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11.6
9.5
31.8

INDIAN FINANCIAL SYSTEM

FINANCIAL SERVICES

SURYATA PRADHAN 12/15/21 FINANCIAL SERVICES

SUBJECT- INDIAN FINANCIAL SYSTEM.

TOPIC- FINANCIAL SERVICES.

Q1) Distinction between Fund-based Financial Services & Fee-based Financial Services:

ANS: Following are the main points of distinctions between fund-based financial services and fee-based financial services:

Points of Distinctions	**Fund-based financial services**	**Fee-based financial services**
1.Definition	Fund-based financial services are those services where financial intermediary institutions provide funds to the business firms for meeting shot-term and long-term requirements.	Fee-based financial services are those expert services which are rendered by some institutions managed by professionals regarding various technical matters.
2.Purpose	The main purpose of this services is providing capital to the business firms.	The main purposes of this service are- a) drafting memorandum of association, articles of association, prospectus etc. b) preparing various projects c) Issue of securities related services d) counselling for the management of companies e) capital restructuring related advice.
3.Consideration	Financial institutions provide funds to the business firms by charging rent or interest.	Financial institutions render various technical services by charging fees.

4.Functions	These services provide alternative capital to the business firms, e.g., lease financing, hire purchase financing, underwriting, etc	These services provide technical and legal advice such as corporate counselling, capital restructuring, etc.
5.Examples	Examples of these services are- a) Equipment leasing, b) Hire purchase finance, c) Bill discounting, d) Venture capital financing, e) Factoring & Forfaiting, f) Housing finance, g) Insurance services, h) Underwriting	Examples of these services are- a)Merchant banking, b) Issue management, c) Portfolio management, d) Capital reorganisation, e) Merger and Acquisition related services, f) Corporate counselling.

Q2) Nature and Features of Merchant Banking

Ans: Merchant Bank is the intermediary that links the companies that require capital and the suppliers of capital. It offers an array of specialised financial services as well as provides capital to the corporate sector. **The salient features of a merchant bank are discussed below:**

A) **Rendering fee-based services:** Merchant banks usually render fee-based services such as issue management, project appraisal, advisory services relating to merger and acquisition, etc.

B) **Rendering financial services**: Merchant banks render financial services mainly to the corporate organisations by charging fees.

C) **Widening the periphery of activities**: Apart from rendering financial advisory services, presently the merchant banks have been providing finance to the corporate organisations. They perform in the entire spectrum of financial markets.

D) **Rendering intermediary function**: Merchant bank acts as the intermediary institution between the issuing companies and the investors. It facilitates the corporate organisations to raise finance by issuing shares and debentures conveniently from the primary market.

E) **Capital market intermediary**: Merchant banks render an array of financial services to the corporate sector. Their activities pertain closely to the capital market activities.

F) **Run by experts and professionals**: Merchant banks are run by professionals and experts. They render technical advice to the corporate organisations. They possess a wide gamut of knowledge about the financial market.

G) **Lower amount of capital**: Merchant banks mainly render technical advice to the corporate sector. For that reason, they need small amount of capital to run their organisations. They are to invest mainly in hiring human capital.

H**) Internationalisation**: Merchant banks are found almost in every country throughout the world. Moreover, merchant banks of a country render their professional services to other countries also. So, the periphery of merchant banking services is not restricted within a country. They spread their footprints in foreign countries or in the global capital market.

I) **Rendering banking services to large business houses:** Merchant banks also render banking services to the big business organisations They do not offer banking services to the individuals. It is their secondary activity. Surplus funds are used by these organisations in this manner and they aim at generating some returns out of it.

J) **Primary market operations**: Merchant banks render service to the corporate sector mainly in primary market operations, i.e., at the time of issue of securities. They undertake huge responsibilities to make the issues successful and ensure the issuing companies to raise the desired amount of capital needed for their expansion, diversification and modernisation. Now, merchant banking services have become indispensable in the primary market operations.

Q3) Distinction between Commercial Bank and Merchant Bank.

Ans: Following are the main points of distinctions between commercial banks and merchant banks:

Points of Distinctions	Commercial Bank	Merchant Bank
1.Definition	A commercial bank is that financial institution which accepts deposits from the public and other institutions and lends money to the borrowers.	A merchant bank is a specialised financial institution which renders professional services to corporate sector with regard to the issue of securities, appraisal of project, capital restructuring, merger and acquisition etc
2. Remuneration	A commercial bank charges interest on loan provided by it and charges commission for rendering ancillary services.	A merchant bank charges fees for services rendered by it.

3. regulation and control	A commercial bank is regulated and controlled by the apex body of the money market, viz. the Reserve Bank of India (RBI).	A merchant bank is regulated and controlled by the apex body of the capital market, viz, the Securities and Exchange Board of India (SEBI).
4. Number of clients	Number of clients of the commercial banks is huge	Number of clients of merchant banks is comparatively less.
5. Clientele	Individuals and all types of institutions are the clients of the commercial banks.	Only large corporate organisations are the clients of the merchant banks. An individual cannot become a client of a merchant bank.
6. Area of activity.	A commercial bank is the player the money market.	A merchant bank is the player in the capital market.
7. Types of investments	A commercial bank provides short and medium-term loans to individuals and working capital loan to trade industry and commerce.	A merchant bank does not provide credit to individuals, it invests in various projects of companies and often buys securities of corporate organisations.
8. Liquidity and investments	Investments of the commercial banks are less liquid.	Investments of the merchant banks are more liquid.
9. Risks of investment	Risks of investments are comparatively high.	Risks of investments are comparatively low.
10. Professional skills of the employees	Employees are not generally professionally qualified.	Here, professional skill is needed for providing the service. So, most of its employees are professionally qualified.
11. Credit creation	A commercial bank creates credit in the money market by receiving deposits and granting credit to the borrowers.	A merchant bank cannot create credit in the system.

