LESSON 1:
FINANCIAL SERVICE

Lesson Objectives

To understand the Concept of Financial Services, its classification and activities.

In general, all types of activities, which are of a financial nature could be brought under the term 'financial services'. The term 'financial services' in a broad sense means "mobilizing and allocating savings". Thus it includes all activities involved in the transformation of savings into investment.

The financial services can also be called 'financial intermediation'. Financial intermediation is a process by which funds are mobilized from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers.

Thus, financial services sector is a key area and it is very vital for industrial developments. A well developed financial services industry is absolutely necessary to mobilize the savings and to allocate them to various invest able channels and thereby to promote industrial development in a country.

Classification of Financial Services Industry

The financial intermediaries in India can be traditionally classified into two :

i. Capital Market intermediaries and

ii. Money market intermediaries.

The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide long term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short term funds. Hence, the term 'financial services industry' includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

Scope of Finacial Services

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

i. Traditional Activities

ii. Modern activities.

Traditional Activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads, viz.

a. Fund based activities and

b. Non-fund based activities.

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

i. Underwriting or investment in shares, debentures, bonds, etc. of new issues (primary market activities).

ii. Dealing in secondary market activities.

iii. Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.

iv. Involving in equipment leasing, hire purchase, venture capital, seed capital.

v. Dealing in foreign exchange market activities.

Non fund based activities : Financial intermediaries provide services on the basis of non-fund activities also. This can be called 'fee based' activity. Today customers, whether individual or corporate, are not satisfied with mere provisions of finance. They expect more from financial services companies. Hence a wide variety of services, are being provided under this head. They include :

i. Managing the capital issue – i.e. management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issue.

ii. Making arrangements for the placement of capital and debt instruments with investment institutions.

iii. Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.

iv. Assisting in the process of getting all Government and other clearances.

Modern Activities

Beside the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder.

i. Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approvals.

ii. Planning for M&A and assisting for their smooth carry out.

iii. Guiding corporate customers in capital restructuring.

iv. Acting as trustees to the debenture holders.

v. Recommending suitable changes in the management structure and management style with a view to achieving better results.

vi. Structuring the financial collaborations / joint ventures by identifying suitable joint venture partners and preparing joint venture agreements.

vii. Rehabilitating and restructuring sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.

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viii. Hedging of risks due to exchange rate risk, interest rate risk, economic risk, and political risk by using swaps and other derivative products.

ix. Managing the portfolio of large Public Sector Corporations.

x. Undertaking risk management services like insurance services, buy-back options etc.

xi. Advising the clients on the questions of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.

xii. Guiding the clients in the minimization of the cost of debt and in the determination of the optimum debt-equity mix.

xiii. Undertaking services relating to the capital market, such as

a. Clearing services

b. Registration and transfers,

c. Safe custody of securities

d. Collection of income on securities

xiv. Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

Sources of Revenue

There are two categories of sources of income for a financial services company, namely : (i) Fund based and (ii) Fee – based.

Fund based income comes mainly from interest spread (the difference between the interest earned and interest paid), lease rentals, income from investments in capital market and real estate. On the other hand, fee based income has its sources in merchant banking, advisory services, custodial services, loan syndication, etc. In fact, a major part of the income is earned through fund-based activities. At the same time, it involves a large share of expenditure also in the form of interest and brokerage. In recent times, a number of private financial companies have started accepting deposits by offering a very high rate of interest. When the cost of deposit resources goes up, the lending rate should also go up. It means that such companies have to compromise the quality of its investments.

Fee based income, on the other hand, does not involve much risk. But, it requires a lot of expertise on the part of a financial company to offer such fee-based services.

Causes For Financial Innovation

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with the increasingly volatile and uncertain market place. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons :

i. **Low profitability :** The profitability of the major FI, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So, they have been compelled to seek out new products which may fetch high returns.

ii. **Keen competition :** The entry of many FIs in the financial sector has led to severe competition among them. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

iii. **Economic Liberalization :** Reform of the Financial sector constitutes the most important component of India's programme towards economic liberalization. The recent economic liberalization measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

iv. **Improved communication technology :** The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities.

v. **Customer Service :** Now a days, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public.

vi. **Global impact :** Many of the providers and users of capital have changed their roles all over the world. FI have come out of their traditional approach and they are ready to assume more credit risks.

vii. **Investor Awareness :** With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds, etc. Again, within the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovations has become the need of the hour.

Financial Engineering

The growing need for innovation has assumed immense importance in recent times. This process is being referred to as financial engineering. 'Financial engineering is the design, development and implementation of innovative financial instruments and process and the formulation of creative solutions to the problems in finance'.

New Financial Products and Services

In these days of complex finances, people expect a financial service company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporate and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial services company to innovate new products and services so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital

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market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are briefly explained hereunder :

i. **Merchant Banking :** A merchant banker is a financial intermediary who helps to transfer capital from those who possess it to those who need it. Merchant banking includes a wide range of activities such as management of customer securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporate, and thus promote industrial development in the country.

ii. **Loan Syndication :** This is more or less similar to consortium financing. But this work is taken up by the merchant banker as a lead manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a government department. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

iii. **Leasing :** A lease is an agreement under which a company or a firm acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called 'rental charges'. In countries like USA, the UK and Japan, equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies. In India also, many financial companies have started equipment leasing business.

iv. **Mutual Funds :** A mutual fund refers to a fund raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing the risk The fund provides investment avenues for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capitalization in the long run.

v. **Factoring :** Factoring refers to the process of managing the sales register of a client by a financial services company. The entire responsibility of collecting the book debts passes on to the factor.

vi. **Forfaiting :** Forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pays ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills.

vii. **Venture Capital :** A venture capital is another method of financing in form of equity participation.

viii. **Custodial Services :** Under this a financial intermediary mainly provides services to clients, for a prescribed fee, like safe keeping of financial securities and collection of interest and dividends.

ix. **Corporate advisory services :** Financial intermediaries particularly banks have setup specialized branches for this. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers, this service is of immense help to the customers.

x. **Securitisation :** Securitisation is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable.

xi. **Derivative Security :** A derivative security is a security whose value depends upon the values of other basic variable backing the security. In most cases, these variables are nothing but the prices of traded securities.

xii. **New products in Forex Markets :** New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them are :

   a. **Forward contract :** A forward transaction is one where the delivery of foreign currency takes place at a specified future date for a specified price. It may have a fixed or flexible maturity date.

   b. **Options :** As the very name implies, it is a contract where in the buyer of options has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his options.

   c. **Futures :** It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange.

   d. **Swaps :** A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates.

xiii. **Lines of Credit :** It is an innovative funding mechanism for the import of goods and services on deferred payments terms. LOC is an arrangement of a financing institution of one country with another to support the export of goods and services to as to enable the importer to import on deferred payment terms.

Challenges Facing the Financial Services Sector

Though financial services sector is growing very fast, it has its own set of problems and challenges. The financial sector has to face many challenges in its attempt to fulfill the ever-growing financial demands of the economy. Some of the important challenges are briefly explained hereunder :

i. **Lack of qualified personnel :** The financial services sector is fully geared to the task of 'financial creativity'. However, this sector has to face many challenges. The dearth of qualified and trained personnel is an important impediment in its growth.

ii. **Lack of investor awareness :** The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments.

iii. **Lack of transparency :** The whole financial system is undergoing a phenomenal change in accordance with the

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requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner.

iv. **Lack of specialization :** In the Indian scene, each financial intermediary seems to deal in a different financial service lines without specializing in one or two areas. In other countries, financial intermediaries specialize in one or two areas only and provide expert services.

v. **Lack of recent data :** Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon 'financial creativity'.

vi. **Lack of efficient risk management system :** With the opening of the economy to multinationals and exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

Present Scenario

The Indian economy is in the process of rapid transformation. Reforms are taking place in every field / part of economy. Hence financial services sector is also witnessing changes. The present scenario can be explained in following terms :

i. **Conservatism to dynamism :** The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. At present numerous new FIs have started functioning with a view to extending multifarious services to the investing public in the area of financial services.

ii. **Emergence of Primary Equity Market :** The capital markets, which were very sluggish, have become a very popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994. After the lowering of bank interest rates, capital markets have become a very popular mode of channelising the savings of medium class people.

iii. **Concept of Credit Rating :** The investment decisions of the investors have been based on factors like name recognition of the company, operations of the Group, market sentiments, reputation of the promoters etc. Now grading from an independent agency would help the investors in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company's point of view, Equity grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments.

iv. **Process of globalization :** The process of globalization has paved the way for the entry of innovative and sophisticated products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentialities for the introduction of innovative, international financial products in India are very great. Moreover, our country is likely to enter the full convertibility era soon. Hence, there is every possibility of introduction of more and more innovative and sophisticated financial services in our country.

v. **Process of liberalization :** Our government has initiated many steps to reform the financial services industry. The government has already switched over to free pricing of issues by the CCI. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. SEBI has liberalized many stringent conditions so as to boost the capital and money markets.

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LESSON 2:
THE FINANCIAL SYSTEM

Lesson Objectives

To understand the Functions of Financial System,Finantial Assets, Intermediaries and Markets.

The economic development of any country depends upon the existence of a well organized financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promotes the well being and standard of living of the people of a country. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system.

The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilize the savings in the form of money and monetary assets and invest them to productive ventures. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development.

Functions of The Financial System

As we know, financial system is very important for the economic and all round development of any country, its major functions can be explained as following :

1 Promotion of Liquidity

The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. In other words, the liquidity refers to cash or money and other assets which can be converted into cash readily without loss. Hence, all activities in a financial system are related to liquidity – either provision of liquidity or trading in liquidity.

2 Mobilization of Savings

Another important activity of the financial system is to mobilize savings and channelise them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of savings into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

Financial Concepts

An understanding of the financial system requires an understanding of the following concepts :

1. Financial Assets
2. Financial Intermediaries
3. Financial markets
4. Financial rates of returns
5. Financial instruments

Financial Assets

In any financial transaction, there should be a creation or transfer of financial asset. Hence, the basic product of any financial system is the financial asset. A financial asset is one, which is used for production or consumption or for further creation of assets. For instance, A buys equity shares and these shares are financial assets since they earn income in future.

One must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning incomes. It is interesting to note that the objective of investment decides the nature of assets. For instance, if a building is bought for residence purposes, it becomes a physical asset, if the same is bought for hiring it becomes a financial asset.

Classification of Financial Assets

Financial assets can be classified differently under different circumstances. Like :

A. (i) Marketable assets and (ii) Non-marketable assets

B. (i) Money/cash asset (ii) Debt asset and (iii) Stock assets

Marketable Assets : Marketable assets are those which can be easily transferred from one person to another without much hindrance. Example – Equity shares of listed companies, Bonds of PSUs, Government Securities.

Non-marketable Assets : If the assets cannot be transferred easily, they come under this category. Example : FDRs, PF, Pension Funds, NSC, Insurance policy etc.

Cash Assets : All coins and currencies issued by the Government or Central Bank are cash assets. Besides, commercial banks can also create money by means of creating credit.

Debt Asset : Debt asset is issued by a variety of organizations for the purpose of raising their debt capital. There are different ways of raising debt capital. Ex.- issue of debentures, raising of term loans, working capital advances etc.

Stock Asset : Stock is issued by business organizations for the purpose of raising their fixed capital. There are two types of stock namely equity and preference.

Financial Intermediaries

The term financial intermediaries includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers. Thus, it refers to all kinds of FIs and investing institutions which facilitate financial transactions in financial markets. They may be in the organized sector or in the unorganized sector. They may also be classified in to two :

i. Capital Market Intermediaries

ii. Money Market Intermediaries.

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Capital Market Intermediaries

These intermediaries mainly provide long term funds to individuals and corporate customers. They consist of term lending institutions like financial corporations and investment institutions like LIC.

Money Market Intermediaries

Money market intermediaries supply only short term funds to individuals and corporate customers. They consist of commercial banks, cooperative bank.

Financial Markets

Generally speaking, there is no specific place or location to indicate a financial market. Wherever a financial transaction takes place it is deemed to have taken place in the financial market. Hence financial markets are pervasive in nature since financial transactions are themselves very pervasive throughout the economic system. However, financial markets can be referred to as those centers and arrangements which facilitate buying and selling of financial assets, claims and services. Sometimes, we do find the existence of a specific place or location for a financial market as in the case of stock exchange.

Classification of Financial Markets

The classification of financial markets in India can be as following :

Unorganized Markets : In unorganized markets, there are a number of money lenders, indigenous bankers, traders, etc. who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc whose activities are not controlled by the RBI. The RBI has already taken some steps to bring unorganized sector under the organized fold.

Organized Markets : In the organized markets, there are standardized rules and regulations governing their financial dealings. There is also a high degree of institutionalization and instrumentalization. These markets are subject to strict supervision and control by the RBI or other regulatory bodies. These organized markets can be further classified into two. They are

i. Capital Market and

ii. Money Market.

Capital Market

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three, namely :

1. Industrial Securities Market
2. Government Securities Market and
3. Long-term Loans Market.

1 Industrial Securities Market

As the very name implies, it is a market for industrial securities, namely : (i) equity shares (ii) Preference shares and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are

a. Primary market or New Issue Market,

b. Secondary market or Stock Exchange.

Primary Market : Primary market is a market for new issues or new financial claims. Hence it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, primary market facilitates capital formation.
There are three ways by which a company may raise capital in a primary market. They are (i) Public issue (ii) Right issue and (iii) Private placement.

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

Secondary Market : Is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government.

2 Government Securities Market

It is otherwise called Gilt-Edged securities market. It is a market where government securities are traded. In India there are many kinds of Government securities – short term and long term. Long-term securities are traded in this market while short term securities are traded in money market.

The secondary market for these securities is very narrow since most of the institutional investors tend to retain these securities until maturity.

3 Long-term Loans Market

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long term loans market may further be classified into – (i) Term loans, (ii) Mortgages and (iii) Financial Guarantees markets.

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LESSON 3:
DEVELOPMENT OF FINANCIAL SYSTEM IN INDIA

Lesson Objectives

To understand the Growth and Development of Financial System in India.

At the time of Independence in 1947, there was no strong financial institutional mechanism in the country. There was absence of issuing institutions and non-participation of intermediary financial institutions. The industrial sector also had no access to the savings of the community. The capital market was very primitive and shy. The private as well as the unorganized sector played a key role in the provision of 'liquidity'. On the whole, chaotic conditions prevailed in the system. Only after the launching of planning era some serious attention was paid to development of a sound financial system in India.

With the adoption of the theory of mixed economy, the development of the financial system took a different turn so as to fulfill the socio-economic and political objectives. The government started creating new financial institutions to supply finance both for agricultural and industrial development and it also progressively started nationalizing some important financial institutions so that the flow of finance might be in the right direction.

The development of financial system in India can be discussed in following headlines.

Nationalization of Financial Institutions : Reserve Bank of India, which was started as a private institution in 1935, was nationalized by the Government in 1948 and given the controlling authority of the financial system. Later on various other large financial institutions like banks and insurance companies were nationalized to avoid the concentration of economic power.

Starting of Unit Trust of India : Another landmark in the development of Indian financial system was starting of UTI in 1964 as a public sector institution to mobilize small savings for corporate / large ventures. UTI is country's largest and oldest mutual fund. Later on various financial institutions and private sector companies started mutual funds to mobilize public deposits.

Establishment of Development Banks : Many development banks were started not only to extend credit facilities to financial institutions but also to render advisory services. These banks were multipurpose institutions which provide medium and long term credit to industrial undertakings, discover investment projects, undertake the preparation of project reports, provide technical advice and managerial services and assist in the management of Industrial units. Among them are IFCI (1948), ICICI (1955), RCI (1958), IDBI (1964), IRCI (1971), IRBI (1997) and SIDBI (1990) are important DFIs.

Institutions for Financing Agriculture, Foreign Trade and Housing : The Government took serious steps to provide sector specific finance facilities. RBI established ARDC (1963) and NABARD (1982), EXIM Bank (1982) and NHB (1988). Recently in 1987 Stock Holding Corp. of India Ltd. was set up to tone up the stock and capital markets in the country.

Venture Capital Institutions : Venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. The IDBI venture capital fund was set up in 1986. The Risk Capital and Technology Finance Corp. was started by IFCI. Likewise ICICI and UTI jointly setup TDICI in 1988.

Credit Rating Agencies : Of late, many credit rating agencies have been established to help investors to make a decision of their investment in various instruments and to protect them from risky ventures. At the same time it has the effect of improving the competitiveness of the companies so that one can excel the other. Credit rating is now mandatory for all debt instruments.

Multiplicity of Financial Instruments : The expansion in size and number of FIs has consequently led to a considerable increase in the financial instruments also. Different types of instruments are available in the financial system so as to meet the diversified needs of the various people.

Legislative support : The Indian financial system has been well supported by suitable legislative measures taken by the Government then and there for its proper growth and smooth functioning. The Indian Companies Act, 1956, Securities Contacts (Regulation) Act, 1956, MRTP Act, 1970, SEBI Act are few examples of legislative support available to financial system. Apart from the above act.

Weakness of Indian Financial System

After the introduction of planning, rapid industrialization has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing demand of the Government and Industries, many innovative financial instruments have been introduced. The Indian financial system is now more developed and integrated today than what it was few years ago. Yet it suffers from some weaknesses. Let us discuss these weaknesses in detail.

i. **Lack of Coordination between different Financial Institutions :** There are a large number of FIs. Most of the vital FIs are owned by the Government. At the same time, the Government is also the controlling authority of these institutions. In these circumstances, the problem of co-ordination arises. As there is multiplicity of institutions in the Indian Financial system, there is lack of coordination in the working of these institutions.

ii. **Monopolistic Market Structures :** In India, some FI's are so large that they have created a monopolistic market structure of financial system. For instance, almost entire life insurance business is in the hands of LIC of India. So large

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structures could retard development of financial system of the country itself.

iii. **Dominance of Development Banks in Industrial Financing :** The development banks constitute the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the FI created by the government, both at the national and regional levels. As such, they fail to mobilize the savings of the public. However, in recent times attempts have been made to raise funds from public through the issue of bonds, units, debentures and so on.

iv. **Inactive and Erratic Capital Market :** The Indian capital market is not strong and dependable. Because of regular scams and frauds, general public is not having faith in the Capital Markets. The weakness of the capital market is a serious problem in our financial system.

v. **Imprudent Financial Practices :** The dominance of development banks has developed imprudent financial practice among corporate customer. The development banks provide most of the funds in the form of term loans. So there is a predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided.

However in recent times, all efforts have been made to activate the capital market. Integration is also taking place between different FIs. Similarly, the refinance and rediscounting facilities provided by the IDBI aim at integration. Thus, the Indian Financial System is undergoing fast changes, to become a well developed one.

Following are the references available in various journals for further knowledge and study.

Regulation of the Financial Sector – Freedom of the Regulator

By - N. Rangachary , Chairman, IRDA, 23 April 2003

'Which way should I take?' asked Alice.

'It all depends on where you want to go.' replied the rabbit.

" Alice In Wonderland by Lewis Carroll

Introduction

I am delighted to be here among many affectionate friends. I am thankful to Shri M.Narasimham, Chairman, Administrative Staff College Of India, Hyderabad and the author of economic reforms in this country to have asked me to deliver this lecture. I am happy that Administrative Staff College of India has now my friend Dr. E.A.S.Sarma directing it. I consider it a privilege to be talking to you in a subject of my choice. I deliberated deeply for a little while on what I should talk today. Convinced that the financial sector of which I am a part today has still some way to go to be fully reflective of the reforms that one should like to see. I chose the subject of regulation of the financial sector. It is coincidental that Shri K.L.N.Prasad, on whose memory this lecture has been arranged was also connected to this sector.

In this heterogeneous time of modernity the altering of the boundaries between a state and its market encompasses, what is variously described as, realigning government, structural reforms towards liberalisation or deregulation, and a change of mix of the mixed economy. To enable an appreciation of this changing mix between State and market in India, a combination of descriptive and analytical approaches is adopted in this address, with a focus on what may be described as relevant functions, processes and balances.

In the year 1990-91 which nominally marks the high water-mark of economic reforms in this country, a de-professionalised intellectual saw for the first time in an organised manner recognition of systemic problems, particularly in the areas of fiscal, public enterprises and overall competitive strength of industry. It also became clear to the policy makers that growth financed by unsustainable fiscal as well as trade deficits lacked institutional underpinning to take the economy to a higher growth path or ensure social justice. Given the fiscal situation, the public enterprises which saw the fiscal support drying up started clamoring for market access, autonomy and even some privatisation. The private sector, including the corporate sector, realised that the capacity of Government to support them was getting eroded due to fiscal compulsions, while regulatory and other demands from Government continued to be perceived as a burden on them. In the absence of fiscal support from Government, they found it worthwhile to seek deregulation and liberalisation, arguing against what they described as over-regulation and under-governance. There was a widespread realisation that the basic assumption of efficiency and effectiveness of State vis-à-vis market appear to be less valid than before, mainly due to technological progress and the institutional characteristics of public sector. The success of alternate models elsewhere, in achieving both higher growth and social justice was impressive and sustained, and was too apparent to be ignored by the public opinion in India.

Redrawing the Boundaries

In the functional approach to the role of the State in the late 'eighties, it was argued that redrawing the boundaries between State and market could be analysed in terms of different roles of State. State's role in economic activity can be broadly classified into that of a Producer-State, i.e. producer of commercial goods and services; Regulatory-State, involving setting and enforcing of rules that govern, encourage or discourage economic activities of market participants; Facilitator-State, involving provision of public goods such as police, judiciary, street lighting; and a Welfare State, ensuring a provision of a wide variety of merit goods such as education and health.

As a producer of commercial goods and services, the major option exercised by the Government was to permit entry of private sector in activities that were reserved for public ownership. This option does not necessarily involve retreat of State in absolute terms though in relative terms, it does amount to it.

While attempts were on to reduce the role of State as a 'producer', correspondingly, there has been deregulation in some and expansion of State in others as a regulator. For example, in capital markets, insurance, telecommunications, electricity and ports national level regulatory authorities under appropriate statutes have been established. Similar initiatives are being considered in some other sectors also. The regulatory authorities are expected to exercise independence from the ministries of the

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Government or the enterprises concerned and provide a broad framework for entry and operating conditions, especially tariff, in a way that would ensure protection and to build the confidence of the investors and consumers, whose interests often get ignored in a monopoly-like situation.

Though at a macro-level there has been deregulation, it is often argued institutional intolerance is undermining the full impact of deregulation. The process of expanding the regulatory role is sometimes described as incomplete, if not inadequate, on the ground that the constitution of regulatory authorities is not necessarily apolitical or designed to counter political cycles; that they are being undermined by Ministries concerned either on account of the narrow and sectarian interests of the public enterprises or to serve what the Ministry perceives to be a larger public interest, and that the regulatory authorities are inadequately provided for, in regard to physical, financial or human resources, to perform their task efficiently and effectively.

However, it is undeniable that, a basic framework for a more transparent, accountable and, expanded role of State as a regulator has been put in place in many crucial sectors, though a focused attention to the strengthening of these authorities may still be necessary.

In its role as a facilitator State in India, the major thrust is to ensure provision of a public-good that is relevant and not necessarily whether State does it on its own or through use of private sector. For example, health services for an accident victim may be a 'public good' while health services for a by pass surgery is a pure commercial good. It must be recognised that a significant part of provision of public goods falls in the jurisdiction of state governments and not in Central Government. Overall, there is a significant scope and a need for review of the state's role as facilitator.

While in some developed countries, a major source of fiscal stress and consequently a major area of reform has been revamping or cutting down on role of State as a Welfare State, in India there is a large consensus on expanding rather than contracting the role of the State in the provision of welfare. The consensus covers entitlements such as medical attention and old age pensions. Some states are attempting to overcome this through effective decentralisation of initiatives and management. Improvements to inefficient provision by public sector and a regulatory framework to govern unbridled private sector in addition to evolving appropriate mix of funding and provision by public and private partnerships appear to be the reform agenda for the future in the realm of State as welfare provider.

Thus the expectations from reforms in India are not in terms of across the board retreat of State in favor of market but, in terms of enhancing States' capacity to permit efficiency-gains and expand availability of public and merit goods. While State is retreating in some areas, such as pure commercial goods or services, it is both retreating and expanding in other areas such as regulations and is expected to expand further in public and merit goods. In general, the direction of reform is a retreat as a producer State and a retreat coupled with expansion as a regulatory State.

New Equilibrium

The evolution of the mix between State and market in India, during the recent reforms, reveals many interesting aspects, especially on the nature of changing mix relevant to us, as also the variety of options exercised. To assess the dynamics of the changing mix, it would be useful to track what may be termed as new equilibrium levels that are emerging as both causes and consequences of a changing mix between State and market. The changing balance between State and market does not happen in isolation, but is related to other factors as well.

As reform progresses, it appears that the relative balance between Centre and state tends to tilt in favor of states. The most important areas for the Central Government's responsibilities are in international trade, financial sector, telecommunications, aviation, and especially banking and corporate law/practices. In most of these areas, factors such as multilateral agreements (say GATS), globalisation, and recommended best practices of the world, tend to get constrained, over a period, since the free and rapid flow of commodities, skills and finances among the countries would require us to be not too much out of alignment.

The balance between the Ministries representing the combination of political executive and Government bureaucracies vis-à-vis the exercise of ownership functions as well as regulatory functions may also change somewhat adverse to Ministries. The process of privatisation, diversified ownership and autonomy of public enterprises may erode the discretionary element of the Ministries. Once separate regulatory bodies on a statutory basis are established and strengthened, they are meant to be autonomous and report to Parliament through an administrative ministry. Often, their membership need not coincide with political cycles and thus may impart greater stability to regulatory regime. Increasing role of semi-autonomous regulatory bodies tilts the balance away from the Ministries and in favour of less volatility in policies.

The relationship among public enterprises and between public and private enterprises could be subject to new balances in several ways. Public enterprise will have to reckon with growing competition from private sector. Regulatory agencies as part of their charter insist on a level playing field between public and private sectors. The public enterprises faced with hard budget constraints, antiquated and non-responsive business practices and procedures, threat of private sector entry and accountability to the new private shareholders where they exist, may have to carve out a new pattern of relationships with the Government and within the organisation.

Strategic cooperation and cross holdings between public and private sectors are inevitable, thus replacing water tight compartmentalisation between them. In fact, this process may necessitate ultimately in the termination of the concept of government companies under Companies Act.

The evolution of new balances between public and private sectors is clearly in the horizon. There are large areas, like healthcare, where a public-private mix is dictating new balances, in regard to ownership, funding, official recognition and governmental regulation. The traditional water tight division between Government or public and private sector each combin-

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ing within itself separate concepts of resourcing and a provision may get blurred and larger scope demanded for the close intermingling of the two. Further, such intermingling may involve non Governmental organisations as well as local initiatives.

Questions of social reforms and social relevance of the globalisation and liberalisation measures are being raised in the context of reform on whether the poor will be worse off than before in absolute terms due to the reforms and whether the balance between poor and non-poor, in relative terms, will worsen as a result of reform. Given the stalemate in State action the poor may not be worse off than before and may even be able to articulate their needs better in the absence of bureaucratically determined services. There is evidence that rural prosperity has been improving significantly in the recent years. The rural-urban continuum would perhaps assert itself, but in any case, rural-urban linkages are set to get strengthened especially when the services sector is growing rapidly and replacing the traditional rural-urban divide.

Changing the Fulcrum in the Financial Sector

In India, individual sectors of the finance industry have been separately regulated and in different time perspectives. The regulatory system has evolved on a piecemeal basis with new legislation being introduced to deal with perceived problems, aided by the occasional fundamental review of the entire system. Generally, however, it has been recognised that there should be a fairly sharp distinction between banking, securities and insurance business. Even at the international level, co-ordination has tended to be within these three broad groups rather than between them.

In India, the system has apparently worked very well compared with other countries. However, as part of the finger pointing culture in which we now seem to live, any failure of a financial institution is seen to be a failure of regulation. Even on this score, India has been remarkably successful compared with, say, the United States, Japan and France. Of course, there have been failures, but there is no way of running a financial system in a competitive marketplace without an occasional failure. Not only has prudential regulation developed in different ways for the different types of institution, but in addition there has been a separate conduct of business regulation for the three sectors. Besides being subject to statutory regulation, there has been official pressure today to ensure that adequate self-regulatory mechanisms are in place.

An observer from another country looking at the system in India in the mid-1990s would have concluded that it did not work very well in theory, but that, at least comparatively speaking; it did work rather well in practice – perhaps a rather typical Indian result. But there is a limit to the extent to which theory and practice can diverge. As financial markets developed during the 1990s, so the system of regulation began to look increasingly inadequate.

The major factors justifying a comprehensive change stem from the radical change in the nature of financial markets and a compelling trend of universalisation and convergence of markets. No longer are markets dominated by specialist institutions serving specialist markets. Liberalisation of the financial markets, partly as a result of policy decisions but partly also in response to the increasing globalisation of the economy and technological developments, has broken down barriers between markets and products. There have been mergers of banks and introduction of new private insurance companies, individual banks have established insurance companies, some bank products look increasingly like insurance products, some securities look like insurance products and so on.

There is an additional factor which points towards the change in the Indian markets regulatory history. Legislation passed by the Parliament was designed to meet a very real need, which is to give greater protection to customers of investment and insurance related businesses. It provided for a regulatory regime which included within it the seeds of self regulatory organisations being overseen by the quasi bodies with statutory powers thereby ensuring prudential supervision on professional lines. This two tier system ensures that inefficiency, tensions and bureaucracy are not built in to the regulatory structure. I have no doubt that the industry played its part by similarly demanding clarity and even longer rulebooks. It is perhaps no surprise that the first few years of the new regulatory regime everybody was too busy building the new regime to bother too much about operating it.

Ideally, the time has now become ripe for the government to give careful thought to a medium term plan for reforming the architecture of financial regulation. This process should not only take account of the past as I have just described it but, as importantly, also the future. It would also be reasonable to expect a continued rationalisation of the financial services sector.

Defining Regulation

In the present context the term 'regulation' may be taken to refer to the control of corporate and commercial activities through a system of norms and rules which may be promulgated either by governmental agencies (including legislatures and courts) or by private actors, or by a combination of the two. The direct involvement of the State is not a necessary condition for the existence of regulation in this sense, since rules may be derived from the activities of industry associations, professional bodies or similarly independent entities.

There is often a close symbiosis between private law and regulatory law although there may be some value in distinguishing between them. While this is widely used in discussion and has some merit as an analytical device, it can also give rise to difficulties if it is applied in a non reflexive way. This is because, firstly, many rules of private law, such as those relating to implied contract terms, fiduciary obligations, and duties of disclosure, have a regulatory impact in the sense of controlling transactions. Secondly, private law rules may form the basis for self-regulation in the sense that contractual associations of commercial actors may produce codes governing the conduct of their trade or profession (or, at a further extreme, impose restrictions on trade which may or may not escape the reach of competition or monopoly or restrictive trade practices law).

It also follows that the term 'deregulation' needs to be used with care. In practice, it tends to be used when referring to the removal of statutory controls. Often, however, this process gives rise to the replacement of one form of regulation by

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another – the common law, or self-regulation, replacing statute - rather than to a diminution in regulation. The picture is complicated further if is assumed that 'deregulation' is necessarily a process leading to the restoration of market forces which had previously been constricted by regulatory controls. Rather, it is often the case that sustainable competition rests upon regulation of a prescriptive or interventionist kind. Thus in various contexts policies or practices aimed at promoting competition have employed regulatory techniques to this end. A good example of this is provided by the operation of the securities markets.

There needs, then, to be recognition of the varieties of regulation and self regulation, and some understanding of how they operate in relation to commercial activity in particular settings. Good policy analysis is not about choosing between the free market and government regulation. Nor is it simply about deciding what the law should proscribe. It is about understanding private regulation – by industry associations, by firms, by peers, and by individual consciences – and how it is interdependent with state regulation.

Reflexive Regulation

The aim of 'reflexive' or 'responsive' regulation is, therefore, to ensure that regulation be responsive to industry structure, and that different structures will be conducive to different degrees and forms of regulation. In some accounts, reflexive law can be used to 'steer' self-regulation: The use of regulatory intervention to induce certain desired ends through second-order effects is characteristic of "reflexive" or "procedural" regulation which aims to achieve its intended effects by encouraging self-regulation at the level of the practices and processes operated by the parties themselves.

An example of this type of regulation is 'enforced self-regulation' and which can be distinguished from 'co-regulation'. Co regulation is the process whereby associations of firms or professionals at the level of the industry concerned promulgate generalised standards for the conduct of trade. The rules in question are arrived at through a process of negotiation and deliberation within the industry. The government exercises loose supervision or oversight in the sense of intervening through competition law to curb rules which plainly have an anti-competitive effect or purpose.

Enforced self-regulation, by contrast, is a form of self-regulation in which regulatory functions are sub-contracted by the state to private commercial actors who, in this case, may be the firms themselves rather than the industry-level associations. The difference from co-regulation is that the state is ready to intervene with more stringent and less firm-specific or 'tailored' standards if private actors do not agree their own rules. The state thereby encourages a negotiated solution which is, in principle, better attuned to local conditions than would be the case with a generalised or imposed set of rules. The use of proscriptive norms and legal (including criminal) sanctions is not ruled out altogether, but, rather, is kept in reserve for situations of extreme noncompliance.

Pyramid of Regulatory Compliance

An important aspect of understanding enforced self-regulation is the 'pyramid' of regulatory compliance. Sanctions are structured in such a way as to combine persuasion in the majority of cases with direct enforcement in a smaller number. At the base of the pyramid, most actors are persuaded to comply through indirect intervention; full sanctions, such as criminal penalties or the withdrawal of a licence to operate, are reserved for the few cases at the top.

1. License Revocation
2. License Suspension
3. Criminal Penalty
4. Civil Penalty
5. Warning Letter
6. Persuasion
7. Command regulation with nondiscretionary punishment
8. Command regulation with discretionary punishment
9. Enforced self-regulation
10. Self-regulation

The purpose of the pyramid is to provide regulatees with maximum incentives for early compliance. This is an acknowledgement that, where 'persuasive' strategies are used, the regulator and the regulatee are, in effect, engaged in bargaining over the terms and timing of compliance, and that without the threat of escalating sanctions, the regulatee may have incentives to hold out in the expectation of being able to negotiate a better deal. It follows that an essential aspect of enforced self-regulation, in contrast to co-regulation, is the retention of a legal sanction (or, ideally, of a series of sanctions or interventions) which can be deployed in the last resort. Nor is it necessarily fatal to the effectiveness of the law in question that sanctions are rarely deployed.

Social Norms and Conventions

At the other extreme of the enforcement pyramid, the usefulness of a strategy of enforced self-regulation may depend on the existence of shared norms of behavior among commercial actors within a particular industry or other context. Where self enforcing norms of this kind are found, the costs of regulatory intervention can be substantially reduced in a number of ways. Where there are 'interpretive communities' of actors, the risk of opportunistic or 'creative' compliance with rules may be reduced. It also allows regulators to frame rules as generalized standards, that is to say, as open-ended norms whose interpretation and application can be left up to the parties, to whom they are addressed, hence reducing the complexity of rules. This also enables rules to evolve in response to a changing economic environment. To be inside an interpretive community means to be already and always thinking and perceiving within the norms, standards, definitions, routines of that community and to share an understanding of the goals that both define and are defined by that context. The greater the degree to which these are common amongst those writing, applying and enforcing the rules, the less it has to be rendered explicit. This has implications both for the degree to which rules have to use precision in an attempt to control and cope with a greater range of contingencies or changes which may arise. What is important is not the weight of regulation in any one system, but rather the effectiveness of the links between regulations at different levels.

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This is not to suggest that the social norms and conventions of 'interpretive communities' should always be regarded as efficient or desirable. They could operate against the interests of third party groups who are excluded from the rule-making process or against what is perceived to be the public interest in a wider sense. Rather, what is being suggested is that one route by which more formal regulation can be made effective is for it to work in conjunction with social norms. Even if this is not possible, an awareness of the existence and effect of informal regulation should be an important aspect of the design of more formal rules.

Strengths and Weaknesses of Self-regulation

The value of reflexive regulation depends upon the particular commercial context in which it is applied, and, in particular, on such factors as the effectiveness of self-regulation and the presence of social norms and conventions guiding the behaviour of commercial actors. In this vein, it may be useful to sum up the strengths and weaknesses of systems of enforced self-regulation.

i. Strengths

Rules would be tailored to match the company. Unlike generalized rules, self-regulation can be adapted to local conditions and industry-specific factors affecting firms.

Rules would adjust more quickly to changing business environments. Rules which are specific to particular firms or industries can be changed more quickly and easily than statutory rules, and so may evolve in response to changing economic and technological conditions.

Regulatory innovation would be fostered. By allowing a variety of approaches to be adopted by firms and commercial actors, the conditions for innovative solutions (and for a degree of competition between alternative solutions) would be enhanced. Rules would be more comprehensive in their scope. Self-regulation encourages companies to deal with a wider range of hazards and abuses than legislatures can efficiently consider.

Companies would be more committed to the rules they wrote. The direct involvement of corporate actors in rule making would make it more difficult to stigmatise legal intervention as illegitimate. The confusion and cost from having two rulebooks (the company's and governments) would be reduced. Self-regulation helps to avoid duplication which might otherwise arise.

Business would bear more of the costs of its own regulation. The costs of enforcement and inspection would be internalized to those particular firms and industries which are particularly prone to creating certain hazards.

More offenders would be caught more often. There would be broader coverage by inspection under self-regulation and companies would have an incentive to engage in internal compliance and enforcement. In addition, internal procedures would be more likely to result in an efficient application of the rules and fewer opportunities for creative interpretations and appeal to the vagaries of inadequately worded legislation.

Compliance would take the path of least corporate resistance. Companies would have powerful incentives to avoid public exposure and enforcement, in part precisely because it would be rare.

Government regulation inevitably generates more costs' since there appear to be 'attenuated' incentives for cost control. Cost advantages from self regulation may come from staffing characteristics; from the speed and flexibility with which rules are administered; from reduced size of the civil service and the shifting of regulatory costs to industry. The agency problems inherent in cutting costs are arguably greater in government departments than in a situation where members of the investment community, for instance, are able to monitor a self-regulatory body.

ii. Weaknesses

Regulatory agencies would bear the costs of approving a vastly increased number of rules. The extent to which this was a problem would depend on how far the rules in question were subject to scrutiny and how far there was a tendency for certain model rules (in the manner of standard form contracts) to be adopted as a matter of common practice.

State monitoring would sometimes be more efficient than private monitoring. Direct government monitoring might be expected to be more efficient where companies themselves do not have the expertise to develop effective internal governance systems, or where the state has an important educational role to play.

Co-optation of the regulatory process by business would be worsened. There would be an increased risk of insider control of the regulatory process or in other words the danger of 'industrial absolutism', but this would depend on how far other affected groups were given representative status in relation to the rule making process.

Particularistic rules might weaken the moral force of laws that should be universal. How far this becomes a problem would depend on the degree to which 'overarching standards' could be enforced, in the last resort, by public agencies. The role of general standards in informing local-level rule making would be an important issue here (as in the degree to which the legal principle of fiduciary obligation informs, in practice, the rules adopted by companies for dealing with conflicts of interests by directors).

Companies would write their rules in ways that would assist them to evade the spirit of the law. The problem of 'creative compliance' is a problem whatever form of regulation is adopted - 'the business community's resourcefulness at law evasion will be a cause for weakness in any system of control.

Companies cannot command compliance as effectively as government. This is not a problem if the State lends its powers of enforcement to the rules put in place by the corporate actors themselves.

The independence of the internal compliance group could never be fully guaranteed. This is a problem which must be addressed by specific institutional devices aimed at enhancing the prestige and status of the internal inspection and compliance process. Therefore it is a function of the particular regulatory design of enforcement systems, rather than a fundamental objection to responsive regulation.

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Role of a Regulator

The existing legislative enactments do not bestow adequate powers on the regulator to make rules, to interpret rules, to investigate breaches of rules, to fine people for breaches of rules, and to keep and retain the fines in all areas which they are supposed to supervise. The essence of having an independent regulator within the flexibility to rule by regulation making ensures that matters which previously could be changed only with the consent of Parliament will be capable of being changed merely by a decision of the respective financial supervisory authority. There is quite properly a very lively debate about this. On the one hand there is much to be said for a flexible system. Legislation can never foresee all eventualities and, furthermore, legislation can never be perfect. Legislation in many cases cannot also be quick enough to correct market aberrations. In many areas sensible actions have been thwarted by faulty legislation. Often industry and regulators combine to try to get round unintended effects of legislation. Surely, according to this argument, it is far preferable if the regulation is as flexible as possible allowing regulators to take account of changing circumstances. Moreover, it is argued, one has to work with and trust the regulators and, if they cannot be trusted, then really it does not matter what sort of legislation one has.

But there is a contrary argument. No one doubts the motives, competence and qualities of the people at the top of the regulatory set up, but that can change. Moreover, sometimes major decisions can be taken some way down a regulatory body where perhaps the staff concerned does not have the broadminded approach of people at the top. If one wants to hear criticisms of any regulatory body, then people who work for other regulatory bodies and civil servants are often ready to oblige. There are a number of regulatory bodies operating today in India which are subject to criticism within government circles. Presumably the Insurance Regulatory And Development Authority, to which I belong, is not entirely immune from this danger at some time in the future.

Normally regulatory bodies are accountable by being subject to parliamentary approval for key variables, for example fees and levies, and they are also subject to a ministerial power of direction - ministers themselves being accountable to Parliament, or perhaps more nowadays to the media.

Objectives of Financial Supervision

The objectives of financial supervision are:

- Maintaining public confidence in the financial system;
- Promoting public understanding of the financial system, including promoting awareness of the benefits and risks associated with different kinds of investment or other financial dealing;
- Securing the appropriate degree of protection for consumers, having regard to the differing degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise which different consumers may have in relation to different kinds of regulated activity and the general principle that consumers should take responsibility for their decisions; and
- Reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime, with particular regard to the desirability of regulated persons being aware of the risk of their businesses being used in connection with the commission of financial crime and taking adequate measures to prevent, facilitate the detection, and monitor the incidence of financial crime.

In addition, in discharging its general functions the financial regulators must have regard to: the need to use its resources in the most efficient and economic way; the responsibilities of those who manage the affairs of authorised persons; the principle that a burden or restriction that is placed on a person, or on the carrying on of a regulated activity, should be proportionate to the benefit the provision is generally intended to confer; the desirability of facilitating innovation in connection with regulated activities; the international character of financial services and markets and the desirability of maintaining the competitive position in India; and the principle that competition between authorised persons should not be impeded or distorted unnecessarily.

Recent Market Developments and Financial Supervisory Regimes

The financial services sectors of most countries have long been much influenced by market developments. These include the removal or weakening of barriers to entry and of restrictions on diversification and on various types of ownership structure; innovation and technological progress (which has had a dramatic impact on the cost of entering some markets for financial services); greater competition; and internationalisation. These developments are interrelated and mutually reinforcing. The result has been a blurring within the financial services sector of the traditional distinctions which used to apply across types of firm, types of product and types of distribution channel, albeit to different a extent and in different ways across different countries.

For financial services firms, this has been manifested as an increase in the number of institutions which cut across traditional sectoral boundaries. This growth in financial conglomerates has resulted in part from the impact of mergers and acquisitions. This also reflects the result of financial services firms extending through internal growth into new areas (for example, insurance companies setting up banks and vice-versa, insurance companies selling investment products, and banks setting up securities and fund management operations), and of new entrants to the financial services sector choosing to offer a range of financial services to their customers. In all of these cases the resulting mix of functions undertaken by the firm has been determined primarily by anticipated profits and the scope for cross-selling products to customers, rather than by any traditional linkages between, or separations across, products.

With the growth of options, increasingly elaborate ways of unbundling, repackaging and trading risks have weakened the distinction between equity, debt and loans, and even between banking and insurance business. Equally, channels of distribution are no longer as specialised as they once were. Banks have used their branches as a sales point for an increasing range of

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products, while many of the new entrants to parts of the financial services sector have introduced new sales methods – such as telephone and internet channels – to a wide range of products which had previously been available only through more traditional channels.

The disappearance of a neat conjunction between a particular type of firm and a limited range of products being supplied by that firm means that it is difficult to regulate on a functional basis, since the traditional functional approach no longer matches the structure of either firms or markets. The emergence of financial conglomerates has challenged traditional demarcations between regulatory agencies and the boundaries between regulators simply no longer reflect the economic reality of the industry.

There is a clear need for regulatory oversight of a financial conglomerate as a whole, since there may be risks arising within the group that are not adequately addressed by any of the specialist prudential supervisory agencies that undertake their work on a solo basis. Many of the threats to the solvency of the institution can be assessed adequately only on a group-wide basis. This includes the assessment not only of whether the group as a whole has adequate capital, but also of the quality of its systems and controls for managing risks, and the caliber of its senior management. Indeed, the importance of systems and controls and of senior management to the standards of compliance achieved by a firm against both the prudential and the conduct of business standards and requirements set by financial services regulators means that it is not possible to draw a clear dividing line between prudential and conduct of business regulation, since, in this respect, both types of regulation have an interest in the same aspects of a firm's business. Moreover, there needs to be an effective exchange of information and a co-ordination of regulatory requirements across the regulators responsible for different parts of a conglomerate's business, as well as mechanisms for coordinated action when problems arise in a conglomerate.

The rationale for an integrated financial services regulator reflects the benefits of clear and consistent objectives and responsibilities, and in resolving any trade offs among those within a single agency. There is a school of thought that feels the developments on the financial markets are associated with increased risks to their stability, which can best be counteracted in the future not only through improved collaboration between regulatory authorities but through integrated regulation.

A convergence effect is seen wherein banks, insurance companies and securities firms are now competing in the same market for the same customers, with similar or often even identical products and via the same distribution channels, which organisationally separate regulation cannot cope, with a view to securing the future stability of the financial system.

However, this does not imply that there is any one model that is optimal for all countries in all circumstances, in part because financial markets have developed – and will continue to develop – differently in different countries. A single regulator need not necessarily deliver these advantages. Specialist divisions/areas will exist even within a single agency, thus creating potential problems in communication, information sharing, co-ordination and consistency. A single regulator in other words could potentially become an over-mighty bully, a bureaucratic leviathan divorced from the industry it regulates. Moreover, there is no single blueprint even for single financial services regulators – countries that have adopted this model developed different approaches to how their integrated regulator operates in practice. These differences include the responsibilities, powers and organizational structure of these regulators, and the legislations under which they operate.

There remain, and will remain for the foreseeable future, major differences between banks, securities firms and insurance companies in the nature of their business or the type of contracts they issue, and hence the nature and form of asset transformation. Firms in all sub sectors have diversified, but almost invariably their core business remains dominant. The nature of the risks is sufficiently different to warrant a differentiated approach to prudential regulation. The rationale for this approach (or for other possible objective-based models with more than one regulator) is attractive – giving regulators clear mandates and ensuring appropriate differentiation in the regulation of different types of activity.

But even if there is a strong case for an institution-wide overview of a financial conglomerate, is it necessary for this to be undertaken by a "lead" regulator (or "coordinator") appointed from among the "solo" regulators responsible for specialised aspects of the institution. This lead regulator would be responsible for taking a consolidated view of the capital adequacy and liquidity of the institution as a whole; taking similarly a group-wide view of more qualitative factors such as the caliber of senior management and the high-level systems and controls of the financial conglomerate; and coordinating and encouraging the exchange of information among the relevant regulatory bodies both under ordinary and abnormal circumstances. Most countries still follow the lead regulator approach.

Risk Based Supervision

Risk-based supervision is a framework that establishes common terminology and approaches to evaluating the management of risk in financial institutions. While it is a common approach, it is flexible enough to be adaptable to virtually all, if not all, financial products and services, and to institutions large and small. The disaggregation of the risks that make up the risk profiles of individual products and services is at the heart of risk-based supervision. By un-blurring the risks that make up each product and service, managers and supervisors are able to understand better risk profiles and evaluate actions taken to minimize the adverse consequences of risk-taking. It is the responsibility of the management of each financial institution to understand the risks associated with the business they are running and to take steps to minimize the adverse consequences of these risks. Risk-based supervision looks at how well management identifies, measures, controls, and monitors risks.

Risk-based supervision requires a deeper understanding of the institutions being supervised and of the environment in which they operate. It requires an understanding of the risk profile of the institution under examination in order to identify areas of

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the greatest risk deserving of closer attention. It requires an understanding of the nature of risks, together with management's ability to deal with both internal and external risks. Once the areas of the greatest risk have been identified, the examiner reviews the risk-management systems in those areas.

That risk-based supervision could have done a better job in reducing the adverse consequences of the Asian crisis which had its origins in three aspects of risk-based supervision:

- Understanding the environment in which financial systems operate;
- Understanding the risk profiles of individual institutions;
- Understanding the risk profiles of the products, services and activities that make up the individual institutions, and aggregating these individual risk profiles into a profile of the institution as a whole.

Good risk management is not an expense to be avoided or minimized; it is not even revenue-neutral; it is a revenue enhancement tool and therefore leads to a capital enrichment. Good risk management allows an institution to operate with a high level of precision. Too much risk with too few controls results in loss. Too many controls and limits, given the corresponding risks, result in loss by incurring unproductive and unnecessary expenses and by foregoing opportunities. Understanding the risk profiles of products and services, and balancing them with actions taken to reduce the adverse consequences of risk-taking, allows an institution to optimize revenues and maximize the use of capital.

Risk-based supervision enhances top-down supervision in three ways. First, it focuses supervisory resources on the areas of the highest risk within individual financial institutions. Second, it uses a common framework and common terminology, developed specifically for risk-based supervision, to assess risks and evaluate management practices, policies, and procedures in the context of managing risks; that is, optimizing returns while minimizing the adverse consequences of risk-taking. Finally, it incorporates an assessment of management's ability to deal with risks beyond the control of management, such as systemic risks and risks in the economic environment in which the financial institution operates.

Regulatory Arbitrage

It is not always the best that all of us should think alike; it is variety that makes life challenging. Regulatory choices and diversity help mitigate potential regulatory abuses. Financial supervision and regulation can only benefit from the variety of viewpoints and checks and balances of a system of more than one regulatory authority. A system in which financial institutions have choices, and in which regulations result from the give and take involving more than one agency, stands a better chance of avoiding the extremes of supervision. A single regulator is likely to have a tendency to suppress risk taking. A system of multiple supervisors and regulators creates checks on this propensity.

The financial services industry today is extremely complex. Regulators, whether rule makers or supervisors cannot be expected to meet the challenge of understanding the issues facing the industry without direct and frequent contact with the regulated institutions.

The current regulatory system does however create some opportunity for "regulatory arbitrage". Within the context of our current regulatory scheme, however, regulatory arbitrage can be good particularly during cycles of over-zealous regulation when regulators focus on actual or perceived negative outcomes. Regulatory arbitrage can put some practical limits on the power of any one regulator.

Separating the rule making and supervisory functions would create the very high risk of an "ivory tower" of rule making, detached from the realities of the financial services industry. Most financial institutions would agree that a supervisory agency is positioned the best to write regulations for the financial institutions that it supervises, and can readily gauge the impact that any regulation will have on those entities.

Regulatory arbitrage will occur whether you have one supervisory or rule making authority or multiple authorities. With only a single rule making or supervisory agency, regulatory arbitrage can go unchecked and have disastrous consequences.

Conflict Resolution

It must also be recognised that in practice governments have been slow and ineffective in resolving conflicts of interest between different objectives and responsibilities between multiple specialist regulators. These problems arise because they either do not have clear objectives and responsibilities or because the institutions were set at different times and are inconsistent with each other. Thus even if all specialist regulators are focused effectively on delivering their own specific mandates, the sum of the parts need to add up to a coherent and consistent overall outcome. Governments may lack the necessary information and experience to take decisions here, and may also be reluctant to do so if it brings them too close to the regulation of individual financial institutions.

Appropriated Differentiation

Multiple regulators however ought to be able to avoid the unjustifiable differences in supervisory approaches and the competitive inequalities imposed on regulated firms through inconsistent rules. However, this does not mean the adoption of a "one size fits all" approach. What is required is harmonisation, consolidation and rationalization of the various principles, rules and guidance in the regulatory material issued by the specialist regulators – so that similar risks are treated similarly irrespective of where they arise – and the need to create and to preserve appropriate differentiation to reflect the different degrees of protection required by different types of consumers.

Institutional Structure for Financial Services Regulation in India

The institutional structure of financial services regulation is important because of the impact of the efficiency and effectiveness of this on the direct and indirect costs of regulation and on the success of regulation in meeting its statutory objectives. To what extent should the structure of financial regulation be driven by the functions which financial services firms undertake, reflecting market developments in the financial services indus-

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try? Is there a first-best institutional arrangement which is independent of these market developments, arising perhaps from economies of scale and scope in undertaking financial regulation, or from some underlying logical of the structure of regulation with the objectives of regulation or with the institutional arrangements for monetary policy and for addressing systemic risk? Are there also implications here for the structure of regulation internationally, not just within national borders?

The existing arrangements for financial regulation involve a large number of regulators, each responsible for different parts of the industry. In recent years as has been seen earlier there is a blurring of the distinction between different kinds of financial services business.

We now turn to a more specific examination of particular areas of regulation in India, beginning with the regulation of financial services. The main regulatory functions are carried out by non-governmental bodies. These responsibilities are largely conferred by different Acts. Financial services have been regulated based on tripod based regulatory structure, comprising of the Reserve Bank Of India, Securities Exchange Board of India and Insurance Regulatory And Development Authority. A High level Capital Markets Committee presently co-ordinates and monitors the financial regulatory system.

The second tier consists of a number of organisations belonging to various categories of statutorily recognised bodies. These include Self-Regulating Organisations, Recognised Professional Bodies, Recognised Investment Exchanges and Recognised Clearing Houses. Together they perform front-line authorisation of financial services businesses and markets.

The Ministry of Finance is responsible for the overall institutional structure of regulation and for the legislation which governs it; for the overall stability of the financial system, for the financial system infrastructure, for the efficiency and effectiveness of the financial sector and, under specified conditions, to undertake financial support operations.

The financial regulators are responsible for the authorisation and supervision of financial services firms, for the supervision of financial markets and of clearing and settlements systems, and for regulatory policy in all these areas.

Corporate Governance

An area where self-regulation should dominate is that of corporate governance regulation. A number of corporate governance codes have followed in fairly rapid succession to address perceived corporate governance weaknesses. Neither the sponsors nor the participants in the process of drafting these codes were government institutions and their enforcement is dependent on shareholder pressure through the Stock Exchange.

Accountability

The existing statutes contain a range of accountability provisions. These include that the Chairman and Board/ Members of the regulatory bodies would be appointed and removed by Government; that in exercising its rule-making powers and setting its policies the Government should act in a way which is compatible with the regulatory objectives set out in the legislation and which is most appropriate for meeting those objectives; that the Government should make an annual report to Parliament upon the discharge of the functions of the regulators and the extent to which regulatory objectives have been met; that the Government is likely to be asked to give periodic evidence to the Parliament; that an advisory committee comprising of non-executive members of the Board are involved through a series of consultations to develop its regulatory approach further besides ensuring that the regulatory institutions function in an economic and efficient way; the Comptroller and Auditor General reviews on the adequacy of internal financial controls and reports on these matters in his annual report; besides ensuring that they maintain a consistent – but not necessarily identical – approach in discharge of their functions.

A further important aspect of accountability is that there must be a clear allocation of responsibilities between the Government and the financial regulators. A memorandum of understanding between the financial regulator and the Government which sets out the responsibilities of the Government for the overall institutional structure of regulation, and for the legislation which governs it; and for the overall stability of the financial system, including the stability of the monetary system, for the financial system infrastructure, for being able in exceptional circumstances and subject to the agreement of the Government to undertake official financial support operations for the efficiency and effectiveness of the financial sector; and of the financial services regulators for the authorisation and supervision of financial services firms, for the supervision of financial markets and of clearing and settlement systems, for the conduct of market-based support operations which do not involve official finance in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, and for regulatory policy on all of these.

The Regulatory Pitfalls

At one time, regulation was believed to be the cure-all for various forms of “market failure” inherent in many industries, such as natural monopolies, externalities and information asymmetries. However, years of regulatory experience in many developed countries reveal that regulations, like markets, can also “fail.” Let us review what constitutes a “regulatory failure,” which was the root cause of waves of deregulation world-wide.

Regulatory failure may occur for two reasons. The first is associated with the “capture theory.” The theory posits that because the regulated companies are likely to have superior information, they can easily manipulate the regulator to their own advantage. Alternatively, these firms can easily form themselves into a formidable lobbying group that may influence government policies. The second reason for a regulatory failure arises from the fact that the regulator itself is not perfect. We must not forget that by creating a regulator, we entrust an enormous amount of responsibility and power unto a single body. This resembles an autocratic government. We all hope for a benevolent and an efficient regulator, but there are both up-side and down-side risks involved when power is concentrated in a single entity.

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The following are major regulatory dilemmas that I am aware of in some countries:

1. Misconception of the role of a regulatory body: As growth in developing economies has been driven by the success of the industrial sector, it is not surprising that the survival and prosperity of producers, rather than the welfare of consumers, constitutes the focus of public policies. Thus, regulation is seen as a process to protect producers (by limiting competition) rather than consumers. While such a view would represent "regulatory capture", for many developing countries that strive ceaselessly for economic prosperity, protection of producers is a widely accepted norm. Collusion and behavior that may limit competition may be allowed if such moves are essential for the survival of the business. As consumer groups in developing countries are usually weak, their voices are unheard or are overlooked. Misconception with regard to the role of regulation is probably the most fundamental and serious regulatory pitfall among Asian countries. With such misconception, regulations are prone to become nothing more than a rent-seeking device of private profiteers.
2. Too much discretion: As economies rush or are rushed to open up their service markets, liberalization is handled haphazardly; little preparation is put into drawing up the appropriate rules and regulations. The principles, the method and the means with which the body is to regulate are left to the discretion of the committee-to-be. There are indeed pros and cons concerning the tightness of laws and regulations. Too detailed a law can leave regulations too rigid, while too lax a law may open the system to the peril of abuse of power and may lead to inconsistency, unpredictability and an unclear decision-making process.

   Where the mandate of the regulator is unclear and where regulatory procedures are ad hoc, the regulatory authority is likely to wield a lot of discretionary power. Moreover, in the absence of an effective competition law and a comprehensive consumer protection law, the regulator will have to assume the enormous task of setting its own set of principles, measures and procedures concerning these matters. The absence of general sets of laws or rules that can be referred to makes the task of regulation significantly more complicated and at the same time, prone to arbitrariness and inconsistencies.
3. Too little transparency: While too much discretion may arise from the ad hoc approach taken with respect to regulation, there are ways to limit the potential adverse results associated with discretion. Regulatory procedure can be made more transparent through public hearings, appeals provision, and notification and publication requirements. Therefore, in a country where the rules and the laws are weak, transparency is the soul of efficient regulation. Unfortunately, regulations in many countries are neither clear nor transparent and decision making neither participating, leaving the system highly susceptible to all the ills of regulatory failure.

   When a regulatory body wields a lot of discretionary power and its regulatory procedures are not transparent, effectiveness depends ultimately on the relative competence of the committee members who set the rules under which they operate. As a result, success stories, or unsuccessful ones for that matter, are closely associated with a certain individual, or a group of individuals, who exercise authority.

   Given that the regulatory performance in such countries relies heavily on the competence of individual committee members, can these countries then find highly qualified personnel to ensure continued effective regulation?
4. Lack of qualified personnel: A qualified committee member would have to be impartial and competent. Impartiality demands that a regulator should not have any direct or indirect vested interest in the business which it regulates, nor hold a political position. Competence requires an exceptional technical and operational knowledge of the business. After all, a regulator should know more about the business than the companies it regulates. With these parallel qualifications, this person will have to be a technocrat or a veteran businessperson who no longer holds a stake in the regulated business. Such an individual could prove non-existent in a developing country. First, the pay scale is generally too low to attract and maintain qualified personnel. Thus, the chance of finding a competent regulator from the government is remote. Secondly, in a fast-growing service sector, the persons who best understand the business are those involved in the business themselves. In a situation where the processes of regulation and liberalisation convert an existing restrictive market to a more open one, as in most of the Asian countries, the choice of competent and technically efficient personnel to man regulatory bodies gets severely limited to the current crop of institutions in the public sector. It is therefore not surprising that half of the committee members of the many regulatory bodies are former employees of the State monopolies. The presence of former operators on the regulatory board may render the impartiality of the regulatory body not only questionable but in many cases lead to a tunnel-vision often affecting the quality of regulation. The lack of qualified and experienced personnel poses a serious problem for most countries.
5. Insufficient Autonomy: Assuming that competent and well-qualified personnel can be found, this still does not guarantee efficient regulation. For the regulator to be able to perform its task effectively, a certain degree of independence from the government is required. Autonomy is determined not only by the institutional structure, but also the extent of financial independence. An independent source of financing, either from a guaranteed line in the national budget or the power to raise and retain licensing fees, or taxes by the regulator from the industry, can certainly promote not only autonomy, but impartiality. Particularly in countries where corruption is rife and patronage is a way of life, financial independence is a requisite for an efficient regulatory body.

One other feature often noticed in the unfolding regimes in the recently liberated economies is the total lack of perception in

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government circles on the concept and principles of regulation namely a reluctance on the part of bureaucracy that controlled the sector erstwhile in its mindset of regulation being equivalent to ownership. The apparent loosening of their hold on the units publicly owned and controlled by it to a proper no nonsensical regulation greatly affects its thinking and action. It is also observed that the public sector companies, hitherto sheltered and cosseted by government, tend to look at regulations as inconveniences and threats to their inertia.

What can be done? At the initial stage where markets become more open to competition and state enterprises are replaced by private operators, the regulatory burden will become overwhelming. The prospect of strengthening the regulatory authorities within the bureaucratic setting is bleak. Low payscale, political meddling and red tape are guarantees that the current inefficiencies will prevail. The establishment of an independent regulatory body, can lessen the severity of the mentioned problems. And to ensure its effectiveness and impartiality, let transparency be the soul of its design.

The Case for Independence

Establishing adequate independence arrangements is crucial to reducing the likelihood of political interference in the supervisory process. The debate on regulatory independence is at the same stage the debate on central bank independence was two decades ago.

Nonetheless, independence for financial regulatory agencies matters for financial stability for many of the same reasons that central bank independence matters. An independent regulator can ensure that the rules of the regulatory game are applied consistently and objectively over time. If bankers know in advance that insolvent banks will be closed—and that lobbying to keep them open will fail—they will behave more prudently, thereby reducing the likelihood of a full-blown banking crisis. In contrast, when politicians become directly involved in enforcing regulations, they may be influenced by other considerations in making their decisions, which then take on an ad hoc quality. The crises that erupted during the 1990s in a number of countries where regulatory and supervisory agencies were not independent strongly support the case for independence. Examples of crises averted because of better regulatory governance would also support the case for independence, but, given the confidential nature of supervision, these are not likely to be revealed.

Perils of Lack of Independence – Lessons from International Experience

Before the Asian crisis began in 1997, Korea's specialized banks and non-bank financial institutions were under the authority of the ministry of finance. The ministry's supervision of non-banks was generally recognized as weak, encouraging regulatory arbitrage and excessive risk taking. As in many other Asian crisis countries, politically motivated forbearance was widespread. The most glaring examples of political interference in financial sector supervision were the government's decisions to intervene in certain banks or to provide them with government funds for recapitalization.

In Japan, the lack of independence of the financial supervision function within the Ministry of Finance is also widely believed to have contributed to financial sector weaknesses. Although there was probably little direct political pressure on the Ministry of Finance to exercise forbearance, the system lacked transparency and was known for widespread implicit government guarantees of banking sector liabilities. Following a decline in the ministry's reputation as a supervisor in the late 1990s, the Japanese government created a new, integrated Financial Supervisory Agency, which was more independent and transparent than its predecessor was. However, the agency, which reports to the prime minister's office rather than to the finance ministry, has achieved disappointing results to date.

Ineffective regulation, weak and dispersed supervision, and political interference in Venezuela were among the main factors in the weakening of banks in the run-up to the 1994 banking crisis. One of the main lessons of this crisis was that there was a need for more independence for financial sector regulators and supervisors and political support for their work.

Global initiatives for Effective Financial Sector Regulation

Political interference in financial sector regulation and supervision contributed to the depth and magnitude of nearly all of the financial crises of the past decade. As a result, the global community—increasingly aware of the need for good regulatory governance as part of a broader effort to prevent (or better manage) financial crises and improve financial sector supervision—has started to look for ways to insulate regulators and supervisors from improper influence. In recent years, the international community, including the International Monetary Fund (IMF) and the World Bank, has launched a number of initiatives to promote and monitor good governance—meaning the way institutions are run, supervised, and held accountable. We are at a point now where we can begin to draw some lessons and rethink our approaches to policymaking. We can also say with greater certainty that the independence of regulatory and supervisory agencies is a cornerstone of good regulatory governance, a topic that has received little attention.

A financial system is only as strong as its governing practices, the financial soundness of its institutions, and the efficiency of its market infrastructure. Instilling and applying sound governance practices are a responsibility shared by market participants and supervisors. Market participants must establish good governance practices to gain the confidence of their clients and the markets. Regulatory agencies play a key role in instilling, and overseeing the implementation of, good governance practices. And regulatory agencies need to follow sound governance practices in their own operations or they will lose the credibility and moral authority they need to be effective in their oversight role—opening the door to moral hazard, unsound market practices, and, ultimately, financial crises.

Further evidence of the desirability of independence comes from the Financial Sector Assessment Program (FSAP) launched in May 1999 by the IMF and the World Bank. The FSAP enables the two institutions to assess the extent to which countries' current regulatory governance arrangements and regulatory independence (or lack thereof) is contributing to vulnerabilities in financial systems. The benchmarks against which a country's current practices are assessed are the IMF Code of Good Practices on Transparency in Monetary and Financial

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Policies, the Basel Core Principles for Effective Banking Supervision, the Committee for Payment and Settlement Systems' Core Principles for Systemically Important Payment Systems, the International Organization of Securities Commissions' Objectives and Principles of Securities Regulation, and the International Association of Insurance Supervisors' Insurance Core Principles.

Thus far, about 50 countries have participated in the FSAP, and assessments have revealed numerous shortcomings. Many supervisory agencies struggle with political influence in the form of interference in the decision-making process, arbitrary removal of senior management, or lack of budgetary independence. Improper influence by the entities they are supposed to supervise is also a big problem. Legal action—or the threat of such action—against supervisors who do not have legal protection in the execution of their job, and supervisors' often inadequate enforcement powers have not only impeded their ability to apply supervisory measures consistently but also undermined the credibility of banking supervision itself. Further undermining supervisory effectiveness is the lack of trained supervisors and uncompetitive salaries. Assessments have revealed that independence and accountability arrangements in the supervision of securities markets and the insurance sector are even weaker than those for banking.

Making Independence Work

To be effective, regulatory agencies must enjoy independence in four areas:

Regulatory independence — means that agencies should have an appropriate degree of autonomy in setting prudential regulations, within the broader legal framework. Supervisors who can define regulations are in a better position to respond quickly and flexibly to changing needs and trends in the international markets. Supervisors will also be more motivated to implement and enforce regulations if they have been closely involved in the rule-making process.

Although supervisors have the autonomy to issue prudential regulations in a large number of countries, they lack such powers while in some other countries, the regulatory powers of government and supervisors are not clearly delineated. Encouraging news is that in several countries where supervisory arrangements have been revised recently, regulatory autonomy has been strengthened.

Supervisory independence — is critical to enforcing rules, imposing sanctions, and managing crises. To be effective, supervision must be largely invisible, but this very invisibility makes supervision vulnerable to interference from both politicians and supervised entities. To protect their integrity, supervisors should enjoy legal protection when carrying out their responsibilities so that they cannot be sued personally for their actions—which can paralyze the supervisory process. Appropriate salaries should help agencies attract and retain competent staff and discourage bribe taking. Introducing rules-based systems for sanctions and interventions could also discourage improper interference.

