products. He may do this with the hope of maximizing total company profits rather than profits for individual items. This objective is found to be effective when great consistency exists within the product mix.

Assessment of Target Market's Evaluation of Price and Its Ability to Purchase

Notes

Although it is assumed that price is a significant issue for customers, the importance of price depends on the type of product and the type of market the company targets. By assessing the target market's evaluation of price, a marketer is in a better position to know how much emphasis to place on price. Information about target market's price evaluation may also aid a marketer in determining how far above the competition a firm can set its prices. Understanding the purchasing power of buyers and knowing how important a product is to them in comparison with other products help marketers to assess the target market's evaluation of price accurately.

Determination of Demand Level of demand of a product is dependent on the levels of price set, thus, having different impacts on the marketing objectives of the concerned firm. We can understand the relationships between price and demand through demand schedule. Demand schedule tells us how much quantity of a product will be demanded (sold) at various prices.

It is known that price quantity relationship is inverse except few exceptions. That is less will be demanded if price is charged high and more will be demanded if price is charged less which means that buyers are price sensitive. In case of specialty or prestige goods, price increase may increase demand because buyers draw a price quality relationship: they take the higher price to signify a better or more exclusive item. We shall now discuss the factors affecting price sensitivity of buyers.

Factors Affecting Price Sensitivity: There are nine factors that affect price sensitivity as identified by Nagle. They are:

1. **Unique value effect:** When the product is considered more unique by the buyers they will usually be less price sensitive.
2. **Substitute awareness effect:** When buyers are less aware of substitutes then they are found to be less price sensitive.
3. **Difficult comparison effect:** When buyers cannot easily compare the quality of substitutes then they are usually less price sensitive.
4. **Total expenditure effect:** If the expenditure on the product is less as to the ratio to buyers' income then they are found to be less price sensitive.
5. **End-benefit effect:** The less the expenditure is to the total cost of the end product the less price sensitive buyers are.
6. **Shared cost effect:** When part of the cost is borne by another party, then buyers are less price sensitive.

Notes

7. **Sunk investment effect:** If the product is used in conjunction with assets previously bought buyers will be less price sensitive.
8. **Price-quality effect:** When the product is assumed to have more quality, prestige, or exclusiveness then buyers are less price sensitive.
9. **Inventory effect:** When buyers cannot store the product then they are less price sensitive.

Pricing in case of IPO/FPO

One of the biggest changes made by SEBI is the removal of the pricing guidelines in case of IPOs and FPOs. Pricing of public issues by unlisted companies, listed companies, banks, infrastructure companies, etc., is free and left to the discretion of the company. However, in practice, it is jointly decided with the Merchant Banker. A company files a draft offer document with SEBI and later on it files the same with ROC after incorporating the comments of SEBI. The company can mention a price band when it files the offer document with SEBI with the cap (i.e., the ceiling) being not more than 20% from the floor price. However, the actual price must be determined before the offer document is filed with the ROC. The pricing mechanism in case of book built issues is specified in para 3.3.3.

In case a listed company is coming out with a joint issue of rights as well as public issue, then it can have differential pricing for the two issues.

Differential pricing is also permitted in case of a firm allotment in an IPO/FPO. However, this price must be higher than the regular category.

The Face Value of shares can also be determined by the companies, e.g., ₹ 10, 5, 2, 1, etc. It cannot be a decimal of a rupee, e.g., ₹ 0.50. Further, in case of an IPO the following additional conditions apply:

- if the issue price is ₹ 500 or more then the Company may fix the face Value below ₹ 10 per share but not lower than ₹ 1 per share;
- if the issue price is less than ₹ 500 then the Company must have a face Value of ₹ 10 per share. Existing companies can freely vary the face value of their shares without any conditions.

Companies have the freedom to fix the issue price. Hence, in case of a price higher than the face value of the shares the balance would be treated as share premium. For instance, if the IPO price for a share of ₹ 10 face value is fixed at ₹ 140, then ₹ 130 would be treated as share premium. The provisions of the Companies Act in respect of such share premium would then be applicable.

3.4 RIGHTS ISSUES

A rights issue is an offering of rights to the existing shareholders of a company that gives them an opportunity to buy additional shares directly from the company at a discounted price rather than buying them in the secondary market. The number of additional shares that can be bought depends on the existing holdings of the shareowners.

Cash-strapped companies can turn to rights issues to raise money when they really need it. In these rights offerings, companies grant shareholders the right, but not the obligation, to buy new shares at a discount to the current trading price. We explain how rights issues work and what they mean for the company and its shareholders.

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Defining a Rights Issue

A rights issue is an invitation to existing shareholders to purchase additional new shares in the company. This type of issue gives existing shareholders securities called rights. With the rights, the shareholder can purchase new shares at a discount to the market price on a stated future date. The company is giving shareholders a chance to increase their exposure to the stock at a discount price.

- A rights issue is one way for a cash-strapped company to raise capital often to pay down debt.
- Shareholders can buy new shares at a discount for a certain period.
- With a rights issue, because more shares are issued to the market, the stock price is diluted and will likely go down.

Until the date at which the new shares can be purchased, shareholders may trade the rights on the market the same way that they would trade ordinary shares. The rights issued to a shareholder have value, thus compensating current shareholders for the future dilution of their existing shares' value. Dilution occurs because a rights offering spreads a company's net profit over a larger number of shares. Thus, the company's earnings per share, or EPS, decreases as the allocated earnings result in share dilution.

Features of a Rights Issue

- Companies undertake a rights issue when they need cash for various objectives. The process enables the company to raise money without incurring underwriting fees.
- A rights issue gives preferential treatment to existing shareholders, where they are given the right (not obligation) to purchase shares at a lower price on or before a specified date.
- Existing shareholders also enjoy the right to trade with other interested market participants until the date at which the new shares can be purchased. The rights are traded in a similar way as normal equity shares.
- The number of additional shares that can be purchased by the shareholders is usually in proportion to their existing shareholding.
- Existing shareholders can also choose to ignore the rights; however, if they do not purchase additional shares, then their existing shareholding will be diluted post issue of additional shares.

Reasons for a Rights Issue

- When a company is planning an expansion of its operations, it may require a huge amount of capital. Instead of opting for debt, they may

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like to go for equity to avoid fixed payments of interest. To raise equity capital, a rights issue may be a faster way to achieve the objective.

- A project where debt/loan funding may not be available/suitable or expensive usually makes a company raise capital through a rights issue.
- Companies looking to improve their debt-to-equity ratio or looking to buy a new company may opt for funding via the same route.
- Sometimes troubled companies may issue shares to pay off debt in order to improve their financial health.

Example of a Rights Issue

Let's say an investor owns 100 shares of Arcelor Mittal and the shares are trading at $10 each. The company announces a rights issue in the ratio of 2 for 5, i.e., each investor holding 5 shares will be eligible to buy 2 new shares. The company announces a discounted price of, for example, $6 per share. It means that for every 5 shares (at $10 each) held by an existing shareholder, the company will offer 2 shares at a discounted price of $6.

- Investor's Portfolio Value (before rights issue) = 100 shares × $10 = $ 1,000
- Number of right shares to be received = (100 × 2/5) = 40
- Price paid to buy rights shares = 40 shares × $6 = $ 240
- Total number of shares after exercising rights issue = 100 + 40 = 140
- Revised Value of the portfolio after exercising rights issue = $ 1,000 + $240 = $1,240
- Should be price per share post-rights issue = $1,240/140 = $8.86

According to theory, the price of the share after the rights issue should be $8.86, but that is not how the markets behave. An uptrend in the share price will benefit the investor, while if the price falls below $8.86, the investor will lose money. The decline in share price can be attributed to several factors. Here are some of them:

- It gives a signal to the market that the company may be struggling, which can be the reason the company issued shares at a discount.
- By issuing more shares, there is dilution in the value of available shares.

Stock Rights Issue

Why Issue a Rights Offering?

Companies most commonly issue a rights offering to raise additional capital. A company may need extra capital to meet its current financial obligations. Troubled companies typically use rights issues to pay down debt, especially when they are unable to borrow more money.

Companies with healthy balance sheets might also raise money through a rights issue to acquire a competitor or open new facilities. For a shareholder, this can create capital gains.

However, not all companies that pursue rights offerings are in financial trouble. Even companies with clean balance sheets may use rights issues. These issues might be a way to raise extra capital to fund expenditures designed to expand the company's business, such as acquisitions or opening new facilities for manufacturing or sales. If the company is using the extra capital to fund expansion, it can eventually lead to increased capital gains for shareholders despite the dilution of the outstanding shares as a result of the rights offering.

For reassurance, a company will usually, but not always, have its rights issue underwritten by an investment bank.

How Rights Issues Work

So, how do rights issues work? Let's say you own 1,000 shares in Wobble Telecom, each of which is worth $5.50. The company is in financial trouble and needs to raise cash to cover its debt obligations. Wobble, therefore, announces a rights offering through which it plans to raise $30 million by issuing 10 million shares to existing investors at a price of $3 each. But this issue is a three-for-10 rights issue. In other words, for every 10 shares you hold, Wobble is offering you another three at a deeply discounted price of $3. This price is 45% less than the $5.50 price at which Wobble stock trades.

As a shareholder, you have three options with a rights issue. You can (1) subscribe to the rights issue in full, (2) ignore your rights, or (3) sell the rights to someone else. Below we explore each option and the possible outcomes.

1. Take Up the Rights to Purchase in Full: To take advantage of the rights issue in full, you would need to spend $3 for every Wobble share that you are entitled to purchase under the issue. As you hold 1,000 shares, you can buy up to 300 new shares (three shares for every 10 you already own) at the discounted price of $3 for a total price of $900.

However, while the discount on the newly issued shares is 45%, the market price of Wobble shares will not be $5.50 after the rights issue is complete. The value of each share will be diluted as a result of the increased number of shares issued. To see if the rights issue does, in fact, give a material discount, you need to estimate how much Wobble's share price will be diluted.

In estimating this dilution, remember that you can never know for certain the future value of your expanded shareholding since it can be affected by business and market factors. But the theoretical share price that will result after the rights issue is complete—which is the ex-rights share price—is possible to calculate. This price is found by dividing the total price you will have paid for all your Wobble shares by the total number of shares you will own. This is calculated as follows:

1,000 existing shares at $5.50	$5,500
300 new shares for cash at $3	$900
Value of 1,300 shares	$6,400
Ex-rights value per share	$4.92 ($6,400.00/1,300 shares)

Notes

So, in theory, as a result of the introduction of new shares at the deeply discounted price, the value of each of your existing shares will decline from $5.50 to $4.92. But remember, the loss on your existing shareholding is offset exactly by the gain in share value on the new rights: the new shares cost you $3, but they have a market value of $4.92. These new shares are taxed in the same year as you purchased the original shares and carried forward to count as investment income, but there is no interest or other tax penalties charged on this carried-forward, taxable investment income.

2. Ignore the Rights Issue: You may not have the $900 to purchase the additional 300 shares at $3 each, so you can always let your rights expire. But this is not normally recommended. If you choose to do nothing, your shareholding will be diluted thanks to the extra shares issued by the company.

3. Sell Your Rights to Other Investors: In some cases, rights are not transferable. These are known as non-renounceable rights. But in most cases, your rights allow you to decide whether you want to take up the option to buy the shares or sell your rights to other investors or the underwriter. Rights that can be traded are called renounceable rights. After they have been traded, the rights are known as nil-paid rights.

To determine how much you may gain by selling the rights, you can estimate the value of the nil-paid rights ahead of time. Again, a precise number is difficult, but you can get a rough value by taking the value of the ex-rights price and subtracting the rights issue price. At the adjusted ex-rights price of $4.92 less $3, your nil-paid rights are worth $1.92 per share. Selling these rights will create a capital gain.

Investors may be tempted by the prospect of buying discounted shares with a rights issue. But it is not always a certainty that you are getting a bargain. In addition to knowing the ex-rights share price, you need to know the purpose of the additional funding before accepting or rejecting a rights issue. Be sure to look for a compelling explanation of why the rights issue and share dilution are necessary as part of a company's strategic plan. A rights issue can offer a quick fix for a troubled balance sheet, but that does not mean that management will address the underlying problems that weakened the balance sheet in the first place. Shareholders should be cautious.

3.4.1 Promoters' Contribution

Minimum promoters' contribution:

(1) The promoters of the issuer shall contribute in the public issue as follows:

(*a*) in case of an initial public offer, not less than twenty per cent of the post issue capital

[**Provided** that in case the post issue shareholding of the promoters is less than twenty per cent, alternative investment funds may contribute for the purpose of meeting the shortfall in minimum contribution as specified for promoters, subject to a maximum of ten per cent of the post issue capital.]

(b) in case of a further public offer, either to the extent of twenty per cent of the proposed issue size or to the extent of twenty per cent of the post-issue capital;

(c) in case of a composite issue, either to the extent of twenty per cent of the proposed issue size or to the extent of twenty per cent of the post-issue capital excluding the rights issue component.

Notes

(2) In case of a public issue or composite issue of convertible securities, minimum promoters' contribution shall be as follows:

(a) the promoters shall contribute twenty per cent as stipulated in clause (a), (b) or (c) of sub-regulation (1), as the case may be, either by way of equity shares or by way of subscription to the convertible securities:

Provided that if the price of the equity shares allotted pursuant to conversion is not predetermined and not disclosed in the offer document, the promoters shall contribute only by way of subscription to the convertible securities being issued in the public issue and shall undertake in writing to subscribe to the equity shares pursuant to conversion of such securities;

(b) in case of any issue of convertible securities which are convertible or exchangeable on different dates and if the promoters' contribution is by way of equity shares (conversion price being pre-determined), such contribution shall not be at a price lower than the weighted average price of the equity share capital arising out of conversion of such securities;

(c) subject to the provisions of clauses (a) and (b) above, in case of an initial public offer of convertible debt instruments without a prior public issue of equity shares, the promoters shall bring in a contribution of at least twenty per cent of the project cost in the form of equity shares, subject to contributing at least twenty per cent of the issue size from their own funds in the form of equity shares:

Provided that if the project is to be implemented in stages, the promoters› contribution shall be with respect to total equity participation till the respective stage *vis-à-vis* the debt raised or proposed to be raised through the public issue.

(3) In case of a further public offer or composite issue where the promoters contribute more than the stipulated minimum promoters' contribution, the allotment with respect to excess contribution shall be made at a price determined in terms of the provisions of regulation 76 or the issue price, whichever is higher.

(4) The promoters shall satisfy the requirements of this regulation at least one day prior to the date of opening of the issue and the amount of

promoters' contribution shall be kept in an escrow account with a scheduled commercial bank and shall be released to the issuer along with the release of the issue proceeds:

Provided that where the promoters› contribution has already been brought in and utilised, the issuer shall give the cash flow statement disclosing the use of such funds in the offer document:

Notes

Provided further that where the minimum promoters' contribution is more than one hundred crore rupees, the promoters shall bring in at least one hundred crore rupees before the date of opening of the issue and the remaining amount may be brought on pro rata basis before the calls are made to public.

Explanation: For the purpose of this regulation:

(*I*) Promoters' contribution shall be computed on the basis of the post-issue expanded capital:

(*a*) assuming full proposed conversion of convertible securities into equity shares;

(*b*) assuming exercise of all vested options, where any employee stock options are outstanding at the time of initial public offer in terms of proviso (*b*) to sub-regulation (5) of regulation 26.

(*II*) For computation of "weighted average price":

(*a*) "weights" means the number of equity shares arising out of conversion of such specified securities into equity shares at various stages;

(*b*) "price" means the price of equity shares on conversion arrived at after taking into account predetermined conversion price at various stages.

3.4.2 Minimum Subscription

The Securities and Exchange Board of India ("SEBI") has issued several relaxations in the Rights Issue Process amid Covid-19, inter-alia, reduction in filing fees, reduction in minimum subscription level from 90% to 75% of the issue size, allowance of a mode other than ASBA for payment of application money, dispatch of rights issue stationery only through email etc.

In continuance of past relaxations SEBI vide its press release no. 51/2020 dated September 23, 2020 ('Press Release') has communicated its decision to amend the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 ('SEBI ICDR Regulations') primarily to ease and rationalize disclosure requirements and eligibility criteria for Fast Track Rights Issue, to make the Rights Issues an efficient, faster and more effective mode of accessing the capital market.

Subsequently, SEBI has notified the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Fourth Amendment) Regulations, 2020 ('ICDR Fourth Amendment 2020') on September 28, 2020. These amendments have become effective from October 1, 2020.

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Objectives: The ICDR Fourth Amendment 2020 is in line with SEBI's intention and earlier amendments to ease the eligibility criteria for Fast Track Rights Issue, significantly truncate the disclosure requirements for preparing a Letter of Offer and provide a rationalized framework to listed Indian companies to raise funds from its shareholders with ease and with minimum required disclosures. The aim of this article is to provide readers a comprehensive and clear comparative view of changes as notified through the ICDR Fourth Amendment 2020 in the Regulatory Framework, Eligibility Criteria, Disclosure Requirements and other allied matters related to Rights Issues.

SEBI has on 23rd September 2020 released a press release intimating about amendments to be made in SEBI ICDR Regulations, 2018 ("ICDR Regulations"/ "Regulations") 2018. Further, on 28th September, 2020, SEBI issued a notification bringing the SEBI (ICDR) (Fourth Amendment) Regulations, 2020 ("Amendment") which was notified in official gazette on 1st October, 2020. The Amendment is specifically focused for matters in relation to rights issue by listed entities. Several changes have been made which includes increasing the threshold for applicability, truncated disclosures in the letter of offer, removing the requirement for appointing a compliance officer, etc. At various places, the amendment is for the purpose of clarification or straightening of language of the Regulations.

In this article we have discussed the major amendments along with the probable impact.

Areas for amendments

1. Increase in issue size for checking applicability: Erstwhile, ICDR Regulations were applicable in case of a rights issue for a size exceeding INR 10 crores. Further, the draft letter of offer ("draft LOF") in such cases is required to be filled with SEBI for its observations. In other cases, i.e. where the issue size is less than INR10 crores the letter of offer ("LOF") is to be filled with SEBI for information and dissemination on the SEBI's website in accordance with Regulation 3. As a matter of temporary relaxation, SEBI vide its Circular dated 21st April, 2020 (April Circular) increased the aforesaid threshold to INR 25 crore for issues opening on or before March, 2020.

By virtue of the Amendment, the limit of INR 10 crores under Regulation 3 has been increased to INR 50 crores. This would mean that while the general conditions and compliance will now be applicable to issue size of INR 50 crore or more, listed companies with a lower issue size will be required to file the LOF with SEBI for informative purpose.

As a result of the Amendment, while the applicability threshold has been increased, however, the companies with a lower issue size are still required to prepare the LOF in terms of the requirements of the ICDR Regulations and file the same with SEBI. Accordingly, while the change will surely be of relief to the entities which are now outside the applicability these Regulations, however, preparation of the LOF in terms of these Regulations will still be required.

Further to this, it should also be noted that practically filling of draft LOF for the purpose of obtaining observations from SEBI and then making prescribed changes generally takes several months. Accordingly, now since many entities will not be required to take the observations from SEBI, the same should help entities raise funds faster.

Notes

2. Relaxation in eligibility to make right issue, for members of promoter group and promoter or director of company who are director in entities, which were earlier debarred by SEBI

Regulation 61 of ICDR Regulations state that an issuer shall not be eligible to make a rights issue of specified securities:

(a) if the issuer, any of its promoters, promoter group or directors of the issuer are debarred from accessing the capital market by the Board;

(b) if any of the promoters or directors of the issuer is a promoter or director of any other company which is debarred from accessing the capital market by the Board.

(c) if any of its promoters or directors is a fugitive economic offender.

Further, explanation to the said Regulations state that

"the restrictions under (a) and (b) above will not apply to the promoters ordirectors of the issuer who were debarred in the past by the Board and the period of debarment is already over as on the date of filing of the draft letter of offer."

However, the language of the said explanation did not cover promoter group or other entities where the promoter or director of the issuer holds similar and which is debarred by SEBI. This lacuna in the language of the existing text gives an impression to result in a permanent restriction on right issue if the members of the promoter group were debarred or unless the concerned person vacated the post in the other entity which was debarred by SEBI from accessing the capital market.

The explanation shall now read as follows

"the restrictions under (a) and (b) above will not apply to the persons or entities mentioned therein who were debarred in the past by the Board and the period of debarment is already over as on the date of filing of the draft letter of offer." After the amendment, all the mentioned persons or entities are now covered under the explanation and hence on completion of period of debarment, the issuer shall be eligible to undertake the right issue.

The above amendment is much needed clarification in the language rather than a relaxation

3. Firm arrangement towards 75% of finance of capital expenditures only: Regulation 62 (1) (c) of ICDR Regulations require that issuer shall make firm arrangements of finance through verifiable means towards seventy five per cent of the stated means of finance for the specific project proposed to be funded from right issue, excluding the amount to be raised through the proposed rights issue or through existing identifiable internal accruals.

The Amendment introduces an explanation to the said clause stating *"For the purpose of this regulation 'finance for the specific project' shall mean finance of capital expenditures only."*

The addition of explanation provides a clarity on calculation of amount that the company has to make firm arrangement for. The explanation also provides a simplification in compliance, as in most projects the capital expenditure are highly predictable unlike revenue expenditure that vary significantly and may not be estimated accurately.

Notes

4. Removing the requirement to appoint a Compliance officer: The Regulation 69 (8) of the ICDR Regulations require appointment of Compliance Officer by the issuer who shall be responsible for monitoring the compliance of the securities laws and for redressal of investors' grievances. The said regulation has been omitted by the amendments.

Further the name of Part IV of Chapter III of ICDR Regulations has been suitably changed from "Appointment of Lead Managers, Other Intermediaries and Compliance Officer" to "Appointment of Lead Managers and Other Intermediaries"

Removing the requirement to appoint a compliance officer is a much needed amendment since the lead manager/designated lead manager to the issue is any way required to ensure compliance with several applicable laws. Accordingly, it was a redundant practice to designate a compliance officer separately for a rights issue.

5. Changes in Disclosure requirements: Regulation 70 of ICDR Regulations require that certain disclosure be made under LOF and Draft LOF. The SEBI has proposed that specified entities shall be required to make disclosures in format provided under Part A or Part-B of Schedule VI.

Disclosure requirements under Part B of Schedule VI have been rationalized to avoid duplication of information in LOF, especially the information which is already available in public domain and is disclosed by the companies in compliance with the disclosure requirements under SEBI listing regulations.

However, the Issuer not fulfilling the conditions above will be required to make disclosures in the format given in Part B-1 of Schedule VI, the disclosures in Part B-1 would be more detailed than that in Part B, however it shall be truncated as compared to Part A, that is applicable for IPO or FPO.

The Part-B of Schedule VI states that following entities shall be eligible to make disclosers under the given format –

1. Issuer has been filing periodic reports, statements and information in compliance with listing regulations for the last one year (instead of the last three years as required earlier) immediately preceding the date of filing Draft LOF or LOF as the case may be.
2. Statement above shall be available on website of Stock Exchanges.

Notes

3. the issuer has investor grievance-handling mechanism which includes meeting of the Stakeholders' Relationship Committee at frequent intervals, appropriate delegation of power by the board of directors of the issuer as regards share transfer and clearly laid down systems and procedures for timely and satisfactory redressed of investor grievances

The mentioned rationalization of disclosures would not only save the listed entities from duplication of task of providing same information that is already disclosed repeatedly but will also ease the accessing of reports by the stakeholders. The decluttering of the disclosures would be beneficial for all, Issuer, investor as well as regulators.

6. Relaxation in Minimum 90% subscription criteria: Regulation 86(1) of ICDR Regulations require that the minimum subscription to be received in the right issue shall be at least ninety per cent of the offer through the offer document, the said limit was temporally relaxed to 75% by the April Circular.

The amendment proposes to remove mandatory requirement of minimum 90% subscription in case the issue is for the purpose of financing other than capital expenditure for a project, provided that the promoters undertake to subscribe fully to their portion of rights entitlement.

The said relaxation should help the issuers looking for financing their business by right issue, specifically for general financing needs of business. The condition that the promoters would be needed to subscribe their entitlements completely would help safeguard the interest of other subscribers.

7. Application in plain paper to contain all the disclosures under the ICDR Regulations: Regulation 78 of ICDR Regulation allow shareholders to make application on plain paper in case he/she has not received application from for the right issue. SEBI has included a proviso to the regulation stating that "SCSBs shall accept such application forms only if all details required for making the application as per these regulations are specified in the plain paper application".

On a general basis an application form contains following details to be entered by the shareholder-

- Name of Issuer
- Name and address of the Equity Shareholder including joint holders;
- Registered Folio Number/DP and Client ID no.;
- Number of Equity Shares held as on Record Date;
- Number of Rights Equity Shares entitled to;
- Number of Rights Equity Shares applied for;
- Number of additional Rights Equity Shares applied for, if any;
- Total number of Rights Equity Shares applied for;
- Total amount paid
- Particulars of cheque/demand draft;
- Savings/Current Account Number and name and address of the bank where the Equity Shareholder will be etc.

Notes

8. FTRI in case of pending Show Cause Notice: Regulation 99 of the ICDR Regulations provide for eligibility criteria for Fast Track Rights Issue (FTRI). FTRI is a faster method of raising funds through right issue whereby the issuer is not required to file draft LOF to SEBI for observations, this makes the process of right issue comparatively faster, enabling issuer to get funds faster.

Clause (h) of the aforesaid regulation restricts the rights issue in case show cause notice have been issued or prosecution proceedings have been initiated by the Board and pending against the issuer or its promoters or whole-time directors.

The amendment provides that the above clause shall now exclude the cases where notice is issued in regards to proceedings for imposition of penalty. However it shall be necessary that disclosures along with potential adverse impact on the issuer are made in the letter of offer.

The said amendment would help compliant companies against whom SCN is issued for violations that are not of serious nature and require only imposition of penalty. As discussed FTRI facilitates faster and cheaper raising of finance by the company, the relaxation would promote the companies to undertake right issue for fund raising activities.

3.4.3 Advertisements

Pre-Issue Advertisements

Lead manager has to ensure that:

- No advertisement relating to the issue shall be released without giving "Risk Factors" in respect of the concerned issue.
- Advertisements shall not contain any matter or matters which is/are extraneous to the contents of the offer documents.
- In all issue advertisements, equal treatment in all respects shall be given to the risk factors and highlights.
- New issue slogans or brand names for the issue should not be coined except the normal commercial name of the company or commercial brand names of its products already in use.
- Making use of models/celebrities, etc. is prohibited.
- In case there is a reservation for the NRIs, the issue advertisement shall specify the same and indicate the source in India from where the individual NRI applicant can procure application forms.
- The lead manager shall ensure that in the case of rights issues, the issuers release an advertisement giving the date of completion of despatch of letters of offer, at least 7 days before the date of opening of the issue, at least in two all India Newspapers.

Post Issue Advertisements

Post issue lead Merchant banker shall ensure that in all issues, advertisement giving details relating to oversubscription, basis of allotment, number, value arid percentage of applications received along with stock, invest, number, value and

percentage of successful allottees who have applied through stock invest, date of completion of despatch of refund orders, date of despatch of certificates and date of filing of listing application is released within 10 days from the date of completion of the various activities at least in an English National daily with wide circulation, one Hindi National Paper and a Regional language daily circulated at the place where registered office of the issue company is situated.

Notes

Post issue Lead Merchant Banker shall ensure that issuer company/ advisors brokers or any other agencies connected with the issue do not publish any advertisement stating that issue has been oversubscribed or indicating investors response to the issue during the period when the public issue is still open for subscription by the public. Advertisement stating that "the subscription to the issue has been closed" may be issued after the actual closure. of the issue.

Basis of Allotment In a public issue of securities, the executive Director/ Managing Director of the Regional stock Exchange along-with the post issue Lead Merchant Banker and the Registrars to the issue shall be responsible to ensure that the basis of allotment is finalised in a fair and proper manner in accordance with the laid down guidelines.

3.4.4 Content of Offer Document

'Offer document' is a document that contains all the relevant company information, promoters, initiatives, financial details, money-raising items, problem types, etc., and is used by the issuer to invite subscription to the issue. In the case of a public issue, the offer document is called 'Prospectus' and the letter of offer in the case of rights issues.

Draft offer document: It means the drafted offer document, i.e. the first document submitted for approval by SEBI companies and stock exchanges, which, after examination, communicates their feedback to the Company, which the Company is expected to integrate into the offer document. For processing a drafted offer paper, SEBI usually needs a period of 30 days. SEBI will put the drafted offer document on its website. It is also put on the websites of registered stock exchanges where it is proposed to list specified securities and to comment publicly on the merchant bankers associated with the issue for a period of at least 21 days. In addition, the issuer must either make a public announcement in one English national daily newspaper, one Hindi national daily newspaper and one regional language newspaper at the place where its registered office is located on the date of filing of the drafted offer document with SEBI or on the next day, disclosing to the public the fact of filing the drafted offer document and inviting the public to give their comments to SEBI.

Companies seeking to raise up to Rs 750 crore can now send their drafted documents to the SEBI Market Regulator Regional Offices.

So far, on behalf of the firms, merchant bankers have been authorized to file with the regional office of SEBI concerned papers for issues worth up to Rs 500 crore.

In a circular issued by SEBI, It was agreed that the drafted offer documents shall be filed with the appropriate regional office of the board under the jurisdiction of which the registered office of the issuer company falls, in respect of issues of a size up to Rs 750 crore.

In addition, the Securities and Exchange Board of India (SEBI) announced that for all regions, companies may file their drafted offer documents at SEBI 's headquarters for issues larger than Rs 750 crore in size.

SEBI has listed four regional offices, northern, eastern, southern and western, in which companies can, on the basis of the estimated size of the issue, file their drafted offer documents or offer documents with the appropriate board office. The new criteria would come into effect for all draft offer documents for issues that are filed with SEBI later on.

Offer document: Following should be the structure of the presentation of the content in an offer document. The basic objective is to help the reader to navigate through the content of an offer document:

- **Cover page**

Complete contact details of the Issuer Firm, lead managers and registrars under this heading, the type, number, price and amount of instruments offered and the size of the issue, and the listing details. Other information is also disclosed, if necessary, such as credit rating, IPO grading, risks in relation to the first issue, etc.

- **Risk Factors**

Under this heading, the management of the issuer business shall present its views on the internal and external risks envisaged by the business and, if any, its proposals to resolve those risks. A notice on the forward-looking statements is also issued by the firm. This detail is disclosed in the document's initial pages and in the abridged prospectus as well. It is usually recommended that before making an investment decision, investors should go through all of the company's risk factors.

- **Introduction**

Under this heading, a description of the sector in which the issuer company works, the business of the issuer company, a description of the consolidated financial statements and other data relating to the general information concerning the firm, the merchant bankers and their responsibilities, the details of the brokers/ syndicate members of the issuer company, the credit rating (in the case of debt issuance), the debtors and their responsibilities, the details of the brokers/ syndicate members of the problem Significant specifics of the capital structure, of the items of the bid, of the funding criteria, of the funding strategy, of the implementation timetable, of the funds deployed, of the sources of financing of the funds already deployed, of the sources of financing of the balance fund requirement, of the provisional use of the funds, of the specific conditions of issuance, of the basis for the issue price, of the tax advantages are also covered.