12. Function	A commercial bank accepts deposits from public and institutions and lends money to individuals and business houses.	A merchant bank renders expert financial advice to its clients.
13. Requirement of capital	A commercial bank requires huge for maintaining its capital adequacy ratio.	A merchant bank does not require amount of capital much capital as it renders mainly advisory services to corporate organisations.
14. Technical assistance	A commercial bank does not render technical assistance to its customers.	A merchant bank renders technical assistance regarding various matters to its clients.
15. Number of employees	A commercial bank employs a large number of staff for carrying on its operations smoothly.	A merchant bank usually does not require large number of staff.
16. Number of banking branches	A commercial bank has a large number of branches across the country.	A merchant bank has a few numbers of branches across the country.
17. Nature of activities	A commercial bank functions stereotype activity.	A merchant bank renders very specialised nature of activities.
18. volume of work	A commercial bank deals with very large number of customers. So, the volume of its work huge.	Comparatively the volume of work is less in case of a merchant bank.

Q4) Discuss the different functions of Merchant Bank.

Ans: A merchant bank plays an important role in the capital market. Mainly it renders professional advisory services to corporate organisations. **<u>The important functions of any merchant banking organisation are discussed below:</u>**

A) **Rendering assistance in the formation of companies:** A merchant bank assists the promoters to form a company. It helps in drafting Memorandum of Association, Articles of Association, Prospectus and other documents. It also helps in incorporation of the company. It makes the floatation of company easier.

B**) Rendering project evaluation:** It is an important function of a merchant bank. After analysing the pros and cons of a project, it produces a statement for the client and gives its expert advice whether the particular project is to be accepted or not. Merchant banks appoint professionals having specialised knowledge about the financial markets. As a result, they are able to render rational and balanced advisory services to their clients.

C) **Issue management**: When a company issues its shares among the general public for raising capital, it has to comply with various legal matters. A merchant bank renders the issue management services to the companies. In this respect, a merchant bank renders the following services:

- It acts as the lead manager or co-manager or consultant to the issue.
- It prepares the prospectus.
- It appoints brokers, registrar, advertising agency, printing agencies, etc, to the issue.
- It fixes the price of shares to be issued, i.e., whether the shares would be issued at par or at a premium, etc.
- It takes the necessary permission from the SEBI and the stock exchange in this regard.

D) **Acts as guarantor**: A merchant bank acts as guarantor to the loans raised by its clients. It helps the entrepreneurs to procure loans from financial institutions on easy terms.

E) **Drawing of rehabilitation scheme for sick units**: A merchant bank prepares a rehabilitation plan for sick companies. It prepares a project for revival of the sick companies after considering various aspects of the company such as possible changes in technology and the products, future prospect of the industry, etc. This rehabilitation plan may be sent to the Board for Industrial and Financial Reconstruction (BIFR) for having the required revival package.

F) **Rendering advisory services**: It renders various advisory services to its clients such a portfolio management, stake sale, acquisition of a company, hiving off the business unit, etc.

G**) Acts as a co-ordinator**: It acts as a co-ordinator among different companies and the investors.

H**) Acts as a positive catalyst in the capital market**: It plays a proactive role in the capital market. It encourages the entrepreneurs by rendering various types of professional advice and on the other hand, bolsters up the morale of the investors to invest in securities of the corporate organisations.

I**) Arrangement of loans for clients**: A merchant bank on behalf of the companies, prepares various projects which are economically viable. It ascertains the loan capital needed for implementing such project on behalf of the companies and takes the responsibility to arrange such loan from other financial institutions.

J) **Rendering advice for merger and acquisition**: When two or more companies are merged, lots of legal formalities are to be maintained. A merchant bank helps the companies to carry out the process of the merger. Moreover, it determines the swap ratio for the allotment of shares of the new company. The ratio at which an acquiring company would offer its own shares in exchange for the shares of the target company during a merger or acquisition, is called as the swap ratio.

k) **Acts as underwriter**: When a company issues its shares or debentures in the primary market, a merchant bank takes the responsibility to make the issue successful. A merchant bank acts as an underwriter and charges fees to the issuing company and provides guarantee to subscribe the shares to some extent which are not subscribed by the investors.

I) **Lease broking**: A merchant bank acts as a lease broker when a company is willing to get an asset on lease. It helps the company to find out the lessor and makes the deal successful.

M) **Financial structuring or restructuring**: A merchant bank helps a newly formed company to design its capital structure. It also helps an existing company to restructure its existing capital structure. It evaluates the different alternative sources of funds and advises the company to raise capital from various sources suitable for it.