Supervisors should be given the sole authority to grant and revoke licenses—with proper appeals procedures in place for those where licenses have been refused or revoked—because they have the best view on the composition of supervised sectors.

Moreover, if power were to be in the hands of another government agency or ministry, threats to revoke the licenses lack teeth. Practices with respect to licensing and withdrawing licenses differ greatly around the world, ranging from the government having sole responsibility (Malaysia), to consultation arrangements (Austria, the Czech Republic, Hungary), to total autonomy for the supervisors (Australia, Belgium, Italy, United Kingdom and India). Typically, governments tend to be more involved in withdrawing than in granting licenses.

Institutional independence — is guaranteed by clear arrangements for appointing and dismissing senior personnel, the agency's governance structure, the roles and responsibilities of board members, and transparency in decision making.

Budgetary independence — is needed so that the agency has the freedom to determine its staffing, training, and remuneration needs. Budgetary autonomy is generally better established in countries where supervisors are part of the central bank, because of the latter's budgetary autonomy, and in countries that recently established an integrated (unified) supervisory agency. Many countries are increasingly using an industry levy to fund regulation, and this can reinforce autonomy by freeing regulators from the government's direct budgetary control.

To be sure, independence for regulatory agencies does not mean the complete absence of political control. One legitimate concern is that independent agencies will turn into "an uncontrolled fourth branch of government." This concern is especially acute for financial sector supervisors, because they possess powers unmatched by most other regulatory agencies. When intervening in the operations of financial institutions or revoking licenses, these agencies exert the coercive power of the state against private citizens. Therefore, accountability, transparency, and integrity are crucial in preventing the abuse of such far-reaching powers. Because they need to justify their actions in terms of their mandate, independent agencies must be accountable not only to those who delegated their responsibilities to them—the executive or legislative branches of government—but also to the public at large. They must also make public—in a comprehensive, accessible, and timely manner—data and other information, particularly about objectives, frameworks, decisions and their rationale, and terms of accountability. Finally, the integrity of agency staff is critical in ensuring that they pursue institutional goals without compromising the goals in their own behavior or self-interest.

Some aspects of financial sector supervision—including the need for confidentiality and the difficulty of measuring the extent to which supervisors are achieving their objectives—make it difficult to ensure accountability. A legal basis for supervisors' actions needs to be established, along with clear objectives; well-defined relationships with the executive, legislative, and judicial branches of government; procedures for appointment and dismissal of chief executives; override mechanisms; budgetary accountability rules; and rules supporting transparency.

Despite the importance of regulatory independence as a component of good regulatory governance, current practice in

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many countries falls short of the ideal. Much work remains to be done to strengthen the independence of regulatory agencies around the world and, by the same token, improve the quality of regulatory governance.

In the interest of financial stability, as much attention should be given to ensuring the independence of the supervisory agencies as has been given to ensuring central bank independence. Effective independence cannot be achieved without support from the broader political environment, however. Vested political interests in the financial system remain strong in many parts of the world, and the cost of overriding regulators is often low and one of the reasons is institutional intolerance of them in this country. Nevertheless, the need to pursue the goal of independent and accountable regulators and supervisors in the interest of long-term financial stability is as great as ever. Politicians must be convinced of this view.

Possible Impact of Recent Policy Changes

Pensions and insurance remain different in the eyes of the Government even if they are increasingly convergent, and it is important to ensure that the interests of insurance companies receive adequate weight in the post budget deliberations of the Government.

The early announcements from the government acknowledge that there would be two bites at the insurance cherry. The first one would transfer insurance supervision to the Insurance Regulatory And Development Authority. This legislation has duly been passed and implemented. The second piece of legislation would complete the reorganization of the Pensions regime with the formation of a new Pensions Regulatory And Development Authority. The new system is ambiguous which it should be. It also opens the scope for a struggle for power between two regulatory bodies - IRDA and the proposed PRDA. There could be overlap of functions between the two – especially in the legal background that annuities could be offered in India only by life insurance companies. Prudence demands that regulatory arbitrage and administrative and regulatory costs and mechanism should be avoided and that would be possible only when a single supervisor for the insurance and pension regime is retained.

It is contrary to the widely held world view integrating the organisations as much as possible in advance of the legislation being implemented. It is apparent that the government's original intention of completing the legislation on pension's regulations is simply not achievable as there is no realistic chance of any bill being introduced in Parliament before the Monsoon 2003, in which case it could not complete its passage through Parliament by the end of the year thereby further delaying reforms in an important area.

The new policy announcement does not address convincingly the risk that pensions business would be subject in the context of multiple functional regulators, in particular because many firms would be subject to regulation by more than one of the regulator (and some by all of them). And the inefficiencies and complications inherent in a multiple regulator structure can only increase as financial conglomerates become more prevalent, thus potentially outweighing the advantages of an objectives-based structure.

Preparing for the Future

Our objectives today are to obtain long-term stability through stability in policy making and stability in the economy. In the modern economy, demand for more openness and transparency than in the past. Openness builds confidence in the Government's ability and determination to maintain economic stability. And we set out clear choices for the country. There is the opportunity now for sustainable growth - growth that will create job opportunities and generate the wealth this country needs.

Ahead of the worldwide reform of the international financial system, and in the wake of the Asian crisis, emerging economies independently introduced various domestic controls and regulations. It is understandable that they resorted to such countermeasures; however, it is an undesirable solution for the long term. A shift from the individual nation approach to a coordinated regional strategy may be a practical alternative for emerging economies.

And the financial services regulators have demonstrated that they are prepared for the future, keeping a close eye on international trends and pressing on with an agenda, which will bring more sweeping reform. On these foundations, they are determined to increase India's share of the financial services pie.

We must never forget that markets are built by the sweat and toil of human hands. The success of financial markets and of the financial services sector is the combined result of the successes of we Indians, each working to build a better life for the families, for the potential rewards of today's marketplace are no different than they were in our parents' generation, nor even our grandparents'.

Appropriate policies and regulations that incorporate the rural and social sectors of the population system must be to permit the provision of financial services that respond to what the poor want. Financial systems that work for the poor majority should: encourage a range of institutions and methodologies; promote rigorous performance standards; and provide appropriate support modalities to help the sector grow. Pillars of sustainable financial services to the poor are: transparency and performance standards for all institutions in micro-finance; financial regulation that fits the needs of micro-finance portfolios; legal structures that work for regulated and institutional infrastructure (finance, capacity building, standards). There are key, distinct roles for practitioners and networks, policy makers and regulators and external actors to play in ensuring sustainable, responsive financial services to the poor.

In the end, our financial markets and our financial institutions provide an opportunity-but only if we have faith in them, in our country, and in ourselves. And I can assure you the regulators in this arena will do their utmost to help strengthen this trust and create an unparalleled competitive advantage-an Indian advantage.

That is, after all, the best way forward.

The End of Development Finance

C P Chandrasekhar, February 22, 2004

Financial liberalization is leading to the death of development banking in the country. Close to two years back, on March 30,

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2002, the Industrial Credit and Investment Corporation of India (ICICI) was through a reverse merger integrated with ICICI Bank. This was the result of a decision (announced on October 25, 2001) by ICICI to transform itself into a "universal bank" that would engage itself not only in traditional banking but investment banking and other financial activities. The proposal also involved merging ICICI Personal Financial Services Ltd and ICICI Capital Services Ltd with the bank, resulting in the creation of a financial behemoth with assets of more than Rs 95,000 crore. The new company was to become the first entity in India to serve as a financial supermarket and offer almost every financial product under one roof.

Destroying Development Banks

Since then similar moves have been underway to transform the other two principal development finance institutions in the country, the Industrial Finance Corporation of India (IFCI), established in 1948, and the Industrial Development Bank of India (IDBI), created in 1964. In early February, finance minister Jaswant Singh, announced the government's decision to merge the IFCI with a big public sector bank, like the Punjab National Bank. Following that decision, the IFCI board has approved the proposal, rendering itself defunct.

More recently the Parliament has, after debating the matter for more than a year, approved the corporatisation of the IDBI and paved the way for its merger with a bank as well. When the bill was put through with some difficulty in the Rajya Sabha, it appeared that the government had provided two commitments. The first was that the it would retain a majority stake in the entity into which the IDBI would be transformed. The government currently has a 58.47 per cent stake in IDBI. And, second that the development finance emphasis of the institution would be retained. But already doubts are being expressed about the government's willingness to stick to the first of these commitments. And once the merger creates a universal bank as a new entity, with multiple interests and a strong emphasis on commercial profits, it is unclear how the second commitment can be met either.

These developments on the development-banking front do herald a new era. An important financial intervention adopted by almost all late-industrialising developing countries, besides pre-emption of bank credit for specific purposes, was the creation of special development banks with the mandate to provide adequate, even subsidised, credit to selected industrial establishments and the agricultural sector. According to an OECD estimate quoted by Eshag, there were about 340 such banks operating in some 80 developing countries in the mid-1960s. Over half these banks were state-owned and funded by the exchequer; the remainder had a mixed ownership or were private. Mixed and private banks were given government subsidies to enable them to earn a normal rate of profit.

Reasons for their Creation

The principal motivation for the creation of such financial institutions was to make up for the failure of private financial agents to provide certain kinds of credit to certain kinds of clients. Private institutions may fail to do so because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned.

In practice, financial intermediaries seek to tailor the demands for credit from them with their funds by adjusting not just interest rates, but also the terms on which credit is provided. Lending gets linked to collateral, and the nature and quality of that collateral is adjusted according to the nature of the borrower and supply and demand conditions in the credit market. In the event, depending on the quantum and costs of funds available to the financial intermediary, the market tends to ration out borrowers to differing extents. In such circumstances, borrowers rationed out because they are considered risky may not be the ones that are the least important from a social point of view.

These problems can be aggravated because certain kinds of insurance markets for dealing with risk are absent and because in some (especially, developing-country) contexts certain kinds of long-term contracts may not just exist. They need to be created by the state, and till such time state-backed lending would be needed to fill the gap.

Industrial development banks also help deal with the fact that local industrialists may not have adequate capital to invest in capacity of the requisite scale in more capital-intensive industries characterised by significant economies of scale. They help promote such ventures through their lending and investment practices and often provide technical assistance to their clients. Some development banks are expected to focus on the small-scale industrial sector, providing them with long-term finance and working capital at subsidised interest rates and longer grace periods, as well as offering training and technical assistance in areas like marketing.

Fundamentally of course, development banking is required because social returns exceed private returns. This problem arises because private lenders are concerned only with the return they receive. On the other hand, the total return to a project includes the additional surplus (or profit) accruing to the entrepreneur. The projects that offer the best return to the lender may not be those with the highest total expected return. As a result good projects get rationed out necessitating measures such as development banking or directed credit.

The Role of Development Banks

It must be said that development banks have played an important role in the Indian context. In his deposition before the Parliamentary Standing Committee on Finance (1999-2000), on September 18, 2000, the Managing Director of ICICI stated: "disbursement by FIs constituted around fifty per cent of gross fixed capital formation by the private corporate sector in the pre-liberalised era. If you see the financial institutions disbursement versus bank credit to industry right from 1951 to the last year, we see that financial institutions have provided significantly more credit for creation of capital in industry in India. It has grown year after year … thus, the FIs have played a pivotal role in the development of Indian industry and have fulfilled their initial objective i.e. to spur industrialisation in the country over the last three to four decades."

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The corporatisation, transformation into universal banks and subsequent privatisation of the DFIs is bound to undermine this role of theirs. The justification for the conversion to universal banking as provided by the Industrial Investment Bank of India (IIBI) in a written reply to the Parliamentary Standing Committee indicates this: "Since compartmentalisation of activities leads to greater transactions cost and inefficiency, no financial intermediary can survive competition if it does not allow itself flexibility to change. In the new financial environment, IIBI is of the opinion that a financial player may be either placed naturally for resources like a commercial bank, or may be a pure financial service provider and retailer like the NBFCs. Still another option is to build a financial supermarket where all the services are available under a single umbrella. The advantages are that they would be free to choose the product mix of their operations and configure activities for optimum allocation of their resources."

The CEO of ICICI made clear what this means in terms of emphasis: "When we were set up, our role was to meet long term resource requirements of the industry. With liberalisation the role has slightly changed. It became developing India's debt market, financing India's infrastructure development, etc. With globalisation, I think, the role is set to change further. Now we have to stress on profitability, shareholder value, corporate governance, while at the same time not losing sight of our goals – the goals that were originally set for us – and the goals that were set up in the interim with liberalisation." Unfortunately, the emphasis on those goals would remain only with regulation. But regulation is diluted by liberalisation.

Impact of Liberalisation

There is another way in which the gradual dissolution of the core of India's development banking infrastructure is related to the process of liberalisation. This was the effects of liberalisation on the profitability of an institution like the IFCI, for example. According to the D Basu Expert Committee, which was appointed by IFCI's governing board to examine the causes of the large NPAs accumulated by the institution and suggest a restructuring, immediately following its corporatisation and initial public offering in 1993, IFCI embarked upon a programme of rapid expansion of business. To scale up the volume of business it increasingly raised resources from the debt markets. This was at a time when interest rates were relatively high. In order to cover the high cost borrowings, the institution was forced to make investments in what were considered high yielding loan assets.

Unfortunately, this occurred at a time when financial liberalisation had put an end to the traditional consortium mode of lending, in which all major financial institutions collaborated in lending to a single borrower as per a mutually agreed pattern of sharing. Liberalisation was introducing an element of competition among financial institutions. In the event, in search of high returns IFCI chose to take relatively large exposures in several green-field projects (notably in the steel and oil sectors).

For a number of reasons these projects did not deliver on their promise. Many of these projects had expected to raise substantial equity from the capital market as well as from the internal resources of group companies. Depressed conditions in the capital market put paid to the first. Recessionary conditions limited the second. Many of these groups were in the traditional commodity sectors such as iron and steel, textiles, synthetic fibres, cement, sugar, basic chemicals, synthetic resins, plastics, etc. Besides the general recessionary environment, some of these sectors were particularly affected by the abolition of import controls and the gradual reduction of tariffs. Internal resource generation, therefore, fell short of expectations. As a result, with inadequate own-financing, in the pipeline many of these projects suffered from cost- and time-overruns.

Unlike other financial institutions, IFCI had not diversified into other types of businesses. Project finance still accounted for 94 per cent of IFCI's business assets. As a result, the impact of NPAs arising from the factors cited above was the greater in the case of IFCI than in the case of other institutions. In addition, there was sharp rise in IFCI's gross NPA level in 1998-99 (Rs 5,783.56 crore as against Rs 4,159.84 crore in the previous year) as a result of the implementation of the mandatory Reserve Bank of India guidelines for classifying non-performing assets. As a result, certain loans, particularly those relating to projects under implementation, which had been treated as performing assets in earlier years, had to be classified as non-performing.

The Basu Committee had noted that some of the factors referred to above such as impact of trade policy liberalisation and tariff reduction, recessionary conditions in the late 1990s, depressed conditions in the capital market, etc, affected other DFIs and banks as well. However, the impact was particularly pronounced in the case of IFCI, as the concentration of risk relative to net worth was much higher. Also, as already stated, other DFIs had started diversifying into non-project related lending and business. It was difficult to survive as a development finance institution in the new environment.

Thus the decline of development finance is clearly related to the process of economic liberalisation. However, as a number of industry associations have noted in recent times, it hardly is true that in a time of growing competition for Indian firms from international business and a growing liberalisation-induced shift in the investment and lending practices of banks and NBFCs away from manufacturing, state support for domestic private investment is not relevant. But given the ethos of liberalisation this does not seem to matter.

Finance and Development - Which Way Now?

by Bimal Jalan, Governor, Reserve Bank of India, 6 December 1999.

1. The Annual Foundation Lecture of this famous College (ASCI, Hyderabad) is an important event in our country's academic calendar. Several of our most distinguished economists, public administrators and thinkers have shared their thoughts with you on this occasion. I feel privileged to have been invited to deliver this year's lecture. My happiness in being able to join you today has been immeasurably enhanced by the presence of Shri M. Narasimham at this function. Shri Narasimham's substantial contribution to monetary economics, public administration, academic institutions, the financial system,

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and international agencies are well known, and I do not wish to embarrass him by recounting these. Permit me only to say that if, in the aftermath of the East Asian crisis, we are able to take some comfort in our relative stability and the resilience of our financial system, it is in no small measure due to the guidance provided by him, particularly in his capacity as Chairman of two high level committees on financial sector reform. My personal association with him goes back nearly 30 years. I have leamt much from him and I have always admired his unfailing commitment to public service and his unflinching confidence in our country's future. Thank you, Mr. Narasimham, for inviting me here.

2. Since I received this invitation, I have been thinking about what I should talk about. After some consideration, and a great deal of trepidation, I have chosen to speak about finance and development, particularly where we are and where we should be going. [1] The role of finance in development has, of course, always been recognised. However, I believe that in the last few years, there has been a fundamental change in the way we think about the financial system and its role in development. Part of this change is due to the changing role being assigned to Government and public sector in the allocation of nation's savings for development. A more dramatic and recent reason for this change is due to the East Asian crisis. This crisis, and its aftermath, have brought to the fore the critical role of the financial system in determining the stability and sustainability of the real economy. As a result, the reform of the financial system, and the rules and the codes that should govern the conduct of financial business, figure high on the domestic agenda for reform as well as the international agenda for global co-operation.

3. I propose to begin this lecture with some reflections on the paradigm shift that has taken place in the literature as well as economic policy making on the role of finance in development. This will be followed by a discussion of some of the lessons emerging from the Asian crisis. I would then touch upon the evolution of the Indian financial system, and end with some reflections on future directions.

I Finance and Development - The Shifting Paradigm

4. In less than four weeks, we will be celebrating the dawn of a new millennium. As we reflect on the history of human civilization in the millennium just ending, it is surprising to recall just how recent is the story of economic growth. As Paul Krugman has noted in a recent book, "economic growth, at least economic growth that raises living standards, is a modern invention. From the dawn of history to the eighteenth century, the world was essentially Malthusian. Improvements in technology and capital investments were always overtaken by population growth; the number of people slowly increased, but their average standards of living did not." [2] Up to about the end of the 19th century, the only countries where per capita incomes were increasing on a sustained basis for any length of time were the Western countries, particularly, England, Germany, France and the United States. During this entire period, the then so-called under-developed or Third World countries continued to be exporters of primary products and importers of industrial products with stagnant, and in some cases, declining per capita incomes. A large number of them were also colonies of the Western powers, and the connection between these two situations - the colonial state and income stagnation - was not missed by their leaders and intellectuals.

5. The development strategies of the newly independent and developing countries in mid- 19th century were framed against this background. The central and the leading role for breaking away from the colonial legacy and for speeding up the process of industrialisation was assigned to the State. The need for the Government to occupy the commanding heights and to lead from the top received further support from the astounding success of the Soviet Union in emerging as a rival centre of political and industrial power within a very short period. India, at that time, played a pioneering role in giving expression to the aspirations of the newly independent Third World countries in the economic field. Thus, in 1956, India's Second Five Year Plan outlined the goals of development strategy in the following terms:

   "The pattern of development and the structure of socioeconomic relations should be so planned that they result not only in appreciable increases in national income and employment but also in greater equality in incomes and wealth. Major decisions regarding production, distribution, consumption and investment - and in fact all significant socioeconomic relationships - must be made by agencies informed by social purpose."

6. In practice, that meant, that all allocation decisions were to be made by the Government or its agencies. The importance of raising resources for development was, of course, considered important. However, the primary emphasis was to be on increasing the domestic savings rate by suppressing consumption, high taxation, and appropriating profits through ownership of commercial enterprises. Accelerated capital accumulation through these means was considered to be the key to development. In a celebrated observation which guided many a planner and policy maker in developing countries, Professor W.Arthur Lewis observed that:

   "The central problem in the theory of economic development is to understand the process by which a community which was previously saving and investing 4 to 5 per cent of its national income or less, converts itself to an economy where voluntary saving is running at about 12 to 15 per cent of national income or more. This is the central problem because the central fact of economic development is rapid capital accumulation (including knowledge and skills with capital). " [3]

7. In the process of capital accumulation, the role of financial system was essentially limited, as allocation decisions were to be made by the central planning authorities and not by the financial markets. To a large extent, financial system also had a limited role in providing incentives for savings and

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capital accumulation as interest rates were controlled, and generally "repressed", and household savings were preempted through high levels of statutory reserve and liquidity ratio. New banks and financial institutions were set up, and old ones were taken over, in order to act primarily as deposit taking agencies and providers of credit and finance for designated and centrally determined purposes.

8. The above development paradigm has, of course, shifted rather sharply in recent years. Almost all developing countries are moving towards a more market-determined strategy of development. There are several factors which have contributed to this change in perception. First and the foremost reason for questioning the earlier strategy was the simple fact that actual results in terms of growth of incomes or industrial development were well below expectations. Despite substantial increase in the domestic savings rates in several countries, including India, rate of growth of incomes was relatively low. While saving rates were rising, so were capital-output ratios because of inefficiencies in the allocation and use of resources. The period of relatively low growth also coincided with a period of virtually persistent and recurring balance of payments crises. Thus, paradoxically, a strategy which was expected to reduce dependency on foreign aid and foreign trade, actually resulted in greater dependence on aid and emergency assistance from abroad.
9. An equally important factor contributing to the change in perceptions was the astonishing success of Japan and the East Asian countries in accelerating their rates of growth by relying on market oriented pattern of industrialisation (with, of course, varying degrees of "guidance" by the State). Japan's per capita rate of growth of 8 per cent per annum during 1953 - 1973 was unprecedented in the history of economic development. No economy had ever grown that fast before, and Japan emerged from the ruins of war to become the world's second largest economy. Similar was the record of industrialisation in East Asia particularly in countries like Hong Kong, Singapore, Taiwan and South Korea. In the 50s, their per capita incomes or the degree of industrialisation was no different from those of the rest of Asia. However, within a period of 30 years, they were able to catch up with the industrialised countries of the West. A final and decisive development leading to the demise of the old strategy was the collapse of the Soviet Union and the acceptance of market-led development strategies by all countries of Eastern Europe.
10. The change in the development paradigm also led to a change in the perception about the role of the financial system in development. It became clear that liberalisation of product markets also requires a well functioning financial system for mobilisation and allocation of savings. Banks, capital markets and financial institutions were no longer seen as mere conduits for channelling savings in pre-determined directions, but as important instruments for allocating savings among alternative investment choices according to their relative efficiency.
11. In the more recent period, after the onset of the East Asian crisis in mid-1997, there has been a further change in the perception about the role of the financial system in development. Earlier, the real economy was supposed to lead and shape the financial system. Today, it is the real economy which is supposed to have become a prisoner of a weak financial system. In other words, proper development of the financial system is no longer regarded as an "ancillary" or an adjunct to the development of the real sector, but as a necessary pre-condition for growth.
12. The above developments in the real world were supported by findings in the theoretical literature which demonstrated the critical role of financial system in the growth process. The financial liberalisation literature developed in 1970s and 1980s stressed the costs of "financial repression", particularly interest rate and exchange rate controls which restricted growth of financial intermediation and the real rate of economic growth. These findings were buttressed by the emergence of endogenous growth literature, which emphasized the importance of financial market as a source of innovation and productivity growth. It was demonstrated that an efficient and well functioning financial system contributed to economic growth by raising the level of saving and investment and the productivity of capital.
13. The change in the perception about the role of financial system in development has been combined with a fair amount of debate on the nature and characteristics of financial markets as distinguished from products or factor markets. Are financial markets special? Do they require a different set of regulatory or supervisory regimes? What are the relative roles of international and domestic institutions and supervisory regimes in ensuring the viability and the integrity of the financial system in a particular country in the context of globalisation or "globality", as some prefer to call it?
14. Financial markets indeed have certain special characteristics. The most important of these is the large volume of transactions and the speed with which financial resources can move from one market to another, and from one instrument to another. A related characteristic is the scope for instant "arbitrage" as between different markets and between different types of instruments. Financial transactions can be highly leveraged and the risk of failure can be transferred by actual decision-makers to innocent by-standers.
15. Another interesting characteristic of these markets is the role of financial intermediaries. There are segments of financial markets, such as stock markets, and bond markets where savers themselves make the decision about when and where their money can be used. Markets are, however, also dominated by financial intermediaries (such as banks, provident funds and pension funds, mutual funds and so on), which take investment decisions as well as risks on behalf of their depositors. Yet another important characteristic of financial markets is the so-called "negative" externalities associated with them. A failure in any one

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segment of these markets may affect all other segments of the market, including the non-financial markets.

16. Financial markets are also highly susceptible to "self-fulfilling" prophecy or expectations. Sometimes "self-fulfilling" expectations can lead to panic as behaviour of a limited group of operators gets generalised. Jagdish Bhagwati has described the classic case of a self-fulfilling prophecy with reference to the behaviour of exchange rates dating back to the 1960s. Let me quote from an old article by him where he illustrates this particular feature of the foreign exchange market:

    "Let the objective reality initially be that the dollar will not depreciate. But suppose that speculators expect the opposite, and move out of the dollar, depreciating it. If the reality were independent of the actions of the speculators, the dollar would go up again, and the market would have chastised and ruined the speculators. But it may well be that as the dollar falls initially with the speculation, wages and hence prices rise in sympathy. If so, the objective reality would itself have changed, legitimating the devaluation of the dollar in view of the speculation-induced rise of prices. Such self-justifying speculation shapes its own reality."[4]

17. In view of the externalities, volatility and certain other special characteristics, it is generally agreed that financial markets have to be closely monitored and supervised. It has also been the past experience that, in view of the growing integration of worldwide financial markets, failure and vulnerability in the domestic market in a particular country can have international implications. Similarly, problems in the external markets can create difficult problems for the functioning of the domestic markets, even if the country concerned was following prudent macro-economic policies. This close relationship between the two markets, domestic and external, raises the question of appropriate duties and responsibilities of domestic supervisory authorities and international financial institutions.

18. Most of these issues have come to the fore in the context of the East Asian crisis and subsequent developments in certain other countries, such as, Russia and Brazil. Let us briefly look at the lessons emerging from recent developments in East Asia and elsewhere.

II Lessons from the Asian crisis

19. Much has been said and written about the causes of the Asian crisis and its aftermath. The literature is voluminous and growing by the day. In some ways, it is as impressive as the earlier literature on the "Asian miracle", and raises the obvious question of what developing countries must learn from their successes. It is not my purpose to review this literature nor to comment on what went wrong and what policies could have been handled better either before or after the crisis. My purpose is limited, and confined to recapturing some aspects of the Asian crisis which may have a bearing on our understanding of the relationship between finance and development, and the lessons that countries like ours need to keep in view in order to avoid having to go through similar devastating experiences in the future.

20. An important point to remember in this connection is that even relatively small mistakes in the conduct of macroeconomic or exchange rate policies can sometimes lead to big crises. The Asian experience is certainly mixed, and the magnitude of macro-economic and other policy failures in different East Asian countries was not the same. However, in several of them, the degree of deviation from the best practices or prudent policies was relatively small. It may be that they persisted with the defence of the pegged exchange rates for a week or two longer than was desirable, or it may be that they did not take corrective monetary or fiscal action early enough. However, the devastation and the pain that their economies went through because of these policy mistakes were sizeable and unprecedented.[5] This, incidentally, was also the experience of Mexico and Argentina in early 1995, when a major emerging crisis was brought under a semblance of control by a massive international rescue effort launched by the IMF, the United States and the World Bank. It is no coincidence that in all these cases, in East Asia as well as in Mexico and Argentina, the proximate cause was the relatively sudden reversal of capital flows on which these economies had become excessively dependent. It had taken a relatively long time to build a climate of confidence, and for capital inflows to rise gradually. However, it took no time for this confidence to be dissipated and for foreign capital to disappear. It is also interesting to note that the major reversal was not only on account of foreign lenders or investors, but also on account of resident holders of domestic assets who rushed to encash or convert their holdings into foreign currency.

21. The point is simply that handling capital flows is not an easy business. While capital account liberalisation and large capital movements have brought considerable growth benefits, they have also brought with them greater potential for volatility in asset prices and financial markets, including forex markets. This can cause unanticipated damage to the real economy during periods of uncertainty about the future economic or political outlook. As mentioned earlier, adverse expectations about a country's future during periods of uncertainty can often become " self-fulfilling ". The fact that such volatility can be aggravated by a weak financial system, leading to severe development problems, has also to be borne in mind. The lesson from the Mexican or East Asian episodes, I must emphasise, is not an argument against capital flows or capital account convertibility. It is about careful and judicious handling of such flows and about the pace of movement towards capital account liberalisation for residents. It is also about building domestic safety nets, for example, by keeping the level of liquid foreign exchange reserves high in relation to short term external obligations.

22. It can not be denied that, despite the earlier spectacular successes, the financial systems of East Asian countries were characterised by several weaknesses. Thus, banks were not subject to effective prudential regulation and supervision. Credit expansion in these countries was large and banks took untenable positions in real estate and other unproductive assets, in the process building up large asset-

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liability and currency mismatches. Banks had also built up huge off-balance sheet liabilities, which moved on to the balance sheet once there was adversity. Cross-border inter-bank positions were also large. Non-banking financial companies contributed to the crisis as these were subject to little or no regulation.

23. Corporates were also highly leveraged. External debt was available at low interest rates and the fixed exchange rates in these countries offered them a false sense of complacency, encouraging them to hold large unhedged positions. External debt was high, short-term, leveraged and concentrated in the private sector. Thus, on the whole, there was an inherent vulnerability in the financial sector, and once expectation turned adverse, this vulnerability easily translated itself into a panic. Standards of accounting practices, financial reporting and disclosure norms were somewhat inadequate in these countries. There was lack of transparency in the operations of market participants as well as the central banks in some cases.

24. Events in East Asia have certainly highlighted the two-way interaction between the financial sector and development and the need for an appropriate policy framework. Improving the efficiency of financial sector through market based reforms is an important concern of the new development paradigm. However, this has to be accompanied by policies, practices and certain amount of restraints that strengthen the financial system towards stability so that growth becomes sustainable. At the same time, proper emphasis has to be placed on growth policies that do not give rise to problems that engender systemic instability in the financial sector (e.g. a large fiscal deficit).

25. A related issue is that of striking an appropriate balance between financial regulation and market freedom. While freedom is essential to foster efficiency, it also raises an equally important question of an appropriate regulatory framework given the wide divergence between private and social interest in ensuring the stability of financial system. Hence, a proper system of regulation relating to prudent risk limits, short-ten-n foreign borrowing and the degree of tolerable maturity mismatches in the banking system assumes critical importance for minimising risks to the stability of the financial system.

26. The most important lesson emerging from the Asian crisis, in my view, is the need to be vigilant about domestic and international developments which may impinge on a country's financial relations with the rest of the world. The process of integration of worldwide financial markets has resulted in product innovation and greater efficiency, but it has also made developing countries subject to greater vulnerability and new risks. Strong fundamentals alone cannot provide full immunity from a crisis. There is a need to take preventive early action, to build firewalls, and to keep some safety nets handy. It is also clear that when things are going well, the rest of the world shares in the prosperity. However, when things go wrong, the price has to be paid primarily by the country concerned. It is, therefore, an important responsibility of the countries themselves to put in place an efficient, prudential and safe financial system which can aid and protect the development process at all times - good and bad.

III The Indian Experience

27. Against the backdrop of the lessons from the Asian crisis, let us now turn to financial sector reforms in India from the perspective of our past experience, the present stage of development and some issues for the future.

The Past

28. As mentioned earlier, our development strategy for nearly forty years or so after independence, placed emphasis on state guided development initiatives, with primary role assigned to the state and its agencies for mobilisation and allocation of savings. It was not until the Eighth Plan that the role of the financial sector and financial markets was given an explicit recognition in the development strategy. The emphasis on accelerating investment rate through state intervention in a number of key areas meant channelling credit to certain preferential sectors at subsidised interest rates, exercising public ownership control on banks and restricting their activities through policy prescriptions. Some of the typical features that got built into this system were the directed lending programme with high levels of cash reserve ratio and statutory liquidity ratio, ceiling on deposit and lending rate, lending to priority sectors, branch licensing, and detailed regulation of banks' loan and investment portfolios.

29. As far as external finance was concerned, India relied primarily on bilateral and multilateral official development assistance and did not encourage private external capital inflows as a way to supplement domestic savings. The exchange rate was administered and there was extensive control over all foreign exchange transactions, which were subject to approval on a case-by-case basis. Because of pervasive exchange controls, the Indian financial system remained largely insulated from international markets. This, however, did not prevent India from suffering regular balance of payments crises year after-year and becoming dependent on aid flows or credits from the IMF.

30. The financial system, as a result, faced little or no competition, either domestic or foreign, and costs and efficiency of transactions were not its primary concern. Productivity was generally poor and profitability low. The system was also subject to limited accountability. By the beginning of 1990s, it was becoming evident that the system could not be sustained without a thorough revamping of its operations.

31. The balance of payments crisis in 1990-91 provided the trigger point of reform in several sectors, including the financial sector. The reform initiatives in financial sector started with Government appointing two committees: one on balance of payments under the chairmanship of Dr. C. Rangarajan, which went into liberalisation of policies in external sector and the second, on the financial sector under the chairmanship of Shri M. Narasimham, which deliberated on domestic financial sector reforms. The

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reform programme in financial sector since 1992 has largely followed the broad approach set out by these two committees, supplemented by the Second Narasimham Committee, which was set up in 1997.

The Present

32. What has been our progress in financial sector reform and what are our achievements so far. In so far as the "arithmeticals" of reform in the financial sector - to use a phrase used by the Narasimham Committee - is concerned, significant progress has been made in the past few years. There has been a steady decline in the level of resource preemption from the banking system. Both cash reserve ratio and statutory liquidity ratio have been reduced from their high levels of 15 per cent and 38.5 per cent, respectively, in 1991-92 to 9 per cent and 25 per cent now. Interest rates in various segments of financial markets have been deregulated in a phased manner. This had preceded the abolition of control on capital issues and freeing of interest rate on private bonds and debentures. While the government borrowing rates are now market determined, there has been a gradual phasing out of interest rate subsidies on bank loans. Wide-ranging reforms have been initiated to develop and deepen the government securities market, money market, capital market and foreign exchange market. The Bank Rate has been reactivated, regular short term Repos at a pre-announced rate are being conducted, and a system of prime lending rate has been introduced to provide direction to movement of interest rates in the credit market.

33. In the sphere of external financial policy, while the exchange rate is market determined, over the years, there has been a progressive liberalisation of foreign direct and portfolio investment, and approval procedures have been considerably simplified. As a result, there are now minimum restrictions on inflow of capital into the economy, or its repatriation and servicing. There has also been a significant liberalisation of policy regarding industry's access to foreign equity and borrowing through long term debt instruments. The banking sector has been given a greater degree of freedom with regard to raising funds abroad and managing their external liability, subject to prudential guidelines. The end result of all these and other reforms has been the growing integration among various segments of financial markets, closer convergence of Indian financial system with practices prevailing in international financial markets, and greater opportunity for investors to access both domestic and international markets. At the same time, care has been taken to avoid excessive short term external liability and asset-liability mismatches.

34. Competitive condition in the banking industry has been facilitated by relaxing entry and exit norms and permitting the public sector banks to raise additional capital from the market (up to a certain level). While public sector banks continue to be predominant, the changing competitive environment in the banking sector has made a significant difference to banking practices and disclosure requirements.

35. Prudential regulation and supervision have formed a critical component of the financial sector reform programme. India has adopted international prudential norms and practices with regard to capital adequacy, income recognition, provisioning requirement and supervision. These norms have been progressively tightened over the years, particularly against the backdrop of the Asian crisis. Recently, the required capital adequacy ratio has been increased to 9 per cent, from 8 per cent, in the banking sector. The mark to market practice for valuation of government securities has been gradually enhanced from 30 per cent in 1992-93 to 75 per cent by 1999-2000. Further refinement, in line with international best practices, in valuation and classification of investments by banks is currently under consideration. As a further prudential measure against credit and market risks, risk weights have been made applicable to government and other securities to take account of price variations.

36. An attempt has also been made to avoid the problems arising from "connected lending". There have been regulations that limit the exposure of individual banks and non-banking finance companies to any particular borrower or groups of borrowers. There are restrictions on banking system's exposure to equity and lending against equity as collateral, and its exposure to real estate is very limited. Prudent limits have been placed on the financial system and the corporate sector as far as external borrowing is concerned.

37. In the area of supervision, a full-fledged institutional mechanism has been developed keeping in view the needs of a strong and stable financial system. The system of off-site surveillance has been combined with periodical on-site supervision for monitoring the risk profile of banks and their compliance with prudential guidelines. The Basle Core Principles for Effective Banking Supervision is substantially being adhered to. A "CAMELS" based rating system for Indian banks has also been introduced. The Reserve Bank's regulatory and supervisory responsibility has been widened to include financial institutions and non-banking financial companies.

38. As a result of these and other measures, some progress in the performance of the Indian banking system in recent years is noticeable. The trend in erosion of profit and capital base has been reversed. The net profits of the public sector banks, as a percentage of their total assets, averaged 0.4 per cent during 1994-95 to 1998-99, against the loss of about 1.0 per cent in 1992-93 and 1993-94. The gross non performing assets of public sector banks (without allowing for provisions) as per cent of total assets have declined from about 12 per cent in 1992-93 to about 7 per cent in 1998-99. As of March 1999, all public sector banks except one had achieved capital adequacy ratios exceeding the prescribed norm of 8 per cent. Currently most of them are on the threshold of the prescribed 9 per cent ratio by March 2000. The improved performance has enabled most of the banks to meet their capital requirement from internal resources and the market without dependence on budgetary support.

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39. The consolidation of financial system in the recent years has led to increased resilience of the Indian economy to external crisis. This has been evident from the muted impact of the Asian crisis on the Indian financial markets. Since then there has been a constant effort to enhance the regulatory and supervisory standards in conformity with international standards.

40. To sum up, it is clear that, thanks to the guidance provided by committees headed by Dr. Rangarajan and Shri Narasimham, there has been significant progress in broadening and strengthening of India's financial system. The task is, however, far from complete. Let us briefly look at some of the areas which require priority consideration in the future.

The Future

41. The agenda for future is long. Fortunately, there has been a widespread interest and debate among experts and market participants on various aspects of financial reform which has enabled India to chart out a path which is best suited to our conditions. Limitations of time - and of your patience - do not permit me to cover the entire agenda for the future .[6] I will, therefore, confine myself to highlighting only a few areas which, in my view, deserve priority.

42. First and foremost, it is necessary to continue with the process of strengthening our prudential, provisioning and capitalisation norms and bring them in line with best international standards. It is equally important to continue with our efforts to introduce maximum transparency, disclosure, and accountability so that investors and counter parties to financial transactions can take their decisions based on full information and their own assessment of market and other risks. Tighter and tougher prudential standards will no doubt cause some pain and impose greater responsibility on banks and other financial institutions. However, as I mentioned before, given the new international focus and externalities and linkages involved, the regulation of the financial sector is no longer a matter of choice or a matter of domestic concern alone. Over a period of time, it is likely that the willingness of the rest of the world to do financial business - either by way of trade credits, direct investments or other types of investments and loans will depend on their confidence in our financial practices. India must remain ahead of the curve in its prudential management.

43. The level of Non-Performing Assets (NPAs) of the banking system in India has shown an improvement in recent years, but it is still too high. Part of the problem in resolving this issue is the carry-over of old NPAs in certain declining sectors of industry. The problem has been further complicated by the fact that there are a few banks which are fundamentally weak and where the potential for return to profitability, without substantial restructuring, is doubtful. The Narasimham Committee and the Verma Committee (which recently submitted its report) have looked into the problems of weak banks and have made certain recommendations which are under consideration of Government and the Reserve Bank. These are also being widely debated, so that an acceptable long term solution can be evolved. Leaving aside the problem of weak banks, in profitable banks also, the NPA levels are still high. A vigorous effort has to be made by these banks to strengthen their internal control and risk management systems, and to set up early warning signals for timely detection and action. The resolution of the NPA problem also requires greater accountability on the part of corporates, greater disclosures in the case of defaults, and an efficient credit information system. Action has been initiated in all these areas, and it is hoped that, with the help of stricter accounting and prudential standards, the problem of NPAs in future will be effectively contained.

44. The problem of NPAs is also tied up with the issue of legal reform. This is an area which requires urgent consideration as the present system, involving substantial delays in arriving at a legal solution of disputes, is simply not tenable. It is hoped that recent efforts, such as establishing more Debt Recovery Tribunals and setting up of Settlement Advisory Committees in banks, would help. However, there is an urgent need to institute a proper legal framework to ensure expeditious recovery of debt and give adequate legal powers to banks to effect property transfers. The absence of quick and efficient system of legal redress constitutes an important "moral hazard" in the financial sector as it encourages imprudent borrowing.

45. In order to allow for growth in their assets in line with real growth in the economy, banks and financial institutions would need to increase their capitalisation quite substantially in the next few years. At present, the minimum shareholding by the Reserve Bank in the State Bank of India, prescribed by legislation, is 55 per cent. The minimum percentage of shareholding by Government in public sector banks is 51 per cent. So far, a number of strong banks have been able to access capital markets to meet their capitalisation requirements in line with prudential guidelines. Some of these banks, including SBI, now have limited scope to raise further capital from the market within the prescribed floor of RBI and Government shareholdings. If the risk weighted assets of these banks grow in line with the growth in the economy in the next five years, additional capital requirements of these banks may exceed Rs. 10,000 crore. As against this requirement, the headroom available for these banks to raise capital from the market is less than Rs. 1,000 crore. After allowing for additional infusion of reserve capital through internal generation and access to subordinated debt, the gap between their additional capital requirement and the leeway available to raise capital from the market will still remain quite sizeable.

46. In this situation, an issue that needs to be debated and resolved is whether this gap should be filled by contribution from the Reserve Bank (in the case of SBI) and Government (in the case of other public sector banks) or whether legislative ceiling for capital to be subscribed by the public should be raised. The provision of additional capital by the Reserve Bank is tantamount to additional

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monetisation, and its monetary impact is equivalent to that of printing additional currency. Contribution to banks' capital by the Government has a similar effect as it will add to Government's deficit, which is already very high. Government, in any case, would need to provide additional capital to weak banks, which are not in a position to raise capital on their own. Does it make economic or fiscal sense to add to this burden further? On balance, there seems to be a strong case for raising the legislative ceiling for market participation in equity capital of public sector banks.

47. At the same time, it has to be recognised that in our situation, particularly in view of the need to give adequate attention to agricultural credit and rural banking as also to maintain public confidence in the safety of banks, the public sector character of these banks should not be given up. Keeping these considerations in view, i.e., those of allowing greater access to markets while at the same time maintaining the public sector character of banks presently owned by the Goverment or the Reserve Bank, it may be necessary to prescribe a maximum (at a suitably low level) for shareholding by any single individual or a corporate in public sector banks. Government may also retain the pre-emptive right to appoint, if it wishes, the Chief Executive and the majority of the Board members in public sector banks.

48. Over the years, progressive liberalisation of financial markets and institutional reforms have led to growing inter links among various segments of financial markets. The emergence of different types of financial intermediaries, in addition to banks and financial institutions, is healthy and desirable. A diversified structure contributes to greater stability of the financial system in the event of unanticipated problems. Part of the reason why problems in Japan's financial sector have persisted for so long is believed to be due to virtually "Bank-only" financial intermediation.[7] In India, while there has been progress in developing various segments of the markets including money and debt markets, the depth of these markets remains low and the volumes as well as number of participants are not very large. An important priority for the future is to develop the depth and breadth of these markets and to allow multiplicity of intermediation possibilities with different risks and leverage profiles. RBI will continue to work with financial experts and market participants to develop an appropriate procedural and policy framework to move in this direction.

49. We also have to devise measures to make our interest rate structure more flexible in order to take account of changes in economic cycles and the inflation outlook. At present, for reasons which were highlighted in the Mid-term Review of Monetary and Credit Policy in October 1999, there are several constraints which limit the flexibility of interest rates in the bankin-a sector as well as the rest of the financial sector. Given the fact that some of these constraints are deeply embedded in historical practices, consumer preference and public sector requirements, it may take some time to fully meet this objective. However, the process should begin now.

50. The above are just a few priority areas which require consideration. These are by no means exhaustive. I believe that if we get these right, it would make movement in other areas of financial reform speedier and easier.

IV Conclusion

51. I would like to conclude with a few observations on the second-half of the title of this lecture, i.e., "Which Way Now?". At the beginning, as you would recall, I had discussed the changing perceptions about the role of finance in development in recent years. The change in the development paradigm from a largely state-directed strategy to a marketoriented one, and the unsatisfactory results of the earlier strategy, highlighted the role of the financial system in efficient mobilisation and allocation of a society's savings. All over the developing world, in the last few years, there has been intense activity in reviewing the structure of the financial markets and taking measures to liberalise and broaden them.

52. Against this background, and against the background of past dissatisfactions with the old strategy, it is interesting to note that the record of development in the nineties has been a highly disappointing one for the developing world as a whole, with two important exceptions - India and China. The nineties - the period of the triumph of capitalism and financial liberalisation - has seen a growth rate of only 3.2 per cent in world output which is lower than the average of 3.9 per cent in the 70s, and not much different from the rate of growth of 3.4 per cent in the 80s. This period has also been a witness to a large number of currency crises (from the ERM crisis in Europe in the early part of the decade to the Mexican, Russian, Asian and the Brazilian crises recently); substantial swings in exchange rates (including the exchange rate of two leading currencies - the dollar and the yen); run ups in asset prices followed by sharp collapse (for example, in Japan, Nordic countries and Asia); and banking crises in almost all the regions of the world.

53. My purpose in drawing your attention to this rather disheartening record is not that we should now return to the old failed strategy. Nor is it to suggest that financial liberalisation or development of the financial markets are unnecessary. The old strategy collapsed under the weight of its own excesses and contradictions. Similarly, there is no doubt that financial reform and liberalisation of markets are necessary, essential and desirable to derive the maximum advantage from the momentous changes that are taking place in technology, international movement of capital, and comparative advantage of nations. My purpose in highlighting some of the problems that have emerged in the world economy in the 90s is to underscore simply one point, and that is that we must not confuse "means" with "ends". Financial reforms and liberalisation of markets are the means to an end, and not ends in themselves. The final objective of a successful development strategy remains what it has always been - a sustained and rising income for all the people, and removal of poverty, deprivation and illiteracy within a reasonable period of time.

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54. While we must remain steadfast in our pursuit of financial sector reforms, the success of this process should not be viewed from the angle of how much freedom it allows to the market players. The real test is how much benefit all this brings in terms of development, including greater employment opportunities and poverty alleviation for those who do not participate in the markets. It will also be wrong to view financial reforms as antithesis of Government's role in development or the role of public policy in widening social choices and opportunities. In developing countries, with massive illiteracy and underdevelopment of infrastructure, Government will continue to have an important and crucial role in creating the necessary conditions for growth through investments in areas, such as, education, health, water supply, irrigation and infrastructure, etc. These and similar tasks cannot be fully taken over by the market. Successful financial reforms must result in strengthening the ability of governments to do what they need to do by helping to generate higher growth, higher revenues and higher productivity. In developed countries, the so-called "potential output" of the economy, whatever its estimated level, can be left to be realised by changing the parameters of financial and monetary policy. In developing countries, the main challenge is to raise the level of potential output by removing the constraints of infrastructure and low human resource development.
55. Which way now? Alongside financial reform and development of markets, I would urge that the country's attention must also turn to fiscal empowerment of the state and improvement in public administration. This College has contributed enormously to inculcating a public service culture in our country, and to train civil servants in the highest traditions of service to the nation. Yet, more than 50 years after Independence, who can deny that our public offices, including public sector institutions,]'Leave a lot to be desired in delivery of services or in the efficient discharge of essential functions? A thorough-going review of our institutional framework, rules, regulations, and accountability of the administrative organs of the state is now essential. The focus has to be on what they do for the people, and not on what they do for themselves. If our public institutions, including those in the field of education and health, are unable to overcome their inertia, then alternative modalities have to be found by Government for delivering these and other services.
56. Many of the functions of the state are now left undone or inefficiently done because of financial stringency at the Center as well as the States. The dependence on borrowings to finance even essential expenditure has been increasing year after year leading to a vulnerable and unsustainable fiscal situation. Without adequate finance, the state cannot fulfill its developmental role or remove the constraints to country's potential output. Pioneering work has been done by our research institutions, as well as by Central and several State Governments, to identify measures that need to be taken to reinvigorate the fiscal system. We must move decisively in this direction without loss of time.
57. With a revitalised fiscal situation and further progress in establishing a forward looking, strong and stable financial system, the first century of the next millennium can truly be a century of development.

Thank you.

Indian Financial Sector After a Decade of Reforms

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1 Introduction

The economic reform process that began in 1991 took place amidst two acute crises involving the financial sector:

- the balance of payments crisis that threatened the international credibility of the country and pushed it to the brink of default; and
- the grave threat of insolvency confronting the banking system which had for years concealed its problems with the help of defective accounting policies.

Moreover, many of the chronic and deeper-rooted problems of the Indian economy in the early nineties were also strongly related to the financial sector:

- The problem of financial repression in the sense of McKinnon-Shaw (McKinnon, 1973; Shaw, 1973) induced by administered interest rates pegged at unrealistically low levels;
- Large scale pre-emption of resources from the banking system by the government to finance its fiscal deficit;
- Excessive structural and micro regulation that inhibited financial innovation and increased transaction costs;
- Relatively inadequate level of prudential regulation in the financial sector;
- Poorly developed debt and money markets; and
- Outdated (often primitive) technological and institutional structures that made the capital markets and the rest of the financial system highly inefficient.

Financial sector reforms have therefore been an important part of the overall reform process.

Yet, after a decade of reforms, many of the deep seated problems in the financial sector remain. The hopes that were raised by the impressive progress in the initial years of the reforms have not been fulfilled. The state has not relinquished its grip on the financial sector.

Except in isolated pockets, competition has not been unleashed in the financial sector on a scale sufficient to produce visible benefits in terms of efficiency, innovation and customer service.

This paper begins with a critical review of financial sector reforms in some key areas. It then goes on to assess the impact that these reforms have had on the corporate sector and on retail investors. Finally, the paper outlines the unfinished agenda of reforms in the financial sector.

2 Exchange Control and Convertibility

2.1 Early Success

One of the early successes of the reforms was the speed with which exceptional financing was mobilized from multilateral

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and bilateral sources to avert what at one stage looked like a imminent default on the country's external obligations. Subsequently, devaluation, trade reforms and the opening up of the economy to capital inflows helped to strengthen the balance of payments position. Substantial reserves were built up out of non-debt-creating capital inflows. The significant reforms in the area of exchange control were:

- Exchange controls on current account transactions were progressively relaxed culminating in current account convertibility.
- Foreign Institutional Investors were allowed to invest in Indian equities subject to restrictions on maximum holdings in individual companies. Initially, there were severe restrictions on foreign investment in debt securities, but these were progressively relaxed.
- Indian companies were allowed to raise equity in international markets subject to various restrictions.
- Indian companies were allowed to borrow in international markets subject to a minimum maturity, a ceiling on the maximum interest rate, and annual caps on aggregate external commercial borrowings by all entities put together.
- Indian mutual funds were allowed to invest a small portion of their assets abroad.
- Indian companies were given access to long dated forward contracts and to cross currency options.

2.2 Subsequent Back Sliding

A substantial part of the reserve build-up has been out of non-debt-creating capital inflows. In later years, however, the government has resorted to borrowing (through the State Bank of India) in the form of the Resurgent India Bonds in 1998-99 and the India Millennium Deposits in 2000-01. These borrowings have been part of a conscious strategy of maintaining a strong exchange rate rather than seeking competitive parity with East Asian competitors and China.

Half way through the reform process, there were serious discussions on moving towards capital account convertibility. A report by the Tarapore Committee (RBI, 1997) prepared a detailed roadmap for such a move. At around this time, however, the Asian Crisis engulfed East and South East Asia. Policy makers in India were quick to conclude that there were major advantages in retaining tight controls on the capital account. However, this status quo posture carries grave risks because:

- The Indian economy is already substantially open to capital inflows, and the existing restrictions are predominantly on capital outflows.
- The capital account is significantly more open to the corporate sector than to individuals.
- India's unwillingness to match the sharp currency depreciation of its East Asian competitors makes it quite possible that the Indian Rupee has been overvalued from the point of view of export competitiveness. All these features were contributory factors in the East Asia, and it is possible that maintenance of the status quo would create serious vulnerabilities in the long run for India as well. In this context, it is heartening that the budget speech for 2002-03 has put capital account convertibility on the agenda once again though no significant steps have been taken in this direction.

3 Banking and Credit Policy

3.1 Banking System Solvency

At the beginning of the reform process, the banking system probably had a negative net worth when all financial assets and liabilities were restated at fair market values (Varma 1992). This unhappy state of affairs had been brought about partly by imprudent lending and partly by adverse interest rate movements. At the peak of this crisis, the balance sheets of the banks, however, painted a very different rosy picture. Accounting policies not only allowed the banks to avoid making provisions for bad loans, but also permitted them to recognize as income the overdue interest on these loans. The severity of the problem was thus hidden from the general public.

The first decade of reforms therefore included the following banking reforms:

- Capital base of the banks was strengthened by recapitalization, public equity issues and subordinated debt.
- Prudential norms were introduced and progressively tightened for income recognition, classification of assets, provisioning of bad debts, marking to market of investments.
- Pre-emption of bank resources by the government was reduced sharply.
- New private sector banks were licensed and branch licensing restrictions were relaxed. The threat of imminent insolvency that loomed large in the early 1990s was, by and large, corrected by the government extending financial support of over Rs 200 billion to the public sector banks. The banks also used a large part of their operating profits to make provisions for non performing assets (NPAs). Capital adequacy was further shored up by revaluation of real estate and by raising money from the capital markets in the form of equity and subordinated debt. In the last couple of years, some public sector banks have also moved aggressively to cut costs by trimming the workforce and by divesting peripheral business units that have not been doing well.

It is noteworthy that the direct government support to the banking system was only about 2% of GDP. By comparison, governments in developed countries like the United States have expended around 5% of GDP to pull their banking systems out of crisis and governments in developing countries like Argentina and Chile have expended more than 15% of GDP (Sunderarajan and Balino, 1991, International Monetary Fund, 1993 and International Monetary Fund, 1998). There was however a large indirect support to the banking system in terms of a favourable regulatory regime that restricted competition within the banking system and smothered competition from outside the banking system (see 3.7 below).

The net effect of the government support and internal restructuring undertaken by the banks themselves was that with the exception of two or three weak banks, the public sector banks appeared to have put the threat of imminent insolvency behind

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them. In recent years, however, the banking system has had to contend with the debilitating effects of an ongoing recession in the manufacturing sector. This has led to significant non performing assets, and if the economic outlook continues to weaken, the financial health of the banking system could deteriorate sharply.

It is also pertinent to note that independent estimates of the percentage of bank loans that could be problematic are far higher than the reported figures on non performing assets, even though the accounting and provisioning norms have moved closer to international norms. During the Asian crisis, the international rating agency S&P published a report estimating potential (worst case) problem loans in the Indian banking sector at 35-60% of total bank credit (Standard and Poor, 1997). Subsequently, S&P has continued to re-affirm this estimate (most recently in Standard and Poor, 2001). By its very nature, the scenarios that underlie S&P's worst case analysis involve assumptions that are severe and unlikely to materialise. Nevertheless, the fact that S&P continues to place India in the weakest category of banking systems (alongside countries like China, Pakistan, Mexico, Thailand and the former CIS countries) is an indication of the potential weaknesses in the banking system. It would thus appear that while the imminent threat of insolvency that existed at the beginning of the reforms has receded, the threat remains latent.

3.2 Governance and Lending Practices

An even more important question is whether the banks' lending practices have improved sufficiently to ensure that fresh lending (in the deregulated era) does not generate excessive non performing assets (NPAs). That should be the true test of the success of the banking reforms. There are really two questions here.

The first question is whether the banks have achieved sufficient managerial autonomy to resist the kind of political pressure that led to excessive NPAs in the past through lending to borrowers known to be poor credit risks. A decade after reforms, it is evident that this has not happened. It is true that in the initial years of the reforms, the political system appeared to have exercised greater restraint in its use of the banking system as a tool for patronage. But this has not been institutionalised in a culture of managerial autonomy, and there is no assurance that the political self restraint will endure.

The second question is whether the banks' ability to appraise credit risk and take prompt corrective action in the case of problem accounts has improved sufficiently. It is difficult to give an affirmative answer to this question.

The managerial response to the threat of non performing assets has been a flight to quality rather than an attempt to improve their credit assessment skills and systems. The RBI's annual report for 2001 points out that "As at end-March 2001, commercial banks held SLR1 securities amounting to 35.1 per cent of their net demand and time liabilities as compared with the statutory SLR requirement of 25.0 per cent. Banks' holding of SLR paper, amounting to about Rs.1,06,000 crore over and above the SLR requirement, was substantially higher than the net annual borrowings of the Central Government."

Some of the reticence to lend is attributable to the increased fear of the anti-corruption wing of the government. There has been a tendency on the part of this wing to regard every non performing loan as a potential case of corruption on the part of the lending officer. Even if the officer is acquitted at the end of the investigations, the investigation procedures are such that the officer would in the meantime have undergone significant mental agony and might also have lost out on several opportunities. The result is a strong disincentive to take lending decisions. Paradoxically, the result of the anti-corruption measures may actually be to increase corruption and worsen the lending portfolio. This is because the honest officers become reluctant to lend as they get few rewards for right decisions and face inquiries for wrong decisions. For the truly corrupt officer, the bribe is probably large enough to compensate for any disciplinary action that may take place. The corrupt officer would also probably have enough friends and money to mount a strong defence and thereby ensure a high probability of an acquittal or a mild punishment. It is self evident that when honest officers stop lending and corrupt officers continue to lend, more loans are likely to go bad and the level of non performing assets are likely to increase.

There has been an unwillingness on the part of the government to recognise that an anti corruption drive can be successful only if it is based on the highest standards of natural justice and provides full protection to honest officers. An investigative system in which people are treated as innocent until proved otherwise is the only sensible one however difficult it may make the investigators' task. It is important to recognise that the very existence of the banks is founded on a sound credit appraisal that allows them to lend to borrowers who are able to borrow from the capital markets only at a high cost. If honest bank officers try to play safe by lending only to topnotch companies, the effect would be an unviable business model because the banks' lending rates to these clients would barely cover their intermediation costs. Lending to less credit worthy customers at rates that reflect the higher risks is the foundation of a healthy banking system. 1 SLR (Statutory Liquidity Ratio) securities consist predominantly of government securities.

A continued flight to quality in the banking system coupled with the continuance of directed credit would eventually convert the entire banking system into an instrumentality of government borrowing and priority sector credit. If the governance system of the banks (particularly the public sector banks) today is such that normal risk based lending has become managerially impossible, the time has come to change the governance system. The fundamental problems are with the ownership of the banking system. After a decade of reforms, it is increasingly apparent that the banking system needs to be privatised after a thorough cleaning up of the balance sheet and possible recapitalisation. Until this is done, all the other banking system reforms will remain incomplete.

3.3 Operational Reforms

At the same time as the financial health of the banking system were being tackled, several operational reforms were introduced in the realm of credit policy:

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- Detailed regulations relating to Maximum Permissible Bank Finance were abolished
- Consortium regulations were relaxed substantially
- Credit delivery was shifted away from cash credit to loan method. However, the slack season credit policy of 2001 has reversed this shift.

These reforms have helped the efficiency of the financial sector and have also helped develop the money market in India. These reforms also have the potential to make the banking system more competitive and put pressure on the banks to become more efficient. This potential has not however been fully realised as the regulatory regime continues to be anti-competitive as discussed in 3.6 and 3.7 below.

3.4 Financial Institutions

It could be said that while at the beginning of the reforms, the banking system faced imminent insolvency but the financial institutions were more or less solvent, the roles were completely reversed after a decade of reforms.

Economic reforms deprived the development financial institutions of their access to cheap funding via the statutory pre-emptions from the banking system. They were forced to raise resources at market rates of interest. Concomitantly, the subsidized rates at which they used to lend to industry gave way to market driven rates that reflect the institutions' cost of funds as well as an appropriate credit spread. In the process, institutions have been exposed to competition from the banks who are able to mobilize deposits at lower cost because of their large retail branch network. The immediate impact of the reforms has been felt on the asset quality of the financial institutions. They have been the victims of sever adverse selection as these institutions have tended to become lenders of last resort to projects that cannot raise finance in the capital markets or from other sources. Moreover, the historical asset base of these institutions exposed them to precisely those sectors of the economy that have been the losers in the reform process – the globally uncompetitive industries that owed their survival to the high degree of protection in the pre-reform era. As a result, the financial institutions have faced mounting levels of non performing assets that could pose a severe threat to their solvency.

Responding to these changes, financial institutions have attempted to restructure their businesses and move towards the universal banking model prevalent in continental Europe. It is difficult to say whether this would only replace a weak financial institution with a weak bank.

What is clear is that neither the government nor the regulator appears to be tackling the problems of this sector with the seriousness and urgency that they deserve. Radical reforms are called for in this sector including drastic restructuring, downsizing of the balance sheet, possible recapitalisation and eventual privatisation.

3.5 Insurance

Private sector insurance companies started operating in India in 2000, several years after the first proposal to allow their entry. The Insurance Regulatory and Development Authority (IRDA) has been set up as the apex regulator for this sector. It is still too early to assess the likely impact of the new players. In the first few months, however, the new entrants do appear to have injected greater competition and dynamism into India's insurance industry. The IRDA has also embarked on a regulatory programme that encourages greater professionalisation and modernisation of this sector. It has taken commendable initiatives for training and certification of insurance agents and for encouraging the development of an actuarial profession. In the past, bright students who were attracted to the actuarial profession by its potential to apply mathematical concepts to real life problems discarded the idea because of the total lack of scope for actuaries in India's nationalised insurance industry.

The major area where insurance reforms have not been sufficiently far reaching is in the area of investment restrictions. Sections 27 and 27A of the Insurance Act place restrictions on investments in shares and corporate bonds. Not only are the quantitative ceilings unnecessarily restrictive, but the qualitative restrictions are not in tune with a modern capital market. For example, the eligibility conditions for corporate debt do not involve the notion of credit rating at all, but depend on quite meaningless backward looking notions of financial soundness.

The key question that remains to be seen is how receptive the regulatory regime would be to financial innovation. The IRDA could play a catalytic and facilitating role here though the restrictive features of the Insurance Act would restrict its freedom. Of particular importance would be the regulatory stance towards capital market linked insurance products like variable life and universal life policies. The Life Insurance Corporation has introduced a variable life policy called Bima Plus. Unlike in the United States where such products are subject to regulation as mutual funds by the securities regulator also, Bima Plus appears to be regulated only as an insurance product and not as a mutual fund. Whether this would spur innovation or lead to regulatory arbitrage remains to be seen.

3.6 Competition and Efficiency

Early in the reforms process, it was recognised that greater competition and innovation would be required so that the public received better financial services. In its mid term review of the reform process (Ministry of Finance, 1993), the government stated: "Our overall strategy for broader financial sector reform is to make a wide choice of instruments accessible to the public and to producers. ... This requires a regulatory framework which gives reasonable protection to investors without smothering the market with regulations. ... It requires the breaking up of monopolies and promotion of competition in the provision of services to the public."

Unfortunately, this is one area where actual progress has lagged far behind stated intent. It is true that some steps have been taken to increase competition between financial intermediaries both within and across categories. Banks and financial institutions have been allowed to enter each other's territories. Fields like mutual funds, leasing, merchant banking have been thrown open to the banks and their subsidiaries. The private sector has been allowed into fields like banking and mutual funds. Nevertheless, major structural barriers remain:

- All major banks and financial institutions continue to be government owned and government managed.

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- The entire mechanism of directed credit and selective credit controls built up over the years is still in place, and is being strengthened in certain areas.
- Financial intermediaries have often been compelled to set up separate arms' length subsidiaries while entering various segments of the financial services industry. This has prevented them from benefiting from economies of scope.
- Competition has also been hindered by the undiminished power of cartels like the Indian Banks Association (IBA). In fact, these cartels have been accorded the tacit support of the regulators. These half hearted attempts at promoting competition raise fears about the extent to which our regulators have succumbed to regulatory capture by the organizations that they are supposed to regulate.
- On the technological front, progress has been slow in important areas. The payment system continues to be primitive despite the central bank's attempts to create an Electronic Fund Transfer System (EFTS). Archaic elements of the telecom regulations have prevented the financial services industry from benefiting from the confluence of communications and computing technologies.

If we imagine a Rip Van Winkle going to sleep in the early 1990s and waking up today, he would not see that much has changed at the grass roots level in the provision of banking services. (The most visible change would be the much greater spread of credit cards – a financial innovation that has little to do with regulatory action).

The extremely slow progress in this area means that the Indian consumer has not seen the benefits of financial sector reforms in the form of better service, better products or better prices. The efficiency gains of financial sector reforms have simply not happened.

3.7 Pro-Bank Tilt of Regulatory Policy

One of the distinctive elements of the financial sector policy is a powerful regulatory protection extended to the banking system. Faced with a financially weak banking system, the policy makers have been unwilling to bite the bullet and recapitalise the predominantly state owned banks to restore their financial health. Instead the policy has been to provide a cosy regulatory regime in which the dominant oligopolistic banks are insulated from competition from new entrants as well as competition from non bank sources of capital. The implicit hope has been that this protected environment will allow them to survive even if they are financially weak.

- The nature and pace of banking sector reforms has been designed to reduce the ability of new banks to take market share away from the incumbents by aggressive competition. I would like to mention in particular the niggardly rate at which new bank licences have been doled out, a licencing policy that effectively excluded most promoters with deep pockets, the extreme restrictions on branch expansion and rationalisation, and ill concealed regulatory hostility to innovation and aggressive marketing. All this meant that the incumbent big banks faced very little threat from new entrants.
- At the same time, potential competition from outside the banking system was ruthlessly destroyed_ The development financial institutions that were financially very sound at the beginning of the reform process were not allowed to transform themselves into universal banks until their financial strength had been substantially eroded. This issue is described in more detail in 3.4 above. The non bank finance companies (NBFCs) that despite their higher cost of funds competed intensely with the banks on the basis of speed, flexibility and innovation were systematically destroyed in the second half of the nineties. In line with international practices, the NBFCs' access to retail funds was severely curtailed. At the same time, the regulatory regime did not allow the NBFCs to fund themselves effectively in the wholesale markets as they do globally.

The very hesitant moves towards capital account convertibility described in 2.2 above have meant that the banks have not had to face cross border competition on the scale that might have been expected in the early 1990s. Moreover restrictions on foreign banks operating in India have made them less of a competitive threat than they might otherwise have been. _ The regulatory regime for money market mutual funds has been designed to prevent them from competing effectively with the banks.

The capital markets have been in a state of decline since the early/mid 1990s for a variety of reasons as described in 5.9 below. However, one of the contributory factors has been a regulatory bias towards the banks and against the capital markets. This has taken several forms including limiting the amount of bank credit to the capital market, unwillingness to allow exchange clearing houses and depositories direct access to the payment system, and an ongoing attempt to keep the government securities market a private inter-bank affair. More important than all these however has been the systematic tendency of the central bank to drain liquidity from the capital markets in situations similar to those in which central banks elsewhere in the world tend to flood the market with liquidity. While the US capital markets have benefited from what has been called the "Greenspan put", the Indian markets have been plagued by what may be called the "RBI call". One final point is that while the scams of 1992 and 2001 both originated in the banking system and then the contagion spread to the capital markets, the regulatory response in both cases was to crack down on the capital markets. This smear strategy has certainly worked to the advantage of the banks.