Notes

- **About us**

A summary of the company's business facts, business strategy, competitive strengths, insurance, industry regulation (if applicable), history and corporate structure, key objects, subsidiary data, board of directors and management, compensation, corporate governance, related party transactions, exchange rates, presentation currency and dividend policy are provided under this heading.

- **Financial statements**

In compliance with the specifications of the Guidelines and discrepancies between any other accounting policies and the Indian Accounting Policies (if the Company has already submitted its financial statements as per either US GAAP / IFRS), this head financial statement and restatement are presented.

- **Legal and other information**

Under this heading, outstanding litigation and material developments are disclosed, litigation affecting the company, the company's promoters, its subsidiaries, and group companies. After the last balance sheet date, material developments, government approvals/licensing agreements, investment approvals (FIPB/RBI etc.), technical approvals, and indebtedness, etc. are also disclosed.

- **Other regulatory and statutory disclosures**

Under this head following information to be disclosed:

Authority to be issued, prohibition by SEBI, the company's eligibility to join the capital market, etc.

Also, the issuer's and the lead manager's disclaimer statement, disclaimer as to jurisdiction, dissemination of details to customers, stock exchange disclaimer clause, listing, impersonation, minimum subscription to be displayed.

Letters of allocation or reimbursement orders, consents, expert opinion, changes in auditors over the last three years, costs of the issue, fees payable to the intermediaries involved in the issue process, information of all previous problems, all pending instruments should also be disclosed.

Commission and brokerage on, prior issues, capitalization of reserves or earnings, choice to subscribe in the question, acquisition of land, revaluation of properties, classes of securities, stock market data for the company's equity securities, pledge vis-à – vis success in past issues and mechanism for redressing investor grievances should also be displayed.

- **Offering information**

In this heading, the terms of the issue should include the ranking of equity securities, dividend payment process, face value and issue price, equity shareholder rights, market lot, investor nomination facility, issue procedure.

In addition to the procedure of making an application, signing the underwriting agreement and filing a prospectus with SEBI / ROC, the notice of statutory ads should also be listed in detail.

It is important to report payment orders, submission of bid form, other orders, disposal of application and application money, interest on refund of excess bid number; allocation basis or allocation.

It is important to disclose the method of proportionate allocation, dispatch of refund orders, correspondence, undertaking by the company, use of issuance proceeds, restrictions on foreign ownership of Indian securities.

Notes

- **Other information**

This includes the summary of the shares in equity and the terms of the Articles of Association, content contracts and inspection papers, statements, descriptions, abbreviations, etc.

Procedure for filing offer document with SEBI

- In order to facilitate operations in the quest for comments on drafted offer papers, drafted offer letters and drafted agreement schemes pursuant to the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and SEBI (Buy-Back of Securities) Regulations, 1998 and the various circulars issued thereunder, SEBI has implemented an online system for filings relating to public issues, rights and insurance issues, institutional placement programme, schemes of arrangement, takeovers and buy backs.
- All merchant bankers who are required to file offer documents and related documents in physical form with SEBI in compliance with the provisions of the Regulations referred to above shall file the same online at the same time through the SEBI Intermediary Portal at *https://siportal.sebi.gov.in.*
- Recognized stock exchanges filing with SEBI under the provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 the drafted scheme of arrangement and relevant documents in physical form shall concurrently file the same online through SEBI Intermediary Portal at *https://siportal.sebi.gov.in.*
- As mentioned above, the simultaneous filing of papers, i.e. physical and online, will start from 1 February, 2018 and continue until 31 March, 2018. Subsequently, physical filing of the aforementioned records will be discontinued as of 1 April, 2018 and only online filing will be approved.

To get started on Portal following steps need to be followed:

Step 1: Self-Registration

Step 2: Check status

Step 2: Login ID creation and activation

Step 4: Login to SEBI portal

Payment options: Applicants will be asked to collect application fee payment information as part of self-registration. For the payment of application fees, the following methods of payment will be approved.

Notes

Offline mode:

- Demand Draft

Online mode:

- Internet Banking
- Debit Card
- IMP

Submission of draft and final offer document

Step 1

1. Offering documents up to ₹ 20 crores shall be sent by lead merchant bankers to the regional office of the Board under whose jurisdiction the issuer company is licensed.
2. The jurisdiction of the regional offices/ headquarters shall be in compliance with Schedule XXII.

Step 2

1. The draft offer document submitted with the Board shall be made public in compliance with Clause 5.6 of Chapter V of the Guidelines.
2. The Lead Merchant Banker shall make available to the Board 10 copies of the draft offer document and 25 copies of the Stock Exchange(s) where it is proposed to list the issue.
3. The Lead Merchant Bankers / Stock Exchange shall make copies of the draft offer document available to the public.
4. Such a fair fee may be paid by the lead merchant banker and the Stock Exchange(s) for supplying a copy of the draft offer paper.

Step 3

1. As per the format specified in Schedule XXIII, the Lead Merchant Banker shall also submit to Board the draft offer document on a computer floppy.

Step 4

1. Lead Merchant Bankers shall apply to the dealing offices of the Board at least two copies of the final printed copy of the final offer document within three (3) days of the filing of the offer document with the Registrar of Companies / concerned Stock Exchange(s), as the case may be.
2. The lead merchant banker shall, within three (3) days of filing the offer document with the Registrar of Companies / concerned Stock Exchange(s), send one final printed copy of the final offer document to the Primary Market Department, SEBI, Head Office, as the case may be.

3. The lead merchant banker shall send to the Primary Market Department, SEBI, Head Office, within three (3) days of filing the final prospectus/ letter of offer with the Registrar of Companies / Stock Exchange(s) concerned, a computer floppy containing the final prospectus/ letter of offer, as defined in Schedule XXIII. The lead manager shall send to SEBI, along with the floppy, an undertaking certifying that the contents of the floppy are in HTML format and are similar, as the case may be, to the printed version of the prospectus/ letter of offer filed with the Registrar of Companies / Stock Exchange concerned.

Notes

Step 5

1. Whenever offer documents are filed with any department/ office of the Board (for public/ rights issues, takeovers or for any other purpose), the following information "certified to be correct" shall be issued by the lead merchant banker in the forwarding letters:

- Registration No.
- Date of registration / Registration renewal.
- Expiration date of registration.
- If submitted for renewal, the date of the submission.
- Any correspondence by the Board that forbids the acting of a merchant banker.
- Any inquiry/ inquiry that the Board conducts.
- Duration of payment of registration/ renewal fees.
- Whether any promoter/ director/ group and/or associate of the issuer company is affiliated and registered with SEBI with securities-related undertakings. If SEBI registers one or more of these persons/ entities, their respective registration numbers. Reasons for non-renewal if registration has expired. Details of every enquiry/ inquiry at any time conducted by SEBI. The penalty levied by SEBI (Penalty includes letter of deficiency/ warning, adjudication proceedings, suspension/ cancellation/ prohibition orders) Unpaid payments, if any, payable by such entities to SEBI.

Step 6

- The offer papers, which are not followed by the details referred to in clause 16.1.5, may be refused.

Step 7

1. Equivalent information shall be collected from other intermediaries by Lead Merchant Bankers to ensure that they comply with these requirements and are eligible for association with the issue concerned.
2. In their letters, the intermediaries often suggest that they have received certain knowledge from other intermediaries.

In a nutshell, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 require each issuer to file a draft offer document with SEBI via a merchant banker(s), being an unlisted company eager to make an initial public

offer and a listed company eager to make a rights issue for a value exceeding Rs. 10 Crore or a public offer. The merchant banker(s) shall, on behalf of the issuer, correspond to SEBI. With regard to the Regulations, SEBI can, within 30 days, submit comments on a draft offer document filed with it.

Notes

Certain abbreviations have been used in the report, the meaning of which is as under:

- IPO (Fresh) = Initial public offer by equity issuance
- IPO (Offer for Sale (OFS)) = Initial public offer by way of an offer to sell existing shares
- IPO (Fresh + OFS) = Initial public offer by selling stock and agreeing to sell existing shares.
- FPO (Fresh) = Public offer via the issue of stock by a listed company
- FPO (Fresh + OFS) = Public offer by a listed company by issuing shares and offering to sell existing shares
- FPO (OFS) = Public offer by a listed company for the sale of existing shares via an offer
- RI = Rights issue for a value exceeding Rs 50 lacs by a listed company
- Composite Issue = Public offer cum rights issue by a company listed
- SE = Stock Exchange
- OD = Offer Document
- LM = Lead Manager to the Issue coordinating
- LM (Pre-issue) = Lead Manager responsible for coordinating with SEBI in respect of the offer document.

This report is intended for the limited purpose of informing SEBI of the processing status of draft bid documents submitted. The issuer/ public should contact the LM(s) concerned for any further information.

3.4.5 Bought Out Deals

A bought out deal is a method of offering securities to the public through a sponsor or underwriter (a bank, financial institution, or an individual). The securities are listed in one or more stock exchanges within a time frame mutually agreed upon by the company and the sponsor. This option saves the issuing company the costs and time involved in a public issue. The cost of holding the shares can be reimbursed by the company, or the sponsor can offer the shares to the public at a premium to earn profits. Terms are agreed upon by the company

The Securities and Exchange Board of India mandates that only private companies can choose this method of issuing securities.

Features

- **Parties:** There are three parties involved in a bought out deal; the promoters of the company, sponsors & co-sponsors who are generally merchant bankers and investors
- **Outright sale:** There is an outright sale of a chunk of equity shares to a single sponsor or a lead sponsor.

- **Syndicate:** The sponsor forms a syndicate for management of resources required & distribution of risk
- **Sale Price:** The sale price is finalized through negotiations between the issuing company & the purchaser which is influenced by reputation of the promoters, project evaluation, prevailing market sentiment, prospects of off-loading these shares at a future date, etc.
- **Fund base:** The bought out deals are fund based activities where funds of merchant bankers get locked in for at least the prescribed minimum period.
- **Listing:** The listing generally takes place at a time when company is performing well in terms of profits & liquidity.

Notes

Advantages and disadvantages

Advantages:

- **Speedy sale:** The bought out deals offer a mechanism for speedy sale of securities involving lower issuing cost.
- **Freedom:** The bought out deals offer freedom for promoters to set a realistic price & negotiate the same with the sponsor.
- **Investor protection:** The bought out deals facilitates better investor protection as the sponsors are rigorously evaluated and appraised by the promoters before off-loading the issue
- **Quality offer:** The bought out deals help in improving the quality of capital flotation and primary market offering.

Disadvantages:

- Sponsors may take control of the company as they own large number of shares.
- When markets are down sponsors may incur losses.
- The risk of market manipulation by the sponsor such as insider trading is high.
- Sponsors can make large profits at the expense of small investors.

How does a Bought Deal Work?

A bought-deal suggest that an investment bank is willing to take all the risk of the securities being issued by a company, by committing to buy the securities before the preliminary. While this type of deal offers a guarantee to the issuing company that it will reach its target of fundraising through the issuance of the securities, an investment bank must find means to sell the acquired securities if profit must be made.

The investment bank takes all the risks of the securities in the sense that the securities might lose value and be sold at a lower price. Another risk that an investment bank might incur is the risk of poor sales. In order to hedge the risk, the bank might request a discount from the issuing company or collaborate with other investment banks to purchase the securities.

Notes

A Bought Deal and Other Forms of Initial Public Offerings

A bought deal is associated with an initial public offering, it is when an underwriter such as an investment bank commits to buy the securities of an issuing company even before the preliminary. The major types of IPOs are fixed price IPO and book building IPO. An underwriter is needed for any of these IPOs to facilitate the process. A fixed price offer is one in which the price of the shares of the issuing company is predetermined by the company.

The investors are aware of the selling price of the shares even before the company goes public. In a book building IPO, on the other hand, an underwriter determines the price of the securities to be issued. The price is set based on the demand for the shares by investors Regardless of the type of IPO a company wants to execute, an underwriter such as an investment bank is needed to perform the following duties;

- Create an IPO team which comprises experts, the regulatory body such as the Securities and Exchange Commission (SEC) in the U.S, lawyers, public accountants and underwriters.
- Make information about the issuing company available to the investors and other participants.
- Compile the financial information of the issuing company and submit for audit.
- Make projections of the future operations of the company.

Bought Out Deals in Investment Banking

Whenever a company wants to go public, they generally appoint investment bankers to be the intermediaries. However, in some cases, investment bankers are looking to make a higher return. They are also willing to take more risks in order to earn that higher return. Over the years, investment banks have devised a strategy wherein they can be more involved in the IPO process and hence can earn a higher return from the same. This process is called a "bought out deal." In this article, we will understand what a bought out deal is and how it works.

Example of a Bought Out Deal

A company wants to sell its shares. It is projected that the market value of the shares will be $1. However, the company needs money immediately. Also, the company is not very sure about whether the IPO will be successful. In such cases, they might consider selling the entire issue to the investment banker at $0.75. If the banker is able to sell for more than $0.75, they stand to make money, or else they will face a net loss.

Bought Out Deal from the Point of View of the Selling Company

Companies tend to opt for bought out deals because of certain specific advantages and disadvantages that these deals have to offer. The details have been listed below:

- In the case of bought deals, the selling company is assured of the funds from the very first day. This means that the uncertainty, as well as the

time required for the public issue to take place, is greatly reduced. The selling company gets money on the spot. The entire risk associated with the stock issuing process is eliminated.

- In the case of a bought deal, the issuing company does not have to pay upfront compensation. Instead, the investment bank earns its compensation as a difference between the purchase and sale price of its shares. This reduces the cash outlay required for the IPO process.
- The main disadvantage for the issuing company is that it has to compromise in terms of price. The investment bankers who invest in these shares are commonly looking to get deep discounts when they buy the entire issue before it reaches the market. Since the entire process is risky, a significant risk premium has to be paid out. This eats into the proceeds which are raised from the IPO. This is the reason that fewer big companies ever use the bought out deal process.
- The promoters of the issuing company also run the risk of a hostile takeover with bought out deals. This is because after bought out deals, the investment banks end up holding large amounts of stock in the company. They are often in a position to collude with the competitors and induce a hostile takeover. This is the reason that trust is an important factor while choosing a partner as far as bought out deals are considered.

Notes

Bought Out Deal from the Point of View of Investment Bankers

Not all investors provide their investors with bought out deals. This is because these deals have some specific risk-reward characteristics which may not be suitable for all banks. Some of these characteristics have been listed below:

- As mentioned above, the underwriters are able to make a handsome return on their investment. This is because the issuing company provides a substantial discount during the sale. The investment bankers know the exact time frame in which they are going to take the company public. They can work out a good internal rate of return on the basis of the investment and the time frame for which the money will be locked.
- Investment bankers know how to create a positive public relations campaign for a company in order to increase the prices of the shares. Hence, they are able to buy low, raise the prices, and earn a handsome return on their investment.
- The only problem that the investment banker faces is that there is always a risk the banker may not be able to resell the issue at a higher price. In some cases, due to adverse macroeconomic events, they may not be able to sell the issue at all. It is for this reason that their capital might end up getting stuck in these shares for a long time. Investment bankers typically want to earn a high return on equity. This is the reason that they factor in the risk and charge an upfront premium.

Notes

3.4.6 Post Issue Work & Obligation

Role of Merchant Banker in IPO Management

SEBI (MERCHANT BANKERS) REGULATIONS, 1992 defines 'merchant banker' as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying, or subscribing to securities or acting as manager, consultant, adviser, or rendering corporate advisory service in relation to such issue management.

A merchant banker provides various services such as Promotional activities, Credit syndication, Project counseling, and Portfolio management, etc. However, one of the primary functions of the merchant banker is issue management, be it IPO, FPO, or right issue. The purpose of this article is to practically analyze the role of a merchant banker in IPO management right from due diligence aspect to allotment/refund of the securities while also discussing applicable provision of SEBI(ICDR) Regulations,2018 and relevant notifications or circulars by SEBI.

The Roles and obligation of the merchant banker can be classified into three groups-

Pre-issue role

Post issue role

Operational guidelines prescribed by SEBI.

Pre-issue role of Merchant Banker in IPO Management

The pre-issue stage is the stage before issuing the securities to the subs. The pre-issue role and obligation of the merchant banker generally involve activities such as due diligence, requisite fee, submission of documents, the appointment of intermediaries, underwriting, etc. Some of the major activities done by the merchant banker in relation to IPO management at this stage are-

- **Due Diligence of the issuer–**

  Regulation 24 of SEBI (ICDR) Regulation, 2018 mandate that lead manager shall exercise due diligence and satisfy themselves about all aspects of the issue including the veracity and adequacy of disclosure in the draft offer document and the offer document which means merchant banker shall ensure that the framework provided by the SEBI shall be complied with and implemented in draft offer documents. A checklist that may be useful for conducting pre-issue due diligence is-

  Check whether the issuer fulfills the eligibility criteria relating to a minimum tangible asset, Net worth, and average operating profit limited mentioned in regulation 6 of ICDR Regulations

  Check whether the issuer is not ineligible to make an IPO under regulation 5 of ICDR Regulations.

  Check whether the issuer satisfies the general conditions for IPO mentioned in Regulation 7 of ICDR regulation

Check whether the issuer has made all the material disclosure in draft offer documents and verifying the content of offer documents

Check whether the minimum promoter contribution requirement mentioned in Regulation 14 is fulfilled Merchant banker is obligated to submit a due diligence certificate along with a Draft offer document to SEBI.

Notes

- **Appointment of intermediaries:** Regulation 23 of the ICDR Regulation imposes the duty to appoint merchant bankers and other intermediaries with merchant banker consultation on the issuer. However, practically it is the merchant who gets the issuer in touch with other intermediaries. This regulation also imposes an obligation on the merchant banker to assess the capability and independence of the intermediaries. As per ICDR Regulation, some of the intermediaries involved in an IPO are-Merchant banker Underwriters Banker to the issue Registrar to the issue Compliance officer Depositories Monitoring agency if issue size exceeds 100 crore
- Filling draft offer document with requisite document Report

  In accordance with Regulation 25 of the ICDR Regulation and other applicable guidelines, the lead manager along with a draft offer letter shall file the following documents with SEBI-

  Due diligence certificate as per schedule V

  Memorandum of Understanding entered between the issuer and the merchant banker

  In case a public or rights issue is managed by more than one merchant banker the rights, obligations, and responsibilities of each merchant banker shall be demarcated as specified in Schedule II.

  Details of Promoter of the issuer and list of the promoter group an undertaking to the Board by the issuer to the effect that transactions in securities by the 'promoter' the 'promoter group' and the immediate relatives of the 'promoters during the period between the date of filing the offer documents with the Registrar of Companies or Stock Exchange as the case may be and the date of closure of the issue shall be reported to the Stock exchanges concerned within 24 hours of the transaction(s).
- Making public the offer document and advertisement of the issue As per regulation 26 of ICDR merchant banker should ensure that draft offer letter is available for the public on SEBI and stock exchange website for at least 21 days from the date of filling. A public announcement is also needed to be made within 2 days of the filling of the offer document in an English and Hindi national newspaper inviting the public to give their comments to the SEBI. A pre-issue advertisement is also required to be made as per regulation 43 after registering the prospectus with ROC containing the disclosure specified in part A of Schedule X. After

Notes

21 days of filing the draft offer document, the merchant banker shall file a statement showing the complaints received by the public and highlights of the proposed amendments to SEBI.

- Setting up mandatory collection center and authorized collection agents As per regulation 23 read with schedule XII; a merchant banker needs to ensure that the issuer designates a collection center in Mumbai,Kolkata, Delhi,Chennai, and at such place where the recognized stock exchange is located. The issuer company can also appoint authorized collection agents in consultation with the Lead Merchant Banker subject to necessary disclosures including the names and addresses of such agents made in the offer document.
- Calculating requisite fee and ensuring legal compliances Report this ad It is the duty of the merchant banker to calculate the required fee needed to be paid with the draft offer document mentioned in Schedule III and ensure that the issue complies with all the relevant legal compliance Post-issue role of Merchant Banker in IPO Management.

The post-issue obligation is the stage after the securities are issued to the subscribers. The major post-issue obligations relate to association with allotment procedure, post-issue monitoring reports, redressal of investor grievances and coordination with intermediaries, etc. This includes-

- Allotment procedure and basis of allotment Merchant banker along with MD of the recognized stock exchange and registrar of the issue is responsible to ensure that the basis of allotment is finalized in a fair and proper manner in accordance with Regulation 49 of ICDR Regulations. The allotment of such shares should be in such a way that the minimum allotment would be equal to the minimum application size as determined and disclosed in the offer document.
- **Post issue monitoring report**

  The merchant banker in case of IPO shall submit a post-issue monitoring report on the 3rd day from the date of closure of the subscription of the issue.
- Post-issue advertisement Regulation 51 of ICDR regulation impose a duty on merchant banker to ensure that a post-issue advertisement giving details relating to subscription, the basis of allotment, value, and percentage of all applicants, date of filing of listing application, etc is released within ten days from the date of various activities in at least one nationwide English and Hindi newspaper.
- **Redressal of investors grievance**

  The Post -issue Lead Merchant Banker shall actively associate himself with post-issue activities namely, allotment, refund and despatch and shall regularly monitor redressal of investor grievances arising therefrom.

- **Coordination with intermediaries**

  It includes coordinating with various agencies connected with the post-issue activity such as registrar to issue, bankers to the issue, bankers to the issue, self-certified banks, and underwriter.

- **Certificate regarding the realization of stock investors and other requirement**

  The Post-Issue Lead Merchant Banker shall submit within two weeks from the date of allotment, a Certificate to the Board certifying that the stock invests on the basis of which allotment was finalized, has been realized Operational guidelines prescribed by SEBI The compliance requirements of merchant banker(s) in relation to operational guidelines cover submission of the draft and final offer documents, instruction on post-obligations, issue of penalty points, and so on. These guidelines can be accessed on the website of SEBI.

Notes

Case study related to Role of Merchant Banker in IPO Management

The recent hit public issue of Burger king India limited is a classic example of how a well-managed issue can benefit all the stakeholders. Burger King is India's fastest growing quick-service restaurant chain which opened up its issue from 2nd December to 4th December 2020. Due to the uncertainties in the market and COVID-19, the role of the merchant became more important than ever.

Activities in the secondary market picked up pace after the benchmarks rebounded on the optimism stemming from the fiscal and monetary stimulus announced by the government and central bank, a faster-than-expected pickup in economic activities after lockdown curbs were eased, robust foreign flows, and a potential Covid-19 vaccine. This issue was managed by 4 merchant bankers being Kotak Mahindra Capital limited, CLSA India private limited, Edelweiss Financial services limited, and JM Financial limited.

The IPO was getting delayed due to regulatory requirements and then COVID which created uncertainties in the mind of the investors. The company came up with 810 crores rs issue and the issue got fully subscribed within 2 hours and was 156 times oversubscribed. One of the major challenges before the merchant banker to gain the trust of the investors as the risk involved was higher. The key risks were-

The outbreak of the Covid-19 pandemic Real and perceived health concerns arising from food-borne illnesses, health epidemics, food quality, allergic reactions or other negative food-related incidents

The termination of master franchise and development agreement.

Demand for products may decrease due to changes in consumer preferences and food habits Business depends in part on the continued international success and reputation of the Burger King brand globally, and any negative impact on the brand may have an adverse impact.

Deterioration in the performance of, or its relationships with, third-party delivery aggregators Inability to identify suitable. locations and successfully develop and roll out new restaurants, and expand into new regions.

Even besides all the issues the merchant bankers involved did their pre and post-issue duties diligently.

Notes

The offer letter of the IPO got accepted by SEBI and the public issue was a hit. This showed how important the role of the merchant banker is and how proper due diligence can be beneficial for everyone.

3.4.7 Investor Protection

Investor protection is a very popular phrase which everyone concerned with regulation of the capital markets uses these days, be they the Securities and Exchange Board of India, Stock Exchanges, Investors associations or for, that matter of fact the companies themselves. The term Investor Protection is a wide term encompassing various measures designed to protect the investors from malpractices of companies, merchant bankers, depository participants and other intermediaries.

Investor Beware should be the watchword of all programmes for mobilization of savings for investment. As all investment has some risk element, this risk factor should be borne in mind by the investors and they should take all precautions to protect their interest in the first place. If caution is thrown to the winds and they invest in any venture without a prior assessment of the risk, they have only to blame themselves. Investors are a heterogeneous group, they are large or small, rich or poor, expert or lay and not all investors need equal degree of protection for their invested amount from the corporate securities.

Meaning: The term 'investor protection' means a process or a mechanism by which the interest of an investor is protected in the security market. Basically, it denotes the acts done with object to bring and also maintain transparency in procedural aspect while dealing with investor through some regulatory bodies by means of some suitable legislation. In order to protect the interest of the investors, various investors protection mechanisms have been established in India. There are mainly three means i.e. mechanisms to protect the interest of investors in the security market regulatory bodies like SEBI, various Acts and Judiciaries.

Investor Protection According to the SEBI Act, 1992 Investor protection is 'protecting the interest of the investors in securities and promoting the development of and to regulate the securities market and for matters connected therewith or incidental thereto.' Generally, investor protection is known as legislation to protect the small investors from unscrupulous investment brokers and advisers. Thus, the term 'investor protection' means those steps and measures which are required to protect the interest of the investors by enacting suitable legislation, establishing regulatory bodies or by passing of regulations or guidelines for protecting the interest of the investors in the capital market.

Notes

Investor Protection Measures by SEBI

Investor protection legislation is implemented under the Section 11(2) of the SEBI Act.

The measures are as follows:

- Formulation of Stock Exchange and other securities market business regulations.
- Registering and regulating the intermediaries of the business like brokers, transfer agents, bankers, trustees, registrars, portfolio managers, investment consultants, merchant bankers, etc.
- Recording and monitoring the work of custodians, depositors, participants, foreign investors, credit rating agencies, etc.
- Registering investment schemes like Mutual fund & venture capital funds, and regulating their functioning.
- Promotion and controlling of self-regulatory companies.
- Keeping a check on frauds and unfair trading methods related to the securities market.
- Observing and regulating major transactions and take-over of the companies.
- Carry out investor awareness and education programme.
- Train the intermediaries of the business.
- Inspecting and auditing the security exchanges (SEs) and intermediaries.
- Assessment of fees and other charges.

The Role of SEBI in Investor Protection

SEBI has given out various methods and measures to ensure the investor protection from time to time. It has published various directives, driven many investor awareness programmes, set up investor protection Fund (IPF) to compensate the investors. Some of are:

1. **Issue of guidelines:** SEBI has issued guidelines to companies (bringing new issues in the market) mutual funds, portfolio managers, merchant bankers, underwriters, lead managers, etc. These guidelines are for bringing transparency in their operations and also for avoiding exploitation of investors by one way or the other. SEBI has introduced a code of advertisement for public issues for ensuring fair and truthful disclosures.

   In order to reduce the cost of issue, the underwriting is made optional on certain terms. These steps are also for the protection of investors. SEBI keeps watch on all intermediaries and see that they follow the guidelines in the right spirit. It also takes panel actions when the guidelines are not followed. These steps give protection to investors.

2. **Public interest advertisements:** SEBI issues public interest advertisements to enlighten investors on the basic features of various instruments and minimum precautions they should take before choosing an investment. The SEBI desires to create awareness among investors

Notes

about their rights and about remedies if problem arise. It has published some booklets for the information and guidance of investors.

3. **Dealing with complaints of investors:** The investors can make complaints to SEBI if they face problems relating to their investment in industrial securities and financial assets. SEBI receives thousands of complaints relating to non-receipt of refund orders, allotment letters, nonreceipt of dividend or interest and delays in the transfer of shares and debentures. SEBI is making efforts to solve such complaints through appropriate measures.
4. **Investor education:** SEBI is aware that investor education is important for his protection. It encourages the formation of investor associations that disseminate information through news letters. SEBI is bringing out two monthly publications for the investors. These are: (a) SEBI-Market Review, (b) SEBI News-letter. These publications are for the education, guidance and protection of investors.
5. **Investor surveys:** SEBI has also conducted surveys in respect of investment and opportunities for the benefit of small investors. The findings of the surveys are given wide publicity so as to provide proper guidance to investors regarding their investment decisions.
6. **Introduction to stockinvest:** SEBI has introduced stockinvest as a new instrument useful while submitting application for shares. This new instrument introduced through the co-operation of banks gives protection to investors as they get interest on the application money till the allotment of shares.
7. **Disclosures by companies:** SEBI has introduced norms for disclosure of half yearly unaudited results of companies. It has also revised the format of prospectus to provide more information to investors. It also insists that every share application form is accompanied by an abridged prospectus. The provisions relating to disclosures are for the information and protection of small/average investors.

Investor Education and Protection Fund

To protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto, the central government (GOI) has established a fund to be called Investor Education and Protection Fund [IEPF]. Objectives of Investor Education and Protection Fund (IEPF)

- Educating investors about how the market operates.
- Making investors educated enough so that they can analyse and take informed decisions.
- Educating investors about the volatility of the markets.
- Making investors realise their rights and various laws about Investing.
- Promoting research and surveys to spread knowledge among the investors.

Notes

Funding of IEPF

Following amounts shall be part of IEPF, if they remain unpaid for a period of seven years from the date of declaration except point (f) and (g):

a. Amounts in the unpaid dividend accounts of companies;

b. The application moneys received by companies for allotment of any securities and due for refund;

c. Matured deposits with companies;

d. Matured debentures with companies;

e. The interest accrued on the amounts referred to in clauses (a) to (d).

f. Grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund; and

g. The interest or other income received out of the investments made from the Fund.

Utilisation of Fund

The Companies Act, 2013 (the Act) provides in itself the purposes for which the Fund shall be utilised in accordance with the Rules. They are:

- To refund in respect of unclaimed dividends, matured deposits, matured debentures, the application money due for refund and interest thereon;
- Promotion of investors' education, awareness and protection;
- Distribution of any disgorged amount among eligible and identifiable applicants for shares or debentures, shareholders, debenture-holders or depositors who have suffered losses due to wrong actions by any person, in accordance with the orders made by the Court which has ordered disgorgement;
- Reimbursement of legal expenses incurred in pursuing class action suits under section 37 and 245 by members, debenture-holders or depositors as may be sanctioned by the Tribunal; and
- Any other purpose incidental thereto.

Investor Grievance Redressal Mechanism of SEBI

Investor Grievances

An investor may have a complaint against, a listed company or an intermediary registered with SEBI. In the event of such complaint, the investor should first approach the concerned company/intermediary against whom there is a complaint. Sometimes the response received may not be satisfactory. Therefore, investors should know as to which authority they should approach, to get their complaints redressed.

Entities against which complaints are handled by SEBI

i. Listed companies

ii. Stock Brokers/Sub-brokers

iii. Stock Exchanges

iv. Depository
v. Depository Participants
vi. Registrars to an Issue/Share Transfer Agent
vii. Mutual Funds viii. Portfolio Managers
ix. Bankers to an Issue
x. Collective Investment Schemes
xi. Credit Rating Agencies
xii. Custodians of Securities
xiii. Debenture Trustees
xiv. Merchant Bankers
xv. Underwriters.