N) **Risk management**: A merchant bank assesses the risk-return ratio of its clients' projects. It gives valuable suggestions to its clients regarding various risk mitigating strategies such as hedging, exchange rate swap or interest rate swap etc. Considering the risk-taking appetite, it renders astute advice to its clients regarding execution of projects.

Q5) Discuss the Importance of Merchant Banking

Ans: A merchant bank plays an important role in economic growth of a country. Merchant banking business has been rapidly growing in our country. The periphery of activities of merchant banks has been spreading since the introduction of liberal economic and industrial policies by the government of India since early 1990s. **The importance of merchant banks are discussed below:**

A) **New issue management**: A merchant bank plays an active role in new issue of securities by a company. It acts as a lead manager. Companies which come out with new issues have to appoint one or more lead managers make the issues successful. Lead managers have a great role to play in the new issues such as preparation of prospectus giving advertisements making arrangement to repay the excess application money, etc. A merchant bank acts as a lead manager of the new issues and tries to make the issue successful.

B) **Portfolio management**: Investing in equities is a highly specialised job. It is not so easy to make money from the equity markets. It requires huge expertise and knowledge about the stock markets. So, investing in equities requires professional advice. A merchant bank appoints professionals having optimum level of skill and knowledge about the stock markets. A merchant bank renders portfolio management services (PMS) by charging some fees to its clients. It plays an important role in this respect.

C) **Project appraisal**: A merchant bank undertakes due diligence of a project. It is run by professionals and astute persons having sufficient knowledge about the economy and industry. They help the corporate organisations regarding acceptability of a project. They appraise and assess the viability of projects of the companies They recommend the companies whether a particular project is to be considered or not after conducting the feasibility and viability study.

D) **Capital restructuring**: In strengthening the capital base of a company and to make the company more competitive, particularly in case of merger and acquisition, capital restructuring is needed. A merchant bank helps the corporate organisations to carry out capital restructuring process successfully. Through the capital restructuring of a company, it helps the management to generate more returns for the shareholders.

E) **Underwriting**: Underwrites play an active role to make the issue of shares and debentures successful and companies are able to procure the desired amount of capital from the primary market. Merchant banks act as underwriters and help the corporate organisations in raising their capital.

F**) Helping corporate sector in raising loans**: Companies may have to resort to borrowed capital such as through issue of debentures, taking long-term loans, etc, apart from owned capital. A merchant bank helps the corporate organisations to raise loans from various financial institutions and helps them in smooth running of business. It ensures the companies to raise debt capital from the market and to create balanced capital structure of the companies. Availability of sufficient amount of borrowed capital helps the companies to enhance their operations.

G**) Rendering assistance in the formation of a company**: A merchant bank assists the promoters to form a company. It helps in drafting Articles of Association, Memorandum of Association, Prospectus etc. It also helps the companies to get incorporated. Thus, entrepreneurs become encouraged to form joint stock companies.

H) **Lease broking**: A merchant bank acts as a lease broker. When a company is willing to get an equipment or other assets on lease, a merchant bank helps the company to find out the lessor and makes the deal successful.

I) **Rendering advice for merger and acquisition**: When two or more companies go for merger, lots of legal formalities are to be adhered to. A merchant bank helps the companies to carry out the process of the merger. Moreover, it determines the “Swap ratio” for the allotment of shares of the new company. In this way, it ensures inorganic growth of the companies [Inorganic growth indicates a growth of a company by involving in merger with other company or acquisition of another company].

J) **Helps to take various strategic decisions**: Corporate organisations are to take various crucial decisions judiciously. A merchant bank helps the companies to take some strategy decisions such as merger and acquisition, expansion of business, diversification of products, etc. It renders invaluable advice to the entrepreneurs to take such strategic decisions.

K) **Keeping a link between companies and investors**: A merchant bank helps in raising capital by the corporate organisations. At the time of new issue of shares, a merchant bank acts as a lead manager of the issue and takes the entire responsibilities of the issue. It fixes the price of the issue, makes advertisement, prepares prospectus, etc. It supplies relevant information about the company and helps the investors to take informed investing decisions. It keeps a close link between the issuing companies and the investors.

L) **Strengthening capital market**: A merchant bank plays an active role towards creating a healthy capital market. It takes the responsibilities for the new issues of companies, encourages investors to invest in equities, helps investors to take informed investment decisions, etc.

M) **Risk management**: A merchant bank assesses the risk-return ratio of its clients' proposed projects. It gives valuable suggestions to its clients regarding risk mitigating strategies such as hedging, swapping, etc.

N) **Financial structuring or restructuring**: A merchant bank helps a newly incorporated company to design its capital structure. It also helps an existing company to restructure its existing capital structure. It evaluates the different alternative sources of funds that the company might resort to it. It helps the company management to create a healthy capital structure. It improves the profitability of the organisation.

Q6) Discuss the Role of Merchant Banks.

Ans: Role of Merchant Banks Merchant banks play multifarious roles in the capital market. Such roles are discussed below:

A) **Acting as lead manager**: Acting as lead manager in the issue of shares of a company is the most important aspect of merchant banking business. It is now compulsory that all public issues must be managed by one or more lead managers. A merchant bank acts as a lead manager in the public issue and makes the issue successful.