The net result of this extremely supportive regulatory regime has been that the weaknesses of the banking system have been masked. It has been possible to keep the explicit cost to the government of banking sector reform quite low (2% of GDP) while the economy has borne a far greater cost in terms of inefficiency and lack of competition. It would indeed be far better for the nation as a whole that the government incurs a larger direct cost of maybe 5-10% of GDP to clean up the banks thoroughly. It would then be possible to replace the current probank tilt of regulatory policy by a pro-competition tilt. The nation as a whole would surely benefit from a healthier and more competitive banking system.

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4 Interest Rate Deregulation and Financial Repression

4.1 Deregulation

Perhaps the single most important element of the financial sector reforms has been the deregulation of interest rates.

- Interest rates were freed on corporate bonds, most bank lending, and on all bank term deposits.
- Introduction of auctions coupled with reduced pre-emption led to more market determined interest rates for government securities.
- Administered interest rates in the banking system are now confined mainly to the rate on savings account, and the concessional lending rates for certain sectors like exports and small loans. The interest rates on small savings instruments offered by the government are also administered, and in a sense provide a floor for bank deposit rates. The government is in the process of linking these rates also to market interest rates and inflation rates.

4.2 Financial Repression

For all practical purposes, financial repression is a thing of the past. One crude measure of repression can be got by comparing the inter bank call market rate (which was more or less free market determined even in the 1980s) with the short term bank deposit rate. From 1981-82 to 1992-93, the call rate exceeded the one year bank deposit rate in every single year with a median excess of 1.5%. From 1993-94 to 1999-00, the situation was reversed: the bank deposit rate exceeded the call rate in 5 out of 7 years, and the median excess of the deposit rate over call rate was 1.6%. This suggests that in the 1980s, the bank deposit rate wasrepressed to the extent of about 3%.

When the prices of financial assets are determined by the free play of market forces, financial markets are able to perform the important function of allocating resources efficiently to the most productive sectors of the economy. To the extent that this has happened in India, this must count as one of the most enduring and decisive successes of the financial reforms. It must however be added that as discussed elsewhere in this paper, the regulators have a tendency to use several indirect tools (including at times “moral suasion”) to influence the direction of the market even after administrative controls have been removed. When this happens, many of the benefits of free financial markets are lost.

5 Capital Markets

The initial burst of economic reforms included a major reform in the capital market – the abolition of capital issues control and the introduction of free pricing of equity issues in 1992. Simultaneously the Securities and Exchange Board of India (SEBI) was set up as the apex regulator of the Indian capital markets. The last decade has seen several significant reforms in the capital markets. The secondary market in particular was completely transformed by technology and competition.

Paradoxically, however, after a decade of reforms, the capital market is less important in the financial system than it was at the beginning of the 1990s. It bears an eerie resemblance to a spanking new shopping mall with the best facilities and infrastructure, but no shoppers in sight. In some ways, the problems are with the real economy. As long as there is vibrancy in the real economy, there is life in the capital markets, but when the real economy itself descends into a spiral of diminishing expectations, it becomes difficult to sustain the vitality of the capital markets. These issues are discussed below.

5.1 Secondary Market Reforms

The secondary markets for stocks witnessed more change and reform than most other components of the financial sector:

- Online trading (the electronic order book) was introduced by the newly set up National Stock Exchange in 1994 and was quickly copied by the other exchanges. The capital market was previously confined to Mumbai (where the largest stock exchange was located) and to a few other centres where smaller exchanges provided poorer execution quality. Within a few years, this gave way to a national market based on satellite communications that abolished geographical barriers. Amongst the benefits were superior liquidity, greater transparency and lower costs.
- The settlement of securities became electronic in the late 1990s. Compulsory dematerialisation was introduced for deliveries in the stock market for institutional investors in 1998 and for retail investors in 1999. Today, practically all the securities settlement in the stock exchanges is in dematerialised form. The benefits have been in the form of faster settlement, lower costs and the elimination of forged and fake shares.
- Rolling settlement on a T+5 cycle was introduced in mid-2001. A decade ago, the settlement was on an erratic fortnightly cycle where settlements were often delayed. The system is still in the process of adapting to the new regime. The settlement period is to be shortened to T+3 in April 2002.
- A derivatives market was established in mid-2000. Initially, this was limited to index futures, but subsequently, index options and individual stock options have been added. This was accompanied by the abolition of the carry forward system that provided limited hedging facilities in the pre-reform era.
- Tighter enforcement of margins and the creation of a central counterparty diminished the risk of settlement failures. In the early 1990s, the long settlement cycle and poor enforcement of margins often led to defaults and settlement failures. In some cases, these defaults also led to the closure of the exchange.
- Internet trading (and mobile trading) have been launched, but are yet to pick up significant volumes. These have the potential to abolish geographical barriers to investors accessing broking services, just as electronic trading abolished geographical barriers to brokers accessing the stock exchange. They have the potential to further reduce costs, promote competition and improve investor service.

A few things still need to be done to complete the modernisation of the stock markets. These include:

- It is necessary to streamline the system of securities lending. A securities lending scheme was introduced in India in 1997. However, to allay the exaggerated fears of the tax

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authorities about its potential use as an instrument of tax planning, it was hemmed in with excessive restrictions. The result has been that the securities lending activity in India has been highly oligopolistic and ineffective.

- It is necessary to dismantle the short sale restrictions that plague the Indian capital market today. As discussed later in this paper, short sale restrictions are probably the single biggest culprit in recent episodes of alleged market manipulation.

5.2 Primary Market

As already mentioned, the first big bang reform in the capital market was the abolition of capital issue controls and the introduction of free pricing. Some elements of merit based regulation still survived in terms of track record requirements (entry norms) and an invidious distinction between premium and par issues. Over time, however, these have also been whittled down and the capital market regulator has moved almost completely to a disclosure based regime of regulation.

The introduction of the book-building route has led to greater efficiencies in the capital raising process and has contributed to improved price discovery. At the same time vast improvements in the disclosure regime discussed later in this paper have laid the foundation for a more transparent primary market.

There is still an element of dirigisme in the attitude of SEBI towards new financial instruments. It was only recently that SEBI allowed non investment grade bonds to be issued and it even now frowns on instruments like equity index linked bonds.

5.3 Disclosure Standards

Disclosure standards in the primary market have seen a gradual but steady improvement. However, the full benefits of this have not been realised because only a small fraction of investors receive the full prospectus. The current regulations require companies to provide an abridged prospectus to all investors, while the full prospectus is available on demand. In practice the on-demand availability of the full prospectus is geographically limited and is often restricted to the larger more sophisticated investors. Regulators have sought to deal with this problem by requiring more information to be reproduced in the abridged offer document, but this leads to information being crammed in fine print on one huge sheet of paper. It appears that the abridged prospectus has its origins in the era of price controls when issues were often oversubscribed a hundred or even a thousand times. At that time, it could be legitimately argued that it would be prohibitively expensive to provide every applicant with an unabridged prospectus. In today's vastly altered scenario, it should be possible for market intermediaries to ensure that every applicant has received a copy of the complete prospectus accompanied by a complete set of financial statements. It is necessary to move in this direction. One possibility would be a regulation that gives any applicant who has not received the full prospectus the right to withdraw his application at any time before allotment. This would incentives the issuer to ensure delivery of the full prospectus to every applicant.

Even more than in the offer document, it is in the area of continuing disclosures that the greatest progress has been made. Five key accounting standards, which have become effective from April 1, 2001, redress the most glaring inadequacies that existed previously in Indian accounting practices. These include the critical areas of consolidation of accounts of subsidiaries, deferred tax accounting and related party disclosures. There are still a number of areas where Indian accounting standards lag behind international best practices, but these are less important than the ones that have been redressed. Moreover, there is reason to hope that these deficiencies will also be removed over a period of time. At the same time, the accounting scandals surrounding the bankruptcy of Enron Corp in the United States have heightened the sense of urgency of adopting global best practices in accounting standards.

There has also been some progress in requiring companies to make disclosures to the stock exchanges in respect of any material developments like mergers, acquisitions, corporate actions, strategic decisions and other events that have a significant impact on the share price. However, both the content and the timeliness of these disclosures leave much to be desired. There have been some initiatives to make effective use of information technology in the collection and dissemination of corporate disclosures (Securities and Exchange Board of India, 2000) on the lines of the EDGAR system in the United States. However, these have yet to move beyond the stage of conceptualisation.

5.4 Takeovers

The SEBI regulations on takeover have brought about a transparent regulatory framework for takeovers. However, there have been only a handful of hostile takeover bids in the last several years and most of these hostile bids have been defeated. That this should be so in a period of rising investor dissatisfaction with the governance and performance of the Indian corporate sector is both surprising and distressing. More than the deficiencies in the take over code itself, it is the major weaknesses in the financial sector that have led to this unsatisfactory state of affairs. In particular, the limited availability of leveraged financing in India, the regulatory bias against innovative financial instruments, and the general climate of political hostility to corporate raiders are to blame.

5.5 Institutionalisation

5.5.1 Extent of Institutionalisation

The post reform period has seen the emergence of a large number and variety of institutions in the capital market

- **Foreign Institutions:** Foreign Institutional Investors (FIIs) registered with SEBI enjoy a high degree of capital account convertibility in an otherwise closed capital account. FIIs are allowed to buy and sell shares in the stock exchange and repatriate the proceeds freely to their home countries. FIIs, as the name suggests, are institutions like mutual funds, pension funds, banks and insurance companies. However, there is a provision for a corporate or high net worth individual to also avail of the same benefits by coming in as a registered sub account of a registered FII. There are restrictions on the aggregate holding of FIIs in any company. As on December 31, 2001, FIIs had in the aggregate invested $14.5 billion in the Indian market. This would represent about 15% of the market capitalisation,

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but it must be noted that the figure of $14.5 billion is the cumulative amount of money brought into India and not the current market value of their portfolio.

No estimates are available of this portfolio value. However, since the market index has fallen sharply in dollar terms since the early 1990s, there is reason to believe that the FII equity holding would be less than 10% of the market capitalisation.

- **Mutual Funds:** In the late 1980s, the mutual fund industry (which till then consisted only of the public sector Unit Trust of India) was thrown open to the public sector banks and financial institutions. In the mid-1990s, private sector mutual funds were permitted. As of September 30, 2001, the mutual fund industry had assets under management of Rs 1.02 trillion. This represents about 20% of the market capitalisation, but since 70% of the mutual fund assets are in schemes that are predominantly debt oriented, and another 17% are in balanced funds, the actual equity holding of the mutual funds probably amounts to only about 5-7% of the market capitalisation. In terms of the competitive structure of the industry, UTI accounted for 50% of assets under management, the private sector funds for 42% and the public sector funds for 8%. In the last couple of years, private sector players have rapidly gained market share from other players.
- **Development Financial Institutions:** In the pre-reform era, development financial institutions and public sector insurance companies provided a major component of long term finance for industry. Along with extending loans, these institutions often subscribed to the equity as well. In many cases, the loans were at subsidised rates of interest, but provided for conversion into equity at highly favourable rates. As a result, financial institutions have a significant shareholding in many large Indian companies. Given the historical background of these holdings, the financial institutions have often behaved like strategic investors rather than portfolio investors. There have been repeated suggestions for restructuring of these holdings including secondary market sales, auctions to strategic bidders, and transfer to mutual funds or other special purpose vehicles. There have also been suggestions that they should simply start behaving like portfolio investors. As discussed earlier in this paper, there is a need for a radical restructuring, downsizing and eventual privatisation of these institutions themselves.
- **Venture Capital Funds:** SEBI has recently liberalised the regulations for venture capital funds and has also permitted foreign venture capital funds to operate in India. They will have the freedom to invest in unlisted companies with the full freedom to repatriate sale proceeds. These new regulations have been notified only recently and it will be some time before these investors start playing a major role in the capital markets.
- **Insurance Companies and Pension Funds:** Private sector insurance companies have started operations only recently. The regulatory framework for pension funds is still under discussion. These institutions have therefore yet to make a impact on the capital market.

5.5.2 Institutional Contribution in Market Development

The contribution of institutional investors to the development and modernisation of our capital markets has been significant, but it has not been as great as one would have expected :

- The institutional investors have played a major role in the professionalisation of the capital markets in India. Their demand for high quality analysis and information has helped spur the growth of these services in India. As little as 10 years ago, beta was unheard of outside academic circles, P/E ratios were regarded as esoteric tools, the financial press was very limited in circulation, and there were no earnings forecasts or other equity analysis. Today, the country boasts of a very vibrant financial press, a very active community of financial analysts, and a high degree of professionalisation of all capital market intermediaries. Much of this has been greatly helped by the growth of institutions that value quality of service more than personal relationships and trust.
- However, the institutions have failed to provide a major impetus to capital market reforms. Both domestic and foreign institutions in India have resisted reforms as vigorously as other market participants. Reforms in India have been pushed forward by academics, by the financial press and by the policy makers (not necessarily in that order). Many of these reforms have had to be pushed through by regulatory fiat even where they were in the long run interests of the institutions themselves. In this sense, institutions have been as myopic in their response to capital market reforms as anybody else. Three examples would illustrate this phenomenon:
- Before India set up its first depository, institutions were most vociferous in their complaints about the risks and costs of the paper based settlement system. But when the depository started operations, they were most reluctant to start availing of its services until SEBI mandated that a minimum percentage of their holdings must be dematerialised. SEBI had to then go on to mandate that institutions could trade only in dematerialised form. (Later SEBI extended this fiat to all investors trading in stock exchanges).
- Institutions have also generally agreed that a shift from account period settlement to rolling settlement is desirable. However, they did not embrace the optional rolling settlement facility that was available for a long period before SEBI made rolling settlement mandatory.
- The institutions have long complained about the lack of hedging mechanisms in India. However, after the derivatives markets were set up, institutions have been reluctant to trade in it. Most observers believe that the success of the market would depend on its first attracting enough retail interest to entice the institutions into it.

5.5.3 Assured Return Schemes and Mutual Fund Solvency

A mutual fund is one of the institutions that, in theory, requires almost no risk capital (Merton and Perold, 1993). However, in India many mutual funds, particularly in the public sector operated schemes that guaranteed a minimum return. These were like bank deposits sweetened with a call option on

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the stock market, but many mutual funds failed to recognize the risks involved in these products. When the portfolios of these schemes did badly (partly due to poor management and partly due to the lacklustre performance of the market itself), the mutual funds had great difficulty in fulfilling their return guarantees. Under pressure from SEBI, the public sector banks and insurance companies that had sponsored these mutual funds provided financial support of nearly Rs 20 billion to the mutual funds to allow them to honour the guarantees. Of these seven mutual funds, one needed a support of Rs 12 billion, three needed about Rs 2 billion each, and three needed relatively small amounts2.

5.5.4 The Problems of Unit Trust of India

The biggest problem however was in the case of the largest and oldest mutual fund, the Unit Trust of India. The oldest of its schemes, US64, had over a period of time developed into a queer animal. It was an open-end scheme, but did not link its repurchase and resale prices to Net Asset Values (NAV). In fact, it did not report NAVs at all. For several years, repurchase and resale prices had been held fairly steady while the fund paid out attractive annual dividends. By the early 1990s, many institutional and retail investors had come to perceive US64 as an attractive fixed income investment though the majority of its investments were actually in equities. Because of its liquid secondary market, many even regarded it as a money market instrument. This was fine as long as US64's NAV was significantly above its repurchase and resale value. This excess provided a safety cushion to absorb market fluctuations.

In the mid-1990s, however, it became clear to careful observers that this safety cushion was being eroded and that the scheme was exposed to a high degree of market risk. It was only in 1998 that UTI itself announced that it had a large deficit in US64; not only was the NAV below the resale price, it was below even par value. A run on the fund appeared likely as investors prepared to exit before the resale price was lowered to bring it in line with NAV. At this stage, the government undertook a bail out in which it paid UTI Rs 33 billion (the book value) for securities that had a market value of only Rs 15 billion. It was also decided to make the scheme NAV based over three years.

In mid 2001, a sharp drop in the Indian market pushed US64 into a large deficit again, but the government now indicated its unwillingness to bail out the institution. The fund then took the drastic step of suspending repurchase and resale of units under the scheme. At the same time, it opened a special liquidity package allowing any investor to redeem up to 3000 units at fixed pre-announced rates starting at Rs 10 for August 2001 and going up to Rs 12 in May 2003.

In January 2002, the scheme reopened for fresh subscription as an NAV based scheme where both purchases and sales are at NAV linked prices. At the same time for old investors, the government offered some relief. First, the facility of redemption at pre-announced rates ranging from Rs 10 to Rs 12 was extended from 3000 units to 5000 units. Second and more important, for holdings above 5000 units, UTI assured a repurchase price of Rs. 10 per unit, or NAV, whichever is higher on May 31, 2003. This assurance was backed by the Government which agreed that in the event of NAV in May 2003 being lower than the guaranteed repurchase price, it would compensate UTI for the difference. Thus after six months of vacillation, the UTI was bailed out by the taxpayer for the second time in four years.

The distinguishing feature of the Unit Trust of India is that it is *not* government owned. The government controls the organisation without owning it. The initial capital of UTI consisted of Rs 50 million of subscription by government institutions to US64 in 1964. This initial capital is not a separate share capital but is merely a part of US64 and even in early years, it was only a small part of US64. Thus the government was just the first of the millions of investors in US64. All the fixed assets3 including the land and buildings of UTI have been bought out of the funds of US64 and are shown as assets of US64. In this sense, the true owners of UTI are the US64 unitholders and the government controls the organisation only by virtue of the UTI Act and not by virtue of ownership.The logical solution to the problems that UTI found itself in would therefore have been for the government to withdraw from the scene by returning UTI to its rightful and legitimate owners – the holders of US64. These owners would then have had the right to decide for themselves how their funds should be managed. The simplest way to achieve this demutualisation would have been for UTI to transfer all its buildings and other asset management related assets from US64 to a new company and to spin this company off to the US64 unit holders. The new company would have become the Asset Management Company (AMC) for all UTI schemes. The UTI Act could then have been repealed and UTI could have been brought under the SEBI Mutual Fund Regulations.

The US64 holders should have been allowed to do what they pleased with the shares that they would have received in the newly created AMC. They could sell them to anybody they choose or they could hold on to them. It was possible that a large domestic or foreign financial institution would have launched a tender offer for these shares to take control of the new AMC. They should be have been allowed to do so with no restrictions other than that imposed by the SEBI Takeover Regulations.

As a rule of thumb, an AMC is valued at 2-3% of assets under management. This would suggest that the new AMC would have been worth about Rs 10-15 billion. The large distribution network, valuable real estate and other fixed assets would probably have added several billion more to the valuation. Thus the shares in the AMC would have gone some way to compensating the US64 holders for the losses that they have suffered under government management. It would also have established the principle that the owners have the right to replace any management that performs badly even if that management is the government itself. Had this solution been adopted in mid 2001 (or even better immediately after the 1998 bailout), it would have avoided using taxpayer money to bail out the investors of US 64 in 2002/2003.

5.6 Market Manipulation

The 1990s have seen a number of episodes of alleged market manipulation in the equities market. Shah and Thomas (2001)

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identify eight significant episodes of alleged market manipulation during the 1990s in the Indian stock markets. There can be some difference of opinion on how many major market manipulation episodes have taken place because there is a tendency among Indian policy makers to regard a large price swing as market manipulation even if it is only a speculative bubble or even if it is justified by fundamentals. Nevertheless, there is no denying that many of the episodes enumerated by Shah and Thomas do provide cause for concern.

In my view, the single most important culprit for the frequency and severity of such episodes is the strong restrictions on short selling that exist in India. All institutions (including banks, financial institutions, mutual funds and foreign institutional investors) are prohibited from short selling in the Indian capital market. This restriction has been in place for a long time, but the restriction has become more serious with the progressive institutionalisation of the capital market in the 1990s. Over a period of time, therefore, an increasingly large and important segment of the market has been precluded from short selling. Moreover, at various critical junctures (most recently in March 2001), the regulators have moved to impose a total ban on short selling by all investors.

To understand why short selling restrictions are so important, we must first note that almost all the episodes enumerated by Shah and Thomas involve alleged attempts by the companies and their promoters to rig up the share prices of their own companies. In a free market, the most powerful weapon against such attempts would be aggressive short selling by rational investors. In the presence of short sale restrictions, however, the best that rational investors can do is to sell all their holdings. Once they have done so, they make no further contribution to price discovery. Market prices are then determined by the alleged manipulators and less rational investors (momentum investors and passive /indexed investors). It now becomes evident that short sale restrictions constitute an open invitation to promoters and managements to rig up the share prices of their own companies. Perhaps inadvertently, the regulatory regime has come to fulfill the fondest dream of these market manipulators.

Even if it were argued that some of these episodes are non-manipulative market crashes, short sale restrictions would be an important explanation for their number and severity. Recent studies in the United States (Hong and Stein, 2001) argue that short sale restrictions in that country are responsible for the high frequency of market crashes there. The mechanism is the same as that described above – short sale restrictions prevent rational bearish investors from contributing to price discovery in the build up to the crash. These studies are all the more important because part of the justification for short sale restrictions in India is derived from the fact that the United States has similar restrictions. It is often forgotten that the United States introduced these restrictions as a misguided knee jerk reaction to the great depression, and has merely persisted with that mistake. More importantly, if our markets are more susceptible to market manipulations than the US market, we should move more aggressively to remove these restrictions and pro-actively facilitate short selling.

In the United States itself, the scandals surrounding the bankruptcy of Enron have tarnished the reputations of the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), the auditors, the rating agencies, the analysts, the boards, the financial press and almost every other element of the regulatory regime. The one group that has come out with flying colours is the lowly short seller who kept pointing at the skeletons in Enron's cupboard when everybody else was intent on turning the other way. It is now apparent that even the United States would therefore benefit from relying on the market forces represented by the short sellers to police its markets.

Another important factor is the unwillingness of the stock exchanges and the regulators to embrace modern software tools for market surveillance and investigation. Despite a longstanding effort to implement stock watch systems, the stock exchanges have yet to make these systems fully effective. Most of the investigations into alleged market irregularities also fail to embrace the tools of information technology. There is a large pool of software talent in the country that could develop modern neural network and artificial intelligence tools that could leapfrog the best in the world. This has not happened.

There has been a tendency to imitate the US model of market surveillance without

recognising that within the US itself, there is considerable disquiet about the model. This was true even before the Enron scandal. As Oesterle (2000) points out in an incisive analysis: "Although the U.S. securities markets are the world's largest and most liquid, it does not follow that the regulatory system has been an unqualified success. Strong economic fundamentals have created and sustained financial markets, not NYSE policing of its floor traders. … A fairer assessment is that the SRO regime has proved to be barely adequate at best. … During quiet periods, the SEC largely relies on SROs to police trading floors, and it routinely approves SRO rules and disciplinary decisions. In other words, the SEC during such periods tends to be lazy and complacent. When a scandal breaks in a trading market, there is embarrassment and handwringing over why the exchange involved was not more vigilant in disciplining its members. The exchange contritely proposes minor rule modifications, often at the SEC's insistence, leaving the exchange's functions and membership largely intact. The SEC approves the changes and, with some fanfare, the regulators and the regulated hail the virtues of the SRO system— until the next scandal. In recent years the SEC has not been able to resist the temptation to tinker too much with the rules of the exchanges. But the illusion that the SEC is guaranteeing the integrity of exchanges removes an incentive for the exchanges themselves to exercise diligence, lest they lose their customers. And customers are lulled into a false sense of security, believing the SEC is closely policing the day-to-day activities of the exchanges."

There is a need to rethink the entire dirigiste model of regulatory surveillance and rely more on countervailing power in the market place. Abolition of short sale restrictions is one way of bringing countervailing power to bear. Another important step is greater transparency and disclosure. Using modern artificial

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intelligence methods it should be possible for the trading system to automatically generate alerts about suspicious trading patterns and price/volume trends. Rather than feed these alerts to a set of error-prone human surveillance officials (with potentially perverse incentives), these alerts should be publicly disseminated. By doing so, the information is placed in the hands of those who have every incentive to take corrective actions. If an automated surveillance alert indicates possible bear manipulation, the bulls are immediately forewarned to protect their own interests. These forewarned investors become a countervailing power to the power of the would-be manipulators. Such an approach would reduce the role of human discretion and replace this discretion by the impersonal logic of computing systems and free markets. This approach would also reduce the agency costs associated with the regulatory approach. I would argue that India with its abundant software talent is uniquely positioned to lead the world in such a process of development.

5.7 Regulation of Listed Companies and Investor Protection

Regulation of listed companies has been a major area of weakness in the Indian regulatory system. The legacy of regional stock exchanges is a major reason for this. The legal framework requires companies to be listed on the regional stock exchange closest to their location. After the advent of electronic trading in the mid-1990s, most of these regional exchanges have become defunct for all practical purposes. There are some exchanges where it is reported that there is nobody even to answer the phone. Yet these exchanges continue to be the front line regulator for the companies for which they are the primary listing. The problem has been somewhat ameliorated by the fact that India's second largest exchange (the BSE) is the primary exchange of listing for a large number of important companies.

However, the competitive dynamics of the securities trading industry is such that a shift of market share away form the BSE to its larger competitor (the NSE) is quite plausible (Varma 2001).

In this situation, the entire framework of listing regulation needs urgent reconsideration. The time has come to consider the establishment of a National Listing Authority on the lines of the similar entity in the United Kingdom. Apart from the organisational issue, it is also necessary to strengthen the statutory basis for regulation of listed companies. Unfortunately, this debate has been cast in terms of empowering the regulators and has led to a dispute of jurisdiction between SEBI and the Company Law Department. I think the real task is that of empowering the shareholders and other investors. We need to put aside the dirigiste notion that the state is the answer to all problems of corporate governance. The goal should be to create a statutory framework under which violation of any SEBI regulation or listing requirement gives the investor the statutory right to sue the company and its management. The United States has used the mechanism of class action law suits to provide more effective investor protection than what any regulator could provide. We could try to replicate that model here or we could try to adapt the PIL (public interest litigation) mechanism that the Indian judiciary has used very effectively. Investors are using the PIL route even today, but only to compel the regulators to take action. What is needed is a statutory sanction for a process in which investors can enforce their rights against companies without the intervention of the regulators at all.

5.8 Emerging Threat of Monopolies

Since the mid-1990s, investors and regulators have benefited from a high degree of competition in the Indian securities industry. Even more than all the policy changes that have taken place, it is technology and competition that have transformed the Indian capital market in the last 7-8 years. If we are unable to maintain this competitive structure of the securities industry, we will lose the single most important driver of capital market modernisation in this country. There is now considerable evidence that critical elements of the Indian securities industry are becoming significantly less competitive than in the past (Varma 2001).

5.8.1 Derivative Markets

In the course of just three months from February 2001 to April 2001, the derivatives market was transformed from a competitive duopoly to an effective monopoly. The BSE's market share was effectively wiped out in this short period. This was an awesome reminder of a well known fact: once an exchange's trading volume drops below a critical mass, a vicious circle ensues in which falling liquidity drives traders away causing liquidity to fall further. The speed with which this happens can take everybody by surprise. More importantly, clawing back lost market share is very difficult. In August 2001, the BSE attempted to re-establish its derivatives market by effectively charging a negative transaction fee. The attempt failed.

5.8.2 Equity Markets

Indian equity markets witnessed a similar shift of market share from BSE to NSE during 1994-95. The newly started NSE took market share away from the established market leader to become the largest exchange in India. The vicious circle of falling liquidity should in normal circumstances have led to the NSE then taking the market away completely from the BSE. This did not happen for two reasons:

- BSE quickly adopted the electronic trading model introduced by the NSE.
- The differing trading/settlement cycles of the two exchanges meant that the product offerings of the two exchanges were not perfect substitutes. (From July 2001, the regime of differing settlement cycles has been done away with. This factor no longer operates).

Since early 2000, the market share of BSE in the combined trading volume of BSE and NSE has been falling steadily from near parity to 36% in December 2001. The BSE's market share is today probably at the borderline of the critical level where the vicious circle of falling liquidity begins to operate. The new regulatory regime that began in July 2001 makes stock markets far more intensely competitive than they were earlier. In this environment, a situation where two exchanges have comparable market shares is not a very stable one. Both exchanges have every incentive to try and push the other below the critical level at which it ceases to be viable. Competitiveness is therefore a

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moving target that requires a proactive management with the ability to respond swiftly to competitive threats and opportunities. It is at this juncture that the BSE finds itself in a situation where there is a governance vacuum. The old mutual governance structure has been swept away, but the promised demutualised governance is not yet in place. In this situation, the ability of the exchange to fight an intense competitive battle and survive is open to doubt. The possibility that the NSE's success in the derivative market could be replicated in the equity market is therefore a very real one.

5.8.3 Depositories

For the last few years, the market for depositories has been a contestable market struggling to become a competitive market. It is now becoming apparent that the second depository (CDSL) is at best a niche player and at worst a failure. The first depository (NSDL) has become an effective monopoly. The Depositories Act clearly envisages a competitive industry structure and provided for a regulatory regime in which the depository was not subjected to price regulation or minimum performance standards. From a theoretical point of view, this regulatory vacuum can be defended only on the ground that the market is highly contestable. For a couple of years after its inception, the market did appear contestable as CDSL waged a price war with NSDL and pursued market share aggressively. Even at the peak of its apparent success, however, what CDSL appeared to be doing was to target a niche market of active traders while leaving NSDL with an effective monopoly over most of the depository business. For reasons that are not fully clear, even this niche model appears to have got into serious trouble in the second half of 2001, but that is not very important. The central argument here is that even in the best of times, CDSL was only a niche player and the depositories business was an effective monopoly.

Is the depository market even contestable? There appear to be significant switching costs for most investors to change their depository participant or depository. More importantly, the regulatory regime has unwittingly created large entry barriers. The key barrier is that the issuer company has to enter into an agreement with the depository and establish electronic connectivity with the depository before that depository can offer dematerialisation services in relation to that issuer. Another key barrier is that the software systems of the existing depositories are not designed with open interfaces to allow any new depository to establish connectivity with them easily and automatically.

5.8.4 Fostering Competition

Reduced competition would remove one of the most powerful positive forces in the Indian capital market. The force that has made our capital markets more investor friendly and provided cost and efficiency gains in the last decade would no longer be available. It is possible that much of what has been achieved in the last few years would be reversed, as monopolies become progressively unresponsive to investor needs.

Given the limited possibility of effective regulation of monopolies in the securities industry, the regulatory initiatives to foster competition are extremely important. Global experience suggests that securities trading is a highly contestable and competitive business (Beny and Jackson, 1999). Fostering competition in this area should be relatively easy (Biglari and Hunt, 2000). What is required is the willingness on the part of the regulator to license new stock exchanges with varying governance structures and market designs. For example, active encouragement to ECNs could be one way to maintain competition in the stock market.

Similarly, regulatory provisions that artificially preserve monopolies should be scrapped quickly. For example, section 13 of the Securities Contract Regulation Act prohibits two persons from entering into securities contracts (other than spot delivery contracts) except through a stock exchange. This section confers totally unwarranted and unjustified monopoly privileges on a stock exchange, and therefore, it needs to be repealed as soon as possible. It is interesting to note that while similar restrictions exist both in the United States and in the United Kingdom, these provisions serve an anti-competitive function there too. In the UK, this prohibition was introduced only after the end of the Second World War and was clearly seen by all concerned as a "reward" for the support that the London Stock Exchange had extended to the war effort. Similarly, in the US, it is now clearly recognised that the prohibition is a protectionist measure whose primary purpose today is to insulate American stock exchanges from foreign competition. In both cases, the "political economy" of this prohibition involves extraneous reasons quite unrelated to investor protection.

Similarly, the by-laws of the stock exchanges must be perused carefully to identify and repeal those that are anti-competitive in nature. Oesterle (2000) provides a good description of how self-regulatory organisations (SROs) use their by-laws to stifle competition. The depository business on the other hand is significantly less competitive globally and is perhaps not highly contestable either. Nevertheless, I believe that regulatory interventions could make this business sufficiently contestable. But for this to happen our regulators would have to go beyond what regulators have done globally. The key is to reduce switching costs for investors and depository participants and to ensure fast and easy inter-connectivity for a potential new depository. The crucial hurdles here are at the software end, and I believe that the regulators would have to extend their oversight to software source code to make this happen. The source code[4] for the key interfaces of the depository must be regarded as part of its by-laws and subjected to the same level of public scrutiny and regulatory oversight.

It might be objected that this would require the depositories to give up their intellectual property in the software created by them. This is not necessarily so. With modern object oriented methodologies, it is possible to hide the actual implementation of most of the software while exposing all the important interfaces to public scrutiny. It should be possible to subject these interfaces to regulatory oversight without compromising the intellectual property of the bulk of the software. While I make no attempt to hide my personal commitment to open source software, the proposal being made here does not require the regulator or the regulatee to embrace the open source movement.

Indeed this must happen not just for depositories but for stock exchanges and other similar oganisations that constitute the

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infrastructure of the capital markets. The ultimate source of competition to the Indian securities industry would be from outside the country. As and when the country becomes more open on the capital account, incumbent monopolies would face intense competition from global exchanges as well as clearing and settlement agencies. However, it is imprudent to rely only on this source of competition.

First, on current indications, an open capital account appears to be a distant destination despite the mention that it finds in the Finance Minister budget speech for 2002-03. Second, a highly competitive domestic industry would be more likely to withstand global competition when it does arrive (Porter, 1990). To tolerate monopolies today would be to risk the complete domination of the Indian securities industry by foreign players when do we open our markets to global competition.

5.9 Status of the Capital Markets

In the early years of the reforms, the Indian capital markets continued to display the growth and vibrancy that have been present since the mid-1980s. However, this soon petered out, and the capital markets ended a decade of reforms at a lower level on most dimensions than at the start of the reforms. In retrospect, it is evident that the eight years beginning 1984 was the golden age of the Indian capital market.

- During the period from January 1984 to October 19925, the market delivered a compounded annual return of about 32% in rupee terms (the market index went up more than 11 times) and 16% in dollar terms (the dollar adjusted index went up nearly 4 times). By contrast, during the two decades from 19656 to 1984 the market had delivered a compounded annual return of less than 6% in rupee terms and less than 1% in dollar terms.
- A major contribution to the stellar performance of the stock market during the golden years came from a sharp rise in the price-earnings ratio. From a level of around 6-7 in the early 1980s, the P/E ratio doubled in the second half of the 1980s and doubled again in the next couple of years.
- As a consequence of this explosive growth, a number of investors were attracted to the capital market. The capital market that used to attract only about 3% of household financial savings in the 1970s and early 1980s absorbed 10% of household financial savings by the end of the 1980s. This figure rose to a whopping 23% in 1991-92.
- The capital market also became a major source of financing for the corporate sector. Money raised in the capital markets accounted for only 1% of gross fixed capital formation in the economy in the 1970s and early 1980s. This figure rose to 6% by 1990 and peaked at 13% in 1993-94.
- Rising prices and large new flotations (including limited partial privatisation of some public sector enterprises) raised the market capitalisation to nearly 50% of GDP in the early and mid-1990s as compared to less than 20% at the beginning of the 1990s. Most of this growth stopped or reversed in the later half of the 1990s:
- At the end of February 2002, the market index in rupee terms was only about 7% above the post scam levels of October 1992. The average market index during the first eleven months of 2001-02 was almost exactly the same as in October 1992. This means zero return in rupee terms in about 9 years. In dollar terms, the average index in the first eleven months of 2001-02 was less than half of what it was in October 1992. A foreign investor investing in Indian stocks just as the country was opening up to foreign capital would have lost half his capital.
- The poor performance of the stock market during the post reform period is due principally to a sharp fall in the price-earnings ratio. In the last couple of years, the P/E ratio has halved from the levels of around 30 reached in the early years of the reforms. The P/E ratio is now back to pre-reform (late 1980s) levels.
- The share of household financial savings flowing into the capital market (which had reached 23% in 1992) fell back to about 5% by the late 1990s. This is approximately the same level as in the early 1980s, and sharply lower than in the late 1980s and early 1990s.
- Capital raised in the primary market as a percentage of Gross Fixed Capital Formation in the economy (which reached 13% in 1993-94) fell back to about 2% by the end of the decade. This is about the same level as in the mid-1980s.
- The market capitalisation in absolute rupee terms stagnated in the second half of the 1990s (except for a spectacular but transient surge during the technology stock boom of 1999 and 2000). As a percentage of GDP, the market capitalisation fell to below 30% by the end of 2000-01 (and to about 25% by the end of 2001). This means that market capitalisation relative to GDP is not significantly higher today than before the reforms.

The only quantitative dimension on which the stock market appears better today than at the beginning of the reforms process is trading volume. Trading volume was only about 25% of market capitalisation throughout the first half of the 1990s. This figure surged to over 150% by the end of the 1990s, and in 2000-01 it reached a spectacular figure of over 400%, propelled in part by the boom in technology stocks. In 2001-02, trading volumes fell sharply from the stratospheric levels seen in 2000-01, but recovered in subsequent months as the markets gradually adapted to the structural changes in the market. During the first nine months of 2001-02, trading volumes averaged about 140%, which is about the same as the levels prior to 2000-01. All this is not to suggest that economic reforms have been bad for the Indian capital market. Quite the opposite is true. India is a good example of Paul Krugman's thesis that "the financial markets offered an immediate, generous advance on the presumed payoff" from economic reforms (Krugman, 1995). Financial markets believe that reforms would pay off in the long run and are therefore willing to provide lavish rewards for economic reform in the belief that a wave of reform is unstoppable. Stock markets thus tend to reward reformers long before they have completed their job. Markets are forward looking and share prices respond to respond to expectations of future reforms. In the Indian case, these expectations turned out to be somewhat premature.

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The market responded enthusiastically to the first whiff of liberalisation in the mid-1980s, and even more euphorically to the major reforms of 1991. The rise in prices in this period reflected not merely the reforms that had been put in place, but also those that were expected to follow in logical progression. As reforms stalled after the securities scam of 1992, the markets performed badly. Looked at this way, the golden age of the Indian capital market during 1984-92 were simply the period in which reforms were actually taking place and were expected to continue. The stagnation since then reflects the slowing down and reversal of the reform process since then.

5.10 Monetary Policy and Debt Markets

In the early nineties, the Indian debt market was best described as a dead market. Financial repression and over-regulation were responsible for this situation (Barua et al., 1994). Reforms have eliminated financial repression and created the pre-conditions for the development of an active debt market:

- The government reduced its pre-emption of bank funds and moved to market determined interest rates on its borrowings. Simultaneously, substantial deregulation of interest rates took place as described earlier.
- Automatic monetization of the government's deficit by the central bank was limited and then eliminated by abolishing the system of *ad hoc* treasury bills. Several operational measures were also taken to develop the debt market, especially the market for government securities.
- Withdrawal of tax deduction at source on interest from government securities and provision of tax benefits to individuals investing in the
- Introduction of indexed bonds where the principal repayment would be indexed to the inflation rate.
- Setting up of a system of primary dealers and satellite dealers for trading in government securities
- Permission to banks to retail government securities
- Opening up of the Indian debt market including government securities to Foreign Institutional Investors. With all these measures, most of the institutional structure for the growth of the money market is now in place. Primary dealers, satellite dealers, rating agencies, transparent trading facilities, gilt mutual funds and a host of other institutional initiatives have created the preconditions for a deep and vibrant money market. Despite all this, a series of policy shocks during the l990s stalled the development of the money market until the end of the decade:
- The securities scam of 1992 was the first major shock to the money market. This scam centred upon repo transactions8 in the government securities market. The repo is one of the safest and most important instruments in any money market anywhere in the world. Unfortunately, the regulatory response to the scam was a ban on repos in the government securities market in India.. Liquidity in the government securities market virtually dried up, and recovered only gradually as the ban on repos was relaxed over a period of several years.
- Just as the market was coming out of the stupor following the scam, the busy season credit policy of 1995 played havoc with the money markets. In 1995, the RBI (possibly under pressure from the government) decided to use monetary policy to stamp out the inflation that was raising its head. The sharp monetary squeeze lasted only half a year before it was substantially eased in the slack season policy of 1996. But in February and March 1996, interest rates went through the roof, and top rated companies and institutions had difficulty raising funds even for short maturities. Borrowers who were below the top rung found the money market effectively closed to them. A number of defaults (euphemistically described as rollovers) took place during this period. The hard blow to the money market was exacerbated by the way in which the central bank chose to conduct the management of the public debt. The sharp monetary squeeze (which the market expected to be temporary) had led to a strongly inverted yield curve in the free market. This posed a problem for the periodic auction of T-bills. Left to the free market, cut off yields on these T-bills would have surged to unacceptable levels. At some of these auctions, therefore, the RBI rejected all competitive bids, accepted the non-competitive bids at the cut-off rate determined by it and let the rest of the T-bills devolve on itself. (Some entities are allowed to bid only on a non-competitive basis where they have to accept the cut-off yield). The unintended consequence of this was that the market for floating rate instruments (tied to the T-bill rate) was virtually destroyed. As short-term rates in the free market rose above 20% and T-bill cut-off rates were kept around 10%, floating rate bonds started sinking. The market was wiped out and some intermediaries who performed market making in these instruments suffered heavy losses as well.
- After recovering from the shocks of 1995-96 the money market were perhaps ready to take off when the Indian rupee came under downward pressure in the wake of the Asian crisis around August 1997. The government at this point decided to defend the rupee though some influential economists argued that a depreciation of the currency would improve our global competitiveness. The government's decision was based on the belief that a sharp fall in the rupee would weaken international confidence in the country. Since the government wanted to conserve its foreign exchange reserves, interest rates became the principal weapon for defending the rupee. On several occasions in 1997 and 1998, the Reserve Bank squeezed liquidity sharply to bolster the currency. The most dramatic of these episodes was in the middle of January 1998: T-bill yields more than doubled, and some prominent money market institutions lost more money on that single day than they had made in the whole year. Episodes like this were repeated throughout the year. After India conducted nuclear tests at Pokharan in May 1998, the RBI was forced to tighten liquidity once again to prevent a slide in the currency. Again in August 1998, just as the Resurgent India Bonds were being launched, the rupee came under renewed pressure, and the RBI had to suck liquidity out of the

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system very sharply. Between August 1997 and August 1998, the Indian yield curve inverted and disinverted three or four times. All this turbulence took a severe toll on the money markets and the institutions that operate in it. After August 1998, the money markets enjoyed a period of relative calm. Since then, there has been a sharp rise in the liquidity in money markets instruments and government securities. The turnover in the wholesale debt market of the NSE rose from about 25% of market capitalisation to over 100% of market capitalisation (see Chart 8). Short-term interest rate benchmarks like NSE MIBOR established themselves and a well defined yield curve began to emerge. Primary dealers and fixed income mutual funds brought a set of active traders into the markets. By 2001, the money markets and government securities markets were more liquid than they had been at any time since the scam of 1992.

There is still a long way to go but India is perhaps closer to the development of a vibrant debt market than ever before. To my mind, the fundamental task now is that of regulatory mindset. It appears to me that the regulator in the pursuit of its policy goals has often tended to act against the market rather than through the market. It has tended to fight the market rather than guide it along the desired path. It has tended to use market distorting interventions rather than market oriented ones. The money market is the arena where the full force of the central bank's monetary policy is felt, and the manner in which the central bank conducts its monetary policy is therefore of great importance. I believe that the regulator should have greater confidence in the efficacy of the price signal in free functioning markets, and should place a little more emphasis on the maintenance of orderly markets. It would then be able to achieve most of its policy objectives without sacrificing the growth and development of the money markets.

Finally, a vibrant corporate debt market cannot emerge until major legal reforms are accomplished in areas like bankruptcy, foreclosure laws, and stamp duties.

6 Impact on the Corporate Sector

6.1 Scope of Corporate Finance

Before the reforms, corporate financial management in India was a relatively drab and placid activity. There were not many important financial decisions to be made for the simple reason that firms were given very little freedom in the choice of key financial policies. The government regulated the price at which firms could issue equity, the rate of interest that they could offer on their bonds, and the debt equity ratio that was permissible in different industries. Moreover, most of the debt and a significant part of the equity was provided by public sector institutions.

Working capital management was even more constrained with detailed regulations on how much inventory the firms could carry or how much credit they could give to their customers. Working capital was financed almost entirely by banks at interest rates laid down by the central bank. The idea that the interest rate should be related to the creditworthiness of the borrower was still heretical. Even the quantum of working capital finance was related more to the credit need of the borrower than to creditworthiness on the principle that bank credit should be used only for productive purposes. What is more, the mandatory consortium arrangements regulating bank credit ensured that it was not easy for large firms to change their banks or vice versa.

Firms did not even have to worry about the deployment of surplus cash. Bank credit was provided in the form of an overdraft (or cash credit as it was called) on which interest was calculated on daily balances. This meant that even an overnight cash surplus could be parked in the overdraft account where it could earn (or rather save) interest at the firm's borrowing rate. Effectively, firms could push their cash management problems to their banks. Volatility was not something that most finance managers worried about or needed to. The exchange rate of the rupee changed predictably and almost imperceptibly. Administered interest rates were changed infrequently and the changes too were usually quite small. More worrisome were the regulatory changes that could alter the quantum of credit or the purposes for which credit could be given.

In that era, financial genius consisted largely of finding one's way through the regulatory maze, exploiting loopholes wherever they existed and above all cultivating relationships with those officials in the banks and institutions who had some discretionary powers. The last decade of financial reforms have changed all this beyond recognition. Corporate finance managers today have to choose from an array of complex financial instruments; they can now price them more or less freely; and they have access (albeit limited) to global capital markets. On the other hand, they now have to deal with a whole new breed of aggressive financial intermediaries and institutional investors; they are exposed to the volatility of interest rates and exchange rates; they have to agonize over capital structure decisions and worry about their credit ratings. If they make mistakes, they face retribution from an increasingly competitive financial marketplace, and the retribution is often swift and brutal.

Broadly the corporate sector has felt the impact of financial sector reforms has been felt in the following key areas:

6.2 Corporate Governance

In the mid nineties, corporate governance became an important area of concern for regulators, industrialists and investors alike. Indian industry considered the matter important enough for them to propose a model corporate governance code (Bajaj, 1997). SEBI introduced a mandatory governance code based on the recommendations of the Birla Committee (Securities and Exchange Board of India, 1999). However, the major pressure for better corporate governance came from the capital markets (Varma, 1997). The decade since the beginning of reforms have witnessed a silent revolution in Indian corporate governance where managements have woken up to the disciplining power of capital markets. In response to this power, the more progressive companies are voluntarily accepting tougher accounting standards and more stringent disclosure norms than are mandated by law. They are also adopting more healthy governance practices.

6.3 Risk Management

The deregulation of interest rates as a part of financial sector reform made interest rates highly volatile. Companies have tried

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to protect themselves from this risk by introducing a call provision in their bonds by which they can redeem the bonds prematurely under certain conditions. Of course, such call options make the bonds more expensive (in terms of a higher coupon rate) or more difficult to sell. Companies have also tried to make the bonds more attractive to investors by giving them a put option to seek premature redemption of the bonds. This may make the bond easier to sell, but it exposes the issuing company to interest rate risk. In the post reform era, corporates have also been faced with high volatility in foreign exchange rates. The rupee-dollar rate has on several occasions moved up or down by several percentage points in a single day as compared to the gradual, predictable changes of the eighties. Indian companies have found to their dismay that foreign currency borrowings which looked very cheap because of a low coupon rate of interest can suddenly become very expensive if the rupee depreciates against the currency in which the bond is denominated.

6.4 Capital Structure

At the beginning of the reform process, the Indian corporate sector found itself significantly over-levered. This was because of the availability of subsidised institutional finance and the lower operating (business) risks in a protected economy. As the corporate sector was exposed to international competition and high real interest rates, Indian companies undertook substantial deleveraging in the mid-1990s. But for a flagging equity market since the mid- 1990s, many companies might have travelled further down this road.

6.5 Group Structure and Business Portfolio

Indian business groups have been doing serious introspection about their business portfolios and about their group structure. Group financial structures are also beginning to change as the existing complex web of inter locking shareholdings slowly gives way to more transparent ownership patterns. Consolidation of accounts (which is mandatory for accounting periods beginning on or after April 1, 2001) companies can no longer hide the true state of affairs behind a complex web of subsidiaries.

6.6 Working Capital Management

Working capital management has been impacted by a number of the developments discussed above - operational reforms in the area of credit assessment and delivery, interest rate deregulation, changes in the competitive structure of the banking and credit systems, and the emergence of money and debt markets. Companies have found their creditworthiness under greater scrutiny than ever before. But top-notch corporate borrowers have benefited from money market borrowing options and other choices. The greater concern for interest rate risk has made choice of debt maturity more important than before. Cash management has become an important task with the phasing out of the cash credit system.

7 Investor Expectations

A decade of reforms has changed several investor expectations, but some expectations have not changed and have now become anachronistic. These unrealistic expectations are a major stumbling block in financial sector reforms. Understanding and correcting them is critical to the success of the reforms.

7.1 Repression and Inflation Expectations

Prior to the reforms, the bank deposit rate was repressed to the extent of about 3% as estimated above. Over extended periods of time, the Indian investor had got accustomed to the idea that safe interest rates in the official market are repressed and that significantly better rates are available in the unofficial market without significant risk. With the end of financial repression in the early-mid 1990s, this perception would perhaps have been broken if official interest rates had risen sharply to signal a decisive break with the past. This did not happen. The end of financial repression coincided with a sharp fall in inflationary expectations, and nominal interest rates fell as financial repression was lifted. Investors do not therefore fully realised that the repression discount that was embedded in bank deposit rates in the past no longer exists.

7.2 Distrust of Equities

Except for the eight golden years described earlier in this paper, the performance of equities in India has been very poor. Except for 1984-1992, equities have historically delivered very little capital appreciation during extended periods of time.

7.3 Changing the Expectations

The key stumbling block, therefore, is that many investors are neither willing to accept the low rate of return available on fixed income investments nor willing to take the higher risk that goes with equities. At one level, we can dismiss these expectations as unrealistic and inconsistent with the risk return tradeoff that is the bedrock of modern finance. On the other hand, these expectation are real and changing them is important for the healthy development of the capital market.

- The existing flawed expectations leave investors vulnerable to various kinds of frauds and get-rich-quick schemes.
- They also account for the great allure of assured return mutual funds. These mutual funds guarantee a minimum return that is comparable to or superior to bank deposits, but promise significant upside from the small part of the portfolio that is allocated to equities. The mutual fund needs to hedge its risks well and price the implicit put option correctly. Otherwise, it could end up taking huge losses as has happened in India.
- These flawed expectations are also the major obstacle to the reforms of the small savings system that offers administered interest rates that are too high relative to the free market.

8 The Unfinished Agenda

Throughout this paper, references have been made to the reforms that remain incomplete. The most important and urgent task that remains to be done is that of dismantling the structural and micro regulations that have accumulated over several decades of a command economy. It is also necessary to make the financial sector more competitive to realise efficiency gains, and to ensure that that consumers receive the benefits of lower costs, better costs and greater choices.

8.1 Banking Sector

Some of the major steps that need to be taken on the banking sector include the following:

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- The banking system must be made more competitive by removing all structural barriers to competition. Unnecessary structural barriers between banks, financial institutions and investment institutions must be eliminated. It is necessary to withdraw regulatory support to cartels like the Indian Banks Association (IBA). Complete branch delicensing should be introduced and banks must be allowed to open, close, swap or sell branches. The logic of deposit deregulation should be carried further with freedom to fix deposit rates on a branch wise basis. This would allow the older large banks to match the new private banks in the highly competitive urban market without necessarily raising rates in the high cost rural branches.
- Now that the privatization of management advocated by the first Narasimham Committee (Ministry of Finance, 1991) has proved to be a myth, it is necessary to move swiftly to privatization of ownership. A pre-requisite for this would be a cleaning up of the balance sheet and possible recapitalisation.
- The pressing problems of the financial institutions need to be addressed by radical restructuring, downsizing of the balance sheet, recapitalisation and eventual privatisation.
- All quantitative credit controls and measures related to directed credit should be withdrawn.
- The payment system must be modernised rapidly by the rapid adoption of technology.

8.2 Capital Market

In the capital market, the important measures that are needed include the following:

- Short sale restrictions must be removed completely for all players including the institutions. This is the best defence against market manipulation.
- The problems that have arisen from the lack of an effective listing authority for many stocks need to be addressed. The time has come to consider the establishment of a National Listing Authority on the lines of the similar entity in the United Kingdom.
- To achieve genuine investor protection, we must empower the investors. The goal should be to create a statutory framework under which violation of any SEBI regulation or listing requirement gives the investor the statutory right to sue the company and its management. We could try to replicate the US class action model here or we could try to adapt the PIL (public interest litigation) mechanism that the Indian judiciary has used very effectively. What is needed is a statutory sanction for a process in which investors can enforce their rights against companies without the intervention of the regulators at all.
- Surveillance systems need to make aggressive use of information technology and rely on greater transparency and public disclosure.
- The regulators must adopt a more aggressive pro-competitive policy in an environment in which the securities industry is threatening to become significantly less competitive than in the past (Varma 2001).
- The regulatory climate must become more friendly to hostile takeovers.
- An effective and competitive securities lending system needs to be put in place.
- It is necessary to broad base the derivative markets by allowing foreign and domestic institutions to operate more freely in this market.

8.3 Debt and Foreign Exchange Markets

In the field of fixed income and foreign exchange markets, the following issues are important:

- The vulnerabilities associated with the current partial opening up of the capital account need to be addressed.
- The conduct of monetary policy and exchange rate policy needs to take less market distorting forms and needs to display greater sensitivity to the goal of orderly markets.

8.4 The Real Economy

Finally, it must not be forgotten that, in the ultimate analysis, a strong financial sector is built on a strong economy. Real sector reforms (for example in the field of bankruptcy law) are very important. Similarly, an essential precondition for the success of the entire financial reforms programme is the maintenance of macroeconomic stability. The large fiscal deficit is, therefore, a grave threat to the long term success of the financial reforms. The dynamism of the reform process that was lost in the mid-1990s needs to be recaptured to satisfy the aspirations of the Indian people for a vibrant modern economy with a strong and efficient financial sector.

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LESSON 4:
NON-BANKING FINANCIAL COMPANIES (NBFC)

Lesson Objectives

To understand the Concept of NBFC, their classifications, and RBI Norms for NBFCs.

Introduction

As you already know, financial services sector consists of various types of institutions, among them Non-banking financial companies are very important. NBFCs are financial intermediaries engaged primarily in the business of accepting deposits and delivering credit. They play an important role in channelising the scarce financial resources to capital formation. NBFCs supplement the role of banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganized sector and to small local borrowers.

Since NBFCs have a more flexible structure as compared to banks, they take quick decisions, assume greater risks and tailor-make their services and charges according to the needs of the clients. They broaden the range of financial services. These are partly fund based and partly fee based.

In clause (b) of the Section 45-I of the Chapter IIIB of the RBI Act, 1934 as a financial institution which is a company a non-banking institution, which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner; such other non-banking institutions or class of such institutions, as the bank may with the previous approval of the central government and by notification in the official gazette specify.

NBFC has also been defined as "a non-banking financial company, which is a loan company or an investment company or a hire purchase company or an equipment leasing company or a mutual benefit finance company".

NBFCs provide a wide range of services such as hire purchase, equipment lease finance, loans, and investments. Due to rapid growth of NBFCs and a wide variety of services provided by them, there has been a gradual blurring of distinction between banks and NBFCs except that commercial banks have the exclusive privilege in the issuance of cheque. All NBFCs are under direct control of RBI in India.

NBFCs can be classified into different segments depending on the type of activities they undertake :

Hire purchase finance company

Investment company including primary dealers

Loan company

Mutual benefit financial company

Equipment leasing company

Chit fund company

Miscellaneous non-banking companies.

The above mentioned entities are either partially or wholly regulated by the RBI. Before we proceed forward let's understand few terms as these are important for further learning.

Deposits : Definition of the deposit is in its broadest sense to include any receipt of money by way of deposit or loan or in any other form. The term excludes following receipts :

i. Amount received from bank.

ii Amount received from development/ State financial corporation or any other financial institution,

iii. Amount received in the ordinary course of business by way of security deposit, dealership deposit, earnest money, advance against order for goods/properties and services.

iv. Amount received by way of subscription in respect of a chit and

v. Loan from Mutual Funds.

Financial Institutions : These mean any non-banking institution / financial companies engaged in any of the following activities :

vi. Financing by way of loans, advances and so on any activity except of its own.

vii. Acquisition of shares/ stocks/ bonds/ debentures/ securities.

viii. Hire purchase.

ix. Any class of insurance, stock-broking etc.

x. Chit-funds and

xi. Collection of money by way of subscription/ sale or units or other instruments/ any other manner and their disbursement.

Now let us discuss various types of NBFCs.

Equipment Leasing Company : This means the company which is a financial institution carrying on the activity of leasing (or lease financing) of equipments as its principal (main) business.

Hire Purchase Finance Company : It is a company which is a financial institution carrying on as its principal activity hire purchase transactions or the financing of such transactions.

Investment Company : It means a company which is a financial institution carrying on as its principal business the acquisition of securities.

Loan Company : It means any company which is a financial institution carrying on the as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own.

Mutual Benefit Finance Company (MBFC) : MBFC (also called **Nidhis**) are NBFCs notified under section 620A of the Companies Act, 1956, and primarily regulated by Department of Company Affairs (DCA) under the directions/ guidelines

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issued by them under section 637A of the Companies Act, 1956. These companies are exempt from the core provision of the RBI Act and NBFC directions relating to acceptance of public deposits. However, RBI is empowered to issue direction in matters relating to deposit acceptance activities and directions relating to ceiling on interest rate. They are also required maintain register of deposits, furnish receipt to depositors and submit returns to the RBI.

Regulatory Non-Banking Companies (RNBC) : RNBCs are a class of NBFCs that cannot be classified as equipment leasing company, hire purchase, loan, investment, *nidhi* or chit fund companies, but which tap public savings by operating various deposit schemes, akin to recurring deposit schemes of Banks. The deposit acceptance activities of these companies are governed by the provisions of Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. To safeguard the interest of depositors, the RBI has directed RNBCs to invest not less than 80% of aggregate deposit liabilities as per the investment pattern prescribed by it. They can invest only 20% of aggregate liabilities or 10 times of its net worth, whichever is lower, in a manner decided by its BOD.

The RNBCs are the only class of NBFCs for which, floor rate of interest is specified by the RBI, while there is no upper limit prescribed for them. RBI has also prescribed prudential norms for RNBCs, compliance with which is mandatory and prerequisite for acceptance of deposits.

Miscellaneous Non-Banking Companies : MNBCs are companies engaged in the chit fund business. The term 'deposit' as defined under section 45I(bb) of the RBI Act, 1934, does not include subscription to chit funds. The chit fund companies are exempted from all the core provisions of the Chapter IIIB of the RBI Act. RBI only controls the deposits accepted by these companies, whereas, administration is regulated by the respective state governments.

Growth of NBFCs : NBFCs in India existed since long. They came into limelight in the second half of the eighties and first half of nineties. NBFCs play an important role in funds mobilization in India. Following RBI data shows their role in funds mobilization.

Aggregate Deposits of Non-Banking Companies

(Rupees crore)

Year	Non-bank Financial Companies			Non-bank Non-Financial Companies			Grand Total		
	Regulated Deposits	Exempted Deposits	Total (2 + 3)	Regulated Deposits	Exempted Deposits	Total (5 + 6)	Regulated Deposits (2 + 5)	Exempted Deposits (3 + 6)	Total (8 + 9)
1	2	3	4	5	6	7	8	9	10
1970-71	41.9	107.8	149.7	189.8	229.2	419.0	231.7	337.0	568.7
1971-72	64.7	146.3	211.0	354.7	126.1	480.8	419.4	272.4	691.8
1972-73	54.3	176.1	230.4	319.4	198.0	517.4	373.7	374.1	747.8
1973-74	80.0	224.0	304.0	403.7	320.9	724.6	483.7	544.9	1028.6
1974-75	104.7	337.7	442.4	393.6	360.7	754.3	498.3	698.4	1196.7
1975-76	128.7	332.8	461.5	416.2	387.5	803.7	544.9	720.3	1265.2
1976-77	147.3	549.0	696.3	572.8	465.8	1038.6	720.1	1014.8	1734.9
1977-78	185.1	564.4	749.5	685.5	627.5	1313.0	870.6	1191.9	2062.5
1978-79	155.6	882.9	1038.5	846.6	751.0	1597.6	1002.2	1633.9	2636.1
1979-80	187.3	1425.3	1612.6	884.6	956.4	1841.0	1071.9	2381.7	3453.6
1980-81	215.0	1260.7	1475.7	1142.3	1570.0	2712.3	1357.3	2830.7	4188.0
1981-82	214.0	1531.6	1745.6	1305.7	2440.5	3746.2	1519.7	3972.1	5491.8
1982-83	237.3	2192.9	2430.2	1740.2	5023.9	6764.1	1977.5	7216.8	9194.3
1983-84	275.6	2885.7	3161.3	2058.9	5903.9	7962.8	2334.5	8789.6	11124.1
1984-85	409.5	3946.5	4356.0	2405.8	9378.6	11784.4	2815.3	13325.1	16140.4
1985-86	485.5	4474.1	4959.6	2781.0	10331.5	13112.5	3266.5	14805.6	18072.1
1986-87	832.3	5109.3	5941.6	3244.5	12214.1	15458.6	4076.8	17323.4	21400.2
1987-88	1136.9	6362.8	7499.7	3598.1	13106.5	16704.6	4735.0	19469.3	24204.3
1988-89	1505.9	8979.0	10484.9	3901.2	14218.8	18120.0	5407.1	23197.8	28604.9
1989-90	1773.4	12869.6	14643.0	4223.7	17215.3	21439.0	5997.1	30084.9	36082.0
1990-91	2040.7	15195.5	17236.2	4706.2	22131.1	26837.3	6746.9	37326.6	44073.5
1991-92	2824.1	17614.4	20438.5	4672.4	26073.9	30746.3	7496.5	43688.3	51184.8
1992-93	4287.8	40668.6	44956.4	4890.1	98250.9	103141.0	9177.9	138919.5	148097.4
1993-94	17389.5	39047.9	56437.4	5812.9	123530.4	129343.3	23202.4	162578.3	185780.7
1994-95	25440.5	60054.6	85495.1	7260.7	151250.5	158511.2	32701.2	211305.1	244006.3
1995-96	38710.6	62961.8	101672.4	8040.1	178869.1	186909.2	46750.7	241830.9	288581.6
1996-97 P	53116.0	71253.7	124369.7	9592.0	214281.1	223873.1	62708.0	285534.8	348242.8

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Deposits Mobilized by the NBFC Sector

(Rupees crore)

Year	NBFCs		RNBCs		**NBFC**
(end-March)	No of Reporting Companies	Public Deposits	No of reporting Companies	Public Deposits	**Sector (3+5) Total Public Deposits**
1	2	3	4	5	6
1998	1420	13571.73	9	10248.72	**23820.45**
1999P	1536	9784.66	11	10644.27	**20428.93**
2000P	996	8337.95	9	11003.77	**19341.72**
P	: Provisional.				
Note	: 1. Data format has been changed after 1996-97 due to new reporting format Following changes in the regulatory framework in 1998. 2. The figures reported for 1998, 1999 and 2000 are end-March figures.				
Source	: RBI Bulletin, Various Issues. www.rbi.org.in				

RBI Act Framework

Introduction : In the 1960s, the RBI made an attempt to regulate the NBFCs by issuing directions relating to the maximum amount of deposits, the period of deposits and rate of interest they could offer on the deposits accepted. Norms were laid down regarding maintenance of certain percentage of liquid assets, creation of reserve funds and transfer thereto every year a certain percentage of profit and so on. To protect the interest of depositors, these directions and norms were revised and amended from time to time.

In the year 1977, the RBI issued two separate sets of guidelines, namely (i) NBFC Acceptance of Deposits Directions, 1977 and (ii) MNBD Directions, 1977 for MNBCs. In 1997, the RBI Act was amended and the RBI was given comprehensive powers to regulate NBFCs. The amended Act made it mandatory for every NBFC to obtain a certificate of registration and have minimum net owned funds. Ceilings were prescribed for acceptance of deposits, capital adequacy, credit rating and net owned funds. This is the only sector which had number of committees trying to regulate its working. The first was the Shah Committee in 1992, followed by the Shere Committee, Khanna Committee and various committees of the RBI.

Based on the report of the Task Force headed by Shri C. M. Vasudev submitted in 1998, the Govt. of India framed Financial Companies Regulation Bill, 2000, to implement the recommendations requiring statutory changes as also consolidate the law relating to NBFC and unincorporated bodies with a view to ensuring depositor protection. The regulations and directions related to NBFCs are divided into following categories :

i. Regulatory norms (under chapter IIIB and IIIC).

ii. RBI Acceptance of Public Deposits Directions.

iii. RBI NBFCs Prudential Norms Directions.

iv. RBI NBFCs Auditors Report Directions.

Now let's discuss these provisions and regulations in detail for complete understanding of the NBFCs.

Regulatory Norms (under Chapter IIIB and IIIC)

First we discuss regulatory norms under chapter IIIB.

Certificate of Registrations : With effect from January, 1997, in order to commence (new company)/ carry on (existing company) the business of a Non-banking financial institution, and NBFC must obtain a certificate of Registration from RBI. The prerequisite for eligibility for such a CoR is that the NBFC should have a minimum Net Owned Fund (NOF) of Rs. 25 Lakh (which has been raised to Rs. 2 Crore from April 21, 1999 for any new applicant).

The RBI, while considering an application for registration, would consider that the NBFC fulfils the following conditions (u/s 45-IA of the RBI Act) :

- The NBFC is/ would be in a position to pay its present/ future depositors in full as and when their claims accrue.
- Its affairs are not being/ likely to be conducted in a manner detrimental to the interests of its present/ future depositors.
- The general character of the management/ proposed management would not be prejudicial to the public interest/ interest of the depositors.
- It has adequate capital structure and earning prospects.
- The public interest would be served by the grant of the certificate to commence/ carry on business in India.
- Grant of the COR would not be prejudicial to the operations/ consolidation of the financial sector consistent with the monetary stability and economic growth considering such other relevant factors specified by the RBI.
- Any other condition fulfillment of which, in the opinion of RBI, would be necessary to ensure that the commencement/ carrying on business in India would not be prejudice to the public interest or the interest of the depositors.
- The RBI may impose conditions while granting registration.

Cancellation of Registration : RBI may cancel COR, if the NBFC :

- Ceases to carry on the business in India.
- Has failed to comply with any condition subject to which the certificate was issued.

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- At any time fails to fulfill any of the above conditions which the RBI considered while granting registration.
- Fails to (a) comply with any directions issued by the RBI under the provisions relating to registration, (b) maintain accounts in accordance with the requirements of any law/ directions/ order issued by the RBI under these provisions and (c) submit/ offer for inspection its books of accounts/ other relevant documents when so demanded by an inspecting authority of the RBI, and
- Has been prohibited from accepting deposits by an order of the RBI under those provisions which have been in force for a period of a least three months.

Net Owned Funds : NOF mean (a) paid up capital and free reserves as per the latest balance sheet minus the accumulated losses, if any, deferred revenue expenditure and other intangible assets, and (b) (i) less investment in shares of subsidiaries/ companies in the same group/ all other NBFCs and (ii) the book value of debentures/ bonds/ outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries/ companies in the same group in excess of 10% of (a) above.

Maintenance of Liquid Assets : NBFCs have to invest in unencumbered approved securities, valued at a price not exceeding current market price, an amount which at the close of business on any day, shall not be less than 5.0 percent but not exceeding 25.0 percent, specified by RBI, of the deposits outstanding at the close of business on the last working day of the second preceding quarter. The RBI may, however specify different percentages of investment in respect of different classes of NBFCs.

Here approved securities mean the securities of any State/ Central Govt. and bonds unconditionally guaranteed by them as regards the payment of interest as well as the repayment of principal. These securities are valued at current market price.