Types of Investor Grievances

S. No.	Nature of Grievance
1.	Delay in transfer of shares.
2.	Non-receipt of shares/dividends/rights/bonus shares.
3.	Delay/ Non-receipts in issue of duplicate shares.
4.	Delay/ Non-receipt of annual reports.
5.	Delay/ Non-receipt of redemption amount of debentures.
6.	Delay/ Non-receipt of interest on debentures.
7.	Delay/ Non-credit of shares in the account by the broker.
8.	Delay/ Non-payment of sale proceeds by the broker etc.
9.	Manipulation in the accounts statements.
10.	Unauthorized trades and unauthorized movements of shares and funds from the clients' accounts.
11.	Delay/ Non-updating of clients' infromation in records.

How Investor Complaints Are Handled In Sebi?

SEBI has a dedicated department viz., Office of Investor Assistance and Education (OIAE) to receive investor grievances and to provide assistance to investors by way of education. Investors who are not satisfied with the response to their grievances received from the Stock Exchanges/Depositories can lodge their grievances with SEBI. Grievances pertaining to stock brokers and depository participants are taken up with respective stock exchange and depository for redressal and monitored by SEBI through periodic reports obtained from them.

Grievances pertaining to other intermediaries are taken up with them directly for redressal and are continuously monitored by SEBI. Grievances against listed company are taken up with the respective listed company and are continuously monitored. The company is required to respond in prescribed format in the form of Action Taken Report (ATR).

Upon the receipt of ATR, the status of grievances is updated. Where the response of the company is insufficient / inadequate, follow up action is initiated.

If the progress of redressal of investor grievances by an entity, is not satisfactory, appropriate enforcement actions (adjudication, direction, prosecution etc.) are initiated against such entity.

SCORES (SEBI Complaints Redress System)

Notes

SCORES is a web based centralized grievance redress system of SEBI. SCORES enables investors to lodge and follow up their complaints and track the status of redressal of such complaints online from the above website from anywhere. This enables the market intermediaries and listed companies to receive the complaints online from investors, redress such complaints and report redressal online. All the activities starting from lodging of a complaint till its closure by SEBI would be online in an automated environment and the complainant can view the status of his complaint online. An investor, who is not familiar with SCORES or does not have access to SCORES, can lodge complaints in physical form at any of the offices of SEBI. Such complaints would be scanned and also uploaded in SCORES for processing.

The salient features of SCORES are:

- SCORES is web enabled and provides online access 24 × 7;
- Complaints and reminders thereon can be lodged online at the above website at anytime from anywhere;
- An email is generated instantaneously acknowledging the receipt of complaint and allotting a unique complaint registration number to the complainant for future reference and tracking;
- The complaint forwarded online to the entity concerned for its redressal;
- The entity concerned uploads an Action Taken Report (ATR) on the complaint;
- SEBI peruses the ATR and closes the complaint if it is satisfied that the complaint has been redressed adequately;
- The concerned investor can view the status of the complaint online from the above website by logging in the unique complaint registration number;
- The entity concerned and the concerned investor can seek and provide clarification on his complaint online to each other;
- Every complaint has an audit trail and
- All the complaints are saved in a central database which generates relevant MIS reports to enable SEBI to take appropriate policy decisions and or remedial actions, if any.

3.4.8 Broker

While beginning your investment journey in stock markets, you must remember that you cannot purchase or sell stocks and securities directly. You can trade in stock markets only with the help of an intermediary, or a stockbroker/ broking firm. These intermediaries are authorised to purchase and sell stocks.

and securities on your behalf via stock exchanges. For the services rendered, the intermediaries charge a fee or commission. They are registered with the Securities Exchange Board of India (SEBI). Various regulations, including the SEBI Act, 1992, Securities Contract Regulations, 1956 etc. govern these intermediaries.

Notes

What Is a Stockbroker?

A stockbroker can either be a registered stockbroking company or an individual. They buy and sell securities on their client's behalf and charge brokerage fees. They act as a vital link between investors and stock exchange by facilitating transactions. On the basis of providing services, stockbrokers are of various types:

- **Full-Service Stockbrokers:** These stockbrokers provide comprehensive services to clients, including providing advisory assistance. They can help an investor gain insight into investment opportunities. Typically, their brokerage fees are based on the total amount of executed trades. These are generally well-established market players, with a range of network offices/branches across the country.
- **Discount Brokers:** They charge comparatively lower fees as compared to full-service brokers. Their services don't include advisory assistance or market research to help clients zero in on a suitable investment opportunity. Usually, they charge a flat fee for undertaking stock market transactions.
- **Brokers Charging Flat Brokerage:** These types of stockbrokers have gained popularity because of the increasing use of digital technology in trading. They are a mix of both full-service and discount stockbrokers, charging a flat rate brokerage fee.

3.4.9 Sub Broker

What Is Sub-Broker?

A sub-broker is an agent of a broker, working with the client, on their behalf. They act as a link between the stockbroker and the client. A stockbroker entrusts the sub-broker with multiple responsibilities, like sourcing clients, providing services and client management. Sub-brokers receive a portion of the fees and charges collected by the stockbroker. A stockbroker can have a wide network of operations across the country via different sub-brokers, who identify and acquire new clients for the stockbroker. Now that you know what is sub-broker, let's compare their differences:

Key Differences Between A Broker and A Sub-broker

- **Broker Vs Sub-Broker Function:** A stockbroker functions independently, while a sub-broker acts as an intermediary between the main stockbroker and its clients. A sub-broker is primarily entrusted with the responsibility of expanding the business network of the original stockbroker. Stockbrokers usually also act as Depository Participants

(DPs) of the National Stock Exchange's (NSEs)-promoted National Securities Depositories Ltd (NSDL) or the Bombay Stock Exchange's (BSEs)-promoted Central Depositories Securities Ltd (CDSL). Here, you must remember that both the depositories maintain stocks and securities in an electronic format. A sub-broker, on the other, hand cannot be a DP.

- **Broker Vs Sub-Broker Registration:** A stockbroker has to be registered with the SEBI. While initially, sub-brokers were also to be registered with the SEBI, the market regulator, since August 2018, has discontinued sub-broker as a category for registration. In its circular dated August 3, 2018, all existing sub-brokers had to compulsorily migrate to the category of 'Authorised Person.' According to the SEBI, an Authorised Person can be an individual, firms or other entities which are appointed by a stockbroker. These can provide access to a trading platform of a stock exchange by acting as an agent of the stockbroker.
- **Broker Vs Sub-Broker Revenue Sharing:** Sub-brokers have a wide range of responsibilities, thereby entitling them to a higher share of revenue generated via the clients. Though the main stockbroker gets a smaller share of the revenue, it has access to overall large revenue generated by scores of sub-brokers.
- **Broker Vs Sub-Broker Brokerage:** Stockbrokers charge direct brokerage fees from clients, while sub-brokers are not allowed to directly charge brokerage fees from clients. Sub-brokers receive the specified portion of the revenue from the stockbrokers.
- **Broker Vs Sub-Broker Importance:** Stockbrokers play a vital role in the stock markets by ensuring sufficient availability of liquidity. They have a key place in the capital markets ecosystem. Sub-brokers, on the other hand, are vital for stockbrokers for expansion of their businesses across regions. A stockbroker provides opportunities to new people to enter the financial market as agents by providing access to the stockbroking firm's cutting-edge trading tools and other services. Sub-brokers have to typically provide a deposit fee with the stockbroker.

Notes

Thus, while investing in stock markets, it is essential to know what is a sub-broker and a stockbroker. Both play a distinct role in the functioning of stock markets. They share some common features as well as differences. While beginning your investment in stock markets, always rely on a trusted and reliable financial partner. Look for features such as an all-in-one trading platform to invest in different stock market options, brokerage cashbacks and zero Demat AMC for up to a year.

3.4.10 Underwriters

Underwriting is a common practice used in the commercial, insurance and investment banking industries. An underwriter typically works for mortgage, loan, insurance or investment companies. During the underwriting process, they

do everything from evaluate your health to assess your financial status. Based on their findings, underwriters help companies determine if they should take on an applicant's contract or not based on their associated level of risk.

Notes

What Is an Underwriter?

An underwriter is a member of a financial organization. They work for mortgage, insurance, loan or investment companies. They assess, evaluate and assume the risk of another party for a fee. Often, you'll see this fee in the form of a commission, premium, spread or interest. At any rate, if you're working with an underwriter, you're most likely seeking approval for a large purchase or insurance coverage.

Each industry has their own underwriters and these individuals must understand the intricacies of their specific field. They use their knowledge and expertise to best asses the risk of an applicant. Underwriters determine if giving a loan or issuing an insurance policy will work in favor of their company. However, if the contract turns out to be too risky, the underwriter is accountable for the loss.

Most underwriters have a bachelor's degree and have completed a training program. Typically, they have an academic major within their industry of specialization. Common majors include finance, business and economics.

What Does an Underwriter Do?

Using the knowledge they have in their field, underwriters decides if a contract is worth the risk. For example, underwriters who work with health insurance companies evaluate the health risk of applicants.

The underwriter will review the applicant's information including age, current health condition and past medical and family history. Using this information and other factors, an underwriter will enter the data into underwriting software. The software will determine the premium amount and terms they should apply to the policy. Also, this assessment determines if the policy is too risky to move forward.

The information provided to various underwriters is subject to the specific case. For example, an underwriter for a health insurance company will review medical details, while a loan underwriter will assess factors like credit history.

An underwriter's job is complex. They have to determine an acceptable level of risk and what's eligible for approval based on their risk assessment. When assessing complicated situations, underwriters may need to conduct research and acquire a large number of details.

Examining the Different Types of Underwriters

Insurance Underwriter: Insurance underwriters asses the risk of insuring a home, car or driver. They also assess individuals who are applying for life insurance policies. Insurance underwriters determine if the contract is profitable for the insurer. They consider if the applicant meets certain criteria to qualify for

an insurance policy. From there, they establish the type of policy for which an applicant is eligible. Finally, they provide an outline of what the policy covers for the applicant's unique circumstances.

Insurance underwriters are insurance professionals. They understand insurance risks and how to avoid them. They use their risk assessment to decide if they will insure someone and under what terms they'll provide a policy.

Notes

In cases without special circumstances, underwriting is done through an automated system. Underwriting programming is similar to a quoting system. It's able to determine if an applicant meets the insurer's specific requirements for coverage.

Mortgage Underwriter: Mortgage underwriters are some of the most commonly used underwriters among the loan industry. Even if a new homeowner has a good income and great credit score, buying a home is still a risky endeavor. A mortgage underwriter must do a thorough risk assessment. Once an assessment is done, the underwriter can confirm if the loan is a manageable undertaking for the applicant.

At any rate, underwriters may review internal information such as the number of mortgages the company has given out. They also review an applicant's credit score and history, proof of steady income, debt-to-income ratio, overall savings and other important factors that determine their risk.

Additionally, the underwriter will assess features in and outside of the mortgage applicant's control, such as the value and type of property. This helps determine if the mortgage terms are fair for all parties.

If an underwriter denies the mortgage, the applicant can appeal the decision. However, the process can be lengthy and often requires a large amount of evidence to be overturned.

Loan Underwriter: Similar to mortgage underwriters, loan underwriters asses the risk involved in lending an applicant a loan such as an auto loan. The objective is to determine if the loan is safe for all parties. Large banks often use a combination of underwriters and underwriting software to determine the risk of lending funds to an applicant. Using the combination of software and an underwriter is a common practice among big and small banks.

In some cases, underwriters may need to assist financial institutions with underwriting for business loans. Depending on the size of the business, an underwriter may need to work with multiple banks.

Securities Underwriter: A securities underwriter is a different type of underwriter. Securities underwriters often work with initial public offerings (IPOs). They asses the investment's risk to determine an appropriate price for an IPO. Typically, a securities underwriter is an employee of the investment bank or another specialist.

One of the biggest risks involved with securities underwriting is the sales period. For instance, if a security doesn't sell for the suggested price, the investment bank is liable for the difference.

Underwriters vs. Agents and Brokers

When it comes to financial products that require the oversight of an underwriter, there's usually also an agent or broker. They're typically who you, the customer, will actually speak with. In basic terms, an agent or broker is simply a salesperson that sells you the product. They may also be responsible for relaying to you the underwriter's final decision on your situation.

Notes

On the other hand, the underwriter has far more decision-making power. That's because, as we state above, their evaluation of your application and financial situation ultimately determines if you receive approval or not.

In many cases, the broker or agent you're dealing with will have a basic understanding of what the company's underwriting policies are. During your conversations with them, they may provide you with some insight into what your likely outcome will be. While this is undoubtedly valuable, the underwriter, again, has the final say.

Underwriters play a crucial role across many financial situations. The process of underwriting also has several complexities, all of which are based on how well the specifics of your finances line up with the company's respective policies. Don't be afraid to ask questions about the underwriting process during your talks with your broker, agent or the company in general. The more you understand about the entire process, the better off you'll be in the end.

Loan and Insurance Tips:

- Consider consulting with a financial advisor before taking on an expensive loan or insurance policy. Finding a qualified financial advisor doesn't have to be hard. SmartAsset's free tool matches you with up to three financial advisors who serve your area, and you can interview your advisor matches at no cost to decide which one is right for you. If you're ready to find an advisor who can help you achieve your financial goals, get started now.
- Be sure to learn how much home you can afford before securing a mortgage. Consider all of the various mortgage providers, too. With an appropriate budget in mind, you'll be able to take on a mortgage with a monthly payment that fits your needs.
- Compare insurance policies from various providers before making a final decision. Whether it's health insurance, life insurance, car insurance or any other type, there are a variety of options to pick from. Take the time to find the one that's right for you and your financial situation.

3.5 SUMMARY

Various classifications have been made in this topic of Company based upon various factors of independence, liability, financial conduct etc. These classifications are not to be observed in isolation as the Company may have two

or more characteristic features of the companies mentioned above and form a very unique kind for itself. The kinds of companies have only been made so as to ease the understanding of the complex legal being that is a Company.

Notes

Share capital increases depending on the rights issue ratio. The company gets positive cash flow (from financing), which can be used to improve its operations. Effective EPS, book value, and other per-share metrics decline because of the higher number of shares .Market price gets adjusted (after book close) after the issuance of rights shares.

Rights issue has been constantly gaining popularity in India with corporate giants such as Reliance Industries, Shriram Transport Finance and Bajaj electrical have chosen the same as a way to raise funds during the pandemic. In order to promote the right issue as a way of raising funds and ease the funding for listed companies the SEBI has made the amendment.

The Amendments are in the directions to make the offer by way of rights issue easier and do away with disclosures or compliance requirements which were duplicated or redundant. Further, the relaxation in minimum subscription and eligibility criteria for FTRI should come to the rescue of the listed entities to raise funds in the times when most businesses are facing liquidity issues.

3.6 EXERCISE

1. What is public issue?
2. Is right issue a preferential allotment?
3. What is meaning of promoters contribution?
4. How many minimum days are given to right issue?
5. What is offer document?

UNIT 4: VENTURE CAPITAL

Notes

Structure:

4.0 Objectives
4.1 Introduction
4.2 Venture Capital
4.2.1 Concept of Venture Capital
4.2.2 History and Evolution of Venture Capital
4.2.3 The Venture Capital Investment Process
4.2.4 Verious Steps in Venture Financing
4.2.5 Incubation Financing
4.3 Summary
4.4 Exercise

4.0 OBJECTIVES

After reading this Unit. you will be able to:

- define the venture capital,
- explain the history and evolution of venture capital,
- understand the venture capital investment process
- discuss the verious steps in venture financing,
- appreciate why and how it is a incubation financing.

4.1 INTRODUCTION

The term venture capital comprises of two words that is, "Venture" and "Capital". Venture is a course of processing, the outcome of which is uncertain but to which is attended the risk or danger of "loss". "Capital" means resources to start an enterprise. To connote the risk and adventure of such a fund, the generic name Venture Capital was coined.

Venture capital is considered as financing of high and new technology based enterprises. It is said that Venture capital involves investment in new or relatively untried technology, initiated by relatively new and professionally or technically qualified entrepreneurs with inadequate funds. The conventional financiers, unlike Venture capitals, mainly finance proven technologies and established markets. However, high technology need not be pre-requisite for venture capital.

Venture capital has also been described as 'unsecured risk financing'. The relatively high risk of venture capital is compensated by the possibility of high returns usually through substantial capital gains in the medium term. Venture capital in broader sense is not solely an injection of funds into a new firm, it is also an input of skills needed to set up the firm, design its marketing strategy, organize and manage it.

Thus it is a long term association with successive stages of company's development under highly risk investment conditions, with distinctive type of financing appropriate to each stage of development. Investors join the entrepreneurs as co-partners and support the project with finance and business skills to exploit the market opportunities.

Notes

Venture capital is not a passive finance. It may be at any stage of business/ production cycle, that is, start up, expansion or to improve a product or process, which are associated with both risk and reward. The Venture capital makes higher capital gains through appreciation in the value of such investments when the new technology succeeds. Thus the primary return sought by the investor is essentially capital gain rather than steady interest income or dividend yield.

The most flexible definition of Venture capital is-

"The support by investors of entrepreneurial talent with finance and business skills to exploit market opportunities and thus obtain capital gains."

Venture capital commonly describes not only the provision of start up finance or 'seed corn' capital but also development capital for later stages of business. A long term commitment of funds is involved in the form of equity investments, with the aim of eventual capital gains rather than income and active involvement in the management of customer's business.

Features of Venture Capital

High Risk: By definition the Venture capital financing is highly risky and chances of failure are high as it provides long term start up capital to high risk-high reward ventures. Venture capital assumes four types of risks, these are:

- **Management risk:** Inability of management teams to work together.
- **Market risk:** Product may fail in the market.
- **Product risk:** Product may not be commercially viable.
- **Operation risk:** Operations may not be cost effective resulting in increased cost decreased gross margins.

High Tech: As opportunities in the low technology area tend to be few of lower order, and hi-tech projects generally offer higher returns than projects in more traditional areas, venture capital investments are made in high tech. areas using new technologies or producing innovative goods by using new technology. Not just high technology, any high risk ventures where the entrepreneur has conviction but little capital gets venture finance. Venture capital is available for expansion of existing business or diversification to a high risk area. Thus technology financing had never been the primary objective but incidental to venture capital.

Equity Participation & Capital Gains

Investments are generally in equity and quasi equity participation through direct purchase of shares, options, convertible debentures where the debt holder has the option to convert the loan instruments into stock of the borrower or a debt with warrants to equity investment. The funds in the form of equity help to

raise term loans that are cheaper source of funds. In the early stage of business, because dividends can be delayed, equity investment implies that investors bear the risk of venture and would earn a return commensurate with success in the form of capital gains.

Notes

Participation In Management

Venture capital provides value addition by managerial support, monitoring and follow up assistance. It monitors physical and financial progress as well as market development initiative. It helps by identifying key resource person. They want one seat on the company's board of directors and involvement, for better or worse, in the major decision affecting the direction of company.

This is a unique philosophy of "hands on management" where Venture capitalist acts as complementary to the entrepreneurs. Based upon the experience other companies, a venture capitalist advise the promoters on project planning, monitoring, financial management, including working capital and public issue. Venture capital investor cannot interfere in day today management of the enterprise but keeps a close contact with the promoters or entrepreneurs to protect his investment.

Length of Investment

Venture capitalist help companies grow, but they eventually seek to exit the investment in three to seven years. An early stage investment may take seven to ten years to mature, while most of the later stage investment takes only a few years. The process of having significant returns takes several years and calls on the capacity and talent of venture capitalist and entrepreneurs to reach fruition.

Illiquid Investment

Venture capital investments are illiquid, that is, not subject to repayment on demand or following a repayment schedule. Investors seek return ultimately by means of capital gains when the investment is sold at market place. The investment is realized only on enlistment of security or it is lost if enterprise is liquidated for unsuccessful working. It may take several years before the first investment starts to locked for seven to ten years. Venture capitalist understands this illiquidity and factors this in his investment decisions.

4.2 VENTURE CAPITAL

Narrowly speaking, venture capital refers to the risk capital supplied to growing companies and it takes the form of share capital in the business firms. Both money provided as start-up capital and as development capital for small but growing firms are included in this definition.

In developing countries like India, venture capital concept has been understood in this sense. In our country venture capital comprises only seed capital, finance for high technology and funds to turn research and development into commercial production.

In broader sense, venture capital refers to the commitment of capital and knowledge for the formation and setting up of companies particularly to those specialising in new ideas or new technologies. Thus, it is not merely an injection of funds into a new firm but also a simultaneous input of skills needed to set the firm up, design its marketing strategy, organise and manage it.

Notes

In western countries like the USA and UK, venture capital perspective scans a much wider horizon along the above sense. In these countries, venture capital not only consists of supply of funds for financing technology but also supply of capital and skills for fostering the growth and development of enterprises.

Much of this capital is put behind established technology or is used to help the evolution of new management teams. It is this broad role which has enabled venture capital industry in the West to become a vibrant force in the industrial development. It will, therefore, be more meaningful to accept broader sense of venture capital.

Characteristics of Venture Capital:

1. Venture capital is essentially financing of new ventures through equity participation. However, such investment may also take the form of long-term loan, purchase of options or convertible securities. The main objective underlying investment in equities is to earn capital gains there on subsequently when the enterprise becomes profitable.
2. Venture capital makes long-term investment in highly potential ventures of technical savvy entrepreneurs whose returns may be available after a long period, say 5-10 years.
3. Venture capital does not confine to supply of equity capital but also supply of skills for fostering the growth and development of enterprises. Venture capitalists ensure active participation in the management which is the entrepreneur's business and provide their marketing, technology, planning and management expertise to the firm.
4. Venture capital financing involves high risk return spectrum. Some of the ventures may yield very high returns to more than Compensates for heavy losses on others which may also have earning prospects.

In nut shell, a venture capital institution is a financial intermediary between investors looking for high potential returns and entrepreneurs who need institutional capital as they are yet not ready/able to go to the public.

Dimensions of Venture Capital: Venture capital is associated with successive stages of the firm's development with distinctive types of financing, appropriate to each stage of development. Thus, there are four stages of firm's development, viz., development of an idea, start up, fledgling and establishment.

The first stage of development of a firm is development of an idea for delineating precise specification for the new product or service and to establish a business-plan. The entrepreneur needs seedling finance for this purpose. Venture capitalist finds this stage as the most hazardous and difficult in view of the fact that majority of the business projects are abandoned at the end of the seedling phase.

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Start-up stage is the second stage of the firm's development. At this stage, entrepreneur sets up the enterprise to carry into effect the business plan to manufacture a product or to render a service. In this process of development, venture capitalist supplies start-up finance.

In the third phase, the firm has made some headway, entered the stage of manufacturing a product or service, but is facing enormous teething problems. It may not be able to generate adequate internal funds. It may also find its access to external sources of finance very difficult. To get over the problem, the entrepreneur will need a large amount of fledgling finance from the venture capitalist.

In the last stage of the firm's development when it stabilizes itself and may need, in some cases, establishment finance to explicit opportunities of scale. This is the final injection of funds from venture capitalists. It has been estimated that in the U.S.A., the entire cycle takes a period of 5 to 10 years.

Functions of Venture Capital: Venture capital is growingly becoming popular in different parts of the world because of the crucial role it plays in fostering industrial development by exploiting vast and untapped potentialities and overcoming threats.

Venture capital plays this role with the help of the following major functions:

Venture capital provides finance as well as skills to new enterprises and new ventures of existing ones based on high technology innovations. It provides seed capital to finance innovations even in the pre-start stage.

In the development stage that follows the conceptual stage, venture capitalist develops a business plan (in partnership with the entrepreneur) which will detail the market opportunity, the product, the development and financial needs.

In this crucial stage, the venture capitalist has to assess the intrinsic merits of the technological innovation, ensure that the innovation is directed at a clearly defined market opportunity and satisfies himself that the management team at the helm of affairs is competent enough to achieve the targets of the business plan.

Therefore, venture capitalist helps the firm to move to the exploitation stage, i.e., launching of the innovation. While launching the innovation the venture capitalist will seek to establish a time frame for achieving the predetermined development marketing, sales and profit targets.

In each investment, as the venture capitalist assumes absolute risk, his role is not restricted to that of a mere supplier of funds but that of an active partner with total investment in the assisted project. Thus, the venture capitalist is expected to perform not only the role of a financier but also a skilled faceted intermediary supplying a broad spectrum of specialist services- technical, commercial, managerial, financial and entrepreneurial.

Venture capitalist fills the gap in the owner's funds in relation to the quantum of equity required to support the successful launching of a new business or the optimum scale of operations of an existing business. It acts as a trigger in launching new business and as a catalyst in stimulating existing firms to achieve optimum performance.

Venture capitalists role extends even as far as to see that the firm has proper and adequate commercial banking and receivable financing. Venture capitalist assists the entrepreneurs in locating, interviewing and employing outstanding corporate achievers to professionalize the firm.

Growth of Venture Capital in India

Venture Capital in India was known since nineties era. It is now that it has successfully emerged for all the business firms that take up risky projects and have high growth prospects as well. Venture Capital in India is provided as risk capital in the forms of shares, seed capital and other similar means.

In 1988, ICICI emerge as a venture capital provider with unit trust of India. And now, there are a number of venture capital institutes in India. Financial banks like ICICI have stepped into this and have their own venture capital subsidiaries. Apart from Indian investors, international companies too have settled in India as a financial institute providing investments to large business firms. It is because of foreign investors that financial markets have developed in India on a large scale. Introduction of western financial philosophies, tight contracts, focus on profitable projects and active involvement in finance was contributed by foreign investors only.

The financial investment process has evolved a lot with time in India. Earlier there were only commercial banks and some financial institutes but now with venture capital investment institutes, India has grown a lot. Business forms now focus on expansion because they can get financial support with venture capital. The scale and quality of the business enterprises have increased in India now. With international competition, there have been a number of growth oriented business firms that have invested in venture capital. All the business firms that deal in information technology, manufacturing products as well as providing contemporary services can opt for venture capital investment in India.

Rise of Venture Capital In India: Nothing Ventured, Nothing Gained

The Indian government's budget for 2014-15 is clearly an investor-friendly one with a slew of provisions and funds earmarked for start-ups in India. Also, a start-up fund worth ₹ 10,000 crore is being mulled by the government. According to Finance Minister Arun Jaitley, it will be "equity, quasi-equity, soft loan and other risk capital for start-ups."

This is encouraging news although angel investors and venture capitalists (VCs) have kept the start-up ecosystem thriving in India till date. Venture capital is an investment in the form of shares or a later stock option in potentially high-risk businesses. The beneficiary companies are usually small or medium-sized firms, requiring seed or early-stage funding for innovation and development of

technology or products with high growth potential. High annual returns ranging from 25-75% are expected on such investments.

Notes

Venture capital can be injected in different stages of a start-up lifecycle:

1. In the initial development stage as 'seed capital' for converting an idea into a commercially viable entity.
2. Implementation or 'start-up capital' when all is ready to commence production.
3. Additional capital to overcome manufacturing teething problems.
4. Establishment capital to facilitate rapid expansion of an established company.

Venture capital is a long-term investment and involves active participation and help from the investor for the development of the company. Often, the presence of the VC investor/s gives the company commercial and financial clout.

Indian venture capital market and investments

Venture capitalism in India began in 1986 with the start of the economic liberalisation. In 1988, the Indian government formalised venture capital by issuing a set of guidelines. Initially, venture capital or VC was limited to subsidiaries set up IDBI, ICICI and the IFC, and focused on large industrial concerns.

But the turning point came when the well-established start-ups by Indians in the Silicon Valley convinced foreign investors that India had the talent and the scope for economic development and growth. Over the years, more and more private investors from India and abroad have entered the Indian venture capital market.

In the early stages, venture capital investments were mainly in the manufacturing sector. However, with changing trends and increased liberalisation, companies in consumer services and consumer retail space emerged as top contenders for VC funding, attracting almost 50% of total VC investments.

Other key industries included IT and IT-related services, software development, telecommunications, electronics, biotechnology and pharmaceuticals, banking and finance/insurance, public sector disinvestment, media and entertainment, and education.

A completely new field that is attracting venture capital is agriculture. This has been fuelled by the realisation that food security is a vital, long-term necessity. Studies suggest that in future, for every ₹ 100 increase in GDP, ₹ 41 will be spent on food.

At the recently held Global AgInvesting Conference, data released indicated that agro businesses would provide better returns of about 11%, compared to 3-5% yield from bonds and equities.

Agriculture could well become the new Mecca for venture capital investments. Leading VC firms such as Venture Dairy, Anterra Capital (a spin-off of Rabobank's proprietary venture capital investment team), SAEF (Small

Enterprise Assistance Funds) and Rabo Equity Advisors' India Agribusiness Fund have already entered this market.

Promoting VC funding in India

Since 1988, ICICI has played a prominent role in promoting venture capital investments in India and currently manages funds over $2 billion.

In fact, India recorded a 13% increase in the amount invested against the global rise of 2%. At $45.8 million, India posted an all-time-high median value at the profitable stage in 2013, the highest value ever seen in any market across all of the development stages since 2007.

Early-stage funding has gone down and more funds have been diverted to later, more profitable stages or spread out in multilevel funding, indicating that investors are cautious about high risks. However, top players such as Sequoia Capital, Rabobank, Google Venture, Seed Venture Fund and World Bank's IFC are investing in India. IFC is the leading investor here, with $1.4 billion.

Most VC investors, both local and global, have leveraged the Mauritius Treaty route to invest in India because tax is only payable in the country of the investor's residence. The SEBI (Securities and Exchange Board of India) can work towards further simplifying the investment procedures and offer attractive IPO and M&A exit ratios.

However, the crucial challenge will be the development of responsible financial and management skills in the invested companies, and understanding the local conditions by foreign investors. A positive factor is that India has a large pool of English-speaking, trained and skilled manpower.

Another trigger to invest in India is that both China and India are the top two growing global economies. The new pro-business Indian government has also inspired confidence and foreign investment worth ₹ 17,000 crore has already been made. So the prospects look rosy for the growth of venture capital in India.

Notes

4.2.1 Concept of Venture Capital

Venture capital is a kind of equity financing specifically for providing fund to high risk projects. It is based upon the partnership formed between the entrepreneur and the venture capitalist and thus, represents an effort to new entrepreneurship which goes further for the conventional projects. Venture capital is an investment in such types of enterprise where the uncertainties are yet to be reduced to minimum risks. It is generally provided to the entrepreneurs with good business thoughts as well as sound knowledge of the particular business but lacking financial resources to execute them. Venture capital can open doors for such new entrepreneurs.

Thus, venture capital can be considered as equity support to finance new concepts that involve a high risk and at the same time, have high development and profitability. Venture capital is important enough to facilitate the small and medium entrepreneurs to initiate innovative enterprises. It is very much linked with inventiveness, novelty, high development and high profit. It is regarded as the launching platform to innovative entrepreneurship.

4.2.2 History and Evolution of Venture Capital

Origin and Evolution

Notes

For the Indian industries, venture capital is quite a new concept. As the name indicates, it deals with providing financial support and stability to new entrepreneurs to initiate and capitalize their business. General Doritos set up the American Research and Development Fund (AR and D) at Massachusetts Institute of Technology in 1946 to finance the commercial utilization of innovative technologies developed in universities in USA and that's where the origin of venture capital lies. This organization provided finance to 100 companies nearly for 11 long years and made its investment 35 times.