B) **Acting as underwriters**: The issuing companies appoint underwriters to make the issue successful. Merchant banks may be appointed as underwriters. They perform underwriting activities very efficiently and successfully.

C) **Acting as bankers to the Issue**: Merchant banks may be appointed as the banker to the issue by the issuing companies. They accept applications and application money from the investors at the time of issue of shares and refund excess application money. They perform these tasks very efficiently.

D) **Acting as brokers to the issue**: Brokers procure subscriptions for the issue from the applicants. Merchant banks may be appointed as brokers by the companies in case of new issues. Merchant banks act very successfully as brokers to the issue.

E) Acting as portfolio managers: The main function of a portfolio manager is to manage the investment portfolio of its clients efficiently. Merchant banks appoint professionals having sound stock market knowledge and skill. So, they perform the functions of portfolio managers very effectively. To act as portfolio manager, the merchant banks require a certificate from the SEBI.

F) **Acting as project counsellor**: The main task of a project counsellor is to appraise the technical, financial and commercial aspects of a project. After evaluating various aspects, gives its recommendations relating to the acceptance or rejection of the project Merchant banks employ experts from the industries who are capable enough to do this job efficiently. So, they act as project counsellors.

G) **Acting as registrars to an issue and share transfer agents**: Merchant banks act as registrars and share transfer agents. In that capacity, they perform the following functions:

- Collecting applications and application money from the applicants.
- Keeping proper records of application money received.
- Guiding the companies in determining the basis of allotment of shares.
- Issuing the allotment letters to the applicants.
- Issuing the refund orders for the excess applications.
- Keeping detail records of the holders of the securities.

H) **Acting as sponsor to the Issue**: Merchant banks act as sponsor to the issue. As sponsors they play the important role such as placement of shares, listing of shares, selection of the broker and the underwriter, etc.

I**) Acting as credit collectors**: Merchant banks play active roles in arranging loans for a company and receive such credit on behalf of its client from the financial institutions. They act as guarantors of loans raised by such companies.

J) **Capital restructuring**: Merchant banks help the companies in restructuring of their capital. They help companies in fixing proper capital gearing ratios. A balanced capital structure helps a company to withstand the financial storm in the industry and to acclimatise the inclement weather in the finance markets. So, merchant banks help the companies in such a manner these companies can easily face new challenges in the capital market.

SEBI's Regulations Regarding Registration of Merchant Bankers

The SEBI regulates the activities of the merchant banks in India. No person would be able carry on any activity as a merchant banker unless it gets the registration certificate from the Securities and Exchange Board of India (SEBI). An application shall be made by any person or organisation to act as merchant banker in any one of the following categories

(a) Category 1:

- to carry on any activity of the issue management, and
- to act as adviser, consultant, manager, portfolio consultant, and underwriter

(b) Category II:

- to act as advisor, co-manager, consultant, portfolio manager and underwriter

(c) **Category III**:

- to act as adviser, underwriter, and consultant to an issue.

(d**) Category IV**:

- to act only as adviser or consultant to an issue.

Following are the prerequisites for granting certificate of registration to a merchant bank by the SEBI:

A) **Body corporate**: The applicant must be a body corporate other than a non-banking financial company.

B**) Adequate infrastructure**: The applicant must have the adequate infrastructure for smooth functioning of its business. Such infrastructural facilities include equipment's, adequate office space and enough manpower.

C) **Trained staff:** The applicant must have at least two experienced employees to carry on the operations as a merchant banker.

D) **Capital adequacy requirement**: The applicant has to fulfil the capital adequacy requirements.

E) **Having no litigation with securities market:** The applicants or its partner, director or principal officer should not have involved in any litigation in any securities market.

F) **Not convicted of any offence**: The applicant or its directors or partners should not have been convicted of any offence by the court.

G) **Professional qualification**: The applicant must possess a professional qualification in finance, law or business management from the government recognised institutions.

H) **Safeguard interest of the investors**: The SEBI will issue certificate of registration to the applicants with a rider that the organisation must protect the interests of the investors. That means the organisation must take utmost care for safeguarding the interest of the investors.

CREDIT RATING:

Features of Credit Rating:

Credit rating is an art as well as a science of assessing the credit risk of a financial instrument. It assigns various symbols to reflect the risks associated with a credit instrument. It never recommends the investors to buy, hold or sell a particular financial instrument. It only expresses an independent opinion about the quality of a credit instrument. The salient features of credit rating are discussed below:

A**) Assessing the creditworthiness**: Credit rating assesses the debt servicing ability of financial instrument. It determines the creditworthiness of the borrower. It assigns some symbols to express the debt repayment ability of the borrower.

B) **Assessing the risk**: It gauges the risks associated with a credit instrument. Investors become aware of the risks associated with a financial instrument on the basis of such rating.

C) **Art and science**: Credit rating is a complex process where some generally accepted principles are followed as well as personal judgements of the experts are given due weightage. So, it is both an art as well as a science.

D) **Creating awareness**: Credit rating does not recommend to buy, hold or sell a particular credit instrument to the investors. It assesses the quality of the issuing financial instruments and helps the investors to take informed investment decisions.