Reserve Fund : Every NBFC shall create a reserve fund and transfer thereto a sum not less than 20% of its net profit every year as disclosed in the profit and loss account and before any dividend is declared. Such fund is to be created by every NBFC, irrespective of the fact whether it accepts public deposits or not. Further, no appropriation can be made from the fund for any purpose without the prior written approval of RBI. The Central Govt. may on the recommendation of the RBI, exempt any NBFC for a specified period from the above requirements, having regard to the adequacy of the paid-up capital and reserves in relation to deposit liabilities. But such exemption can be granted only if the reserve fund together with the share premium account of the NBFC is not less than its paid-up capital.

Under Chapter III-B, RBI has comprehensive powers to seek any information from NBFCs, to impose penalties and penal interests in case of any default by NBFCs to provide required information or other default.

Provisions of Chapter III-C are mainly for non-corporate bodies. Non-corporates are not permitted to accept deposits after April 1, 1997. However, individuals can accept deposits from (i) relatives (ii) any other individual for his personal use, but not for lending or business purpose. The non-corporate entities, which hold deposits, should replay it immediately after such deposit becomes due for repayment or within two years from the date of such commencement whichever is earlier. They are prohibited from issuing or causing to be used any advertisement in any form for soliciting deposits.

If certain documents relating to the acceptance of deposits in contravention of the requirements are secreted in any place, a court on application by an authorized officer of the RBI/ State Government may issue a warrant to search for such documents. Such warrants would have the same effect as one issued under the Code of Criminal Procedure.

If a person contravenes any of the above provisions, he would be punishable with imprisonment for a term which may extend to two years or with a fine up to twice the amount of deposit received or Rs. 2000 whichever is more or with both. Generally, the imprisonment and the fine would not be less than one year and Rs. 1000 respectively. A fine exceeding Rs.2000 may be imposed in special circumstances.

RBI Acceptance of Public Deposits Directions

The RBI issues directions to regulate acceptance of deposits by NBIs/ FIs. These directions contain provisions regulating the amount/ period of deposits, rates of interest, brokerage etc. They also exempt from their purview certain types of borrowings/ money received by these companies. Main provisions related to deposit acceptance are as under.

Ceiling on quantum of public deposits : The RBI prescribes how much deposits an NBFC can accept, depending upon the nature of business, NOF and credit rating given the NBFC. At present following norms are applicable :

i. Loan and investment companies : If the company has NOF of Rs. 25 Lakh, minimum investment grade (MIG) credit rating, complies with all the prudential norms and has CRAR of 15 percent – 1.56 times of NOF

ii. Equipment leasing and hire purchase finance companies : If company has NOF of Rs. 25 Lakh and complies with all the prudential norms (a) with MIG credit rating and 12% CRAR – 4 times of NOF (b) without MIG credit rating but CRAR 15% or above – 1.5 times of NOF or Rs. 10 crore whichever is less.

Down grading of credit rating : In the event of downgrading of credit rating below the minimum specified investment grade the excess deposit should be regularized in the manner specified. An ELC/HPFC must immediately stop accepting deposits and report the position within 15 days to the RBI and reduce within three years from the date of such downgrading of credit rating the amount of excess public deposit to nil or the appropriate extent permissible to which it is entitled to accept by repayment as and when such deposit falls due or otherwise. A LC/IC must stop immediately accepting the deposits, report to RBI within 15 days and reduce within three years the amount of excess to nil by repayment as and when such deposit fall due or otherwise. In the event of excess public deposit arising out of the regulatory ceiling or downgrading of credit rating, the NBFC may renew the maturing public deposit subject to the compliance of the repayment stipulations and

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other provisions of these directions. No matured public deposit should be renewed without the voluntary consent of the depositor.

Ceiling of Interest Rates : There was a ceiling of 12.5% per annum on the rate of interest on deposits with effect from November 1, 2001. For RNBCs minimum interest rate is 4% on daily deposits and 6% on other than daily deposits. It may be paid or compounded at rests not shorter than monthly rests. (Check RBI web site for latest ceiling).

Period of Deposits : All the NBFCs cannot accept demand deposits. For other deposits periods are (i) NBFC – 12 to 60 months (ii) RNBCs – 12 to 84 months and (iii) MNBCs (chit funds) – 6 to 36 months.

Payment of brokerage : The permissible brokerage, commission, incentives or any other benefit on deposits with all NBFCs is 2% of the deposit. The expenses by way of reimbursement on the basis of related vouchers/ bills produced up to 0.5 % of the deposits are also permitted.

Renewal of deposits : The NBFCs can permit the existing depositors to renew their deposits before maturity to avail of the benefit of a higher rate of interest provided (i) the deposit is renewed in accordance with the other provisions of these directions and for a longer duration than the remaining period of the original contract and (ii) the interest on the expired period of the deposit is reduced by 1 percent from the rate which the NBFC would have ordinarily paid had the deposit been accepted for the period for which it has run; any interest paid earlier in excess of such reduced rate is recovered/ adjusted. In this context, a depositor means any person who has made a deposit with a company; or a heir, legal representative, administrator or assignee of the depositor.

Advertisements and statements in lieu of advertisement: All NBFCs have to mandatorily comply with the provisions of the NBFC/MNBC Advertisement Rules, 1977. They also should specify in every advertisement the following:

i. Actual rate of return by way of interest, premium, bonus and other advantages to the depositors.
ii. Mode of repayment of deposit.
iii. Maturity period of deposit
iv. Interest payable on deposits
v. Rate of interest payable on withdrawal of the deposits
vi. Terms and conditions for the renewal of deposits
vii. Any other special feature relating to the terms and conditions for the acceptance/ renewal of deposits and
viii. The information relating to the aggregate dues (including the non-fund bases facilities provided to) from companies in the same group or other entities/ business venture in which directors and or the NBFC are holding substantial interest and the total amount of exposure to such companies.

Where a NBFC intends to accept deposits without inviting such deposits, it has to file a statement in lieu of the advertisement with the RBI containing all the particulars specified above and duly signed in the specified manner. Such a statement is valid for six months. Fresh statements would have to be delivered in each succeeding year before accepting public deposit in that financial year.

Repayment of deposits : The directions do not permit premature withdrawal of deposits within three months from the date of acceptance. The NBFCs are required to pay interest on withdrawal before maturity at the request of the depositor at the specified rates, namely (i) no interest on withdrawal between three and six months, (ii) not more than 10% p.a. between 6-12 months and (iii) 1% less than the contracted rate on withdrawals after 12 months but before maturity. In case of MNBCs, the interest on such withdrawals is nil between 3-6 months and 1% less than the contracted rate after 6 months but before maturity. The RNBCs can deduct 2% from the rate, which they would have normally paid to the depositors upon maturity, on withdrawal after one year but before expiry of the period of deposit.

In the event of death of depositor, the deposit can be repaid prematurely to the surviving depositor(s) in the case of joint holding with survivor clause, or to the nominee or to the legal heirs with interest at the contracted rate up to the date of repayment. Moreover, a loan can be granted to a depositor after the expiry of three months from the date of deposit at a rate of interest 2% above the contracted rate in the deposit by NBFC up to 75% of the amount of deposit and up to 70% by MNBC.

Maintenance of liquid assets : Under section 451 B, the RBI has specified that the NBFCs holding public deposits should maintain minimum liquid assets in the form of unencumbered approved securities at 15% of public deposits with effect from April 1, 1999. In the case of RNBCs, a sum not less than the aggregate amount of their liabilities to the depositor is to be held by them as specified investment. The RNBCs are required to submit a certificate from an auditor to this effect every six months, that is, on June 30 and December 31. The aggregate amount of liabilities means the total deposits received together with interest/premium/bonus, accrued on the amount of deposits according to the terms of contract. The directions stipulate that the RNBCs should deploy their funds in such a way that, of their aggregate liabilities:

i. Not less than 10% in fixed deposits in public sector banks, which can be withdrawn only for repayment of deposits.
ii. Not less than 70% is held in the form of unencumbered approved securities valued at market value, of which not less than 10% is in securities of the Central / State governments / Government guaranteed bonds, and
iii. Not more than 20% or ten times the net owned funds of the RNBC, whichever is lower, is in other safe investment approved by the board of directors.

Safe custody of Approved securities : All NBFCs have to designate one of the scheduled commercial banks as its designated banker in the place where their registered offices are situated, intimate in writing to the RBI and entrust to such bank the unencumbered approved securities required to be maintained by it in pursuance to Section 451B of the RBI Act. Alternatively, NBFC may entrust such securities to Stock Holding Corporation of India Ltd, with the prior approval of RBI, subject to conditions as RBI may specify.

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LESSON 5:
NON-BANKING FINANCIAL COMPANIES (NBFC)

Lesson Objectives

To understand the RBI Prudential Norms. Norms related to Auditors' Report.

RBI NBFCs Prudential Norms directions

Pursuant to the recommendations of the *Narsimham* Committee and Shah committee, the RBI had prescribed with effect from April, 1993, prudential norms for all types of financial companies with NOF of Rs. 50 Lakh and above, which had to be compulsorily registered with it. In the public interest and to regulate the credit system to the advantage of the country, in exercise of the powers conferred by section 45 JA of the amended RBI Act, the RBI issued directions w.e.f. January 31, 1998; NBFCs Prudential Norms Directions, 1998. These provisions for directions apply to all NBFCs excluding MBFCs with a NOF of Rs. 25 Lakh and above and accepting/holding public deposits.

These norms can be divided into two categories : (i) norms applicable to only those NBFCs which are accepting / holding public deposits and (ii) norms applicable to all NBFCs, irrespective of whether they accept / hold public deposits or not. Let us discuss both the norms one by one.

Prudential norms applicable to only those NBFCs which accept/hold public deposits: These norms are mainly concerned with safety of public funds.

1 Capital to Risk Assets Ratio (CRAR)

The NBFCs holding/accepting public deposits are required to maintain CRAR as under -

i. EL/HPF companies with MIG credit rating - 12 percent

ii. EL/HPF companies without MIG credit rating - 15 percent

iii. Loan/Investment companies - 15 percent

iv. RNBCs - 12 percent

CRAR comprises of tier I and tier II capital, to be maintained on a daily basis and not merely on the reporting dates. Tier I capital consists of NOF (core capital) but includes compulsorily convertible preference shares as a special case for CRAR purpose. Tier II capital is all quasi capital like preference shares (other than CCPS), subordinated debt, convertible debentures and so on. Tier II capital should not exceed Tier I capital. General provisions and loss reserves not to exceed 1.25 percent of the risk weighted assets. Subordinated debt is issued with original tenure of 60 months or more.

Restrictive Norms : If a company does not comply fully with the prudential norms it is not allowed to accept/hold public deposits. If any NBFC defaults in repayment of matured deposits, it is prohibited from creating any further assets until the defaults are rectified. NBFCs cannot invest more than 10% of owned funds in real estate (except for its own use). They are also restricted to invest in unquoted shares to following extent (i) EL/HPF companies 10% of NOF and (ii) LC/ICs 20% of NOF.

Concentration of Credit/ Investments : The NBFCs accepting/holding public deposits cannot lend to any single borrower and single group of borrowers in excess of 15 and 25 percent of their owned funds respectively. The ceiling on investment in shares of another company and a single group of company is the same. The permissible ceiling on loans and investments taken together is 25% to a single party and 40% to single group of parties. For determining these limits, off-balance sheet exposure should be converted into credit risk by applying the appropriate conversion factors. The investments in debentures should be treated as credit and not investment for the purpose of determining the concentration of credit. Moreover, the ceiling on credit/ investment would be applicable to the own group of the NBFCs as well as to the other group of borrowers/investing companies.

The above ceilings on credit/investment concentration are not applicable to RNBCs in respect of investment in approved securities, bonds, debentures and other securities issued by the Government company / public financial institution / bank.

Half yearly returns : NBFCs accepting /holding public deposits must submit their half yearly returns in prescribed format at the end of March and September, every year, within 3 months from the due date. Such returns may or may not be audited, but the figures must be certified by the auditors of the company.

Prudential norms applicable to all NBFCs, irrespective of whether they accept/hold public deposits or not: These norms are mainly concerned with working of the companies.

Income recognition norms : The recognition of income on NPA (non-performing assets) is allowed on cash basis only. The unrealized income recognized earlier is required to be reversed.

NPA norms : Recognition of income on accrual basis before the asset becomes NPA as under : Loans and Advances – up to 6 months and 30 days past due period (past due period done away with effect from March 31, 2003), Lease & HPF – 12 months.

Restrictive norms : NBFCs are not allowed to advance loans/ credit against their own shares.

Accounting standards : All the Accounting Standards and Guidance Notes issued by Institute of Chartered Accountants of India (ICAI) are applicable to all NBFCs, in so far as they are not inconsistent with the guidelines of RBI.

Accounting for investments : All NBFCs to have a well defined investment policy. The investments are classified into two categories (i) long-term investments and (ii) current investments. Long-term investments are to be valued as per

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AS-13 of ICAI. Current investments are further classified into (a) quoted and (b) unquoted.

Current quoted investments are valued at lower of cost or market value. Block valuation permitted for quoted investments, notional gains or losses within the block are permitted to be netted, but not inter-block, net notional gains to be ignored but notional losses to be provided for.

Valuation norms for current unquoted investment are as under :

a. Equity shares – at lower of cost or break up value or fair value.
b. Rs. 1 for the entire block of holding if the balance sheet of the investee company is not available for last two years.
c. Preference shares at lower of cost or face value
d. Government securities at carrying cost
e. Mutual fund units at net asset value (NAV) for each scheme
f. Commercial Paper (CP) at its carrying cost.

Asset classification : The NBFCs are required to classify all forms of credit (including receivables) to be classified into four categories, i.e. (i) Standard (ii) Sub-standard (iii) Doubtful and (iv) Loss asset.

Standard Asset : An asset in respect of which no default in repayment of principal or payment of interest is perceived and which does not disclose any problems nor carry more than normal risk attached to the business.

Sub-standard Asset : Sub standard asset is one (i) which has been classified as NPA for a period not exceeding two years, (ii) where the terms of the agreement regarding interest and/or principal have been renegotiated or rescheduled after the commencement of operations until the expiry of one year of satisfactory performance under the renegotiated/ rescheduled terms.

Doubtful Asset : A doubtful asset means term loan/ leased asset/ hire-purchase asset/ any other asset which remains sub-standard asset for a period exceeding two years.

Loss Asset : A loss asset is one where loss has been identified by the NBFC or internal or external auditors or the RBI inspection to the extent the amount has not been written off, wholly. Alternatively, it may be an asset which is adversely affected by a potential threat of non-recoverability due to, either erosion in the value of the security/ non-availability of security or any fraudulent act/ omission on the part of the borrower.

Provisions for NPA – Loans and Advances : All NBFCs are required to provide for various assets as following :

Sub standard assets : 10% of outstanding balance

Doubtful assets :	20% (doubtful up to 1 year) of O/s balance
	30% (doubtful 1 to 3 years)
	50% (doubtful more than 3 years)
Loss Assets :	100% of the outstanding balance

Provision for NPA : EL & HP : Unsecured portion to be fully provided for. Further provision on net book value (NBV) of EL/HP assets. Accelerated additional provisions against NPAs as per following rates :

NPA for 1 to 2 years	10% of NBV
NPA for 2 to 3 years	40% of NBV
NPA for 3 to 4 years	70% of NBV
NPA for more than 4 years	100% of NBV

Value of any other security considered only against additional provisions. Rescheduling in any manner will not upgrade the asset up to 12 months of satisfactory performance under the new terms. Repossessed assets to be treated in the same category of NPA or own assets option lies with the company.

Risk-weights and credit conversion factors : Risk-weights to be applied to all assets except intangible assets. Risk-weights to be applied after netting off the provisions held against relative assets. Risk weights are 0, 20 and 100. Assets deducted from owned fund like exposure to subsidiaries or companies in the same group or intangible to be assigned 0 per cent risk weight. Exposures to all-India financial institutions at 20% risk weighted and all other assets to attract 100% risk weights. Off-balance sheet items to be factored at 50 or 100 and then converted for risk weight.

Disclosure Requirements

i. Every NBFC is required to separately disclose in its balance-sheet the provisions made as outlined above without netting them from the income or against the value of asset.
ii. The provisions shall be distinctly indicated under separate heads of accounts as under
a. Provisions for bad and doubtful assets and
b. Provisions for depreciation in investments.
iii. Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the NBFC
iv. Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general provisions and loss reserves may be written back without making adjustment against them.

Supervision : In order to ensure that NBFCs function on sound lines and avoid excessive risk taking, the RBI has developed a four pronged supervisory framework based on :

i. On-site inspection structured on the basis of assessment and evaluation of CAMELS (Capital, Assets, Management, Earnings, Liquidity and Systems) approach.
ii. Off-site monitoring supported by state-of-art technology. It is through periodic control reports from NBFCs.
iii. Use of Market Intelligence System.
iv. Exception reports of statutory auditors of NBFCs.

The RBI supervises companies not holding public deposits in a limited manner. Companies with asset size of Rs. 100 crore and above are subject to annual inspection while other non-public deposit companies are supervised by rotation one in every five years.

RBI NBFCs Auditors' Report Directions

Now lets us discuss the Directions given by RBI related to Auditors Report. W.e.f. January 31, 1998, RBI has given directions to statutory auditors report, which is applicable to all auditors of NBFCs. The main requirements of the directions are as described below.

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Matters Included in Auditor's Report : In addition to the normal auditors report u/s 277 of the Companies Act, on the financial statements of NBFCs to the shareholders, the auditors should also make a separate report to the Board of Directors of the NBFCs containing statements on matters of supervisory concern to the RBI detailed below.

In case of All NBFCs : The auditors have to report whether the NBFC :

- Has applied for registration with the RBI
- Is incorporated before January 9, 1997.
- Has received any communication about grant/refusal of COR and
- Has obtained a COR of incorporation on/after January 9, 1997.

In case of NBFCs Accepting / Holding Public Deposits : The directors are directed to include a statement on the following :

- The public deposits accepted by the NBFC together with other borrowings, namely, issue of unsecured non-convertible debentures/bonds to public, from shareholders and any other deposit not excluded from the definition of the NBFCs Acceptance of Public Deposits Directions, 1998 are within the limits admissible under the provisions of these directions.
- The credit rating for fixed deposits assigned by the rating agency on the specified date is in force, and the aggregate amount of the outstanding deposits at any point of time during the year has exceeded the limit specified by the rating agency.
- The NBFC has defaulted in paying to its depositors the interest and/or principal amount of the deposits after such interest and/or principal became due.
- The NBFC has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts and concentration of credit/investments as specified by the NBFCs Prudential Norms Directions, 1998.
- The CAR as disclosed in the return submitted to the RBI in terms of RBI Prudential Norms Directions, 1998 has been correctly determined and such ratio is in conformity / compliance with the minimum CRAR prescribed by the RBI.
- The NBFC has complied with the liquidity requirements and kept the approved securities with a designated bank.
- The NBFC has furnished to the RBI within the stipulated period the half yearly return on the specified prudential norms and
- The NBFC has furnished to the RBI within the stipulated period the return on deposits as specified in the first schedule to the NBFC Acceptance of Public Deposit Directions, 1998.

In Case of NBFC not Accepting Public Deposits : The auditor's report should also include a statement as to whether (i) The board of directors of the NBFC has passed a resolution for the non-acceptance of any public deposits (ii) the NBFC has accepted any public deposits during the period and (iii) the NBFC has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it.

As regards the IC type of NBFCs which does not accept public deposits and has invest at least 90% of its assets in the securities of its group/holding/subsidiary companies as long term investment, the statement in the auditor's report should mention whether :

i. The BOD has passed a resolution for the non-acceptance of public deposits.
ii. The IC has accepted any public deposit during the relevant period/year.
iii. The NBFC has through a resolution of BOD identified the group/ holding/ subsidiary companies.
iv. The cost of investment in group/ holding/ subsidiary companies is not less than 90 percent of the cost of the total asset of the NBFC/IC at any point of time throughout the accounting period and
v. The IC has continued to hold securities of group/ holding/ subsidiary companies as long term investments and has not traded in those investments during the accounting period / year.

So far we have discussed the norms prescribed by RBI related to NBFCs. For latest information you shall visit various websites (i.e. www.rbi.org.in; www.nic.in, etc) and refer to business dailies and magazines (i.e. The Economic Times, Business Standard, Business World, Business Today, etc.)

For reference following are articles from Journals and Internet.

Investment in India - Banking - Financial Sector & Banking

Financial Sector and Banking:
Continuing reforms in the banking sector were aimed at improving the efficiency and financial strength of commercial banks. Aggregate deposits of the scheduled commercial banks stood at $ 1.48 billion in IFY1997-98, an increase of 15.1 percent.

Net Profits of Commercial Banks
Net profits of scheduled commercial banks rose sharply from $ 24 million in 1995-96 to1.2 billion in 1996-97, an increase of 387 percent. Much of the increase was due to marking government securities to market prices, following significant declines in prevailing interest rates. Three public sector banks received capital restructuring loans from the government totaling $ 68 million in 1997-98, enabling those banks to reach a capital adequacy ratio of 8 percent.

Autonomy Package
In November 1997, the Indian government announced an autonomy package for financially stronger public sector banks to help them compete more efficiently in a liberalized environment

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and to accelerate credit creation. Eleven banks qualified for the autonomy package.

The Criteria for Administrative Autonomy are:

- Capital adequacy of at least 8 percent;
- Net non-performing assets of less than 9 percent;
- Minimum net owned funds of more than $ 2.5 million (Rs 100 crore);
- And a net profit for the last three years.

Banks that meet the four criteria will be given operational freedom in most administrative matters.

RBI Norms for NBFC's

The RBI has relaxed its norms for non-bank finance companies (NBFCs) with regard to taking deposits from the public. It has allowed equipment leasing and hire-purchase finance companies with investment-grade ratings to access public deposits, raised the ceiling on the amount of public deposits these NBFCs may accept and extended the deadline for full compliance on its regulations by two years, until December 2000. The financial viability of many NBFCs continues to be of concern to the government and RBI regulators. There is considerable consolidation activity in this sector as NBFCs adjust to the tougher standards they are being required to meet.

WTO Negotiations on Financial Services:

India made a number of new commitments in the WTO Financial Services agreement concluded in Geneva in December 1997. These modest commitments will come into effect in January 1999.

Major features of India's offer include:

- Granting most favored nation (MFN) status to all foreign banks and financial services companies (including insurance),
- Dropping a previous MFN exemption on banking;
- Granting 12 new bank branch licenses per year to foreign banks (up from the present commitment of 8 per year);
- Lifting the 10 percent ceiling on reinsurance by Indian insurance companies;
- Allowing 51 percent foreign investment in financial consulting, factoring, leasing, venture capital, merchant banking and non-banking finance companies.

Insurance Sector

In addition, 49 percent foreign equity will be allowed in stock brokerages; and foreign financial services companies, including banks, will be allowed to invest venture capital in India up to 51 percent of a company's equity Insurance.

Legality

As part of his 1998-99 budget presentation to Parliament on June 1, the Finance Minister announced his intention to open the insurance sector to competition from Indian private sector companies. He also proposed to convert Insurance Regulatory Authority (IRA) into an independent, statutory body. Both actions will require Parliament to adopt new legislation, including amendments to two Acts which reserve life insurance and general insurance for government owned monopolies.

Foreign Insurance Companies

The government has not yet clarified whether foreign insurance companies will be allowed to participate as minority joint venture partners when the sector is opened up. Many observers believe that the government will allow foreign participation to compensate for a lack of capital and expertise among likely participants in the Indian private sector.

LIC and GIC

The government has granted substantial operational autonomy to the Life Insurance Corporation (LIC) and General Insurance Corporation (GIC), both of which have monopoly positions in their respective sectors under current law. LIC can now appoint fund managers/investment advisors both in India and abroad and is allowed to invest 60 percent of its insurance funds in approved market investments. New measures also provide more lenient investment norms, permission to trade in securities subject to prescribed limits and more delegation of operational powers to the four general insurance subsidiaries of GIC.

Capital Account Convertibility

The *Tarapore* Committee report on Capital Account Convertibility, released in June 1997, recommended a three-year timeframe for complete capital account convertibility of the rupee. The Committee set out the following preconditions for full convertibility:

- Reduction of the fiscal deficit to 3.5 percent of GDP by 1999-2000;
- An average inflation rate of 3-5 percent for the period 1997-2000;
- Complete deregulation of all interest rates in 1997-98;
- A reduction in the cash reserve ratio (CRR) to about 3 percent;
- Reduction in the level of banks' non-performing assets from an estimated 13.7 percent of total loans in March 1997 (actual NPAswere 17.8 percent of total loans) to 5 percent in 1999-2000; and
- The adoption of a transparent exchange rate policy by 2000.

There is a general consensus in government and business community that India should not move to capital account convertibility until these conditions have been met, lest India suffer the kind of currency crisis which hit other Asian countries in 1997.

Top NBFCs have Lesser Cost of Funds than Banks

www.business-standard.com - Business Standard/ Mumbai April 29, 2004.

Crisil, the rating agency, said cost of funds for highly rated non-banking finance companies (NBFCs) is less than that for banks. This means the historical advantage that banks enjoyed over NBFCs where resources are concerned has gradually diminished. Earlier, NBFCs faced a 182 basis points disadvantage in their funding costs vis-a-vis banks' all-inclusive funding cost of 12.75 per cent.

However, the scenario has reversed now with NBFC enjoying a funding cost benefit of 48 basis points vis-a-vis banks' all-inclusive funding cost of 6.53 per cent. In the past, NBFCs had

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a significant disadvantage against banks because of the considerable spread that the latter earned on their deployed assets versus their deposits.

The NBFC business model has strengthened considerably over the past few years in terms of their access to varied funding sources. The growth of the mutual fund industry and the emergence of securitisation as a borrowing tool have helped strengthen the NBFC sector.

A break-up of NBFCs sources of funds shows that in FY 2002-03 non convertible debentures & commercial paper accounted for 47 per cent of the total resources raised as against 39 per cent in FY 1999-2000; fixed deposits — eight per cent (16 per cent); loans from banks and other sources — 45 per cent (unchanged); and securitisation — nine per cent (one per cent). Crisil reasoned that with declining interest rates and falling spreads over G-Sec yields, however, banks funding cost advantage has been wiped out.

This is after factoring in the reduction in the negative carry that banks bear owing to their statutory liquidity ratio and cash reserve ratio investments, which has also fallen because of the decline in opportunity cost of the funds thus deployed, and the operating costs incurred for mobilising their deposits.

"This has contributed in no mean measure in strengthening the business model of these NBFCs," the agency said. In the past, banks have enjoyed an inherent advantage over NBFCs in terms of raising term deposits at relatively lower costs and raising resources through savings and current accounts.

The southward movement in interest rates since FY 1998-99 has had a twofold impact on banks' cost metrics. Not only has the benefit from low-cost current and savings accounts declined but the spreads on their investments in government securities vis-a-vis their cost of term deposits has also declined.

A flavour of numbers for banks' indicates that the cost of term deposits has declined sharply by about 525 basis points since 1999-2000 in line with the declining trend in the yield on G-Secs, while the yield on G-Secs has declined even more by over 650 basis points. The interest on savings accounts has, however, fallen by only 150 basis points in the same period.

Crisil believes that this has reduced the benefit that banks enjoyed by virtue of having access to current and savings accounts by 147 basis points. Of this 94 basis points is because of a reduced benefit from savings accounts while 53 basis points emanates from current accounts.

Banks have also been affected by the higher reduction in yields on the investments in G-Secs vis-a-vis their term deposit costs. Historically, banks enjoyed a positive spread on an incremental basis of about 150 basis points on the yield on their investments in G-Secs (of 8-10 year maturity) over their cost of term deposits (2-3 year maturity).

This spread has been wiped out since the last 18 months, partly because of the high liquidity in money market and partly due to the relatively higher decline in yields on G-Secs over the term deposits. The overall reduction in the banks' gross spreads because of the twin factors of declining interest rates and lower spreads on G-Sec yields is about 297 basis points.

Crisil, however, pointed out that even though the universe of NBFCs rated by it has demonstrated a clear strengthening of their business model, the banking model continues to have several advantages over that of NBFCs. The rating agency believes that a bank's resource base is considerably more stable because of the high proportion of retail deposits in the total funding base.

Moreover, banks have the potential to earn a significant fee income from transaction banking and other services. Banks have cross-selling opportunities to the large retail population that they tap to raise resources.

NBFCs barred from Accepting NRI Deposits

www.business-standard.com - Business Standard / Mumbai April 26,2004.

In another step to stem dollar inflows into the country, the Reserve Bank of India (RBI) on April 24 barred non banking financial companies (NBFCs) from accepting expatriates' deposits made through fresh remittances from abroad. An RBI statement said entities other than banks have been disallowed from accepting deposits made by expatriates from foreign currency and repatriable rupee accounts.

"They will, however, be permitted to continue to hold the existing deposits and also renew such deposits held in the name of the NRIs (non-resident Indians) on repatriation or non-repatriation basis," it added.

Prior to this directive, a company registered under the Companies Act, 1956, or a body corporate created under an Act of Parliament or State Legislature, and NBFCs were also permitted to collect deposits.

According to market players, the latest central bank move is yet another step aimed at discouraging dollar inflows and to cap the rapid appreciation in the rupee, which has gained by about 3.5 per cent against the dollar in 2004.

According to the latest weekly statistical supplement released by the RBI, the country's foreign exchange reserves in the week ended April 16 rose to $117.592 billion against $116.060 billion in the previous week.

The RBI also stated that NBFCs will not be permitted to accept deposits from NRIs by debit to their non-resident external (NRE) or foreign currency non-resident (bank) (FCNR-(B)) accounts.

However, it added that these entities can accept deposits from NRIs by debit to non-resident ordinary (NRO) accounts, provided that the amount deposited with such entities does not represent inward remittances or transfer from NRE / FCNR(B) accounts into this account.

On April 17, the RBI had extended a ceiling on the rate of interest offered by banks and NBFC's on non resident deposits.

Norms on NBFC Exposure to Core Loans Altered

www.business-standard.com - Business Standard August 02,2003.

The Reserve Bank of India today modified the prudential norms applicable to non-banking finance companies (NBFCs) in relation to their exposure to infrastructure loans. It has also

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tightened its norms on classification of non-performing assets in the sub-standard assets category.

The RBI has also allowed NBFCs to exceed exposure norms in single party by 5 per cent and for single group of parties by 10 per cent when additional exposure is on account of infrastructure related loans and investments.

The apex bank has also allowed, all investments by NBFCs in AAA rated securitised paper, pertaining to the infrastructure facility, a lesser risk weight of 50 per cent instead of 100 per cent.

The RBI has said that a non-performing asset (NPA) will be classified in sub-standard category for a period of only 18 months, instead of the present norm of 24 months, from the date it is recognised as NPA.

It has also added that the asset will be classified as a a doubtful asset, after an asset has remained in sub-standard category for 18 months, as against the present norm of 24 months. The RBI specified that for the purpose of encouraging NBFCs to grant infrastructure loans, when infrastructure loans granted by NBFCs are restructured or renegotiated or rescheduled before the assets have been classified as sub-standard, they can continue to be classified as standard assets, subject to certain conditions.

RBI has also pointed that the long-term financing of infrastructure projects may lead to asset- liability mismatches, particularly when such financing is not in conformity with the maturity profile of the NBFCs' liabilities.

The NBFCs would, therefore, need to exercise due vigil on their asset-liability position to ensure that they do not run into liquidity mismatches on account of lending to such projects, the RBI added. It also pointed that timely and adequate availability of credit is the pre-requisite for successful implementation of infrastructure projects.

"Multiplicity of appraisals by every institution involved in financing, leading to delays, has to be avoided and the NBFCs should be prepared to broadly accept technical parameters laid down by leading public financial institutions. Also, setting up a mechanism for an ongoing monitoring of the project implementation will ensure that the credit disbursed is utilised for the purpose for which it was sanctioned," said RBI.

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LESSON 6:
NON-BANKING FINANCIAL COMPANIES (NBFC)

Lesson Objectives

- To understand the RBI Prudential Norms.
- Norms related to Auditors' Report.

RBI NBFCS Prudential Norms Directions

Pursuant to the recommendations of the Narsimham Committee and Shah committee, the RBI had prescribed with effect from April, 1993, prudential norms for all types of financial companies with NOF of Rs. 50 Lakh and above, which had to be compulsorily registered with it. In the public interest and to regulate the credit system to the advantage of the country, in exercise of the powers conferred by section 45 JA of the amended RBI Act, the RBI issued directions w.e.f. January 31, 1998; NBFCs Prudential Norms Directions, 1998. These provisions for directions apply to all NBFCs excluding MBFCs with a NOF of Rs. 25 Lakh and above and accepting/holding public deposits.

These norms can be divided into two categories : (i) norms applicable to only those NBFCs which are accepting / holding public deposits and (ii) norms applicable to all NBFCs, irrespective of whether they accept / hold public deposits or not. Let us discuss both the norms one by one.

Prudential norms applicable to only those NBFCs which accept/hold public deposits: These norms are mainly concerned with safety of public funds.

1. Capital to Risk Assets Ratio (CRAR) : The NBFCs holding/accepting public deposits are required to maintain CRAR as under -

i. EL/HPF companies with MIG credit rating	- 12 percent
ii. EL/HPF companies without MIG credit rating	- 15 percent
iii. Loan/Investment companies	- 15 percent
iv. RNBCs	- 12 percent

CRAR comprises of tier I and tier II capital, to be maintained on a daily basis and not merely on the reporting dates. Tier I capital consists of NOF (core capital) but includes compulsorily convertible preference shares as a special case for CRAR purpose. Tier II capital is all quasi capital like preference shares (other than CCPS), subordinated debt, convertible debentures and so on. Tier II capital should not exceed Tier I capital. General provisions and loss reserves not to exceed 1.25 percent of the risk weighted assets. Subordinated debt is issued with original tenure of 60 months or more.

Restrictive Norms : If a company does not comply fully with the prudential norms it is not allowed to accept/hold public deposits. If any NBFC defaults in repayment of matured deposits, it is prohibited from creating any further assets until the defaults are rectified. NBFCs cannot invest more than 10% of owned funds in real estate (except for its own use). They are also restricted to invest in unquoted shares to following extent (i) EL/HPF companies 10% of NOF and (ii) LC/ICs 20% of NOF.

Concentration of Credit/ Investments : The NBFCs accepting/holding public deposits cannot lend to any single borrower and single group of borrowers in excess of 15 and 25 percent of their owned funds respectively. The ceiling on investment in shares of another company and a single group of company is the same. The permissible ceiling on loans and investments taken together is 25% to a single party and 40% to single group of parties. For determining these limits, off-balance sheet exposure should be converted into credit risk by applying the appropriate conversion factors. The investments in debentures should be treated as credit and not investment for the purpose of determining the concentration of credit. Moreover, the ceiling on credit/ investment would be applicable to the own group of the NBFCs as well as to the other group of borrowers/investing companies.

The above ceilings on credit/investment concentration are not applicable to RNBCs in respect of investment in approved securities, bonds, debentures and other securities issued by the Government company / public financial institution / bank.

Half yearly returns : NBFCs accepting /holding public deposits must submit their half yearly returns in prescribed format at the end of March and September, every year, within 3 months from the due date. Such returns may or may not be audited, but the figures must be certified by the auditors of the company.

Prudential norms applicable to all NBFCs, irrespective of whether they accept/hold public deposits or not: These norms are mainly concerned with working of the companies.

Income recognition norms : The recognition of income on NPA (non-performing assets) is allowed on cash basis only. The unrealized income recognized earlier is required to be reversed.

NPA norms : Recognition of income on accrual basis before the asset becomes NPA as under : Loans and Advances – up to 6 months and 30 days past due period (past due period done away with effect from March 31, 2003), Lease & HPF – 12 months.

Restrictive norms : NBFCs are not allowed to advance loans/ credit against their own shares.

Accounting standards : All the Accounting Standards and Guidance Notes issued by Institute of Chartered Accountants of India (ICAI) are applicable to all NBFCs, in so far as they are not inconsistent with the guidelines of RBI.

Accounting for investments : All NBFCs to have a well defined investment policy. The investments are classified into two categories (i) long-term investments and (ii) current

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investments. Long-term investments are to be valued as per AS-13 of ICAI. Current investments are further classified into (a) quoted and (b) unquoted.

Current quoted investments are valued at lower of cost or market value. Block valuation permitted for quoted investments, notional gains or losses within the block are permitted to be netted, but not inter-block, net notional gains to be ignored but notional losses to be provided for.

Valuation norms for current unquoted investment are as under:

a. Equity shares – at lower of cost or break up value or fair value.
b. Rs. 1 for the entire block of holding if the balance sheet of the investee company is not available for last two years.
c Preference shares at lower of cost or face value
d. Government securities at carrying cost
e. Mutual fund units at net asset value (NAV) for each scheme and
f. Commercial Paper (CP) at its carrying cost.

Asset classification : The NBFCs are required to classify all forms of credit (including receivables) to be classified into four categories, i.e. (i) Standard (ii) Sub-standard (iii) Doubtful and (iv) Loss asset.

Standard Asset : An asset in respect of which no default in repayment of principal or payment of interest is perceived and which does not disclose any problems nor carry more than normal risk attached to the business.

Sub-standard Asset : Sub standard asset is one (i) which has been classified as NPA for a period not exceeding two years, (ii) where the terms of the agreement regarding interest and/or principal have been renegotiated or rescheduled after the commencement of operations until the expiry of one year of satisfactory performance under the renegotiated/ rescheduled terms.

Doubtful Asset : A doubtful asset means term loan/ leased asset/ hire-purchase asset/ any other asset which remains sub-standard asset for a period exceeding two years.

Loss Asset : A loss asset is one where loss has been identified by the NBFC or internal or external auditors or the RBI inspection to the extent the amount has not been written off, wholly. Alternatively, it may be an asset which is adversely affected by a potential threat of non-recoverability due to, either erosion in the value of the security/ non-availability of security or any fraudulent act/ omission on the part of the borrower.

Provisions for NPA – Loans and Advances : All NBFCs are required to provide for various assets as following :

Sub standard assets :	10% of outstanding balance
Doubtful assets :	20% (doubtful up to 1 year) of O/s balance
	30% (doubtful 1 to 3 years)
	50% (doubtful more than 3 years)
Loss Assets :	100% of the outstanding balance

Provision for NPA : EL & HP : Unsecured portion to be fully provided for. Further provision on net book value (NBV) of EL/HP assets. Accelerated additional provisions against NPAs as per following rates :

NPA for 1 to 2 years	10% of NBV
NPA for 2 to 3 years	40% of NBV
NPA for 3 to 4 years	70% of NBV
NPA for more than 4 years	100% of NBV

Value of any other security considered only against additional provisions. Rescheduling in any manner will not upgrade the asset up to 12 months of satisfactory performance under the new terms. Repossessed assets to be treated in the same category of NPA or own assets option lies with the company.

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ii. The provisions shall be distinctly indicated under separate heads of accounts as under
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    b. Provisions for depreciation in investments.
iii. Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the NBFC
iv. Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general provisions and loss reserves may be written back without making adjustment against them.

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iii. Use of Market Intelligence System.
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Now lets us discuss the Directions given by RBI related to Auditors Report. W.e.f. January 31, 1998, RBI has given

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- Has applied for registration with the RBI
- Is incorporated before January 9, 1997.
- Has received any communication about grant/refusal of COR and
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In case of NBFCs Accepting / Holding Public Deposits : The directors are directed to include a statement on the following :

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- The credit rating for fixed deposits assigned by the rating agency on the specified date is in force, and the aggregate amount of the outstanding deposits at any point of time during the year has exceeded the limit specified by the rating agency.
- The NBFC has defaulted in paying to its depositors the interest and/or principal amount of the deposits after such interest and/or principal became due.
- The NBFC has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts and concentration of credit/investments as specified by the NBFCs Prudential Norms Directions, 1998.
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- The NBFC has complied with the liquidity requirements and kept the approved securities with a designated bank.
- The NBFC has furnished to the RBI within the stipulated period the half yearly return on the specified prudential norms and
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As regards the IC type of NBFCs which does not accept public deposits and has invest at least 90% of its assets in the securities of its group/holding/subsidiary companies as long term investment, the statement in the auditor's report should mention whether :

i. The BOD has passed a resolution for the non-acceptance of public deposits.

ii. The IC has accepted any public deposit during the relevant period/year.

iii. The NBFC has through a resolution of BOD identified the group/ holding/ subsidiary companies.

iv. The cost of investment in group/ holding/ subsidiary companies is not less than 90 percent of the cost of the total asset of the NBFC/IC at any point of time throughout the accounting period and

v. The IC has continued to hold securities of group/ holding/ subsidiary companies as long term investments and has not traded in those investments during the accounting period / year.

So far we have discussed the norms prescribed by RBI related to NBFCs. For latest information you shall visit various websites (i.e. www.rbi.org.in; www.nic.in, etc) and refer to business dailies and magazines (i.e. The Economic Times, Business Standard, Business World, Business Today, etc.)

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LESSON 7:
LATEST RBI / MINISTRY OF FINANCE GUIDELINES FOR NBFCS

Lesson Objectives

- To understand the latest regulatory norms and rules for NBFCs.
- To learn legal restrictions on NBFCs and latest rulings by courts in this regards.

This lesson is combination of two activities :

1. A small group of 7-8 students will be made and each group is required to
   a. Collect latest RBI / MOF guidelines related to NBFCs,
   b. Collect latest court decisions related to NBFC cases.
2. A presentation by each group on their findings.

To achieve the lesson objective you are required to search business magazines, financial dailies and internet (websites of Ministry of Finance, RBI, Supreme Court etc) and prepare an assignment in approx 500 words. You can also contact Financial and Legal advisors in your city / in your contact to collect the information.

Each group shall base the presentation on findings. You are advised to make use of audio visual devices and computers to give an effective presentation.

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LESSON 8:
TUTORIAL

Lesson Objectives

- To help clear all doubts and difficulties on the topics so far covered.
- To provide the students extra input in form discussion and problem solving.

To achieve the lesson objective, you are advised to come prepared with all your problems, doubts and difficulties on the topics discussed so far and an open discussion will be conducted so that the faculty as well as your classmates clears all your doubts.

For reference following are articles from Journals and Internet.

www.indiamark.com

Investment in India - Banking - Financial Sector and Banking

Financial Sector and Banking

Continuing reforms in the banking sector were aimed at improving the efficiency and financial strength of commercial banks. Aggregate deposits of the scheduled commercial banks stood at $ 1.48 billion in IFY1997-98, an increase of 15.1 percent.

Net Profits of Commercial Banks

Net profits of scheduled commercial banks rose sharply from $ 24 million in 1995-96 to1.2 billion in 1996-97, an increase of 387 percent. Much of the increase was due to marking government securities to market prices, following significant declines in prevailing interest rates. Three public sector banks received capital restructuring loans from the government totaling $ 68 million in 1997-98, enabling those banks to reach a capital adequacy ratio of 8 percent.

Autonomy Package

In November 1997, the Indian government announced an autonomy package for financially stronger public sector banks to help them compete more efficiently in a liberalized environment and to accelerate credit creation. Eleven banks qualified for the autonomy package.

The criteria for administrative autonomy are:

- capital adequacy of at least 8 percent;
- net non-performing assets of less than 9 percent;
- minimum net owned funds of more than $ 2.5 million (Rs 100 crore);
- and a net profit for the last three years.

Banks that meet the four criteria will be given operational freedom in most administrative matters.

RBI Norms for NBFC's

The RBI has relaxed its norms for non-bank finance companies (NBFCs) with regard to taking deposits from the public. It has allowed equipment leasing and hire-purchase finance companies with investment-grade ratings to access public deposits, raised the ceiling on the amount of public deposits these NBFCs may accept and extended the deadline for full compliance on its regulations by two years, until December 2000. The financial viability of many NBFCs continues to be of concern to the government and RBI regulators. There is considerable consolidation activity in this sector as NBFCs adjust to the tougher standards they are being required to meet.

Wto Negotiations on Financial Services

India made a number of new commitments in the WTO Financial Services agreement concluded in Geneva in December 1997. These modest commitments will come into effect in January 1999.

Major Features of India's Offer Include

- granting most favored nation (MFN) status to all foreign banks and financial services companies (including insurance),
- dropping a previous MFN exemption on banking;
- granting 12 new bank branch licenses per year to foreign banks (up from the present commitment of 8 per year);
- lifting the 10 percent ceiling on reinsurance by Indian insurance companies;
- allowing 51 percent foreign investment in financial consulting, factoring, leasing, venture capital, merchant banking and non-banking finance companies.

Insurance Sector

In addition, 49 percent foreign equity will be allowed in stock brokerages; and foreign financial services companies, including banks, will be allowed to invest venture capital in India up to 51 percent of a company's equity Insurance.

Legality

As part of his 1998-99 budget presentation to Parliament on June 1, the Finance Minister announced his intention to open the insurance sector to competition from Indian private sector companies. He also proposed to convert Insurance Regulatory Authority (IRA) into an independent, statutory body. Both actions will require Parliament to adopt new legislation, including amendments to two Acts which reserve life insurance and general insurance for government owned monopolies.

Foreign Insurance Companies

The government has not yet clarified whether foreign insurance companies will be allowed to participate as minority joint venture partners when the sector is opened up. Many observers believe that the government will allow foreign participation to compensate for a lack of capital and expertise among likely participants in the Indian private sector.

LIC and GIC

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The government has granted substantial operational autonomy to the Life Insurance Corporation (LIC) and General Insurance Corporation (GIC), both of which have monopoly positions in their respective sectors under current law. LIC can now appoint fund managers/investment advisors both in India and abroad and is allowed to invest 60 percent of its insurance funds in approved market investments. New measures also provide more lenient investment norms, permission to trade in securities subject to prescribed limits and more delegation of operational powers to the four general insurance subsidiaries of GIC.

Capital Account Convertibility

The Tarapore Committee report on Capital Account Convertibility, released in June 1997, recommended a three-year timeframe for complete capital account convertibility of the rupee. The Committee set out the following preconditions for full convertibility:

- Reduction of the fiscal deficit to 3.5 percent of GDP by 1999-2000;
- An average inflation rate of 3-5 percent for the period 1997-2000;
- Complete deregulation of all interest rates in 1997-98;
- Reduction in the level of banks' NPAs from an estimated 13.7% of total loans in March'97 (actual NPAs were 17.8% of total loans) to 5% in 1999-2000; and
- A reduction in the cash reserve ratio (CRR) to about 3 percent;
- The adoption of a transparent exchange rate policy by 2000.

There is a general consensus in government and business community that India should not move to capital account convertibility until these conditions have been met, lest India suffer the kind of currency crisis which hit other Asian countries in 1997.

Top NBFCS have Lesser Cost of Funds Than Banks

www.business-standard.com - Business Standard/ Mumbai April 29, 2004

Crisil, the rating agency, said cost of funds for highly rated non-banking finance companies (NBFCs) is less than that for banks. This means the historical advantage that banks enjoyed over NBFCs where resources are concerned has gradually diminished. Earlier, NBFCs faced a 182 basis points disadvantage in their funding costs vis-a-vis banks' all-inclusive funding cost of 12.75 per cent.

However, the scenario has reversed now with NBFC enjoying a funding cost benefit of 48 basis points vis-a-vis banks' all-inclusive funding cost of 6.53 per cent. In the past, NBFCs had a significant disadvantage against banks because of the considerable spread that the latter earned on their deployed assets versus their deposits.

The NBFC business model has strengthened considerably over the past few years in terms of their access to varied funding sources. The growth of the mutual fund industry and the emergence of securitisation as a borrowing tool have helped strengthen the NBFC sector.

A break-up of NBFCs sources of funds shows that in FY 2002-03 non convertible debentures & commercial paper accounted for 47 per cent of the total resources raised as against 39 per cent in FY 1999-2000; fixed deposits — eight per cent (16 per cent); loans from banks and other sources — 45 per cent (unchanged); and securitisation — nine per cent (one per cent). Crisil reasoned that with declining interest rates and falling spreads over G-Sec yields, however, banks funding cost advantage has been wiped out.

This is after factoring in the reduction in the negative carry that banks bear owing to their statutory liquidity ratio and cash reserve ratio investments, which has also fallen because of the decline in opportunity cost of the funds thus deployed, and the operating costs incurred for mobilising their deposits.

"This has contributed in no mean measure in strengthening the business model of these NBFCs," the agency said. In the past, banks have enjoyed an inherent advantage over NBFCs in terms of raising term deposits at relatively lower costs and raising resources through savings and current accounts.

The southward movement in interest rates since FY 1998-99 has had a twofold impact on banks' cost metrics. Not only has the benefit from low-cost current and savings accounts declined but the spreads on their investments in government securities vis-a-vis their cost of term deposits has also declined.

A flavour of numbers for banks' indicates that the cost of term deposits has declined sharply by about 525 basis points since 1999-2000 in line with the declining trend in the yield on G-Secs, while the yield on G-Secs has declined even more by over 650 basis points. The interest on savings accounts has, however, fallen by only 150 basis points in the same period.

Crisil believes that this has reduced the benefit that banks enjoyed by virtue of having access to current and savings accounts by 147 basis points. Of this 94 basis points is because of a reduced benefit from savings accounts while 53 basis points emanates from current accounts.

Banks have also been affected by the higher reduction in yields on the investments in G-Secs vis-a-vis their term deposit costs. Historically, banks enjoyed a positive spread on an incremental basis of about 150 basis points on the yield on their investments in G-Secs (of 8-10 year maturity) over their cost of term deposits (2-3 year maturity).

This spread has been wiped out since the last 18 months, partly because of the high liquidity in money market and partly due to the relatively higher decline in yields on G-Secs over the term deposits. The overall reduction in the banks' gross spreads because of the twin factors of declining interest rates and lower spreads on G-Sec yields is about 297 basis points.

Crisil, however, pointed out that even though the universe of NBFCs rated by it has demonstrated a clear strengthening of their business model, the banking model continues to have several advantages over that of NBFCs. The rating agency believes that a bank's resource base is considerably more stable because of the high proportion of retail deposits in the total funding base.

Moreover, banks have the potential to earn a significant fee income from transaction banking and other services. Banks

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have cross-selling opportunities to the large retail population that they tap to raise resources.

Nbfcs Barred From Accepting NRI Deposits

www.business-standard.com - Business Standard / Mumbai April 26,2004

In another step to stem dollar inflows into the country, the Reserve Bank of India (RBI) on April 24 barred non banking financial companies (NBFCs) from accepting expatriates' deposits made through fresh remittances from abroad. An RBI statement said entities other than banks have been disallowed from accepting deposits made by expatriates from foreign currency and repatriable rupee accounts.

"They will, however, be permitted to continue to hold the existing deposits and also renew such deposits held in the name of the NRIs (non-resident Indians) on repatriation or non-repatriation basis," it added.

Prior to this directive, a company registered under the Companies Act, 1956, or a body corporate created under an Act of Parliament or State Legislature, and NBFCs were also permitted to collect deposits.

According to market players, the latest central bank move is yet another step aimed at discouraging dollar inflows and to cap the rapid appreciation in the rupee, which has gained by about 3.5 per cent against the dollar in 2004.

According to the latest weekly statistical supplement released by the RBI, the country's foreign exchange reserves in the week ended April 16 rose to $117.592 billion against $116.060 billion in the previous week.

The RBI also stated that NBFCs will not be permitted to accept deposits from NRIs by debit to their non-resident external (NRE) or foreign currency non-resident (bank) (FCNR-(B)) accounts.

However, it added that these entities can accept deposits from NRIs by debit to non-resident ordinary (NRO) accounts, provided that the amount deposited with such entities does not represent inward remittances or transfer from NRE / FCNR(B) accounts into this account.

On April 17, the RBI had extended a ceiling on the rate of interest offered by banks and NBFC's on non resident deposits.

Norms on NBFC Exposure to Core Loans Altered

www.business-standard.com - Business Standard August 02,2003

The Reserve Bank of India today modified the prudential norms applicable to non-banking finance companies (NBFCs) in relation to their exposure to infrastructure loans. It has also tightened its norms on classification of non-performing assets in the sub-standard assets category.

The RBI has also allowed NBFCs to exceed exposure norms in single party by 5 per cent and for single group of parties by 10 per cent when additional exposure is on account of infrastructure related loans and investments.

The apex bank has also allowed, all investments by NBFCs in AAA rated securitised paper, pertaining to the infrastructure facility, a lesser risk weight of 50 per cent instead of 100 per cent.

The RBI has said that a non-performing asset (NPA) will be classified in sub-standard category for a period of only 18 months, instead of the present norm of 24 months, from the date it is recognised as NPA.

It has also added that the asset will be classified as a a doubtful asset, after an asset has remained in sub-standard category for 18 months, as against the present norm of 24 months. The RBI specified that for the purpose of encouraging NBFCs to grant infrastructure loans, when infrastructure loans granted by NBFCs are restructured or renegotiated or rescheduled before the assets have been classified as sub-standard, they can continue to be classified as standard assets, subject to certain conditions.

RBI has also pointed that the long-term financing of infrastructure projects may lead to asset- liability mismatches, particularly when such financing is not in conformity with the maturity profile of the NBFCs' liabilities.

The NBFCs would, therefore, need to exercise due vigil on their asset-liability position to ensure that they do not run into liquidity mismatches on account of lending to such projects, the RBI added. It also pointed that timely and adequate availability of credit is the pre-requisite for successful implementation of infrastructure projects.

"Multiplicity of appraisals by every institution involved in financing, leading to delays, has to be avoided and the NBFCs should be prepared to broadly accept technical parameters laid down by leading public financial institutions. Also, setting up a mechanism for an ongoing monitoring of the project implementation will ensure that the credit disbursed is utilised for the purpose for which it was sanctioned," said RBI.

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LESSON 9:
THEORETICAL AND REGULATORY

Lesson Objectives

- To understand the Concept of Lease Financing,
- Regulations related to Leasing,
- Documentation, Taxation and Reporting of Lease.

Introduction

Among the various methods of customer credit, lease financing is one of the very important methods. In developing economies it provides a safe mode of financing, where customer gets the equipment he requires, and the financer has the safety through ownership of the equipment. Now let us discuss in detail various aspects of leasing.

Meaning: Lease is a contractual arrangement / transaction in which a party (lessor) owning an asset / equipment provides the asset for use to another party / transfer the right to use the equipment to the user (lessee) over a certain / for an agreed period of time for consideration in form of / in return for periodic payments / rental with or without a further payment (premium). At the end of the contract period (lease period) the asset / equipment is returned to the lessor.

It is a method of financing the cost of an asset. It is a contract in which a specific equipment required by the lessee is purchased by the lessor (financier) from a manufacturer / vendor selected by the lessee. The lessee has the possession and use of an asset on payment of the specified rental over a pre-determined time. Lease financing is, thus a device of financing / money lending. The real function of lessor is not renting of asset but lending of funds or financing or extending credit to the borrower.

Main characteristics of lease financing can be explained as following:

Parties to Contract: There are essentially two parties to the contract of leasing i.e. financer (or owner - Lessor) and user (lessee). Also, there could be lease-broker who works as an intermediary in arranging lease finance deals, in case of exposure to large funds. Apart from above three there are some times lease-financers also, who refinances to the lessor (owner).

Ownership Separated from User: The essence of a lease finance deal is that during the lease-period, the ownership of assets vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

Lease Rentals: The consideration which the lessee pays to the lessor for the lease transaction is the lease rental. The lease rentals are so structure as to compensate the lessor the investment made in the asset (in the form of depreciation), the interest on the investment, repairs and so forth, borne by the lessor, and servicing chares over the lease period.

Term of lease: The term of lease is the period for which the agreement of lease remains in operations. Every lease should have a definite period otherwise it will be legally inoperative. The lease can be renewed after expiry of the term.

Classification of Lease: A lease contract can be classified on various characteristics in following categories:

A. Finance Lease and Operating Lease
B. Sales & Lease back and Direct Lease
C. Single investor and Leveraged lease
D. Domestic and International lease

Finance Lease: A Finance lease is mainly an agreement for just financing the equipment / asset, through a lease agreement. The owner / lessor transfers to lessee substantially all the risks and rewards incidental to the ownership of the assets (except for the title of the asset). In such leases, the lessor is only a financier and is usually not interested in the assets. These leases are also called "Full Payout Lease" as they enable a lessor to recover his investment in the lease and derive a profit. Finance lease are mainly done for such equipment / assets where its full useful / economic life is normally utilized by one user – i.e. Ships, aircrafts, wagons etc.

Generally a finance lease agreement comes with an option to transfer of ownership to lessee at the end of the lease period. Normally lease period is the major part of economic life of the asset.

Operating Lease: An operating lease is one in which the lessor does not transfer all risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period. The operating lease is normally for such assets which can be used by different users without major modification to it. The lessor provides all the services associated with the assets, and the rental includes charges for these services. The lessor is interested in ownership of asset / equipment as it can be lent to various users, during its economic life. Examples of such lease are Earth moving equipments, mobile cranes, computers, automobiles etc.

Sale and Lease Back: In this type of lease, the owner of an equipment / asset sells it to a leasing company (lessor) which leases it back to the owner (lessee).

Direct Lease: In direct lease, the lessee and the owner of the equipment are two different entities. A direct lease can be of two types: Bipartite and Tripartite lease.

Bipartite lease: There are only two parties in this lease transaction, namely (i) Equipment supplier-cum-financer (lessor) and (ii) lessee. The lessor maintains the assets and if necessary, replace it with a similar equipment in working condition.

Tripartite lease: In such lease there are three different parties (i) Equipment supplier (ii) Lessor (financier) and (iii) Lessee. In such leases sometimes the supplier ties up with financiers to provide financing to lessee, as he himself is not in position to do so.

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Single investor lease: This is a bipartite lease in which the lessor is solely responsible for financing part. The funds arranged by the lessor (financier) have no recourse to the lessee.

Leveraged lease: This is a different kind of tripartite lease in which the lessor arranges funds from another party linking the lease rentals with the arrangement of funds. In such lease, the equipment is part financed by a third party (normally through debt) and a part of lease rental is directly transferred to such lender towards the payment of interest and installment of principal.

Domestic Lease: A lease transaction is classified as domestic if all the parties to such agreement are domiciled in the same country.

International Lease: If the parties to a lease agreement domiciled in different countries, it is known as international lease. This lease can be further classified as (i) Import lease and (ii) cross border lease.

Import lease: In an import lease, the lessor and the lessee are domiciled in the same country, but the equipment supplier is located in a different country. The lessor imports the assets and leases it to the lessee.

Cross border lease: When the lessor and lessee are domiciled in different countries, it is known as cross border lease. The domicile of asset supplier is immaterial.

Advantages of Leasing

Leasing offers advantages to all the parties associated with the agreement. These advantages can be grouped as (i) Advantages to Lessee (ii) Advantages to lessor.

Advantages to the Lessee: The lease financing offers following advantages to the lessee:

Financing of Capital Goods: Lease financing enables the lessee to have finance for huge investments in land, building, plant & machinery etc., up to 100%, without requiring any immediate down payment.

Additional Sources of Funds: Leasing facilitates the acquisition of equipments/ assets without necessary capital outlay and thus has a competitive advantage of mobilizing the scarce financial resources of the business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

Less costly: Leasing as a method of financing is a less costly method than other alternatives available.

Ownership preserved: Leasing provides finance without diluting the ownership or control of the promoters. As against it, other modes of long-term finance, e.g. equity or debentures, normally dilute the ownership of the promoters.

Avoids conditionality: Lease finance is considered preferable to institutional finance, as in the former case, there are no strings attached. Lease financing is beneficial since it is free from restrictive covenants and conditionality, such as representation on board etc.

Flexibility in structuring rental: The lease rentals can be structured to accommodate the cash flow situation of the lessee, making the payment of rentals convenient to him. The lease rentals are so tailor made that the lessee is bale to pays the rentals from the funds generated from operations.

Simplicity: A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation.

Tax Benefit: By suitable structuring of lease rentals a lot of tax advantages can be derived. If the lessee is in tax paying position, the rental may be increased to lower his taxable income. The cost of asset is thus amortized faster to than in a case where it is owned by the lessee, since depreciation is allowable at the prescribed rates.

Obsolescence risk is averted: In a lease arrangement the lessor being the owner bears the risk of obsolescence and the lessee is always free to replace the asset with latest technology.

Advantage to the Lessor: A lease agreement offers various advantages to lessor as well. Let us discuss those advantages one by one.

Full security: The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset in case of default by the lessee.

Tax benefit: The greatest advantage to the lessor is the tax relief by way of depreciation.

High profitability: The leasing business is highly profitable, since the rate of return is more than what the lessor pays on his borrowings. Also the rate of return is more than in case of lending finance directly.

Trading on equity: The lessor usually carry out their business with high financial leverage, depending more on debt fund rather equity.

High growth potential: The leasing industry has a high growth potential. Lease financing enables the lessee to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital.

Limitations of Leasing

On one hand leasing offers various advantages to both lessor and lessee, but on the other hand it also has some limitations. Now let us try to visualize these limitations.

Restrictions on use of limitations: Under a lease agreement, sometimes restrictions are imposed related to uses, alteration and additions to asset even though it may be essential for the lessee.

Limitations of Financial Lease: A financial lease may entail a higher payout obligations, if the equipment is found not useful and the lessee opts for premature termination of the lease. Besides, the lessee is not entitled to the protection of express or implied warranties since he is not the owner of the asset.

Loss of Residual Value: The lessee never becomes the owner of the leased asset. Thus, he is deprived of the residual value of the asset and is not even entitled to any improvements done by the lessee or caused by inflation or otherwise, such as appreciation in value of leasehold land.

Consequences of Default: If the lessee defaults in complying with any terms and conditions of the lease contract, the lessor may terminate the lease and take over the possession of the

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leased asset. In case of finance lease, the lessee may be required to pay for damages and accelerated rental payments.

Understatement of Lessee's assets: Since the leased asset do not form part of lessee's assets, there is an effective understatement of his assets, which may sometimes lead to gross underestimation of the lessee. However, there is now an accounting practice to disclose the leased assets by way of footnote to the balance sheet.

Double sales tax: With the amendment of sales tax law of various states, a lease financing transaction may be charged to sales-tax twice – once when the lessor purchases the equipment and again when it is leased to the lessee.

Regulatory Framework of Leasing in India

As such there is no separate law regulating lease agreements, but it being a contract, the provisions of The Indian Contract Act, 1872 are applicable to all lease contracts. There are certain provisions of law of contract, which are specifically applicable to leasing transactions. Since lease also involves motor vehicles, provisions of the Motor Vehicles Act are also applicable to specific lease agreements. Lease agreements are also subject to Indian Stamp Act.

We will discuss in short main provisions of The Indian Contract Act, 1872 related to leasing.

Contract: A contract is an agreement enforceable by law. The essential elements of a valid contract are – Legal obligation, lawful consideration, competent parties, free consent and not expressly declared void.

Discharge of Contracts: A contract me by discharged in following ways – By performance, by frustration (impossibility of performance), by mutual agreement, by operation of law and by remission.

Remedies for Breach of Contract: Non-performance of a contract constitutes a breach of contract. When a party to a contract has refused to perform or is disabled from performing his promise, the other party may put an end to the contract on account of breach by the other party. The remedies available to the aggrieved party are – Damages or compensations, specific performance, suit for injunction (restrain from doing an act), suit for *Quantum Meruit* (claim for value of the material used).

Provisions Related to Indemnity and Guarantee: The provisions contained in the Indian Contract Act, 1872 related to indemnity and guarantee are related to lease agreements. Main provisions are as under –

Indemnity: A contract of indemnity is one whereby a person promises to make good the loss caused to him by the conduct of the promisor himself or any third person. For example, a person executes an indemnity bond favoring the lessor thereby agreeing to indemnify him of the loss of rentals, cost and expenses that the lessor may be called upon to incur on account of lease of an asset to the lessee. The person who gives the indemnity is called the 'indemnifier' and the person for whose protection it is given is called the 'indemnity-holder' or 'indemnified'.

In case of lease agreements, there is an implied contact of indemnity, where lessee will have to make good any loss caused to the asset by his conduct or by the act of any other person, during the lease term.

Guarantee: A contract of guarantee is a contract, whether oral or written, to perform the promise or discharge the liability or a third person in case of his default. A contract of guarantee involves three persons – 'surety' who gives guarantee, principal debtor and creditor. A contract of guarantee is a conditional promise by the surety that if the debtor defaults, he shall be liable to the creditor.

Bailment: The provisions of the law of contract relating to bailment are specifically applicable to leasing contracts. In fact, leasing agreement is primarily a bailment agreement, as the main elements of the two types of transactions are similar. They are:

i. There are minimum two parties to a bailment i.e. bailor – who delivers the goods and bailee – to whom the goods are delivered for use. The lessor and lessee in a lease contract are bailor and bailee respectively.
ii. There is delivery of possessions/transfer of goods from the bailor to the bailee. The ownership of the goods remains with the bailor.
iii. The goods in bailment should be transferred for a specific purpose under a contract.
iv. When the purpose is accomplished the goods are to be returned to the bailor or disposed off according to his directions.

Hence lease agreements are essentially a type of bailment. Following are the main provisions related to lease.

Liabilities of Lessee: A lessee is responsible to take reasonable care of the leased assets. He should not make unauthorized use of the assets. He should return the goods after purpose is accomplished. He should pay the lease rental when due and must insure & repair the goods.

Liabilities of Lessor: A lessor is responsible for delivery of goods to lessee. He should take back the possession of goods when due. He must disclose all defects in the assets before leasing. He must ensure the fitness of goods for proper use.

Remedies for Breach of Contract

In case of breach of contract various remedies are available to aggrieved party. They are as following:

Remedies to the lessor: The lessor can forfeit the assets and can claim damages in case of breach by lessee. The lessor can take repossession of the assets in case of any breach by the lessee.

Remedies to the lessee: Where the contract is repudiated for lessor's breach of any obligation, the lessee may claim damages for less resulting from termination. The measure of damages is the increased lease rentals (if any) the lessee has to pay on lease of other asset, plus the damages for depriving him from the use of the leased asset from the date of termination of the date of expiry of lease term.

Sub-lease of a Leased Asset: The lessee must not do any act, which is not consistent with the terms of the lease agreement. Lease agreements, generally, expressly exclude the right to sub-lease the leased asset. Thus, one should not sub-lease the leased assets, unless the lease agreement expressly provides.

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Effect of sub-lease: The effect of a valid sub-lease is that the sub-lease becomes a lease of the original lessor as well. The sub-lease and the original lessor have the same right and obligations against each other as between any lessee and lessor.

Effect of termination of Main lease: A right to sub-lease is restricted to the operation of the main lease agreement. Thus, termination of the main lease will automatically terminate the sub-lease. This may create complications for sub-lessee.

So far we have discussed the main provisions related to The Indian Contract Act, 1872. Now let us discuss the other laws related to leasing.

Motor Vehicles Act: Under this act, the lessor is regarded as dealer and although the legal ownership vests in the lessor, the lessee is regarded owner as the owner for purposes or registration of the vehicle under the Act and so on. In case of vehicle financed under lease/hire purchase/hypothecation agreement, the lessor is treated as financier.

Indian Stamp Act: The Act requires payment of stamp duty on all instruments/ documents creating a right/ liability in monetary terms. The contracts for equipment leasing are subject to stamp duty, which varies from state to state.

RBI NBFCs Directions: RBI Controls mainly working of Leasing Finance Companies. It does, not in any manner, interfere with the leasing activity.

Lease Documentation and Agreement

A lease transaction involves a lot of formalities and various documents. The lease agreements have to be properly documented to formalize the deal between the parties and to bind them. Documentation is necessary to overcome any sort of confusion in future. It is also legally required, since it involves payment of stamp duty. Without proper documentation, it will be very difficult to prove your claim in competent court, in case of any dispute.

The essential requirements of documentation of lease agreements are that the person(s) executing the document should have the legal capacity to do so; the documents should be in prescribed format; should be properly stamped, witnessed and the duly executed and stamped documents should be registered, where necessary with appropriate authority.

Now, let us discuss in short, the formalities required.

