promotion of them as a leading global provider of data and analytics.

6.Infometrics Valuation and Rating Pvt. Ltd.

INFOMERICS Valuation and Rating Private Limited is a SEBI registered and RBI authorised credit rating agency. The company aims to reduce information asymmetry between lenders and investors and connecting borrowers and issuers with various fund-raising options and channels.

7.India Ratings and Research Pvt. Ltd.

India Ratings and Research (Ind-Ra) is dedicated to offering the credit markets in India accurate, fast, and prospective credit opinions. Ind-Ra has gained a considerable market position in India's fixed income market thanks to its foundation of independent thinking, rigorous analytics, and an open and fair approach to credit research.