E) **Using some symbols**: Credit rating agencies use some predetermined symbols to exhibit the credit risks of a financial instrument. Commonly used symbols are 'AAA' that stands for highest safety and implies that any adverse changes will not affect its financial soundness, similarly 'BBB denotes moderate safety, etc.

F**) Relevant factors**: Some relevant factors which are taken into account by the rating agencies are as follows:

- overall condition of the particular industry in which the issuing firm belongs to,
- operating efficiency of the issuing firm,
- overall reputation of the issuing firm,
- profitability of the firm,
- nature of corporate governance maintained by the firm,
- past performance and a company's past track records,
- quality of assets of the firm,
- Interest burden of the company, etc.

G) **Rating fees**: Credit rating agencies charge their fees to the issuing houses for rendering rating services. But the end users, i.e., investors do not have to pay anything for getting this service.

H) **Evaluation of the management's efficacy:** Rating procedure includes appraisal of management's ability to tide over a difficult situation.

I) **Extremely specialised services**: Credit rating is not an easy task It is a specialised service. It requires in-depth study of the issuing companies, and their financial statements, prospectus and other relevant documents. Credit rating agencies appoint professionals to do this job.

J) **Continuous processing**: Credit rating is not a static job. It is a continuous process. with the passage of time, due to changes in financial performance of a company financial position and the associated risks also change. As a result, rating done by a company is valid for a particular period. With the passage of time, it becomes obsolete. It requires further rating after a stipulated time period

K) **Reflects quality of corporate governance**: A good rated financial instrument reveals the effectiveness of management and the quality of corporate governance A high degree of corporate governance uplifts the status of the company to an enviable stature and it speaks of the rating.

Discuss the statement "Credit Rating is a Combination of Science and Art"

Ans: Credit rating is a technique or process of ascertaining the creditworthiness of the borrower to repay its debts. The prime objective of credit rating is to provide guidance to investors in determining the credit risks associated with the credit instruments. It evaluates the capability of the borrowers to repay the debt in accordance with the terms and conditions. It is a judgement about a borrower's financial prospects. It assigns some pre-determined symbols to indicate the quality of the credit instruments. It assesses the credit risks associated with the credit instruments Credit rating a complex process. It applies some scientific tools and techniques and, at the same time, depends on personal skills, expertise and judgement.

It is said that the credit rating is the combination of both science and art.

- **Arguments for treating credit rating as science**: Some experts are of the opinion that credit rating is a science and their arguments are:
  - **Organised body of knowledge**: It is based on some principles and specialised knowledge. These functions cannot be performed without having special knowledge.
  - **Universal application**: The techniques of credit rating are applied universally.
  - **Continuous observation**: The commonly used principles are the results of continuous observations.
  - **Scientific approach**: Decisions are taken on the basis of scientific techniques based on theoretical and empirical evidences. So, credit rating can be considered as a "science".
- **Arguments against treating credit rating as science**: Following arguments are given by some experts for not treating credit rating as a science
  - **Absence of definite rules and regulations**: In the credit rating process, no definite rules and regulations are used. So, it cannot be treated as science.
  - **Uncertainty of results**: The forecast made in the process of credit rating may not tally with the actual results.
  - **Not a pure science**: The techniques and formulae used in the process of credit rating are not technically tested. So, it cannot be considered as pure science.
  - **Flexibility:** In some cases, variations in using the techniques and formulae are found. So cannot be considered as a science.

ART:

- **Arguments for treating credit rating as an art:**

Some expert opinion that credit rating is an art. They set the following features to proof that it is an art:

- **Application of practical knowledge**: Practical knowledge is required to conduct this process. Without having sufficient amount of practical knowledge rating cannot be done successfully.
- **No need for special curriculum**: It does not require specific curriculum. The power of personal judgement and intelligence are required in this process.
- **Creativity:** It is a creative work. It is a very complex process where innovative ideas and creativity are required.
- **Historical instance**: In some cases, historical instances are followed in the process of credit rating.

All these arguments suggest that credit rating is really an art.

- **Argument against treating credit rating as an art**: Some experts say that the credit rating cannot be considered as an art because of the following reasons:
    - **Necessity of special knowledge**: It is an expert's job. An ordinary person cannot do this job. It requires huge amount of specialised knowledge about the financial markets.
    - **Scientific Approach**: Decisions are taken by applying scientific approach. So, it cannot be a pure art.

From the above discussion it can be concluded by saying that credit rating is a combination of both art and science.

Objectives of Credit Rating:

Ans: Credit rating is the process of assigning values to the debt instruments issued by corporate organisations and other institutions by using some pre-determined symbols. It assesses the ability of the borrowers to repay the debts as per the terms and conditions. The main objectives of credit rating are discussed below.

A) **Benchmark of quality**: It assigns values to the credit instruments by analysing the qualitative standard of the firm. It expresses the qualitative standard of the credit instruments and the investors can compare the grading of a particular credit instrument with that of others.

B) **Assigning various symbols**: After analysing the creditworthiness of the borrower, various types of symbols are used to indicate the credit quality of the instruments. So, it becomes helpful for the investors to understand the quality of the instruments.