To, take a decision whether to finance a lease or lease an asset, the lessor/ financier requires a lot of commercial document of the lessee e.g. balance sheet for last 3 years, MOA & AOA, copies of board resolution etc. After taking a decision to lease / finance the asset, a lease agreement is created. The lease agreement specifies legal rights and obligations of the lessor and lessee. Usually a maser lease agreement is signed which stipulates all the conditions that govern the lease. This sets out the qualitative terms in the main part of the document while the equipment details, credit limits, rental profile and other details are provided in the attached schedules.

To simplify the process of executing and integrating the specific lease arrangement, the master lease agreement provides that:

i. the lease of equipment is governed by the provisions of the master lease agreement;
ii. The details of the leased equipment shall be communicated to by the lessor to the lessee and
iii. The lessee's consent and confirm that the details to be provided by the lessor shall be final and binding on the lessee.

Clauses in Lease Agreement: There is no standard lease agreement, the contents differ from case to case. Yet a typical lease agreement shall contain following clauses:

i. Nature of lease: This clause specifies whether the lease is an operating lease, a financial lease or a leveraged lease. It also specifies that the lessor agrees to lease the equipment to the lessee and the lessee agrees to take on lease from the lessor subject to terms of the lease agreement, the leased asset.
ii. Description of equipment
iii. Delivery and re-delivery of asset
iv. Lease Period & Lease Rentals
v. Uses of assets allowed
vi. Title: Identification and ownership of equipment
vii. Repairs and maintenance
viii. Alteration and improvements
ix. Possession: must detail – charges, liens and any other encumbrances.
x. Taxes and Charges
xi. Indemnity clause
xii. Inspection by lessor
xiii. Sub-leasing: prohibition or allowed
xiv. Events of defaults and remedies
xv. Applicable law, jurisdiction and settlement.

Apart from the main / master lease agreement the attachments consists of

i. Guarantee agreement
ii. Promissory note
iii. Receipt of goods
iv. Power of attorney
v. Collateral security and Hypothecation agreement.

Accounting / Reporting Framework and Taxation of Leasing

An appropriate method of accounting is necessary for income recognition of the lessor and asset disclosure for the lessee. The concern for a proper method of accounting for lease transaction is based on two considerations. In the first place, there is likely to be a distortion in the profit and loss account if lease rental is recognized as per the lease agreement. Secondly, distortions are also likely to occur if the assets taken on lease are not disclosed in the lessee's balance sheet.

Research Papers, Articles in Journals and Magazines on lease financing (for reference)

Leasing Industry in India: Problems and Prospects

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A Lease is a contract whereby the owner of an asset (the lessor) gives to another party (the lessor) gives to another party (the lessee) the right to use the asset, usually for an agreed period of time in return for the consideration of rent. The objective of this paper is to deal with the problems faced by leasing companies in India; and to assess the prospects of the Indian Leasing Companies in India; and to assess the prospects of the Indian leasing industry. The conclusions are based on 28 lessors' questionnaire-response and the outcome of the indepth interviews of the executives of leasing companies. The paper is presented in three sections. The first section provides an introduction of the growth and structure of the leasing industry; the second deals with the problem-areas of leasing, and the last section dwells on the prospects of leasing business in India.

The equipment leasing has significantly grown all over the world. Even in India, the growth of equipment leasing has been phenomenal. During the last five years, literally 600 leasing companies have been floated in India, of which around 100 are active. It has also been observed that a large number of industrial organisations, both in the private and public sectors are considering leasing as one of the alternatives for financing the equipment acquisition. Presently, leases have come in all modes, sizes, and varieties. A large number of companies are using or have plans to use leasing as a source of finance in one way or the other. It is interesting to note the rising share of leased assets to the total investments on assets. For instance, the share of leased assets to total investments ranged from 5 per cent to 33 per cent in 1988 in the EEC countries, and the US, respectively. These developments have touched India also. In India, today equipment, from satellites to aircrafts to autos are obtained through leasing.

Leasing companies have grown from a few lessors in 1980, to more than 600 (public and private limited) by 1988. In India, the equipment leasing boom began in 1985, rapidly covering plant and machinery, furniture and fixture, vehicles, computers, and household durables. However, it is to be noted that though the number of leasing companies increased phenomenally, the size of business in terms of leased assets did not increase accordingly. Table 1 presents an estimate of the assets leased from 1984 through 1990. The growth is noticeable but not very pronounced. However, In India, the share of the leased assets formed less than 1 per cent, in spite of over 600 companies coming into existence by 1988.

It is observed from the leasing market that leasing companies started quoting different lease rentals for the same transaction. A majority of the companies declared dividends ranging from 15 to 25 per cent from the first year of operations itself.

Current Scenario

The year 1989 saw stabilised leasing industry, which is trying to consolidate its position in the market. The RBI implemented the norms for bank finance to leasing companies and issued guidelines on public deposits. On the one hand, the public sector companies showed interest in acquiring assets through lease financing, and on the other, financial institutions, such as IFCI, IDBI, LIC, UTI, etc., and banks have come forward to lend to the leasing companies. Other commercial banks also floated their own subsidiaries to undertake leasing and other Merchant banking activities. The Credit Rating Information Services of India's (CRISIL) rating has also helped a few leasing companies to establish their market for public deposits. The 1990-91 budget has once again created a conducive climate for the growth of the leasing business by abolishing Section 115J of Income Tax Act 1961. Thus, the demand for leasing business is expected to grow further. It is expected that the importance of leasing industry in India is bound to increase with the passage of time and growth in industrialisation.

Table

Assets Leased by Industry (Rs in crores)

Year	Assets Leased during the year	Cumulative assets leased
1984	50	170
1985	80	250
1986	180	430
1987	220	650
1988	365	1015
1989	517	1532
1990	870	2402

Source: Estimate based on the basis of annual reports of leasing companies and other press reports collected by the author.

Structure of Leasing Industry

Today, there are over 400 private and public limited leasing companies in the country involved in diverse leasing activities. A large number of them are private sector companies. This is in contrast to the western counterpart, where mostly subsidiaries of banks and approved financial institutions dominate the leasing scene.

Private Sector Leasing

Presently, this segment consists of about 400 leasing companies, and plays a significant role in providing lease finance facilities to different industries and helps raise funds from various unexplored sources. The following are the important constituents of the private sector leasing industry.

Pure Leasing Companies

These companies, floated to do exclusively leasing business, operate independently without any link or association with any other organisation or group of organisations to do leasing business. A few examples of such organisations are the First Leasing Co of India Ltd. (FLGI), The Twentieth Century Finance Corporation Ltd. (TGFL), and the Grover Leasing Ltd.

Hire Purchase and Finance Companies

These companies were floated prior to 1980 to do hire purchase and finance business, especially vehicles, and partly, invest in shares and debentures of other companies. During the post-80s, they added leasing to their activities and turned into leasing companies. In this segment, a few companies treat leasing as a major activity, while some others accept leasing on a small scale as a tax-planning device. These are older than other companies in the leasing industry. A few such companies are: Sundaram Finance Ltd (SFL), Mercantile Commercial and Credit Corporation ltd. (MCCL), and Motor and General Finance Ltd. (MGF).

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Subsidiaries of Manufacturing Group Companies

These companies consist of two categories: (I) subsidiaries of manufacturing companies, known as vendor leasing companies; and (ii) in-house leasing (captive leasing) companies. The objective of the former is to boost and promote the sales of its parent companies' products through offering leasing facilities. On the other hand, the captive leasing companies are floated to meet the group companies' fund requirements. Some of the in-house leasing companies are also set up to avoid the income tax by the group companies. Another objective of this type is to raise funds to a large extent from outside sources, by using the group's name; since leasing companies are allowed high debt-equity ration of 10:1 tax avoidance is suspected to be the major objective of the in-house leasing companies. For example, the needs of the loss-incurring company by extending leasing facility at a very low rentals (which even are not sufficient to recoup the cost of equipment) and by simultaneously leasing to a profit-making company within the group at an extremely high rentals (to compensate for the loss incurred in other transactions) and reduce the tax burden of a profit-making company. The leasing company earns sufficient profit to compensate for the losses in leasing transactions with loss-incurring companies within the group. The profit-making company is benefited because of the tax deductibility of high lease rentals. Thus, the taxes which ought to have bolstered government revenues are channellised into loss incurring company of the group.

Because of these advantages, big industrial houses jumped into the fray by setting up in-house and vendor subsidiary companies. Perhaps, this has led to a proliferation of in-house set-ups. For example, Swadeshi Leasing Ltd was floated by the Hindustan Motors Ltd., the key Leasing Ltd. by JK Synthetics Ltd., the Classic Leasing by ITC Ltd., Nagarjuna Finance Ltd., by the Empire Industries, Eligi Equipment Finance by the Eligi Group, and DCL Finance by DCL Group. A few examples of subsidiaries of manufacturing companies are Ashok Leyland Finance Ltd. of Ashok Leyland Ltd., Krest Development and Leasing Ltd. of Best and Crompton Ltd., Bajaj Auto Finance of Bajaj Auto Ltd., and Enfield Finance of Enfield India Ltd. Besides, a few leasing companies are subsidiaries of finance and leasing companies - Cholamandlam Finance Ltd is a subsidiary of Cholamandlam Investment and Finance Ltd., Response Hire Purchase and Credit Ltd. of First Leasing and Empire Credit Ltd. belongs to Empire Leasing. Further, four leasing companies were floated jointly by banks, the International Finance Corporation (IFC), and private leasing companies. Most leasing companies are engaged in the business of leasing, and hire purchase financing. In leasing, they are primarily concerned with equipment financing, ranging from machine tools to big earth moving and chemical plants. A few companies also engage in real estate business and property development, and one or two companies are also involved in leasing of safe deposit lockers in almost all major cities in the country.

Public Sector Leasing

The public-sector leasing organisations are divided into (a) leasing divisions of financial institutions; (b) subsidiaries of nationalised commercial banks; and (c) other public sector leasing organisations.

Financial Institutions

Financial institutions, an important constituent of the public sector leasing industry in India, were created with the basic objective of providing long-term finance to the private sector firms. They have recently started leasing business as one of their activities through their leasing divisions or subsidiaries. They include ICICI, IFCI, IRBI, the National Small Industries Corporations (NSIC). Similarly, the Shipping Credit and Investment Company of India (SCICI) emerged as the first financial institutions to offer lease facilities in foreign currencies. However, SCICI is specialising in leasing of ships, deep-sea fishing vessels and related equipment to its clients.

Subsidiaries of Commercial Banks

Presently, this is the growing segment of the public sector leasing industry. Consequent upon the amendment of Section 19(1) of the Banking Regulation Act 1949, banks can set up subsidiaries for undertaking leasing activities. Hence, banks are setting up subsidiaries with not less than 51 per cent of shareholding, for transacting equipment- leasing business or to invest in shares within the limits specified in section 19(2) of the Act. The aggregate investment of a bank in a subsidiary and/or not in shares of the leasing companies should not exceed 10 per cent of the paid-up capital and reserves of the bank. The pioneers in this segment are SBI Capital Markets Ltd., (SBI Cap) and Canbank Financial Services Ltd. (Canbank), wholly owned subsidiaries of the State Bank of India, and Canara Bank, respectively. Both these companies have already undertaken leasing in a big way. Recently, a few other banks have also joined the bandwagon - BOB Fiscal Services Ltd., a subsidiary of the Bank of Baroda, BOI Financial Services Ltd., a subsidiary of the Bank of India, PNB Capital Services Ltd., a subsidiary of the Punjab National Bank.

Other Public Sector Organisations

A few State-level industrial development organisations, such as the State Industrial Investment Corporation of Maharashtra (SICOM), the Gujarat Industrial and Investment Corporation (GIIC), and the UP Industrial Investment Corporation (UPIIC) have floated their own subsidiary leasing companies. A few public sector manufacturing companies, such as the Electronics Corporation of India Ltd. (ECIL), CMC Computers Ltd., the Bharat Electronics Ltd. (BEL), and the Hindustan Packaging Co Ltd. (HPCL), have also started leasing to sell their equipment through lease rather than outright sale.

Problems

Growth, financial or economic, in its wake brings problems, and leasing is no exception. With this in view, it was decided to inquire into the problems and prospects of leasing industry in India through an empirical survey. The following sections are based on 28 lessors' questionnaire-response and the outcome of the in-depth interviews of the executives of leading leasing firms.

The phenomenal growth of leasing companies, their lease business, and the acceptance of leasing as a method of acquiring assets, however, have raised some problems. Increasing attention, therefore needs to be given to the following problems of leasing companies of India. The main problems are: resource crunch; inadequate tax benefits and sales tax burden;

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rigid procedure for import/cross-order leasing; lack of proper and integrated accounting standards; lack of proper and integrated accounting standards; lack of legislation; existence of cut-throat competition; and lack of expertise in the management.

Resource Crunch

The sources of finance available to leasing companies are: (a) equity share capital; (b) reserves and surplus; (c) debentures; (d) long-term loans; (e) public deposits; (f) bank loans; and (g) inter-corporate deposits and other sources. Of late, looking at the performance and prospects, investors seem to have lost confidence in leasing companies. This is reflected in the fact that the shares of most leasing companies are quoted at an extremely lower price, compared to the book value and per value. Therefore, it is becoming difficult for the leasing companies to raise equity share capital in the existing conditions. It is also not possible for them to issue either fully or partly convertible debentures because these are closely linked with the net-worth and trading of equity shares in the market.

The nature and amount of bank finance made available to leasing companies were not subject to any restrictions until recently. The Reserve Bank of India appointed a committee under the chairmanship of GS Dahotre to structure the norms regarding bank finance to leasing companies. Based on the recommendations of the committee, the following guidelines have since been issued by RBI with regard to bank finance.

The bank borrowings of a leasing company cannot exceed three times its Net Owned Fund (NOF). NOF = Paid-up capital + Free Reserves - Accumulated Balance of Loss - Balance of Deferred Revenue Expenditure - Intangible Assets - Investment/ Deposits with subsidiary companies/affiliates - Loans and advances due from subsidiary companies/affiliates).

Banks can extend credit only in the form of a cash-credit facility since financing is done primarily against lease rentals receivable.

For each lease transaction, the borrowing limit will be arrived at with the help of the following formula:

Lease rentals receivable for the next 5 years X 75% of the cost of the leased asset
Total lease rentals receivable for the Entire period

The overall during limit for leasing company will be aggregate of the limits calculated as above for the individual transactions. The cash credit facility offered will be on a revolving basis. That is, as the liability/drawing limit for the earlier leasing transactions are liquidated or reduced, the drawing limit for other new lease transactions can be availed.

Bank finance will be available for only finance leases of new equipment. Hence, operating leases are not eligible for bank finance. Also, sale and lease back arrangement and leases of second-hand assets are not eligible for bank finance. For smaller and medium companies, it will be difficult to raise funds by way of bank loans.

The public deposits are the significant source of the leasing companies. The RBI has amended the earlier Non-Banking Financial Companies Directives, 1977, effective from 28 March 1989. Two important provisions of these directives are: (1) minimum period for acceptance of deposits by equipment leasing companies has been increased to 24 months from six months; and (2) the maximum period extended from 36 months to 60 months. However, the rate of interest cannot exceed 14 per cent per annum. It is observed from the examination of the annual reports of the companies for the year 1987-88 that in terms of size of the public deposits, there were nine companies (29 per cent) in the range of more than Rs.10 crores, - Lakshmi General Finance Ltd. with Rs.45 crores, Sakthi Finance Ltd. Rs. 42 crores, the First Leasing Co of India Ltd. Rs.21 crores, the Investment Trust and Finance Ltd. Rs. 19 and the Industrial Credit and Syndicate Ltd with Rs.14 crores, followed by Nagarjuna Finance Ltd. Rs.13 crores. All these are south-based, especially Madras-based. One company is north-based - The Motor and General Finance Ltd. (MGF) having public deposits of Rs.35 crores. It is evident from this that Madras-based companies have mobilised deposits to the maximum extent as they have branches all over the country.

A look at the branch network of the selected companies reveals that most of the south-based companies have more branches than other leasing companies. Thus, Sundaram Finance Ltd. has 39 branches, followed by Sakthi Finance Ltd. with 27 branches Mercantile Credit Corporation Ltd. 23 branches, the Industrial Credit and Development Syndicate Ltd. 22 branches, the Investment Trust of India Ltd. 19 branches, and Lakshmi General Finance Ltd. 13 branches. Only one of the north-based companies, Grower Leasing Ltd., has ten branches. The major concern of these branches appears to be mobilising deposits from the public directly or indirectly through fixed deposits brokers rather than doing leasing business. The leasing companies used the branches as an instrument to mop up fixed deposits. In addition to the branch network, a few leasing companies had used CRISIL's rating as a weapon to boost their fixed deposits. Sundaram Finance Ltd., Cholamandalam Investment and Finance Co Ltd. (CIFIL), from Madras, and the 20th Century Finance Corporation (TCFC), Bombay, had approached CRISIL, for rating and were awarded, FAAA (Triple A) which stands for highest safety. Another company from Bombay, the Empire Finance Co Ltd., was awarded FA + which stands between FAA (high safety) and FA (adequate safety).

Presently, leasing companies are facing problems in raising fixed deposits since the minimum period of deposits is two years. Only good and big companies may be able to borrow by way of deposits. Thus, it is indicated that there is going to be an acute shortage of money - the raw materials of leasing companies.

According to Ramakrishna Rao, Managing director, Magnificent Leasing, while the demand for leasing increased, raw material supply (resources) became a severe constraint. A few companies also had management problems, this being a specialised business. Ranina, an expert in taxation and chairman, Mazada Leasing has said: All leasing companies are facing the problem of resource crunch. Most of the companies have not been able to raise any funds since 1986-87". Similarly, our analysis of the responses to the questionnaire showed that, four companies (14 per cent of the respondents) faced problem in raising share capital and long-term debt, and eight respondents (29 per cent) in getting bank finance, whereas 15 respondents (58 per cent) had problem in mobilising public deposits.

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Inadequate Tax Benefits

Unfortunately, the tax benefits which leasing companies enjoy in the developed countries are not available to the Indian leasing companies. Tax benefits arising out of depreciation, investment allowance of deposit scheme, etc., are not conducive to the growth and promotion of leasing companies. Investment allowance (u/s 32A) was abolished from 1 April 1987, and in its place an investment deposit scheme (u/s 32 AB) has been introduced. Under this scheme, the amount of deduction is limited to 20 per cent of the profit of eligible business or profession as per the audited accounts. However, this scheme excludes certain categories of leasing. The latest position is that even this has been abolished as announced in the budget of 1990-91

In addition to the above, the Finance Act 1987, had introduced Section 115J of Income Tax Act, 1961 which provided for a minimum tax of 30 per cent on the book profits of a company. The leasing companies brought within the orbit of this new tax provision faced uneasiness; now this has been abolished, as announced in the budget 1990-91.

Sales Tax Problems

Leasing companies are also facing the problems of sales tax. The 46th Amendment to the Indian Constitution, which came into force from February 1983, has empowered the State governments to levy sales tax on the transfer of rights or to the use of any goods for valuable consideration. As a result, the legal position of finance lease is a "deemed sale" under the State Sales Tax Act. The governments of Andhra Pradesh, Bihar, Gurjarat, Haryana, Karnataka, Kerala, Maharashtra, Madhya Pradesh, Orissa, Tamil Nadu, and West Bengal have already amended their sales tax Acts in accordance with the 46th amendment to the Constitution. Hence, leasing companies are required to pay sales tax at higher rates on a lease transaction as they are not being allowed to use 'G' forms. This makes leasing more expensive, as the cost of the asset acquired under lease finance gets enhanced to the extent of sales tax paid by the leasing companies. This is bound to cripple the leasing industry, which is still in the nascent stage. In view of the burden created by sales tax, the Central Government should take immediate steps and formulate guidelines, ensuring uniform legislation among various States. It should ensure uniformity in the scope and contents of the sales tax. The facility of using 'G' should also be extended to leasing companies.

Prabhu, Chairman, Canara Bank in his chairman's speech in June 1989 remarked that there were certain avoidable constraints restraining the lease finance from becoming a major source of corporate finance. The levy of sales tax on rentals by many State governments makes leasing unattractive. The benefits of lease finance, in terms of accelerated modernisation and industrial growth, are to that extent adversely affected. Yet another problem is in obtaining approval for issue of 'C' Forms by lessors under the Central Sales Tax.

It is noticed from the analysis of the questionnaire responses that 100 per cent of the respondents suggested that Section 115J of the Income-Tax Act, 1961, and sales tax on lease rentals should be abolished with immediate effect. About three-fourths of the respondents expressed that the investment allowance and investment deposit scheme should be extended to the leasing companies. The leasing companies would feel relieved since Section 115 has been scrapped.

Rigid Procedure for Import Leasing

In India, Leasing industry has high potential in areas like import leasing or international leasing. Recently, a few leasing companies entered the arena of import leasing. The import and Export Policy for 1985-88 has laid down the following eligibility criteria for leasing companies to do import leasing.

- The memorandum and articles of association of the leasing company must specifically provide for leasing as one of the objectives.
- The leasing company must have a minimum paid-up share capital and reserves of Rs.1 crore.
- The share of leasing company must be listed in a recognised stock exchange.
- Thus, leasing of imported equipment has been restricted to a meagre part of the industry. A number of respondents indicated the problems of import leasing and made the following suggestions:
- Import of OGL items to be permitted without approval of the Joint Chief Controller of Imports and Exports (JCCI & E).
- The Chief Controller of Imports and Exports (CCI&E) has to reduce the period for giving permission for import leasing.

Accounting Problem

The Indian leasing companies are following a variety of lease accounting practices. Lessees neither show the leased assets on the asset side nor the future lease rental obligations as liabilities. Therefore, the lease transaction seems to be an off-balance sheet transaction. Lessors show the leased assets as owned assets in their balance sheets, even though they lose the economic possession of assets by making finance lease.

The first flaw is reporting the lease income in the financial statements. It is evident from the examination of books that the accounting practices of various leasing companies have been far from uniform and consistent. The leasing companies are not amortising the value of the leased asset during the primary lease period (period in which leasing companies recovered more than 95 per cent of the asset value). Instead of amortising the full equipment cost, leasing companies are debiting a small part of the leased asset's cost by way of straight-line depreciation in the books of accounts. The depreciation is being shown for more than eight years, even though there would not be any income through the asset. Hence, in such a case, the basic accounting concept of matching the cost with revenue is totally ignored.

The second flaw lies in showing the leased assets in the balance sheet. Different leasing companies have adopted a variety of methods and there is no consistency in the presentation of accounts. It is interesting to note that the method of providing depreciation is also different from that of owned assets. Leasing companies are following written down value methods

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of depreciation for owned assets and straight -line method for leased assets.

In the light of these practices, the Institute of Chartered Accountants of India (ICAI) has issued a "Guidance Note on Accounting a Leases". The following are some of the important requirements.

a. The assets leased out should be shown under "Fixed Assets" separately as "Assets on Lease" and classified in the same manner as other fixed assets.

b. A matching annual charge representing the difference from the lease and finance income is to be debited to the profit and loss account. This annual charge will consist of the minimum statutory depreciation as per the Companies Act, and lease equalisation charge where the lease charge is in excess of the said depreciation.

The recent amendment to the Companies Act, 1956, ensures that all the companies including leasing companies, should follow accrual system of accounting. This will cause unnecessary hardship to the leasing companies. However, there is disagreement in the treatment of depreciation allowances, possessions of assets under the Income-tax Act, 1961, and the Indian Companies Act 1956. There is thus a strong discontentment among leasing companies regarding the accounting treatment in their financial statements. The leasing Industry feels that the ICAI did not provide adequate transition period for the implementation of the guidance note. In this connection, the Equipment Leasing Association (ELA), India, made representation to the ICAI indicating the need for providing a reasonable transition period till the requirements are in agreement with that of tax, monetary, and corporate policies and practices. In fact, a group of leasing companies obtained a stay order in Madras High Court, preventing ICAI from implementing the provisions of the guidance note. ELA, continuing its constructive approach with ICAI, has suggested an alternative method of providing depreciation.

Lack of Proper Legislation

In fact, the only legal reference available to lessors and lessees in the Hire Purchase Act, 1972. Another act, the Transfer of Property Act (Sections 105 to 117), deals with only immovable properties. Even today, the leasing industry is following these acts in addition to the section 126 to 180 of the Indian Contract Act, 1872. Hence, it is obvious that there is neither a comprehensive leasing law nor government policy to guide the leasing business. Now, it is the right time, for the Central Government to make efforts to pass an act know as "Indian Lease Act," to cover leasing business.

The private sector leasing companies are facing cut-throat competition from the public sector leasing organisations, such as ICICI, IFCI, SBI Cap, and Canbank, Compared to the small private sector companies; these are at a privileged position in that they get funds at cheaper cost. Therefore, these public sector leasing organisations have good tie-ups with blue chip and big companies and public sector manufacturing companies. These have better terms and conditions than the private sector companies. Besides, keen and unequal competition exist even among the private sector leasing companies because of the oligopolistic nature of the leasing industry. Sometimes, highly profitable and high tax companies may also create competition by offering lease finance in order to avoid the income tax through leasing as a tax-planning device.

Management Problem

Without knowing the lease business, a large number of entrepreneurs had entered the leasing fray with others money. Management of leasing fray with others' money. Management of leasing companies thus requires a different orientation compared to the management of manufacturing and trading companies. The leasing companies need people with specialised knowledge and skill to evaluate and appraise the credit worthiness and soundness of the potential as well as existing lessees from time to time. The leasing companies need to evaluate the structure of innovative lease packages and options in order to cater to the needs and requirements of different segments of the market.

The second issue relates to the composition of the board of directors of leasing companies. A scrutiny of the board of directors of leasing companies reveals that almost all the board of leasing companies are dominated by the retired chairmen / managing directors or chief managers of banks or financial institutions. Moreover, the same person is associated with many such companies. What is interesting is that most such directors do not have any financial stake in the leasing companies! The objective of the promoters in including such popular figures is to attract instantaneous response to public issues, whereas, the retired executives are finding these offers as retirement benefits. What is worse, most of these directors do not have either the time or willingness to devote attention to the regular and routine business. If these directors provide efficient and effective guidance and supervision, how come some of the leasing companies have diversified into unrelated areas and a sizable number disappeared from the scene?

According to Vinay Sawhney, Chairman of the Worldlink Finance Ltd.(chairman's) speech, Third AGM, 28 March 1989), the leasing industry in India has failed to make any significant contribution to the process of capital asset formation in the past few years due to (a) limited resource mobilisation capabilities, (b) restrictive bank support, and (c) lack of trained manpower. He suggested that careful planning, systematic institution building, innovative approach, and well throughout staff training programmes are the key to the ultimate success in leasing business. According to Santhanam, Chairman, Sundaram Finance Ltd. (Speech in 34th AGM 24 Sept 1987), there has been a keen competition in leasing business from the financial institutions and subsidiaries of commercial banks.

An analysis of responses on problem areas of leasing indicates that almost all the companies faced one or the other problem in the leasing market. They have referred to a number of factors affecting the financial performance of their companies (Tab 2).

Table 2 shows that about 90 per cent of respondents stated that sales tax on lease rentals and Section 115J of the Income Tax Act, 1961, have affected the financial performance of the companies, and half the respondents felt that competition is keen and intense. Only a few cited other problems. It is also noted that about one-third of the respondents indicated that

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they have marketing problems, such as under-quoting of lease rentals (rate war) by competitors, and special and innovative schemes of leasing divisions of financial institutions and subsidiaries of banks. About one-third of the respondents expressed that there is a need for the lease broker services to facilitate marketing functions of lease, while the rest of them (three-fourths) felt otherwise - no need for broker services.

Table

Description of Problems by respondents

Description of problems	No. of companies	Percentage
Competition is keen and intense	12	46
High interest rate burden	3	12
Lack of business opportunities	3	12
Defaults in rental payments	2	8
Sales tax on lease rentals	26	93
Income-tax under Section 115J	25	90
High cost of operation	5	19
Low margin/unprofitable rentals	4	15

As regards policy issues, 20 respondents (70 per cent) suggested that the Central Government should take immediate steps to abolish the sales tax on lease rentals and Section 115J of the Income Tax Act, 1961 to give a boost to the industry. (Section 115J has been abolished in the budget 1990-91). More than half the companies suggested that leasing companies should also be allowed to avail the investment allowance and investment deposit scheme. (However, these two were abolished in the budget 1990-91). One-fifth of the respondent wanted the minimum period of public deposits to be reduced to six months, against the current period of 24 months, while a few also stated that bank finance to leasing companies should be increased to five to six times their net-owned funds. A few respondents felt that there is room for simplifying the procedure for import leasing. From the foregoing, it can be concluded that the major problems of the leasing companies are: the high incidence of sales tax on lease rentals; cut-throat and keen competition; inability to raise resource on a continuous basis, in case of both new and old companies due to varied reasons; no legislation to guide, direct, and control leasing companies and leasing business; and lack of a trained and experience manpower.

Prospects

Despite these problems, the leasing business in India has its own growth potential and prospects. Equipment leasing has come to stay as a new device in providing the necessary resources for maintaining the tempo of industrial growth. Leasing has acquired a special importance in the economics of the developing countries, particularly for financing the small-and medium-scale industries. Capital formulation through leasing can help growth with minimum investment. It is estimated that by the end of March 1991, the Indian leasing industry raised capital from various sources approximately to the tune of Rs.4,000 crores.

Leasing has great potential in India in view of the fact that barely less than 1 per cent of the total industrial investment is so far financed through leasing, compared to 30-40 per cent capital investment through leasing in the developed countries, such as the US, the UK, and 10 to 20 per cent in Australia, Canada, Japan, etc. The well-managed and large resourceful leasing companies are going to see better days with good profitability during the next few years. The leasing business continues to grow and flourish, and the consumers - lessees (different segments of market) are growing in number and size. Demand for leasing business continues to grow at a faster rate, and there is adequate space for all. In the coming years, perhaps, the fastest and largest growth industry would be leasing since the public sector organisations are actively involved in the industry not only as lessors but also as lessees.

Financial institutions are armed with much inexpensive and comparatively vast funds in their hands for deployment in leasing. These bodies can, therefore, function as catalysts for market growth for leasing rates and, therefore, influences the profitability levels. Several financial bodies, notably subsidiaries of banks or financial institutions, are taking substantial amount of leasing from the public sector units, such as ONGC, Air-India, Indian Airlines, Shipping Corporation, HMT, SAIL, BHEL, BEL, Vayudoot, Coal India Ltd., and service-oriented sectors like transportation and communication departments, and professions, such as medical, consultancy, engineering, etc.

The financial institutions and subsidiaries of commercial banks on the one hand, and the private sector leasing companies, on the other, may have to play an important role in the development of the leasing business. Recently, there was a proposal from the Asian Development Bank (ADB) to set up a 100 crore Indian Leasing Industry fund which has been approved by the Central Government. The fund is to be jointly promoted by ICICI, UTI, and ADB. The Indian public is likely to have a stake in the fund. The main objective of the fund is to provide long-term loans to the private sector finance companies. Another notable development is that the Equipment Leasing Association of India (ELA) at Madras, and the Association of Leasing, Finance and Housing Development Companies (LFH), at Bombay, were formed with a (view) to promoting, aiding, helping, encouraging the leasing business, and protecting the interests of the leasing companies. Besides, a few of the finance, accounting, tax and management consultants are working as lease brokers, who also will contribute to the growth of leasing business.

Leasing companies are not only useful to big and medium industries but also opened a new window for financing professionals, and consumers; they are also contributing to the growth of the consumer goods industries. Leasing companies will get an additional inflow of relatively inexpensive funds from IDBI, IFCI, UTI, since they offer medium-term loan at 15 per cent interest. Their branch networks are working in full swing in exploring new markets for public deposits. A few leasing companies have even set up mobile offices to mobilise more fixed deposits from investors at their offices and residences.

Presently, leases in India are generally small-ticket leases. The equipment ordinarily leased are plants and machinery; however, the important potential markets are heavy plant and machinery, ships aircraft, satellites, data processing equipment, trucks, chemical plants, high-tech equipment by means of import

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leasing, leveraged leasing, and vendor leasing. Leasing has also plenty of scope in the service sectors, such as developing the transportation and communication industries. Recently, the Motor Vehicles Act has been amended for incorporating the interest of the lessor in the registration certificate. This was a long awaited demand of the industry, and the government has done well in recognising the importance of the leasing industry in developing the transport sector. This will help increase the vehicle leasing for transport and non-transport industry. The electronic and technological revolution sweeping the office automation and data processing would create ample scope for leasing.

Leasing is a service industry as it provides funds and also taps the capital market. It supplements the government's developmental plan by supplying equipment to the industry. The Eight plan's projections, coupled with the flexible government policies towards industry, modernisation and expansion of capabilities and the emphasis on technological up-gradation augurs well for the prospects of leasing. The Central Government has reacted fairly as far as monetary, fiscal, and regulatory policy issues were concerned. The manner and direction of growth will be, to some extent, affected by fiscal, monetary and economic policies, although leasing industry is not dependent upon them. Leasing will thrive whatever be the fiscal and monetary system adopted, provided only that it does not treat leasing disadvantageously.

Leasing is growing industry. It is seen that leasing has grown in the latter 80s, and is still growing. It is, however, worth nothing that despite good prospects for leasing, many existing private sector leasing companies do not find a place in the market; only a few leaders from the private sector, besides the public sector, remain in the fray. This shows that the leasing industry needs the full support, co-operation, and encouragement of the government. At the same time, regulatory framework is essential to control its mushroom growth and irregularities, and to ensure a healthy growth. It is expected that a substantial number of manufacturers of many types of equipment may set up their leasing operations either as an integral part of the parent company or through a subsidiary to sell their products. As long as the leasing industry continues to be innovative, it will find a ready market for the service it has to offer.

Leasing Knows No Frontiers!!!

Apart from the need to raise finance in the international financial markets, cross-border leasing transactions mostly involve tax benefits, claimed in the country of residence of the lessor, the lessee, or both.

In recent years, the cross-border leasing market involving Dutch-based moveable and immoveable assets has continued to be very active. Cross-border leasing transactions involving power plant and waste management facilities operated by Dutch utilities, and leasing transactions involving railroad stock and Dutch-operated aircraft, have all attracted extensive publicity in recent years.

The Dutch tax system particularly facilitates cross-border leasing transactions. This is the result of a combination of factors, including the absence of withholding tax on cross-border interest and rental payments, and the willingness of the Dutch tax authorities to confirm the tax treatment of a particular transaction in advance.

Lease financing for the purchase of aircraft, transportation equipment, industrial machinery, and other types of equipment is available across nations. Capabilities indispensable for the structuring of cross-border leasing arrangements include an in-depth knowledge of the asset value of the items leased, an ability to move quickly and flexibly along with market trends, and knowledge of detailed information on legal, accounting, and tax matters.

How to Proceed?

Once a lessee decides to go ahead with cross-border leasing, what are the steps to be followed?

- **Identifying a Lessor**

  Cross border lease is very different from conventional domestic finance transactions hence, identifying a lessor is the most tedious job. For example, the capital markets in the United States, are extraordinarily deep. However, cross-border transactions may involve jurisdictions like in Sweden and Denmark, which have low levels of equity available at any given time. Germany and Japan have larger equity markets, but other factors like tax laws and defeasance requirements, demand for manufacturing equipment from the lessor's country, overall economic conditions, and the appetite for tax-oriented transactions at a specific time can constrain opportunities to close cross-border leases.

- **Understanding the Participants, Terms and Conditions of the transaction**

  Market participants are unique in each country, and unrelated to the players in domestic financial markets. The most distinguishing features are the terms, conditions and transaction structures. Issues like, defeasance arrangements or title may sometimes result in "hung-up" deals (deals without any further action).

- **Working with a financial advisor**

  Some lessees prefer to appoint a legal counsel or an advisor who is experienced in the cross-border leasing field. There are two general options available to the advisor for designing a cross-border lease:

  - Develop a bid specification to select the placement agency, quoting the highest net benefit and best risk sharing arrangements. Or
  - Use competitive appraisal process to identify a placement agent, who will then act on behalf of the lessee to solicit competitive bids from equity sources in targeted countries, as well as conduct a competition for defeasance arrangements among banks or investment bankers.

- **Understanding "how the deal works"**

  It is important to understand the working of the deal. The following two basic questions need to be answered:

  1. How market participants are compensated?
  2. What are the local procurement regulations governing the transaction?

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Some jurisdictions allow negotiations for advisors and underwriters, while others use competitive bidding. A typical cross-border lease transaction may involve multiple procurements say, placement agent, equity, debt, deposits, lessee counsel, appraisers, currency-related financial products and the like. This sometimes results in the lessee preferring a complete package. For example, Avenue Corporate Services Pvt. Ltd., Misha Consultancy Nexus India Ltd. are a few consultancy firms that provide professional advisory and consulting services in cross-border leasing.

- **Evaluation Factors**

  Cross-border leasing is a highly specialised field; hence the following factors demand consideration:

  - Volume and history of successfully completed cross-border lease transactions.
  - Continuous history of involvement in the cross-border field.
  - Ongoing presence in overseas markets, and familiarity with the countries that are the most likely sources of equity for the assets to be leased.
  - Recent track record in identifying equity and closing transactions while serving as financial advisor in comparably scaled deals covering similar types of assets.

  The global market conditions like interest rates, depth of capital markets and tax law environments are volatile rendering sensitivity to cross-border leases. Therefore, it is advisable to seek leasing proposals three to six months prior to taking delivery of assets, or placing an order. Japanese leveraged leases tend to be more restrictive regarding title issues and it is suggested that these issues, be clearly set out prior to making domestic financing arrangements for the acquisition,

- **Calculating Costs and Benefits**

  The benefits derived from a cross-border lease depend to a great extent on the country's' tax laws, the participants' income, and interest rate differentials between the two countries. Exchange rate fluctuations also affect the benefit equation. The costs to achieve that benefit are, the appraisal, legal, financial advisor, and other fees paid by the transit system to undertake the transaction. The remainder is the Net Benefit.

To sum up, Cross-border Leasing in emerging markets is becoming an important tool in trade finance. More and more jurisdictions are gearing up to make it an attractive form of financing.

1. **"Defease"** means to bank sufficient proceeds from the transaction to cover lease and loan requirements. This may also be accomplished through the purchase of an annuity.
2. **Different types of assets and legal title situations**

   The inability to legally defeat Japanese leveraged leases makes them more attractive for shorter-lived assets, such as buses, telecommunications equipment, or possibly computerized signal and fare collection systems.

Japan does not require that the assets being financed have Japanese manufacturing content. Longer-lived assets, such as rail vehicles, are better suited to the European lease markets because of greater availability of defeasance options.

German lessors tend to require that the assets have German manufacturing content. Equipment for which title has passed to the lessee is not suited to Japanese leasing guidelines, and is more favourably viewed under the European tax environments.

FAQ's - www.MyVakil.com - Your Legal Advisor Online.htm

1. Can I acquire equipment for my business without buying it?

   You can acquire equipment for your business without buying it. You can take the equipment on lease through lease finance.

2. How does lease finance work?

   Lease finance is a contract for leasing an asset or equipment. The owner of the asset leases the asset to the lessee conferring the exclusive rights to use and possess the equipment for a specific period. The contract will require the lessee to make fixed periodic payments or 'rent' to the lessor for use of the leased equipment. The contract is known as Lease Finance Agreement. The lessor remains the owner of the asset during the period of lease and after its termination.

3. What are the ways for leasing equipment?

   There are three ways by which you can lease equipment:

   i. You can select and order the equipment and then seek financing through a leasing company.

   ii. You can select the equipment by working with a vendor or a manufacturer, who offers leasing through its own subsidiary.

   iii. You can obtain the equipment directly through a leasing company.

4. What are the types of lease I can get?

   The two most common types of lease are operating lease and financial lease. A lessee needs to choose between these two types depending upon the type of asset and the period of lease.

5. What is financial lease?

   Financial lease is a long-term lease. The lessee uses the asset for its lifetime during the period of lease. The asset will be of no value at the end of the lease period. The period of lease is long enough for the lessor to recover the investment as well as profit in a single leasing transaction.

6. What is operating lease?

   Operating lease is a short-term lease. The life of the asset is not consumed in a single lease. The asset is normally capable of being leased more than once. The lessor does not recover the entire investment on the asset from a single lease but recovers the investment through multiple leases.

7. What is the mode of payment of rent in a lease finance transaction?

   You can make payments by cheque or demand draft. Generally leasing companies collect post-dated cheques for payment of rent for the entire duration of the lease.

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8. Are there advantages in a lease finance transaction?

   Leasing is more advantageous compared to other financing options, in that it offers a combination of-

   i. Minimum cash investment
   ii. Fixed payments
   iii. Convenience of upgrading and adding additional equipment
   iv. Tax benefits

9. What are the tax benefits derived by the lessor and lessee in a lease finance transaction?

   The lessor claims depreciation on the asset, as he is the owner of the asset during the lease finance period and even after its termination. Depreciation can be claimed on the actual cost incurred by the lessor for the asset at such rates as are prescribed under the Income Tax Act. The lessee, on the other hand, is entitled to claim deductions on the rent paid by him for the asset under the Income Tax Act.

10. Do I have to be a company to take lease of equipment?

    It is not necessary to be a company to take lease of equipment. A sole proprietor or a partnership firm can also take lease.

11. Can a house or flat be taken on lease under lease finance transaction?

    A house or flat cannot be given or taken on lease, as lease finance must be for a movable asset only. A house or a flat is an immovable asset and comes within the purview of real estate leasing.

12. Can I approach a leasing company for leasing an asset of my choice?

    The lessee has the right to select the asset from a manufacturer or supplier of his choice. The lessor only pays the price of the asset and procures it for the use of the lessee.

13. Can I lease equipment for an unspecified period?

    You cannot lease equipment for an unspecified period. The period of lease must be fixed.

14. Can the asset be taken back before the expiry of the lease period?

    The lessor has an option to cancel the lease and take possession of the asset if the lessee does not comply with the terms of the lease finance agreement.

15. Does the lessor require a guarantee for giving the equipment on lease?

    Most lessors require a guarantor as additional security for giving the equipment on lease. If the lessee defaults in payment of lease rentals, the lessor can recover the lease rentals from the guarantor. However, a guarantor is not required when the lessee gives collateral security such as title deeds of immovable property, for complying with the terms of the lease.

16. Does the lease finance agreement attract stamp Duty?

    Lease finance agreement must be engrossed on a non-judicial stamp paper of the value of Rs 10/- (Article 5, Schedule I of the Indian Stamp Act) irrespective of the value of the asset or aggregate amount of lease rentals.

17. Does lease finance agreement require registration?

    Lease finance agreements deal with movable property and hence registration is not compulsory under the Registration Act.

18. Who should insure the asset under a lease finance agreement?

    It is the duty of the lessee to insure the leased equipment. If in any case the lessor insures the leased equipment, he has the right to recover the cost of insurance from the lessee if the agreement provides for it.

19. Will the leasing company provide equipment warranty?

    Leasing companies do not normally provide equipment warranties. The manufacturer or vendor of the equipment provides equipment warranties and is solely responsible for service or warranty issues.

20. Can the lessor assign his rights under the lease finance agreement to a third party?

    The lessor may assign any of his rights to any person under the lease finance agreement and the person to whom such rights are assigned shall be entitled to the full benefits of such rights. The assignment rights are not available to the lessee. However, the lessee may assign his rights with the prior permission of the lessor or if the lease finance agreement provides for such assignment.

21. Can the lessee transfer the asset to another?

    The lessee does not have any right to sell, assign, mortgage, hypothecate or sublet the asset to anyone else, unless the lease finance agreement provides for it, or there is prior written consent of the lessor.

22. What is the difference between lease finance and hire purchase?

    In the case of lease finance, the lessee has to return the assets once the lease period expires. In the case of hire purchase, the hirer has the option to purchase the asset on completion of the hire period.

In the case of lease finance agreement, the lessor can claim the depreciation benefit under the Income Tax Act as he is the owner of the asset. In the hire purchase agreement, the hirer can claim the depreciation benefit under the Income Tax Act as he is deemed to be owner of the asset.

Over to Lease Finance

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Till 1995, project finance for infrastructure was limited to borrowings and equity capital. Over the past three years, however, lease financing has been emerging as a project financier's delight. The power sector, for example, has already completed leasing deals worth Rs 500 crore over the past three years. The Railways and shipping companies have also started opting for this method.

Leasing has become a popular option for infrastructure projects because it suits both bankers and project managers. For banks the advantages of leasing to infrastructure projects is the

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relatively lower risk. This is because assets in infrastructure leases are secured and lease deals are usually structured in such a way that the possibility of bad debts is lower.

For project managers, leasing also translates into lower fixed and financing costs. A major component of fixed costs, especially in thermal and gas-based power projects and transport projects like the Railways, is basically equipment. Leased equipment reduces overall costs and helps save on subsequent depreciation and interest on funds the company would have otherwise borrowed. The other major advantage of lease financing in projects is that no standard debt equity ratios are applicable, since lease finance does not qualify either as borrowing or equity. This means that companies can operate on a relatively low equity base.

Typically, projects tend to operate on a debt equity ratio of about 2:1. However, for projects for which equipment is leased what matters is not the debt equity ratio but the debt service coverage ratio (the number of times the operating profit is covered the outstanding debt payments). Acceptable ratios would be about two.

The essence of project financing lies in the recourse financiers have to assets. Infrastructure projects allow conventional lenders access only to fixed assets. This is not of immediate use — after all, what can a banker do with a power plant of a generating company that has defaulted on loans. But with leasing, financiers actually own the assets, and this gives them the advantage of a tax-saving depreciation shelter.

The benefits of a reduced tax liability can then be passed on to the lessee company. This means that the company's financial costs could be far lower than a conventional term loan would allow. Typically, term loan rates vary from 15 to 17 per cent, depending on the promoter. By contrast, items with a depreciation shelter of about 25 per cent, would attract rental rates of 13 to 14 per cent. A corporate guarantee from a high quality customer would reduce funding costs even more.

But though leasing allows for asset security, lease financiers to infrastructure projects have been concerned about cash flow risks — which can be high for, say, power generating companies that depend on notoriously loss-making state electricity boards for payment. That is why lease deals in India are increasingly being structured to cover cash-flow risks.

One of the favourite methods of covering such cash flow risks is through structured leasing techniques (Figure 1). The Infrastructure Leasing and Financial Services (ILFS) last year, for instance, worked out a five-year structured leasing deal for Chemplast Sanmar, which was diversifying into shipping. ILFS along with ORIX Corporation of Japan provided the funds for Chemplast's purchase of the ship MT World Castle. The ship, in turn, was given out on a time charter to the governments Oil Coordination Committee (OCC). Chemplast was able to secure a high price for the time charter that allowed for a 12 per cent return on equity. That is, the time charter covered the variable operational costs and allowed Chemplast a minimum return of 12 per cent. As important, the charter payments were assured because they bore a sovereign guarantee.

Despite this assured cash flow which, in turn, would have meant assured lease rental payments, ILFS chose to be circumspect. It opted for an overseas escrow account into which the charter rentals were credited. The ILFS-ORIX combine had first charge on the account, Chemplast second charge. The entire deal was doubly safe for the lease financiers because they were the owners of the ship, which is a relatively liquid asset.

In the Chemplast-OCC deal, there were actually no cash flow risks. But this method could work just as well for power projects where cash flow risks are high because they depend on state electricity boards for payment. In such cases, however, the deal would need to be backed by letters of credit or by bank guarantees. Chemplast is not the only one to use such structure leasing mechanics. The Indian Railways has been increasingly doing so. The Railways is Indias largest lessee; its annual leasing bill could be as high as Rs 500 crore. Although it usually routes its deals through the Indian Railway Corporation, it has also worked out lease arrangements with the State Bank of India, the Industrial Development Bank of India and ILFS.

The first two deals was essentially to finance the Railways rolling stock — wagons and the like. But the deal with ILFS was unique in that it leveraged a special purpose vehicle or a holding company to raise money from commercial banks and institutions through a syndicated lease.

The Rs 125-crore lease was for acquisition of permanent way hardware (basically railway tracks) for the Konkan Railway Corporation Ltd, which is also a special purpose vehicle created to implement the 1,200 km rail link along the west coast.

The deal worked like this (Figure 2). Konkan Railway Corporation deposits a 20 per cent of the asset value with ILFS. ILFS in turn sets up a special purpose vehicle with this money and leverages it to raise debt from other financial institutions, banks and companies.

But since the assets in this case — railway tracks — are virtually illiquid, ILFS created an escrow account into which the Railways deposited parts of its freight and passenger earnings from the Konkan railway. The ILFS-owned special purpose vehicle had first charge on this account.

Now, other finance companies are beginning to look to the Railways for structured leasing deals. GE Caps, for instance, is prepared to offer rolling stock leases up to 20 years. But the major problem with these kind of leases is the mismatch between the depreciation period (written down value) and the tenor of the loan.

The tenor of the lease would have to coincide with asset fully depreciating at the end of the lease period. GE Caps says it can solve this by breaking up the lease period into two legs. During the primary lease period, when the lessor will also benefit from the depreciation rates, the rentals will be high and during the secondary lease period the rentals would be low. But this method has not appealed to the Railways because the overall costs are high — as much as 19 per cent.

An alternative method would be to domicile the lease elsewhere, where the depreciation rates could match the tenor of the lease. But cross border domiciling of leases could mean that the lessor would have to assume the exchange risk and the Railways is unlikely to agree to this. So the GE Caps lease offers have not elicited favourable responses so far.

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Now, state electricity boards have already begun using such methods to finance their asset replacement plans. For instance, the Assam State Electricity Board is negotiating with banks for hydro-electric generation equipment on a structured lease basis. The deal could cost up to Rs 300 crore, making it the single biggest lease transaction in India.

Deals like this could mark the start of big ticket leasing in India. Once this takes off, bankers could find that the conventional high-risk nature of infrastructure funding could change completely.

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LESSON 10:
HIRE PURCHASE – CONCEPTUAL, LEGAL AND REGULATORY FRAMEWORK

Lesson Objectives

- To understand the Concept of Hire Purchase Finance,
- Regulations related to Hire purchase.

Introduction

Hire purchase is a mode of financing the price of the goods to be sold on a future date. In a hire purchase transaction, the goods are let on hire, the purchase price is to be paid in installments and hirer is allowed an option to purchase the goods by paying all the installments. Hire purchase is a method of selling goods. In a hire purchase transaction the goods are let out on hire by a finance company (creditor) to the hire purchase customer (hirer). The buyer is required to pay an agreed amount in periodical installments during a given period. The ownership of the property remains with creditor and passes on to hirer on the payment of the last installment.

A hire purchase agreement is defined in the Hire Purchase Act, 1972 as peculiar kind of transaction in which the goods are let on hire with an option to the hirer to purchase them, with the following stipulations:

a. Payments to be made in installments over a specified period.
b. The possession is delivered to the hirer at the time of entering into the contract.
c. The property in goods passes to the hirer on payment of the last installment.
d. Each installment is treated as hire charges so that if default is made in payment of any installment, the seller becomes entitled to take away the goods, and
e. The hirer/ purchase is free to return the goods without being required to pay any further installments falling due after the return.

Features of Hire Purchase Agreement

- Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installments.
- Each installment is treated as hire charges.
- The ownership of the goods passes from the seller to the buyer on the payment of the last installment.
- In case the buyer makes any default in the payment of any installment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as hire charges.
- The hirer has the right to terminate the agreement any time before the property passes. That is, he has the option to return the goods in which case he need not pay installments falling due thereafter. However, he cannot recover the sums already paid as such sums legally represent hire charges on the goods in question.

Hire Purchase v/s Installment Sale

Though both the system of consumer credit are very popular in financing and look similar, there is clear distinction between the two. In an installment sale, the contract of sale is entered into the goods are delivered and the ownership is transferred to the buyer but the price is paid in specified installments over a period of time.

In hire purchase the hirer can purchase the goods at any time during the term of the agreement and he has the option to return the goods at any time without having to pay rest of the installments. But in installment payment financing there is no such option to the buyer. In installment payment, the ownership of the goods is transferred immediately at the time of entering into the contract. Whereas in hire purchase the ownership is transferred after the payment of last installment or when the hirer exercises his option to buy goods.

Lease Financing v/s Hire Purchase Financing

The two modes of financing differ in the following respect:

	Hire purchase	Lease financing
Ownership	Financer is the owner, and owner ship is transferred after payment of last installment.	Financer is the owner, but ownership is never transferred.
Depreciation	Hirer is entitled to claim depreciation benefit.	The lessor is entitled to claim depreciation benefit.
Magnitude	Low	High
Extent	Less than 100% (50-75%)	Up to 100%
Maintenance	Hirer's responsibility	Lessor's responsibility
Tax benefits	Hirer	Lessor

Legal Framework

There is no exclusive legislation dealing with hire purchase transaction in India. The Hire purchase Act was passed in 1972. An Amendment bill was introduced in 1989 to amend some of the provisions of the act. However, the act has been enforced so far. The provisions of are not inconsistent with the general law and can be followed as a guideline particularly where no provisions exist in the general laws which, in the absence of any specific law, govern the hire purchase transactions. The act contains provisions for regulating:

1. the format / contents of the hire-purchase agreement
2. warrants and the conditions underlying the hire-purchase agreement,
3. ceiling on hire-purchase charges,
4. rights and obligations of the hirer and the owner.

In absence of any specific law, the hire purchase transactions are governed by the provisions of the Indian Contract Act and the Sale of Goods Act. In chapter relating to leasing we have discussed the provisions related to Indian Contract Act, here we will discuss the provisions of Sale of Goods Act.

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Sale of Goods Act

In a contract of hire purchase, the element of sale is inherent as the hirer always has the option to purchase the movable asset by making regular payment of hire charges and the property in the goods passes to him on payment of the last installment. So in this context we will discuss the provisions of Sales of Goods Act, which apply to hire purchase contract.

Contract of Sale of Goods: A contract of sales of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price. It includes both an actual sale and an agreement to sell.

Essential Ingredients of a Sale: A contract of sale is constituted of following elements:

i. Two parties: namely the buyer and the seller, both competent to contract to effectuate the sale.

ii. Goods: The subject matter of the contract.

iii. Money consideration: price of the goods.

iv. Transfer of ownership: of the general property in goods from the seller to the buyer.

v. Essentials of a valid contract under the Indian Contract Act.

Sales v/s Bailment: In a sales, there is a conveyance of property in goods from seller to the buyer for a price and the buyer becomes the owner of goods and can deal with them in the manner he likes. In case of bailment (or leasing) there is a mere transfer of possession of goods from the bailor to the bailee.

Sales v/s Mortgage, Pledge and Hypothecation: The essence of contract of a sale is the transfer of general property in the goods. A mortgage is a transfer of interest in the goods from a mortgagor to mortgagee to secure a debt. A pledge is a bailment of goods by one person to another to secure payment of a debt. A hypothecation is an equitable charge on goods without possession, but not amounting to mortgage. The essence and purpose of these contract is to secure a debt. All the three differ from sale, since the ownership in the goods is not transferred which is an essential condition of sale.

Sale v/s hire purchase: A hire purchase agreement is a kind of bailment whereby the owner of the goods lets them on hire to another person called hirer, on payment of certain stipulated periodical payments as hire charges or rent. If the hirer makes payments regularly, he gets an option to purchase the goods on making the full payment. Before this option is exercised, the hirer may return the goods without any obligation to pay the balance rent. The hirer is however, under no compulsion to exercise the option and purchase the goods at the end of the agreement period.

A hire purchase contract, therefore, differs from sale in the sense that:

(i) In a hire purchase the possession of the goods is with the hirer while the ownership vests with the original owner.

(ii) There is no agreement to buy but only an option is given to hirer to buy the goods under certain conditions, and

(iii) The ownership in the goods passes to the hirer when he exercises his option by making the full payment.

Goods: The subject matter of a contract of sale is the 'goods'. 'Goods' mean every kind of movable property excluding money and auctionable claims. Besides, growing crops, standing trees and other things attached to or forming part of land, also fall in the meaning of goods, provided these are agreed to be severed from land before sale or under the contract of sale. Further, stocks, shares, bonds, goodwill, patent, copyright, trademarks, water, gas, electricity, ships and so on are all regarded as goods.

Destruction of goods before making of contract: Where in a contract for sale of specific goods, at the time of making the contract, the goods, without knowledge of the seller, have perished or become so damaged as no longer to answer to their description in the contract, the contract is null and void. This rule, however, does not apply in case of unascertained goods.

Destruction of Goods after the Agreement to sell but before sale: Where in an agreement to sell specific goods, if the goods without any fault on the part of the seller, have perished or become so damaged as no longer answer to their description in the agreement, the agreement becomes void, provided the ownership has not passed to the buyer. If the title to the goods has already passed to the buyer he must pay for the goods though the same cannot be delivered.

Document of Title to goods: A document of title to goods is one which entitles and enables its rightful holder to deal with the goods represented by it, as if he were the owner. It is used in the ordinary course of business as proof of ownership, possession or control of goods, e.g. cash memo, bill of lading, dock warrant, warehouse keeper's or wharfingers certificate, lorry receipt, railway receipt and delivery order.

Price: The price means the money consideration for transfer of property in goods from the seller to the buyer. The price may be ascertained in any of the following modes:

i. The price may be expressly stated in the contact.

ii. The price may be left to be fixed in manner provided in the contract.

iii. Where the price is neither expressed in the contract nor there is any provision for its determination, it may be ascertained by the course of dealings between the parties.

iv. It may be a 'reasonable price'.

v. It may be agreed to be fixed by 'third party valuation'.

The most usual mode is however, by expressly providing price in the contract.

EM or security deposit: In certain contract the buyer pays an amount in advance as earnest money deposit or as a security deposit, for the due performance on his part of the contract. Though the amount of earnest money is adjustable towards the price of the goods, it differs from the price in the sense that while payment towards the prices is recoverable, EM is liable to be forfeited if the buyer fails to perform his part and the contract goes off.

Doctrine of Caveat Emptor (Let the Buyer Beware): If the buyer relies on his own skill and judgment and takes the risk of the suitability of the goods for his purpose, it is no part of the seller's obligation to caution the buyer of the defects in the

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goods or to give to the buyer an article suitable for his purpose. If the buyer relies on his own skill and judgment and the goods turn out to be defective, he cannot hold the seller responsible for the same.

This is known as the 'doctrine of caveat emptor' or 'let the buyer beware'. This applies to all sale contracts invariably, except in following cases:

a. When the buyer makes known to the seller the particular purpose for which he requires the goods and relies on the seller's skill and judgment.
b. When the goods are sold by description by a manufacturer or seller who deals in goods of that description, the seller is bound to deliver the goods of merchantable quality.
c. When the purpose for which the goods are purchased is implied from the conduct of the parties or from the nature or description of the goods, the condition of quality or fitness for that particular purpose is annexed by the usage of trade.
d. When the seller either fraudulently misrepresents or actively conceals the latent defects.

Transfer of Property in goods: The property in goods is said to be transferred from the seller to the buyer when the latter acquires the proprietary rights over the goods and the obligations linked thereto. The transfer of property in goods is the essence of a contract of sale.

The moment when the property in goods passes from the seller to the buyer is significant from the point that risks associated with the goods follow the ownership, irrespective of the delivery. If the goods are damaged or destroyed, the loss is borne by the person who is the owner of the goods at the time of damage or destruction. The two essential requirements for transfer of property in the goods are

a. Goods must be ascertained and
b. The parties must intend to pass the property in the goods.

Performance of a sale contract: Performance of a sale contract implies, as regards the seller to deliver the goods, and as regards the buyer to accept the delivery and make payment for them, in accordance with the terms of the contract. Unless there is a contract to the contrary, delivery of the goods and payment of the price are concurrent conditions and are to be performed simultaneously.

Delivery of goods: 'Delivery' means 'voluntary transfer of possession of goods from one person to another'. Delivery may be (a) actual (b) symbolic or (c) constructive.

Delivery is said to be actual when the goods are handed over physically. A symbolic delivery takes place where the goods are bulky and incapable of actual delivery e.g. a car is delivered by handing over the keys to the buyer. A constructive delivery is a delivery by attornment which takes place when the person in possession of the goods acknowledges that he holds the goods on behalf and at the disposal of the other person.

Acceptance of Delivery: The buyer is said to have accepted the goods, when he signifies his assent that he has received the goods under, and in performance of the contract of sale. A buyer cannot reject the goods after he has accepted them. A buyer is deemed to have accepted the goods, when:

a. He intimates to the seller, his acceptance or
b. He retains the goods, beyond a reasonable time, without intimating to the seller that he has rejected them or
c. He does any act in relation to the goods which is consistent with the ownership of the seller.

Hire Purchase Agreemnt

A hire purchase agreement is in many ways similar to a lease agreement, in so far as the terms and conditions are concerned. The important clauses in a hire purchase agreement are:

1. **Nature of Agreement:** Stating the nature, term and commencement of the agreement.
2. **Delivery of Equipment:** The place and time of delivery and the hirer's liability to bear delivery charges.
3. **Location:** The place where the equipment shall be kept during the period of hire.
4. **Inspection:** That the hirer has examined the equipment and is satisfied with it.
5. **Repairs:** The hirer to obtain at his cost, insurance on the equipment and to hand over the insurance policies to the owner.
6. **Alteration:** The hirer not to make any alterations, additions and so on to the equipment, without prior consent of the owner.
7. **Termination:** The events or acts of hirer that would constitute a default eligible to terminate the agreement.
8. **Risk:** of loss and damages to be borne by the hirer.
9. **Registration and fees:** The hirer to comply with the relevant laws, obtain registration and bear all requisite fees.
10. **Indemnity clause:** The clause as per Contract Act, to indemnify the lender.
11. **Stamp duty:** Clause specifying the stamp duty liability to be borne by the hirer.
12. **Schedule:** of equipments forming subject matter of agreement.
13. **Schedule of hire charges.**

The agreement is usually accompanied by a promissory note signed by the hirer for the full amount payable under the agreement including the interest and finance charges.

So far we discussed the legal aspect, let's now discuss the taxation aspect of the hire purchase agreement.

Taxation Aspects

The taxation aspects of hire purchase transaction can be divided into three parts (a) Income Tax, (b) Sales Tax and (c) Interest Tax.

Income Tax Aspect

Hire purchase, as a financing alternative, offers tax benefits both to the hire-vendor (hire purchase finance company) and the hirer.

Income tax assessment of the Hire purchase or hirer: The hirer is entitled to (i) The tax shield on depreciation calculated with reference to the cash purchase price and (ii) the tax shield

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on the finance charges. Even though the hirer is not the owner he gets the benefit of depreciation on the cash price of the asset/equipment. Also he can claim finance charges (difference of hire purchase price and cash price) as expenses. If the agreement provides for the option of purchasing the goods as any time or of returning the same before the total amount is paid, no deduction of tax at source is to be made from the consideration of hire paid to the owner.

Income tax assessment of the Owner or financer: The consideration for hire/hire charges / income received by the hire vendor / financer is liable to tax under the head profits and gains of business and profession where hire purchase constitute the business (mainstream activity) of the assessee, otherwise as income from other sources. The hire income from house property is generally taxed as income from house property. Normal deduction (except depreciation) are allowed while computing the taxable income.

Sales Tax Aspect

The salient features of sales tax pertaining to hire purchase transactions after the Constitution (Forty Sixth Amendment) Act, 1982, are as discussed in following points:

a. ***Hire purchase as Sale:*** Hire purchase, though not sale in the true sense, is deemed to be sale. Such transactions as per se are liable to sales tax. Full tax is payable irrespective of whether the owner gets the full price of the goods or not.

b. ***Delivery v/s Transfer of property:*** A hire purchase deal is regarded as a sale immediately the goods are delivered and not on the transfer of the title to the goods. The quantum of sales tax is the sales price, thus the sales tax is charged on the whole amount payable by the hirer to the owner. The sales tax on a hire purchase sale is levied in the state where the hire purchase agreement is executed

c. ***Rate of tax:*** The rate of sales tax on hire purchase deals vary from state to state. There is, as a matter of fact, no uniformity even regarding the goods to be taxed. If the rates undergo a change during the currency of a hire purchase agreement, the rate in force on the date of the delivery of the goods to the hirer is applicable.

Interest Tax

The hire purchase finance companies, like other credit / finance companies, have to pay interest tax under the Interest Tax Act, 1974. According to this Act, interest tax is payable on the total amount of interest earned less bad debts in the previous year at a rate of 2 percent. The tax is treated as a tax deductible expense for the purpose of computing the taxable income under the Income Tax.

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LESSON 11:
HIRE PURCHASE – ACCOUNTING, REPORTING AND TAXATION

Lesson Objectives

- To understand the Concept of Hire Purchase Finance,
- Regulations related to Hire purchase.

Introduction

Hire purchase, as a form of financing, differs from lease financing in one basic respect: while in hire purchase transaction, the hirer has the option to purchase the asset at the end of the period on payment of the last installment of hire charge, the lessee does not have the option to acquire the ownership of the leased asset. A hire purchase transaction has, therefore, some typical features from the point of view of accounting and reporting.

First, although the legal title over the equipment remains with the hire vendor (financer), all risks and rewards associated with the asset stand transferred to the hirer at the inception of the transaction. The accounting implication is that the asset should be recorded in the books of the hirer. The hire-vendor should record them as hire asset stock in trade or as receivables.

Secondly, the hirer should be entitled to the depreciation claim. Finally, the hire charges, like the lease rental in a financial lease, have two components (a) interest charges (b) recovery of principal.

In India, we do not have any accounting guidelines or standards for accounting treatment of hire purchase. There is also no specific law / regulation to govern hire purchase contracts. The aspects which have a bearing on the accounting and reporting of hire purchase deals are the timings of the capitalization of the asset (inception v/s conclusion of the deal), the price, the depreciation charge and the treatment of hire charges.

Now, let us discuss the accounting and reporting treatment of transactions in the books of hirer and financer.

Accounting Treatment in the Books of Hirer

The cash purchase price of the asset is capitalized and the capital content of the hire purchase installment, that is, the cash purchase price less down payment, if any, is recorded as a liability. The depreciation is based on the cash purchase price of the asset in conformity with the policy regarding similar owned assets. The total charges for credit (unmatured finance charge at the inception of the hire purchase transaction) is allocated over the hire period using one of the several alternative methods, namely, effective rate of interest method, sum of years digits method and straight line method.

Accounting Treatment in the Books of Hire-vendor (Finance Company)

At the inception of the transaction, the finance company should record the hire purchase installments receivables as current asset (i.e. stock on hire) and the unearned finance income component of these installments as a current liability under the head unmatched finance charges. At the end of each accounting period, an appropriate part of the unmatured finance income should be recognized as current income for the period. It would be allocated over the relevant accounting periods on the basis of any of the following methods (a) ERI (b) SOYD and (c) SLM. At the end of each accounting period, the hire purchase price less the installments received should be shown as receivable / stock on hire and the finance income component of these installment should be shown as current liability / unmatched finance charge. The direct costs associated with structuring the transactions / deal should be either expensed immediately or allocated against the finance income over the hire period.

Financial Evaluation

Now let us discuss the framework of financial evaluation of a hire purchase deal vis-à-vis a finance lease from both the hirer's as well as the finance company's viewpoint.

From the Point of View of the Hirer (Purchaser):

The tax treatment given to hire purchase is exactly the opposite of that given to lease financing. It may be recalled that in lease financing, the lessor is entitled to claim depreciation and other deductions associated with the ownership of the equipment including interest on the amount borrowed to purchase the asset, while the lessee enjoys full deduction of lease rentals. In sharp contrast, in a hire purchase deal, the hirer is entitled to claim depreciation and the deduction for the finance charge (interest) component of the hire installment. Thus, hire purchase and lease financing represent alternative modes of acquisition of assets. The evaluation of hire purchase transaction from the hirer's angle, therefore, has to be done in relation to leasing alternative.

Decision criterion: The decision criterion from the point of view of hirer is the cost of hire purchase vis a vis the cost of leasing. If the cost of hire purchase is less than the cost of leasing, the hirer should prefer the hire purchase alternative and vice-versa.