Noticing the grand success of the AR and D, big companies in the USA like Xerox, 3m and General Electric also jumped into the field of venture capital. This trend was suddenly followed by Japanese. The early 1950s noticed the growth in number of companies undergoing venture capital. In UK it was seen during the 19th century when European Merchant Bankers supported the growth of industry in their dominions like South Africa, India and USA. Ultimately in India also some companies showed interest in venture capital.

The TATA Group's Investment Corporation of India successfully developed a number of companies like Associated Bearings, CEAT Tires during the period of Independence. Afterwards, venture capital financing was first started by IFCI which sponsored The Risk Capital Foundation In 1975.

Aims of Venture Capital:

(a) It satisfies the ambition of entrepreneurs.

(b) It gives life to potential business enterprise.

(c) It provides proper direction to guide new entrepreneurs.

(d) It helps in building enterprise.

Features of Venture Capital:

(a) It assumes a high level of risks in the anticipation of earning a high profit.

(b) It finances high-risk projects.

(c) It actively guides the innovative enterprise.

(d) It takes generally 4 to 5 years to attain the desired level of profit.

(e) It is fundamentally a long-standing venture and the incomes are in the form of capital gains.

(f) Venture capitalists normally discontinue their investment in the assisted company when it reaches a definite juncture of profitability.

(g) It carries a royalty related to sales generated by the company after commercialization.

Venture Capital: Financing Steps

Once the company decides to opt for the venture capital funding route, it becomes essential to follow proper system and procedure. In India, the typical venture capital fund raising process involves the following steps:

1. Identifying the accurate investment financier: The Company should prefer to work with an Investment Banking firm (IB) that offers the following skill set:

(a) Very good perception and vision of venture capital business

(b) Good understanding of company's trade and production

(c) aptitude to tell a good and factual story about the company

(d) knowledge of dealing with the Venture capital

(e) Good set of connections in the Venture Capital community

2. Preparation of Investment Memorandum and Financial Model: After the finalization of the investment banking firm, the company should work to prepare the Investment Memorandum (IM) and a Financial Model (FM) in coordination with the investment bank. A good IM is very important for the company's business as it addresses most of the investor's key questions and queries and helps the investor to make up his mind for the company. A Financial Model includes various business variables like revenue drivers; cost drivers, capital expenses etc. in a Microsoft Excel file and projects the company revenues, profitability, cash flows and finance necessities for next 5 to 7 years.

3. Short listing and approaching the venture capital funds: The next step is to list out the investors whom the investment banker will approach on behalf of the company. While short-listing the investors, it should be kept in mind that the short listed investors should be comfortable with the company's production, stage of business (seed stage, early stage, growth stage, pre-IPO etc.) and the company's finance necessities.

4. Meeting the Venture Capital Funds: The investment banker approaches the venture capital finances and starts making presentation to them. The purpose of these presentations is to arrange the first meeting between the promoters of the company and the investors. In the follow-up meetings, the company tries to convince the investors about the investment. Once the investors are convinced, they issue a Term Sheet.

5. Signing the Term Sheet: A Term Sheet (TS) generally covers all the key terms and conditions of the investment. The valuation of the company and the transaction structure are the most important terms in the TS. There are a number of other important terms related to investor's exit, board memberships etc, which are also covered in the Term Sheet. Once there is an agreement on all the terms, a non-binding Term Sheet is signed between the company and the investors.

6. Due Diligence by the Investors: After the Term Sheet, investors conduct a due diligence process on the company. Generally investor's due diligence process focuses on the following aspects of the company and its expansion plans:

(a) Financial

(b) Production

(c) Technical

Notes

7. Signing the shareholder's agreements and funds transfer: Once the investors are pleased with the outcome of the due diligence process, they issue a Shareholder's Agreement (SHA). SHA covers all the terms of the Term Sheet and other important terms and conditions regarding dispute resolution, non-compete, lock-in, share transfer process etc. Generally lawyers from the company's side and the investor's side are also involved in this process. Once there is an agreement, all the shareholders of the company and the investors sign the SHA and investor transfers funds to the company.

Sources of Venture Capital

The important sources of venture capital in our country are as follows:

1. **Programme for Advancement of Commercial Technology (PACT):** It was the first venture capital funding in India, started in 1995 to finance Indian firms in commercializing the innovative technologies. It was started by Indo-US joint ventures known as Programme for Advancement of Commercial Technology.
2. **Technology Development and Investment Corporation of India (TDICI):** Technology Development and Investment Corporation of India (TDICI) was the first venture capital company of India and it was promoted by ICICI in 1986.
3. **Risk Capital and Technology Finance Corporation (RCTFC):** It is an autonomous body launched by Industrial Finance Corporation of India (IFCI). It promotes and supports the entrepreneurs especially engaged in technological development.
4. **Venture capital scheme of IDBI:** This scheme of IDBI is emerging as one of the major sources of venture-capital funding. It is meant specifically to support projects which promote innovative and experimental technologies in Indian conditions.

Following is the list of some of the players engaged in the venture capital finance in the India:

(a) ANZ Grindlays Bank
(b) Credit Capital Venture Fund (India) Ltd
(c) 20th Century Venture Capital Corporation
(d) APIDC Venture Capital Ltd
(e) Canbank Venture Capital Fund
(f) Gujarat Venture Finance Ltd
(g) Industrial Development Bank of India
(h) IL and FS Venture Corporation
(i) SBI Capital Venture Fund
(j) Pardeshiya Industrial and Investment Corporation of Uttar Pradesh Ltd (PICUP)

Criteria Adopted By Venture Capitalists To Provide Venture Capital Finance:

The following criteria are taken into consideration by the venture capitalists while going for investment decisions:

(a) The reliability, business insight and the entrepreneurial spirit of the management team are considered as the most essential factors.

(b) The background of the entrepreneur and his administration team

(c) The technical practicability and commercial feasibility of the project, procedure or service

(d) Huge and speedily developing market opportunity

(e) Advantage in terms of price or cost

(f) Guts for satisfactory profitability over a period of four to seven years.

Merits of Venture Capital:

(a) Venture capital helps in promotion of industrialization in the country.

(b) It helps in developing and promoting innovative technologies.

(c) It helps the new entrepreneurs to convert their thoughts into reality.

(d) It enhances employment opportunities.

(e) It develops entrepreneurship in the country

4.2.3 The Venture Capital Investment Process

Venture capital investment is one of the most flexible form of financing technology based or innovative business firms. It is a more wide way of getting finances for investment in business enterprises which hold a bright future in terms of profit and as well as growth.

Venture capital is invested as equity shares and not as any type of a loan. Because of investment in shares, venture capital is also known as risk capital. The investment is majorly in risky projects.

Broadly speaking, venture capital is a source of necessary risk capital like financing for shares. It has now emerged as the best financing alternative in developing as well as developed countries. Approximately 70 countries provide the facility of venture capital investment to the business enterprises.

For a virtual capital investment, you need to have the following traits:

- A business firm which has the potential to grow in near future
- The investment should be for a long time like from two to ten years.
- The business should have had invested in shares of established business enterprises which hold a strong history of profits.
- The risk level should be high of the ongoing projects in the firm that also ensure high amount of profits.
- Once the funding is done, the investor must remain active.

Notes

Some of the examples of venture capital investment that were made in the past are as follows:

- A software development based company steps into telecommunication switch in Israel.
- A hand tool manufacturer in china with low cost products and high operational efficiency but the best quality.
- An exporter of horticultural products in Africa
- A national store chain in and around India

These examples show how investments are made in venture capital. They show growth in business firms and a high level of sales and profitability which is best for an investor.

Private equity investments are equity investments that are not traded on public exchanges (such as The New York Stock Exchange (NYSE) is the largest securities exchange in the world, hosting 82% of the S&P 500, as well as 70 of the biggest). Institutional and individual investors usually invest in private equity through limited partnership agreements, which allow investors to invest in a variety of venture capital projects while preserving limited liability (of the initial investment).

Venture capital investing projects are usually run by private equity fundsPrivate Equity FundsPrivate equity funds are pools of capital to be invested in companies that represent an opportunity for a high rate of return. They come with a fixed with each PE fund running a portfolio of projects it specializes in. For instance, a private equity fund specializing in artificial intelligence may invest in a portfolio of ten venture capital projects on fully intelligent vehicles.

Stages of Venture Capital Investing

1. Seed-stage Capital: Seed-stage capital is the capital provided to help an entrepreneur (or prospective entrepreneur) develop an idea. Seed stage capital usually funds the research and development (R&D)Research and Development (R&D)Research and Development (R&D) is a process by which a company obtains new knowledge and uses it to improve existing products and introduce of new products and services and research into prospective markets.

2. Early-stage Capital: Early-stage capital is venture capital investing provided to set up initial operation and basic production. Early stage capital supports product development, marketing, commercial manufacturing, and sales.

3. Later-stage Capital: Later-stage capital is the venture capital investing provided after the business generates revenues but before an Initial Public Offering (IPO)Initial Public Offering (IPO)An Initial Public Offering (IPO) is the first sale of stocks issued by a company to the public. Prior to an IPO, a company is considered a private company, usually with a small number of investors (founders, friends, family, and business investors such as venture capitalists or angel investors). Learn what an IPO is. It includes capital needed

for initial expansion (second-stage capital), capital needed for major expansions, product improvement, major marketing campaigns, mergers & acquisitions (third-stage capital), and capital needed to go public (mezzanine or bridge capital).

Notes

Characteristics of Venture Capital Investing

1. Illiquid: Venture capital investments are usually long-term investments and are fairly illiquid compared to market-traded investment instruments. Unlike, publicly traded investment instruments, VC investments don't offer the option of a short-term payout. Long-term returns from venture capital investing depend largely on the success of an IPO.

2. Long-term investment horizon Venture capital investments feature a structural time-lag between the initial investment and the final pay-out. The structural time-lag increases the liquidity risk. Therefore, VC investments tend to offer very high returns to compensate for this higher than normal liquidity risk.

3. Large discrepancy between private valuation and public valuation (market valuation): Unlike standard investment instruments that are traded on some organized exchange, VC investments are held by private funds. Thus, there is no way for any individual investor in the market to determine the value of the investment. The venture capitalist also does not know how the market values his investment. This causes IPOs to be the subject of widespread speculation from both the buy-side and the sell-side.

4. Entrepreneurs lack full information about the market: The majority of venture capital investing is into innovative projects whose aim is to disrupt the market. Such projects offer potentially very high returns but also come with very high risks. As such, entrepreneurs and VC investors often work in the dark because no one else has done what they are trying to do.

5. Mismatch between entrepreneurs and VC investors: An entrepreneur and an investor may have very different objectives with regards to a project. The entrepreneur may be concerned with the process (i.e., the means) whereas the investor may only be concerned with the return (i.e., the end).

6. Mismatch between VC investors and fund managers: An investor and a fund manager may have different objectives regarding a particular project. The difference in interest depends largely on the contract signed by the fund manager. For instance, many fund managers are paid based on the size of the VC fund and not based on the returns generated. Such fund managers tend to take on excessive risk with regards to investments.

Investment process describes the way in which venture capital assistance is provided to the entrepreneurs. The entrepreneur who has an idea which qualifies for venture capital assistance should contact appropriate and right venture capitalists for assistance.

Selection of investment decision is very important both for the entrepreneur and the capitalists. The proposal for assistance by the entrepreneur to the venture capitalist is the first official step in the investment process.

Notes

The venture capital investment process has two aspects, (i) the assessment by the entrepreneur as to whom he should contact for assistance and a comparison of the terms and conditions of various venture capitalists and (ii) assessment of the entrepreneur and his proposal by the investor. Considering the type of industry, nature investment and risk involved in it, the investors generally apply some criteria for investment: Investors consider only those proposals which qualify these stipulations.

The investment process involves the knowledge of the:

(A) Eligibility criteria for evaluating proposals,

(B) Screening of venture capitalist by the entrepreneur,

(C) Screening of entrepreneur and the proposal by the venture capitalists,

(D) Stages of venture capital financing and

(E) Types of finance provided by venture capitalists.

A brief description of these processes is given below:

A. Eligibility Criteria for Proposals:

The minimum eligibility conditions to process an application for venture capital assistance are:

(a) The Venture must be Technically Feasible: The technology/ idea should have proper technology base and the technology/ idea should have integrity and viability for commercial production. It is to be laboratory proven.

(b) It should be Commercially Viable: There must be public acceptance for the idea/ technology. If commercial production takes place there should be adequate reason to believe that there will be demand for the item in the market.

(c) The Technical & Managerial Competence and Integrity of the Entrepreneur: The entrepreneur should have technical competence to apply his idea to production and manage the project to success. The entrepreneur must be reliable and should have consistency in doing.

(d) The Long Run Competitive Advantage of the Units: The idea should have long run competitive advantage over other existing products/service in the market.

(e) Future Prospects: The idea should have an excellent future in the coming years. At least the investor should make sure that the product will not become obsolete in the near future.

(f) Availability of Inputs: Availability of inputs/factors of production is another important factor considered before financing. However good

the idea is, if inputs for production are not available in right quantity, it is of no use in commercial applications. Thus the financier prefers only those projects for which inputs are available in right quantity.

(g) **Legality of the Proposal:** The financier makes sure that the proposal is legally viable by all respects. That is it satisfies pollution standards, emission standards, government policies, etc.

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B. Screening of Venture Capitalist by the Entrepreneur:

There are several venture capital organizations in India both in government sector and in private sector. The lending policies and other terms and conditions of these organizations vary widely. The proposer must be vigilant in selecting the right capitalists.

The following points worth consideration while choosing venture capitalists:

(a) **Approach of the Capitalists:** The entrepreneur should assess the approach and attitude of the venture capitalist. Some capitalists show very keen interest and offer all possible value added service (hands on approach) in fields of activity. Hands on approach of capitalist are also called 'investment nurturing'.

Investment nurturing is the process by which venture capitalists continue to involve themselves in the operations of the concerns assisted by them. It is through personal discussions, plant visits, feedbacks, periodic reports studies etc. that they make it possible. Some capitalists may be very passive in dealing with entrepreneurs (hands off approach). The entrepreneur should approach those who offer very hands on approach.

(b) **Terms and Conditions:** The entrepreneurs should assess the implications of each of the terms and conditions laid down in the agreement.

(c) **Exit Policy:** The entrepreneur should assess the exit policy of the capitalists. There are several modes of exit available for the venture capitalist.

(d) **Availability of funds:** Financial base and liquidity of the capitalist are other important area to be looked into. It will be easy for one with adequate financial base to provide adequate finance in adequate quantity in times of emergency if it so happens.

(e) **Past history of the Capitalists:** Always the past history of the capitalist to be analyzed and to be dealt with only those who have a steady and straight past profile.

(f) **Miscellaneous:** Procedural delay, processing charges, rate of interest, duration of advance etc. are other matters of concern.

Notes

C. Screening of Entrepreneur and the Proposal by the Venture Capitalists:

As investing in ventures is highly risky the capitalist has to be vigilant in assessing and granting advances to such ventures. The capitalist assess the proposal of entrepreneurs at various stages and apply number of assessment tools to assess the credibility of the proposer, his past history, feasibility of the proposal, amount involved and amount requested by the proposer, future growth prospects of the idea/technology etc.

To assess the potential of the idea and the proposer the venture capitalists apply the following tests and analysis:

1. Fundamental Analysis: Here the venture capitalists analyses and assesses the fundamental aspects of the proposed business. It includes analysis and assessment of the following:

(a) **Past history:** It assess the past history of the proposer, its date of incorporation, summary of annual reports, profile of the company for years, etc.,

(b) **Management:** Here the company assesses the quality of its management It also assess the quality of board of directors, shareholders etc.,

(c) **Products:** The capitalist checks the quality and features of the company's products.

(d) **Markets:** The markets which the company serves, nature of industry, degree of competition etc.

(e) **Manufacturing:** Manufacturing and operational aspects of the business is to be checked. That is to say the type of technology used, access to sources of supply, manufacturing capacity and the holdings of premises etc. and

(f) **Risks:** The capitalist need to assess the potential risk involved in it.

2. Financial Analysis: The financial analysis is undertaken to assess the performance of the strategies of the organization. The capitalists assesses the earnings growth of the organization, margin of profit, time lag between investment and return, impact on cash flow, expected value of the company at the time divestment and finally anticipated financial risks and the strategies of the management to tie over it. In the assessment for venture capital, financial performance is very vital.

3. Portfolio Analysis: Here in portfolio analysis the capitalists assess the present portfolio balance of the proposer at the time of proposal. The capitalist also assesses the feasibility of the future portfolio, if the proposal is accepted and loans granted. The proposal will be considered only if the future portfolio is acceptable. Portfolio analysis involves analysis of the size; stage, location and industry of the investment proposal for all these are closely connected with portfolio.

4. Divestment Analysis: Here the capitalists analyses the opportunity for divestment (Exit). It assesses the method, timing and valuation of the company upon divestment. There are four common ways in which venture capitalists divest their interests in the venture projects. These are called exit mechanisms.

They are:

- **(i) Trade Sale:** It is in the form of an unexpected or unsolicited bid. Here the venture capitalists sell its interests/investment to a company in a trade. This usually takes place when there are many interested parties to acquire the interests of the financier. The sales may be for the stake of financier alone or may be of the entire company itself.
- **(ii) Take-Out:** It is the process of selling capitalist's interests in the venture project to another venture capitalist or financing/ insurance company or pension fund manager or management holding company by way of private placement.
- **(iii) Earn Out:** Here the entrepreneur himself buys back the stake of venture capitalists at agreed assessed price and the capitalists realize his money with return. So under this method no third party is involved. The entrepreneur will be given an option for this right at the time of investment.
- **(iv) Floatation/IPO Method:** This is another exit route for the venture capital investment. It is also called IPO (Initial Public Offer). Here securities are issued through stock market for public subscription. It requires strong management team to make the process a success. If securities are given to pre-arranged buyers it is called 'placing'. If the company places its shares before the public for subscription at a fixed price, it is called 'offer for sale'. And if the company calls for tenders from the public quoting name, number of shares and price offered it is called 'tender'.
- **(v) Puts and Calls Method:** Under this method, the exit takes place through puts and calls. The put option is the right to sell, while the call option is the right of the entrepreneur to buy. For this purpose the capitalists arrives at an agreed price as per agreed formula. The prices of the assets are arrived at using pre-determined formula. They generally use Book value method or P/E ratio or Percentage of sales method or Multiplier cash flow method or independent valuation or agreed price method to arrive the price of the organization.
- **(vi) Liquidation:** It is resorted to when the venture becomes and utter failure due to tough competition or technology failure, obsolescence etc. Here exit takes place in involuntary manner. Here the entire organization goes into liquidation and the financier gets his share.

  In short the venture capitalists assess everything as possible before granting advance. Right from feasibility analysis of the proposal till divestment of its stake, the capitalists assess everything possible before advancing money.

D. Stages of Venture Capital Financing:

Venture capital is provided at two separate stages of venture development. They are the early stage financing and the later stage financing.

I. Early Stage Financing:

(i) **Seed Capital:** This is an early stage financing in a project life. It is the amount of capital provided to start the business. This will be comparatively small in value. The European Venture Capital Association defines seed capital as "the financing of the initial product development or the capital provided to an entrepreneur to prove the feasibility of a project and qualify for startup capital".

Research and development projects means the amount required to conduct researches to study the market feasibility other needs before the business starts commercial production. The past history of the entrepreneur and the quality of the project are the major determinants at this stage of financing.

(ii) **Startup Capital:** Startup capital is defined as the "capital needed to finance the product development, initial marketing and the establishment of product facilities".

The word start up signifies the stage where a new activity is launched.

(iii) **Second Round Finance:** It means the finance provided to capture more and more markets and to increase production and sales. At this stage venture capitalists advance more debt finance to organizations.

II. Later Stage Financing:

1. **Development Capital:** This is provided for purchasing new machineries, plants or expansion of business or to set up new marketing and distribution set up etc. The duration of such finance may be one to three years.

2. **Expansion Finance:** This is provided for expansion projects such as bigger factory, larger warehouse, new factories, new products etc. The duration of such loans ranges from one to three years.

3. **Replacement Capital:** It is provided to purchase shares of other owners. This may be due to family problems or personal need of funds or so. This type of finance has duration of one to three years.

4. **Turnarounds:** This means financing for acquisition of a sick company which requires much specialized skills. It requires rescheduling of all the company's borrowings, management and ownership. It is a highly risky financing and its duration is for three to five years. In such cases the financing company sometimes nominates its chairman and appoints its nominees in the director board of the company.

5. **Management Buy Outs (MBOs):** It refers to the transfer of management control by creating a separate business by separating it from their existing owners. This takes place in two forms, namely

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MBOs and MBIs. Financing the existing client to acquire another existing product line/business is called Management Buyouts (MBO). The European Venture Capital Association defines MBOs as "the acquisition of a company (or the shares in that company) from the existing owners by a team of existing management/employees.

The vending shareholders may or may not have been actively involved in the running of the company, the acquiring groups are presumed to be actively involved in the day-to-day running of the company and are making the acquisition with a view towards becoming active owner-managers." Deals pertaining to the purchase of management holding of an enterprise are called 'buy -out-deals'.

6. **Management Buy In (MBIs):** Financing an outsider group to acquire an existing company is called Management Buy In (MBIs). The European Venture Capital Association defines MBIs as "funds provided to enable a manager or group of managers from outside the company to buy-in the company with the support of venture capital investors". It is highly risky than buy-outs.

7. **Mezzanine Finance:** It is the last stage in equity related financing to venture projects. It is finance given to private companies in the final run up to a trade sale or a public issue. It is a type of secured credit provided as bridge finance with a maturity of less than two years. Sometimes it is given as high-raking equity (preference shares).

   It is to be noted that venture capital is provided at all stages of the project life cycle. The financier is there with the entrepreneur at all wakes of his business. It provides finance when in need; it provides skill and knowledge if needed and facilitates easy launching and marketing of products. Before investment the proposals have to be analyzed in detail for its credibility and feasibility. Following methods are popularly used in the assessment of VC proposals.

E. Types of Finance Provided by Venture Capitalists:

Venture capitalists provide funds for feasible ventures only. Feasibility of the projects is assessed by the financier. Moreover financiers specialize in some areas of investment. Some financiers provide finance for seed capital requirements, some for early expansion schemes and some for exit financing. Apart from the above some financiers concentrate on software industry, some on health care and some on agri-based units.

Whatever be the area of finance, financiers provide finance in any of the following ways:

(a) **Equity:** One of the most common forms of venture capital financing is by way of purchasing equity of the venture. Financiers purchase a maximum of 49% of the total equity of the venture. Thus the ownership and management always rests with entrepreneur. This is the safest form of financing for entrepreneur as it involves no periodical or annual payments.

Notes

(b) **Conditional Loan:** It is another form of venture financing. It is a debt and the borrower needs to pay financier. It is provided sometimes at no interest and sometimes at a nominal interest. This is fixed considering the project and the borrower. In addition the borrower is to pay a royalty to the lender. The royalty is fixed as a percentage of the turnover. As it is set as a percentage of turnovers, this will not affect the entrepreneur badly. Later on when the venture picks up in business the rates of interest will be increased and royalty decreased.

(c) **Convertible Loans:** These are loans but have an option to convert to equity shares if the venture fails to make interest payments in time.

(d) **Income Notes:** It is another form of investment. It is a compromise between conventional loans and conditional loans. The assisted firms are to pay both interest and royally on sales but at substantially lower rate.

4.2.4 Verious Steps in Venture Financing

The requirements of funds vary with the life cycle stage of the enterprise. Even before a business plan is prepared the entrepreneur invests his time and resources in surveying the market, finding and understanding the target customers and their needs. At the seed stage the entrepreneur continue to fund the venture with his own or family funds.

At this stage the funds are needed to solicit the consultant's services in formulation of business plans, meeting potential customers and technology partners. Next the funds would be required for development of the product/process and producing prototypes, hiring key people and building up the managerial team. This is followed by funds for assembling the manufacturing and marketing facilities in that order.

Finally the funds are needed to expand the business and attain the critical mass for profit generation. Venture capitalists cater to the needs of the entrepreneurs at different stages of their enterprises. Depending upon the stage they finance, venture capitalists are called angel investors or private equity supplier/investor.

Venture capital was started as early stage financing of relatively small but rapidly growing companies. However various reasons forced venture capitalists to be more and more involved in expansion financing to support the development of existing portfolio companies.

With increasing demand of capital from newer business, Venture capitalists began to operate across a broader spectrum of investment interest. This diversity of opportunities enabled Venture capitalists to balance their activities in term of time involvement, risk acceptance and reward potential, while providing on going assistance to developing business.

Different venture capital firms have different attributes and aptitudes for different types of Venture capital investments. Hence there are different stages of entry for different Venture capitalists and they can identify and differentiate

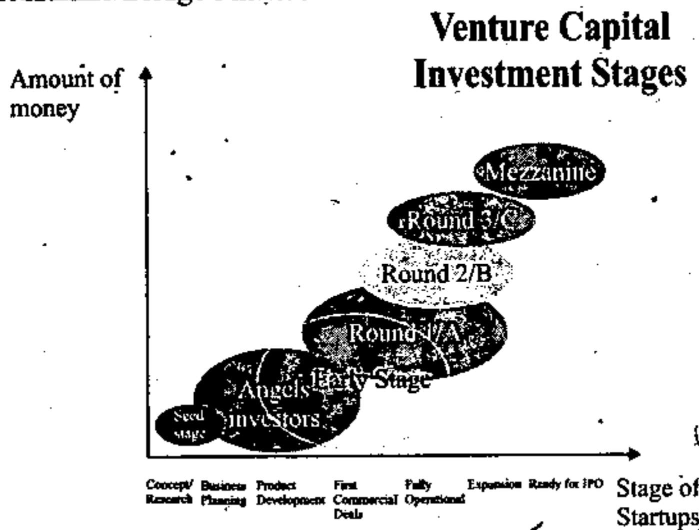
between types of Venture capital investments, each appropriate for the given stage of the investee company, These are:-

1. Early Stage Finance

- Seed Capital
- Start up Capital
- Early/First Stage Capital
- Later/Third Stage Capital

2. Later Stage Finance

- Expansion/Development Stage Capital
- Replacement Finance
- Management Buy Out and Buy ins
- Turnarounds
- Mezzanine/Bridge Finance



Not all business firms pass through each of these stages in a sequential manner. For instance seed capital is normally not required by service based ventures. It applies largely to manufacturing or research based activities. Similarly second round finance does not always follow early stage finance. If the business grows successfully it is likely to develop sufficient cash to fund its own growth, so does not require venture capital for growth.

The table below shows risk perception and time orientation for different stages of venture capital financing.

Financing Stage	Period (funds locked in years)	Risk perception	Activity to be financed
Early stage finance Seed	7-10	Extreme	For supporting a concept or idea or R & D for product development
Start up	5-9	Very high	Initializing operations or developing prototypes

Notes

Notes

First stage	3-7	High	Start commercial production and marketing
Second stage	3-5	Sufficiently high	Expand market & growing working capital need
Later stage finance	1-3	Medium	Market expansion, acquisition & product development for profit making company
Buy out-in	1-3	Medium	Acquisition financing
Turnaround	3-5	Medium to high	Turning around a sick company
Mezzanine	1-3	Low	Facilitating public issue

1. Seed Capital: It is an idea or concept as opposed to a business. European Venture capital association defines seed capital as "The financing of the initial product development or capital provided to an entrepreneur to prove the feasibility of a project and to qualify for start up capital".

The characteristics of the seed capital may be enumerated as follows:

- Absence of ready product market
- Absence of complete management team
- Product/ process still in R & D stage
- Initial period / licensing stage of technology transfer

Broadly speaking seed capital investment may take 7 to 10 years to achieve realization. It is the earliest and therefore riskiest stage of Venture capital investment. The new technology and innovations being attempted have equal chance of success and failure. Such projects, particularly hi-tech, projects sink a lot of cash and need a strong financial support for their adaptation, commencement and eventual success. However, while the earliest stage of financing is fraught with risk, it also provides greater potential for realizing significant gains in long term.

Typically seed enterprises lack asset base or track record to obtain finance from conventional sources and are largely dependent upon entrepreneur's personal resources. Seed capital is provided after being satisfied that the entrepreneur has used up his own resources and carried out his idea to a stage of acceptance and has initiated research. The asset underlying the seed capital is often technology or an idea as opposed to human assets (a good management team) so often sought by venture capitalists.

Volume of Investment Activity

It has been observed that Venture capitalist seldom make seed capital investment and these are relatively small by comparison to other forms of venture finance. The absence of interest in providing a significant amount of seed capital can be attributed to the following three factors:

1. Seed capital projects by their very nature require a relatively small amount of capital. The success or failure of an individual seed capital investment will have little impact on the performance of all but the

smallest venture capitalist's portfolio. Larger venture capitalists avoid seed capital investments. This is because the small investments are seen to be cost inefficient in terms of time required to analyze, structure and manage them.

2. The time horizon to realization for most seed capital investments is typically 7-10 years which is longer than all but most long-term oriented investors will desire.

3. The risk of product and technology obsolescence increases as the time to realization is extended. These types of obsolescence are particularly likely to occur with high technology investments particularly in the fields related to Information Technology.

Notes

2. Start up Capital: It is the second stage in the venture capital cycle and is distinguishable from seed capital investments. An entrepreneur often needs finance when the business is just starting. The start up stage involves starting a new business. Here in the entrepreneur has moved closer towards establishment of a going concern. Here in the business concept has been fully investigated and the business risk now becomes that of turning the concept into product.

Start up capital is defined as: "Capital needed to finance the product development, initial marketing and establishment of product facility."

The characteristics of start-up capital are:

- Establishment of company or business. The company is either being organized or is established recently. New business activity could be based on experts, experience or a spin-off from R & D.
- Establishment of most but not all the members of the team. The skills and fitness to the job and situation of the entrepreneur's team is an important factor for start up finance.
- Development of business plan or idea. The business plan should be fully developed yet the acceptability of the product by the market is uncertain. The company has not yet started trading.

In the start up preposition venture capitalists investment criteria shifts from idea to people involved in the venture and the market opportunity. Before committing any finance at this stage, Venture capitalist however, assesses the managerial ability and the capacity of the entrepreneur, besides the skills, suitability and competence of the managerial team are also evaluated. If required they supply managerial skills and supervision for implementation.

The time horizon for start up capital will be typically 6 or 8 years. Failure rate for start up is 2 out of 3. Start up needs funds by way of both first round investment and subsequent follow-up investments. The risk tends t be lower relative to seed capital situation. The risk is controlled by initially investing a smaller amount of capital in start-ups.

The decision on additional financing is based upon the successful performance of the company. However, the term to realization of a start up

investment remains longer than the term of finance normally provided by the majority of financial institutions. Longer time scale for using exit route demands continued watch on start up projects.

Notes

Volume of Investment Activity: Despite potential for specular returns most venture firms avoid investing in start-ups. One reason for the paucity of start up financing may be high discount rate that venture capitalist applies to venture proposals at this level of risk and maturity. They often prefer to spread their risk by sharing the financing. Thus syndicates of investor's often participate in start up finance.