C) **Safeguarding investors' interest**: Rating agencies appraise the quality of the instruments issued by corporate organisations considering various important parameters. A highly rated instrument indicates that the risk related to repayment is less. Again, a poorly rated instrument indicates huge risks. So, investors get an idea about the risks associated with various credit instruments available in the financial markets. Rational investors give due weightage to the credit rating and take their investing decisions. In this way, they can reduce the risks relating to their investments. Rating agencies play an important role towards protecting the investors interest.

D) **Help to the functionaries**: Capital market functionaries (such as, brokers, sub-brokers, portfolio consultants, etc.) possess a wide range of knowledge about the stock markets. They constantly evaluate various financial instruments available in the markets and accordingly render advice to their clients. Credit rating helps them to get the adequate knowledge about the credit quality of various financial instruments.

E) **Rendering professional services**: Credit rating agencies appoint professionals having sufficient knowledge about the financial markets. Through the process of rating of various credit instruments, they express their independent and professional opinions regarding the quality of the bonds and other securities issued by some companies. So, investors, brokers, sub-brokers, etc., get the professional services from the credit rating agencies.

F**) Assessing the financial soundness**: Rating agencies assess the financial conditions of the issuing organisations meticulously. Various tools and techniques are used for measuring the financial soundness of the organisations. So, through the credit rating symbols, an investor gets the idea of the financial soundness of the issuing organisations.

G**) Bringing discipline**: Credit rating agencies play an important role in bringing discipline among the corporate borrowers. They strive to improve their financial structure and mitigate the overall operating risks for achieving better ratings and thereby enhancing their acceptability among the investors.

H**) Ensuring smooth functioning of intermediaries**: Various intermediaries such as brokers, underwriters, investment bankers etc., take part in the management of capital issues. Credit rating agencies help them by evaluating the creditworthiness of the borrowers or the issuing companies. Rating agencies ensure smooth functioning of these intermediaries.

I) **Ensuring transparency**: Credit rating agencies compel the companies which issue their securities to bring more transparency in disclosure of financial and other relevant information for the stakeholders.

J**) Determining the market prices**: Credit rating helps the issuing companies to fix the issue price properly for their shares or debentures. If the rating is good then the company may fix higher price for the instrument. On the other hand, lower price is fixed when the rating is not so good. A highly rated company may procure substantial amount of capital by issuing their securities.

Importance of Credit Rating:

Credit rating helps in strengthening the financial markets Credit rating agencies play an important role in the financial system. It enables the investors to assess the risk-return ratio of financial instruments. It helps the investors in taking balanced and informed decisions. It is a tool in the hands of various financial institutions for making their appropriate investment and lending decisions It also helps the market regulators in bringing stability in the financial markets. It plays an important role in the financial markets. Following are the Importance of credit rating:

A) **Safeguarding investors' interest**: Credit instruments issued by the corporate houses are rated by the rating agencies They render the professional services to the borrowers by adopting fundamental analysis and technical analysis. Investors become aware of the financial soundness of the borrowers and the risks associated with the credit instruments. Accordingly, investors take their investment decisions. A highly rated financial instrument offers comparatively low rate of interest and a low-rated instrument allows high rate of interest. The investors according to their risk-taking appetite, take investing decisions. So, credit rating helps them to take balanced and informed decisions. Rating agencies play a key role in protecting the interest of the investors.

B**) Reflecting the associated risks**: Credit rating agencies, after conducting a thorough study, gauge the associated risks with the financial instruments issued by the corporate houses. It helps the investors to take informed decisions and make their investments according to their risk-taking abilities.

C) **Assessing financial solvency**: By conducting thorough analysis, the credit rating agency assesses the financial solvency position of the borrowers. It helps the investors in taking their decisions judiciously.

D) **Helping in investment strategies**: Investors invest in various types of financial instruments considering their risk-taking ability. A risk averter invests in those instruments where risk is comparatively low. He prefers to invest in those securities where he gets the highest safety. Hence, the return is not given much weightage. On the other hand, an investor having high risk-taking ability, invests in those securities where the return is high, and he is ready to take much risk for that. Credit rating discloses the risks associated with the financial instruments and help the investors to make their investment strategies rationally.

E**) Forecasting financial strength and weakness of the company**: Rating agencies conduct thorough study of the financial statements and other documents of the issuing companies

They give their score cards to the companies. Through their rating reports, they pinpoint the financial strengths and weaknesses of the companies. The management of the companies which are poorly rated take remedial measures to uplift their performances. The management of that company try their level best to plug the loopholes noticed by the rating agencies leaving no stone unturned.

F**) Helping the stock market functionaries:** Stock market functionaries such as brokers, sub brokers, portfolio consultants, etc. possess sufficient knowledge about the stock markets. They continuously evaluate various financial instruments available in the market. Credit rating helps them to get adequate knowledge about the credit quality of the financial instruments. As a result, they can render better services to their clients.

G**) Rendering professional services**: Credit rating is an expert's job. Only experts and professionals having huge exposure in the financial markets can do this job. Rating agencies appoint professionals and experts to conduct the financial rating properly. As a result, rating done by these experts become acceptable and reliable to all concerned. So, all the concerned parties such as investors, issuing companies, brokers, sub-brokers, consultants, etc. become greatly benefited from the rating.

H) **Bringing discipline**: Credit rating agencies play an important role in bringing discipline among the corporate borrowers. They try to improve their financial structure and reduce the overall risks.