Cost of hire purchase: The cost of hire purchase to the hirer consists of the following:

1. Down payment
2. + Service Charges
3. + Present value of hire purchase payments discounted by the cost of debt.
4. – Present value of depreciation tax shield discounted by cot of capital.
5. – Present value of net salvage value discounted by cost of capital.

Cost of leasing: The cost of leasing consists of the following elements:

1. Lease management fee
2. + PV of lease payments discounted by cost of debt.

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3. – PV of tax shield on lease payments and lease management fee discounted by cost of capital.
4. + PV of interest tax shield on hire purchase by cost of capital.

From the View Point of Vendor / Financer

Hire purchase and leasing represent two alternative investment decisions of a finance company / financial intermediary / hire-vendor. The decision criterion therefore is based on a comparison of the net present values of the two alternatives, namely, hire purchase and lease financing. The alternative with a higher NPV would be selected and the alternative having a lower NPV would be rejected.

NPV of Hire purchase Plan: The NPV of HPP consist of

1. PV of hire purchase installments
2. + Documentation and service fee.
3. + PV of tax shield on initial direct cost
4. – Loan amount
5. – Initial cost.
6. – PV of interest tax on finance income (interest)
7. – PV of income tax on finance income meted for interest tax
8. – PV of income tax on documentation and service fee.

NPV of Leas Plan: The NPV of LP consists of the following elements:

1. PV of lease rentals.
2. + Leas management fee
3. + PV of tax shield on initial direct costs and depreciation.
4. + PV of Net salvage value.
5. – Initial investment
6. – Initial direct costs.
7. – PV of tax liability on lease rentals and lease management fee.

Hire Purchase FAQ's

www.indiainfoline.com

1. What is Hire Purchase?

It is a transaction by which a person buys a movable asset and pays the sale consideration to the financier in installments. It is an agreement of hire with an option to the hirer to purchase the asset. He is allowed to use the asset immediately, but becomes its owner only after he exercises the option after paying the entire installments. So in effect, he takes a loan from the owner or financier. During the repayment period the ownership remains with the financier.

2. What is 'option to purchase'?

In a hire purchase agreement, at the end of the hire period when all hire charges have been paid, the hirer has the option to purchase the asset at a value fixed by the financier. This is known as the option to purchase.

3. What are the kinds of assets purchased under a hire purchase agreement?

Movable assets like cars, machinery, fixtures and furniture, computers and electronic items, that can be delivered physically, can be purchased. Immovable property cannot be purchased under a hire purchase agreement. The transaction with reference to immovable property is normally referred to as sale and lease agreement.

4. Is a guarantor required in a Hire purchase agreement and if so who can be a guarantor?

A guarantor is not essential for a hire purchase transaction, unless the financier insists on it. Most financiers however insist on a guarantor. The guarantor acts as an additional security against default in payment by the hirer. Any creditworthy person can be a guarantor, if the financier is satisfied that he can repay the money in case of default by the hirer.

5. What is the financier's security in a Hire purchase agreement, without a guarantor?

The financier may ask the hirer for an immovable property as security. However the primary security for the financier is the product purchased under the agreement.

6. What precautions should a hirer take before he enters into a hire purchase agreement?

Before entering into a hire-purchase agreement, a person should 1.Sign on a hire purchase agreement form containing the terms of hire purchase. 2. Insist for a copy of the agreement for his record. 3. Keep a record of all payments made to the financier till the payment of the last installment. 4. Get a 'no dues' receipt from the financier after full payment of the hire purchase charges.

7. Can I pre-pay all my installments under hire purchase agreement?

Normally a financier does not allow any pre-payment of installments unless he is compensated for the loss of interest.

8. Will default or delay in the payment of installments attract penalty?

Yes. Usually, the hirer has to pay a penalty or fine to the financier for default or delay in the payment of the dues under the agreement.

9. What are the income tax implications in the case of a hire purchase?

In the hire purchase the hirer carrying business or profession gets benefit of depreciation. He can also claim deduction on the interest paid on hire charges, in his income tax assessment.

Hire Purchase: Taking the Customer to Court

www.business-standard.com / Business Standard September 05,2001

Under modern hire purchase agreements, the hirers are simply paying for the use of the goods and for the option to buy them

Though hire purchase agreements are very common while buying consumer goods, there is no specific law that caters to the needs of the modern times. Parliament passed the Hire Purchase Act in 1972, but it is a classic case of neglect.

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It has not been notified in the official gazette in three decades. Therefore it has no force of law. As a result, hire purchase agreements are covered by the law of contract and the interpretation given by the courts to the agreements.

Many of those who rush to buy motor vehicles and other goods realise the rigours of the contract only when the repossessors arrive. But then it is too late, as the Supreme Court judgement last week in Charanjit Singh vs Sudhir Mehra showed. Even in law, it is a lost battle for the buyer.

In this case, Sudhir bought a motor vehicle under a hire purchase agreement with a non-banking financial institution. When the instalment stopped, the financier forcibly took away the vehicle from the motor mechanic where it was given for repairs.

The purchaser filed a criminal complaint against the financier for theft, cheating and criminal breach of trust. The financier moved the Punjab high court for quashing the complaint.

The high court dismissed it. So it moved the Supreme Court which quashed the complaint after finding fault with the high court view.

The problem arises because most of those who go in for hire purchase agreements do not understand the nature of the contract. The deed is also deliberately made bulky by the financier so that an ordinary buyer would not take time to read the terms.

Even if they try to read it, the legalese would put off even the educated. If you ask for your copy of the agreement after signing on the dotted lines till your fingers ache, there would be evasive answers. Thus it is a losing battle from the start.

Hire purchase agreements were originally entered into between the dealer and the customer and the dealer used to extend credit to the customer. But as hire purchase gained popularity, the dealers could not expand the working capital. Then the financier came into the picture. The finance company would buy the goods from the dealer and let them to the customer under the hire purchase agreement.

The dealer would deliver the goods to the buyer and then drop out of the transaction, leaving the finance company to collect the instalments directly from the customer.

Under modern hire purchase agreements, the hirers are simply paying for the use of the goods and for the option to buy them. The finance charge, representing the difference between the cash price and the hire purchase price, is not interest but represents a sum which the hirer has to pay for the privilege of being allowed to discharge the purchase price of goods in instalments.

In this case, the small print gave the financier the right to “enter any building, premises or place where the vehicle may be kept for inspection, re-possession or attempt to re-possess”.

It further emphasised that such attempts will not make the financier liable for any civil or criminal action at the instance of the hirer. Therefore, even if a case is filed against the financier for dacoity in such circumstances (as in Sardar Trilok Singh vs Satya Deo, 1979), the financier will have the upper hand. The Supreme Court, in Damodar Valley Corporation v/s State of Bihar has discussed different types of agreements in the nature of hire purchase. These and other judgements make tedious reading.

What is required now is a comprehensive legislation taking into consideration the needs of the consumerist era. The law-makers who have neglected to notify the 1972 Act must now start working on a new legislation on the subject.

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LESSON 12:
COMPARATIVE STUDY OF VARIOUS FORMS OF CREDIT

Lesson Objectives

- To understand the various forms of customer credit and their comparative study.
- Develop an understanding, so that financing offers can be best evaluated.

Dear Students, so far you have studied various forms of financing options. After studying in detail various forms of consumer credit / financing options, it becomes essential to make their comparative study and evaluation of each with respect to other, so you get an objective idea that which form of credit is best suited for which situation.

You all have to submit a write up on comparative advantages and disadvantages of various forms of credit, namely: Leasing, Hire Purchase, Installment payment and term loan.

Your faculty will provide you a case study, for discussion in the class based on various forms of credit.

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LESSON 13:
FACTORING – THEORETICAL FRAMEWORK

Lesson Objectives

- To understand the Concept of Factoring.
- Methodology of Factoring and Forfeiting.
- Types of factoring.

Introduction

Receivables constitute a significant portion of current assets of a firm. But, for investment in receivables, a firm has to incur certain costs such as costs of financing receivables and costs of collection from receivables. Further, there is a risk of bad debts also. It is, therefore, very essential to have a proper control and management of receivables. In fact, maintaining of receivables poses two types of problems; (i) the problem of raising funds to finance the receivables, and (it) the problems relating to collection, delays and defaults of the receivables. A small firm' may handle the problem of receivables management of its own, but it may not be possible for a large firm to do so efficiently as it may be exposed to the risk of more and more bad debts. In such a case, a firm may avail the services of specialised institutions engaged in receivables management, called factoring firms.

At the instance of RBI a Committee headed by Shri C. S. Kalyan Sundaram went into the aspects of factoring services in India in 1988, which formed the basis for introduction of factoring services in India. SBI established, in 1991, a subsidiary-SBI Factors Limited with an authorized capital of Rs. 25 crores to undertake factoring services covering the western zone

Meaning and Definition

Factoring may broadly be defined as the relationship, created by an agreement, between the seller of goods/services and a financial institution called .the factor, whereby the later purchases the receivables of the former and also controls and administers the receivables of the former.

Factoring may also be defined as a continuous relationship between financial institution (the factor) and a business concern selling goods and/or providing service (the client) to a trade customer on an open account basis, whereby the factor purchases the client's book debts (account receivables) with or without recourse to the client - thereby controlling the credit extended to the customer and also undertaking to administer the sales ledgers relevant to the transaction.

The term" factoring" has been defined in various countries in different ways due to non-availability of any uniform codified law. The study group appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988 recommended, in simple words, the definition of factoring as under:

"Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor:

- Finance
- Maintenance of accounts
- Collection of debts
- Protection against credit risks".

The above definition, however, applies only to factoring in relation to supply of goods and services in respect of the following:

i. To trade or professional debtors

ii. Across national boundaries

iii. When notice of assignment has been given to the debtors.

The development of factoring concept in various developed countries of the world has led to some consensus towards defining the term. Factoring can broadly be defined as an arrangement in which receivables arising out of sale of goods/services are sold to the "factor" as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Hence the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer (s).

Glossary of Terminology

The common terminology used in a factoring transaction are as follows:

i. Client He is also known as supplier. It may be a business institution supplying the goods/services on credit and availing of the factoring arrangements.

ii. Customer A person or business organisation to whom the goods/ services have been supplied on credit. He may also be called as debtor.

iii. Account receivables Any trade debt arising from the sale of goods/ services by the client to the customer on credit.

iv. Open account sales Where in an arrangement goods/ services are sold/supplied by the client to the customer on credit without raising any bill of exchange or promissory note.

v. Eligible debt Debts, which are approved by the factor for making prepayment.

vi. Retention Margin maintained by the factor.

vii. Prepayment An advance payment made by the factor to the client up to a certain percent of the eligible debts.

Nature of Factoring

Factoring is a tool of receivable management employed to release funds tied up in credit extended to customers.

1. Factoring is a service of financial nature involving the conversion of credit bills into cash. Accounts receivables, bills recoverable and other credit dues resulting from credit sales appear in the books of account as book credits.

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2. The risk associated with credit are taken over by the factor which purchases these credit receivables without recourse and collects them when due.
3. A factor performs at least two of the following functions:
   i. Provides finance for the supplier including loans and advance payments.
   ii. Maintains accounts, ledgers relating to receivables.
   iii. Collects receivables.
   iv. Protects risk of default in payments by debtors.
4. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales. It acts as another financial intermediary between the buyer and seller.
5. Unlike a bank, a factor specialises in handling and collecting receivables in an efficient manner. Payments are received by the factor directly since the invoices are assigned in favor of the factor.
6. Factor is responsible for sales accounting, debt collection and credit control protection from bad debts, and rendering of advisory services to their clients.
7. Factoring is a tool of receivables management employed to release funds tied up in credit extended to customers and to solve the problems relating to collection, delays and defaults of the receivables.

Mechanism of Factoring

Factoring business is generated by credit sales in the normal course business. The main function of factor is realisation of sales. Once the transaction takes place, the role of factor step in to realise the sales/collect receivables. Thus, factor act as a intermediary between the seller and till and sometimes along with the seller's bank together.

The mechanism of factoring is summed up as below:

i. An agreement is entered into between the selling firm and the firm. The agreement provides the basis and the scope understanding reached between the two for rendering factor service.
ii. The sales documents should contain the instructions to make payment directly to the factor who is assigned the job of collection of receivables.
iii. When the payment is received by the factor, the account of the firm is credited by the factor after deducting its fees, charges, interest etc. as agreed.
iv. The factor may provide advance finance to the selling firm conditions of the agreement so require.

Parties to the Factoring

There are basically three parties involved in a factoring transaction.

1. The buyer of the goods.
2. The seller of the goods
3. The factor i.e. financial institution.

The three parties interact with each other during the purchase/sale of goods. The possible procedure that may be followed is summarised below.

The Buyer

1. The buyer enters into an agreement with the seller and negotiates the terms and conditions for the purchase of goods on credit.
2. He takes the delivery of goods along with the invoice bill and instructions from the seller to make payment to the factor on due date.
3. Buyer will make the payment to the factor in time or ask for extension of time. In case of default in payment on due date, he faces legal action at the hands of factor.

The Seller

1. The seller enters into contract for the sale of goods on credit as per the purchase order sent by the buyer stating various terms and conditions.
2. Sells goods to the buyer as per the contract.
3. Sends copies of invoice, delivery challan along with the goods to the buyer and gives instructions to the buyer to make payment on due date.
4. The seller sells the receivables received from the buyer to a factor and receives 80% or more payment in advance.
5. The seller receives the balance payment from the factor after paying the service charges.

The Factor

1. The factor enters into an agreement with the seller for rendering factor services i.e. collection of receivables/debts.
2. The factor pays 80% or more of the amount of receivables copies of sale documents.
3. The factor receives payments from the buyer on due dates and pays the balance money to the seller after deducting the service charges.

Types of Factoring

A number of factoring arrangements are possible depending upon the agreement reached between the selling firm and the factor. The most common feature of practically all the factoring transactions is collection of receivables and administration of sale ledger. However, following are some of the important types of factoring arrangements.

1. Recourse and Non-recourse Factoring

In a recourse factoring arrangement, the factor has recourse to the client (selling firm) if the receivables purchased turn out to be bad, Let the risk of bad debts is to be borne by the client and the factor does not assume credit risks associated with the receivables. Thus the factor acts as an agent for collection of bills and does not cover the risk of customer's failure to pay debt or interest on it. The factor has a right to recover the funds from the seller client in case of such defaults as the seller takes the risk of credit and creditworthiness of buyer. The factor charges the selling firm for maintaining the sales ledger and debt collection services and also charges interest on the amount drawn by the client (selling firm) for the period.

Whereas, in case of non-recourse factoring, the risk or loss on account of non-payment by the customers of the client is to be borne by the factor and he cannot claim this amount from the selling firm. Since the factor bears the risk of non-payment,

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commission or fees charged for the services in case of non-recourse factoring is higher than under the recourse factoring. The additional fee charged by the factor for bearing the risk of bad debts/non-payment on maturity is called *del credere* commission.

2. Advance and Maturity Factoring

Under advance factoring arrangement, the factor pays only a certain percentage (between 75 % to 90 %) of the receivables in advance to the client, the balance being paid on the guaranteed payment date. As soon as factored receivables are approved, the advance amount is made available to the client by the factor. The factor charges discount/interest on the advance payment from the date of such payment to the date of actual collection of receivables by the factor. The rate of discount/interest is determined on the basis of the creditworthiness of the client, volume of sales and prevailing short-term rate.

Sometimes, banks also participate in factoring transactions. A bank agrees to provide an advance to the client to finance a part say 50% of the (factored receivables - advance given by the factor). For example :

Assume total value of the factored debt/receivable is	Rs. 100
A factor finances 80 % of the debt.	Rs. 80
Balance value of debt	Rs. 20
Say, bank finances 50% of the balance i.e.	Rs. 10.

Thus, the factor and the bank will make a pre-payment of Rs. 90 (i.e. 90% of the debt) and the client's share is only 10% of the investment in receivables. In case of maturity factoring, no advance is paid to client and the payment is made to the client only on collection of receivables or the guaranteed payment data as the case may be agreed between the parties. Thus, maturity factoring consists of the sale of accounts receivables to a factor with no payment of advance funds at the time of sale.

3. Conventional or Full Factoring

Under this system the factor performs almost all services of collection of receivables, maintenance of sales ledger, credit collection, credit control and credit insurance. The factor also fixes up a draw limit based on the bills outstanding maturity-wise and takes the corresponding risk of default or credit risk and the factor will have claims on the debtor as also the client creditor.

It is also known as Old Line Factoring. Number of other variety of services such as maturity-wise bills collection, maintenance of accounts, advance granting of limits to a limited discounting of invoices on a selective basis are provided. In advanced countries, all these methods are popular but in India only a beginning has been made. Factoring agencies like SBI Factors are doing full factoring for good companies with recourse.

4. Domestic and Export Factoring

The basic difference between the domestic and export factoring is on account of the number of parties involved. In the domestic factoring three parties are involved, namely:

The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of language.

1. Customer (buyer)
2. Client (seller)
3. Factor (financial intermediary)

All the three parties reside in the same country. Export factoring is also termed as cross-border/international factoring and is almost similar to domestic factoring except that there are four parties to the factoring transaction. Namely, the exporter (selling firm or client), the importer or the customer, the export factor and the import factor. Since, two factors are involved in the export factoring, it is also called two-factor system of factoring.

Two factor system results in two separate but inter-related contracts:

1. between the exporter (client) and the export factor.
2. export factor and import factor.

The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of language. He also assumes customer trade credit risk, and agrees to collect receivables and transfer funds to the export factor in the currency of the invoice. Export/International factoring provides a non-recourse factoring deal. The exporter has 100 % protection against bad debts loss arising on account of credit sales.

5. Limited Factoring

Under limited factoring, the factor discounts only certain invoices on selective basis and converts credit bills into cash in respect of those bills only.

6. Selected Seller Based Factoring

The seller sells all his accounts receivables to the factor along with invoice delivery challans, contracts etc. after invoicing the customers. The factor performs all functions of maintaining the accounts, collecting the debts, sending reminders to the buyers and do all consequential and incidental functions for the seller. The sellers are normally approved by the factor before entering into factoring agreement.

7. Selected Buyer Based Factoring

The factor first of all selects the buyers on the basis of their goodwill and creditworthiness and prepares an approved list of them. The approved buyers of a company approach the factor for discounting their purchases of bills receivables drawn in the favour of the company in question (i.e. seller). The factor discounts the bills without recourse to seller and makes the payment to the seller.

8. Disclosed and Undisclosed Factoring

In disclosed factoring, the name of the factor is mentioned in the invoice by the supplier telling the buyer to make payment to the factor on due date. However, the supplier may continue to bear the risk of bad debts (i.e. non-payments) without passing to the factor. The factor assumes the risk only under non-recourse factoring agreements. Generally, the factor lays down a limit within which it will work as a non-recourse. Beyond this limit the dealings are done on recourse basis i.e. the seller bears the risk.

Under undisclosed factoring, the name of the factor is not disclosed in the invoice. But still the control lies with the factor. The factor maintain sales ledger of the seller of goods, provides short-term finance against the sales invoices but the entire

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transactions take place in the name of the supplier company (seller).

Functions of a Factor

The purchase of book debts or receivables is central to the function of factoring permitting the factor to provide basic services such as :

1. Administration of sellers' sales ledger.
2. Collection of receivables purchased.
3. Provision of finance.
4. Protection against risk of bad debts/credit control and credit protection.
5. Rendering advisory services by virtue of their experience in financial dealings with customers.

These are explained as under.

1. Administration of Sales Ledger

The factor assumes the entire responsibility of administering sales ledger. The factor maintains sales ledger in respect of each client. When the sales transaction takes place, an invoice is prepared in duplicate by the client, one copy is given to customer and second copy is sent to the factor. Entries are made in the ledger on open-item method. Each receipt is matched against the specific invoice. On any given date, the customer account indicates the various open invoices outstanding. Periodic reports are sent by factor to the client with respect to current status of receivables and amount received from customers. Depending upon the volume of transactions, the periodicity of report is decided. Thus, the entire sales ledger administration responsibility of the client gets transferred to the factor. He performs the following functions with regard to the administration of sales ledger:

i. He ensures that invoices raised represent genuine trade transactions in respect of goods sold or services provided.
ii. He updates the sales ledger with latest invoices raised and cash received.
iii. He ensures that monthly statements are sent to the debtors, efforts are made to collect the dues on the due dates through an efficient mechanism of personal contacts, issuance of reminders, telephone messages etc.
iv. He remits the retention to the clients after collection of the dues. Where the factoring is operating on Fixed Maturity Period (FMP) basis, the factor is to ensure that the client is paid the retention money at the expiry of the said period.
v. He establishes close links with the client and the customers to resolve the various disputes raised in respect of quantity or quality of the goods/services supplied besides the unauthorised discounts claimed or deducted by the debtors while making payment.
vi. He reviews the financial strength of the debtors at periodic intervals to ensure collectability of debts.
vii. He submits at periodic intervals the reports containing information as to the details of overdue unpaid invoices, disputes, legal cases etc. to the client.

2. Collection of Receivables

The factor helps the client in adopting better credit control policy. The main functions of a factor is to collect the receivables on behalf of the client and to relieve him from all the botherations/problems associated with the collection. This way the client can concentrate on other major areas of his business on one hand and reduce the cost of collection by way of savings in labor, time and efforts on the other hand. The factor possesses trained and experienced personnel, sophisticated infrastructure and improved technology which helps him to make timely demands on the debtors to make payments.

3. Provision of Finance

Finance, which is the lifeblood of a business, is made available easily by the factor to the client. A factor purchases the book debts of his client and debts are assigned in favor of the factor. 75% to 80 percent of the assigned debts is given as an advance to the client by the factor.

a. Where an agreement is entered into between the client (seller) and the c factor for the purchase of receivables without recourse, the factor becomes responsible to the seller on the due date of the invoice whether or not the buyer makes the payment to the factor.
b. Where the debts are factored with recourse- the client has to refund the full finance amount provided by the factor in case the buyer fails to make the payment on due date.

4. Protection Against Risk

This service is provided where the debts are factored without recourse. The factor fixes the credit limits (i.e. the limit up to which the client can sell goods to customers) in respect of approved customers. Within these limits the factor undertakes to purchase all trade debts and assumes risk of default in payment by the customers. The factor not only relieves the client from the collection work but also advises the client on the creditworthiness of potential customers. Thus the factor helps the client in adopting better credit control policy. The credit standing of the customer is assessed by the factors on the basis of information collected from credit rating reports, bank reports, trade reference, financial statement analysis and by calculating the important ratios in respect of liquidity and profitability position.

5. Advisory Services

These services arise out of the close relationship between a factor and a client. Since the factors have better knowledge and wide experience in field of finance, and possess extensive credit information about customer's standing, they provide various advisory services on the matters relating to :

a. Customer's preferences regarding the clients products.
b. Changes in marketing policies/strategies of the competitors.
c. Suggest improvements in the procedures adopted for invoicing, delivery and sales return.
d. Helping the client for raising finance from banks/financial institutions, etc.

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The factor provides his client with a periodical statement on the sanctioned limit, utilised credit and balance outstanding. The following data is provided regularly:

a. List of book debts taken over

b. Book debts realised

c. Age-wise classification of the debts

d. Debts collected and due for collection

e. Debts purchased with recourse or without recourse etc.

Cost of Services

The factor provides various services at some charge in the form of a commission expressed as a value of debt purchased. It is collected in advance. The commission is in the form of interest charged for the period between the date of advance payment and date of collection/guarantee payment date for short term financing as advance part payment. It is also known as discount charge.

The cost of factoring services primarily comprises of the following two components:

1. Administrative charges /factoring fees

This is charged towards providing various services to the clients namely (a) sales ledger administration (b) credit control including processing, operational overheads and collection of debts (c) providing, protection against bad debts.

This charge is usually some percent of the projected sales turnover of the client for the next twelve months. It varies between 1 to 2.5 percent of the projected turnover. The quantum of charged depends upon the following factors.

a. Type of industry
b. Financial strength of the client as well as of the debtors
c. Volume of sales
d. Average invoice value
e. Terms of trade
f. Type(s) of service(s) offered
g. Required profit margin to the factor
h. Extent of competition
i. Security to the factor etc.

2. Discount charges

This is levied towards providing instant credit to the client by way of prepayment. This is normally linked with the base rate of the parent company or the bank from which the factoring institution is borrowing money, say, 1 to 2.5 percent above the said rate.

Impact on Balance Sheet

Factoring, as a financial service has a positive impact on the Balance Sheet as can be illustrated with the help of an example:

Balance Sheet: Pre-factoring Position

(Rs. crores)

Current Liabilities (CL)		Current Assets (CA)	
Bank borrowing against		Inventory	100
i. Inventory		Receivables	80
ii. Receivables	50	Other current assets	20
	120		
Other current liabilities	30		
	150		
Net Working Capital (CA-CL)	50		
Total Current Liabilities	200	Total Current Assets	200

Original Current Ratio 1.33: 1 (200 : 150)

The requirement of net working capital is Rs. 50 crores (Current Assets - Current Liabilities). As the borrower carries other current liabilities to the extent of Rs. 30 crores he is eligible for a maximum bank borrowing of Rs. 120 crores divided into cash credit limit of Rs. 70 crores against inventory and Rs.50 crores against receivables, taking into account the stipulated margins for inventory and receivables and also the proportion of individual levels of inventory of Rs. 100 crores and receivables of Rs. 80 crores.

On the basis of above data, the borrower is eligible for working capital limits aggregating Rs. 120 crore under the second method of: lending as recommended by the Tondon Committee.

Assume the borrower decides to factor his debts. The Receivables aggregating Rs. 80 crore are purchased by a factor who in turn makes advance payment of 80% i.e. Rs. 64 crore. He retains Rs. 16 crore (factor reserve) which will be repaid on payment by the customer.,

Balance Sheet: Post-factoring Position

(Rs. Crore)

Current Liabilities (CL)		Current Assets (CA)	
Bank: borrowing against		Inventory	100
Inventory		Receivables (Due from factor)	16
Other current liaoilities	16	Other current assets	20
Net working capital	50		
(CA;-CL)	136		136

New Current Ratio 1.581: r-(136 : 86)

The impact of factoring on balance sheet may be stated in terms of :

1. *Improvement in Current Ratio*. The current ratio improves from 1.33: 1 (before factoring) to 1.58 : 1. The new current ratio is better for the client and his credit rating goes up before public eye.

2. *Reduction in Current Liabilities*. An advance payment of Rs. 64 crores (i.e. 80% of 80 crore) is utilised in repaying the bank borrowings against receivables to the tune of Rs. 50 crores and for meeting other current liabilities to the tune of Rs. 14 crores. The net effect of factoring transaction is that the current liabilities get reduced by Rs. 64 crore.

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3. *Off-Balance Sheet Finance*. Since the client's debts are purchased by the factor and amount is paid to the client, it serves as off the balance sheet finance and appears in the balance sheet only as a contingent liability in the case of recourse factoring. Because in case of default by the buyer, the client will have to refund the finance amount to the factor. But in case of non-recourse factoring, it does not appear anywhere in the financial statement of the borrower.

Thus factoring services help the client to improve the structure of balance sheet.

Advantages of Factoring

Factoring is becoming popular all over the world on account of various services offered by the institutions engaged in it. Factors render services ranging from bill discounting facilities offered by the commercial banks to total take over of administration of credit sales including maintenance of sales ledger, collection of accounts receivables, credit control, protection from bad debts, provision of finance and rendering of advisory services to their clients. Thus factoring is a tool of receivables management employed to release the funds tied up in credit extended to customers and to solve problems relating to collection, delays and defaults of the receivables.

A firm that enters into factoring agreement is benefited in a number of ways, some of the important benefits are outlined below:

1. The factors provides specialised services with regard to sales ledger administration and credit control and relieves the client from the botheration of debt collection. He can concentrate on the other major areas of his business and improve his efficiency.
2. The advance payments made by the factor to the client in respect of the bills purchased increase his liquid resources. He is able to meet his liabilities as and when they arise thus improving his credit standing position before suppliers, lenders and bankers. The factor's assumption of credit risk relieves him from the tension of bad debt losses. The client can take steps to reduce his reserve for bad debts.
3. It provides flexibility to the company to decide about extending better terms to their customers.
4. The company itself is in a better position to meet its commitments more promptly due to improved cash flows.
5. Enables the company to meet seasonal demands for cash whenever required.
6. Better purchase planning is possible. Availability of cash helps the company to avail cash discounts on its purchases.
7. As it is an off balance sheet finance, thus it does not affect the financial structure. This would help in boosting the efficiency ratios such as return on asset etc.
8. Saves the management time and effort in collecting the receivables and in sales ledger management.
9. Where credit information is also provided by the factor, it helps the company to avoid bad debts.
10. It ensures better management of receivables as factor firm is specialised agency for the same. The factor carries out assessment of the client with regard to his financial, operational and managerial capabilities whether his debts are collectable and viability of his operations. He also assesses the debtor regarding the nature of business, vulnerability of his operations; and assesses the debtor regarding the nature of business, vulnerability to seasonality, history of operations, the term of sales, the track record and bank report available on the past history.

Limitations

The above listed advantages do not mean that the factoring operations are totally free from any limitation. The attendant risk itself is of very high degree. Some of the main limitations of such transactions are listed below:

1. It may lead to over-confidence in the behavior of the client resulting in over-trading or mismanagement.
2 The risk element in factoring gets accentuated due to possible fraudulent acts by the client in furnishing the main instrument "invoice" to the factor. Invoicing against non-existent goods, pre-invoicing (i.e. invoicing before physical dispatch of goods), duplicate-invoicing (i.e. making more than one invoice in respect of single transaction) are some commonly found frauds in such operations, which had put many factors into difficulty in late 50's all over the world.
3. Lack of professionalism and competence, underdeveloped expertise, resistance to change etc. are some of the problems which have made factoring services unpopular.
4. Rights of the factor resulting from purchase of trade debts are uncertain, not as strong as that in bills of exchange and are subject to settlement of discounts, returns and allowances.
5. Small companies with lesser turnover, companies having high concentration on a few debtors, companies with speculative business, companies selling a large number of products of various types to general public or companies having large number of debtors for small amounts etc. may not be suitable for entering into factoring contracts.

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LESSON 14:
FACTORING AND FORFEITING – FINANCIAL EVALUATION

Lesson Objectives

- Study Financial Evaluation of Factoring.
- Understand Concept of Forfeiting.
- Position of Factoring & Forfeiting in India.

Cost-benefit Analysis of Factoring (Financial Evaluation)

The cost-benefit analysis of factoring is concerned with comparing of costs and benefits associated with factoring. A firm would prefer to have factoring arrangements if the risk of default or non-payment is high and the cost involved by way of fees and service charges of the factor are less than the benefits associated with the same. The following examples illustrate the financial evaluation of factoring.

Example 1. Bharat Ltd. decides to liberalise credit to increase its sales. The liberalised credit policy will bring additional sales of Rs. 3,00,000. The variable costs will be 60 % of sales and. there will be 10% risk for non-payment and 5 % collection costs. Will the company benefit from the new credit policy?

Solution

Additional Sales Revenue	Rs. 3,00,000
Less: Variables Cost (60%) Incremental Revenue	180000
Incremental Revenue	120000
Less: 10% for non-payment risk	30000
	90000
Less 5% for costs of collection	15000
Additional Revenue from increased sales due to liberal credit policy	75000

Factoring v/s Bill Discounting

In addition to the rendering of factoring services, banks and financial institutions also provide bills discounting facilities to provide finance to the client.

Following are the similarities and differences between the two services.

Dissimilarities/Differences

The two services differ from each other in the following respects:

Bills Discounting	Factoring
1. It is a provision of finance against bills.	1. Factoring renders all services like maintenance of sales ledger, advisory services, etc in addition to the provision of finance.
2. Advances are made against the bills	2. Trade debts are purchased by assignment.
3. The drawer undertakes the responsibility of collecting the bills and remitting the proceeds to financing agency.	3. Factoring undertakes to collect the bills of the client.
4. Bills discounted may be rediscounted several times before the maturity	4. Debts purchased for factoring cannot be rediscounted, they can only be refinanced
5. Bill discounting is always with recourse, i.e. in case of default the client will have to make good the loss.	5. Factoring may be with or without recourse.
6. Bill financing is individual transaction oriented i.e. each bill is separately assessed on its merits and got discounted purchased.	6. Whereas in factoring, bulk is provided against several unpaid trade generated invoices in batches. It follows the principle of 'whole turnover'
7. Bill finance is always 'In Balance Sheet' financing i.e. both the amounts of receivables and bank credit are reflected in the balance sheet of the clients as current assets and current liabilities respectively. This is because of the 'with recourse' nature of the facility.	7. In full factoring services facility is 'off balance sheet' arrangement, as the client company completes his double entry accounting by crediting the factor for consideration value.
8. The drawee or the acceptor of the bills is in full knowledge of the bank's charge on the receivables arising from the sale of goods and services.	8. Factoring services like 'undisclosed factoring' are confidential in nature i.e. the debtors are not aware of the arrangements. Thus, the large industrial houses availing such facility can successfully claim of running business of their own without any outside financial support.

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Similarities

1. Both provide short-term finance.
2. Both get the account receivables discounted which the client would have otherwise received from the buyer at the end of credit period.

Forfaiting

The forfaiting owes its origin to a French term 'a forfait' which means to forfeit (or surrender) ones' rights on something to some one else. Forfaiting is a mechanism of financing exports:

a. by discounting export receivables
b. evidenced by bills of exchanges or promissory notes
c. without recourse to the seller (viz; exporter)
d. carrying medium to long-term maturities
e. on a fixed rate basis upto 100% of the contract value.

In other words, it is trade finance extended by a forfaiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount. Forfaiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms. Recourse to forfaiting usually takes place where the credit is for long date maturities and there is no prohibition for extending the facility where the credits are maturing in periods less than one year.

Parties to Forfaiting

There are five parties in a transaction of forfaiting. These are

i. Exporter
ii. Importer
iii. Exporter's bank
iv. Importer's bank
v. The forfaiter.

Mechanism

1. The exporter and importer negotiate the proposed export sale contract. Then the exporter approaches the forfaiter to ascertain the terms of forfaiting.
2. The forfaiter collects details about the importer, supply and credit terms, documentation etc.
3. Forfaiter ascertains the country risk and credit risk involved.
4. The forfaiter quotes the discount rate.
5. The exporter then quotes a contract price to the overseas buyer by loading the discount rate, commitment fee etc. on the sale price of the goods to be exported.
6. The exporter and forfaiter sign a contract.
7. Export takes place against documents guaranteed by the importer's bank.
8. The exporter discounts the bill with the forfaiter and the latter presents the same to the importer for payment on due date or even sell it in secondary market.

Documentation

1. Forfaiting transaction is usually covered either by a promissory note or bills of exchange.
2. Transactions are guaranteed by a bank.
3. Bills of exchange may be 'availed by' the importer's bank. 'Aval' is an endorsement made on bills of exchange or promissory note by the guaranteeing bank by writing 'per aval' on these documents under proper authentication.

Costs of forfaiting

The forfaiting transaction has typically three cost elements:

1. Commitment fee, payable by the exporter to the forfaiter 'for latter's' commitment to execute a specific forfaiting transaction at a firm discount rate with in a specified time.
2. Discount fee, interest payable by the exporter for the entire period of credit involved and deducted by the forfaiter from the amount paid to the exporter against the availised promissory notes or bills of exchange.
3. Documentation fee.

Benefits of forfaiting

Forfaiting helps the exporter in the following ways:

1. It frees the exporter from political or commercial risks from abroad.
2. Forfaiting offers 'without recourse' finance to an exporter. It does not effect the exporter's borrowing limits/capacity.
3. Forfaiting relieves the exporter from botheration of credit administration and collection problems.
4. Forfaiting is specific to a transaction. It does not require long term banking relationship with forfaiter.
5. Exporter saves money on insurance costs because forfaiting eliminates the need for export credit insurance.

Problem areas in forfaiting and factoring where legislation is required.

1. There is, presently, no legal framework to protect the banker or forfaiter except the existing covers for the risks involved in any foreign transactions.
2. Data available on credit rating agencies or importer or foreign country is not sufficient. Even exim bank does not cover high-risk countries like Nigeria.
3. High country and political risks dissuade the services of factoring and banking to many clients.
4. Government agencies and public sector undertakings (PSUs) neither promptly make payments nor pay interest on delayed payments.
5. The assignment of book debts attracts heavy stamp duty and this has to be waived.
6. Legislation is required to make assignment under factoring have priority over other assignments.
7. There should be some provisions in law to exempt factoring organization from the provisions of money lending legislations.
8. The order 37 of Civil procedure code should be amended to clarify that factor debts can be recovered by resorting to summary procedures.

Thus, the existing legal framework governing the transactions of factoring business is not adequate to make the functioning simple, inexpensive and attractive in the market. In order to

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ensure that the functioning of a factor is with ease and confidence the legal framework should:

a. define the rights, liabilities, duties and obligations of the parties involved, in a clear and comprehensive manner, so that the parties can plan their affairs with certainty, and

b. be supportive of the transactions and procedures involved, so that they may be undertaken and completed simply and inexpensively.

In short, areas like 'assignment', 'stamp duty', 'priorities of factoring assignment', 'liabilities of the debtor', 'obligations of banks', realisation of debts through simple legal process etc. require focused attention. A draft bill on the factoring of debts due to industrial and commercial undertakings has been prepared which awaits clearance by the Government of India. Once this bill is passed majority of the constraints will be eliminated.

Factoring in India

Banks do provide non-banking financial services such as housing finance, leasing and hire-purchase, factoring and forfaiting. An amendment was made in the Banking Regulation Act in 1983, whereby banks were permitted to provide these services either through their own departments or divisions or through their subsidiaries. Direct and indirect lending services were provided by setting up merchant banking and mutual funds subsidiaries. Factoring and forfaiting services were of recent origin following the recommendation of the Kalyansundarm Committee, set up by the RBI in 1988.

The Committee was constituted to examine the feasibility of factoring services in India, their constitution, organisational setup and scope of activities. The group recommended setting up of specified agencies or subsidiaries for providing the factoring services in India.

While attempting to assess the potential demand for factoring services in India, the study group under the leadership of Mr. C. S. Kalyansundram estimated the value of outstanding open account credit sales available for financing during 1989-90 at Rs. 12,000 crores in respect of SSI and Rs. 4500 crores for medium and large scale sector. Assuming only 50% of the above business will be available for factoring, the aggregate potential demand for factoring was expected to be around Rs. 4000 crores per annum mainly emerging from the SSI and large and medium companies.

Major Players

The first factoring company was started by the SBI in 1991 namely Factors and Commercial Ltd. (SBI FACS) followed by Canara Bank and PNB, setting the subsidiaries for the purpose. While the SBI would provide such services in the Western region, the RBI has permitted the Canara Bank and PNB to concentrate on the Southern and Northern regions of the country, for providing such services for the customers. The major players since 1991 are Canbank Factors, SBI Factors and later Foremost Factors. The new entrants in the market include ICICI, HSBC and Global Trade Finance. Canback Factors leads in the domestic market with about .65%-70%of the share.

The Vaghul Committee Report on Money Market Reforms has stressed on the need for factoring services to be developed in India as part of the money market instruments. Many new instruments had already been introduced like Commercial Paper (CP), Pm1icipation Certificates (PC), Certificates of Deposits etc. but the factoring service has not developed to any significant extent in India.

Factoring in India - A Note

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The paper traces the genesis of factoring service in India, which is still in its infancy. It brings out the advantages and disadvantages of factoring. The potential for factoring has also been stated.

The eighties in India was witness to a virtual deregulation of capital market a number of innovative financial instruments and schemes was born. The policy of the power- that - be also helped in the development of money market. The capital market mutatis mutandis tried to transplant some of the successful schemes of the west. The working group (1987) on the money market, headed by Vaghul, observed: "Despite various measures taken over the years to enable the small-scale sector to recover its dues from the medium and large industries (and in particular the public sector) the small-scale units face a liquidity bind because of their inability to collect the dues". Since the earlier efforts to popularise a bill market in India did not have the desired results an alternative had to be found. Available data reveal that funds locked up in book debts have been increasing at a faster rate than growth in sales turnover or build-up in inventories (Anantha Krishnan, 1990).

Thus, factoring as a remedy became a fait accompli. A committee was constituted under the chairmanship of Kalyana Sundaram (198-) to examine the feasibility of factoring services in India and suggest operational modalities , s of launching such a service.

This note discusses the salient features of factoring and tries to analyse its relevance in the context of the changing financial scenario and the development of financial services industry.

Factoring is essentially a management (financial) service designed to help firms better manage their receivables; it is, in fact, a way of offloading a firm's receivables and credit management on to some one else - in this case, the factoring agency or the factor. Factoring involves an outright sale of the receivables of a firm by another firm specialising in the management of trade credit, called the factor. Under a typical factoring arrangement a factor collects the accounts on the due dates, effects payments to its client firm on these days (irrespective of whether or not it has received payment or not) and also assumes the credit risks associated with the collection of the accounts. For rendering these services, the factor charges a fee which is usually expressed as a percentage of the total value of the receivables factored. Factoring is thus an alternative to in-house management of receivables. The complete package of factoring services includes (1) sales ledger administration; (2) finance; and (3) risks control.

Sales ledger administration: For a service fee, the factor provides its client firm professional expertise in accounting and maintenance of sales ledger and for collection of receivables.

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Finance: The factor advances up to a reasonable percentage of outstanding receivables that have been purchased, say, about 80 percent immediately, and the balance minus commission on maturity. Thus, the factor acts as a source of short-term funds.

Risk Control: The factor having developed a high level of expertise in credit appraisal, reduces the risk of loss through bad debts.

Depending upon the inherent requirements of the clients, the terms of factoring contract vary, but broadly speaking, factoring service can be classified as (a) Non-recourse factoring; and (b) recourse factoring. In non recourse factoring, the factor assumes the risk of the debts going "bad". The factor cannot call upon its client-firm whose debts it has purchased to make good the loss in case of default in payment due to financial distress. However, the factor can insist on payment from its client if a part of the receivables turns bad for any reason other than financial insolvency.

In recourse factoring, the factoring firm can insist upon the firm whose receivables were purchased to make good any of the receivables that prove to be bad and unrealisable. However, the risks of bad debts is not transferred to the factor.

Legal Aspects

The legal status of a factor is that of an assignee. Once the factor purchases the receivables of a firm and this fact is notified to the customers, they are under a legal obligation to make all remittances to the factor' A customer who by mistake remits the payments to the firm is not discharged from his obligations to the factor until and unless the firm remits the proceeds to the factor. The factoring agreement governs the legal relationship between a factor and the firm whose receivables are to be factored, and is so drawn as to suit the various needs specifying the period of validity of the contract and modalities of termination.

Financial Aspects

Factoring involves two types of costs: (a) factoring commission; and (b) interest on funds advances.

Factoring commission represents the compensation to the factor for the administrative services provided and the credit risk borne. The commission charged is usually 2-4 per cent of the face value of the receivables factored, the rate depending upon the various forms of service and whether it is with or without recourse.

The factor also charges interest on advances drawn by the firm against uncollected and non-due receivables. In the Ul(, it is the practice to advance up to 80 per cent of the value of such outstanding at a rate of interest which is 2-4 per cent above the base rate. This works out to near the interest rate for bank overdrafts.

The cost of factoring varies, from 15.2 to 16.20 per cent (Singh, 1988), 15.6 to 16.0 percent (SBI Monthly Review, 1989), and the margins in which the factors will have to operate would be extremely narrow. The strategy of factors, therefore, must be to carve out a niche in the services segment namely, receivables management and generate revenues by way of commission rather than concentrate on lending and financing activities where the margins are low.

Factoring offers the following advantages from the firm's point of view:

Advantages

Firms resorting to factoring also have the added attraction of ready source of short-term funds. This form of finance improves the cash flow and is invaluable as it leads to a higher level of activity resulting in increased profitability.

By offloading the sales accounting and administration, the management has more time for planning, running and improving the business, and exploiting opportunities, The reduction in overheads brought about by the factor's administration of the sales ledger and the improved cash flows because of the quicker payments by the customers result in interest savings and contribute towards cost savings.

Disadvantages

Factoring could prove to be costlier to in-house management of receivables, specially for large firms which have access to similar sources of funds as the factors themselves and which on account of their size have well organised credit and receivable management.

Factoring is perceived as an expensive form of financing and also as finance of the last resort. This tends to have a deleterious effect on the creditworthiness of the company in the market.

Potential

In the Indian context, factoring is being viewed as a source of short-term finance. The estimated aggregate potential demand for factoring (finance) would be about Rs 4,000 crores (SBI Monthly Review, 1989). There seems to be a tendency to view factoring primarily as a financing function - a source of funds to fill the void of bank financing of receivables for small-scale industries and others. This attitude is fraught with dangers and could lead to a "catch 22" situation.

In launching factoring service, the thrust should be in the twin areas of receivables management, and credit appraisal; factoring agencies should be viewed as vehicles of development of these skills. Since the small-scale sector lacks these sophisticated skills, factors should be able to fill the gap. Giving priority to financing function would be self-defeating as receivable management would be given the back-seat. It is for the factors to generate the necessary surpluses to mop up the additional resources and then embark on financing function. However, for policy reasons, should these go hand in hand, then the accent should be on receivable management otherwise, these agencies would end up as financing bodies.

From the firm's point of view, factoring arrangements offer certain financial benefits in the form of savings in collection costs, reduction in bad debt losses, and reduction in interest cost of investment in receivables. On the other hand, the firm incurs certain costs, in the form of commissions and interest on advances. Therefore, to assess the financial desirability of factoring as an alternative to in-house management of receivables, the firm must assess the net benefit of this option, using the profit criterion approach. The factors have to establish their credibility in offering better management of receivables and financing at competitive rates to the clients.

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LESSON 15:
BILLS DISCOUNTING

Lesson Objectives

- To understand the Concept of Bills Discounting and
- Regulations related to Bills Discounting.

Introduction

Bill discounting, as a fund-based activity, emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial scene in India. In the post-1992 (scam) period its importance has substantially declined primarily due to restrictions imposed by the Reserve Bank of India. The purpose of the Chapter is to describe bills discounting as an asset-based financial service. The aspects of bills discounting covered include its concept, advantages and disadvantages, bills market schemes, procedures and processing, post-securities scam position and some gray-areas. The main points are also summarised.

Concept

According to the Indian Negotiable Instruments Act, 1881:

"The bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument."

The bill of exchange (B/E) is used for financing a transaction in goods which means that it is essentially a trade-related instrument.

Types of Bills

There are various types of bills. They can be classified on the basis of when they are due for payment, whether the documents of title of goods accompany such bills or not, the type of activity they finance, etc. Some of these bills are:

Demand Bill This is payable immediately "at sight" or "on presentment" to the drawee. A bill on which no time of payment or "due date" is specified is also termed as a demand bill.

Usance Bill This is also called time bill. The term usance refers to the time period recognized by custom or usage for payment of bills.

Documentary Bills These are the B/Es that are accompanied by documents that confirm that a trade has taken place between the buyer and the seller of goods. These documents include the invoices and other documents of title such as railway receipts, lorry receipts and bills of lading issued by custom officials. Documentary bills can be further classified as: (i) Documents against acceptance (D/A) bills and (ii) Documents against payment (DIP) bills.

D/ A Bills In this case, the documentary evidence accompanying the bill of exchange is deliverable against acceptance by the drawee. This means the documentary bill becomes a clean bill after delivery of the documents.

DIP Bills In case a bill is a "documents against payment" bill and has been accepted by the drawee, the documents of title will be held by the bank Dr the finance company till the maturity of the B/E.

Clean Bills These bills are not accompanied by any documents that show that a trade has taken place between the buyer and the seller. Because of this, the interest rate charged on such bills is higher than the rate charged on documentary bills.

Creation of a B/E Suppose a seller sells goods or merchandise to a buyer. In most cases, the seller would like to be paid immediately but the buyer would like to pay only after some time, that is, the buyer would wish to purchase on credit. To solve this problem, the seller draws a B/E of a given maturity on the buyer. The seller has now assumed the role of a creditor; and is called the drawer of the bill. The buyer, who is the debtor, is called the drawee. The seller then sends the bill to the buyer who acknowledges his responsibility for the payment of the amount on the terms mentioned on the bill by writing his acceptance on the bill. The acceptor could be the buyer himself or any third party willing to take on the credit risk of the buyer.

Discounting of a B/E The seller, who is the holder of an accepted B/E has two options:

1. Hold on to the B/E till maturity and then take the payment from the buyer.
2. Discount the B/E with a discounting agency. Option (2) is by far more attractive to the seller.

The seller can take over the accepted B/E to a discounting agency bank, NBFC, company, high net worth individual] and obtain ready cash. The act of handing over an endorsed B/E for ready money is called discounting the B/E. The margin between the ready money paid and the face value of the bill is called the discount and is calculated at a rate percentage per annum on the maturity value.

The maturity a B/E is defined as the date on which payment will fall due. Normal maturity periods are 30,60,90 or 120 days but bills maturing within 90 days seem to be the most popular.

Advantages : The advantages of bill discounting to investors and banks and finance companies are as follows:

To Investors

1. Short-term sources of finance;
2. Bills discounting being in the nature of a transaction is outside the purview of Section 370 of the Indian Companies Act 1956, that restricts the amount of loans that can be given by group companies;
3. Since it is not a lending, no tax at source is deducted while making the payment charges which is very convenient, not only from cash flow point of view, but also from the point of view of companies that do not envisage tax liabilities;
4. Rates of discount are better than those available on ICDs; and

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5. Flexibility, not only in the quantum of investments but also in the duration of investments.

To Banks

1. Safety of Funds The greatest security for a banker is that a B/E is a negotiable instrument bearing signatures of two parties considered good for the amount of bill; so he can enforce his claim easily.
2. Certainty of Payment A B/E is a self-liquidating asset with the banker knowing in advance the date of its maturity. Thus, bill finance obviates the need for maintaining large, unutilised, ideal cash balances as under the cash credit system. It also provides banks greater control over their drawls.
3. Profitability Since the discount on a bill is front-ended, the yield is much higher than in other loans and advances, where interest is paid quarterly or half yearly.
4. Evens out Inter-Bank Liquidity Problems The development of healthy parallel bill discounting market would have stabilized the violent fluctuations in the call money market as banks could buy and sell bills to even out their liquidity mismatches.

Discount Rate and Effective Rate of Interest Banks and finance companies discounting bills prefer to discount LlC (letter of credit)-backed bills compared to clean bills. The rate of discount applicable to clean bills is usually higher than the rate applicable to LlC-based bills. The bills are generally discounted up-front, that is, the discount is payable in advance. As a consequence, the effective rate of interest is higher than the quoted rate (discount). The discount rate varies from time to time depending upon the short-term interest rate. The computation of the effective rate of interest on bills discounting is shown in following illustration

Illustration

The Hypothetical Finance ltd. discounts the bills of its clients at the rate specified below:

i. L/C - backed bills, 22 per cent per annum

ii. Clean bill, 24 per cent per annum

Required: Compute the effective rate of interest implicit in the two types of bills assuming usance period of (a) 90 days for the L/C - based bill and (b) 60 days for the clean bill and value of the bill, Rs 10,000.

Solution Effective Rate of Interest on L/C - based Bill:

Value of the bill,	Rs 10,000	
Discount charge	Rs. 550	(Rs 10,000x 0.22 x 90/360)
Amount received by the client,	= Rs 9,450	(Rs 10,000 - Rs 550)
Quarterly effective interest rate	= 5.82%	[Rs 90 x 100/Rs. 9450]
Annualised effective rate of interest, [(1.0582)4 - 1] x 100 = 25.39%		
Effective Rate of Interest on Clean Bill:		
Value of bill	Rs 10,000	
Discount Charge,	= Rs 400	(Rs 10,000 x 0.24 x 60/360)
Amount received by the client	= Rs 9,600	(Rs 10,000 - Rs 400)
Quarterly rate of interest	= 4.17%	(Rs. 400/Rs 9,600)x100
Effective rate of interest per annum,	= 17.75%.	

Bill Market Schemes

The development of bill discounting as a financial service depends upon the existence of a full-fledged bill market. The Reserve Bank of India (RBI) has constantly endeavored to develop the commercial bills market. Several committees set-up to examine the system of bank financing and money market had strongly recommended a gradual shift to bills finance and phase-out of the cash credit system. The most notable of these were: (i) Dehejia Committee, 1969, (ii) Tandon Committee, 1974, (iii) Chore Committee, 1980 and (iv) Vaghul Committee, 1985. This section briefly outlines the efforts made by the RBI in the direction of the development of a full-fledged bill market.

Bill Market Scheme, 1952

The salient features of the scheme were as follows:

i. The scheme was announced under Section 17(4)(c) of RBI Act which enables it to make advances to scheduled banks against the security of issuance of promissory notes or bills drawn on and payable in India and arising out of bona fide commercial or trade transaction bearing two or more good signa-tures one of which should be that of scheduled bank and maturing within 90 days from the date of advances;

ii. The scheduled banks were required to convert a portion of the demand promissory notes obtained by them from their constituents in respect of loans/overdrafts and cash credits granted to them into usance promissory notes maturing within 90 days to be able to avail of refinance under the scheme;

iii. The existing loan, cash credit or overdraft accounts were, therefore, required to be split up into two parts, that is:
   a. one part was to remain covered by the demand promissory notes, in this account further with-drawals or repayments were as usual being permitted;
   b. the other part, which would represent the minimum requirement of the borrower during the next three months would be converted into usance promissory notes maturing within ninety days.

iv. This procedure did not bring any change in offering same facilities as before by banks to their constituents. Banks could lodge the usance promissory notes with RBI- for advances as eligible security for borrowing so as to replenish their loanable funds.

v. The amount advanced by the RBI was not to exceed the amount lent by the scheduled banks to the respective borrowers.

vi. The scheduled bank applying for accommodation had to certify that the paper presented by it as collateral arose out of bona fide commercial transactions and that the party was creditworthy.

vii. The RBI could also make such appropriate enquiries as it deemed fit, in connection with eligibility of bills and call for any further information from the scheduled banks concerned.

viii. Advances to banks under the scheme, in the initial stages, were made at one-half of one per cent below the bank rate.

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The confessional rate of interest was withdrawn in two stages of one quarter of one per cent each and ceased to be operative from November 1956.

ix. As a further inducement to banks, the RBI agreed to bear half the cost of the stamp duty incurred in converting demand bills into time bills.

x. In the initial stages the minimum limit for an advance which could be availed of from the RBI at any time was fixed at Rs 25 lakh and the individual bills tendered for the purpose were not to be less than rupee one lakh. Subsequently, however, the scheme was liberalised and the minimum amounts were reduced from Rs 25 lakh to Rs 10 lakh (reduced further to Rs 5 lakh in February 1967) and from Rs I lakh to Rs 50,000. The scheme, which was initially, restricted to licensed scheduled commercial banks having deposits (including deposits outside India) of Rs 10 crore or more was later extended to all licensed scheduled commercial banks, irrespective of the size of their deposits.

The scheme virtually ceased to function in 1970. The main reasons being:

i. Lack of specialised institutions for discharging the functions of acceptance and discount houses;

ii. Paucity of usance bills-both domestic and foreign;

iii. Traders found cash credit facility conveniently available from banks and avoided usance bills as an instrument of credit;

iv. Export bills were negotiated by banks under letters of credit opened by foreign importers and foreign correspondent banks;

v. Banks got refinance against declaration of export bills from RBI Exim-Bank when needed;

vi. Lack of practice of discounting the bills with other banks having excess liquidity;

vii. Criteria for creditworthiness of the traders was not evolved to avoid risk of defaults of redemption on maturity of the bills.

Bill Market Scheme, 1970

In pursuance of the recommendations of the Dehejia Committee, the RBI constituted a working group (Narsimham Study Group) to evolve a scheme to enlarge the use of bills. Based on the scheme suggested by the study group, the RBI introduced with effect from November 1, 1970, the new bill market scheme in order to facilitate the re-discounting of eligible bills of exchange by banks with it. To popularise the use of bills, the scope of the scheme was enlarged, the number of participants was increased, and the procedure was simplified over the years. The salient features of the scheme are as follows:

Eligible Institutions All licensed scheduled banks and those which do not require a licence (i.e. the State Bank of India, its associate banks and natioanlised banks) are eligible to offer bills of exchange to the RBI for rediscount. There is no objection to a bill accepted by such banks being purchased by other banks and financial institutions but the RBI rediscounts only such of those bills as are offered to it by an eligible bank.

Eligibility of Bills The eligibility of bills offered under the scheme to the RBI is determined by the statutory provisions embodied in section 17(2)(a) of the Reserve Bank of India Act, which authorise the purchase, sale and rediscount of bills of exchange and promissory notes, drawn on and payable in India and arising out of bona fide commercial or trade transactions, bearing two or more good signatures, one of which should be that of a scheduled bank or a state co-operative bank and maturing:

a. In the case of bills of exchange and promissory notes arising out of any such transaction relating to the export of goods from India, within one hundred and eighty days;

b. In any other case, within ninety days from the date of purchase or rediscount exclusive of days of grace;

c. The scheme is confined to genuine trade bills arising out of genuine sale of goods. The bill should normally have a maturity of not more than 90 days. A bill having a maturity of 90 to 120 days is also eligible for rediscount, provided at the time of offering to the RBI for rediscount it has a usance not exceeding 90 days. The bills presented for rediscount should bear at least two good signatures. The signature of a licensed scheduled bank is treated as a good signature;

d. Bill of exchange arising out of the sale of commodities covered by the selective credit control directives of the RBI have been excluded from the scope of the scheme to facilitate the selective credit controls and to keep a watch on the level of outstanding credit against the affected commodi-ties; and

e. The following types of bills are acceptable to RBI for the purpose of re-discount:

   i. Bills drawn on and accepted by the buyer's bank,

   ii. Bills drawn on buyer and his banker jointly and accepted by them jointly,

   iii. Bills drawn on and accepted by the buyer under an irrevocable letter of credit and certified by the buyer's bank which has opened the letter of credit in the manner specified by RBI, that is, that the terms and conditions of the letter of credit have been duly complied with by the seller.

   iv. Bills drawn on and accepted by the buyer and endorsed by the seller in favour of his bank and bearing a legend signed by a licensed scheduled bank which should endorse the bill, confirming that the bill will be paid by bank three days before the date of maturity,

   v. Bills drawn and accepted in the prescribed manner and discounted by a bank at the instance of the drawee.

Where the buyer's bank is not a licensed scheduled bank, the bill should additionally bear signature of a licensed scheduled bank.

Procedure for Rediscounting Eligible banks are required to apply to the RBI in the prescribed form giving their estimated requirements for the 12 month ending October of each year and limits are sanctioned /renewed for a period of one year running from November 1 to October 31 of the following year. The RBI presents for payment bills of exchange rediscounted by it and such bills have to be taken delivery) by the rediscounting banks against payment, not less than three working days before

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the dates of maturity)f the bills concerned. In case bills are retired before the dates, pro-rata refund of discount is allowed by the RBI.

For rediscounting purposes, bills already rediscounted with RBI may be lodged with it. The un-expired period of the usance of the bills so offered should not be less than 30 days and the bills should not bear the endorsement of the discounting bank in favour of a party other than the RBI.

Banks to Hold Bills Rediscounted In the first year of the operation of the scheme, the banks are required to lodge all eligible bills with the RBI for availing themselves of the rediscounting facilities. 11 November 1971, actual lodgement of bills of the face value of Rs 2 lakh and below was dispensed with od the banks were authorised to hold such bills with themselves. This limit was increased to Rs 10 lakh in November 1973. The banks are required to make declarations to the effect that they hold eligible bills of a particular aggregate value on behalf of the RBI as its agents, and on this basis the RBI pays to them the is counted value of such bills. The discounting banks are also required to endorse such bills in favour of the BI before including them in the declarations and also re-endorse the bills in their own favour when they "e retired. Since 1975, banks are permitted to rediscount bills with other commercial banks as well as ~rtain other approved financial institutions. Since June, 1977, there is a ceiling on the rate of rediscount on Ich bills which has been varied by the banks from time to time.

The bill rediscounting scheme over the years has been gradually restricted and at present this facility is treated by the RBI on a discretionary basis. During the year 1981-82 (July-June) no fresh bill rediscountin-g limits were sanctioned to the banks and as such there were no outstanding under the scheme from October 23, 1981. The amount of bills rediscounted each year has shown wide variations, but during each . the four years (1974-75 to 1977-78) (April-March), the volume had been well over Rs 1,000 crore; in sequent years a comparative declining trend set in the utilisation of the facility due to its being available only on discretionary terms.

In order to revitalise the bill market scheme, several committees made recommendations in the light of experience of the operations of the scheme. On the basis of these, several measures were initiated by the n to promote bill financing. The important ones being: (1) a ceiling on the proportion of receivable (75 per cent) eligible for financing under the cash credit system, (2) discretion to banks to sanction additional hoc limits for a period not exceeding 3 months, upto an amount equivalent to 10 per cent of the existing I limit subject to a ceiling of Rs 1 crore, (3) stipulation on ratio of bill acceptance to credit purchases (25 per cent), (4) setting up of the Discount and Finance House of India (DFHI) to buy/sell/discount short-term Is, (5) reduction in the discount rate on usance bills, (6) remission of stamp duty on bills drawn on/made 'in favour of a bank/cooperative bank. The procedure requiring the bill to the endorsed and delivered to re discounter at every time of rediscounting has been done away with. A derivative usance promissory note is issued by the discounter on the strength of the underlying bills which have tenor corresponding to, or lesser than, tenor of the derivatives usance promissory note and in any case not more than 90 days. The derivative promissory note is exempted from stamp duty.

The re-discounting facility from the RBI has gradually slowed and banks have been encouraged to rediscount bills, with one another as well as with approved financial institutions such as LIC, GIC, UTI, ICICI, IRBI, ECGC, selected cooperative banks and mutual funds and so on. Processing/Precaution/Defaults/Grey Areas Credit Assessment Banks and NBCFs (the main discounting agencies) undertake a detailed ap-praisal of a customer and thoroughly assess his creditworthiness before providing the bills discounting (BD) facility. Regular credit limits are fixed by banks and NBFCs for individual parties for purchase and discounting of clean bills and documentary bills separately. These limits are renewed annually and are based on the following considerations:

i. Quantum of business undertaken by the party, that is, turnover of inventory;

ii. Credit worthiness of drawer (client);

iii. Credit worthiness of drawee and details of dishonor, if any;

iv. Nature of customer's industry.

Appraisal of the customer is done through several means:

1. The most important step is a careful scrutiny of the customer's operations and its financial viability. For this, a detailed analysis of his financial statements is carried out.
2. Since the liability of the drawee also arises in case he accepts and dishonors the bill, credit informa-tion about the drawee is also collected. The drawer is asked to furnish a list of his purchasers and their banks so that a report of their credit risk can be compiled. This is especially easy for banks, as a confidential report can be easily routed through banking channels.
3. Banks have access to frequently published Indian Banks Association (IBA) bulletins which indicate the names of unsatisfactory drawees banks and their default rates.
4. Both banks and NBFCs have built up substantial credit intelligence database which are constantly updated based on market information. Once a client defaults, he is blacklisted and may find it difficult. to discount his B/E subsequently.

Thus, in case of an existing client it is assessed that there is no overdue bill pending and the clients' limits cover the amount of the bill submitted for discounting. In the case of a new client thorough enquiry about the creditworthiness of the party is made from the banker of the client, market and other finance companies. Once satisfactory report is obtained, a limit is normally fixed for the party. An effort is made to ensure that the risk is well spread amongst several drawees. In order to keep a proper control, there should be proper follow up of the bills due and the limits fixed for the clients should be reviewed/reassessed at an appropriate interval of time. Special attention is paid to the following points while reviewing bills discounting limits:

i. The earlier sanctioned limits are fully utilised by the client;

ii. The bills were promptly paid on maturity date;

iii. In case of unpaid bills, funds were paid by the drawer.

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Once the party is granted a bill discounting limit, the party approaches the finance company for each and every bill for discounting. The following documents are submitted along with the letter of request:

a. Invoice;
b. Challan;
c. Receipt of goods acknowledged by buyer;
d. Hundi/Promissory note;
e. Truck receipt/Railway receipt;
f. Post dated cheque for the interest amount.

While fixing the limit for bill discounting the balance sheet and profit and loss account are properly analysed and various ratios are calculated to arrive at a sound business decision.

Precautions The finance companies take following precautions while discounting bills:

i. The bills are not accommodation bills but are genuine trade bills.
ii. Bills are drawn on the places where the finance company is operating or has a branch office as it would facilitate contact with drawee in case of exigencies.
iii. The goods covered by the documents are those in which they party deals.
iv. The amount of the bills commensurate with the volume of business turnover of the party.
v. Bills are drawn on a place where the goods have been consigned.
vi. The credit report on the drawee is satisfactory.
vii. The description of goods mentioned in the invoice and railway receipt/truck receipt are same.
viii. The goods are not consigned directly to the buyer.
ix. The goods are properly insured.
x. The usance bill is properly stamped.
xi. Bills offered for discount do not cover goods whose prices fluctuate too much.
xii The goods covered under the bill are not of perishable nature.
xiii. The bills are not stale.
xiv. The truck receipt is in the form of prescribed by the Indian Banks Association.
xv. The bills are drawn in favour of the finance company and have been accepted by the drawee.

Dealing with Default The cycle of liabilities in a bill discounting transaction is as follows: The drawee is liable to the drawer; and the drawer to the discounting agency. However, the bank/INBFC looks mainly to its customer (drawer or drawee) for recovery of its dues. In case of default, the discounting agency can resort to noting and protesting as laid down by the Negotiable Instrument Act. In reality, however, since litigation is both cumbersome and expensive, a combination of negotiation and compromise is used. At worst, some dues ,may be written off. NBFCs generally build-in a large number of safeguards to guard against default. Banks generally dis-count LC- backed bills which are default-proof.

Grey Areas There are certain features of the Indian industry which have impeded the growth of a healthy bill discounting market (BD):

Participants Most of the customers approaching banks/NBFCs for bills discounting are SSI (Small scale industries) units. For such enterprises, it is very difficult to undertake proper credit assessment.

Kite Flying The practice of discounting accommodation bills is known as kite flying. When A draws a BI E on B without there being any underlying movement of goods and B accepts it to accommodate A, the BI E is called an accommodation kite bill. If A now 'discounts it, he has uninterrupted use of funds for the maturity period of the bill. These funds are generally routed into the capital market to earn a very high return on the due date the amount of the B/E is repaid by A. This practice has severally stilted the genuine bill market, by imparting false liquidity to the system.

Supply Bills B/E drawn by suppliers/contractors on Government departments are called supply bills, These are not accepted by the Government. However, contractors are able to get them discounted with nationalised banks. If there is a default on the due dates, banks simply debit the dues to the 'Government a/c'. This practice depresses the level of cash flow in the bill market because a B/E is being discounted without a corresponding flow of cash.

Reduced Supply Several corporate houses and business groups do not accept B/E drawn on them. Accepting such bills is seen to be damaging to their pride. Such attitudes reduce the supply of bills and discourage the culture of drawing and discounting bills.

Stamp Duties No stamp ~duties are levied on LC (letter of credit) backed bills upto 90 days. This has resulted in a lop sided growth in the bills market with practically no bills being drawn for a period exceeding 90 days. The market, therefore, lacks depth.

Present Position of Bills Discounting

Financial services companies had been acting till the early nineties as bill-brokers for sellers and buyers of bills arising out of business transactions. They were acting as link between banks and business firms. At times they used to take up bills on their own account, using own funds or taking short-term accommodation from banks working as acceptance/discount houses. They had been handling business approximating Rs 5,000 crores annually. Bill discounting, as a fund-based service, made available funds at rates I per cent lower than on ash credit finance and bill finance constituted about one-fourth of bank finance.