3. Early Stage Finance: It is also called first stage capital is provided to entrepreneur who has a proven product, to start commercial production and marketing, not covering market expansion, de-risking and acquisition costs. At this stage the company passed into early success stage of its life cycle. A proven management team is put into this stage, a product is established and an identifiable market is being targeted.

British Venture Capital Association has vividly defined early stage finance as: "Finance provided to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales but may not be generating profits."

The characteristics of early stage finance may be:

- Little or no sales revenue.
- Cash flow and profit still negative.
- A small but enthusiastic management team which consists of people with technical and specialist background and with little experience in the management of growing business.
- Short term prospective for dramatic growth in revenue and profits.

The early stage finance usually takes 4 to 6 years time horizon to realization. Early stage finance is the earliest in which two of the fundamentals of business are in place i.e. fully assembled management team and a marketable product. A company needs this round of finance because of any of the following reasons:

- Project overruns on product development.
- Initial loss after start up phase.

The firm needs additional equity funds, which are not available from other sources thus prompting venture capitalist that, have financed the start up stage to provide further financing. The management risk is shifted from factors internal to the firm (lack of management, lack of product etc.) to factors external to the firm (competitive pressures, in sufficient will of financial institutions to provide adequate capital, risk of product obsolescence etc.)

At this stage, capital needs, both fixed and working capital needs are greatest. Further, since firms do not have foundation of a trading record, finance will be difficult to obtain and so Venture capital particularly equity investment without associated debt burden is key to survival of the business.

The following risks are normally associated to firms at this stage:

- The early stage firms may have drawn the attention of and incurred the challenge of a larger competition.
- There is a risk of product obsolescence. This is more so when the firm is involved in high-tech business like computer, information technology etc.

Notes

4. Second Stage Finance: It is the capital provided for marketing and meeting the growing working capital needs of an enterprise that has commenced the production but does not have positive cash flows sufficient to take care of its growing needs. Second stage finance, the second trench of Early State Finance is also referred to as follow on finance and can be defined as the provision of capital to the firm which has previously been in receipt of external capital but whose financial needs have subsequently exploded. This may be second or even third injection of capital.

The characteristics of a second stage finance are:

- A developed product on the market
- A full management team in place
- Sales revenue being generated from one or more products
- There are losses in the firm or at best there may be a break even but the surplus generated is insufficient to meet the firm's needs.

Second round financing typically comes in after start up and early stage funding and so have shorter time to maturity, generally ranging from 3 to 7 years. This stage of financing has both positive and negative reasons.

Negative reasons include:

1. Cost overruns in market development.
2. Failure of new product to live up to sales forecast.
3. Need to re-position products through a new marketing campaign.
4. Need to re-define the product in the market place once the product deficiency is revealed.

Positive reasons include:

1. Sales appear to be exceeding forecasts and the enterprise needs to acquire assets to gear up for production volumes greater than forecasts.
2. High growth enterprises expand faster than their working capital permit, thus needing additional finance. Aim is to provide working capital for initial expansion of an enterprise to meet needs of increasing stocks and receivables.

It is additional injection of funds and is an acceptable part of venture capital. Often provision for such additional finance can be included in the original financing package as an option, subject to certain management performance targets.

5. Later Stage Finance: It is called third stage capital is provided to an enterprise that has established commercial production and basic marketing set-

up, typically for market expansion, acquisition, product development etc. It is provided for market expansion of the enterprise. The enterprises eligible for this round of finance have following characteristics.

- Established business, having already passed the risky early stage.
- Expanding high yield, capital growth and good profitability.
- Reputed market position and an established formal organization structure.

"Funds are utilized for further plant expansion, marketing, working capital or development of improved products." Third stage financing is a mix of equity with debt or subordinate debt. As it is half way between equity and debt in US it is called "mezzanine" finance. It is also called last round of finance in run up to the trade sale or public offer.

Venture capitalists prefer later stage investment vis a vis early stage investments, as the rate of failure in later stage financing is low. It is because firms at this stage have a past performance data, track record of management, established procedures of financial control. The time horizon for realization is shorter, ranging from 3 to 5 years.

This helps the venture capitalists to balance their own portfolio of investment as it provides a running yield to venture capitalists. Further the loan component in third stage finance provides tax advantage and superior return to the investors.

There are four sub divisions of later stage finance.

1. Expansion / Development Finance
2. Replacement Finance
3. Buyout Financing
4. Turnaround Finance

Expansion / Development Finance

An enterprise established in a given market increases its profits exponentially by achieving the economies of scale. This expansion can be achieved either through an organic growth, that is by expanding production capacity and setting up proper distribution system or by way of acquisitions. Anyhow, expansion needs finance and venture capitalists support both organic growth as well as acquisitions for expansion.

At this stage the real market feedback is used to analyze competition. It may be found that the entrepreneur needs to develop his managerial team for handling growth and managing a larger business.

Realization horizon for expansion / development investment is one to three years. It is favored by venture capitalist as it offers higher rewards in shorter period with lower risk. Funds are needed for new or larger factories and warehouses, production capacities, developing improved or new products, developing new markets or entering exports by enterprise with established business that has already achieved break even and has started making profits.

Notes

Replacement Finance: It means substituting one shareholder for another, rather than raising new capital resulting in the change of ownership pattern. Venture capitalist purchase shares from the entrepreneurs and their associates enabling them to reduce their shareholding in unlisted companies. They also buy ordinary shares from non-promoters and convert them to preference shares with fixed dividend coupon. Later, on sale of the company or its listing on stock exchange, these are re-converted to ordinary shares. Thus Venture capitalist makes a capital gain in a period of 1 to 5 years.

Buy-out/Buy-in Financing: It is a recent development and a new form of investment by venture capitalist. The funds provided to the current operating management to acquire or purchase a significant share holding in the business they manage are called management buyout. Management Buy-in refers to the funds provided to enable a manager or a group of managers from outside the company to buy into it. It is the most popular form of venture capital amongst later stage financing.

It is less risky as venture capitalist in invests in solid, ongoing and more mature business. The funds are provided for acquiring and revitalizing an existing product line or division of a major business. MBO (Management buyout) has low risk as enterprise to be bought have existed for some time besides having positive cash flow to provide regular returns to the venture capitalist, who structure their investment by judicious combination of debt and equity. Of late there has been a gradual shift away from start up and early finance to wards MBO opportunities. This shift is because of lower risk than start up investments.

Turnaround Finance: It is rare form later stage finance which most of the venture capitalist avoid because of higher degree of risk. When an established enterprise becomes sick, it needs finance as well as management assistance foe a major restructuring to revitalize growth of profits. Unquoted company at an early stage of development often has higher debt than equity; its cash flows are slowing down due to lack of managerial skill and inability to exploit the market potential.

The sick companies at the later stages of development do not normally have high debt burden but lack competent staff at various levels. Such enterprises are compelled to relinquish control to new management. The venture capitalist has to carry out the recovery process using hands on management in 2 to 5 years. The risk profile and anticipated rewards are akin to early stage investment.

Bridge Finance: It is the pre-public offering or pre-merger/acquisition finance to a company. It is the last round of financing before the planned exit. Venture capitalist help in building a stable and experienced management team that will help the company in its initial public offer. Most of the time bridge finance helps improves the valuation of the company. Bridge finance often has a realization period of 6 months to one year and hence the risk involved is low. The bridge finance is paid back from the proceeds of the public issue.

4.2.5 Incubation Financing

An incubated fund is a fund that is first offered privately in an incubation period. Investors in this type of fund are usually employees associated with the fund and their family members. Hedge funds also commonly use incubated funds to test new strategies and offerings.

Notes

An incubated fund may also be called a limited distribution fund.

Breaking Down Incubated Fund

An incubated fund is usually launched with a specified trial period. In some cases, a fund company may test several funds in an incubation trial with the best performing funds advancing. Incubated fund launches are advertised to a select group of individuals and also typically funded with firm capital. These funds generally go through two phases, incubation and public offering.

Incubation: Incubation is the trial period an investment company uses to test new funds. During the incubation period, the incubated fund is only offered to a select group of investors. Investment companies will often test incubated funds with select investors, such as employees and family members. Hedge funds also use a similar approach for incubated funds with the offerings available only to fund employees and family members.

In some cases, a fund may choose to test several strategies in an incubation period. If successful, the fund may launch all-new strategies or they may plan to launch only the best performing strategy.

Factors Influencing Incubated Funds: Incubated funds can be a prudent way to test a particular fund strategy, specifically if the fund company believes it may have a high susceptibility to risks. Using an incubation period allows an investment company to make a small investment in the management and activities of the fund. An incubated fund will closely monitor the trading mechanisms and transaction costs associated with the fund's activities. Other factors influencing its potential launch to the public will include vehicle structure, registration constraints, demand and potential for success in comparison to other funds in the market or with the fund family. Overall, a small investment made in an incubated fund can far outweigh the costs of launching an unsuccessful fund that requires closing after only a short period of time.

Public Launch: In addition to testing the operational activities of a fund in an incubation trial, the test phase also allows companies to privately gauge the potential public market support it will receive from distributors, intermediaries and service providers. These entities are important to the public launch of registered funds specifically. Distributors partner with the fund to market and list it with discount brokerages and on financial advisor platforms. Additionally, most new funds sign waiver and discount agreements that keep the net expenses lower in the first few years after the public launch. Once a fund company decides to clear a fund for launch, it may also provide additional capital for the fund, which is integrated into its waivers and discount agreements, helping to potentially keep expenses comparatively lower than other fund competitors.

Disclosures: A fund company is generally not required to disclose incubation trials in its registration documents. In some cases, however, fund companies may utilize performance obtained in an incubation trial as hypothetical returns. Critics sometimes find this practice misleading since incubation trial performance may not always fully represent the returns and expenses incurred in the public market. Investors should always be cautious of hypothetical returns and ensure that they fully understand the assumptions associated with them.

Notes

4.3 SUMMARY

Venture capital (VC) is a form of private equity and a type of financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential. Venture capital generally comes from well-off investors, investment banks, and any other financial institutions.

Venture capital (VC) is a form of private equity financing that is provided by venture capital firms or funds to startups, early-stage, and emerging companies that have been deemed to have high growth potential or which have demonstrated high growth (in terms of number of employees, annual revenue, scale of operations, etc).

Venture capital firms or funds invest in these early-stage companies in exchange for equity, or an ownership stake. Venture capitalists take on the risk of financing risky start-ups in the hopes that some of the firms they support will become successful. Because startups face high uncertainty, VC investments have high rates of failure. The start-ups are usually based on an innovative technology or business model and they are usually from high technology industries, such as information technology (IT), clean technology or biotechnology.

The typical venture capital investment occurs after an initial "seed funding" round. The first round of institutional venture capital to fund growth is called the Series A round. Venture capitalists provide this financing in the interest of generating a return through an eventual «exit» event, such as the company selling shares to the public for the first time in an initial public offering (IPO), or disposal of shares happening via a merger, via a sale to another entity such as a financial buyer in the private equity secondary market or via a sale to a trading company such as a competitor.

4.4 EXERCISE

1. What is a Venture Capital in India?
2. Discuss the Origin of Venture Capital?
3. What do Venture Capital to Invest in?
4. What are the steps in Venture Capital financing?
5. Do startup incubators take equity?

UNIT 5: CREDIT RATINGS

Notes

Structure:

5.0 Objectives
5.1 Introduction
5.2 Credit Ratings
  5.2.1 Types of Credit Rating
  5.2.2 Advantage and Disadvantage of Credit Rating
  5.2.3 Credit Rating Agencies and Their Methology
  5.2.4 International Credit Rating Practices
5.3 Securitization
  5.3.1 Concept of Securitization
  5.3.2 Securitization as A Funding Mechanism
  5.3.3 Securitization in India
5.4 Summary
5.5 Exercise

5.0 OBJECTIVES

After reading this Unit. you will be able to:

- define the credit ratings,
- explain the advantage and disadvantage of credit rating,
- discuss the international credit rating practices,
- analysis the securitization,
- understand the securitization as a funding mechanism,
- discuss the securitization in india.

5.1 INTRODUCTION

With the increasing market orientation of the Indian economy, investors value a systematic assessment of two types of risks, namely "business risk" arising out of the "open economy" and linkages between money, capital and foreign exchange markets and "payments risk". With a view to protect small investors, who are the main target for unlisted corporate debt in the form of fixed deposits with companies, credit rating has been made mandatory. India was perhaps the first amongst developing countries to set up a credit rating agency in 1988.

The function of credit rating was institutionalised when RBI made it mandatory for the issue of Commercial Paper (CP) and subsequently by SEBI. when it made credit rating compulsory for certain categories of debentures

and debt instruments. In June 1994, RBI made it mandatory for Non-Banking Financial Companies (NBFCs) to be rated. Credit rating is optional for Public Sector Undertakings (PSUs) bonds and privately placed non-convellible debentures upto Rs. 50 million. Fixed deposits of manufacturing companies also come under the purview of optional credit rating.

Notes

5.2 CREDIT RATINGS

Meaning and Definition: Credit rating is the opinion of the rating agency on the relative ability and willingness of tile issuer of a debt instrument to meet the debt service obligations as and when they arise. Rating is usually expressed in alphabetical or alphanumeric symbols. Symbols are simple and easily understood tool which help the investor to differentiate between debt instruments on the basis of their underlying credit quality. Rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding. In other words, the rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security.

The rating measures the probability that the issuer will default on the security over its life, which depending on the instrument may be a matter of days to thirty years or more. In fact, the credit rating is a symbolic indicator of the current opinion of the relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated. It can also be defined as an expression, through use of symbols, of the opinion about credit quality of the issuer of security/instrument.

Importance of Credit Rating: Credit ratings establish a link between risk and return. They thus provide a yardstick against which to measure the risk inherent in any instrument. An investor uses the ratings to assess the risk level and compares the offered rate of return with his expected rate of return (for the particular level of risk) to optimise his risk-return trade-off. The risk perception of a common investor, in the absence of a credit rating system, largely depends on his familiarity with the names of the promoters or the collaborators.

It is not feasible for the corporate issuer of a debt instrument to offer every prospective investor the opportunity to undertake a detailed risk evaluation. It is very uncommon for different classes of investors to arrive at some uniform conclusion as to the relative quality of the instrument. Moreover they do not possess the requisite skills of credit evaluation. Thus, the need for credit rating in today's world cannot be over emphasised. It is of great assistance to the investors in making investment decisions. It also helps the issuers of the debt instruments to price their issues correctly and to reach out to new investors.

Notes

Regulators like Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) use credit rating to determine eligibility criteria for some instruments. For example, the RBI has stipulated a minimum credit rating by an approved agency for issue of commercial paper. In general, credit rating is expected to improve quality consciousness in the market and establish over a period of time, a more meaningful relationship between the quality of debt and the yield from it. Credit Rating is also a valuable input in establishing business relationships of various types. However, credit rating by a rating agency is not a recommendation to purchase or sale of a security. Investors usually follow security ratings while making investments.

Ratings are considered to be an objective evaluation of the probability that a borrower will default on a given security issue, by the investors. Whenever a security issuer makes late payment, a default occurs. In case of bonds, non-payment of either principal or interest or both may cause liquidation of a company. In most of the cases, holders of bonds issued by a bankrupt company receive only a portion of the amount invested by them. Thus, credit rating is a professional opinion given after studying all available information at a particular point of time.

Such opinions may prove wrong in the context of subsequent events. Further, there is no private contract between an investor and a rating agency and the investor is free to accept or reject the opinion of the agency. Thus, a rating agency cannot be held responsible for any losses suffered by the investor taking investment decision on the basis of its rating. Thus, credit rating is an investor service and a rating agency is expected to maintain the highest possible level of analytical competence and integrity.

In the long run, the credibility of rating agency has to be built, brick by brick, on the quality of its services provided, continuous research undertaken and consistent efforts made. The increasing levels of default resulting from easy availability of finance, has led to the growing importance of the credit rating. The other factors are:

i. The growth of information technology.

ii. Globalisation of financial markets.

iii. Increasing role of capital and money markets.

iv. Lack of government safety measures.

v. The trend towards privatisation.

vi. Securitisation of debt.

5.2.1 Types of Credit Rating

1. Credit Rating Categories and Details

Credit Rating Categories	
Corporations, etc.	Creditworthiness of corporations or similar entities as given below, and creditworthiness of financial instruments such as securities (excluding asset securitization products and other structured financial instruments) that are issued by the relevant corporations or similar entities: (i) (Industrial) Corporations, etc. (ii) Financial Institutions, etc. (including insurance companies) (iii) Public Sector Entities (iv) Medical Institutions, Educational Institutions, etc. (v) Sovereign and Overseas Public Sector Entities, etc.
Structured Finance Products, etc.	Creditworthiness of thoseas given below: (i) Asset Securitization Products (ii) Other Structured Finance Products as given below: • Securities issued by investment companies or the relevant companies, or loans to the relevant companies • ABCP program (limited to types with the bank's full support) • Repackaged products (limited to single-credit financial products with the credit situation of their underlying assets being deemed effectively the same as the credit situation of the relevant financial products) • Securities issued by companies associated with project finance or the relevant companies, or loans to the relevant companies • Securities issued by companies associated with shipping finance or the relevant companies, or loans to the relevant companies • Other products similar to the above

2. Types of Credit Ratings and Definitions of Rating Symbols for Corporations, etc.

Notes

(1) **Definition of Default:** "Default" means a state in which principal and/or interest payments of financial obligations cannot be made as initially agreed. This includes the state where JCR judges it is impossible that principal and interest payments of the financial obligations can be made as agreed due to filing of a petition for legal proceedings such as Bankruptcy, Corporate Reorganization, Civil Rehabilitation, or Special Liquidation proceedings.

(2) Long-term Issuer Rating Scale

AAA	The highest level of certainty of an obligor to honor its financial obligations
AA	A very high level of certainty to honor the financial obligations
A	A high level of certainty to honor the financial obligations
BBB	An adequate level of certainty to honor the financial obligations. However, this certainty is more likely to diminish in the future than with the higher rating categories.
BB	Although the level of certainty to honor the financial obligations is not currently considered problematic, this certainty may not persist in the future.
B	A low level of certainty to honor the financial obligations, giving cause for concern
CCC	There are factors of uncertainty that the financial obligations will be honored, and there is a possibility of default.
CC	A high default risk
C	A very high default risk
LD	JCR judges that while an obligor does not honor part of the agreed to financial obligations, but it honors all its other agreed to financial obligations.
D	JCR judges that all the financial obligations are, in effect, in default.

A plus (+) or minus (–) sign may be affixed to the rating symbols from AA to B to indicate relative standing within each of those rating scales.

(a) A Long-term Issuer Rating Scale enables comparison of the overall capacity of an obligor (issuer) to honor its entire financial obligations with such overall capacity of others.

(b) The same Definitions of Rating Symbols and Scales shall be applied to the Ability to Pay Insurance Claims Rating.

(3) Long-term Issue Rating Scale

AAA	The highest level of certainty of an obligor to honor its financial obligations
AA	A very high level of certainty to honor the financial obligations
A	A high level of certainty to honor the financial obligations
BBB	An adequate level of certainty to honor the financial obligations. However, this certainty is more likely to diminish in the future than with the higher rating categories.

BB	Although the level of certainty to honor the financial obligations is not currently considered problematic, this certainty may not persist in the future.
B	A low level of certainty to honor the financial obligations, giving cause for concern
CCC	There are factors of uncertainty that the financial obligations will be honored, and there is a possibility of default.
CC	A high default risk
C	A very high default risk
D	JCR judges that the obligation is in default.

A plus (+) or minus (–) sign may be affixed to the rating symbols from AA to B to indicate relative standing within each of those rating scales.

(a) A Long-term Issue Rating Scale enables comparison of certainty that the obligations of more than a year will be honored.

(b) In light of attempting to call investors' attention to this matter, JCR may make notch differences between a Long-term Issue Rating and Long-term Issuer Rating when it considers there is a difference in terms of probabiltiy of recovery between the two as a result of assessing the degree of certainty that the obligation will be honored as agreed.

(c) A Long-term Issue Rating includes an issuer's specific obligations it owes such as bonds and issue programs (e.g., medium-term note program).

(d) The same Definitions of Rating Symbols and Scales shall be applied to ratings for hybrid securities such as preferred stock.

(4) Short-term Issuer Rating Scale

J-1	The highest level of certainty of an obligor to honor its short-term financial obligations. Within this rating category, obligations for which the certainty is particularly high are indicated by the symbol J-1+.
J-2	A high level of certainty to honor the short-term financial obligations, but slightly less than J-1
J-3	An adequate level of certainty of an obligor to honor its short-term financial obligations, but susceptible to adverse changes in circumstances
NJ	The certainty of an obligor to honor its short-term financial obligations is less than in the upper-ranking categories.
LD	JCR judges that while an obligor does not honor part of the agreed to financial obligations, but it honors all its other agreed to financial obligations.
D	JCR judges that all the financial obligations are, in effect, in default.

(a) An Issuer Rating Scale enables comparison of the overall capacity of an obligor (issuer) to honor its entire financial obligations with

Notes

such overall capacity of others. A Short-term Issuer Rating reflects an issuer's overall capacity to honor its entire financial obligtions within a year.

(5) Short-term Issue Rating Scale

Notes

J-1	The highest level of certainty of an obligor to honor its short-term financial obligations. Within this rating category, obligations for which the certainty is particularly high are indicated by the symbol J-1+.
J-2	A high level of certainty to honor the short-term financial obligations, but slightly less than J-1.
J-3	An adequate level of certainty of an obligor to honor its short-term financial obligations, but susceptible to adverse changes in circumstances
NJ	The certainty of an obligor to honor its short-term financial obligations is less than in the upper-ranking categories.
D	JCR judges that the obligation is in default.

(a) A Short-term Issue Rating Scale enables comparison of degrees of certainty that the obligations of within a year will be honored.

(b) A Short-term Issue Rating includes an issuer's specific obligations it owes such as commercial paper programs (including electronic commercial paper).

3. Types of Credit Ratings and Definitions of Rating Symbols for Structured Finance Products, etc.

All the aforementioned Types of Credit Ratings and Definitions of Rating Symbols shall be applied to ratings for Structured Finance Products, etc. For ratings on Investment Corporations, etc., both Issuer Rating and Issue Rating shall be applied.

4. Preliminary Rating: A preliminary rating is a credit rating assigned as a preliminary evaluation while material terms for issue to be rated are not yet finalized. When the issuing terms are finalized, JCR will confirm them and will assign a credit rating anew.

The credit rating determined in this way is sometimes called a final rating. The rating level of the final rating may be different from that of the preliminary rating, depending on the final content of the terms, etc.

5. Unsolicited Credit Rating ("p" Rating): An unsolicited credit rating is a credit rating assigned without solicitation by an obligor (issuer). JCR will assign an unsolicited credit rating with the consent of an issuer and, when assigned, JCR shall publicize the unsolicited credit rating without delay.

In this case, JCR shall make it clear by affixing "p" to the rating symbol that the relevant credit rating is assigned without the solicitation by the issuer. Even for an unsolicited credit rating, JCR will assign the credit rating based on the same credit rating process, information and methodologies as those for a solicited credit rating, in principle.

Even in cases where it is impossible to conduct an interview with the issuer or where only partial undisclosed information will be available or none of such information will be obtainable, JCR may assign an unsolicited credit rating when JCR can ensure the quality of the information used for the unsolicited credit rating. For a credit rating for a sovereign, in some cases, JCR may assign a rating without the consent of the applicable nation. Further, JCR will publicize a sovereign credit rating without affixing "p" to the rating symbol even if it is an unsolicited sovereign credit rating, however, JCR shall indicate in its press release that the relevant credit rating is the unsolicited credit rating.

6. Rating Outlook: A Rating Outlook is JCR's opinion regarding the likely direction of an issuer rating or an ability to pay insurance claims rating in one or two years after determination of the rating. A Rating Outlook falls into the following five categories: Positive, Stable, Negative, Developing, or Multiple.

Positive means that a rating may be raised, while Negative means it may be lowered. Stable means that a rating is not likely to change in the foreseeable future. In a few instances, Developing or Multiple Outlook is assigned. Developing means that a credit rating may be upgraded or downgraded. Multiple means that an issuer has multiple outlooks for its ratings when it is highly likely that a credit rating on individual bonds, bank loans, an issuer rating, etc. will be revised with different directions of rating.

Even in cases where a rating outlook is Positive, Negative, Developing, or Multiple for a credit rating, it does not mean that the credit rating will necessarily be changed and, in the same way, even in cases where a rating outlook is Stable, the credit rating may be changed without changing the outlook in advance.

7. Credit Monitor: While there is a likelihood of a change in the credit rating, because a serious event occurs or is likely to occur such as a serious accident, proposed merger, lawsuit, administrative action, substantial change in business performance or capital enhancement, and when JCR deems it necessary to obtain additional information or make an additional analysis with respect to the event for determination of the credit rating, JCR will at any time place the credit rating under Credit Monitor, initiate a review procedure for the rating and will make an public announcement to that effect.

A credit rating under Credit Monitor is identified by prefixing "#" to the rating symbol until its removal. JCR designates directions to the Credit Monitor placed on all credit ratings, which indicates its opinion regarding the likely direction of the rating.

A direction falls under three categories: Positive, Negative, or Developing. Positive means that a rating may be upgraded, while Negative means it may be downgraded. Developing means that a rating may be upgraded or downgraded. Credit Monitor will be removed usually when JCR obtains the necessary information and completes the analysis about the event. The time to be spent before removing Credit Monitor is usually relatively short. However, in cases where JCR deems it important to confirm that certain conditions must be satisfied

such as the case of approval for a merger by shareholders or the regulatory authority, then the time to the removal of Credit Monitor may become prolonged. A credit rating under Credit Monitor does not mean that the credit rating will necessarily be changed in the future. In the same way, a credit rating may be changed without being placed under Credit Monitor in advance.

Notes

8. Suspension and Withdrawal of Credit Rating: JCR may suspend a credit rating if JCR deems that it is temporarily difficult or impossible to review the credit rating when a significant change occurs to the objective circumstances such as a situation where it becomes difficult or impossible to obtain the necessary information to review the credit rating.

Suspension is a temporary measure, and if the event that caused Suspension is unlikely to be resolved, the credit rating will be withdrawn. A credit rating will be withdrawn if JCR deems that it will be impossible to conduct a rating review into the future, because a significant change occurs to the objective circumstances such as lack of obligor (issuer) cooperation for provision of information.

A credit rating may also be withdrawn if JCR deems that it is no longer necessary to sustain the credit rating due to bankruptcy procedures involving the issuer or other circumstances, or in the event that the need arises in order to comply with laws and ordinances,or in the event that unavoidable circumstances occur in order to conduct business. A credit rating will be withdrawn when JCR receives a request from the person who solicited the rating to withdraw the rating and accepts the request.

When any securities or money market instruments to be rated extinct due to reasons such as redemption at maturity, early redemption, withdrawal of shelf registration, or change from preliminary rating to final rating, such ratings shall cease to exist without the need to be withdrawn.

Credit Rating Agencies in India

Credit Rating Agencies (CRA) assess creditworthiness of organisation and different entities. In simple words, these agencies analyse a debtor's ability to repay the debt and also rate their credit risk.

All the credit rating agencies in India are regulated by SEBI (Credit Rating Agencies) Regulations, 1999 of the Securities and Exchange Board of India Act, 1992. There are a total of six credit agencies in India viz, CRISIL, CARE, ICRA, SMREA, Brickwork Rating, and India Rating and Research Pvt. Ltd.

How Credit Rating Agencies Work

Credit rating agencies assign ratings to an organization or an entity. The entities that are rated by credit rating agencies comprise companies, state governments, non-profit organisations, countries, securities, special purpose entities, and local governmental bodies. Credit rating agencies take into consideration several factors like the financial statements, level and type of debt, lending and borrowing history, ability to repay the debt, and the past debts of the entity before rating their credit. Once a credit rating agency rates the

entities, it provides additional inputs to the investor following which the investor analyses and takes a sound investment decision. Poor credit rating indicates that the entity is at a high risk of defaulting. The credit ratings that are given to the entities serve as a benchmark for financial market regulations. Credit ratings are published by agencies like Moody's Investors Service and Standard and Poor's (S&P) based on detailed analysis.

Notes

Some of the Top Credit Rating Agencies in India are:

1. Credit Rating Information Services of India Limited (CRISIL): CRISIL is one of the oldest credit rating agencies in India. It was launched in the country in 1987 following which the company went public in 1993. Headquartered in Mumbai, CRISIL ventured into infrastructure rating in 2016 and completed 30 years in 2017.

CRISIL acquired 8.9% stake in CARE credit rating agency in 2017. It launched India's first index to benchmark performance of investments of foreign portfolio investors (FPI) in the fixed-income market, in the rupee as well as dollar version in 2018. The company's portfolio includes, mutual funds ranking, Unit Linked Insurance Plans (ULIP) rankings, CRISIL coalition index and so on.

2. ICRA Limited: ICRA Limited is a public limited company that was set up in 1991 in Gurugram. The company was formerly known as Investment Information and Credit Rating Agency of India Limited. Before going public in April 2007, ICRA was a joint venture between Moody's and several Indian financial and banking service organisations.

The ICRA Group currently has four subsidiaries - Consulting and Analytics, Data Services and KPO, ICRA Lanka and ICRA Nepal. At present, Moody's Investors Service, the international Credit Rating Agency, is ICRA's largest shareholder. ICRA's product portfolio includes rating for - corporate debt, financial rating, structured finance, infrastructure, insurance, mutual funds, project and public finance, SME, market linked debentures and so on.

3. Credit Analysis and Research limited (CARE): Launched in 1993, CARE offers credit rating services to areas such as corporate governance, debt ratings, financial sector, bank loan ratings, issuer ratings, recovery ratings, and infrastructure ratings. Headquartered in Mumbai, CARE offers two different categories of bank loan ratings, long-term and short-term debt instruments.

The company also offers ratings for Initial Public Offerings (IPOs), real estate, renewable energy service companies (RESCO), financial assessment of shipyards, Energy service companies (ESCO) grades various courses of educational institutions.

CARE Ratings has also ventured into valuation services and offers valuation of equity, debt instruments, and market linked debentures. Moreover, the company has launched a new international credit rating agency 'ARC Ratings' by teaming up with four partners from South Africa Brazil, Portugal, and Malaysia..

ARC Ratings has commenced operations and completed sovereign ratings of countries, including India.

4. Brickwork Ratings (BWR): Brickwork Rating was established in 2007 and is promoted by Canara Bank. It offers ratings for bank loans, SMEs, corporate governance rating, municipal corporation, capital market instrument, and financial institutions.

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It also grades NGOs, tourism, IPOs, real estate investments, hospitals, IREDA, educational institutions, MFI, and MNRE. Brickwork Ratings is recognised as external credit assessment agency (ECAI) by Reserve Bank of India (RBI) to carry out credit ratings in India.

5. India Rating and Research Pvt. Ltd.: India Ratings is a wholly-owned subsidiary of the Fitch Group. It offers credit ratings for insurance companies, banks, corporate issuers, project finance, financial institutions, finance and leasing companies, managed funds, and urban local bodies. In addition to SEBI, the company is recognised by the Reserve Bank of India and National Housing Bank.

