CHAPTER VI

Unit: IV Financial Services

Merchant Banks: Functions and Role, SEBI Regulations; Credit Rating: Objectives and Limitations, SEBI Regulations; Credit Rating Institutions and their functions.

Introduction

Financial Services

Financial services are economic services provided by the finance industry, encompassing a broad range of businesses. It includes banking, insurance, leasing and hire purchase, merchant banking, portfolio management, depository services, factoring etc. It is an extremely important sub-sector within the financial system, as it *facilitates* fund flow from the surplus sector to the deficit sector of the economy.

Financial services may be of different types. For example, we can classify them as either (i) **fund-based** or (ii) **fee-based.**

In **fund-based** activities, the financial service company requires to make outlay of and manage funds. Its revenue is dependent on its efficiency in doing so. There are risks involved in fund-based activities. Examples of fund-based activities are: Factoring, Leasing and hire-purchase, Underwriting, Banking etc.

In **fee-based** activities, the financial service provider works on behalf of some client(s) against a fee. Risk is absent to a large extent. Its revenue basically depends on its fees. Examples of **fee-based** activities are: Issue management, Portfolio management, **Credit rating**, Corporate counselling etc. **Merchant banking** is basically a fee-based activity.

In this chapter, we shall discuss two of the above-mentioned financial services – (i) Merchant banking, and (ii) Credit rating. We start with merchant banking.

Merchant Banking

According to SEBI, a merchant banker may be defined as *any entity " who is engaged in the business of issue management either by making arrangement regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management."*

Some important points emerge from the above definition.

First, a merchant banker undertakes ***issue management,***

Second, a merchant banker ***renders corporate advisory services in relation to such issue management.***

However, as we shall see later, while the above two are the basic functions of a merchant banker, it may offer a much wider range of services.

Why do we need a merchant banker?

The need for a merchant bank exists from the viewpoints of both capital raising firms and capital supplying investors.

Firms raising capital through an issue have to face growing complexities in rules and procedures stipulated by the authorities (SEBI in case of India). They need the services of a skilled agency which could provide help in these matters in a packaged form. A merchant banker with their skills and updated knowledge-base provides this service to the corporate units.

On the other hand, investors supplying funds have the assurance that the profile of the issuing firm has been duly examined by a specialised agency. Also, they are made aware of the risks involved, and can be sure that all relevant rules have been complied with. This is very important for the proper functioning and transparency of the capital market.

Realising the importance of a merchant banker in respect of the capital market, SEBI has now made it compulsory to use the services of merchant bankers at the time of raising fresh capital.

Functions of merchant banks

The functions of a merchant bank can be described as follows:

(i) Management, marketing and underwriting of new issues,
(ii) Project appraisal, counselling and project preparation,
(iii) Merger, amalgamation and-take-over related services,
(iv) Syndication of loans,
(v) Corporate advisory services,
(vi) Extending assistance for technical and financial collaboration and joint ventures,
(viii) Raising of Euro dollars and issue of foreign currency bonds,
(ix) Acting as portfolio managers

It may be noted that all merchant banks may not offer all the above-mentioned services. The above list gives us an idea about the range of services a merchant bank may perform.

Merchant banking is basically a **fee-based** activity. In other words, it involves provision of certain financial services (as specified above) to a client against some fee. It is also a **skill-based** activity, as explained below:

- Mobilising funds - from India and abroad - has become a highly sophisticated and specialised activity, because of a complex set or system of national and international rules,
- Management of such funds also involves considerable technical, economic and financial expertise,
- Managing merger, amalgamation and take-overs also require great specialisation, in view of complex rules.

Difference between a Merchant Bank and a Commercial Bank

Basis	Commercial Bank	Merchant Bank
Basic Function	• Commercial banks provide the basic banking services like accepting deposits and lending money to general public. • Commercial banks are the key institutions in respect of the payment system.	• Merchant Banks cannot accept deposits, nor can it offer credit facilities • Merchant Banks cannot participate in the payment system. • The basic function of a merchant banker is **issue-management**

Provides service to	General public, and also firms	Only firms
Influence on money supply	Can create credit, and hence, can influence money supply	Cannot create credit, and has no influence on money supply
Regulator	**RBI**	**SEBI**
Exposure to risk	Significant	Quite insignificant
Role	Financier	Financial advisor/consultant

It may be noted that an applicant can carry on the activity as portfolio manager only if he obtains separate certificate of registration under the provisions of the Securities and Exchange Board of India (Portfolio Manager) Regulations, 1993.