However, the bill re-discounting facility was misused by banks as well as the bill-brokers. The Jankiraman Committee appointed by the RBi which examined the factors responsible for the securities-scam identified the following misuse of the scheme:

Banks have been providing bill finance outside the consortium without informing the consortium bank-ers;

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- They have been drawing bills on companies and they themselves discounted such bills to avail of rediscount facilities;
- In cases where banks provided additional finance outside the consortium arrangement by way of billlimits covering sales of goods, the sales proceeds had been unavailable to them to provide production finance;
- Bill finance had been provided to dealers/ stockiest of large manufacturing companies without proper appraisal of their credit needs;
- Bills discounted by front companies set up by industrial groups on their parent companies which were obviously accommodation bills were discounted/ rediscounted by banks;
- The rediscounting of bills by finance companies with banks was done at a much lower rate of interest;
- Although bills are essentially trade documents, bills related to electricity charges, custom charges, lease rentals etc. were also discounted. This was mainly due to the lack of depth in the bills market and NBFCs felt the need for new instrument or schemes to increase their business.
- No records regarding bill discounting were ever maintained by banks.

In order to stop misuse of the bill discounting facility by banks, the RBI issued guidelines to banks in July 1992. The main elements of these guidelines are as follows:

i. No fund/non-fund based facility should be provided by banks outside the consortium arrangement;

ii. Bill finance should be a part of the working capital credit limit;

iii. Only bills covering purchase of raw materials/inventory for production purposes and sale of goods should be discounted by banks;

iv. Accommodation bill should never be discounted;

v. Bill re-discounting should be restricted to usance bills held by other banks. The banks should not rediscount bills earlier discounted by finance companies;

vi. -Funds accepted by banks for portfolio management should not be deployed for discounting bills.

vii. Overall credit limit to finance companies including bills discounting should not exceed three times the net worth of such companies; and I

viii. For discounting LC-backed bills by NBFCs, the bill must be accompanied by a no-objection certificate from the beneficiary bank.

As a result, there was substantial decline in the volume of bill discounting. Presently, the volumes are on an average Rs 80-100 crore per month and Rs 800 - 900 crore per year. The ban on re-discounting has also resulted in falling margins for the NBFCs. They are not able to find cash rich companies/individuals ready to discount/rediscount bills.

Research Papers, Articles in Journals and Magazines on Bills Discounting

(for reference)

Financing Working Capital: Emerging Options

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ASCI - Journal of Management, Volume 20, No. 2-3.

In this paper an attempt has been made to cover conceptual, decisional, and policy issues concerning financing of working capitaL Most of the issues in this area are controversial Both in thought and in action, the area of management and financing of working capital has, in modem history, always been characterised by bifoculism, paradox, and ambiguity. This has happened mainly because of the conceptual ambiguities which have always been taken advantage of by the practitioners. This paper attempts to clarify some of the basic concepts. It brings out the emerging options in this growing field. It concludes that in the days to come the varieties of instruments will proliferate, but cautions that they will become popular only with the introduction of CDs and CPs.

The conceptual bi-foculism can be traced back to Adam Smith's Wealth of Nations published towards the end of the 18th century. This was also evident in the classic controversy between the banking and the currency schools in the 19th century (Singh, 1975). It is also current in the present day world as the difference in views of the economist and the businessman.

In other words, there have always been two focuses on working capital and its financing. The economist has been concerned largely with real investment and real output. and, with the real assets and their financing. This focus has, therefore, mainly been on the balance sheet, the stock variables, the credit allocation and the credit multiplier. Further, in this line of thinking, the emphasis has been on investment (in inventory and book debts), the operating cycle, and the optimisation of the turnover of the working capital or what has sometimes been called the circulating capital. It is generally assumed that the coefficients relating the stock variables of inventory and book debts to output and sales are technologically determined and fixed in the short run. However, in real life, these coefficients have tended to vary with innovations in managerial practices and, in some cases, have tended to assume even zero values. The economist has, in general, also considered finance as superfluous or mere numeraire.

The other focus has always been held by the businessmen. They consider finance having its own significance. Atypical illustration is that of a partner withdrawing his capital and therefore affecting the liabilities side of the balance sheet, and not the assets side. The dominant focus of the business world has been the cash flow: the flow variables, the cash gap, or the surplus or the deficit arising out of differences between the total cash inflows and the total cash outflows during a given period of time.

In this line of thinking, the funds or the money or the purchasing power (defined as cash plus credit) has to be viewed as flows into and out of a common pool. It implies that it is not very relevant to link the specific sources of financing to either the circulating or fixed assets. The cash gap is determined by the totality of financial flows arising as a result of either acquisition or sale of any type of asset, and, also as a result of contracting of new liabilities or paying off of the old ones. The

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typical businessman does not feel comfortable with any linkage of specific type of liability to any specific type of asset. For him, money is money, and it has to be managed on the basis of overall cash surpluses or cash deficits arising out of the operations during a particular period of time. Of course, the financial world has always made a distinction between the capital employed or the resource finance on the one hand, and the short-term credit or the recourse finance, on the other. They have always linked the short period cash gaps with financial credit.

The two views are no doubt different. The economist would like to correlate the usage of financial credit with the output and seek to maximise the credit multiplier. This is the basic reasoning relating investment and output, on the one hand, and with money and prices, on the other, with which the central monetary authorities all over the world are always concerned. Viewed in this perspective, no doubt, it makes sense. But, the business world has always looked beyond such relationships and asserted that financial credit should be related to cash gaps arising not only as a result of investment but also because of changes in the liabilities. Thus far, this reasoning appears to be justified. The trouble arises when the businessman's view is extended and assumes the character of money games, what Iacocca (1985) calls as going beyond manufacturing and marketing to earn money on money. Such games always carry with them the element of controversy. They can, and generally have degenerated into market crashes. Moreover, the history has always faced the ethical question of earning rewards without any sacrifice or taking of risk. In today's world when attempts are being made to popularise the Islamic banking, the ethical issue of Riba cannot be totally set aside.

The other important conceptual issue is the distinction between the two definitions of working capital. Assuming the economist's identification of the problem as that of financing investment in working capital assets, one definition of working capital is the investment in circulating assets, or in inventory and book debts comprising the operating cycle of a manufacturing-cum-marketing firm. With trade creditors or the account payable deducted, it is also known as the net operating cycle. It may also be noted that investment in assets comprising the gross operating cycles are conventionally called the current assets. These, in turn, are defined as assets which in normal course of operations are meant to be converted into cash within a period not exceeding one year. Correspondingly, for the concept of current liabilities the definition restricts them only to those liabilities which, in normal course of operations, are meant to be paid within a period of next 12 months. It is apparent that circulating working capital or current assets, and, current liabilities are basically in the nature of renewable aggregates. Their levels fluctuate within a year. There may be higher or lower degrees of seasonalities in their levels for different firms. But there is always a core element which may keep continuously rising over the long run.

The other concept is that of the net working capital. It is defined as the difference between the current assets and the current liabilities. Implicit in this definition is the principle that the entire amount of current assets should not be financed out of current liabilities which includes short-term financial credit. In other words, the ratio between the current assets and the current liabilities should always be greater than one. One reason which supports the principle is that the excess of current assets over current liabilities, the net working capital, represents the safety margin available to the creditors of the firm, and therefore, represents the liquidity strength of the company. It determines in a large measure its creditworthiness in the market. The other reason is that the core part of investment in working capital assets which has the character of long-term investment should be financed not out of financial credit or recourse finance but out of the resource finance or the capital funds. Most of the current controversies in the area of financing working capital in India today are based on the conceptual differences presented above. In the latter part of the paper, an attempt will be made to highlight these in the context of the emerging scenario in India.

It may also be added, as part of introduction, that the statistical data used in the paper are contained in the three tables in the text. All the figures have been taken from various publications of the Reserve Bank of India. Data on variables relating to the corporate world are taken from the Reserve Bank studies on financing of large and medium sized companies in India based on a sample of 1,650 companies. The Reserve Bank has been changing the size of the sample. The statistics contained in the tables used in this paper has been worked out on the basis of the uniform size of the sample for all the years, from 1969 to 1989.

Historical Context

In general, it can be stated that bank credit has all over the world been a major source of financing the working capital. However, in their details, policies and practices in India have been very different from those obtaining in the developed countries. In the west, the major focus has been on short-term financing or the seasonal bank credit to meet the requirements of the fluctuating component of the cash gaps. In other words, the banks in the developed countries provide financial credit for filling short-term cash gaps as part of the working capital finance and not the fixed component or the long-term cash gaps.

Moreover, the amount of bank credit made available to industry is determined by cash gaps and not by the amount of investment in inventory and book debts. This has two implications. First, the availability of financial credit from banks is determined by the need for cash liquidity and the lending is not related to the availability of security of current assets. The banks try to carefully assess that the borrowing company will be able to repay the short-term loans/credit within a period of 365 days, that is, bring liability to bank to zero for some time during the year. The banks provide credit on the strength of the creditworthiness of the borrowing company which, in turn, is also determined by the strength of the current ratio and the amount of net working capital. In other words, a sizable part, the fixed component of investment in working capital, is financed out of long-term capital funds.

In India, the present policies and practices have evolved in a particular historical context. It may be stated that in this country creditworthiness as judged by the strength of the current ratio

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and the net working capital has never been the overriding criterion for the commercial banks to decide to lend funds for financing the working capital. The major consideration has been the current assets charged in favour of the bank as security against borrowing. Therefore, the correlation between the bank credit available to industry and the holding of inventory and book debts by it should be positive and very high. In reality, this is not so because the security basis is, in fact, not followed strictly. Compliance is largely only on paper.

Further, it also implies that bank credit in large part is not meant to assume the character of the filler of short-term cash gaps. Under the Indian conditions, banks, in general, finance the fixed component or investment in core current assets as well. No distinction is made in practice between the fixed and fluctuating components of the working capital finance by the commercial banks. The result is that in a vast majority of cases, and most of the time, the current ratios are low, and the net working capital is thin.

There are reasons to justify this major deviation from the international practice. India has in recent years built up a big industrial set-up and is generally rated, judged by the size of investment in its industry, as the eighth or the ninth -industrial nation in the world. This industrial growth has been made possible because of the national policies aiming at targeted investment for deliberate import substituting industrialisation. Easier access to bank credit has, no doubt, contributed towards faster growth of investment in industry.

In short, in an economy engineered by national planning, the economist's view has dominated the policy formulation. This means that the focus has largely been on relating bank credit to investment in working capital. This approach has also derived its strength from the long-standing practice of the banks of lending against the security of the assets.

While in the two decades of the 50s and the 60s, the emphasis was on asking the banks to lend, or, as it has euphemistically been called to provide larger short-term bank credit to industry, the underlying idea was to get away from "security based" lending to "need based" lending. During those years, it was felt that the banks were restricting the availability of credit to industry by following strict norms relating to margins and by lending against the security of current assets. The industry wanted security margins to be lowered and more credit made available to them by the banks so as to meet the need for more investment in inventory and book debts so as to keep their operations growing.

Liberalisation of policies and practices during those years led to criticism in the banking circles. It was said that the banks were getting farther and farther away from financing the fluctuating or the short-term requirements of the industry and were getting involved deeper and deeper into financing of what was described as permanent core financing by the Dehejia Committee report in the late 60s. It was also asserted that the relationship between the availability of bank credit and growth of industrial output was getting weaker, because bank credit was being utilised for acquiring long-term fixed assets and for holding speculative and flabby inventories.

It is in this background that the Tandon Committee (1975) reviewed the bank credit policies and practices in the early 70s. It recommended that adequate information on prescribed format should be made available by the borrowing companies to the commercial banks to enable the latter to practice need based lending. Secondly, it also recommended norms for investment in inventories and book debts, so that the borrowing companies should not cross the outer limits of reasonable requirements of working capital finance. Thirdly, it also laid down that a certain minimum amount of investment in working capital should be financed by long-term capital funds which really meant laying down a minimum current ratio. Its recommendations were implemented; they formed the basis of policies and practices in 70s and the 80s.

Two points are important in this connection. First, the Tandon committee emphasised need based credit, but it could not adequately provide for the criterion of creditworthiness. It ignored the fact that Indian commercial banks were moving into a position in which they were taking more than normal risking lending. A distinction between fixed and fluctuating components of bank credit was made. But on the requests of the banker and the borrowers, the policy makers decided later to drop this feature after a brief experimentation. Second, it cannot also be claimed that the guidelines issued by the Reserve Bank to the commercial banks based on the Tandon Committee recommendations were in practice implemented with adequate care during the two decades. However, on paper, the guidelines still remain the basis to be followed by the commercial banks for providing working capital finance to the industry.

Despite many attempts for improvement (including Tandon Committee formulations), policies and practices in the area of financing working capital by commercial banks in India are full of bifoculism, paradoxes, and ambiguities. The fact is that three different sets of criteria which in many respects do not agree with each other are being followed simultaneously in practice. The first is the basis laid down by the Tandon Committee which is used in - credit appraisals for determining the credit needs of the borrowing companies so as to enable the commercial banks to fix and sanction credit limits which cannot be exceeded during the period for which they are sanctioned. These are based on the calculation of the maximum permissible bank finance worked out as per the norms and the method laid down originally by the Tandon Committee and revised marginally by the Reserve Bank of India in subsequent years.

For an illustration, let it be assumed that the maximum permissible bank finance, and based on that the total limit sanctioned works out to Rs 100 crores in the case of Company X. The practice also demands simultaneous observance of the old security criterion. In other words, the company would not be permitted on any day during the period for which the limit has been sanctioned, to draw an amount exceeding its drawing power, which is arrived at by deducting the stipulated margins from the book value of the inventories and book debts hypothecated to the banks as securities. This drawing power, in practice, is most likely to be either more or less than Rs. 100 crores for the company X, that is, the total limit sanctioned. Therefore, interesting situations arise where companies have

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higher limits sanctioned but lower drawing power and vice versa. Then there is the third paradox. As part of reality, there will be actual drawings from the bank(s) by the companies which will fluctuate on day-to-day basis. These drawings are made, in accounting terminology, largely from the cash credit accounts. It is interesting to note that this account which is the centrepiece of the Indian system is operated on the basis of cash flow mechanism. Any cheque, irrespective of the fact, whether it is related to payments in respect of current assets or fixed assets or repayment of current or non-current liabilities, can be debited to this account. The same applied to credits. In other words, the essence of the matter is that operationally the borrower finances the overall cash gap based on cash flows. Since, in practice, for the company X all three figures of the total limit sanctioned, the drawing power and the drawings are at any time not likely to equal I 00, it gives rise to dissatisfaction, criticism, and lack of faith in the wisdom of the policies and practices.

Empirical Context

A look at the statistical facts relating to the last two decades leads to interesting results. Important conclusions are as follows:

I It can be said that availability of bank credit which has been the main source of financing working capital of the Indian industries has not been a problem. More credit flowed to industry with the passage of time. In other words, demand and supply matched very well. On an average, during the two decades of the 70s and 80s, bank credit availed by industry in India grew at a linear rate of 14.4 per cent per year. This takes care of the average annual rate of growth of industrial output of 5.6 per cent per year plus the inflation rate of 8.6 per cent. This was made possible largely because of easy market conditions or the high liquidity position of the banks. During these years, the savings rate was high and the bank deposits grew, on an average, by about 20 per cent per year.

Although more credit was allocated to the priority sectors, the industry could be accommodated fully to meet its growing, demand of bank credit to finance its working capital. Access to credit has not been a problem, but interest burden on the industry has been growing fast and the cost of credit has been a major area of concern. This has largely been caused by high rates of interest, high borrowings, and high investment in inventories and book debts; which, in turn, happened because the industry tended to record a low turnover of their current assets and because lower percentage of capital funds were used for financing the working capital.

2 Tables 1 -3 show that on an average, the ratio between chargeable current assets and the sales, or, the turnover for RBI sample companies during the 70s and the 80s was 2.42. As per its norms, the Tandon Committee laid down a minimum turnover ratio of 2. The Indian industry has at macro-level been close to the minimum. Along with low turnover ratio of working capital assets the current ratio indicating availability of capital funds to finance working capital has been too low. On an average, it was around 1.21 which is lower than the minimum ratio of 1.33 laid down by the Tandon Committee. Or, to put it differently, on an average, only 16.9 per cent of the total current assets were financed by long-term capital funds (or the net working capital), whereas the minimum required by the RBI guidelines based on the Tandon Committee guidelines was 25 per cent to reach the 1.33 current ratio. These two indicators lead to the conclusion that high interest rate has been caused largely because of the low levels of the two critical ratios.

3 In table 3, the compound annual rates of growth have been worked out in percentage for the RBI sample of 1,650 large- and medium sized companies over the years 1971-72 and 1986-87. These growth rates show that the interest expenses grew at the rate of 16.1 per cent per year, whereas the sales grew only by 12.1 per cent per year. It is also interesting to observe that the inventory grew over the period only qt an annual compound rate of 7.5 per cent. But, at the same time, the book debts increased by 17.4 per cent which is much higher than the rate of growth of sales thereby affecting the over-all investment in inventory plus book debts. This did not permit improvement in over-all ratio of turnover of current assets. At the same time, because of the current ratio and net working capital position did not improve the short-term borrowing from banks increased for the sample companies at an annual rate of 16.5 per cent It may also be noted that the increase in net investment in fixed assets increased by 15 per cent per year, that is, faster than the sales, necessitating a much higher rate of growth of 26.4 per cent per year in long-term borrowings. All these factors put together explain the high rate of increase in interest expenses. Therefore, as it has already been pointed out earlier, the high interest costs have been a cause of serious concern of the Indian industry, particularly now when the environment is becoming more competitive.

Year Wholesale price index [% rate of growth] Industrial production [% rate of growth] Total Industry Small Industry Large & Medium Industry

1970-71	5.5	5.1	29.7	38.5	36.4
1971-72	5.6	4.4	24.1	15.6	25.9
1972-73	10.0	5.9	10.2	19.2	8.3
1973-74	20.2	0.5	22.6	32.8	20.4
1974-75	25.2	1.9	22.0	18.5	22.9
1975-76	1.0	5.3	16.4	12.8	17.3
1976-77	2.0	12.2	2.6	23.9	2.2
1977-78	5.2	3.4	10.8	19.9	8.3
1978-79	0.0	6.9	7.6	26.5	1.6
1979-80	17.1	1.2	17.8	22.1	16.1
1980-81	18.2	0.7	14.2	19.1	12.2
1981-82	9.3	9.2	19.4	26.1	16.4
1982-83	2.6	3.1	33.9	12.9	44.1
1983-84	9.4	6.7	1.5	20.7	5.5
1984-85	7.0	8.5	10.3	21.3	4.9
1985-86	5.7	8.7	12.6	19.8	8.7
1986-87	5.3	9.1	16.0	16.6	15.7
1987-88	7.6	7.5	30.0	4.3	48.8
1988-89	-	-	19.4	17.2	20.4
1989-90	-	-	27.3	22.5	29.4
Average rate of growth	8.61	5.6	14.4	20.4	13.8

Recent Past

Taking an overall view, the two decades of the 70s and the 80s were characterised by the domination of the economists' view over the view of the business community. There are several important implications on this development.

First, it is difficult to judge the success of the new need based basis of lending followed by commercial banks for working

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capital investment based on the system recommended by the Tandon Committee. Statistically, there was some improvement in inventory turnover ratios, but there was no impact on book debts resulting ultimately in higher short-term borrowings and higher interest expenses. The net working capital position also did not improve. But, in qualitative terms, the improvement in terms of greater awareness and systemic changes within industry as well as within the commercial banks was significant. Many companies in the country started taking management of their working capital and its financing more seriously than before.

Table : Financing of Current Assets

Year	Sales /	CCA NWC /	TCA x 100 CR = CA /CL
1971-72	2.19	17.9	1.21
1972-73	2.32	17.3	1.21
1973-74	2.24	16.4	1.20
1974-75	2.25	20.4	1.26
1975-76	2.31	17.8	1.22
1976-77	2.50	18.4	1.23
1977-78	2.54	6.6	1.10
1978-79	2.52	16.8	1.20
1979-80	2.48	17.9	1.22
1980-81	2.51	17.9	1.22
1981-82	2.49	17.9	1.22
1982-83	2.40	17.1	1.21
1983-84	2.45	17.1	1.21
1984-85	2.57	15.6	1.19
1985-86	2.49	17.5	1.21
1986-87	2.42	17.6	1.21
Average ratios	2.42	16.9	

Table : Compound Annual Rates of Growth

Particulars	1971-72	1986-87	Compound rate of growth in %
1. Sales	7851	43861	12.1
2. Changes in the balance sheet Amounts of inventory	302	897	7.5
3. Net investment of funds in fixed assets during the period	404	3301	15.0
4. Change in the level of trade credit changed	82	915	17.4
5. Change in the level of trade credit obtained	106	626	12.5
6. Change in the level of short term borrowings	85	843	16.5
7. Change in the level of long term borrowings	48	1631	26.4
8. Interest expenses	257	2403	16.1

Second, the business community reacted sharply to some of the rigidities and conditionalities built into the new system of bank lending for working capital. It can be argued that there was a genuine need for laying down of a few norms by the central monetary authority in the country, in the early 70s. They have served a useful historical purpose in focusing on the criticalities of management of industrial finance. That phase is now over. It will be a mistake to carry forward the norm-based micro-level approach into the future. The environment has changed significantly and a new look at the system is necessary as we move into the 90s.

Third, it is also necessary to note that the statistical evidence against the norms is strong. Recent stud ' ies have shown that if the relevant key financial ratios for RBI sample companies are taken and analysed, it is found that a large number of observations are many standard deviations away from the mean. In other words, statistical distributions are too flat and the reality seems to be that almost every company has a uniqueness about i4 and, it needs to be treated as such (Singh, Bhattacharyay, 1989). Moreover, even in the area of management philosophy, the approach towards management of working capital is moving away from norms and models to strategic choices (Singh, 1988).

Fourth, it is also necessary to realise that banking and finance have all over the world also undergone a sea-change during the 80s. The major idea underlying the new environment is deregulation and consequently greater reliance on market mechanisms. The business world has grown weary of the edifice of controls engineered by the economists and the. planners to achieve better allocation of resources and better rates of growth. It is felt that they are tending to become counter-productive. The new wave is against micro-level controls and there is demand for the central monetary authority keeping only eyes on but hands off. As a matter of fact, a stage has come when bypass banking is tending to overtake regulation engineering. As the new environment is beginning to develop, disinter mediation and securitisation are growing resulting, in the development of new options for raising finance by industry, and they promise lower costs of funds.

New Developments

Recent developments have interesting features. They imply more competition among banks, breakdown of the concept of commercial banking and movement towards diversified banking. They also imply activation of money and capital markets, development of new financial products and services all leading towards lower costs of funds. But what is most important to note is that these developments bring in the creditworthiness to the centre of the stage. They are based on more disclosure, more transparent and clean balance-sheets, better information systems and better rates for higher credit rated borrowing companies.

It may be useful to highlight some of the basic elements of the new approach before the current Indian scene is examined in detail. There is now a distinction emerging between the operating and the financing side of financial management in the corporate sector. The operating side includes better management of inventories and book debts. But what is new is the emergence of the role of the money manager or the treasurer on the financing side, and a larger and sharper focus on the management of the cash flows. It appears that the emphasis is shifting from economics to finance. It also appears that the treasurer's or money manager's office is tending to become a separate profit centre in its own right.

This shift away from variables of assets and liabilities towards variables of cash flows can easily be seen as the expansion and partition of the cash flow matrix. The conventional matrix for cash flow management is given in Exhibit 1. It provides for planning and control of various items of receipts and disbursements of cash under separate heads for different planning periods based on weekly, fortnightly or monthly columns. Each quantity entering into this matrix has three attributes: the magnitude, the timing, and the uncertainty; and, a number of assumptions regarding sales, purchases, production, credit plans and policies. One purpose of the exercise is to forecast the cumulative cash gaps for each period. Depending upon the algebraic signs they take, they represent either surpluses or deficits, or cash gaps. The other purpose of the subsequent managerial process is to improve the bottom line by changing

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magnitudes, timings, uncertainties, by changing underlying policies and practices relating to the management of the working capital, in essence, the inventories, credit and collections, or, the operating cycle.

The Indian scenario has been changing. The practice has, in recent years, undergone significant changes. In the early 70s when the rates of interest for lending to the corporate sector were in one go almost doubled, the general practice changed over to avoid credit balances in current deposit accounts. As the interest rates jumped up from about 8 or 9 per cent to 17 or 18 per cent, it was considered unwise to maintain credit balances in current accounts because they did not earn interest.

However, towards the end of the 70s after experiencing two credit squeezes, the corporate finance managers started lamenting the loss of financial flexibility arising out ofcomplete dependence upon commercial banks for filling their cash gaps. Therefore, with early 80s the tendency to draw whenever possible money from banks and to keep credit balances in current deposit accounts again came back into practice. And, in later half of the 80s as new opportunities started emerging, the corporate finance managers started parking their temporarily idle cash balances for earning interest revenue on them with a view to minimising the interest burden on their companies. Moreover, this also coincided with the emergence of many cash-surplus companies on the scene which were all set to take on to the new developments.

What has really happened is that the traditional matrix has got expanded and partitioned into two matrices. The second matrix is given in Exhibit 2. It starts with cumulative cash gap and moves on to current account balance, short-term borrowings from banks and the market, drawing power from banks, and, investment in money market instruments or other short-term quick assets coming under the purview of money manager. They include management of cash collections and payments and float to improve the bottom line and parking of idle funds to earn money on money.

It appears, in future, the focus in the area of financing the working capital in India would not only be on current assets, current liabilities, net working capital, and the current ratio. There will also be another major area of focus: the bottom-line and the portfolio of investment in quick assets. This would make quick ratio not only relevant but also important for a large number of companies, and, that is what makes the situation formally bifocal.

Towards New Scenario

During the second half of the 80s, the national policies in India were modified with a view to liberalising regulations and to activate capital and money markets. Trends towards greater financialisation of savings and greater securitisation of financial assets have already started. With the activation of the capital market, larger volume of funds are being raised through debentures, and many debenture issues are being made, specifically to make more funds available for financing working capital. Many public sector units also raised funds through bonds. The corporate sector, in general, has been more active in raising, funds through public deposits as well. The current regulations restrict the amount of funds that ran be raised by a company by way of public deposits. As it has already been argued earlier, a part of the investment in working capital assets is always of long-term nature. Recent attempts to raise funds for financing working capital through public deposits and through bonds and debentures in the capital market although relatively few in number, are in the right direction because they strengthen the net working capital position and, therefore, improve creditworthiness of the concerned companies and also bring down the over-all cost of funds. As it happens, interest rates on short term borrowings in India are still higher compared to the rates prevalent for long-term borrowings.

Recent changes in the short-term money market are more significant for raising the working capital finance. With passage of time, most of these recent developments are likely to assume great significance during the 90s. The way things are developing, it appears that the exclusive dependence of the Indian companies on commercial banks for financing their working capital will, in large number of cases, no longer be necessary.

There is a healthy trend towards better management of cash movements and money manages position is gradually being involved. Although, only a few companies have got themselves involved thus far, serious attempts have been started to decentralise cash collection and to speed up collection with the help of services provided by some of the banks in the country. This is meant to reduce the float and improve the bottom-line of the cash flows. Further, attempts are also being made to streamline the working capital management and to reduce the need for working capital finance. Focus: the first matrix. But what is more important is the growing active interest in generating cash surpluses and parking them in short-term investments as and when they are available. These attempts lead to faster recycling of funds, reduction in need for borrowing and lowering of the interest burden. Focus: the second -matrix, demanding policy and operational decisions on all rows.

With a view to activating the money market, the banking system in India has introduced two new instruments. Treasury bills and commercial bills are already available. To these certificates of deposits issued by commercial banks and commercial paper issued by the corporate bodies have been specifically for use by the corporate sector. The certificates of deposit provide an opportunity to the corporate manager to raise short-term funds in the money market. The Reserve Bank has issued guidelines for issuing the two new money market instruments. These guidelines are highly restrictive in character because the eligibility criteria have been set too high. There have been some subsequent liberalisation too. It is expected that as the experiment succeeds, the eligibility criteria will be further liberalised to permit larger number of companies to use CDs and CPs. It is also expected that the variety and range of instruments would also widen, and the secondary market would get itself established.

In this connection, it is relevant to point out that the basic idea underlying the introduction of new money market instruments and supportive new financial services, is to enable the corporate sector to raise funds more easily, to use funds already available

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more effectively and to reduce the interest burden. An active money market is meant to provide short-term funds at rates of interest much lower than long-term rates of interest. Treasury bills are, to some extent, used but only by the banks. They themselves also accept term deposits for short periods. In these cases, the rates of interest have fluctuated around 8 to 10 per cent. It is expected that under ideal conditions these should be the rates around which short-term money market in India should fluctuate. A prime rate would emerge and the CDs and CPs would also get related to it.

It is no doubt true that the Reserve Bank is overcautious. It is also not yet ready to exercise control over the monetary system if new developments pick up fast. All its control instruments and policies were developed in the past to meet the then prevailing conditions. It will have to review its own working and devise new control measures. This is what in the new environment, is called re-regulation. With more freedom available to banks, as well as players on the other side of the market it will be necessary to change regulations so that non fund and off the balance sheet business of banks and all other financial institutions can be regulated to achieve the national objectives.

For this purpose, some of the old ideas may have to be drastically revised. For example, it is not necessary to look at new money market instruments in the Tandon Committee perspective. It is no doubt true that more active use of CDs and CPs would drastically alter the nature of other current assets and current liabilities on corporate balance-sheets. That would demand a major reconsideration of the present system. But it is not wise to link operations relating to new money market instruments to maximum 'permissible bank finance or not to permit revolving underwriting arrangements and instead, permit only standby agreements within the credit limit sanctioned by the banks. In other words, it will have to be understood that if new developments are to be encouraged in the 90s, one cannot restrict them by the wisdom of the 70s.

There is the other side of the picture; it is also necessary to take note of the developments beyond the official market. What has really been happening in the unofficial market in the last few years is somewhat dysfunctional. The first major development in the market was the emergence of the financial service called portfolio management. Since the Reserve Bank regulations did not permit, it emerged as a sort of bypass banking. It was not prohibited either. Some banks started offering interest rates around 12 per cent to the corporate sector for their cash surpluses. The money was invested in either UTI units or public sector bonds and the banks made some profit for themselves. To ensure absolute liquidity, the banks signed buyback agreements with their corporate clients. This meant reward without risk and also a more than normally expected reward on short-term deposits in India. The RBI prohibited portfolio management for periods shorter than a year.

Another most important development has been the removal of the ceiling of 10 per cent interest rate for the call market. Therefore, the call rates have on many occasions risen too high touching sometimes even 50 per cent and more. It is expected that the rates would somewhat stabilise in the near future, as the banks get used to the new game. There are, however, some banks and also some corporate money managers and private matchmakers who believe that in a country like India, demand and supply position of money is likely to keep the rates in the call market often times as high as 30 or 40 per cent. They are gearing themselves up for business opportunities under such conditions. In recent months, things have gone to the extent that some corporate money managers have availed credit facilities from some commercial banks at 16 per cent and through matchmakers lent them back through commercial banks at 30 or 4O per cent to other commercial banks. The matchmakers have also been busy in arranging inter-corporate short-term borrowings and lendings at rates above 20 per cent. In such transactions, commercial banks have also been involved. On the other hand, discounting of commercial bills which carry interest rates lower than 15 percent has not been so popular because the rediscount rates have not been higher.

These two parallel developments described above are apparently contradictory. On the other hand, the authorities at the national level have been trying to deregulate, to activate money and capital markets, to introduce new money market instruments in the expectation that money market would offer opportunities to the corporate money managers and banks to do more business and earn reasonable profit and, at the national level, to raise more funds in the market at reasonable cost of funds. On the other hand, the matchmakers in the market are using the new freedom to arrange inter corporate borrowing and lending, lending surplus funds to banks to meet their cash reserve requirements and to continue the short-term portfolio management service by replacing buyback arrangements with forward purchases. There have been several occasions in the recent past when liquidity in the market was tight and several companies have been made fabulous profits through such transactions, and, these profits have been earned through totally risk-free transactions. They cannot be considered functional.

The situation is, therefore, paradoxical. There is the hope that gradually things will, in due course, settle down and both the banks and the corporate money managers will start using available instruments and play the game within the guidelines and the policies of the Reserve Bank and help in achieving the national objectives. There is also the fear that the new environment might promote more of bypass banking, and ultimately, the experiment in freeing the call market rate may have to be considered a failure.

As against this, it might be noted that many Indian companies with the help of commercial banks have been gaining access to foreign funds raised in international money markets through the issue of commercial paper at fairly low rate of interest. This not only makes cheaper funds available to the Indian industry but also helps in bridging the foreign exchange gap.

All innovations in financial world get popularised with passage of time. As attempts in India are being made to broaden the range of options available to corporate managers to finance their working capital through more deregulation, disinter mediation, securitisation, institutionalisation, and internationalisation, it should be recognised that to begin with only a few companies and a few banks would be involved. As

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these developments proliferate, with passage of time, the number of players and the variety of instruments will increase. This hope will materialise only if the introduction of instruments like CDs and CPs becomes popular both in the banking and in the corporate world. If they are pushed aside by somewhat clandestine and bypass banking in which the name of the game will only be making money on money, the bus will be missed. Much would depend upon whether the money game is played as chess or poker.

Bill Discounting - An Avenue for Retail Investors too

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

A lot of people believe that bills discounting falls in the purview of banks and financial institutions. While this may be correct to a large extent, it is also true that most of the smaller value bills of big corporates and smaller, but sound, companies is undertaken by retail investors, who have funds to spare for a certain period.

Bills discounting is of two types

1. Purchase bills discounting and
2. Sales bill discounting.

A purchase bill discounting means that the investor discounts the purchase bill of the company and pays the company, who in turn pay their supplier. The investor gets his money back from the company at the end of the discounting period.

A sales bills discounting means the investor discounts the sales bill of the company and pays directly to the company. The investor gets his return from the company at the end of the discounting period.

Funds The funds generally required for this type of transaction start from Rs300,000 to upto Rs2mn. The tenure, generally, ranges from 60 days to upto 180 days.

Procedure The procedure is that a broker will contact you with proposals to discount bills of different companies at different rates of discounting. The better companies command discounting rates of 13% to 15%, while the lesser known, by size and by safety, have to pay discounting rates of 17% to as high as 28%. It is later explained what factors determine the discount rates. When an investor and the company agree to a particular bill discounting transaction, the following is what the company gives to the investor:

The original copies of bills to be discounted;

A hundi / promissory note; Post dated cheque.

The investor simply has to issue a cheque. The amount of cheque is arrived at after deducting the discount rate. The post-dated cheque that the company gives is of the full amount of the transaction. This can be better explained with an example as follows.

Company A wants to discount its purchase bill of Rs200,000 for a period of three months. Investor P agrees to do so at a discount rate of 21%. The deal is mutually agreed. Now, the investor will issue a cheque of Rs189,500.This figure is arrived at as follows:

= 200,000 x 21% x 3/12

Thus the investor gets his/her interest before the end of the period on discounting.The company on its part will issue a post-dated cheque of Rs200,000 for three months period.

Here we see that the investor benefits in two ways:

He gets the interest element at the first day of issuing the cheque. i.e. he does not include that part in his cheque amount. Thus he can earn interest on this interest for a three-month period. Even a simple bank fixed deposit on it will earn @5% p.a. By investing Rs189,500 for three months, the investor earns Rs10,500 on it. A return of 22.16%.

Discount Rates The rates depend on the following factors:

The Broker: The broker has a good influence on the rates offered by companies. His relations with the company and the investor do make a difference of a couple of percentage point in discounting rates.

Market Liquidity: Liquidity crunch in the market tends to hike up the rates even in the best of the companies. Since this instrument is a short tenure one, short-term changes in the market liquidity greatly affect the discount rates.

Volume/Value of Discounting: When the volume/value of discounting done by the investor is high, he is looking at security more than returns. The company on its part is looking at savings by way of reduced legal paper work and a higher amount of dedicated funds for a said period and hence on the whole reduced costs to the company.

Frequency: An investor who is regular bills discounter for the company may get upto 1% to 1.5% points higher interest rates than a new investor. As for the investor he is trying it out with a new company and will agree to a lesser rate to ensure safety.

Company's finance resources: This is one of the biggest factors that decide the discount rates. A Public limited company generally tends to have a cheaper source of finance as against any other form of company. Working capital financing of companies to a large extent manipulates the rates the companies are willing to discount their bills at.

Caveat The following points need to be remembered when dealing in this instrument.

One must have a thorough knowledge of the company whose bills are discounted. Their industry, competition, people at the helm and their reputation in the market. This is necessary as it is going to be the company that is going to pay you from its earnings.

There is no legal fall back option in case of default by the company. The company does sign a promissory note, but legal respite using this will take years to happen. The investor is not a secured creditor for the company nor does he get any preference on winding up of the company.

Brokers need to be people who are well known to you. Since most of the deals happen through them, you should know the broker well enough to trust him and his deals. Spurious brokers are plenty out there in the market and a watchful eye must be kept. Even after investing in the company a regular

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watch on the company's fortune and a constant touch with the broker would be warranted.

RBI Tightens Norms for Bills Discounting

THE Reserve Bank of India has permitted banks to sanction limit for bills discounting to borrowers in accordance with the loan policy as approved by their board of directors.

In its guidelines on discounting and rediscounting of bills by banks, based on the recommendations of the working group on discounting of bills by banks, the RBI has said banks should lay down a bills discounting policy approved by their board of directors and consistent with their policy of sanctioning of working capital limits.

In a circular issued to all scheduled commercial banks, the apex bank has said the procedure for board approval should include banks' core operating process from the time the bills are tendered till these are realised.

Banks should open letters of credit (LCs) and purchase, discount, negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks.

Therefore, banks should not extend fund-based (including bills financing) or non-fund-based facilities like opening of LCs, providing guarantees and acceptances to non-constituent borrower or a non-constituent member of a consortium, multiple banking arrangement.

While purchasing, discounting, negotiating bills under LCs or otherwise, banks have been asked to establish genuineness of underlying transaction documents.

Accommodation bills should not be purchased, discounted or negotiated by banks.

Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.

Bills rediscounts should be restricted to usancebills held by other banks. Banks should not rediscount bills earlier discounted by non-banking financial companies (NBFCs) except in respect of bills arising from sale of light commercial vehicles and two-/three-wheelers.

Banks may exercise their commercial judgment in discounting of bills of services sector.

In order to promote payment discipline which would to a certain extent encourage acceptance of bills, all corporates and other constituent borrowers having turnover above threshold level as fixed by the bank's board of directors should be mandated to disclose 'aging schedule' of their overdue payables in their periodical returns submitted to banks.

Banks should not enter into repo transactions using bills discounted/rediscounted as collateral.

Banks should follow the above instructions strictly and any violation of these instructions will be viewed seriously and invite penal action from the RBI.

Banking : Tightening the noose

HISTORY has shown that banking crisis are followed by reforms. Bankers expect history to repeat itself in the forthcoming monetary policy.

Investigations into the Madhavpura Co-operative Bank episode have shown that stock brokers have misused the Ahmedabad-based cooperative bank's funds to the extent of Rs 1000 crore.

This includes the Rs 800 crore lent to stock broker Ketan Parekh and Rs 200 crore to Mukeshbabu by Madhavpura Cooperative Bank.

A fallout of this is expected to be RBI measures aimed at curbing such violation of norms. But it is unlikely that any dramatic changes on bank's capital markets exposure would be announced in this policy.

The central banks has always debated major policy changes with senior bankers before implementing them. A draft report on bank's exposure in the capital market was circulated last week and comments from banks are expected only in May.

But in the short run, RBI is expected to announce fine turning of some of the existing prudential norms. Some bankers feel that the central bank will tighten norms in respect of the maximum conuter-party exposure in inter-bank deals.

It is also likely that the RBI will take the first step towards introducing risk based supervision In the last two credit policy, RBI has expressed its intentions to move towards RBS.

RBS would imply monitoring banks by allocating supervisory attention according to the risk profile of each institutions. It would be done by upgrading the supervisory tools like on-site and off-site inspections and putting in place market intelligence mechanism.

Besides this, several other draft reports which have been circulated and largely debated could be notified in the forthcoming policy.

These include a draft guideline credit exposure limits which suggest broadening the definition of net worth and thereby permitting higher loan exposure limits to individual and group accounts.

There are draft norms on strengthening the bills discounting mechanism and extending it scope to service sector, a paper on pre-empt corrective action which will enable RBI to pre-empt any deterioration in the banking system.

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LESSON 16:
HOUSING FINANCE

Lesson Objectives

- To understand the Concept of Housing Finance.
- Knowledge of Housing finance schemes and working of housing finance companies.

Introduction

In the country development of housing finance started very late. Initially it was the responsibility of government to provide the finance in this sector, as there was no initiative from private sector. The setting up of National Housing Bank (NHB) a fully owned subsidiary of the RBI in 1988 as the apex institution, marked the beginning of the emergence of housing finance as a fund-based financial service in the country. Since than, it has grown both horizontally as well as vertically with the entry of specialized financial institutions / companies in the private, public and joint sectors.

Real growth of housing finance sector was witnessed in last five years, due to rapid reduction in interest rates and governments efforts to boost housing infrastructure. Also, growth was propelled because of Income Tax benefit available on housing loans to individuals.

Housing Finance System

The implementation of housing finance policies presupposes efficient institutional arrangements. Although there were a large number of agencies providing direct finance to individuals for house construction, there was no well established finance system till the mid eighties in as much as it had not been integrated with the main financial system of the country. The setting up of the National Housing Bank as a fully owned subsidiary of the RBI as an apex institution was the culmination of the fulfillment of a long overdue need of the housing finance industry in the country. The system has been characterized by the emergence of several specialized financial institutions which have considerably strengthened the organization of the housing finance system in the country. In last few years, various companies have jumped into the field of housing finance, but major business is with few well recognized companies only.

Now let us look into the system of housing finance and discuss few of the important organizations in the system.

Central and State Government

Till the mid-eighties, the responsibility to provide housing finance rested by and large with the government. The Central and State governments support the housing / building efforts indirectly. The Central government has introduced, from time to time, various social housing schemes. The role of the Central government vis a vis these schemes is confined to laying down broad principles, providing necessary advice and rendering financial assistance in the form of loans and subsidies to the state governments and union territories. The Central government has set up the Housing and Urban Development Corporation (HUDCO) to finance and undertake housing and urban development programme, development of land for satellite towns, besides setting up of building material industry.

The Central government provided equity support to HUDCO and guarantees the bonds issued by it. Apart from this, both Central and State governments provide due house building advances to their employees. While the Central Government formulates the housing schemes, the state governments are the actual implementing agencies.

Housing and Urban Development Corporation (HUDCO):

HUDCO was established on 25th April 1970 as a fully owned government enterprise with following objectives:

i. To provide long-term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country.
ii. To finance or undertake the setting up of building materials industries.
iii. To finance or undertake the setting up of new satellite towns.
iv. Administer the moneys received, from Government of India or other such grants for purposes of financing or undertaking housing and urban development programmes.
v. To subscribe to the debentures and bonds to be issued by the state housing boards, improvement trusts, development authorities and so on, specifically for the purpose of financing housing and urban development programmes.

The HUDCO was established with an equity base of Rs. 2 crore. Over the years, the Government has expanded the equity base. It has further been able to mobilize resources from institutional agencies like LIC, GIC, UTI, commercial banks, international assistance as well as through public deposits.

The HUDCO provided assistance benefiting masses in urban and rural areas under a broad spectrum of programmes like rural & cooperative housing, urban employment through housing and shelter development, land acquisition, basic sanitation and environmental improvement of slums, consultancy for technology transfer, building material industry and building technology.

The HUDCO has also been entrusted with the responsibility to finance urban infrastructure projects with additional equity support provided by the Ministry of Urban Development, Government of India. The infrastructure projects cover sectors of water supply, sewerage, drainage, solid waste management, transport nagars / terminals, commercial – social infrastructure, road, bridges and are development projects and so on.

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Insurance Organizations / Corporations

The LIC and GIC support housing activity both directly and indirectly. The LIC is statutorily required to invest 25 percent of the net accretion of funds in socially oriented housing, electrification, water supply and so on. Besides subscribing to bonds of the HUDCO and state housing boards, LIC grants loans to state governments for their rural housing programmes and to public sector companies for construction of staff quarters. Though LIC has been granting loans to individuals, directly, the thrust to housing finance was provided when, in 1989, the LIC promoted a subsidiary for the purpose, namely the LIC Home Finance Ltd.

The GIC and its subsidiaries are required to invest 35% of their annual accretions by way of loans to socially oriented schemes such as housing. It supports housing almost exclusively indirectly by subscribing to bonds/debentures floated by the HUDCO and state housing boards. It has also set up a housing finance subsidiary called the GIC Housing Finance Ltd., in July 1990 to enable it to lend directly to individuals.

Commercial Banks

Commercial banks lending to individuals for housing emerged in the wake of the report of the working group on Role of Banking System in Providing Finance for Housing Schemes. They have been lending to the housing-sector based on annual credit allocations made by the RBI.

Cooperative Banks

The cooperative banking sector consists of State Cooperative Banks, district central cooperative banks and primary urban cooperative banks. The RBI issued the first set of comprehensive guidelines, for these cooperative banks, in 1984. Cooperative banks finance individuals, cooperative group housing societies, housing boards and others who undertake housing projects for EWS, LIGs and MIGs.

Specialized Housing Finance Institutions

There are certain institutions termed as 'Specialized HFI', which cater only to the needs of the housing sector. They can further be classified as housing finance companies promoted in the public / private / joint sectors and cooperative housing finance societies. A lead player in HFC category is the HDFC Ltd. It lends, mainly for new residential housing to individuals, groups of individuals, and individual members of cooperative societies.

Besides the HDFC, a number of HFCs have been sponsored by banks such as SBI Home Finance Ltd, Canfin Homes Ltd, IndBank Housing Finance Ltd, Citihomes etc.

Housing Finance Schemes

To cater to the diverse needs of housing in India, the HFIs / HFCs have tailored a variety of housing finance schemes. Let us discuss, in short, salient features of these schemes.

Housing Loan Schemes of Commercial Banks

As observed earlier, 1.5 percent of incremental deposits of commercial banks have to be made available to the housing sector every year. These have to be done in accordance with RBI guidelines. The housing loans/ finance are provided to individuals, institutions, public agencies, and so on. The salient features of housing finance schemes of commercial banks are as following:

Loans to Individuals: Individuals eligible for housing loans fall into four categories, namely, those belonging to economically weaker section/ low, middle and higher income groups; those owning land and capable of liquidating the loan within stipulated time; those purchasing residential flats from state housing boards/ improvement trusts / cooperative societies / private builders and others and those belonging to SC/ST, who have been allocated land by the government.

The rate of interest is charged according to the amount of advance and RBI PLR. The SC/ST borrowers have to pay concessional rates on housing loan. Normally commercial banks do not pay full cost of the house and the owners/borrowers have to bring in the margin money. Normally margin money is 25% of the cost.

The amount of loan depends on the capacity of the borrower to repay and the cost of construction, subject to a maximum limit of Rs. 10 lakh.

Repayment of the loan has to be done in equal monthly installments within a maximum period of 15 years. Initial moratorium of 18 months or until completion of construction whichever is earlier may also be allowed. The normal security for the housing loan is mortgage of property purchased from the proceeds of the loan. However, where it is not feasible the banks may accept security of adequate value in the form of life insurance policies, Government promissory notes, shares and debentures, gold ornaments and such other securities.

Banks also entertain supplementary finance for repair/alterations/ additions to the house / flat/ building already financed by them.

Loans to Institutions / Public Agencies by Commercial Banks: This can be further classified into four categories:

Term loans to housing finance institutions: HFIs can avail of term loans from banks. The quantum is determined on the basis of debt equity ratio, track record, recovery performance and other relevant factors. In no case, the quantum of term loans to be granted to the HFC/ HFIs together with the outstanding loans in the existing term loans from the banking system should exceed their NOF. This norm is however, relaxable in the case of HFC/ HFIs promoted /sponsored by commercial banks as also in respect of the HUDCO and HDFC.

Lending to Housing Boards and other Agencies: Banks may extend term loans to state level housing boards and other public agencies on the same terms and conditions as indicated in the case of HFIs. Banks, however, look into the past performance of such boards in recovering the installments from beneficiaries and also stipulate that the boards ensure prompt and regular recovery of loan installments from the beneficiaries.

Financing for Land Acquisition: Banks grant loans to public agencies for acquisition and development of land provided it is a part of the complete project including development of infrastructure such as water system, drainage, roads, provisions of electricity and so on. The maximum period of repayment is three years if project also covers construction of houses. Credit

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extended to individual beneficiaries should conform to the terms and conditions applicable to individual borrowers.

Loans to Builders: Builders who wish to avails of credit for development of plots coupled with the construction of flats/ houses under refinance scheme of the NHB are granted loans by the banks, subject to certain conditions like

i. The loan amount in respect of at least 75% of the dwelling units (flats/houses) should not exceed Rs. 3 lakh per individual unit.
ii. Builders' own contribution should not be less than 25% of the cost of the project which is to be brought in first and used before disbursement of bank loan.
iii. The bank loan is in the shape of term loan for a period of three to five years linked to each specific project. The finance is made available for the completion of the project which includes construction of the dwelling units.
iv. The dwelling units should be sold through open advertisement, to the prospective buyers at the predetermined prices to avoid speculation.
v. On completion of the project, the dwelling units should be sold on outright sale basis to allottees who may avail of loans from banks.
vi. Sale proceeds are to be utilized by builders strictly for repayment of the term loans given to them by the banks.

Sbi Home Finance – Housing Finance Schemes

The SBI Home Finance (SBIHF) provides housing finance to individuals, corporate bodies and promoters and developers. The main features of these schemes can be classified as following:

Housing loan Schemes for Individuals: SBIHF sanctions loans to individuals for construction of houses, purchase of houses / flats and repairs, renovation, addition alteration extension etc. The loans are sanction for a period ranging from 5 to 20 years, up to Rs. 10 lakhs based on the repayment capacity of borrower.

Schemes for promoters and developers: The purpose of housing loans given to this category of borrowers is an additional source of finance to supplement their own resources, for construction of residential housing projects. Maximum limit of loan amount is 50% of the project cost or balance required for completion of the project. Repayment is normally done in three years in suitable installments, based on the cash flow of the project.

Schemes for Corporate: The SBIHF has designed three alternative schemes for lending to corporate bodies: (a) for construction / purchase of staff quarters for their own employees, (b) for on-lending to their employees in accordance with their own housing schemes and (c) loans to their employees nominated by them. The upper limit in all the three schemes is Rs. 5 lakh for each individual dwelling.

Hdfc Scheme For Individuals

The HDFC advances housing loans to individuals for (a) buying or constructing houses, (b) extension or improvement of existing houses, (c) acquiring a self-contained flat in an existing or proposed cooperative society/ apartment owners association and (d) independent bungalow / row house. Loan can be availed of up to a maximum of 85% of the cost of the property including the cost of land. The maximum loan to an individual can be Rs. 25 Lakh. Although the equated monthly installment of repayment is over 15 years period, the repayment does not ordinarily extend beyond the age of retirement or 65 years of age of the borrower, whichever is earlier.

Glossary - Housing Loan

Acceptance Letter: The letter that a borrower eagerly waits to fill up. Once the loan is issued by the way of sanction letter, the applicant communicates his willingness to accept the loan by way of an acceptance letter. He has to send this within a time frame of 1-3 months from the date of the sanction letter.

Advance EMI: Pay back time! Number of equated installments in the form of post dated cheques, paid out in advance at the time of disbursement of loan.

Administrative Fee: Unavoidable pay out by which bank/ HFC can make money of you. A one time fee; generally non-refundable; payable before the loan is disbursed. Rates may vary from 1-2% of the loan amount.

Close Relatives: As per the section 6 of the company act, a close relative is one who is acceptable as a guarantor is any of the following: Father, Mother (including step mother), son (including step son), son's wife, daughter (including step daughter), son's son, son's son's wife, son's daughter, son's daughter's husband, daughter's husband, daughter's son, daughter's son's wife, daughter's daughter, daughter's daughter's husband, brother (including step brother), brother's wife, sister (including step sister), wife/husband and sister's husband. However they should comply with the age and other norms of the company to be considered as guarantors.

Commitment Fee: Much like other commitments, which if one screws up one gets the short end of the straw. It is an interest, which is charged if you do not draw the sanctioned loan amount within a period of 6-7 months. The interest rate is usually about 1-2%.

Credit Appraisal: The IMPORTANT PEOPLE! Every Housing Finance Company (HFC) has its own panel of credit appraisal officers who process applications. They take into account various factors like income of the applicants, number of dependents, monthly expenditure, repayment capacity, employment history, number of years service left over and other factors, which affect the credit rating of the borrower. Proof of income will also be verified for the purpose of approval of loan. The time taken for receipt of such information is crucial since it affects the length of time required for a loan approval.

Documentation: Documentation is the papers to be signed in connection with the loan at the HFC,i.e.the loan papers.

Down Payment: Wonder why it's called down payment when it has to be paid up-front? Housing Finance companies normally give loans up to 80-85% of the value of the property. The balance would have to be paid by the buyer, as a payment before he draws on the loan amount. Encumbrance: Document to ward of the nightmare of property litigation. It records details

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of transfer of ownership of a property in succession right to the current owner. It shows the date, the names of the parties involving the amount of consideration, the extent and schedule of the property. This certificate can be obtained from the sub registrars' office for a payment of fee. This certificate is also useful in establishing the events as to how and when the present owner came into possession of the property.

Equated Monthly Installment (EMI): Loan repayments are usually in Equal Monthly Installments over the tenure of the loan. Some banks also offer a Variable Installment Scheme in the beginning of the loan period. This is beneficial for those individuals who are trying to maximise their tax breaks in the initial years and expect future tax breaks to fall

Exposure/Extent of loan: The loan amount as against the value of the asset/product. Try avoiding an indecent exposure, it's better for your health as well!

Floating Rate: Here the interest rate on the loan depending on the Prime Lending Rate (PLR) fixed by the Reserve Bank. This change can happen as frequently as one in six months. If the PLR falls, you benefit and if it rises... However, in case of a fall your payments remain the same for every month. The finance company will refund some of your EMI cheques and effectively compensate you by reducing the tenure of the loan. The reverse happens if the PLR rises, much to your disadvantage. Whoever said that this is a floating rate has got be joking. It's best called the sink or ride the crest rate, wouldn't you agree?

Flat Rate: Percentage representation of the amount of annual interest on the total loan amount.

Interest Tax: Housing Finance companies have to pay a tax on the interest income they receive. One should check whether the interest rates quoted include interest tax or not. This tax is normally about 2% of the interest rates charged. Interest tax has been abolished from April,2000 .

Interest Rate: Rate at which the lenders charge interest for the loan amount.

IRR: Internal Rate of Return is the rate at which the lender accounts for interest.

Legal Scrutiny Report: The documents which are pertaining to your property needs to be scrutnised by the legal personnel of the HFC to ensure that you are buying a property that is clear and marketable.

License for Construction: This is basically permission to construct or an authorization in writing issued along with the loan application.

Margin Amount: Margin Amount is the difference between the total cost of the project and the loan amount sanctioned. This money has to be invested by the borrower prior to the release of the loan amount.

Marketable Title: A person is said to have a marketable title only when the title to the property is clear and he/she has the right and capacity to transfer the same.

Market Value: This is the value of the property as per the prevailing market value.

Obligation: The borrower in terms of the agreement will be obligated to keep up the schedule of repayment to deposit the post dated cheques periodically and to keep the property free from encumbrance.

Prepayment Charges: Most HFCs charge some fee for pre-payment of loan before the tenure is over. Your earning capacity normally increases with your age and a pre-payment fee can be a big cost. The fee is normally in the range of 1-2% of the pre-paid amount.

Pre-Sanction Inspection of Property: After the receipt of the loan application, a loan officer from the HFC conducts an inspection of the property to ascertain the location of the property, verify the technical details of the house and the stage of construction.

Property Tax: This is the tax which is levied by the local authority such as Corporation, Municipality etc. to the person in whose name the property stands.

Refinance Charge: Home Housing Finance companies do not charge you for prepayments from your own savings. However, if you retire a loan using money borrowed from another Finance Company, you will have to pay a refinance charge of 1-2% of the loan outstanding.

Registration Value: This is the value of the property at which the property is registered.

Role of Guarantor: The role of a guarantor is commitment by the way of agreeing to the terms and conditions of the loan and liable to the extent of the loan/liability together with the interest and other charges.

Rest: A contradictory word here as it does nothing but increase your tension. Interest rates are quotes on a daily rest, monthly rest or annual rest basis. The annual rest quote implies that the company gives you the credit for the monthly principal repay-ments only at the end of each year. Such loans are therefore more expensive than a monthly/daily rest loan. The shorter the tenure of the loan, the greater the effective interest rate differ-ence will be.

Sale Agreement: Sale Agreement is an agreement which is entered in between the parties dealing with the property and which creates a right to obtain a sale deed mentioning the property. Generally it precedes a sale deed and normally it fixes a time for completion, payment of earnest money or part payment of purchase consideration.

Sale Deed: This is an instrument in writing which transfers the ownership of the property/properties in exchange for a price paid or considered. This document is required to be registered compulsorily.

Sanction Letter: This is the letter which communicates the sanctioned terms and conditions once the loan is approved.

Sanctioned Plan: A drawing containing the plans, section of elevations of areas along with detailed schedules, specifications and area statements on which the sanctioning authorities grant permission to carry out work as regulated in the bye laws.

Stamp Duty: It is the duty/fee payable on the different instruments / documents as per the prescribed rate. The adequacy of stamp duty should be ensured to make a docu-ment valid and enforceable.

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Statement of Account: The statement indicating the outstanding loan amount, the amount paid by the borrower, the appropriations made towards the interest and principal, etc. at the end of the financial year.

Tenure of the Loan: Normally, loans are given for a period of 1-15 years. Some companies also give loans up to 20 years at an additional interest cost of 0.25% -0.5%.

Housing Finance Sector Booms Ahead

12/16/2003, Source: Times News Network

That's not all. Banks are falling over themselves in a bid to capture market share. As a result, consumers now have plenty of choices from an array of innovative schemes. Also, the easy accessibility of loans has proved to be a catalyst in the upswing in real estate rates, particularly on the outskirts of metropolitan cities like Bangalore, Delhi and Mumbai over the past six months. We check out on the various home loan schemes on offer from various banks.

Super savers

In the case of some schemes from new entrants into the home loan retailing spectrum, the 'super saver' schemes are being offered at a rate of as low as 6% per annum for the first year, and 6.5% per annum for the second year. The scheme subsequently operates on a floating rate basis from the third year onwards, in line with the prevalent market rates. This effectively means that the consumer has to pay an equated market installment (EMI) of around Rs 842 per month per Rs 1 lakh borrowed in the first year, which goes up to around Rs 885 per lakh per month in the second year. From the third year onwards, the rate would on a floating basis, in line with the interest rate prevalent at that time. But in such schemes, there is a lock-in period before the consumer can opt to get the loan refinanced from another banker. The penalties are heavy too.

A variant of this scheme is for the lower income class, who expect an increase in their income in a year or two. Here, the EMI is Rs 660 or Rs 686 per month per lakh in the first year, which subsequently shoots up from the next year.

Split rates

As the name suggests, the amount borrowed from a bank is charged on a floating as well as fixed basis. Usually 40% or 20% of the amount of home loan is treated on a fixed rate of interest, while 60% or 80% is charged on floating rate basis. In case of floating schemes, rates are usually lower by around 50 basis points than in fixed rates. Thus, part of the rate-hike risk (20% or 40%) gets capped. But on the flip side, fixed rates (currently 8.25 %) are subject to be reviewed after three years.>

Convenience schemes

These home financing schemes are initiated by well known developers in pact with housing finance companies or banks. Under such schemes, customers can book the property to be developed by the construction company/developer by paying just 5% of the aggregate value of the property. For the remaining amount, the housing finance company/bank, which has already approved the project, gives a loan within one month of booking.

Since the loan is sanctioned in the name of the buyer but remitted to the developer at that point, the developer shares 65-70% of the EMI of the borrower till the property is handed over to the buyer. The rest (one-third of every EMI for about two years) is paid by the borrower. This is effectively his cash discount payment.

The schemes are usually for 20-year terms only and cannot be foreclosed by the borrower. Thus, it is a win-win situation for the housing finance company, which gets EMIs for 20 years, as well as the developer, who gets a cash-down payment.

These schemes are ideal for those buyers of property, who want to make the most of the upcoming real estate boom, with a view of resale and minimum investment. For the real prospective users of property, such schemes are a costly proposition.

Floating/Fixed Rates

Apart from the above variants, normal floating and fixed rate schemes are also available. However, in most cases, fixed rate schemes are costlier by 50 basis points. There are standard processing/administrative charges of 0.5% of the loan, and the penalty for getting these refinanced are 2% of the outstanding loan amount. Prepayment from savings account is permitted without any charges, in most cases.

With competition heating up, it is up to the consumer to make the choice from among the available home financing schemes, since interest rates have come to a new low.

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LESSON 17:
HOUSING FINANCE: NHB, REGULATORY FRAMEWORK, REFINANCE

Lesson Objectives

- To Know the Regulatory Framework for Housing Finance, Understand the working of NHB.
- To understand the system of Refinance.

Introduction

The National Housing Bank, being apex body for regulating the housing finance, controls all housing finance institutions and companies. Let us study the NHB first to understand its working.

National Housing Bank (NHB)

The NHB was established in 1988 under the NHB Act, 1987 to operate as a principal agency to promote housing finance institutions both at local and regional level, and to provide financial and other support to them. The HFIs include institutions, whether incorporated or not, which primarily transact or have as one of their principal objects the transacting of the business of providing finance for housing, either directly or indirectly.

The NHB is an incorporated body, with powers to establish it offices, branches and agencies at any place in and outside India (subject to RBI approval). Its is a 100% subsidiary of RBI with a fully paid up capital of Rs.350 crores. Its capital can be increased up to Rs. 2000 crores with a restriction that at least 51% of the paid capital will be held by RBI / Government / Public Sector banks or Public sector financial institutions.

The management of the NHB is with a Board of Directors, headed by the Chairman (or Chairman and Managing Director). The other members of the board are Two Directors, experts in any field which is useful for NHB, Two Directors, experienced in running financial institutions, Two Directors elected by shareholder, other than RBI/ Central Government, Two directors from out of the RBI directors, Three Directors from amongst the Central Government officials and Two Directors from amongst the State Government officials.

Business of NHB

The NHB has the powers to get involved into various business activities, subject to provisions of NHB Act. Main activities of NHB are as following:

a. Promoting, establishing, supporting / aiding in the promotion / establishment/ support of HFIs.

b. Making of loans and advances or rendering any other form of financial assistance, whatsoever, for housing activities to HFIs, banks, state cooperative agricultural and development banks or any other institutions / class of institutions notified by the Government.

c. Subscribing to / purchasing stocks, shares, bonds, debentures and securities of every other description.

d. Guaranteeing the financial obligations of HFIs and underwriting the issue of stocks / shares / bonds/ debentures/ other securities of HFIs.

e. Drawing, accepting, discounting / rediscounting, buying/ selling and dealing in bills of exchange/ promissory notes, bonds/ debentures, hundies, coupons and other instruments.

f. Promoting/ forming/ conducting or associating in promotion/ formation/ conduct of companies / mortgage banks / subsidiaries/ societies/ trusts/ other associations of persons it may deem fit for carrying out all/ any of its functions under NHB Act.

g. Undertaking research and surveys on construction techniques and other studies relating to / connected with shelter / housing and human settlement.

h. Formulating scheme(s) for purposes of mobilization of resources and extension of credit for housing.

i. Formulating schemes for economically weaker sections of society which may be subsidized by Government or any other sources.

j. Organizing training programmes / seminars/ symposia on matters relating to housing.

k. Providing guidelines to HFIs to ensure their growth on sound lines.

l. Providing technical / administrative assistance to HFIs.

m. Coordinating with the LIC, UTI, GIC and other FI in the discharge of its overall functions.

n. Exercising all powers and functions in the performance of duties entrusted to it under the NHB Act or under any other law in force for the time being.

o. Acting as agent of the Central / State Government/ The RBI or any authorities as may be authorized by the RBI.

p. Any other kind of business which the Government may, on the recommendations of the RBI, authorize.

q. Generally, doing of all such matters and things as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under the NHB Act.

Borrowing and Acceptance of Deposits

For purpose of carrying out its functions, the NHB may

a. Issue and sell bonds and debentures with or without the Guarantee of Central Government, ins such manner and on such terms as may be prescribed;

b. Borrow money from the Central Government, banks, financial institutions, mutual funds and from any other authority or organization or institution approved by the Government on such terms and conditions as may be agreed upon;

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c. Accepting deposits repayable after such period and on such terms as may generally or specially be approved by the RBI;

d. Borrow money from the RBI (i) by way of leans and advances and generally, obtain financial assistance in a manner specified by the RBI; (ii) out of the National Housing Credit (Long-term Operations) Fund established under section 46-D of the RBI Act;

e. Receive, for services rendered, remuneration, commission, commitment charges, consultancy charges, service charges, royalties, premium, license fees and any other consideration of whatever description;

f. Receive gifts, grants, donations or benefactions from the Government or nay other source.

The Central Government may guarantee the bonds and debentures issued by the NHB as to the repayment of principal and the payment of interest at rates(s) fixed by the Government.

Powers of NHB

Being an apex institution for housing finance, the government has given it exclusive powers in the NHB Act. A brief description of the powers is following:

Powers to transfer rights: The rights and interest of the NHB in relation to any loan/ advance made or any amount recoverable may be transferred by it wholly or partly in any form. Notwithstanding such transfer, the NHB may act as a trustee for the transferee in terms of Sct. 3 of the Indian Trusts Act, 1882.

Power to Acquire rights: The NHB has the right to acquire, by transfer/ assignment, the rights and interest of any institution in relation to any loan / advance made / amount recoverable wholly or partly by the execution / issue of any instrument or by the transfer of any instrument or in any other manner in which the rights and interest in relation to such loan/ advance may be lawfully transferred.

Power to recover dues as land revenue.

Power to impose conditions: To protect its interest, the NHB may impose any conditions on HFIs.

Power to call for repayment before agreed period: In order to protect its interest NHB can call for prepayment of loans from borrowing institutions.

Access to Records: The NHB has free access to all such records of the institutions / persons availing of any credit facilities from it, the perusal of which may be necessary in connection with the provisions of finance or other assistance to the institution / refinance of any loan/ advance to such person by the institution.

Power to inspect

Power to Collect and publish credit information.

Provisions Relating to Housing Finance Institutions

Now let us discuss the provisions related to HFIs.

Registration and Net Owned Funds: To commence and carry on business, every HFI set up as a company should obtain a certificate of registration from the NHB and have net owned funds of Rs. 25 lakh or such higher amount as may be specified by the NHB from time to time.

Cancellation of Registration: The registration of a HFI can be cancelled by the NHB if it (a) ceases to carry on business, (b) has failed to comply with any condition subject to which the registration was issued (c) at any time fails to fulfill any of the conditions laid down for grant of registration (d) fails to comply with any directions by the NHB.

Maintenance of Percentage of Assets: At least 5 percent or such higher percentage, not exceeding 25 percent, as specified by the NHB from time of deposits outstanding at the close of business on the last working day of the second preceding quarter of a HFI should be invested in unencumbered approved securities valued at a price not exceeding their current market price.

Reserve Funds: A reserve fund should be created by the HFIs by transfer of a sum not less than 20% of net profits every year before the payment of any dividend.

Issue of Prospectus / Advertisement: If considered necessary in public interest, the NHB by general / special order – regulate / prohibit by any HFI of any prospectus / advertisement soliciting deposits from the public and (b) specify the conditions subject to which it can be issued.

Determination of Policy and issue of Directions: In public interest and to regulate the housing finance system of the country, NHB may determine the policy and issue direction, within the overall policy framework of the Government.

Collection of information about deposits and issue of direction.

Power of the NHB to prohibit Acceptance of deposit.