6. Small and Medium Enterprises Rating Agency of India (SMERA): Established in 2005, SMERA is a joint initiative of SIDBI, Dun & Bradstreet India and leading banks in India. SMERA has joined hands with prominent institutions such as IIT Madras, The Bangladesh Rating Agency Limited, CAFRAL, CoinTribe, and SIES. Apart from its shareholder banks, SMERA has also entered into MoUs with over 30 Banks, Financial Institutions and Trade Associations of the country.

5.2.2 Advantage and Disadvantage of Credit Rating

Advantages of Credit Rating

Different benefits accrue from use of rated instruments to different class of investors or the company. These are explained as under:

A. Benefits to Investors

1. Safety of investments. Credit rating gives an idea in advance to the investors about the degree of financial strength of the issuer company. Based on rating he decides about the investment. Highly rated issues gives an assurance to the investors of safety of Investments and minimizes his risk.
2. Recognition of risk and returns. Credit rating symbols indicate both the returns expected and the risk attached to a particular issue. It becomes easier for the investor to understand the worth of the issuer company just by looking at the symbol because the issue is backed by the financial strength of the company.
3. Freedom of investment decisions. Investors need not seek advise from the stock brokers, merchant bankers or the portfolio managers before making investments. Investors today are free and independent to take investment decisions themselves. They base their decisions on

rating symbols attached to a particular security. Each rating symbol assigned to a particular investment suggests the creditworthiness of the investment and indicates the degree of risk involved in it.

4. Wider choice of investments. As it is mandatory to rate debt obligations for every issuer company, at any particular time, wide range of credit rated instruments are available for making investment. Depending upon his own ability to bear risk, the investor can make choice of the securities in which investment is to be made.
5. Dependable credibility of issuer. Absence of any link between the rater and rated firm ensures dependable credibility of issuer and attracts investors. As rating agency has no vested interest in issue to be rated, and has no business connections or links with the Board of Directors. In other words, it operates independent of the issuer company, the rating given by it is always accepted by the investors.
6. Easy understanding of investment proposals. Investors require no analytical knowledge on their part about the issuer company. Depending upon rating symbols assigned by the rating agencies they can proceed with decisions to make investment in any particular rated security of a company.
7. Relief from botheration to know company. Credit agencies relieve investors from botheration of knowing the details of the company, its history, nature of business, financial position, liquidity and profitability position, composition of management staff and Board of Directors etc. Credit rating by professional and specialised analysts reposes confidence in investors to rely upon the credit symbols for taking investment decisions.
8. Advantages of continuous monitoring. Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency downgrades or upgrades the rating symbols following the decline or improvement in the financial position respectively.

Notes

B. Benefits of Rating to the Company

A company who has got its credit instrument or security rated is benefited in the following ways.

1. Easy to raise resources. A company with highly rated instrument finds it easy to raise resources from the public. Even though investors in different sections of the society understand the degree of risk and uncertainty attached to a particular security but they still get attracted towards the highly rated instruments.
2. Reduced cost of borrowing. Investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return. A company can reduce the cost of borrowings by quoting lesser interest on those fixed deposits or debentures or bonds, which are highly rated.

Notes

3. Reduced cost of public issues. A company with highly rated instruments has to make least efforts in raising funds through public. It can reduce its expenditure on press and publicity. Rating facilitates best pricing and timing of issues.
4. Rating builds up image. Companies with highly rated instrument enjoy better goodwill and corporate image in the eyes of customers, shareholders, investors and creditors. Customers feel confident of the quality of goods manufactured, shareholders are sure of high returns, investors feel secured of their investments and creditors are assured of timely payments of interest and principal.
5. Rating facilitates growth. Rating motivates the promoters to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future. Moreover highly rated companies find it easy to raise funds from public through new issues or through credit from banks and FIS to finance their expansion activities.
6. Recognition to unknown companies. Credit rating provides recognition to relatively unknown companies going for public issues through wide investor base. While entering into market, investors rely more on the rating grades than on 'name recognition'.

C. Benefits to Intermediaries

Stock brokers have to make less efforts in persuading their clients to select an investment proposal of making investment in highly rated instruments. Thus rating enables brokers and other financial intermediaries to save time, energy costs and manpower in convincing their clients.

Advantages of Credit Ratings

Credit Rating can be simply defined as a data backed up opinion of rating agency which reflects the ability and willingness of the manager of debt instruments to fulfill its debt obligation when required. In simple terms, credit ratings rank the issuer and debt instruments on the basis of their ability to fulfill the debt obligation. Credit Ratings are usually expressed in alphabetic and alphanumeric symbols.

Credit Ratings help to differentiate and rank various debt instruments and their issuer on the basis of their underlying credit quality. Credit Ratings are

very useful in understanding the quality of instruments or ability of the company and assist in informed investment decisions. Investors usually use credit ratings to optimise their risk-return trade-off.

Credit Ratings are important for both the parties; investors and issuer companies. Investors can make informed decisions with the help of credit rating and the issuer company can also take advantage of credit ratings of its instruments. Some of the advantages of credit ratings are discussed as below.

Notes

Following are the advantages of credit rating:

1. Helps in Investment Decision
2. Freedom of Investment Decisions
3. Assurance of safety
4. Choice of Instruments
5. Dependency on Rating
6. Continuous Monitoring
7. Easy to Raise Fund
8. Good Corporate Image
9. Lower the Cost of Public Issue
10. Easy and Lowers Cost of Borrowing
11. Help Non-popular Companies
12. Rating Facilitates Growth

Benefits to the Investor

Following are the benefits of credit rating to the investor:

- Helps in Investment Decision
- Freedom of Investment Decisions
- Assurance of safety
- Choice of Instruments
- Dependency on Rating
- Continuous Monitoring

Helps in Investment Decision: Credit rating gives an idea of the creditworthiness of the issuing company and the risk associated with a particular security. Depending upon the credit rating investor can decide whether to invest in such company or not.

Freedom of Investment Decisions: For common people it is very difficult to take investment decisions. Before taking investment decisions they seek advice from the stock brokers, merchant bankers or portfolio managers. Credit rating service makes the task easy by attaching rating symbols to a particular security.

Rating symbol assigned to a particular instrument suggests the creditworthiness of the instrument and indicates the degree of risk involved in it.

Notes

Assurance of safety: A high rating assures the investor about the safety of the instrument. Companies having high ratings of their instruments maintain healthy financial discipline.

Choice of Instruments: By rating the securities, credit rating agencies enables an investor to select a particular instrument from many alternatives available.

Dependency on Rating: The ratings assigned to the instruments are authentic and reliable. The rating firms are independent of issuing company and have no business connection with. Hence, they give a fair rating to the instruments. This brings confidence among the investors.

Continuous Monitoring: Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency downgrades or upgrades the rating symbols depending upon performance and position of the company.

Following are the benefits of credit rating to the company:

Easy to Raise Fund: It become very easy for a company to raise fund from the market if the instruments issued by the company are highly rated. A high rating gives confidence to the investors. Many investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return.

Good Corporate Image: High credit rating of securities helps in improving the corporate image of a company. A high credit rating increases the level of confidence among the investors. This helps in creating a good corporate image of the company.

Lower the Cost of Public Issue: A company with highly rated instruments has to make least efforts in raising funds through public issue. A good credit rating gives good publicity to the company. Companies with highly rated instruments enjoy better goodwill and corporate image in the eyes of customers, shareholders, investors and creditors.

Investors feel secured of their investments and creditors are assured of timely payments of interest and principal.

Easy and Lowers Cost of Borrowing: A company with highly rated debt instruments has to make least efforts in raising funds from the market. A high rating indicates low risk. High rated instrument will enable the company to offer low rate of interest. The investors will accept low interest because of low risk involvement.

High credit rating gives the company wider spectators for borrowing. It can easily approach financial institutions, banks, investing companies, public etc. for borrowings.

Help Non-popular Companies: Good credit rating gives exposure to the company. If the instruments issued by a company get publicity, the company with low publicity gets popularity. It will now become easy for the company to raise fund from the market.

Rating Facilitates Growth: Rating motivates the management of the company to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future.

Disadvantages of Credit Rating

Credit rating suffers from the following limitations

1. Non-disclosure of significant information. Firm being rated may not provide significant or material information, which is likely to affect the investor's decision as to investment, to the investigation team of the credit rating company. Thus any decisions taken in the absence of such significant information may put investors at a loss.
2. Static study. Rating is a static study of present and past historic data of the company at one particular point of time. Number of factors including economic, political, environment, and government policies have direct bearing on the working of a company. Any changes after the assignment of rating symbols may defeat the very purpose of risk indicativeness of rating.
3. Rating is no certificate of soundness. Rating grades by the rating agencies are only an opinion about the capability of the company to meets its interest obligations. Rating symbols do not pinpoint towards quality of products or management or staff etc. In other words rating does not give a certificate of the complete soundness of the company. Users should form an independent view of the rating symbol.
4. Rating may be biased. Personal bias of the investigating team might affect the quality of the rating. The companies having lower grade rating do not advertise or use the rating while raising funds from the public. In such a case the investors cannot get the true information about the risk involved in the instrument.
5. Rating under unfavorable conditions. Rating grades are not always representative of the true image of a company. A company might be given low grade because it was passing through unfavorable conditions when rated. Thus, misleading conclusions may be drawn by the investors which hampers the company's interest.
6. Difference in rating grades. Same instrument may be rated differently by the two rating agencies because of the personal judgment of the investigating staff on qualitative aspects. This may further confuse the investors.

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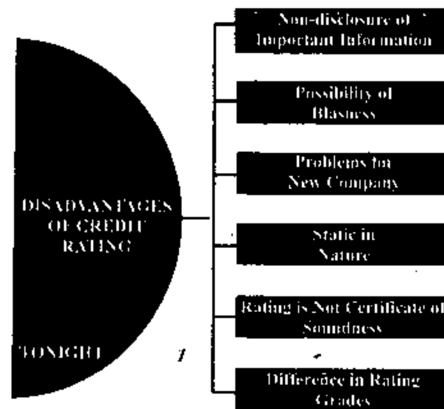


Main Disadvantages of Credit Rating

Disadvantages of Credit Rating are as follows:

(1) Biased rating and misrepresentations: In the absence of quality rating, credit rating is a curse for the capital market industry, carrying out detailed analysis of the company, should have no links with the company or the persons interested in the company so that the reports impartial and judicious recommendations for rating committee.

The companies having lower grade rating do not advertise or use the rating while raising funds from the public. In such cases the investor cannot get information about the riskness of instrument and hence is at loss.

(2) Static study: Rating is done on the present and the past historic data of the company and this is only a static study. Prediction of the company's health through rating is momentary and anything can happen after assignment of rating symbols to the company.

Dependence for future results on the rating, therefore defeats the very purpose of risk indicativeness of rating. Many changes take place in economic environment, political situation, government policy framework which directly affect the working of a company.

(3) Concealment of material information: Rating Company might conceal material information from the investigating team of the credit rating company. In such cases quality of rating suffers and renders the rating unreliable.

(4) Rating is no guarantee for soundness of company: Rating is done for a particular instrument to assess the credit risk but it should not be construed as a certificate for the matching quality of the company or its management. Independent views should be formed by the user public in general of the rating symbol.

(5) Human bias: Finding off the investigation team, at times, may suffer with human bias for unavoidable personal weakness of the staff and might affect the rating.

(6) Reflection of temporary adverse conditions: Time factor affects' rating, sometimes, misleading conclusions are derived. For example, company in a particular industry might be temporarily in adverse condition but it is given a low rating. This adversely affects the company's interest.

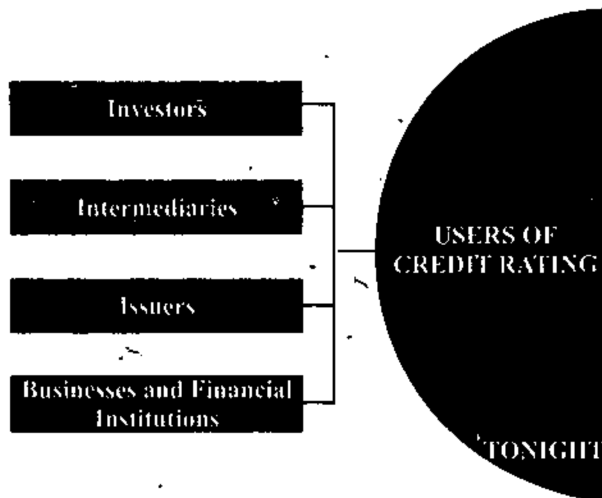
(7) Down grade: Once a company has been rated and if it is not able to maintain its working results and performance, credit rating agencies would review the grade and down grade the rating resulting into impairiring the image of the company.

(8) Difference in rating of two agencies: Rating done by the two different credit rating agencies for the same instrument of the same issuer company in many cases would not be identical. Such differences are likely to occur because of value judgement differences on qualitative aspects of the analysis in tow different agencies.

Users of Credit Rating

There are broadly four users of credit rating:

- Investors
- Intermediaries
- Issuers
- Businesses and Financial Institutions



Users of Credit Rating

Investors: Investors are the prime users of credit rating. They often use credit ratings to assess credit risk and to compare different issuers and debt issues when making investment decisions. Individual investors, for example, may use credit ratings in evaluating the purchase of a municipal or corporate bond from a risk tolerance perspective.

Institutional investors, including mutual funds, pension funds, banks, and insurance companies often use credit ratings to supplement their own credit analysis of specific debt issues.

Intermediaries: Intermediaries like Investment bankers help to facilitate the flow of capital from investors to issuers. They may use credit ratings to benchmark the relative credit risk of different debt issues, as well as to set the initial pricing for individual debt issues and to help determine the interest rate these issues will pay.

Intermediaries that structure special types of debt issues may look to a rating agency's criteria when making their own decisions about how to configure different debt issues, or different tiers of debt.

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Issuers: Issuers use credit ratings to provide independent views of their creditworthiness and the credit quality of their debt issues. Issuers may also use credit ratings to help communicate the relative credit quality of debt issues, thereby expanding the universe of investors. In addition, credit ratings may help them anticipate the interest rate to be offered on their new debt issues.

As a general rule, if creditworthiness is more the issuer need to pay lower interest rate to attract investors and issuer with lower creditworthiness will typically pay a higher interest rate to offset the greater credit risk assumed by investors.

Businesses and Financial Institutions: Businesses and financial institutions may use credit ratings to assess counterparty risk, which is the potential risk that a party to a credit agreement may not fulfill its obligations. For example, in deciding whether to lend money to a particular organization or in selecting a company that will guarantee the repayment of a debt issue in the event of default, a business may wish to consider the counterparty risk.

A credit rating agency's opinion of counterparty risk can therefore help businesses analyze their credit exposure to financial firms that have agreed to assume certain financial obligations and to evaluate the viability of potential partnerships and other business relationships.

5.2.3 Credit Rating Agencies and Their Methology

Credit Rating Agencies

Credit Rating Agencies (CRA) assess creditworthiness of organisation and different entities. In simple words, these agencies analyse a debtor's ability to repay the debt and also rate their credit risk. All the credit rating agencies in India are regulated by SEBI (Credit Rating Agencies) Regulations, 1999 of the Securities and Exchange Board of India Act, 1992. There are a total of seven credit agencies in India viz, CRISIL, CARE, ICRA, SMREA, Brickwork Rating, India Rating and Research Pvt. Ltd and Infomerics Valuation and Rating Private Limited.

How Credit Rating Agencies Work

Credit rating agencies assign ratings to an organization or an entity. The entities that are rated by credit rating agencies comprise companies, state governments, non-profit organisations, countries, securities, special purpose entities, and local governmental bodies. Credit rating agencies take into consideration several factors like the financial statements, level and type of debt, lending and borrowing history, ability to repay the debt, and the past debts of the entity before rating their credit.

Once a credit rating agency rates the entities, it provides additional inputs to the investor following which the investor analyses and takes a sound

investment decision. Poor credit rating indicates that the entity is at a high risk of defaulting. The credit ratings that are given to the entities serve as a benchmark for financial market regulations. Credit ratings are published by agencies like Moody's Investors Service and Standard and Poor's (S&P) based on detailed analysis.

Some of the Top Credit Rating Agencies in India are:

1. Credit Rating Information Services of India Limited (CRISIL): CRISIL is one of the oldest credit rating agencies in India. It was launched in the country in 1987 following which the company went public in 1993. Headquartered in Mumbai, CRISIL ventured into infrastructure rating in 2016 and completed 30 years in 2017. CRISIL acquired 8.9% stake in CARE credit rating agency in 2017. It launched India's first index to benchmark performance of investments of foreign portfolio investors (FPI) in the fixed-income market, in the rupee as well as dollar version in 2018. The company's portfolio includes, mutual funds ranking, Unit Linked Insurance Plans (ULIP) rankings, CRISIL coalition index and so on.

2. ICRA Limited: ICRA Limited is a public limited company that was set up in 1991 in Gurugram. The company was formerly known as Investment Information and Credit Rating Agency of India Limited. Before going public in April 2007, ICRA was a joint venture between Moody's and several Indian financial and banking service organisations. The ICRA Group currently has four subsidiaries - Consulting and Analytics, Data Services and KPO, ICRA Lanka and ICRA Nepal. At present, Moody's Investors Service, the international Credit Rating Agency, is ICRA's largest shareholder. ICRA's product portfolio includes rating for - corporate debt, financial rating, structured finance, infrastructure, insurance, mutual funds, project and public finance, SME, market linked debentures and so on.

3. Credit Analysis and Research limited (CARE): Launched in 1993, CARE offers credit rating services to areas such as corporate governance, debt ratings, financial sector, bank loan ratings, issuer ratings, recovery ratings, and infrastructure ratings. Headquartered in Mumbai, CARE offers two different categories of bank loan ratings, long-term and short-term debt instruments. The company also offers ratings for Initial Public Offerings (IPOs), real estate, renewable energy service companies (RESCO), financial assessment of shipyards, Energy service companies (ESCO) grades various courses of educational institutions. CARE Ratings has also ventured into valuation services and offers valuation of equity, debt instruments, and market linked debentures. Moreover, the company has launched a new international credit rating agency 'ARC Ratings' by teaming up with four partners from South Africa Brazil, Portugal, and Malaysia. ARC Ratings has commenced operations and completed sovereign ratings of countries, including India.

4. Brickwork Ratings (BWR): Brickwork Rating was established in 2007 and is promoted by Canara Bank. It offers ratings for bank loans, SMEs,

corporate governance rating, municipal corporation, capital market instrument, and financial institutions. It also grades NGOs, tourism, IPOs, real estate investments, hospitals, IREDA, educational institutions, MFI, and MNRE. Brickwork Ratings is recognised as external credit assessment agency (ECAI) by Reserve Bank of India (RBI) to carry out credit ratings in India.

Notes

5. India Rating and Research Pvt. Ltd.: India Ratings is a wholly-owned subsidiary of the Fitch Group. It offers credit ratings for insurance companies, banks, corporate issuers, project finance, financial institutions, finance and leasing companies, managed funds, and urban local bodies. In addition to SEBI, the company is recognised by the Reserve Bank of India and National Housing Bank.

6. Acuite Ratings & Research Limited: Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 8,300 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and section of industries. It has its Registered and Head Office in BKC, Mumbai.

7. Infomerics Valuation and Rating Private Limited: An RBI-accredited and SEBI-registered credit agency, Infomerics Valuation and Rating Private Limited saw its inception by eminent finance professionals and is now run under the leadership of Mr. Vipin Mallik. The credit bureau strives to offer an unbiased and detailed analysis and evaluation of credit worthiness to NBFCs, banks, corporates and small and medium scale units. It is through their rating and grading system that they determine the credit worthiness of an organisation. Infomerics helps in reducing any kind of information asymmetry amongst investors and lenders. Keeping transparency as it is core value, the credit bureau makes sure to deliver comprehensive and accurate reports and records of all their clients.

A Brief History of Credit Rating Agencies

Credit ratings provide retail and institutional investors with information that assists them in determining whether issuers of bonds and other debt instruments and fixed-income securities will be able to meet their obligations.

When they issue letter grades, credit rating agencies (CRAs) provide objective analyses and independent assessments of companies and countries that issue such securities. Here is a basic history of how the ratings and the agencies developed in the U.S. and grew to aid investors all over the globe.

An Overview of Credit Ratings

Countries are issued sovereign credit ratings. This rating analyzes the general creditworthiness of a country or foreign government. Sovereign credit ratings take the overall economic conditions of a country into account, including the volume of foreign, public and private investment, capital market transparency,

and foreign currency reserves. Sovereign ratings also assess political conditions such as overall political stability and the level of economic stability a country will maintain during times of political transition.

Notes

Institutional investors rely on sovereign ratings to qualify and quantify the general investment atmosphere of a particular country. The sovereign rating is often the prerequisite information institutional investors use to determine if they will further consider specific companies, industries, and classes of securities issued in a specific country.

Credit ratings, debt ratings, or bond ratings are issued to individual companies and to specific classes of individual securities such as preferred stock, corporate bonds, and various classes of government bonds. Ratings can be assigned separately to both short-term and long-term obligations.

Long-term ratings analyze and assess a company's ability to meet its responsibilities with respect to all of its securities issued. Short-term ratings focus on the specific securities' ability to perform given the company's current financial condition and general industry performance conditions.

The Big Three Agencies

The global credit rating industry is highly concentrated, with three agencies—Moody's, Standard & Poor's, and Fitch—controlling nearly the entire market.Together, the provide a much-needed service for both borrowers and lenders, as well as to lenders. They intend to give the market information that is both reliable and accurate about the risks associated with certain kinds of debt.

Fitch Ratings

Fitch is one of the world's top three credit rating agencies. It operates in New York and London, basing ratings on company debt and its sensitivity to changes like interest rates. When it comes to sovereign debt, countries request Fitch—and other agencies—to provide an evaluation of their financial situation along with the political and economic climates.

Investment grade ratings from Fitch range from AAA to BBB. These letter grades indicate no to low potential for default on debt. Non-investment grade ratings go from BB to D, the latter meaning the debtor has defaulted.

History: John Knowles Fitch founded the Fitch Publishing Company in 1913, providing financial statistics for use in the investment industry via "The Fitch Stock and Bond Manual" and "The Fitch Bond Book." In 1923, Fitch introduced the AAA through D rating system that has become the basis for ratings throughout the industry.With plans to become a full-service global rating agency, in the late 1990s Fitch merged with IBCA of London, subsidiary of Fimalac, a French holding company.

Fitch also acquired market competitors Thomson Bank Watch and Duff & Phelps Credit Ratings. Fitch began to develop operating subsidiaries specializing in enterprise risk management, data services, and finance-industry training

starting in 2005 with the acquisition of a Canadian company, Algorithmics, and the creation of Fitch Solutions and Fitch Training.

Moody's Investors Service

Moody's assigns countries and company debt letter grades, but in a slightly different way. Investment grade debt goes from Aaa—the highest grade that can be assigned—to Baa3, which indicates that the debtor is able to pay back short-term debt. Below investment grade is speculative grade debt, which are often referred to as high-yield or junk. These grades range from Ba1 to C, with the likelihood of repayment dropping as the letter grade goes down.

History: John Moody and Company first published "Moody's Manual" in 1900. The manual published basic statistics and general information about stocks and bonds of various industries. From 1903 until the stock market crash of 1907, "Moody's Manual" was a national publication.

In 1909, Moody began publishing "Moody's Analyses of Railroad Investments," which added analytical information about the value of securities. Expanding this idea led to the 1914 creation of Moody›s Investors Service, which, in the following 10 years, would provide ratings for nearly all of the government bond markets at the time. By the 1970s Moody's began rating commercial paper and bank deposits, becoming the full-scale rating agency it is today.

Standard & Poor's

S&P has a total of 17 ratings it can assign to corporate and sovereign debt. Anything rated AAA to BBB- is considered investment grade, meaning it has the ability to repay debt with no concern. Debt rated BB+ to D is considered speculative, with an uncertain future. The lower the rating, the more potential it has to default, with a D-rating being the worst.

History: Henry Varnum Poor first published the "History of Railroads and Canals in the United States" in 1860, the forerunner of securities analysis and reporting that would be developed over the next century. Standard Statistics formed in 1906, which published corporate bond, sovereign debt, and municipal bond ratings. Standard Statistics merged with Poor's Publishing in 1941 to form Standard and Poor's Corporation, which was acquired by The McGraw-Hill Companies in 1966.

Standard and Poor's has become best known by indexes such as the S&P 500, a stock market index that is both a tool for investor analysis and decision-making, and a U.S. economic indicator.

Nationally Recognized Statistical Rating Organizations

The credit ratings industry began to adopt some important changes and innovations in 1970. Investors subscribed to publications from each of the ratings agencies and issuers paid no fees for performance of research and analyses that were a normal part of the development of published credit ratings.

Notes

As an industry, credit ratings agencies began to recognize that objective credit ratings significantly helped issuers: They facilitated access to capital by increasing a securities issuer›s value in the marketplace and decreasing the costs of obtaining capital. Expansion and complexity in the capital markets coupled with an increasing demand for statistical and analytical services led to the industry-wide decision to charge issuers of securities fees for ratings services.

In 1975, financial institutions such as commercial banks and securities broker-dealers sought to soften the capital and liquidity requirements passed down by the Securities and Exchange Commission (SEC). As a result, nationally recognized statistical ratings organizations (NRSROs) were created. Financial institutions could satisfy their capital requirements by investing in securities that received favorable ratings by one or more of the NRSROs.

This allowance is the result of registration requirements coupled with greater regulation and oversight of the credit ratings industry by the SEC. The increased demand for ratings services by investors and securities issuers, combined with increased regulatory oversight, has led to growth and expansion in the credit ratings industry.

Regulation and Legislation: Since large CRAs operate on an international scale, regulation occurs at several different levels. Congress passed the Credit Rating Agency Reform Act of 2006, allowing the SEC to regulate the internal processes, record-keeping, and certain business practices of CRAs. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, commonly referred to as Dodd-Frank, further grew the regulatory powers of the SEC including the requirement of a disclosure of credit rating methodologies.

Credit rating agencies are regulated at several different levels.

The European Union (EU) has never produced a specific or systematic legislation or created a singular agency responsible for the regulation of CRAs. There are several EU directives, such as the Capital Requirements Directive of 2006, that affect rating agencies, their business practices and their disclosure requirements. Most directives and regulations are the responsibility of the European Securities and Markets Authority.

The Financial Crisis: Credit rating agencies came under heavy scrutiny and regulatory pressure following the financial crisis and Great Recession of 2007 to 2009. It was believed that CRAs provided ratings that were too positive, leading to bad investments. Part of the problem was that despite the risk, the agencies continued to give mortgage-backed securities (MBSs) AAA-ratings.

These ratings led many investors to believe that these investments were very safe with little to no risk.The agencies were accused of trying to raise profits as well as their market share in exchange for these inaccurate ratings. This helped lead to the subprime mortgage market collapse that led to the financial crisis.

To add fuel to the fire, the agencies' European sovereign debt ratings were also cause for scrutiny. After the calamity caused by the debt crisis of several European countries including Greece and Portugal, the agencies downgraded the ratings of other nations in the EU.

Notes

Some have argued that regulators have helped to prop up an oligopoly in the credit rating industry, providing rules that act as barriers to entry for small- or mid-sized agencies. New rules in the EU have made CRAs liable for improper or negligent ratings that cause damage to an investor.

Investors may utilize information from a single agency or from multiple rating agencies. Investors expect credit rating agencies to provide objective information based on sound analytical methods and accurate statistical measurements. Investors also expect issuers of securities to comply with rules and regulations set forth by governing bodies, in the same respect that credit rating agencies comply with reporting procedures developed by securities industry governing agencies.

The analyses and assessments provided by various credit rating agencies provide investors with information and insight that facilitates their ability to examine and understand the risks and opportunities associated with various investment environments. With this insight, investors can make informed decisions as to the countries, industries, and classes of securities in which they choose to invest.

Methodology of Credit Rating

The process of credit rating begins with the prospective issuer approaching the rating agency for evaluation. The experts in analyzing banks should be given a free hand and they will collect data and informant and will investigate the business strength and weaknesses in detail. The entire process of rating stands on the for of confidentiality and hence even the most confidential business strategies, marketing plans, future outlook etc., are revealed to the steam of analysis.

The rating is based on the investigation analysis, study and interpretation of various factors. The world of investment is exposed to the continuous onslaught of political, economic, social and other forces which does not permit any one to understand sufficiently certainty. Hence a logical approach to systematic evaluation is compulsory and within the framework of certain common features the agencies employ different methodologies. The key factors generally considered are listed below:

1. Business Analysis or Company Analysis: This includes an analysis of industry risk, market position of the company, operating efficiency of the company and legal position of the company.

- **Industry risk:** Nature and basis of competition, key success factors; demand supply position; structure of industry; government policies, etc.
- **Market position of the company within the Industry:** Market share; competitive advantages, selling and distribution arrangements; product and customer diversity etc.
- **Operating efficiency of the company:** Locational advantages; labor relationships; cost structure and manufacturing as compared to those of competition.

- **Legal Position:** Terms of prospectus; trustees and then responsibilities; system for timely payment and for protection against forgery/fraud, etc.

2. Economic Analysis: In order to evaluate an instrument an analyst must spend a considerable time in investigating the various economic activities and also analyze the characteristics peculiar to the industry, whose issue the analyst is concerned with. It will be an error to ignore these factors as the individual companies are always exposed to changing environment and the economic activates affect corporate profits, attitudes and expectation of investors and the price of the instrument. hence the relevance of the economic variables such as growth rate, national income and expenditure cannot be ignored. The analysis, while doing the economic forecasting use surveys, various economic indicators and indices.

Notes

3. Financial Analysis: This includes an analysis of accounting, quality, earnings, protection adequacy of cash flows and financial flexibility.

- **Accounting Quality:** Overstatement/under statement of profits; auditors qualification; methods of income recognition's inventory valuation and depreciation policies, off balance sheet liabilities etc.
- **Earnings Protection:** Sources of future earnings growth; profitability ratios; earnings in relation to fixed income changes.
- **Adequacy of cash flows:** In relation to dept and fixed and working capital needs; variability of future cash flows; capital spending flexibility working capital management etc.
- **Financial Flexibility:** Alternative financing plans in ties of stress; ability to raise funds asset redeployment.

4. Management Evaluation:

- Track record of the management planning and control system, depth of managerial talent, succession plans.
- Evaluation of capacity to overcome adverse situations
- Goals, philosophy and strategies.

5. Geographical Analysis:

- Location advantages and disadvantages
- Backward area benefit to the company/division/unit

6. Fundamental Analysis: Fundamental analysis is essential for the assessment of finance companies. This includes an analysis of liquidity management, profitability and financial position and interest and tax sensitivity of the company.

- **Liquidity Management:** Capital structure; term matching of assets and liabilities policy and liquid assets in relation to financing commitments and maturing deposits.
- **Asset Quality:** Quality of the company's credit-risk management; system for monitoring credit; sector risk; exposure to individual borrower; management of problem credits etc.

- **Profitability and financial position:** Historic profits, spread on fund deployment revenue on non-fund based services accretion to reserves etc.
- **Interest and Tax sensitivity:** Exposure to interest rate changes, hedge against interest rate and tax low changes, etc.