Merchant bankers in India

In India, there are public sector, private sector as well as foreign participants in the merchant banking industry. Some of the important merchant bankers are listed below:

Public sector: SBI Capital Markets, Punjab National bank, IFCI Financial Services

Private sector: ICICI Securities, Axis Bank, Bajaj Capital, Tata Capital Markets, Yes Bank, Kotak Mahindra Capital Company, Reliance Securities

Foreign merchant bankers: Goldman Sachs (India) Securities, Morgan Stanley India, Barclays Securities (India), Bank of America, Citigroup Global Markets India.

Credit Rating

Introduction

Credit rating is the **opinion** of the rating agency on the relative **ability and willingness** of the issuer of a debt instrument to **meet the debt service obligations**. Rating is usually expressed in **alphabetical or alphanumeric** symbols. Symbols are a simple and easily understood tool which helps the investor to understand the credit quality of a debt instrument. Rating companies also publish explanations for their symbols to facilitate better understanding.

Objectives of credit rating: why do we need it?

We know that if markets are to function efficiently, there should be perfect knowledge among the participants. In case of capital market or a money market, it is not possible for all lenders or investors to have correct and up-to-date information about the credit-worthiness of a borrower. Three possible outcomes of this **information deficiency** are as follows:

(a) The lender (investor) may decide not to lend to any of the prospective borrowers,
(b) He may demand a risk premium, that is, a higher-than-normal rate of interest,
(c) He may choose the wrong borrower, that is, one who is less credit-worthy.

In any of the above three cases, we will say that resource allocation has been inefficient. This happens because of a **information deficiency**. Therein lies the merit of credit rating. **Credit rating removes the information deficiency of the prospective investors** to a great extent.

Ratings are used not only by the general public, but all classes of investors – mutual funds, portfolio managers, insurance companies, banks etc. Therefore, the price of a bond is affected by its rating.

The borrower also gains, as he does not have to pay any additional risk-premium than what is justified. Imperfect information raises the cost of borrowing. Thus, ratings – by offering important information - reduce the cost of capital.

Ratings are beneficial for the regulatory agencies as well. The basic task of a regulator is to ensure that (i) markets function efficiently and transparently, and that (ii) investor rights are protected. We can claim that credit rating performs these duties, because it discloses information about the borrower, thereby raising transparency and protecting investors' rights.

Ratings are beneficial for Intermediaries too. Intermediaries like investment and merchant bankers use the rating for pricing, in placement and marketing the issues. The ratings are also used in case of asset securitisation. Ratings make decision-making in respect of exposure levels and risk undertaking s easy.

Credit rating is beneficial for the country as well. Ratings **reduce uncertainty**. Less uncertainty means **greater saver confidence**, which encourages bond market growth and greater market efficiency. The reduction in uncertainty about the credit risks of unknown issuers, help to channel more savings into productive projects. Thus, ratings promote economic growth and a better standard of living for a fairly large section of people.

Let us now summarize what we have discussed above:

- Credit rating estimates **ability to repay debt**. It is a formal assessment of a corporation, conglomerates or even a country.
- A credit rating is usually expressed in **alphabetical or alpha-numeric terms**.
- Credit ratings **remove information –deficiency** among prospective investors.
- By reducing uncertainty, **credit ratings facilitate more efficient resource allocation**.
- Credit rating is beneficial for the **lender (investor**), for the **borrowing unit**, for the **regulator**, for the **intermediary** and even for the **country**.

From the above discussion, the **objectives of credit rating** can be expressed as follows:

1. To express opinion about the relative credit-worthiness of the issuer of a debt instrument, that is, the borrower – whether it is a company, a conglomerate or a government,
2. To **reduce** and **remove information-deficiency** among the lenders, regulators and intermediaries,
3. To help **allocate resources efficiently,**
4. To assist in (though indirectly) **national capital formation,**
5. To help the regulator(s) **in** running the money and capital markets smoothly and efficiently.
6. To help the intermediaries to make pricing decisions more efficiently, and make issue management easier for them.

It must be noted that it is neither possible nor desirable, to totally eliminate subjectivity while making a credit rating. Rating does not originate from a pre-determined mathematical formula. Rating agencies do a lot of numerical analysis, but they have to take into account factors like management quality, corporate strategy etc.