I) **Marketing pool**: If the rating of the financial instruments of the issuing company becomes satisfactory, that company is able to raise funds from the market without facing much hassles.

J**) Determining the market prices**: Credit rating helps the issuing companies to fix the issue price prudently. If the rating is good, the company may fix higher price; on the other hand, lower price is fixed when the rating is poor.

<u>Functions of Credit Rating:</u>

Credit rating is the assessment of a borrower's credit quality. It is a highly specialised job. It performs the functions of appraising the borrower's capability to repay the debt as per terms and conditions of the issue. Important functions of credit rating are discussed below:

A) **Assessing the associated risks**: Rating agencies conduct the functions of credit rating very meticulously and independently, and publish the unbiased rating of the credit instruments. They make a thorough study considering all the relevant factors of the issuing companies and assess the default-risk of the companies. Investors become aware of the associated risks of investing in the credit instruments available in the financial markets. It helps them to take informed investment decisions.

B) **Assessing the qualitative standard of the credit instruments**: Credit rating assesses the quality of the credit instruments of the issuing companies. In this process, financial soundness, managerial quality, reputation of the firm, capital structure of the firm, interest burden, etc. are considered. Credit rating gauges standards of the credit instruments.

C) **Assessing the financial strength and weakness**: Rating agencies consider number of factors such as company's financial position, capital gearing ratio, company's debt burden, interest service coverage ratio, return on capital employed, etc., in evaluating credit quality of the instruments.

D**) Rendering professional services**: Credit rating agencies appoint professionals and experts having high degree of knowledge about the financial markets. They conduct the tasks of rating very minutely, and the investors and other market intermediaries get benefited immensely from the credit rating. A professional touch is witnessed in the process of credit rating.

E) **Determining the market prices**: Credit rating helps the issuing companies to fix the issue price of their securities rationally. If the rating is good, the company may fix higher price. On the other hand, lower price is fixed when the rating is poor.

F) **Bringing confidence of the investors**: The task of credit rating is done by the professionals and experts having enough skill and knowledge about the financial markets. They conduct the study independently and unbiasedly. Investors repose their faith on the credit rating and invest accordingly. So, credit rating instils confidence in the investors' minds regarding the financial instruments.

G) **Helping the stock market functionaries**: Stock market functionaries such as brokers, sub-brokers, portfolio consultants, etc., become largely benefited from the credit rating. They get enriched by going through the rating agencies' reports on the data analysis of various companies. As a result, the functionaries are able to guide their clients more effectively.

H) **Making periodical disclosure**: Rating agencies rate the financial instruments of various companies several times over a short period. With the passage of time, companies' financial position changes. As a result, creditworthiness of the companies also changes. So, credit rating agencies rate the credits and ability of the companies (to meet such debt obligations) several times within a short period. It becomes able to clarify the current financial position of the companies.

I) **Evaluating companies' performances**: Rating agencies constantly appraise the operating performances of the companies. As a result, strengths and weaknesses of the companies' get revealed. Management of such companies can take remedial measures accordingly to remove such weaknesses.

J**) Rendering unbiased services:** Rating agencies render professional services to the companies in assessing their creditworthiness. After conducting thorough analysis of relevant factors, they produce unbiased reports which are acceptable to the investors and market intermediaries.

K**) Helping the investors for taking investment decisions**: General investors do not have much information about the quality of the credit instruments available in the market. Moreover, they are not able to estimate the financial soundness of the issuing company on the basis of the data available from the company. Credit rating agencies express their unbiased opinions regarding the quality of the credit instruments available in the market. As a result, investors are able to take informed decisions with regard to the investments in securities.

Advantages of Credit Rating:

Credit rating plays an important role in the financial system. Users of the credit rating such as investors, brokers, portfolio consultants, banks and other financial institutions, insurance companies, Etc., get immensely benefited by using the ratings in taking their decisions. The advantages of credit ratings are shown below.

A) **Revealing the associated risks**: Rating agencies conduct the tasks of rating very diligently. They reveal the risks associated with the financial instruments issued by the companies. They use various types of symbols to indicate the associated risks of the instruments. Investors and other users of the ratings become able to take their decisions considering the risks associated with the instruments.

B) **Comparative analysis**: Rating agencies use various types of symbols to reveal the credit quality of the financial instruments. The investors, based on such credit ratings, may compare the ratings of various credit instruments available in the market, and take their decisions accordingly.

C) **Helping the investors**: A rational investor uses credit rating as an important tool in investing his money in various securities in the financial market. Credit rating is done very diligently and rationally, and it is able to exhibit the correct financial position of the rated companies. It helps the investors in taking right investment decisions.

D) **Rendering professional services**: Credit rating agencies hire professionals having specialised knowledge about the finance markets. They conduct the tasks of rating very diligently applying their skill and knowledge. As a result, users of credit rating ultimately get the professional services and are benefited immensely.

E) **Saving the valuable time of the investors**: Rating agencies conduct their work very prudently and meticulously. As a result, information supplied by the rating agencies are very much reliable. Investors use the ratings in taking investment decisions. So, it saves their valuable time.