Country's Credit Rating

Country's credit rating denotes its ability to source debt from the international market at a reasonable cost. Low rated nations will have discounts, offer high yield and are treated as risky investment. Risk relates to default. Country's credit rating involves evaluation of external financial accounts and macro economic factors and is directed towards future trends. Credit rating of any country involves evaluation of:

- **Economic growth and development:** Gross national product and gross domestic product, population growth, Infrastructure development, good financial management, saving growth rate, industrial production, agricultural production, growth of services sector etc.
- **Balance of trade and balance of payments:** Export products, export prices, diversification of products and export market, global competition, import substitution, etc.
- **Debt service ratio:** This indicates the country's external vulnerability. This is a ratio of external debt to total external earnings including export earning and earning from tourism, etc.
- **Debt composition:** Soft loans, commercial borrowings, interest rate structure, proportion of external debt.
- **Liquidity:** Level of reserves, foreign exchange reserves, import coverage ratio, currency backed by assets such as gold.
- **Political and internal stability:** Socio-religious conflicts, majority government strong opposition, unequal economic distribution, relations with neighboring countries, political factors are not predictable and is prone to unexpected events.
- **Inflation and price stability.**

Political challenges, economic transformation and policy consensus, fiscal imbalances and imposing public sector debt burdens are all factors which enhance or inhibit the credit rating of a country while political and economic forces are clearly a key determination of sovereign credit risk in emerging market countries, the financial pressures due to fiscal indiscipline pose threat to liquidity problems and default. Fiscal control is the key indicator of improving or deteriorating credit quality.

Drawbacks of Credit Rating

Following are some of the drawbacks of credit rating:

- The ratings process attempts to provide a guidance to investors/creditors in determining the risks associated with the instrument/credit

obligation. It does not attempt to provide a recommendation and does not take into account factors like market prices, personal risk/reward preferences that might influence investment decisions.

- The ratings process is based on certain primitives. The agency, for instance, does not perform an audit. Instead, it has to rely solely on information provided by the user. Consequently, to the extent that the information provided is inaccurate and incomplete, the rating process is compromised.
- To the extent that a certain instrument of a specific company attracts a lower rating, the company has an incentive to shop around for the best possible rating, compromising the authenticity of the rating process itself.

Notes

Credit Rating Agencies in India

The concept of credit rating has been widely discussed and debated in India in recent times. Since the setting up of the first credit rating agency. Credit Rating and Information Services of India Ltd. (CRISIL) in India in 1987, there has been a rapid growth of credit rating agencies in India. The major players in the Indian market, apart from CRISIL include Investment Information and Credit Rating agency of India Ltd. (ICRA), promoted by IDBI in 1991 and Credit Analysis and Research Ltd. (CARE), promoted by IFCI in 1994. Duff and Phelps has tied up with two Indian NBFCs to set up Duff and Phelps Credit Rating India (P) Limited in 1996.

Major International Credit Rating Agencies

As capital flows have become increasingly global and turbulence in one economy has had contagion effects across the globe, credit ratings have spread outside the domain of the home country to overseas markets. Credit ratings are in use in the financial markets of most developed economies and several emerging market economies as well. The principal characteristics of the major internationally known rating agencies are as follows:

Name of the agency	Home country	Ownership	Principle
Moody's Investors Service	U.S.A	Dun and Bradstreet	Full Service
Fitch Investors Service	U.S.A	Independent	Full Service
Standard and Poor's Corporation	U.S.A	Mcgraw Hill	Full Service
Canadian Bond Rating Service	Canada	Independent	Full Service (Canada)
Thomson Bank Rating	U.S.A	Thomson Company	Financial Institutions
Japan Bond Rating Institute	Japan	Japan Electronic Journal	Full Service (Japan)

Duff and Phelps Credit Rating	U.S.A	Duff and Phelps Corporation	Full Service
IBCA Ltd.	United Kingdom	Independent	Financial Institutions

Notes

Over time, the agencies have expanded the depth and frequency of their coverage. The leading U.S. credit rating agencies rate not ply the long-term bonds issued by corporate in the U.S., but also wide variety of other debt instruments including, for example, municipal bonds, asset-backed securities, private placements, commercial paper programmes and bank certificates of deposit (CDs). In addition, the leading rating agencies also play a major role in evaluating sovereign ratings.

Most of the rating agencies have long had their own symbols. Some of them use alphabets; others use numbers; many use a combination of both for ranking the risk of default. The default risk varies from extremely safe to highly speculative. Gradually, major agencies has emerged to provide finer rating gradations to help investors distinguish more carefully among issuers. Standard & Poor Corporation in 1974 and Moody's in 1982 started attaching plus and minus symbols to their ratings. Other modifications of the grading scheme-including the addition of a 'credit watch' category to denote that a rating is under review-have also become standard.

5.2.4 International Credit Rating Practices

Credit rating agencies play an indispensable role in the financial system. They are instrumental to the growth of the financial markets, as credit ratings are used in financial instruments for the issuer to borrow capital funds. In the United States, they are deeply embedded in many of the legislative, regulatory and supervisory policies which rely on credit ratings for the securities held by financial institutions and for issuers' ratings. Thus, when downgrades in the credit ratings of some financial instruments and large issuers will occur, it can destabilize and create spillover effects in the financial markets due to the markets' reaction through the divestment of their funds from the said security .

For one, the Enron and WorldCom collapse in 2001-2002 created triggers among legislators and regulators as it had shaken the financial market in the United States. The credit rating agencies were blamed for their failure to detect the problem and to warn the public of the two companies' questionable financial and accounting practices until a few days before they declared bankruptcy. Many market participants believe that oversight must have been exercised and should always be one of the primary responsibilities of the credit rating agencies mentioned that GCRAs have been instrumental to the global financial crisis arising from the fall of the US subprime market in 2007.

This resulted from the increasing level of defaults in subprime financial instruments which were embedded in many structured finance products. The

subsequent downgrades on large number of these structured products that were backed by subprime mortgages have heavily jeopardized the financial market activities.

Global Credit Rating Agencies (GCRAs) weaknesses were also highlighted in the bailout of Bear Stearns and the fall of AIG and Lehman Brothers in 2008. Many believe that some of their credit ratings led investors to take considerable risks. Concerns about potential chain reactions of these defaults have intensified after the crisis, as many investors incurred substantial losses while others begun to change benchmarks for their asset portfolio holdings.

Notes

Servicing the escalating debt levels coupled with deteriorating profitability, made companies vulnerable to risks and losses in the face of protracted downturn in corporate and financial activities. Major disruptions in the financial system were also evident, as massive losses were incurred by few large financial institutions whose long-term investments were placed on these below-investment grade financial instruments.

The intensifying liquidity and solvency problems among large banks led to the great financial debacle and systemic shocks. This problem had escalated into a full-blown crisis which caused major disruptions not only in the US financial system but in the global financial systems. In the Global Financial Stability report, it was indicated that in 2007 and 2008, many large "mature financial institutions" were given financial assistance in the form of capital injection via sovereign wealth funds (SWFs). This move had provided them ample yet short-term capital buffers.

However, it prompted these FIs to reduce their asset holdings (investments) in order to preserve their capital funds explained that despite GCRAs' claim that the credit ratings they provide are merely opinion and are based on the quality of information supplied by the issuers, they should still be more stable and not just "point-intime" ratings Against this backdrop, this research will provide comprehensive discussions on the dynamics of the credit rating industry such as their roles and functions, the issues related to independence, data quality and integrity of the rating process, transparency/disclosure, the business/economic models used by CRAs and the industry's market structure and regulation.

Roles and Functions of Credit Rating Agencies

Despite several criticisms, CRAs have been instrumental to the growth of the global financial markets. As one of the indirect market players in the financial system, credit rating agencies play a vital role in the global financial markets, especially during the early 1990s when its development had heightened at an increasing pace. The increased importance of this sector is remarkable especially when viewed in the context of globalization.

A. They help in the provision of information on the issuer's creditworthiness.

Credit rating agencies provide unbiased and systematic evaluation of the creditworthiness of the issuer through rigorous assessment of various financial

statements and other financial and operational data which are used in the credit risk metrics . They are trusted by various market participants, given that, the ratings that they provide are viewed to be credible. They are capable of identifying and anticipating the risk that may not be seen and undertaken by the lenders who wish to extend credit to the issuer.

Notes

While internal risk assessment can be undertaken by financial institutions, the type and depth of scrutiny that are made by the CRAs are more advanced and comprehensive compared to these institutions. However, this does not discount the capabilities of many financial institutions for managing enterprise-wide risks. Understandably, the investments made by rating agencies in financial and human resources to build its resources are crucial. Credit and other financial information about the issuer is made available to the users of these credit ratings for free or at lower costs. For a typical investor, undertaking his own risk assessment is not an efficient move.

B. Credit Ratings issued by CRAs are used as benchmarks by market participants.

Instead of just an opinion or source of information about the credit risk faced by an issuer or a financial issue, market participants look at credit ratings as benchmarks for decision making processes. Like other lenders, such as banks, assessment goes beyond mere credit risk to come up with a better analytical perspective about the company in the assignment of a credit rating. The non-credit risks are described by as the transactions that are linked with the company's liability structure, other risks associated with a pool of assets that can affect payment of its obligations, exogenous factors related to a third party's performance and other legal and documentation risks.

Gonzalez et al (2004) report that CRAs usually incorporate stability in their credit ratings assessments based from the demands of their core clientele base. Since the activities of the credit rating agencies and the services they offer have diversified over the years, from purely providing statistical ratings to portfolio management, financial advisory and other ancillary services, the profile of their clients and their requirements will normally dictate the quality of their credit assessments.

They noted that if their core clients are portfolio managers and issuers rather than investors, the provision of information at large a scale (to various investors) will expand the CRA activities. This will encompass the provision of "monitoring signals" that can be found in a principal-agent relationship.

C. Ratings influence market prices.

Usually, an investor reacts to any information that is available in the market. Any new information about the borrower affects his investment decision, which provides an impact on the interest that will be paid by the issuer (for fixed income securities and structured finance products) and/or the market value of the financial assets/instruments held by the investor.

Various market participants have relied so much from CRAs to the extent that the credit ratings that they provide over the past years were regarded as a "certification" for investors to make investment decisions in a particular security or equity.

D. Credit ratings issued help reduce information asymmetry.

Notes

The concept of asymmetric information has been well established and discussed in various economic and finance theories. As described by information asymmetry exists when one party has access to information over the other party.

In the credit market, the borrower has more advantage over the lender and this asymmetry leads to the lender requiring additional information from the borrower as part of its typical credit risk analytical protocols. However, when information is scarce or not disclosed by the borrower, it leads to the lenders' difficulty in deriving reliable information about him or the financial instrument. This eventually results to credit rationing as lenders become very selective in granting loans. Bebczuck (2003) notes that there are instances where good borrowers are penalized from this as they will also be required to pay the same interest rates as bad borrowers, as part of the bank's lending provisions.

Aside from credit rationing, the author considers moral hazard and monitoring costs as among the other forms of information asymmetry. The adverse selection problem caused by information asymmetry often influences borrowers to undertake risky investments. This also explains why borrowers move away from bank credit and resort to financial markets, in the hope of securing lower cost of funds for either operational activities or other capital investments.

To reduce this adverse selection problem in the financial market, a credible third party information provider can act as an intermediary between the two parties. Thus, the role of credit rating agencies come into play through the use of public and/or private data which is processed using specific methodologies to evaluate the risks associated with the financial asset or the issuer. As mentioned earlier, the task of gathering relevant this information associated with the issuer is daunting, especially for small investors whose funds are relatively smaller compared to large and institutional investors who may be able to conduct their own related researches.

Credit rating agencies, on the other hand, enjoy the economies of scale in this respect for different types of issues or instruments. The overall technical capabilities that CRAs cannot be compared with the internal models or credit risk metrics used by large financial institutions. If credit rating agencies fall short in their role of providing accurate and unbiased information about the issuer, therefore, there would not be any incentive for the investors to employ their services. Over the years, the investors have relied so much on them especially with the development of financial markets in both developed and emerging market economies where various financial instruments including structured finance products are introduced.

Notes

Business Models Used by Credit Rating Agencies

To better understand how CRAs operate, it is important to establish the business models that they used. Some of the issues that were highlighted in the global financial crisis were related to conflict of interest between the payments they received for the rating services vis-a-vis their roles as providers of unbiased information.

A. Issuer-Pays Model: In this business model, the rating agencies are paid by the issuers of financial instruments for the credit rating that will be provided for the said securities. From the issuers' point of view, a credit rating is needed as a medium to borrow in the financial market. The credit rating serves as a marketing tool for them to convey the message that the security is a good investment. The issuer and the credit rating agency benefit from this type of arrangement. However, others believe that they charge high fees for issue ratings depending on the complexity of the transactions and the type of the instrument being issued in the financial market.

With increased competition arising from the reduction in the barriers to entry, this reduces the reputational incentives enjoyed by GCRAs since there is an incentive for them to inflate the credit ratings in exchanges for getting the rating business and maintaining a long relationship with the issuer.

This model had raised a lot of questions due to the conflict of interest issue. Except for unsolicited credit ratings, under the issuer-pays model, a CRA normally requires the issuer to furnish the agency the required documents and other information needed to arrive at accurate and transparent company's rating assessment. Given this undertaking, it provides the investors a better perspective about the debt issuer, in case the issuer wishes to have its rating assessment published.

They benefit from this business model because ratings are free. This knowledge gap problem, as described by is reduced through the credit rating agency's provision of opinionated about the issuer's creditworthiness and the riskiness of the financial instrument associated with the issuer.

Despite the credit rating costs borne by the issuers, they believe that the credit rating provided them greater benefits in procuring cheaper financing at either national or international financial markets compared to those that do not have credit ratings or to the financing provided by credit institutions.

B. Subscriber-Pays Model: Under this model, the investors pay for the ratings provided by the CRA for financial securities or for the use of access to the information needed regarding the issuer or an issuance of financial instrument. It is also called as user-paid model. This model or concept started in early 1900s when John Moody started to sell credit ratings to bond investors. This subscription concept enables the investor or subscriber to make informed investment decisions in maximizing his return on investments and in increasing the value of his financial asset holdings.

As capital market flourished in the United States, commercial papers and other debt instruments were offered to supplement the existing bond and other government securities offerings. However, this concept was abandoned by the GCRAs during mid 70s when they started to charge the issuers of debt instruments instead of the investors or subscribers for the credit rating services they provide.

The same type of model is typically utilized by credit bureaus which clearly highlights the role of CRAs as "risk information brokers". As emphasized by Walker (2010), it provides third-party transparent and unbiased ratings for the investors due to the CRA's independence from the rated company/issuer. This drives competition among credit rating agencies in providing better services by conducting regular reviews and update of their credit ratings and by improving the quality of their rating assessments.

Unlike the issuer-pays model, subscribers do not have sufficient information which is proprietary to the issuer since the credit rating agency can generally conduct only quantitative analysis about the issuer using publicly available information that can be processed through the use of various analytical models.

It was cited that there are still some investors who utilize the services of small CRAs to rate debt instruments in their favour through the use of publicly available information. This model helps large investors to make good judgment about a prospective investment or an existing one. From the business standpoint, credit rating business is difficult to maintain since it requires investments in resources (i.e.: employment of qualified analysts, use of different models for specific credit risk assessment, etc.).

Issues Related to Credit Rating Agencies and Credit Rating Process

A. On the Independence of the CRA

The credit rating agencies' independence is very crucial as it affects the rating actions for the rated financial instruments or issuers. The Enron case and the global financial crisis showed that the independence of the rating agency and/or its analysts is sometimes compromised. It was cited in a report that in 1998, Merrill Lynch was threatened by Enron that it will withhold its investment banking business with the agency if it does not improve its rating. It was also noted that analyst behaviour (i.e.: rating recommendations or disclosure of proposed investment ratings to the issuer) creates conflict of interest problems especially if the rating is tied to their compensation.

This conflict of interest issue has become a pressing problem among regulators. Some argue that the issuer-pays model creates greater conflicting interest problems than the subscriber-pays model. Regardless of the business model, a credit rating must be subject to high standards of independence and accountabilities among credit rating agencies.

In a free market economy, there is no single set of business model that is appropriate for all credit rating agencies. First, the choice of the business model

will depend on their respective goals and the business strategies they used in the provision of credit rating services and on the market structure of the company. Besides, there is no regulatory framework that neither requires the specific use of a business model nor indicates who should pay the credit ratings.

Notes

Unlike regulated industries, the credit rating business is unique. From the perspective of a CRA, building resources such as a provision of database system, hiring and training human resources (i.e.: analysts, portfolio managers) and risk assessment capabilities, is already a daunting tasks. This requires large capital investments to finance them.

As had been mentioned in the preceding discussions, these investments may affect CRA independence vis-a-vis issuers due to the potential conflict of interest, especially under the issuer-pays business model. As cited by IOSCO (2008), CRAs have the responsibility to provide credit ratings in a timely manner and their dealings with the issuers must not compromise the quality of the rating. Harper (2011) cited reasons for the change in the business model:

1. Concerns among rating agencies on the issue of "free rider" among non-paying investors: Credit rating agencies believe that this move will eliminate the potential free-rider problem once the rating is published. It is possible that the credit rating will be disclosed by the subscriber to relatives and friends. As a result, the credit rating business might be compromised, as it will not gain the full value of the information it creates. In other words, it undermines their income potential arising from the fees they charge to the subscriber.

2. Willingness among issuers to pay for their rating assessments: Issuers welcome the idea of paying for their ratings in the hope of getting better ratings. They believe that paid ratings are better compared to unsolicited ratings given by the rating agencies. It translates to low risk associated with their debt issuances.

3. Increasing rating-based regulations and wide acceptance of ratings by reputable rating organization: As most literature indicates, many regulations in the United States favour credit ratings provided by reputable rating agencies. With the introduction of Nationally Recognized Statistical Rating Organizations (NRSRO) concept in the Exchange Act, global CRAs benefitted from the rating-based regulations. This model, however, raises a conflict of interest issue which undermines the Independence of the credit rating agency. Since most of them receive compensation in the form of fees from the issuer, the pressure to inflate ratings would be high. Since many CRA's provide ancillary services, there is likelihood that some rating actions may be compromised.

To ensure that favourable ratings will be issued on their behalf, they are inclined to employ the financial advisory services or other services of the CRA, which are typically bundled with the rating services provided, at a cost. There are several criticisms that were made regarding this issue where the three GCRAs gave high rating actions to companies with rated securities that are traded in the market.

B. Quality and Integrity of the Rating Process

This aspect is very important to the investors and other market players. Lenders invest excess funds in financial assets that will provide them reasonable rates of return. On the other hand, the issuer wants to borrow funds. While several alternatives are available in the market, the issuer will choose the financing instrument that will bring his costs down by increasing the price of the security. Aside from bank loans which are difficult to access due to stringent requirements by credit institutions, the issuer borrows funds through the issuances of securities.

On the other hand, the investors are interested to get information about the issuer or the security to serve as assurance that the potential investment would be safe. The disclosure of information by the issuer is viewed as biased because they have more information about the financial asset and their company than the investors. They normally or selectively disclose information that will always favour them. Since there will be unwilling investors to invest their money in the said asset, the issuer is confronted with the problem of financing its business.

Thus, a credit rating is able to provide assistance in solving these issues by the investors and issuers through a credit rating assessment. Likewise, the quality of information gathered by the CRA is crucial in the assessment. Failure to do the necessary assessment of this information may put them in a negative position. Rafailov (2011) cited that in Asia, credit ratings given to issuers or provided to securities showed that the quality of data or reports provided by the issuers were not comparable with the existing standards used in developed market.

In this respect, credit rating agencies failure to undertake their crucial roles in the financial market, whether the issuer is sovereign (the government) or a corporate borrower, had affected the Asian Market. This remains a debatable issue among policymakers and researchers. Regulations are already being undertaken among countries to resolve issues on the quality of the rating process.

Flandreau, Gaillard and Packer (2010) point that the existing competition among credit rating agencies can provide adverse effects on the quality of credit assessment especially when ratings are inflated.

They mention that since rating agencies receive payment from the issuers, the ratings that will be given may be compromised due to the favourable ratings that will be given.

Thus, it is imperative that the third party information provided by CRAs must be reliable and credible. In other words, it must portray the quality of the financial instrument as they are believed to be unbiased. Likewise, they must be undertaken using methodologies that could interpret the riskiness of the issuer or the financial instrument.

In fact, this was already emphasized in the 2004 IOSCO's Code of Conduct Fundamentals which incorporates the quality and integrity of the rating process as an important Principle underlying the code. This principle takes into

consideration the reduction of information asymmetry between the issuer and the investor. The integrity of the rating process must be ensured to reflect the creditworthiness of the borrower.

While several risk exposures may affect the company, CRAs typically unravel their credit risk exposure using a combination of publicly available data and those provided by the latter. It is in this context that GCRAs failed to undertake, as they claimed that it is not their responsibility to identify any fraud arising from the information supplied by the issuer (McDonald, 2006) Especially with the growth or proliferation of structured finance products in the market, its quality may be difficult to assess compared to the traditional financial instruments, if the investor will only rely from its own research.

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As mentioned earlier, the credit rating agency can vouch the accuracy and reliability of the information provided in the rating for the said product whose complexity may provide difficulty among those who would like to do similar or related procedures to determine its riskiness. However, with the corporate scandals that occurred over the past years, rating agencies were accused of compromising their assessments, including the rating process they undertake, in exchange for the renewed business with the issuer by deciding on a rating that are favourable to the issuers or the rated instrument.

This undertaking lowers or downgrades the rating standards of the CRA and makes it vulnerable to risk and criticisms. Since there are no specific rules relating to the rating methodologies that should used by a CRA, the question hinges on whether these methodologies are of good calibre or meet the minimum standard for each rating? This boils down again to the issue of the reputation of the credit rating agency as perceived by both the issuer and the investors.

If the issuer believes that credit rating could provide them value for their investments, therefore, they will use the service of the said credit rating agency. In one study, Cinquigrana (2009) mentions that profit will still prevail over quality under the issuer-pays model. This was based on the WorldCom and Enron scandals, where credit rating agencies were charged of inflating the credit ratings. Where rating shopping exists, the issuer chooses a rating agency that gives him a better rating than the one with a lower rating.

C. Transparency

Credit rating agencies collect information about the issuer or the financial instrument, which help the lender in gaining information regarding the creditworthiness of the company. This way, investors can make better decisions before putting their money in portfolio of investible funds using the information provided. This credit rating can also be used to monitor the performance of the issuer or any issuance over time. Like other financial advisors, CRAs fill this information gap or problem. On the other hand, it does not discount the capability of financial institutions in conducting their own investigation.

External ratings can provide FIs a better perspective about the issuer as their reputation and expertise in the analysis of the creditworthiness of the

companies are known. There were also issues on the lack of full disclosure of information on the key assumptions and methodologies used by CRAs to enable the investors to evaluate whether there are flaws or weaknesses in the rating process. Regulations on this matter were already provided. It was highlighted during the hearing held by the Committee on Financial Services of the U.S. House of Congress that improvements in the regulatory framework that focus on the transparency and reliability of the credit rating process must be undertaken by SEC.

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As pointed out by Fitch during the said hearing, it discloses the required information needed by the investors including the methodologies that it used. Hence, it was cited that the responsibility should not only rest on the rating agencies but also among issuers and underwriters : Since most credit ratings have been paid for, the issuer or its underwriter has an incentive to provide information that would be beneficial to make its security offering attractive in the financial market.

In fact, IOSCO's Statement of CRA Principles and the revised Code of Conduct Fundamentals have emphasized the provision by the credit rating agencies of relevant information disclosure regarding rating methodologies and the underlying assumptions that support them which is crucial in the effective functioning of the system . Timely access to the credit rating and full disclosure of relevant information regarding the credit risk of the security or the issuer will allow investors to make informed and well-thought decisions regarding their investments.

It is believed that an efficient allocation of capital is made possible when investors are able to carefully assess the merits of the investments (i.e.: accuracy, fairness, etc.). Also, the monitoring cost related to regulatory recognition of ratings will also decline. Appropriate disclosure of information will promote transparency which highlights that the information provided is free from any omission to conceal any fraudulent activity by the issuer or any misstatements and misrepresentation by the credit rating agency.

5.3 SECURITIZATION

What is securitization

The subprime mortgage crisis that began in 2007 has given the decades-old concept of securitization a bad name. Securitization is the process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities.

Securitization got its start in the 1970s, when home mortgages were pooled by U.S. government-backed agencies. Starting in the 1980s, other income-producing assets began to be securitized, and in recent years the market has grown dramatically. In some markets, such as those for securities backed by

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risky subprime mortgages in the United States, the unexpected deterioration in the quality of some of the underlying assets undermined investor confidence. Both the scale and persistence of the attendant credit crisis seem to suggest that securitization—together with poor credit origination, inadequate valuation methods, and insufficient regulatory oversight—could severely hurt financial stability.

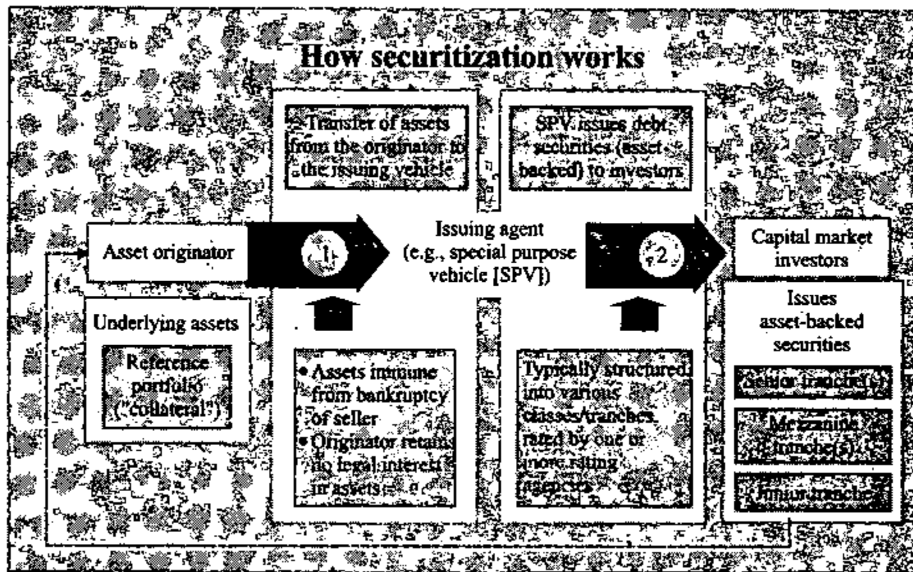
Increasing numbers of financial institutions employ securitization to transfer the credit risk of the assets they originate from their balance sheets to those of other financial institutions, such as banks, insurance companies, and hedge funds. They do it for a variety reasons. It is often cheaper to raise money through securitization, and securitized assets were then less costly for banks to hold because financial regulators had different standards for them than for the assets that underpinned them. In principle, this "originate and distribute" approach brought broad economic benefits too—spreading out credit exposures, thereby diffusing risk concentrations and reducing systemic vulnerabilities.

Until the subprime crisis unfolded, the impact of securitization appeared largely to be positive and benign. But securitization also has been indicted by some for compromising the incentives for originators to ensure minimum standards of prudent lending, risk management, and investment, at a time when low returns on conventional debt products, default rates below the historical experience, and the wide availability of hedging tools were encouraging investors to take more risk to achieve a higher yield. Many of the loans were not kept on the balance sheets of those who securitized them, perhaps encouraging originators to cut back on screening and monitoring borrowers, resulting possibly in a systematic deterioration of lending and collateral standards.

The securitization process: In its most basic form, the process involves two steps (see chart). In step one, a company with loans or other income-producing assets—the originator—identifies the assets it wants to remove from its balance sheet and pools them into what is called the reference portfolio. It then sells this asset pool to an issuer, such as a special purpose vehicle (SPV)—an entity set up, usually by a financial institution, specifically to purchase the assets and realize their off-balance-sheet treatment for legal and accounting purposes. In step two, the issuer finances the acquisition of the pooled assets by issuing tradable, interest-bearing securities that are sold to capital market investors. The investors receive fixed or floating rate payments from a trustee account funded by the cash flows generated by the reference portfolio.

In most cases, the originator services the loans in the portfolio, collects payments from the original borrowers, and passes them on—less a servicing fee—directly to the SPV or the trustee. In essence, securitization represents an alternative and diversified source of finance based on the transfer of credit risk (and possibly also interest rate and currency risk) from issuers to investors. In

a more recent refinement, the reference portfolio is divided into several slices, called tranches, each of which has a different level of risk associated with it and is sold separately. Both investment return (principal and interest repayment) and losses are allocated among the various tranches according to their seniority.



The least risky tranche, for example, has first call on the income generated by the underlying assets, while the riskiest has last claim on that income. The conventional securitization structure assumes a three-tier security design—junior, mezzanine, and senior tranches. This structure concentrates expected portfolio losses in the junior, or first loss position, which is usually the smallest of the tranches but the one that bears most of the credit exposure and receives the highest return. There is little expectation of portfolio losses in senior tranches, which, because investors often finance their purchase by borrowing, are very sensitive to changes in underlying asset quality.

It was this sensitivity that was the initial source of the problems in the subprime mortgage market last year. When repayment issues surfaced in the riskiest tranches, lack of confidence spread to holders of more senior tranches—causing panic among investors and a flight into safer assets, resulting in a fire sale of securitized debt. Securitization was initially used to finance simple, selfliquidating assets such as mortgages. But any type of asset with a stable cash flow can in principle be structured into a reference portfolio that supports securitized debt.

Securities can be backed not only by mortgages but by corporate and sovereign loans, consumer credit, project finance, lease/trade receivables, and individualized lending agreements. The generic name for such instruments is asset-backed securities (ABS), although securitization transactions backed by mortgage loans (residential or commercial) are called mortgage-backed securities. A variant is the collateralized debt obligation, which uses the same structuring technology as an ABS but includes a wider and more diverse range of assets.

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The allure of securitizing: Securitization started as a way for financial institutions and corporations to find new sources of funding—either by moving assets off their balance sheets or by borrowing against them to refinance their origination at a fair market rate. It reduced their borrowing costs and, in the case of banks, lowered regulatory minimum capital requirements. For example, suppose a leasing company needed to raise cash. Under standard procedures, the company would take out a loan or sell bonds. Its ability to do so, and the cost, would depend on its overall financial health and credit rating. If it could find buyers, it could sell some of the leases directly, effectively converting a future income stream to cash.

The problem is that there is virtually no secondary market for individual leases. But by pooling those leases, the company can raise cash by selling the package to an issuer, which in turn converts the pool of leases into a tradable security. Moreover, the assets are detached from the originator's balance sheet (and its credit rating), allowing issuers to raise funds to finance the purchase of assets more cheaply than would be possible on the strength of the originator's balance sheet alone.

For instance, a company with an overall "B" rating with "AAA"-rated assets on its books might be able to raise funds at an "AAA" rather than "B" rating by securitizing those assets. Unlike conventional debt, securitization does not inflate a company's liabilities. Instead it produces funds for future investment without balance sheet growth. Investors benefit from more than just a greater range of investible assets made available through securitization. The flexibility of securitization transactions also helps issuers tailor the risk-return properties of tranches to the risk tolerance of investors.