IPO grading: IPO grading is also conducted by credit rating agencies. It is the professional assessment of a Credit Rating Agency (CRA) on the fundamentals of a company in relation to the other listed equity shares in India. It is mandatory for the issuer company coming with initial public offer (IPO) to obtain IPO grading from a Credit Rating Agency and disclose the same on the cover page of offer document and Application form. IPO grading endeavours to provide the investor with an informed, objective independent and unbiased opinion of a CRA after analyzing various relevant factors.

Factors considered in grading

The indicative list of areas that are generally looked into by the CRA while arriving at an IPO grade includes:

- **Business Prospects and Competitive Position**
- **Industry Prospects**
- **Company Prospects**
- **Financial Position**
- **Management Quality**
- **Corporate Governance Practices**
- **Compliance and Litigation History**
- **New Projects—Risks and Prospects**

The Grades

Grading is generally assigned on a five point scale with a higher score indicating stronger fundamentals and vice versa as below.

IPO grade 1: Poor fundamentals

IPO grade 2: Below average fundamentals

IPO grade 3: Average fundamentals

IPO grade 4: Above average fundamentals

IPO grade 5: Strong fundamentals

Concerns about the rating mechanism

Despite the great utility of credit ratings, there are concerns about their reliability and accuracy. SEBI has also made an effort to review its supervisory process in respect of credit rating agencies (CRAs) in 2017. Let us briefly state the areas of concern, which can also be considered as **possible limitations.**

Issuer-pays system: We know that credit rating is a fee-based financial service. Globally, the **'issuer pays'** principle is followed, and CRAs receive their remuneration from the very firms they are about to assess. As a result, there is doubt on the independence, and reliability of the ratings. Accordingly, The Committee on Review of Eligibility Norms constituted by SEBI stated that:

*"The globally prevalent **issuer-pays rating agency model** has a structural **conflict of interest**, since the entity that commissions and pays for the rating exercise is also being rated"*

Irregular updating of ratings: Critics argue that CRAs often lag behind market indicators. They believe that while initial ratings tend to be accurate, CRAs do not maintain adequately updated ratings. CRAs should continuously monitor the company's performance and market conditions, and review their ratings. Critics say that this is not done diligently.

Lack of competition: There is a prevailing lack of competition in the credit rating sector. In India, there are very few dominant players in the market. **CRISIL,** the largest credit rating agency has over 60% of the market share in the ratings business. A competitive environment is necessary for transparent rating.

Why do we need regulation of CRAs?

All the above-mentioned issues represent areas of concern, and as credit rating is very important for proper functioning of the market, there is need to regulate CRAs. It is a fact that CRAs were not properly regulated in developed countries till the advent of the global financial crisis in 2007. In the post-crisis period, it was widely felt that CRAs were largely responsible for the crisis.

In India, however, SEBI had put in place a comprehensive regulatory system right from its inception. Let us now take a brief look at the regulatory regime in India in respect of CRAs.

Regulatory regime for credit rating agencies in India

On a global perspective, SEBI was one of the first regulators to put forth a comprehensive regulatory framework of CRAs through the SEBI (Credit Rating Agencies) Regulations, 1999. The regulatory framework can be broadly expressed as follows:

Registration and eligibility for registration: SEBI Regulations stipulate that CRAs should be companies promoted by persons who have experience in the field of credit rating i.e., by financial institutions or by persons who have a net-worth of more than Rs. 100 crore. CRAs themselves need to have a minimum net-worth of Rs. 5 crore and adequate infrastructure, professionals and employees to carry on the activity of issuing credit ratings.

Obligations: The SEBI Regulations require that CRAs must conduct their activities in accordance with the terms of their agreement with the issuer, and in compliance with the principles laid down in the SEBI Regulations. The SEBI Code of Conduct stipulates that the CRAs conduct their activities with integrity, competence, independence and confidentiality. In addition, CRAs are required to monitor their rating throughout the lifetime of the securities rated and carry on periodic reviews of their rating as well.

Disclosure: The SEBI Regulations mandates the CRAs to maintain and disclose their ratings in a specified manner. They also stipulate that CRAs should maintain copies of their all relevant documents in respect of a rating (like terms and conditions of agreement, records of decisions of rating committees and fees charged) for at least five years.

Others: The SEBI regulations also require that the CRA must submit information and documents to SEBI whenever asked to do so, must not rate instruments issued by the promoters, and will be open to investigation, examination and punitive measures.