F) **Enhancement of reputation of a company**: Credit rating elevates the status of a company. If the company achieves a higher credit rating from the rating agencies, it helps to enhance the goodwill of the co.

G) **Reducing cost of capital**: A company which gets a high rating from a rating agency becomes able to raise capital from the market at a low rate of interest. So, it helps such a company to reduce its cost of capital. Low cost of capital propels the return on investments (ROI) and earning per share (EPS).

H) **Helping the stock market functionaries**: Stock market functionaries such as brokers, sub brokers, portfolio consultants, etc. are immensely benefited by credit rating. They become aware of the financial position of a company by studying the rating reports and accordingly they are able to render right information to their clients.

I) **Instilling confidence**: Credit rating instils confidence in the minds of the investors about the financial soundness of the issuing companies. This confidence helps in improving the business environment in an economy.

J) **Helping the banks and other financial institutions**: Banks and other non-banking financial institutions rely on credit rating and take their lending decisions. They hardly provide credit to the poorly rated companies. However, they provide substantial amount of credit to the highly rated companies.

K**) Rendering advice**: Credit rating renders advisory services to the market intermediaries and to the market regulators in bringing stability in the financial market.

Limitations of Credit Rating:

The limitations of credit rating are as follows:

A) **Discrepancies in ratings**: Usually issuing companies approach two or more rating agencies for the rating of their securities. Sometimes it is seen that the rating assigned by one rating agency differs from that of others. So, a discrepancy is found and the investors get confused about the reliability of the instruments.

B) **Unreliable:** Ratings assigned by the rating agencies are not always reliable. Sometimes it is found that the highest rated securities perform badly. So, it cannot be relied upon fully. Hence, it cannot be regarded as a full proof mechanism for protecting the investors' interest.

C) **Wrong assessment of risks**: Sometimes rating agencies wrongly assess the risks associated with the securities. So, the investors are misguided by rating agencies and they suffer loss by depending upon such ratings.

D) **Absence of objective information**: Sometimes rating agencies fail to supply objective information about the securities to the investors. As a result, investors fail to perceive the actual risks involved with such securities.

E**) Lack of due diligence**: In some cases, rating agencies conduct the tasks of rating without giving much efforts. As a result, misleading results come out with their rating. Lack of due diligence on their part renders the entire process of credit rating almost futile

F) **Making exaggerated statement**: Sometimes unholy nexus is found between an issuing company and the rating agencies. Dishonest employees of rating agencies for their personal gain make a secret deal with the issuing company. They make exaggerated statement and portray a rosy picture by suppressing the gloomy situation about the financial condition of the company. As a result, innocent investors bear the brunt of making bad investments.

G) **Lack of competence**: Sometimes the tasks of rating are entrusted by the rating agencies with some employees who are not competent enough, and they may not have adequate knowledge about the finance markets and the rating procedures. Naturally the rating done by those employees become misleading and confusing, Ultimately the investors invest their money relying upon such ratings and ultimately suffer huge loss.

H) **Non-disclosure of the rating methodology**: As per the SEBI's code of conduct, the methodology used by the rating agencies have to be disclosed to the companies, users and the public. Sometimes it is found that the rating agencies do not disclose the rating mechanism properly.

I) **Lack of promptness**: Sometimes rating agencies do not complete the tasks of credit rating within the reasonable time period. As a result, the entire process of raising capital by the companies gets delayed.

J) **Divulging confidential information**: In conducting the rating process, the high officials of the rating agencies get some confidential information of the companies. Some unscrupulous employees disclose the confidential information to the traders or to the brokers and earn undue profits. The confidential information of the companies become public. Ultimately this tells upon the interest of the companies.

Process of Credit Rating:

Various steps of credit rating are

A) Request for rating:

B) Assignment of responsibility to the rating team.

C) Collection of information.

D) Meeting with the top-level managerial persons.

E) Rating decision.

F) Disclose the rating information.

G) Rating review.

ROLE OF CREDIT RATING:

- INCREASE THE CONFIDENCE OF THE INVESTORS
- ROLE IN MOBILISING FUNDS BY COS.
- ROLE REGARDING INVESTORS PROTECTION.
- ROLE IN INCREASING THE STATUS OF THE CO.
- ROLE REGARDING SMOOTH FUNCTIONING OF FINANCIAL INTERMEDIARIES.
- ROLE IN MEASURING EFFICIENCY OF THE CO.
- ROLE RELATING TO IMPROVING CORPORATE GOVERNANCE.

SEBI GUIDELINES FOR CREDIT RATING AGENCIES.

- AGREEMENT WITH CLIENTS.
- MONITORING RATING.
- PROCEDURE FOR REVIEW OF RATING
- SUBMISSION OF INFORMATION TO THE SEBI
- COMPLIANCE WITHCIRCULARS ETC., ISSUED BY THE BOARD

- APPONTMENT OF COMPLIANCE OFFICER
- MAINTENANCE OF BOOKS OF A/CS RECORDS
- CONFIDENTIALITY
- RATING PROCESS
- DEFAULT STUDIES
- DEALING WITH CONFLICT OF INTEREST
- OBLIGATIONS IN RESPECT OF RATING OF STRUCTURED FINANCE PRODUCTS
- UNSOLICITED CREDIT RATINGS
- DISCLOSURES