For instance, pension funds and other collective investment schemes require a diverse range of highly rated long-term fixed-income investments beyond what the public debt issuance by governments can provide. If securitized debt is traded, investors can quickly adjust their individual exposure to credit-sensitive assets in response to changes in personal risk sensitivity, market sentiment, and consumption preferences at low transaction cost.

Sometimes the originators do not sell the securities outright to the issuer (called "true sale securitization") but instead sell only the credit risk associated with the assets without the transfer of legal title ("synthetic securitization"). Synthetic securitization helps issuers exploit price differences between the acquired (and often illiquid) assets and the price investors are willing to pay for them (if diversified in a greater pool of assets).

Growth of securitization: The landscape of securitization has changed dramatically in the last decade. No longer is it wed to traditional assets with specific terms such as mortgages, bank loans, or consumer loans (called self-liquidating assets). Improved modeling and risk quantification as well as greater data availability have encouraged issuers to consider a wider variety of asset

types, including home equity loans, lease receivables, and small business loans, to name a few. Although most issuance is concentrated in mature markets, securitization has also registered significant growth in emerging markets, where large and highly rated corporate entities and banks have used securitization to turn future cash flow from hard-currency export receivables or remittances into current cash. In the future, securitized products are likely to become simpler. After years of posting virtually no capital reserves against highly rated securitized debt, issuers will soon be faced with regulatory changes that will require higher capital charges and more comprehensive valuation. Reviving securitization transactions and restoring investor confidence might also require issuers to retain interest in the performance of securitized assets at each level of seniority, not just the junior tranche.

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5.3.1 Concept of Securitization

Securitization is a process by which identified pools of receivables, which are usually illiquid on their own, are transformed into marketable securities through suitable repackaging of cashflows that they generate.

The Broader Meaning of Securitization

- **Securitization is the process of commoditization:** The basic idea is to take the outcome of this process into the market, the capital market. Thus, the result of every securitization process, whatever might be the area to which it is applied, is to create certain instruments, which can be placed in the market.
- **Securitization is the process of integration and differentiation:** The entity that securitizes its assets first pools them together into a common hotchpot (assuming it is not one asset but several assets, as is normally the case). This process of integration. Then, the pool itself is broken into instruments of fixed denomination. This is the process of differentiation.
- **Securitization is the process of de-construction of an entity:** If we think of an entity's assets as being composed of claims to various cash flows, the process of securitization would split apart these cash flows into different units. We classify these units, and sell these classified units to different investors as per their needs. Therefore, securitization breaks the entity into various sub-sets. We will discuss further the present-day meaning of securitization after some more understanding of generic meaning of the term. The process of converting an asset or a relationship into a security or a commodity.

Meaning of Security: The meaning of security in the context of securitization is not static but dynamic. With respect to securitization, the word "security" does not mean what it traditionally might have meant under corporate laws or commerce: a secured instrument. The word "security" here means a financial claim that is generally manifested in form of a document, its essential feature being "marketability". To ensure marketability, the instrument must

have general acceptability as a "store of value". Therefore, it is generally rated by credit rating agencies, or it is secured by charge over assets. In addition, to ensure liquidity, the instrument is generally made in homogenous lots.

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Securitization Process: The successful execution of a securitization depends on the investor's uncontested right to securitized cash flows. Hence, securitized loan need to be separated from the originator of the loan. In order to achieve this separation, a securitization is structured as a three-step frame work:

1. A pool of loan is sold to an intermediary by the originator of the loans. This intermediary (called a special purpose vehicle or SPV) is usually incorporated as trust. The SPV is an entity formed for the specific purpose of transferring the securitized loans out of the originator's balance sheet, and does not carry out any other business.
2. The SPV issues securities, backed by the loan, and by the payment streams associated with these loans. These securities are purchase by investors. The proceeds from the sale of the securitized are paid to the originator as a purchase consideration for the loan receivables.
3. The cash flows generated by the loans over a period of time are used to repay investors. There could also be some credit support built into the transaction to protest investors against possible losses in the pool. However, the investors will typically have no recourse to the originator.

Need for Securitization: The generic need for securitization is similar to that of organized financial markets. From the distinction between a financial relation and a financial transaction earlier, we understand that a relation invariably needs the coming together and remaining together of two entities. Not that the two entities would necessarily come together of their own, or directly. They might involve a number of financial intermediaries in the process, but a relation involves fixity over a certain time. Financial relations are created to back another financial relation, such as a loan being taken to acquire an asset, and in that case, the needed fixed period of the relation hinges on the other that it seeks to back-up.

Financial markets developed in response to the need to involve a large number of investors. As the number of investor's keeps on increasing, the average size per investors keeps on coming down, because growing number means involvement of a wider base of investors.

The small investor is not a professional investor. He needs an instrument, which is easier to understand, and provides liquidity and legal sanction. These needs set the stage for evolution of financial instruments which would convert financial claims into liquid, easy to understand and homogenous products. They would be available in small denominations to suit even a small investor. Therefore, securitization in a generic sense is basic to the world of finance, and it is right for us to say that securitization envelopes the entire range of financial instruments, and the range of financial markets.

Reasons for Growth of Securitization:

1. Financial claims often involve large sums of money, which is outside the reach of the small investor who lacks expertise. In order to cater to this need development of financial intermediation. In a simple case an intermediary such as a bank obtains resources of the small investors and uses the same for the larger investment need of the user.
2. Small investors are typically not in the business of investments, and hence, liquidity of investments is most critical for them. Underlying financial transactions need fixity of investments over a fixed time, ranging from a few months to may be a number of years. This problem could not even be sorted out by financial intermediation, since, the intermediary provided a fixed investment option to the seeker, and itself requires funds with an option for liquidity. Or else, it would be into serious problems of a mismatch. Hence, the answer is a marketable instrument.
3. Generally, instruments are easier understood than financial transactions. An instrument is homogeneous; usually made in a standard form, and generally containing standard issuer obligations. Hence, it can be understood generically. Besides, an important part of investor information is the quality and price of the instrument, and both are difficult to be ascertained.

The need for securitization was almost inescapable, and present day's financial markets would not have been what they are, unless some standard thing that market players could buy and sell, that is, financial securities, were available. Therefore, there is large scope for development in this area. Capital markets are today a place where we can trade, claims over entities, claims over assets, risks, and rewards.

5.3.2 Securitization as A Funding Mechanism

Securitization is a carefully structured process by which a pool of loans and other receivables are packaged and sold in the form of asset-backed securities to the investors to raise the required funds from them. Through this process relatively illiquid assets are converted into securities. Securitization falls under the broad category termed as structured finance transactions.

Structured finance refers to securities where the promise to repay the investors is backed by the value of the underlying financial asset or the credit support of a third party to the transaction or some combination of the two. Thus, securitization is nothing but liquefying assets comprising loans and receivables of an institution through systematic issuance of financial instruments.

Structured financing instruments are derivatives of traditionally secured debt instruments where the credit standing of the instrument is supported by a lien on specific assets or by some other form of credit enhancement such as a guarantee. With a conventional secured bond, the primary source of repayment of the bond is still the earning power and cash flow of the issuer.

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In a securitized transaction, the burden of repayment on the bond shifts away from the issuer to a pool of assets or to a third party. The cash flows from the pools of assets which have been securitized provide the funds for repayment to the bond.

Securitized transaction is termed as structured transaction because through specific choices relating to the type and amount of assets in the pool and particular features of the transaction; these securities may be structured to achieve a desired level of risk and a desired level of rating.

Securitization is said to have taken place when a company's assets are removed in one way or the other form from its balance sheet and are funded instead by investors. The investors receive tradable financial instruments evidencing the investment without recourse to lending institution. The entire transaction, from the accounting point of view, is carried out on the asset side of the balance sheet, that is, one asset gets converted into another.

Mechanism of Securitization

Typically, the mechanism of securitization is outlined below:

(i) The process of securitization starts with identification by the company (the originator) the loans or bills receivable in its portfolio, to prepare a basket or pool of assets to be securitized. The package usually forms an optimum mix so as to ensure fair marketability of the instrument to be issued.

Further, the maturities are also so chosen that the package represents one homogeneous lot. The pool of receivables is backed by the underlying securities held by the originator (in the form of mortgage, pledge, charge, etc.).

(ii) The pool of assets so identified is then sold to a specific purpose vehicle (SPV) or trust. Usually an investment banker performs the task of an SPV, which is also called an issuer, as it ultimately issues the securities to investors.

(iii) Once the assets are acquired by SPV, the same are split into individual shares/securities which are reimbursed by selling them to investors. These securities are called 'Pay or Pass Through Certificates' (PTC) which are so structured as to synchronize for redemption with the maturity of the securitized loans or bills.

A PTC thus represents a sale of an undivided interest to the extent of the face value of the PTC in the aggregate pool of assets acquired by the SPV from the originator.

(iv) Repayments under the securitized loans or bills keep on being received by the originator and passed on to the SPV. To this end, the contractual relationship between the originator an d the borrowers/obligates is allowed to subsist in terms of the pass through transaction; alternatively a separate agency arrangement is made between the SPV (Principal) and the originator (agent).

(v) Although a PTC could be with recourse to its originator, the usual practice has been to make it without recourse. Accordingly, a PTC holder takes recourse to the SPV and not the originator for payment to the principal and interest on the PTCs held by him. However, a part of the credit risk, as perceived (and not interest risk), can be absorbed by the originator, by transferring the assets at a discount, enabling the SPV to issue the PTCs at a discount to face value.

(vi) The debt to be securitized and the PTC issues are got rated by rating agencies on the eve of the securitization. The issues by the SPV could also be guaranteed by external guarantor-institutions to enhance creditability of the issues. The PTCs, before maturity, are tradable in a secondary market to ensure liquidity for the investors.

From the above, it is evident that the primary participants involved in the issuance of securitization transaction are the originator, obligors, the SPV, the servicer and the credit enhancer. The originator has the assets which are sold or used as collateral for the assets backed securities. Originators are generally manufacturing companies, financial institutions, banks and non-banking finance companies.

The term obligors' refers to borrowers who have taken loans from the originators resulting in the creation of the underlying asset. The SPV or trust raises funds to buy assets from the originator by selling securities to investors.

It uses the cash flow generated by the financial assets in the pool to pay interest and principal to investors and covers its own costs. The servicer/receiving and paying agent is responsible for collecting principal and interest payments on assets when due and for pursuing the collection from delinquent accounts.

The service is usually the originator or an associate of the originator. The credit enhancer provides the required amount of credit support to reduce the overall credit risk of a security issue.

Credit enhancement is provided by the originator in the form of senior-subordinate structure over collaterisation or through a cash collateral. Third party credit enhancement generally takes the form of a letter of credit or a surety bond.

Utility of Securitization: Securitization as a financial instrument is becoming extremely popular the world over with more and more issuers resorting to raising funds through this route. This is for this fact that it confers lot of benefits on the parties to the process.

Securitization serves as handmade to organization in raising additional funds to finance their growth programme. Companies with poor credit standing and therefore finding it difficult to procure resources from the market can obtain funds by issuing asset back securities at lower interest cost due to higher credit rating on such securities. Even if the issuer is not an AAA rated company, it can issue an AAA rated securitized asset.

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This can be done by carefully selecting the portfolio on the basis of criteria stipulated by the rating agency. What is more useful is that relatively illiquid assets are converted into marketable securities providing liquidity and alternate funding sources. Another advantage to the company is economy in the use of funds and greater recycling of resources leads to higher business turnover and profitability.

Further, cost of raising funds by way of securitization is cheaper than that involved in funding by way of conventional fund-raising instruments like shares, bonds, debentures, and commercial papers. Through its novel mechanism of diversifying the risk factors, enhancing the credit and removing uncertainties for investors, structured securitization facilitates the originator to access the securities market at debt ratings higher than its overall corporate rating. As a result, the company can secure funds at lower cost.

The cost of raising funds against securitized assets depends essentially on quality of assets to be securitized and image of the issuer in the minds of investors. Obviously, the price at which an asset based securities is sold or the discount which the buyer gets differs from deal to deal. Further, bargaining powers of the negotiations bear upon the cost of acquiring funds through securitization.

Securitization also facilitates strengthening of capital adequacy of the originating company by isolating the loan-assets from the originator's balance sheet and by removing or replacing them. Securitization is equally useful to investors. It offers multiple new investment instruments for mutual funds, insurance companies, pension funds and general investors to cater to their needs and preferences. Besides widening the choice and availability, it also provides for higher return and liquidity for the instrument.

The unique benefit which investors derive from securitization is that they can look past the issuing entity to the collateral pool that the issue represents. This transparency reduces uncertainly for the investor as to the risk element. Being a structured asset backed security, the instrument provides higher protection against rating down-grades of the originator, as compared to traditional debt securities.

It also provides opportunity for matching cash flows and managing ALM since securitized instrument carries regular monthly cash flows and has varying maturities. The prevalence of secondary markets would offer liquidity.

As a product of raising funds against receivables, securitization is far superior to bills discounting or factoring. Bill discounting has emerged as a working capital product employed to raise funds out of short-term trade receivables. In contrast, securitization is a medium to long-term source.

Even in a mature bill market, the sheer quantum of paper work in raising money against bills of long maturities would be a deterrent. Although factoring appears to be similar to securitization as the factor buys the receivables of a

company at a discount, there has traditionally been no intention to rate the portfolio or create a secondary market for the receivables.

Further, factoring has emerged as a trade financing tool rather than for medium or long-term financing. However, the securitization process, if not carried out prudentially, can leave risks with the originating bank without allocating capital to back them. While all banking activity entails operational and legal risks, these may be greater under more complex activity.

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It is felt that the main risk a bank may face in a securitization scheme arises if a true sale has not been achieved and the selling institution is forced to recognize some or all of the losses if the assets subsequently cease to perform. Also, funding risks and constraints on liquidity may arise if assets designed to be securitized have been originated, but because of disturbances in the market, the securities cannot be placed.

5.3.3 Securitization in India

Securitization in India began in the early nineties, with CRISIL rating the first securitization program in 1991-92. Initially it started as a device for bilateral acquisitions of portfolios of finance companies. These were forms of quasi-securitizations, with portfolios moving from the balance sheet of one originator to that of another. Originally these transactions included provisions that provided recourse to the originator as well as new loan sales through the direct assignment route, which was structured using the true sale concept.

Through most of the 90s, securitization of auto loans was the mainstay of the Indian markets. But since 2000, Residential Mortgage Backed Securities (RMBS) have fuelled the growth of the market.

The need for securitization in India exists in three major areas - Mortgage Backed Securities (MBS), the infrastructure Sector and other Asset Backed Securities (ABS). It has been observed that Financial Institutions/banks have made considerable progress in financing of projects in the housing and infrastructure sector. It is therefore necessary that securitization and other allied modalities get developed so that Financial Institutions/Banks can offload their initial exposure and make room for financing new projects.

With the introduction of financial sector reforms in the early nineties, Financial Institutions/banks, particularly the Non-Banking Financial Companies (NBFCs), have entered into the retail business in a big way, generating large volumes of homogeneous classes of assets (such as auto loans, credit cards).

This has led to attempts being made by a few players to get into the ABS market as well. However, still a number of legal, regulatory, psychological and other issues need to be sorted out to facilitate the growth of securitization in India.

A.1. Current Scenario in India

Securitization in India adopts a trust structure with the underlying assets being transferred by way of a sale to a trustee. Albeit a trust is not a legal entity,

a trustee is entitled to hold property, which is distinct from the property of the trustee or other trust properties held by him. Thus, the trust is termed as a Special Purpose Vehicle (SPV).

The SPV issues securities that are either 'Pass Through Securities', or 'Pay Through Securities (PTS)'. In case of Pass Through Securities, the investors holding them acquire beneficial interest in the underlying assets held by the trustee.

Whereas, in case of PTS, investors holding them acquire beneficial interest only in the cash flows realised from the underlying assets and that too in order of and to the extent of the obligation contracted with the holders of the respective senior and subordinated branches of PTS. Under either scenario, the legal ownership of the underlying assets continues to vest in the trustee.

Mortgage Backed Securities (MBS)

In 2004-05, the Mortgaged Backed Securities market grew moderately at 13% with the issuance valued at ₹ 33.4 billion. There was also an increase in the 'par' transactions with all 15 transactions being made in 2005 having a 'par' structure. Since the underlying home loans in MBS pool have a floating-rate, the scheduled cash flow on such pools is uncertain and liable to change, depending on actual interest rate. Moreover, options to convert from fixed to floating rate and vice-versa, coupled with negotiated re-pricing of loans, added to the uncertainty of the cash flow in the MBS pool.

With the underlying loans earning floating rates, Pass Through Certificates (PTCs) in MBS issues are also being predominantly priced on a floating rate basis. In 2005, 52% of issuance was based on a floating rate. But given the significant expansion in the housing finance business, there is room for even more significant expansion in the MBS market.

However, the long-term tenure of MBS and the lack of liquidity in the secondary market discourage investors from getting actively involved in the market. Also home loans in India get pre-paid or re-priced, thus exposing the structures to significant interest rate risk and leading to higher credit enhancement requirements.

Asset Backed Securities (ABS)

In 2005, the market for Structured Finance (SF) grew by 121% in terms of value and 41% in the number of transactions, while the ABS market doubled from ₹ 80.9 billion in 2004 to ₹ 222.9 billion in 2004. ABS was the largest product class, accounting for 72% of the SF market in 2005. This was three times higher than the volume of ₹ 81 billion in 2003. The growth in ABS issuance was the result of the following factors:

- Continued increase in disbursements by key retail asset financers,
- Investors familiarity with the underlying asset class,
- Relatively shorter tenure of issuances,
- Stability in the performance of a growing number of past pools

Notes

Table A1: Trend in Structured Finance Volumes (₹ billion)

Type	2001-02	2002-03	2003-04	2004-05
ABS	12.9	36.4	80.9	222.9
MBS	0.8	14.8	29.6	33.4
CDO/LSO	19.1	24.3	28.3	25.8
PGS	4	1.9	0	16
Others	0	0.4	0.5	10
Total	36.8	77.7	139.2	308.2

(COD; Corporate Debt Obligations, LSO; Loan Sell off, PGS; Partial Guarantee Structure)

Another important aspect of recent ABS issuance is the increasing preference of floating rate yields. In 2005, 13% of the PTCs issued had a floating rate yield while the corresponding figure for 2004 was only 6%. Repackaged securities was also introduced, where in the cash flow on certain existing PTCs issued under an ABS transaction are acquired by a SPV and fresh PTCs are issued against the same.

Given that the Asset Backed Securities are still new for the investors in India market, their preference is for AAA/AA rated instruments as there is no market for the subordinated paper or 'Junk Bond'.

In 2005, ₹ 2.8 billion worth of Corporate Debt Obligations (CDO) and ₹ 23 billion worth of individual corporate loans were securitised. The impeding factor in CDO growth is that, investment decisions in the CDO pool are influenced by base rating of the underlying corporate exposures.

A.2. Issues facing Indian securitized market

A.2.1. Regulatory issues Stamp Duty: One of the biggest hurdles facing the development of the securitization market is the stamp duty structure. Stamp duty is payable on any instrument which seeks to transfer rights or receivables, whether by way of assignment or novation or by any other mode. Therefore, the process of transfer of the receivables from the originator to the SPV involves an outlay on account of stamp duty, which can make securitization commercially unviable in several states.

If the securitized instrument is issued as evidencing indebtedness, it would be in the form of a debenture or bond subject to stamp duty. On the other hand, if the instrument is structured as a Pass Through Certificate (PTC) that merely evidences title to the receivables, then such an instrument would not attract stamp duty, as it isn't an instrument provided for specifically in the charging provisions.

Among the regulatory costs, the stamp duty on transfers of the securitized instrument is again a major hurdle. Some states do not distinguish between conveyances of real estate and that of receivables, and levy the same rate of stamp duty on the two. Stamp duty being a concurrent subject, specifically calls for a consensual legal position between the Centre and the States.

A.2.2. Foreclosure Laws: Lack of effective foreclosure laws also prohibits the growth of securitization in India. The existing foreclosure laws are not lender friendly and increase the risks of MBS by making it difficult to transfer property in cases of default.

Notes

A.2.3. Taxation related issues: Tax treatment of MBS SPV Trusts and NPL Trusts is unclear. Currently, the investors (PTC and SR holders) pay tax on the income distributed by the SPV Trusts and on that basis the trustees make income pay outs to the PTC holders without any payment or withholding of tax. The view is based on legal opinions regarding assessment of investors instead of trustee in their representative capacity..

It needs to be emphasized that the Income Tax Law has always envisaged taxation of an unincorporated SPV such as a Trust at only one level, either at the Trust SPV level, or the Investor/Beneficiary Level to avoid double taxation. Hence, any explicit tax pass thro regime if provided in the Income Tax Act does not represent conferment of any real tax concession or tax sacrifice, but merely represents a position that the Investors in the trust would be liable to tax instead of the Trust being held liable to tax on the income earned.

Amendments need to be made to provide an explicit tax pass thro treatment to securitization SPVs and NPA Securitization SPVs on par with the tax pass thro treatment applied under the tax law to Venture Capital Funds registered with SEBI. To make it certain that investors as holders of Mutual Fund (MF) schemes are liable to pay tax on the income from MF and ensure that there is no tax dispute about the MBS SPV Trust or NPA Securitization Trust being treated as an AOP(Association of Persons), SEBI should consider the possibility of modifying the Mutual Fund Regulations to permit wholesale investors (investors who invests not less than Rs. 5 million in scheme) to invest and hold units of a closed-ended passively managed mutual fund scheme.

The sole objective of this scheme is to invest its funds into PTCs and SRs of the designated MBS SPV Trust and NPA Securitization Trust. Recognizing the wholesale investor and Qualified Institutional Buyers (QIB) in securitization Trusts, there should be no withholding of tax requirements on interest paid by the borrowers (whose credit exposures are securitized) to the securitization Trust.

Similarly, there should be no requirement of withholding tax on distributions made by the securitization Trust to its PTC and/or SR holders. However, the securitization Trust may be required to file an annual return with the Income-tax Department, Ministry of Finance, in which all relevant particulars of the income distributions and identity of the PTC and SR holders may be included. This will safeguard against any possibility of revenue leakage.

A.2.4. Legal Issues: Listing of PTCs on stock exchange: Currently, the SCRA definition of 'securities' does not specifically cover PTCs. While there is indeed a legal view that the current definition of securities in the SCRA includes any instrument derived from, or any interest in securities, the nature of the instrument and the background of the issuer of the instrument, not being

homogenous in respect of the rights and obligations attached, across instruments issued by various SPVs, has resulted in a degree of discomfort among exchanges listing these instruments.

To remove any ambiguity in this regard, the Central Government should consider notifying PTCs and other securities issued by securitization SPV Trust as 'securities' under the SCRA. Some issues under the SARFAESI Act: The ambiguity about whether or not Asset Reconstruction Companies (ARCs) and Securitization Companies (SCs) registered with the RBI can establish multiple SPV Trusts, has been resolved by a specific provision in the form of sec.7 (2A) of the SARFAESI Act.

In view of this, it is now possible to unambiguously adopt the trust SPV structure even under the SARFAESI Act for MBS, ABS or NPL securitization. The current definition of 'Security Receipt (SR)' envisages SR to be the evidence of acquisition by its holder of an undivided right, title or interest in the financial asset involved in securitization. This definition is appropriate and sufficient for securitization structures where securities issued are all characterized as 'Pass Through Securities'.

However, where the SPV Trust intends issuing Pay Through Securities with different classes or branches having senior or subordinated rights to the cash flow from realization of financial assets, the current definition of a SR may prove legally inadequate. There is need for an amendment that enables the SR to also be an evidence of the right of its holder to the cash flows from realization of the financial asset involved in securitization.

The construct of the SARFAESI Act is such that it enables SRs to be issued to and held by Qualified Institutional Buyers (QIBs), but does not include NBFCs or other corporate bodies, unless they are notified either by the Central Government as financial institution.

In order to deepen the market for SRs, there is a need to broad base the investor base that qualifies to invest in SRs. With a view to deepen the investor base of QIBs which can invest in SRs, it is suggested that NBFCs and non-NBFCs with owned net funds in excess of Rs.500 million be permitted to invest in SRs as QIBs. Similarly, private equity funds registered with SEBI as venture capital funds may also be permitted to invest in SRs within the limits that are applied for investment by venture capital funds in corporate debt instruments.

A.3. Recent Developments

In the 2005-06 budget, the Finance Minister made certain proposals to strengthen the capital market. The following are a list of the measures proposed in the budget to bolster the corporate bond market:

- Amending the definition of 'securities' under the Securities Contracts Regulation Act, 1956 so as to provide a legal framework for trading of securitized debt including mortgage backed debt
- Appointing High Level Expert Committee on Corporate Bonds and Securitization to look into the legal, regulatory, tax and market design issues in the development of the corporate bond market.

Notes

These measures are expected to open up new opportunities for international investors to take part in the growing Indian economic boom. The amendments will allow securitized debt to be traded on the stock exchanges, which will widen and deepen liquidity in the debt markets leading to efficient pricing of risks. Securitization, by diversifying away borrower default risk, should attract new market participants including foreign institutional investors. This will enable easier access to long-term debt for infrastructure projects.

In February 2006, the RBI has released its final guidelines governing the securitization of performing assets in India in response to a High-Level Committee report. These final guidelines will have a definite impact on several issues and should enable the development of a vibrant and robust securitization market.

Some of the positive aspects of the recent notification are as following:

- A clear definition of what constitutes first and second loss credit enhancements.

The guidelines clearly define first and second loss credit enhancements. First loss represents the credit enhancement required to raise the rating of the instrument to an investment grade rating. Second loss represents the incremental credit enhancement to achieve the final rating of the instrument.

This definition is a crucial step in the right direction, as it would enable the market to operate on a commonly shared understanding on an issue that has been the subject of much speculation and debate. Besides, it enables harmonization of credit enhancement across transactions, and facilitates comparison and analysis, which are a pre-requisite for potential second loss services provision by third parties.

- Confirmation that exposures to securitization transaction will be classified as exposures to the underlying assets.

Investments in securitization transactions have been classified to represent exposure to the assets owned by the trust. This is a crucial notification, as several investors in the past insisted on classifying SPV Trusts as conventional corporate credit exposures, being uncomfortable with the ambiguity on this issue.

This clarification puts the subject to rest. It is also expected that investors will be able to use securitization as an effective means of obtaining exposure to directed lending in priority sectors, such as Small Road Transport Operators (SRTOs), agricultural lending and small home loans.

- Encouragement of active third party involvement in transactions.

This is the most positive aspect of the guidelines as it represents a paradigm shift with respect to securitization transactions. The guidelines actively encourage the participation of third parties, which is expected to increase transparency and create a vibrant market for independent service providers. It will facilitate a preferential capital treatment in comparison to the originators, if they choose to provide second loss credit enhancement.

Notes

They will need to provide capital at a risk weight of 100% vis-à-vis a complete write-off of capital if the originator provides second loss enhancement. At least 25% of the liquidity enhancement provided in the transaction will need to come from an independent third party other than the originator.

This recommendation symbolizes a clear shift in the regulator's approach to the product and it reflects the need to build a healthy third party participation in the market. Several market participants have shown great deal of interest in providing these services. Insurance companies, both private and public, have also expressed interest in providing credit insurance solutions, which will tremendously increase the depth and vibrancy of the market. The guidelines are also expected to increase transparency on disclosures of securitization exposures by originators.

However some provisions of these guidelines are expected to have an adverse impact on market growth in the short term. Originators will face challenges on account of:

- Continued ambiguity on the applicability of the guidelines for past transactions and for direct assignment of loan receivables. The mode of implementation of the guidelines whether retrospective or prospective, has not been specified yet. The guidelines indicate that implementation for past transactions would be under taken on a case-by-case basis. But given the significant impact that this decision could have on the financial and capital position of banks and financial institutions, a clear directive on the issue would be appropriate.

- Prohibition of upfront profit recognition in securitization despite a complete sale of assets to the SPV.

The guidelines prohibit profit recognition on securitization transactions at the time of sale. Profits need to be amortized over the tenor of the transaction. This is a departure both from the draft guidelines issued by the RBI in April 2005 and from past ICAI.

Assuming that the transaction has passed the required tests of true sale and represents a fixed limited downside risk for the seller, the denial of profits could be considered onerous. Besides it would create a deferred tax asset as the sale and profit will be recognized for income tax computation. This move is expected to impact market attractiveness for the product, as profit recognition has been one of the motivations for several originators.

A.4. Conclusion

The RBI guidelines thus provide a robust regulatory and institutional framework for the orderly development of the securitization market in the long term. At the same time the guidelines have eliminated some incentives for securitization. This will lead to temporary reduction in issuance volume. However, in the medium and long term, the securitization market is expected to witness reasonable growth.

Notes

The stringent norms presently proposed on capital allocation for credit enhancements will drive originators towards mezzanine strips. Consequently, a new class of investors in these products, who are comfortable with sub-AAA exposures, is expected to emerge. Thus large banks and financial institutions are expected to enter the market actively as investors.

The proposed guide lines on Basel II implementation for banks, providing significant capital relief for investments in bonds with high credit ratings, is also expected to enhance the demand for AAA/AA paper which can be efficiently structured into securitization transactions.

With the proposed recognition of PTCs as securities under the SCRA, and the subsequent listing of PTCs, interest from both domestic as well as foreign investors will witness a rise.

5.4 SUMMARY

Credit rating is a professional judgment about the likelihood that someone or organization will fulfill their financial obligation as at when due. Through credit rating, the likelihood of debt payment is reflected in standings on the assessment of individual and corporate creditworthiness.

Securitization is the process of converting a group of nonmarketable assets, or expected future cash flows on the assets, into units of marketable securities in order to sell the underlying assets in the capital market to generate money for a business. In the context of banking, securitization is the process of converting a pool of loans, and sale of the pooled loans, as units of secured marketable securities to investors to meet the funding need of a bank. It is the conversion of expected future cash inflows (i.e., service incomes and repayments) from a pool of loans into units of secured marketable securities which are sold to investors to raise capital for a bank.

Some funding need triggers a securitization deal, while the existence of a robust capital market nourishes it. Securitization has significance and implications for risk management in bank lending. Certain objectives of securitization underline its significance as a capital market instrument. It helps a bank to unlock and recoup funds tied up in risk assets, optimize earnings while enhancing return on capital employed, mitigate credit risk, create an alternative source of cash flow, manage its balance sheet, tap into occasional windows of opportunity that may open to it, and explore new investments in and outside lending.

The process of, and steps involved in, securitization of loans can be more or less complicated, depending on the level of development of the capital market. In developing countries where the market is still evolving, securitization is hardly a welcome option. Five parties—the obligors, originator, and a SPV, there are also the investors and administrator or servicer—with mutually exclusive roles, are involved in the conduct of securitization.

The main document in loan securitization transaction and investment is a PTC. The PTC serves as evidence of investment in securitized loans. Issuance of PTCs to investors is preceded by the creation of marketable securities on a set of pooled loans. Thus, the PTCs represent the securities so created and investors may buy as many units of the securities as they want. Investors consider other important factors, especially the risk, yield, quality, and diversity of the securitized loans, as well as collateral strength of loans backing the securities.

Notes

5.5 EXERCISE

1. What is the concept of credit rating?
2. How many rating agencies are there in India?
3. What is securitization and its process?
4. Discuss the types of credit rating?
5. Analyze the Securitization in India.