Powers to file winding up petition.

Powers to Inspection.

Power to order Repayment of Deposits

Power to appoint recovery officers for recovery of funds due to HFIs registered with NHB.

Power to impose penalties: In case any HFI fails to furnish or furnishes any wrong information, than NHB can impose penalties as per the provisions of NHB Act.

Power to make rules & Power of Board of Directors of the NHB to make regulations: In consultation with government and with prior approval of RBI, the NHB may make rules and regulations, not inconsistent with the NHB Act to provide for all matters for which provision is necessary / expedient for the purpose of giving effect to the provisions of the NHB Act.

Nhb's Housing Finance Companies Directions

As the principal housing finance company, the NHB is authorized, in public interest, to give directions to housing finance companies, which primarily transact or have as their principal object the transacting of business providing finance for housing whether directly or indirectly. We discuss herewith, main elements of the NHB directions to HFIs.

Registration: Every HFC accepting public deposit, having minimum net owned funds of Rs. 25 lakh should be registered with NHB. The registration is subject to following conditions:

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i. That the HFC is/ would be in a position to pay its present/ future depositors in full as and when their claims accrue.

ii. That its affairs are not being / are not likely to be conducted in a manner detrimental to interest of its present/ future depositors.

iii. That the general character of its management/ the proposed management would not be prejudicial to public interest / the interest of the depositors.

iv. That it has adequate capital structure and earning prospects.

v. That the public interest would be served by the grant of certificate of registration to it.

vi. That the grant of certificate of registration would not be prejudicial to the operation and growth of the housing finance sector of the country.

vii. Any other condition, fulfillment of which in the opinion of the NHB, would be necessary to safeguard the public interest or the interest of the depositors.

Acceptance of Deposits

The HFCs can accept deposits from public, subject to NHB Act provision.

Public Deposits and Minimum Credit Rating

Any HFC having **NOF of Rs. 25 lakh** and above can accept public deposits if it has obtained credit rating for fixed deposits not below **Grade A** from any of the approved rating agencies. The duration of deposit could be 12 to 84 months. In case credit rating of the HFC falls below Grade A, it is directed to stop immediately accepting fresh public deposits. It has to maintain a register of deposits with all necessary information about the deposit. An HFC with NOF of up to Rs. 10 crore can accept public deposit to the tune of 10 times its NOF. Each HFC has to pay interest on all the public deposits it accepts. The rate of interest cannot exceed the overall limit prescribed by the NHB from time to time.

Housing Finance companies can pay interest on overdue deposits. But this interest will be subject to provisions of the directions given by NHB. If the HFC fails to pay deposit along with interest on due date, it would pay amount along with interest on the overdue time portion of the deposit on a future date. NHB has also given direction for repayment of deposits. No public deposit can be repaid within three months from the date of acceptance. And if, a deposit is repaid prematurely, interest on that has to be reduced as per the norms prevailing at that time.

HFC can grant loan against public deposit accepted by it. Such loan amount should not exceed 75% of the deposit and interest rate charged should be at least 2% above the interest payable on the deposit.

Special Provisions

NHB has also provided some special provisions for HFCs. Lets discuss these provisions.

Maintenance of Minimum Liquid Assets: Every HFC should is required to invest in India in approved securities at market price, not less than 6 percent and up to 25 percent of the public deposits outstanding at the close of business on the last working day of the second preceding quarter. HFCs are required to maintain in India in an account with a bank or NHB or by subscription to bonds issued by NHB, a sum not less than 12.5% of public deposits, together with investment in approved securities. The HFC should entrust to one of the banks designated by it on that behalf, in the place where its registered office is situated, the approved securities required to be maintained by it.

Reserve Funds: Every HFC should create a reserve fund and transfer therein at least 20% of its net profit every year, before any dividend is declared. Any special reserve created by HFC in terms of Section 36(I)(viii) of the Income Tax Act, may take into account any sum transferred by it for the year to such special reserve for the purpose of this reserve.

Employee Security Deposit: A housing finance company receiving any amount in ordinary course of its business as security deposit from any of its employees for due performance of his / her duties, should keep it in a joint account with the employee in a bank or in a post office.

Miscellaneous Provisions

These provisions relate to submission of balance sheet, Directors' report, Auditor's Certificate, returns to NHB by HFCs and advertisement.

A. The HFCs are required to deliver to the NHB an audited balance sheet as on the last date of each financial year and audited profit and loss account in respect of that year as passed it in general meeting together with a copy of the report of the BOD within 15 days of such meeting as also a copy of the report and the notes on accounts furnished by its auditors.

B. The HFC should also furnish to the NHB a copy of the Auditor's report to the BOD and a certificate from its Auditors, being members of the ICAI in the prescribed format containing all necessary information.

C. Every HFC should submit to the NHB a return furnishing the specified information with reference to its position as on the specified date. Also, every HFC should, within one month from the commencement of business, deliver to the NHB a written statement containing list of names and designation of its principal officers, their complete postal address and contact information, specimen signatures etc.

D. Every HFC accepting public deposits is required to comply with the provisions of the NBFC and Miscellaneous NBC (Advertisement) Rules, 1977.

Prudential Norms

The NHB guidelines to HFCs on prudential norms for income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, capital adequacy and concentration of credit/ investments are discussed hereunder.

Income Recognition: For the policy on income recognition to be objective it should be based on recognized accounting principles. Income from NPAs should be considered to have accrued and be recognized only when it is actually received. Interest on NPA should not be booked as income if such interest has remained outstanding for more than six months.

Accounting Standard: All accounting standards and guidelines notes issued by the ICAI dealing with lease accounting/

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depreciation/ income recognition and so on may be followed by an HFC.

Accounting for Investment: All investments in securities should be bifurcated into current investments and long-term investments. A current investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made. A long-term investment is an investment other than a current investment.

Quoted current investments should be valued at cost or market value whichever is lower. Unquoted current investments should be valued at cost or breakup value whichever is lower. Long term investments should be valued in accordance with the accounting standards issued by ICAI.

Asset Classification

The HFCs should classify their loans and advances and any other form of credit into four broad groups: (a) standard assets (b) sub-standard assets (c) doubtful assets and (iv) loss assets. Following definitions can be used for classifying assets:

Standard Assets: A standard asset is one in respect of which no default in repayment of principal or payment of interest is perceived and which does not disclose any problems nor carry more than normal risk attached to business. Such an asset in not an NPA.

Substandard Asset: A standard asset is one which has been classified as NPA for a period not exceeding two years. Such an asset would have well-defined credit weakness that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the HFC would sustain some loss, if deficiencies are not corrected.

Doubtful Assets: A doubtful asset is one which has remained NPA for a period exceeding two years. Term loans, where installments of principals have remained overdue for a period exceeding two years, should be treated as doubtful asset. A loan classified as doubtful has all the weaknesses inherent in that classified as sub-standard with the added characteristics that the weakness may make collection/liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss Assets: A loss assets is one where loss has been identified by an HFC on internal/ external auditors/ the NHB inspection but the amount has not been written off, wholly or partly. Such an asset is considered un-collectable although there may be some salvage or recovery value.

Provisioning

The HFCs are required to provide for loans and advances assets as follows:

Loans, Advances and other Credit Facilities including Bills purchased and discounted: Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realization of the security and erosion over time in the value of security charged, the HFC should make provisions against sub-standard, doubtful and loss assets in respect of loans advances and other credit facilities including bills purchased and discounted as under:

Loss Asset: The entire asset should be written off. If they are permitted to remain in the books for any reason, 100% of the outstanding balance should be provided for.

Doubtful Asset: 100% provision to the extent amount is deemed to be unrecoverable. For others, 20-50% of the secured portion depending upon the period for which the asset is considered to be doubtful.

Sub-standard Asset: A general provision of 10% of the total outstanding should be made.

Capital Adequacy Norms

The HFCs should achieve a minimum capital adequacy norm of 10% of the risk weighted assets and off-balance sheet items by March, 2001 and 12 percent by March 31, 2002. The total of the Tier-II elements should be limited to a maximum of 100% of total of the Tier-I elements.

Reporting: The HFCs should furnish half-yearly return, in duplicate, indicating (a) capital funds and risk asset ratio (b) calculations of risk weighted assets and off-balance sheet exposures and (c) certain other data. The return should be signed by the Chief Executive of the company or in his absence, his authorized representative and be certified by the auditors of the company and submitted within a period of two months from the close of the half-year.

Concentration of Credit / Investment: The HFCs should not lend / invest more than 15 percent of their owned funds to any single party / in shares of another company and more than 25% to a single group of parties / in shares of single group of companies. They should not lend and invest (loans/investment taken together) more than 25% of owned fund to a single party and more than 40% to a single group of parties.

Loans against HFC's own shares prohibited: No HFC should lend against its own share, any kind of loans / advances or credit whatsoever.

Refinance Support to HFC'S

The NHB has issued guidelines to HFCs who desire to avail of refinance facilities from the NHB for their growth on sound lines and to be healthy, viable and cost effective. The main elements of the guidelines for extending refinance support to HFCs are discussed hereunder.

Organisation and Main Activities: An HFC which desires to avail of refinance facility from the NHB should, inter alia (a) be a public limited company (b) provide long term finance for construction or purchase of houses in India for residential purposes and (c) invest 75% pf its 'capital employed' by way of long-term finance for housing.

Minimum Paid-up capital and listing requirements: The HFC should have a minimum-paid up capital or NOF of not less than Rs.10 Crores or such other amount as may be stipulated from time to time by the NHB and/or the SEBI for listing shares on recognized stock exchange(s). The promoter's contribution in their share capital would be as per the SEBI requirements from time to time.

Submission of Application: The HFCs should submit their application for refinance support in such form and furnish such information / statements and so on as may be required by the NHB for its considerations.

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Name of the Company and Promoters: The HFC should also comply with following: They should not (a) bear a name resembling / similar / akin to the name of any construction company with which the promoters of the HFC may be associated, (b) be a subsidiary of a construction company, (c) have/ promote, as subsidiary, a construction company, (d) indulge in construction activities of any kind, either directly or indirectly. The Chairman, MD or any whole-time director of any HFC should not hold the offices of Chairman, MD or whole time director in a construction company with which the promoters of the HFC may be associated or vice-versa.

Board of Directors: The AOA of the HFC should contain necessary provisions for appointment of nominee directors by the NHB. The appointment of CEO of HFCs, if deemed necessary, should be made in consultation with the NHB.

The HFC seeking refinance facility should comply with the Provisions of Housing Finance Companies (NHB) Directions, 1989. It should lend money only at the rates prescribed by NHB from time to time. The HFC must follow the Prudential norms and guidelines issued by the NHB.

The refinance facility is at sole discretion of the NHB and cannot be claimed as a matter of right. It would be also subject to refinance policy and exposure norms adopted by the NHB from time to time.

Equity Support to HFCs:

For the growth of HFCs on sound lines and to be healthy, viable and cost effective, the NHB extends equity support to them. Now let us discuss the NHB guidelines in respect of equity support to HFCs.

Organization and main activity: The HFCs desirous of availing of equity participation from the NHB should, like the scheme for availing refinance, be a public company and fulfill other criterion like the refinance scheme.

Minimum Paid-up capital and listing requirement: The HFC should have a minimum paid up capital of Rs. 5 crores or such other amount as may be stipulated from time to time b the NHB and / or the SEBI for listing their shares on recognized stock exchanges. The promotees' contribution in share capital should be as per the SEBI requirement from time to time. They should get their shares listed on recognized stock exchange(s) in India as may be stipulated by NHB. They should conform and / or comply with all other rules, regulations, instructions, guidelines or orders issued by the NHB or any other authority empowered in that behalf. The NHB's participation in equity in any case would not exceed 10% of the paid up capital of an HFC or Rs. 1 crore, whichever is lower.

Other procedures/formalities like Submission of application, Name of the Company and Promoters, Board of Directors, are same as the formalities for refinance scheme.

Credit Rating: The HFC before approaching the NHB for equity support, should obtain credit assessment rating of themselves or equity grading by one of the four credit rating agencies namely – CRISIL, ICRA, CARE or DCR India. A minimum rating of CARE three or ICRA six or CRISIL six or equivalent rating or DCR India would be necessary for them to become eligible for equity support from the NHB.

Shareholder's Agreement: The HFCs should enter into a shareholder's agreement with the NHB laying down covenants regarding substantive issues like undertaking of new business, amalgamation, mergers, takeovers, flotation of subsidiaries, appointment of nominee directors and so on. The covenants would also include 'buy back' of shares and the method of valuation of shares which would be market value of shares at the stock exchange, or net asset value/ intrinsic value of shares or earning per share or cost of investment plus interest agreed rate, whichever be the highest.

Pricing of Shares / Cost of Investment: In the case of new HFCs without track record of profitability and dividend making, first public issue of equity shares would be subscribed by the NHB at par, and in the case of existing companies, price would be determined and approved by the BOD of the NHB.

The equity participation by the NHB would be at the sole discretion of NHB and not claimed as a matter of right.

Housing Finance Industry - An Overview

Highlights

- Significantly, there has been no dearth of demand for housing and consequently for finances for the same have been abundant.
- Market dynamics play a pivotal role in determining the lending rates. Considering the same, the housing finance industry has been in a slump in recent times.
- The entry of banks into the housing finance sector has posed a serious threat to already existent players in the field.
- The housing sector is witnessing a clash between major players. Foremost amongst this is the ICICI and HDFC imbroglio. The later is giving sleepless nights to HDFC.
- Tax sops provided by the Government of India is a significant step towards upholding the future prospects of this industry.

Sector Comments

Nearly 25 lakh houses are built every year in India. However, the nation's requirement is around 65 lakh houses per annum. The housing sector in India is facing an estimated shortage of 4.1 crore houses and according to the Ninth Plan, the demand-supply gap in urban housing is 3.3 crore houses. In case, all these urban housing dwellings were to be built, it would require an investment of Rs. 150,370 crore.

Traditionally, the housing finance business has been yielding a margin of around 2 per cent. The skill of the players is in converting their advances that have a maturity period of 15-30 years with the deposits that mature within three years. Though, the National Housing Bank (NHB) refinances housing loan up to Rs. 2 lakh disbursed to the lower income group, this is just a negligible proportion of advances to the major players. The primary sources of funds are fixed deposits, debentures, private placement of bonds and borrowings from banks and financial institutions. Thus, efficient financial management has a key role to play in this industry.

Lending rates are predominantly market-driven and in view of the same, the housing finance industry has been in a slump in recent times with there being low demand from builders and

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investors alike. Furthermore, the entry of banks into the housing finance sector has also not augured well for the industry. Most housing finance companies cater mainly to the higher income group having reasonably assured creditworthiness. In a scenario marked with the absence of speedy foreclosure regulations, most companies prefer to stay away from rural and the Low-Income Group (LIG). However, it must be noted that demand for housing in the Middle-Income Group and High Income Group segments has also recorded a steady rise lately.

Market profile

The Indian housing finance sector is crowded with players of all sizes and nature: government organisations, insurance companies, banks, housing finance companies and co-operative organisations like HUDCO and NHB. Major players in the Industry are HDFC, LIC Housing Finance, Dewan Housing, Can Fin Homes, SBI Home Finance and Gujarat Rural Housing. The youngest entrant into the Industry, which is penetrating rapidly, is ICICI. Interestingly, both Can Fin Homes Limited and its parent Canara Bank are into housing finance. It is the same with quite a few banks, for example, SBI and SBI Home Finance Limited, Bank of Baroda and BOB Finance, Vysa Bank and Vysyabank Housing. Though HDFC and ICICI also have their banking arms, they compete with each other in personal loans, but not housing loans.

The industry comprises of nearly 383 housing finance companies although disbursements from only the leading 26 institutions are eligible for re-finance from National Housing Bank, which is the regulatory body for these companies. These Housing Finance Companies (HFCs) constitute nearly 95 % of the total disbursement by the industry. However, owing to the slump in real estate market over the last few years, the industry posted a fairly low disbursement growth.

Market trends

The housing sector is witnessing a clash between major players. HDFC had ruled this sector with a lion's stranglehold. It was smooth sailing for HDFC all these years and it seemed that its monopoly was there to stay forever. However, out of the blue emerged ICICI Home Loans, when this financial institution decided to clash arms with HDFC on its home front. Within a year of its launch, ICICI Home Loans is giving the industry leader, HDFC, sleepless nights.

Undercutting in the interest rates is all in the game and so is every other trick in the book. HDFC is gathering its wits to beat its competitor at its own game. It launched an aggressive hoarding campaign designed in the style of 'follow the leader'. HDFC has launched its website propertymartindia.com as a joint venture with the Mahindras. Following suit, ICICI too, launched its home portal www.indiahomeseek.com. So the war rages on both at the retail level and also in the form of a cyber war. ICICI has lowered its prime lending rates on short and medium term loans from 13 per cent to 12.5 per cent. Thus, bringing the interest on housing loans at par with the foreign exchange loans.

HDFC also reduced the interest rates on its housing loans from 13.25 per cent to 13 per cent. It went an extra mile to woo the borrowers of loans up to Rs. 1 crore by allowing them the facility to either opt for a fixed interest rate of 13 per cent or a floating interest rate of 12.5 per cent. As the name indicates, a borrower opting for the first choice will have to repay the loan at an interest rate of 13 per cent irrespective of any future hike or cut in the rates. Those choosing the second option would be subject to the vagaries of the interest market and may gain or lose in the bargain. The company has also reduced the interest on loans borrowed by non-resident Indians. These loans repayable within five years will attract an interest rate of 11.5 per cent per annum while loans with a term of 6-10 years will be charged interest at 12.5 per cent. The above rates are under the fixed interest rate option. Similar floating rate loans would be charged at 5 per cent less interest. Originally, only the commercial banks offered housing loans on floating interest rates, now that HDFC is offering loans at a 12 per cent floating rate, ICICI also has a floating rate home loan in the pipeline.

Price sensitivity factors

- Noteworthy fact here is that NHB refinance to the HFCs comprises a mere 7% of the loans disbursed. In other words, most HFCs have to arrange for a major part of the disbursals from their own resources. Thus, low spreads, mismatched asset and liability, competition posed by banks with recent regulations requiring commercial banks to invest 40 per cent of their advances towards the priority sector, etc. pose problems for the lending division.
- The first housing finance company to cut down its interest rate after RBI slashed the PPF interest rate by 1 per cent on January 14, 2000 was HUDCO. When the National Housing Bank, the refinancing agency of all housing finance companies, slashed its rates by up to 50 basis points, it triggered off a virtual interest war in the industry. HDFC, ICICI, LIC Housing Finance, PNB Housing Finance Limited and a host of others followed suit. In a game of one-upmanship, the companies have been vying with one another to offer the best deal in a rapidly growing market.
- CRISIL has forecast an increase in the interest rates in the second half of this year. This will be due to the demand of funds by the Centre and also the corporate exceeding the supply. The Central Government has projected a Rs. 31,000 crore higher borrowing this year than last year's figure of Rs. 86,000 crore. The State Government borrowings would add up to a further Rs. 27,500 crore and the corporate demand would be higher by Rs. 11,000 crore. As compared with the supply, CRISIL expects the short fall to be around Rs. 15,800 crore. To make up this short fall, even if there is a 1 per cent cut in CRR, interest rates are still bound to increase.
- The Union Budget 2000-01 has given a shot in the arm to the industry by raising the exemption applicable to individual borrowers on the interest paid on housing loans to Rs. 1 lakh. The existing tax rebate of 20 per cent under section 88 of the Income tax Act of 1961, covered repayment of housing loans, subject to a maximum of Rs. 10,000. The same has now been doubled to Rs. 20,000. This, coupled with the lowering of the interest rate would enable a borrower to enjoy tax exemption upto a loan of Rs. 7.5 lakh for a 15-year term. He can now have access to

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better tax planning options on account of the exemption and a lower Equated Monthly Instalment (EMI) due to longer term of repayment. Furthermore, individuals who already own a house can now invest in a new house and yet claim exemption from capital gains on the sale of the asset. The tax exemption on the interest paid on housing loans has also been extended up to the year 2003. This move will benefit the salaried employees, especially the middle-class populace. A dream of providing 25 lakh rural houses has been envisaged in the budget. Out of these, 12 lakh houses will be built under the 'India Awas Yojana' and another one-lakh houses would be provided under the 'Credit-cum-Subsidy' scheme for families with an annual income below Rs. 32,000. Moreover, around 1.5 lakh houses to be constructed under the 'Golden Jubilee Rural Housing Finance Scheme' will be eligible for refinance from the NHB.

- The industry has found new avenues such as securitisation, which are expected to be launched in the market very soon. This mechanism would require a pool of assets (mortgages), which would be sold by the HFCs to NHB. These assets in turn would act as a Special Purpose Vehicle (SPV) and would be sold as pass through certificates to investors, which initially would be from groups earning pension funds, mutual funds, financial institutions, commercial banks and other trusts or institution which require monthly fixed income.
- The mortgages would be for loans up to a period of 10 years, on which HFCs would earn 16 % from borrowers. The spread is to be passed back to the concerned HFCs in the form of premium at purchase of mortgages or service charge over a period of time. It is expected that with the success of securitisation the circulation of funds would increase coupled with cash flows generated by these funds. Furthermore, a secondary market for mortgages would become feasible for HFCs.

Outlook

The industry is witnessing a boom at present boosted by the generous budget sops and rock bottom real estate prices. The demand is a result of genuine individual needs for housing. The prospects of the industry would be further strengthened on the amendments to the Rent Control Act and repealing of the controversial Urban Land Ceiling Act. Thus, the housing finance industry is on solid ground and has interesting prospects ahead. As for the small players, they will have to take the harsh decision to either exit the industry or merge with bigger entities. It is also amply clear that in the future, industry leader HDFC will have to share the spoils with the aggressive young turk - ICICI. Notwithstanding the competition, the customer has nothing to lose as he can choose the best loan scheme from the ICICI and HDFC fold, with minimum interest and a nil processing fee.

Conclusion

Despite the abovementioned factors, several bottlenecks still exist in the industry, which have to be taken care of before any of the above can bring about an improvement in the prospects of the industry. From an overall viewpoint demand for housing is ever rising and the same would be reflected on the demand for funds. Hence, the profitability of the industry should commence on the positive track in the future.

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LESSON 18:
TUTORIAL

Lesson Objectives

- To clear all the doubts of the students related to concepts covered in various topics so far covered.

Dear Students, so far we have had around one third of the total course of this particular subject. I hope you have been able to understand the concepts and their practical usage as an aspiring manager / entrepreneur.

Today's session is just to solve all your difficulties in topics so far covered. If you have any doubt or require any clarification on any topic, lets discuss that.

I also want you to collect newspaper clippings, web articles and articles from journals, for discussion and information sharing. The purpose of our study is not just to learn the theoretical concept, but also to understand their practical / actual usage in day to day life. Hence it is very important for you to collect such information and share / discuss it with your colleagues.

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LESSON 19:
VENTURE CAPITAL – THEORETICAL CONCEPT

Lesson Objectives

- To understand the Concept of Venture Capital,
- Types of venture capital funds, mode of operations and terminology of venture capital.

Introduction

Venture Capital has emerged as a new financial method of financing during the 20th century. Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects.

There is a common perception that venture capital is a means of financing high technology projects. However, venture capital is investment of long term finance made in:

1. Ventures promoted by technically or professionally qualified but unproven entrepreneurs, or
2. Ventures seeking to harness commercially unproven technology, or
3. High risk ventures.

The term 'venture capital' represents financial investment in a highly risky project with the objective of earning a high rate of return. While the concept of venture capital is very old the recent liberalisation policy of the government appears to have given a fillip to the venture capital movement in India. In the real sense, venture capital financing is one of the most recent entrants in the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked. These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. In addition to providing capital, these VCFs (venture capital firms) take an active interest in guiding the assisted firms.

A young, high tech company that is in the early stage of financing and is not yet ready to make a public offer of securities may seek venture capital. Such a high risk capital is provided by venture capital funds in the form of long-term equity finance with the hope of earning a high rate of return primarily in the form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Thus, a venture capitalist (VC) may provide the seed capital for unproven ideas, products, technology oriented or start up firms. The venture capitalists may also invest in a firm that is unable to raise finance through the conventional means.

Features of Venture Capital

"Venture capital combines the qualities of a banker, stock market investor and entrepreneur in one."

The main features of venture capital can be summarised as follows:

i. High Degrees of Risk Venture capital represents financial investment in a highly risky project with the objective of earning a high rate of return.

ii. Equity Participation Venture capital financing. is, invariably, an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable. .

iii. Long Term Investment Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.

iv. Participation in Management In addition to providing capital, venture capital funds take an active interest in the management of the assisted firms. Thus, the approach of venture capital firms is different from that of a traditional lender or banker. It is also different from that of a ordinary stock market investor who merely trades in the shares of a company without participating in their management. It has been rightly said, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one".

v. Achieve Social Objectives It is different from the development capital provided by several central and state level government bodies in that the profit objective is the motive behind the financing. But venture capital projects generate employment, and balanced regional growth indirectly due to setting up of successful new business.

vi. Investment is liquid A venture capital is not subject to repayment on demand as with an overdraft or following a loan repayment schedule. The investment is realised only when the company is sold or achieves a stock market listing. It is lost when the company goes into liquidation.

Origin

Venture capital is a post-war phenomenon in the business world mainly developed as a sideline activity of the rich in USA. The concept, thus, originated in USA in 1950s when the capital magnets like Rockfeller Group financed the new technology companies. The concept became popular during 1960's and 1970's when several private enterprises started financing highly risky and highly rewarding projects. To denote the risk and adventure and some element of investment, the generic term "Venture Capital" was developed. The American Research and Development was formed as the first venture organisation which financed over 100 companies and made profit over 35 times its investment. Since then venture capital has grown' vastly in USA, UK, Europe and Japan and has been an important contribution in the economic development of these countries.

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Of late, a new class of professional investors called venture capitalists has emerged whose specialty is to combine risk capital with entrepreneurs management and to use advanced technology to launch new products and companies in the market place. Undoubtedly, it is the venture capitalist's extraordinary skill and ability to assess and manage enormous risks and extort from them tremendous returns that has attracted more entrants. Innovative, hi-tech ideas are necessarily risky. Venture capital provides long-term start-up costs to high risk and return projects. Typically, these projects have high mortality rates and therefore are unattractive to risk averse bankers and private sector companies.

Venture capitalist finances innovation and ideas, which have potential for high growth but are unproven. This makes it a high risk, high return investment. In addition to finance, venture capitalists also provide value-added services and business and managerial support for realizing the venture's net potential.

Types of Venture Capitalists

Generally, there are three types of organized or institutional venture capital funds -

i. Venture capital funds set up by angel investors, that is, high network individual investors

ii. Venture capital subsidiaries of corporations - these are established by major corporations; commercial bank holding companies and other financial institutions

iii. Private capital firms/funds-The primary institutional source of venture capital is a venture capital firm venture capitalists take high risks by investing in an early stage company with little or no history and they expect a higher return for their high-risk equity investments in the venture.

Modes of Finance by Venture Capitalists

Venture capitalists provide funds for long-term in any of the following modes

1. ***Equity*** - Most of the venture capital funds provide financial support to entrepreneurs in the form of equity by financing 49% of the total equity. This is to ensure that the ownership and overall control remains with the entrepreneur. Since there is a great uncertainty about the generation of cash inflows in the initial years, equity financing is the safest mode of financing. A debt instrument on the other hand requires periodical servicing of debt.

2. ***Conditional loan*** - From a venture capitalist~ point of view, equity is an unsecured instrument and hence a less preferable option than a secured debt instrument. A conditional loan usually involves either no interest at all or a coupon payment at nominal rate. In addition, a royalty at agreed rates is payable to the lender on the sales turnover. As the units picks up in sales levels, the interest rate are increased and royalty amounts are decreased.

3. ***Convertible loans*** - The convertible loan is subordinate to all other loans, which may be converted into equity if interest payments are not made within agreed time limit.

Areas of Investment

Different venture groups prefer different types of investments. Some specialize in seed capital and early expansion while others focus on exit financing. Biotechnology, medical services, communications, electronic components and software companies seem to be attracting the most attention from venture firms and receiving the most financing. Venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability.

In India, software sector has been attracting a lot of venture finance. Besides media, health and pharmaceuticals, agri-business and retailing are the other areas that are favored by a lot of venture companies.

Stages of Investment Financing

"Venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability." Venture capital firms usually recognise the following two main stages when the investment could be made in a venture namely:

A. Early Stage Financing

i. Seed Capital & Research and Development Projects.

ii. Start Ups

ii. Second Round Finance

B. Later Stage Financing

i. Development Capital

ii. Expansion Finance

iii. Replacement Capital

iv. Turn Arounds

v. Buy Outs

A. Early Stage Financing This stage includes the following:

I. Seed Capital and R & D Projects: Venture capitalists are more often interested in providing seed finance *i. e.* making provision of very small amounts for finance needed to turn into a business.

Research and development activities are required to be undertaken before a product is to be launched. External finance is often required by the entrepreneur during the development of the product. The financial risk increases progressively as the research phase moves into the development phase, where a sample of the product is tested before it is finally commercialised "venture capitalists/ firms/ funds are always ready to undertake risks and make investments in such R & D projects promising higher returns in future.

II. Start Ups: The most risky aspect of venture capital is the launch of a new business after the Research and development activities are over. At this stage, the entrepreneur and his products or services are as yet untried. The finance required usually falls short of his own resources. Start-ups may include new industries / businesses set up by the experienced persons in the area in which they have knowledge. Others may result from the research bodies or large corporations, where a venture capitalist joins with an industrially experienced or corporate partner. Still other start-ups occur when a new company

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with inadequate financial resources to commercialise new technology is promoted by an existing company.

III. *Second Round Financing:* It refers to the stage when product has already been launched in the market but has not earned enough profits to attract new investors. Additional funds are needed at this stage to meet the growing needs of business. Venture Capital Institutions (VCIs) provide larger funds at this stage than at other early stage financing in the form of debt. The time scale of investment is usually three to seven years.

B. Later Stage Financing

Those established businesses which require additional financial support but cannot raise capital through public issue approach venture capital funds for financing expansion, buyouts and turnarounds or for development capital.

I. *Development Capital:* It refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public, thus needs financial support. Funds are needed for the purchase of new equipment/ plant, expansion of marketing and distributing facilities, launching of product into new regions and so on. The time scale of investment is usually one to three years and falls in medium risk category.

II. *Expansion Finance:* Venture capitalists perceive low risk in ventures requiring finance for expansion purposes either by growth implying bigger factory, large warehouse, new factories, new products or new markets or through purchase of exiting businesses. The time frame of investment is usually from one to three years. It represents the last round of financing before a planned exit.

III. *Buy Outs:* It refers to the transfer of management control by creating a separate business by separating it from their existing owners. It may be of two types.

   i. Management Buyouts (MBOs): In Management Buyouts (MBOs) venture capital institutions provide funds to enable the current operating management/ investors to acquire an existing product line/business. They represent an important part of the activity of VCIs.

   ii. Management Buyins (MBIs): Management Buy-ins are funds provided to enable an outside group of manager(s) to buy an existing company. It involves three parties: a management team, a target company and an investor (i.e. Venture capital institution). MBIs are more risky than MBOs and hence are less popular because it is difficult for new management to assess the actual potential of the target company. Usually, MBIs are able to target the weaker or under-performing companies.

IV. Replacement Capital-V CIs another aspect of financing is to provide funds for the purchase of existing shares of owners. This may be due to a variety of reasons including personal need of finance, conflict in the family, or need for association of a well known name. *The* time scale of investment is one to three years and involve low risk.

V. Turnarounds-Such form of venture capital financing involves medium to high risk and a time scale of three to five years. It involves buying the control of a sick company which requires very specialised skills. It may require rescheduling of all the company's borrowings, change in management or even a change in ownership. A very active "hands on" approach is required in the initial crisis period where the venture capitalists may appoint its own chairman or nominate its directors on the board.

In nutshell, venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability. Venture capitalists evaluate technology and study potential markets besides considering the capability of the promoter to implement the project while undertaking early stage investments. In later stage investments, new markets and track record *of* the business/entrepreneur is closely examined.

Factors Affecting Investment Decisions

The venture capitalists usually take into account the following factors while making investments:

1. Strong Management Team. Venture capital firms ascertain the strength of the management team in terms of adequacy of level of skills,., commitment and motivation that creates a balance between members in area such as marketing, finance and operations, research and development, general management, personal management and legal and tax issues. Track record of promoters is also taken into account.
2. A Viable Idea. Before taking investment decision, venture capital firms consider the viability of project or the idea. Because a viable idea establishes the market for the product or service. Why the customers will purchase the product, who the ultimate users are, who the competition is with and the projected growth of the industry?
3. Business Plan. The business plan should concisely describe the nature of the business, the qualifications of the members of the management team, how well; the business has performed, and business projections and forecasts. The promoters experience in the proposed or related businesses is an important consideration. The business plan should also meet the investment objective of the venture capitalist.
4. Project Cost and Returns A. VCI would like to undertake investment in a venture only if future cash inflows are likely to be more than the present cash outflows. While calculating the Internal Rate of Return (IRR) the risk associated with the business proposal, the length of time his money will be tied up are taken into consideration. Project cost, scheme of financing, sources of finance, cash inflows for next five years are closely studied.
5. Future Market Prospects. The marketing policies adopted, marketing strategies in relation to the competitors, market research undertaken, market size, share and future market prospects are some of the considerations that affect the decision.
6. Existing Technology. Existing technology used and any technical collaboration agreements entered into by the promoters also to a large extent affect the investment decision.

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7. Miscellaneous Factors. Others factors which indirectly affect the investment decisions include availability of raw material and labor, pollution control measures undertaken, government policies, rules and regulations applicable to the business/industry, location of the industry etc.

Selection of Venture Capitalists

Venture capital industry has shown tremendous growth during the last ten years. Thus, it becomes necessary for the entrepreneurs to be careful while selecting the venture capitalists. Following factors must be taken into consideration:

1. Approach adopted by VCs - Selection of VCs to a large extent depends upon the approach adopted by VCs.

a. Hands on approach of VCs aims at providing value added services in an advisory role or active involvement in marketing, recruitment and funding technical collaborators. VCs show keen interest in the management affairs and actively interact with the entrepreneurs on various issues.

b. Hands off approach refers to passive participation by the venture capitalists in management affairs. VCs just receive. periodic financial statements. VCs enjoy the right to appoint a director but this right is seldom exercised by them.

In between the above two approaches lies an approach where V C' s approach is passive except in major decisions like change in top management, large expansion or major acquisition.

(2) Flexibility in deals - The entrepreneurs would like to strike a deal with such venture capitalists who are flexible and generous in their approach. They provide them a package which best meet the needs of the entrepreneurs. VC's having rigid attitude may not be preferred.

(3) Exit policy - The entrepreneurs should ask clearly the venture capitalists as to their exit policies whether it is buy back or quotation or trade sale. To avoid conflicts, clarifications should be sought in the beginning, the policy should not be against the interests of the business. Depending upon the exit policy of the VCs, selection would be made by the entrepreneurs.

(4) Fund viability and liquidity - The entrepreneurs must make sure that the VCs has adequate liquid resources and can provide later stage financing if the need arises, also, the VC has committed backers and is not just interested in making quick financial gains.

(5) Track record of the VC & its team - The scrutiny of the past performance, time since operational, list of successful projects financed earlier etc. should be made by the entrepreneur. The team of VCs, their experience, commitment, guidance during bad times are the .other consideration affecting the selection of VCs.

Procedure Followed by VCs

a. Receipt of proposal. A proposal is received by the venture capitalists in the form of a business plan. A detailed and well-organised business plan helps the entrepreneur in gaining the attention of the VCs and in obtaining funds. A well-prepared business proposal serves two functions.
   1. It informs the venture capitalists about the entiepreneurs ideas.
   2. It shows that the entrepreneur has detailed knowledge about the proposed business and is aware of the all potential problems.

b. Appraisal of plan. VC appraises the business plan giving due regard to the creditworthiness of the promoters, the nature of the product or service to be developed, the markets to be served and financing required. VCs also conduct cost-benefit analysis by comparing future expected cash inflows with present investment.

c. Investment. If venture capital fund is satisfied with the future profitability of the company, it will take step to invest his own money in the equity shares of the new company known as the assisted company.

d. Provide value added services. Venture capitalists not only invest money but also provide managerial and marketing assistance and operational advice. They also make efforts to accomplish the set targets which consequently results in appreciation of their capital.

e. Exit. After some years, when the assisted company has reached a certain stage of profitability the VC sells his shares in the stock market at high premium, thus earning profits as well as releasing locked up funds for redeployment in some other venture and this cycle continues.

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LESSON 20: VENTURE CAPITAL – NATIONAL AND INTERNATIONAL SCENARIO

Lesson Objectives

- To get an understanding of national and international scenario of venture capital financing.
- Governments efforts in the venture capital area.

Venture Capital in India

Venture capital was almost absent till 1975 when Industrial Finance Corporation of India (IFCI) set up Risk Capital Foundation (RCF). This was considered as the first step in the direction of venture capital.

In the year 1976, initiative had been taken by the Government of India to create Technical Development Fund (TDF) in the Ministry of Industry with the assistance of World Bank. The main intention was to ensure sufficient rupee resources to finance the modernisation programs.

In the year 1986, Government of India announced the setting up of venture capital fund (VCF) to encourage the enterprise based on indigenous technology and upgradation of existing technology.

Grindlays Bank of Australia set up Indian Technology Fund Ltd. (ITFL) with the objective of providing venture capital assistance to young and growing companies seeking funds at early stages.

State Bank of India and Canara Bank have entered in the business of venture capital. SBI Capital Markets (SBI Caps), a subsidiary of SBI's merchant banking has set up a venture capital fund for "brought out deals". Under this scheme SBI Caps invests ip. the equity- shares of new companies.

The Industrial Credit and Investment Corporation of India (ICICI) also entered in the field of venture capital by establishing a venture capital fund for assisting small and medium entrepreneurs with initial equity capital. This was provided for developing and commercialising the indigenous technology.

India has taken a unique step in introducing venture capital in the area of bio-technology. The Bangalore based Bangalore Genei Pvt. Ltd. will be India's first ever venture capital bio-technology company engaged in the manufacture of enzymes used in genetic engineering manipulations in research and technology.

A significant feature of venture capital financing in India, which is little recognised, is the support the commercial banks provide to small scale industries. The small scale industries in India run both the risks inherent in a venture capital project-the failure of management and the high risks in the venture.

The venture capital providers in India (other than the commercial banks' efforts as stated above) can be divided into following categories.

1. Specialised financial institutions and their financing schemes.
2. Funds promoted by state level institutions.
3. Funds promoted by public sector banks.
4. Private agencies.
5. Overseas venture capital funds.

I. Special/Sed Financial Institutions And Their Financing Schemes

In India, the Industrial Financial Corporations of India (IFCI), Industrial Development Bank of India (IDBI) and the Industrial Credit and Investment Corporation of India (ICICI) are the major three institutions, which are engaged in the financing of high tech new ventures. The difference and similarities between three schemes of IFCI, IDBI and ICICI are discernible from the objectives sought to be pursued under the broad characteristics of the schemes precisely explained below.

A. Risk Capital Scheme of IFCI

The IFCI began its equity financing through its Risk Capital Foundation (RCF) by providing risk capital assistance on soft terms to first generation entrepreneurs. The corporation envisages to provide assistance to technologists and the professionals who do not have adequate resources of their own for contributing to equity capital of the industrial projects undertaken by them with a view to enlarging entrepreneurial base for wider dispersal of ownership and control of industry in the national interest. The corporation is continuing its efforts through the newly formed Risk Capital and Technology Finance Corporation Ltd. (RCTFC) set up in 1988 as a wholly owned subsidiary of the IFCI. RCTFC was established with an objective of providing financial support to such activities in the area of innovative technology, energy conservation and environmental pollution. Some of the projects financed under the new scheme of IFCI include development of artificial intelligence software, three Dimensional Computer animation, educational robots, hybrid seeds etc.

In addition to operating its own schemes, the RCTC also manages a Venture Capital Unit Scheme VECAUS-III (started in mid-1991) with a resource base of Rs. 30 crores with participation from the UTI, IFCI and World Bank in equal proportions.

B. Technology Development & Information Company of India Ltd. (TDICI) of ICICI

Encouraged by the response to technology financing, ICICI floated a separate company-Technology Development and Information Company of India (TDICI) in collaboration with UTI in 1988. Apart from Venture Capital financing TDICI activity profile includes technology consultancy services and technology escort services such as marketing, business management, export marketing and guidance for individual venture capital projects etc. TDICI makes investments in highly risky projects promising high return in future. It gives preference to

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companies, which are unable to raise public share capital and would not be financed by anyone else.

In addition to equity participation (upto a maximum of 49%) undertaken by typical venture capital companies, TDICI offers the unique option of conditional loans. The entrepreneur neither pays interest on it nor does he have to repay the principal amount. If the venture succeeds, TDICI recovers back its investment in the form of royalty on sales which ranges between 2 % to 8 % . On the contrary, if venture fails to take off even after 5 years, TDICI will consider writing off the loan.

TDICI usually has a nominee on the Boards of companies with whom it enters into long-term contracts. TDICI assists such venture projects in arranging working capital finance, recruiting senior executives. It als.o takes advise of the outside experts in taking various decisions. Some of the projects financed by ICICI includes:

i Mastek a Bombay based software firm in which TDICI invested Rs. 42 lakh in equity in 1989 went public in 1992. It showed an annual growth of 70% to 80% in the turnover.

ii Temptation Foods which exports frozen vegetables and fruits, went public in November, 1992. The TOICI invested Rs. 50 lakhs in its equity .

C. SEED Capital Scheme or Venture Capital Fund of IDBI

IDBI's scheme is known as "Seed Capital Scheme" intended to help create a new generation of entrepreneurs who have the requisite traits of entrepreneurship but who lack financial resources to promote industrial ventures. The assistance is provided for meeting the risk capital requirements of entrepreneurs.

IDBI is doing well under the venture capital fund scheme by assisting the projects which are engaged in the promotion and development of indigenous technology, that is new and untested in India. The financial assistance is provided under this scheme in the areas of chemical, software electronics, biotechnology, food products and medical equipment.

The project cost varies between Rs. 5 lakh to Rs. 250 lakh. IDBI provides assistance both for financing the cost of fixed assets as well as for meeting the operating expenses in the form of unsecured loans carrying a concessional interest rate of 6% p.a. during the early stages of development.

II. Funds Promoted by State Level Institutions

Funds promoted by state level institutions include:

a. APIDC- Venture Capital Ltd. (A VCL)

This is wholly owned by the Andhra Pradesh Industrial Development Corporation Ltd. It aims at specialising venture fund management company. It has been entrusted with the management of a fund, namely APIDC - Venture Capital Fund. It is established with a capital of 13.5 crores contributed by APIDC, IDBI, Andhra Bank and IOB and few small organisations. The A VCL undertakes investments with the objective of bringing technological innovations in order to improve quality, reduce energy consumption, increase competition and enhanced exports.

(b) Gujarat Venture Finance Ltd. (GVFL)

The GVFL has been promoted by Gujarat Industries Investment Corporation Ltd., (GIIC) in association with Gujarat Lease Finance Corporation Ltd., Gujarat Alkalies and Chemicals Ltd. and Gujarat State Fertiliser Corporation Ltd. GIIC holds 40% of the equity capital of the GVFL and the rest is contributed by other three organisations. The GVFL is a fund management company, and presently acts as a trustee manager of a venture fund, namely (GVCF) Gujarat Venture Capital Fund, started in 1990. GVFL provides finance for innovations in technology leading to an improvement - in product quality and energy conservation, for launching new products based on imported technology.

III. Funds Promoted by Public Sector Banks Such as Canara Bank Venture Capital Fund (CVCF)

This fund has been promoted by Canara Bank and its subsidiary Canbank Financial Services Ltd. (CANFINA). It was set up in 1989 as a trust. It provides finance in the form *of* equity, conditional loans, conventional loans or both. Its capital base is Rs. 24 crores. The Fund aims at providing financial support for commercial exploitation *of* new technologies, technology upgradation to improve quality etc.

IV. Private Agencies

Venture capital funds set up in the private sector include

1. Credit Capital Venture Fund (CCVF)
2. 20th Century Venture Capital Fund
3. India Investment Fund
4. Indus Venture Capital Fund (IVCF) (5) SBI Capital Venture Capital Fund

(1) Credit Capital Venture Fund (CCVF) - The Credit Capital Venture Fund (India) was established in 1986. It has a capital base of 10.8 crores. The principal shareholders are Credit Capital Finance Corporation, Bank of India, Asian Development Bank, Common Wealth Development Corporation. It finances ventures promising high returns with maximum assistance limited to Rs. 50 lakhs. It also provides value added services in an advisory role and actively participates in marketing, recruitment and management affairs. -Thus it helps the entrepreneurs to realise maximum returns. It has recently launched 10 state funds of Rs. 10 crore each. It is now known as Lazard Credit Capital Fund (India) Ltd. (LCCVF).

(2) 20th Century Venture Capital Fund It was promoted by 20th Century Finance Ltd. and has a resource base of Rs. 20 crores. The fund aims at reviving the sick industries and help first generation entrepreneurs.

(3) India Investment Fund It is India's first private venture capital fund mainly subscribed by Non-Resident Indians (NRIs). The Fund is "an offshore company owned predominantly by NRI investors incorporated in early 1987. The fund provides equity or equity linked finance to new projects or often young as well as established Indian companies which can demonstrate a potential for sustained growth. The maximum assistance made available to one venture is limited to Rs. one crore. The principal investment objectives of the fund is long term capital appreciation.

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Merchant Banking Division of Grindlays Bank has been retained as the advisers for the Fund which evaluates and recommends specific investment proposals. The fund follows hands off approach in making the investment.

(4) Indus Venture Capital Fund (lVCF) This fund was promoted by Shri T. Thomas, the former Director of Unilever. The Indus Venture Management Ltd. (IVML) has been entrusted with the management of (IVCF). IVCF has a capital resource of Rs. 21 crores contributed by IVML, the IDB!, IFCI, Deutsche Bank, International Finance Corporation (Washington) and a few other national/international organisations.

(5) SBI Capital Venture Capital Fund. This fund has been set up by the SBI Capital Markets Ltd. to finance ventures through its "bought out deals". The objective behind the fund is to promote new capital issues by purchasing them when capital market is sluggish and disposing them off at times when market picks-up. The fund has a capital base of Rs. 10 crore.

V. Overseas Venture Capital Funds

Overseas Venture Capital Funds look for investment in areas ensuring high and guaranteed returns such as tourism, hospitals, air transport, information technology, communication, pharmaceutical, consumer durables, food processing industry, machinery components and textiles etc. Following are some of the examples where foreign venture capitalists have undertaken investments:

1. The global insurance giant, AIG, has tied up with IL & SF to float a 150 million venture fund.
2. The IL & SF is also planning to launch a $ 100 million fund with the ADB.
3. George,Sors has already floated the Indocean Fund.
4. NIKKO Securities has tied up with Walden and San Francis Company to float a venture capital fund with a minimum capital of $ 50 million.

Difficulties in India

1. The restrictive legal and financial framework is one of the main reason for -die lack of development of venture capital industry in India.
2. Fundamentally, there are no private pools of capital of finance risk ventures in India. The financial institutions occupy a dominant position in providing long term finance to Indian industry. FIs and the state development agencies do provide limited amounts of equity finance to assist in the development of new business but there are no private, professionally managed investment capital sources.
3. There are no private sector insurance companies or pension funds gathering regular premium income and virtually no private banks willing to devote a small portion of their resources to the venture capital projects.
4. Small companies have no access to share capital or long term debenture capital. The absence of a proper system of financing such companies has been a major gap in the Indian capital market.
5. While the government institutions no doubt meet part of venture capital requirements, tl1eir procedural delays and bottlenecks, the rigidity of the government's announced parameters for priority lending and strict standards about security and collaterals and the like often create problems for new entrepreneurs wishing to set up enterprises in high technology areas.
6. Venture capital financing involves funding of relatively new projects with no proven record in market acceptability. This does not make the venture capital financing an attractive investment. There are other more attractive options available to an investor.
7. The venture capitalists have not been given tax incentives commensurate with the risks they carry. This has also been responsible for the slow growth of venture capital industry.

Need for Growth

India possesses a pool of young educated and technically qualified 'entrepreneurs with real innovative mind. Vast potentials of our country need to be properly tapped for continuous development, broadening of the industrial base of high-tech industries and to promote the growth of technology. Venture capital would provide the required initial funding facilities for the advancement of untried and untested technology. This new financing scheme would remove the constraints like inadequate funds, lack of encouragement to our young entrepreneurs etc. The changing economic scenario and the liberalisation of capital market would bring greater depth to the capital market as a whole, introducing more genuine investors of substance with long time horizons, provide avenues for the institutions to realise their equity portfolios more easily (freeing funds for more new investment) and generally improve market liquidity. This would improve equity cult.

SEBI (Venture Capital Fund) Regulations, 1996

The existing set up of venture capital in India needs to be streamlined and strengthened. The entry of private sector should be encouraged. Tax exemptions and concessions should be given to the investors investing in risky ventures. Government should offer attractive opportunities to foreign investors to invest in venture capital firms.

SEBI has been a regulatory body for venture capital companies or funds with effect from Jan. 25, 1995. It issued certain guidelines on 4th December, 1996 which defines venture capital fund as "fund established in the form of a company or trust which raises moneys through loans, donations, issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations". The Guidelines are listed below:

I. Registration of Venture Capital Funds

Application for Grant of Certificate

1. Any company or trust proposing to carry on any activity as a venture capital fund on or after the commencement of these regulations shall make an application to the Board for grant of a certificate.
2. Any company or trust, who on the date of commencement of these regulations is carrying any activity as a venture

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capital fund without a certificate shall make an application to the Board for grant of a certificate within a period of three months from the date of such commencement: Provided that the board, in special cases, may extent the said period up to a maximum of six months form the date of such commencement.

3. An application for grant of certificate under sub-regulation (1) or sub-regulation (2) shall be made to the Board in Form A and shall be accompanied by a non-refundable application fee of Rs. 25,000 by way of bank draft issued in favor of SEBI at Mumbai.
4. Any company or trust referred to in sub-regulation (2) who fails to make an application for grant of a certificate within the period specified therein shall cease to carry on any activity as a venture capital fund.
5. The Board may in the interest of the investors issue directions with regard to the transfer of records, documents or securities or disposal of investments relating to its activities as a venture capital fund.
6. The Board may in order to protect the interests of investors appoints any person to take charge of records, documents, securities and for this purpose also determine the terms and conditions of such an appointment.

Eligibility criteria. For the purpose of the grant of a certificate by the Board the applicant have to fulfil in particular the following conditions, namely

a. If the application is made by a company
   i. memorandum of association as has its main objective, the carrying on of the activity of a venture capital fund;
   ii. it is prohibited by its memorandum and articles of association from making an invitation to the public to subscribe to its securities;
   iii. its director or principal officer or employee is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant;
   iv. its director, principal officer or employee has not at any time been convicted of any offence involving moral turpitude or any economic offence;
   v. it is a fit and proper person;

b. if the application is made by a trust
   i. the instrument of trust is in the form of a deed and has been duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908) ;
   ii. the main object of the trust is to carry on the activity of a venture capital fund;
   iii. the directors of its trustee company, if any or any trustee is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant;
   iv. the directors of its trustee company, if any, or a trustee has not at any time, been convicted of any offence involving moral turpitude or of any economic offence;
   v. the applicant is a fit and proper person;

c. the company or trust has not been refused a certificate by the Board or its certificate has been suspended or cancelled.

Furnishing of information, clarification: The Board may require the applicant to furnish such further information as it may consider necessary.

Consideration of application: An application which is not complete in all respects shall be rejected by the Board: Provided that, before rejecting any such application, the applicant shall be given an opportunity to remove, within thirty days of the date of receipt of communication, the objections indicated by the Board: Provided further that the Board may, on being satisfied that it is necessary to extend the period specified in the first proviso, extend such period by such further time not exceeding ninety days.

Procedure for Grant of Certificate

1. If the Board is satisfied that the applicant is eligible for the grant of certificate, it shall send an intimation to the applicant.
2. On receipt of intimation, the applicant shall pay to the Board, the registration fee of Rs. 500,000 payable by way of bank draft in favor of SEBI at Mumbai.
3. The Board shall on receipt of the registration fee grant a certificate of registration in Form B.

Conditions of certificate: The certificate granted shall be *inter alia*, subject to the following conditions, namely-'

a. the venture capital fund shall abide by the provisions of the Act, the Government of India Guidelines and 1hese regulations;
b. the venture capital fund shall not carry on any other activity other than that of a venture capital fund;
c. the venture capital fund shall forthwith inform the Board in writing if any information or particulars previously submitted to the Board are found to be false or misleading in any material particular or if there is any change in the information already submitted.

Procedure where Certificate is not Granted

1. After considering an application if the Board is of the opinion that a certificate should not be granted, it may reject the application after giving the applicant a reasonable opportunity of being heard.
2. The decision of the Board to reject the application shall be communicated to the applicant within thirty days.

Effect of Refusal to Grant Certificate

1. Any applicant whose application has been rejected shall not carryon any activity as a venture capital fund.
2. Any company or trust whose application for grant of certificate has been rejected by the Board shall, on and from the date of the receipt of the communication cease to carry on any activity as a venture capital fund.
3. The Board may in the interest of the investors issue directions with regard to the transfer of records, documents or securities or disposal of investments relating to its activities as a venture capital fund.

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4. The Board may in order to protect the interests of the investors appoint any person to take charge of records, documents, securities and for this purpose also determine the terms and conditions of such an appointment.

II Investment Conditions and Restrictions

Minimum investment in a venture capital fund

1. A venture capital fund may raise monies from any investor whether Indian, foreign or non-resident Indian.
2. No venture capital fund set up as a company or any scheme of a venture capital fund set up as a trust shall accept any investment from any investor which is less than five lakh rupees: Provided that nothing contained in sub-regulation (2) shall apply to investors who are (a) employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust; or (b) non-resident Indians; or (c) persons or institutions of foreign origin.

Restrictions on investment by a venture capital fund. All investments made or to be made by a venture capital fund shall be subject to the following restrictions:

a. the venture capital fund shall not invest in the equity shares of the company or institutions providing financial services;

b. at least 80 per cent of funds raised by a venture capital fund shall be invested in

   i. the equity shares or equity related securities issued by a company whose securities are not listed on any recognised stock exchange: Provided that a venture capital fund may invest in equity shares or equity related securities of a company whose securities are to be listed or are listed where the venture capital fund has made. these investments through private placements prior to the listing of the securities;

   ii. the equity shares or equity related securities of a financially weak company or a sick industrial company, whose securities mayor may not be listed on any recognised stock exchange.

   Explanation-For the purposes of this regulation, a "financially weak company" means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50 % but less than 100 % of its networth as at the beginning of the previous financial year;

   iii. providing financial assistance in any other manner to companies in whose equity shares the venture capital fund has invested under sub-clause (i) or sub-clause (i), as the case may be.

   Explanation-For the purposes of this regulation, "funds raised" means the actual monies raised from investors for subscribing to the securities of the venture capital fund and includes monies raised from the author of the trust in case the venture capital fund has been established as a trust but shall not include the paid up capital of the trustee company, if any.

Prohibition on listing - No venture capital fund shall be entitled to get its securities or units, as the case may be, listed on any recognised stock exchange till the expiry of three years from the date of the issuance of securities or units, as the case may be, by the venture capital fund.

III. General Obligations and Responsibilities

Prohibition on inviting subscription from the public No venture capital fund shall issue any document or advertisement inviting offers from the public for the subscription or purchase of any of its securities or units.

Private placement A venture capital fund may receive monies for investment in the venture capital fund through private placement of its securities or units.

Placement Memorandum

1. The venture capital fund established as a trust shall, before issuing any units, file witl1 the Board a placement memorandum which shall give details of the terms subject to which monies are proposed to be raised from investors.
2. A venture capital fund established as a company shall, before making an offer inviting any subscription to its securities, file with the Board a placement memorandum which shall give details of the terms subject to which monies are proposed to be raised from the investors.

Contents of Placement Memorandum

1. The placement memorandum referred to in sub-regulation (1) of regulation shall contain the following, namely:
   a. details of the trustees or trustee company of the venture capital fund; .
   b. details of entitlement on the units of the trust for which subscription is being sought;
   c. details of investments that are proposed to be made;
   d. tax implications that are likely to apply to investors;
   e. manner of subscription to the units of the trust;
   f. the period of maturity, if any, of the scheme;
   g. the manner, if any, in which the scheme is to be wound up;
   h. manner in which the benefits accruing to investors in the units of the trust are to be distributed;
   i. details of the asset management company, if any, and of fees to be paid to such a company.
2. The placement memorandum referred to in sub-regulation (2) above shall contain the following namely:
   a. details of the securities that are being offered;
   b. details of investments that are proposed to be made;
   c. details of directors of the company;
   d. tax implications that are likely to apply to investors;
   e. manner of subscription to the securities that are to be issued;
   f. manner in which the benefits accruing to investors in the securities are to be distributed; and
   g. details of the asset management company, if any, and of fees to be paid to such a company.

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Circulation of placement memorandum. The placement memorandum may be issued for private circulation only after the expiry of twenty-one days of its submission to the Board: provided that if, within twenty-one days of submission of the placement memorandum, the Board communicates any amendments to the placement memorandum, the venture capital fund shall carry out such amendments in the placement memorandum before such memorandum is circulated to the investors.

Changes in the placement memorandum to be intimated to the Board Amendments or changes to any placement memorandum already filed with the Board can be made only if

a. a copy of the placement memorandum indicating the changes is filed with the Board; and

b. within twenty-one days of such filing, the Board has not communicated any objections or observations on the said amendments or changes.

Maintenance of Books and Records.

1. Every venture capital fund shall maintain for a period of ten years books of accounts, records and documents which shall give a true and fair picture of the state of affairs of the venture capital fund.
2. Every venture capital fund shall intimate the Board, in writing, the place where the books, records and documents referred to in sub-regulation (1) are being maintained.

Power to Call for Information

1. The Board may at any time call for any information from a venture capital fund with respect to any matter relating to its activity as a venture capital fund.
2. Where any information is called for under sub-regulation (1) it shall be furnished to the Board within fifteen days.

Submission of Reports to the Board

The Board may at any time call upon the venture capital fund to file such reports as the Board may desire with regard to the activities carried on by the venture capital fund.

Winding up

1. A scheme of a venture capital fund set up as a trust shall be wound up,
   a. when the period of the scheme, if any, mentioned in the placement memorandum is over;
   b. if it is the opinion of the trustees or the trustee company, as the case may be, that the scheme shall be wound up in the interests of investors in the units;
   c. if seventy-five per cent of the investors in the scheme pass a resolution at a meeting of unit holders that the scheme be wound up ; or
   d. if the Board so directs in the interests of investors.
2. A venture capital fund set up as a company shall be wound up in accordance with the provisions of the Companies Act. 1956 (1 of 1956).
3. The trustees or trustee company of the venture capital fund set up as a trust shall intimate the Board and investors of the circumstances leading to the winding up of the scheme under sub-regulation (1).

Effect of Winding up

1. On and from the date of intimation, no further investments shall be made on behalf of the scheme so wound up.
2. Within three months from the date of intimation the assets of the scheme shall be liquidated, and the proceeds accruing to investors in the scheme distributed to them after satisfying all liabilities.

IV. Inspection and Investigation

Board's Right to Inspect or Investigate

1. The Board may appoint one or more persons as inspecting or investigating officer to undertake inspection or investigation of the books of accounts, records and documents relating to a venture capital fund for any of the following reasons, namely
   a. to ensure that the books of account, records and documents are being maintained by the venture capital fund in the manner specified in these regulations;
   b. to inspect or investigate into complaints received from investors, clients or any other person, on any matter having a bearing on the activities of the venture capital fund;
   c. to ascertain whether the provisions of the Act and these regulations are being complied with by the venture capital fund; and
   d. to inspect or investigate *suo motu* into the affairs of a venture capital fund, in the interest of the securities market or in the interest of investors.

Notice before Inspection or Investigation

1. Before ordering an inspection or investigation the Board shall give not less than ten days notice to the venture capital fund.
2. Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of the investors no such notice should be given, it may by an order in writing direct that the inspection or investigation of the affairs of the venture capital fund be taken up without such notice.
3. During the course of an inspection or investigation, the venture capital fund against whom the inspection or investigation is being carried out shall be bound to discharge its obligations as given below.

Obligations of Venture Capital Fund on Inspection or Investigation by the Board.

1. It shall be the duty of the venture capital fund whose affairs are being inspected or investigated, and of every director, officer and employee thereof, of its asset management company, if any, and of its trustees or directors or the directors of the trustee company, if any, to produce before the inspecting or investigating officer such books, securities, accounts, records and other documents in its custody or

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control and furnish him with such statements and information relating to the venture capital fund, as the inspecting or investigating officer may require, within such reasonable period as the inspecting officers may specify. .

2. The venture capital fund shall allow the inspecting or investigating officer to have reasonable access to the premises occupied by such venture capital fund or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the venture capital fund or such other person and also provide copies of documents or other materials which, in the opinion of the inspecting or investigation, as the case may be.
3. The inspecting or investigating officer, in the course of inspection or investigation shall be entitled to examine or to record the statements of any director, officer or employee of the venture capital fund.
4. It shall be the duty of every director, officer or employee, trustee or director of the trustee company of the venture capital fund to give to the inspecting or investigating officer all assistance in connection with the inspection or investigation, which the inspecting or investigating officer may reasonably require.

Submission of Report to the Board

The inspecting or investigating officer shall, as soon as possible, on completion of the inspection or investigation submit an inspection or investigation report to the Board: Provided that if directed to do so by the Board, he may submit an interim report.

Communication of Findings, etc. to the Venture Capital Fund

1. The Board shall, after consideration of the inspection or investigation report or the interim report communicate the findings of the inspection officer to the venture capital fund and give him an opportunity of being heard.
2. On receipt of the reply if any, from the venture capital fund, the Board may call upon the venture capital fund to take such measures as the Board may deem fit in the interest of the securities market and for the due compliance with the provisions of the Act and these regulations.

V Procedure for Action in Case of Default

Suspension of certificate. The Board may suspend the certificate granted to a venture capital fund where the venture capital fund:

a. contravenes any of the provisions of the Act or these regulations;
b. fails to furnish any information relating to its activity as a venture capital fund as required by the Board;
c. furnishes to the Board information which is false or misleading in any material particular;
d. does not submit periodic returns or reports as required by the Board;
e. does "not co-operate in any enquiry, inspection or investigation conducted by the Board;
f. fails to resolve the complaints of investors or fails to give a satisfactory reply to the Board in this behalf.

Cancellation of certificate. The Board may cancel the certificate granted to a venture capital fund

a. when the venture capital fund is guilty of fraud or has been convicted of an offence involving moral turpitude; "
b. the venture capital fund has been guilty of repeated defaults of the nature. Explanation - In this regulation, "fraud" has the same meaning as is assigned to it in section 17 of the Indian Contract Act, 1972 (9 of 1872) ; or
c. contravenes any of the provisions of the Act or these regulations.

Manner of Making Order of Cancellation or Suspension- No order of suspension or cancellation of certificate shall be made by the Board, except after holding an enquiry.

Manner of Holding Enquiry before Suspension or Cancellation

1. For the purpose of holding an enquiry the Board may appoint one or more enquiry officers.
2. The enquiry officer shall issue to the venture capital fund, at its registered office or its principal place of business, a notice setting out the grounds which on action is proposed to be taken against it and calling upon it to show cause against such action within a period of fourteen days from the date of receipt of the notice.
3. The venture capital fund may, within fourteen days from the date of receipt of such notice, furnish to the enquiry officer a written reply, together with copies of documentary or other evidence relied on by it or sought by the Board from the venture capital fund.
4. The enquiry officer shall give a reasonable opportunity of hearing to the venture capital fund to enable him to make submission in support of its reply made under sub-regulation (3).
5. Before the enquiry officer, the venture capital fund may appear through any person duly authorised by the venture capital fund: Provided that not lawyer or advocate shall be permitted to represent the venture capital fund at the enquiry: Provided further that where a lawyer or an advocate has been appointed by the Board as a presenting officer under sub-regulation (6), it shall be lawful f6r the venture capital fund to present its case through a lawyer or advocate.
6. The enquiry officer may, if he considers it necessary, ask the Board to appoint a presenting officer to present its case.
7. The enquiry officer shall, after taking into account all relevant facts and submissions made by the venture capital fund, submit a report to the Board and recommend the penal action, if any, to be taken against the venture capital fund as also the grounds on which the proposed action is justified.

Show-cause Notice and Order

1. On receipt of the report from the enquiry officer, the Board shall consider the same and may issue to the venture capital fund a show-cause notice as to why the penal action as

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proposed by the enquiry officer should not be taken against it.

2. The venture capital fund shall, within fourteen days of the date of the receipt of the show-cause notice, send a reply to the Board.
3. The Board, after considering the reply, if any, of the venture capital fund, shall, as soon as possible pass such order as it deems fit.

Effect of Suspension and Cancellation of Certificate

1. On and from the date of the suspension of the certificate, the venture capital fund shall cease to carryon any activity as a venture capital fund during the period of suspension, and shall be subject to such directions of the Board with regard to any records, documents or securities that may be in its custody or control, relating to its activities as venture capital fund, as the Board may specify.
2. On and from the date of cancellation of the certificate, the venture capital fund shall, with immediate effect, cease to carryon any activity as a venture capital fund, and shall be subject to such directions of the Board with regard to the transfer of records, documents or securities that may be in its custody or control, relating to its activities as venture capital fund, as the Board may specify.

Publication of Order of Suspension or Cancellation

The order of suspension or cancellation of certificate passed may be published by the Board in two newspapers.

Venture Capital in India

Globalisation may or may not have shrunk distance, but it certainly appears to have compressed time. After reading up on the venture capital industry in the US, it appears that what should have been a 10-year parole, a period of introspection about idiotic ideas let loose, has now been shortened to just four years. Venture capital is back in fashion, and perhaps with a difference. Comments from industry leaders suggest that a critical lesson in humility has been imbibed and the wild guys of the fraternity have been thrown out.

Who can argue with “We have learnt from our mistakes” or “Technology by itself is insufficient to create wealth, what matters is its innovative usage.” This we-have-been-reformed air almost makes you believe that the initial frenzy leading up to the dotcom bust of 2000 is over and a process of sensible recomposition has begun. It all sounds so unexceptionable, so reasonable and so really polite.

But just a few scratches below the surface, you still get some stuff that either makes no sense or is just old wine in new bottles. Instead of “eyeballs” and “angel investors”, the new terms are “audience management” and “permission filtering technology.” You still get the sense that many of these guys are overloaded with money, off on the hunt for the next Big Idea, and are having a jolly good time just trying to be different for the sake of it.

I came across an interesting study: in the US, from 1992 to 1996, about $10 billion per year of venture capital was invested, producing on average 25-40 per cent annual rates of return. Those were good years. But then came the bad. From 1997 to 2001, the amount per year soared, reaching $70 billion in 2000, but the returns became negative. Nobody knows exactly how much in the negative, since there is a cloak of secrecy, but estimates range from 10 to 30 per cent in the red. Of course, some of this has to do with the tanking of US equity markets, but many were just plain bad investments.

In India, reliable estimates of VC funding are also difficult, mostly because not all that is reported is real and because rules allow many VC transactions to fall outside official statistics by making them indistinguishable from routine foreign investment. Still, there is broad agreement that VC funding in India in the calendar year 2003 was in the $500-600 million range, a sharp drop from $1.1 billion in 2002 and $900 million in 2001. Over 80 per cent new VC investment in India is in profitable companies rather than start-ups, with Internet companies clearly out of favour and BPO, media, entertainment and healthcare emerging as the new stars.

But Indian VC investment, for all its brouhaha, is essentially small, far less than China and Japan, and far less exciting. In fact, India has now slipped to the 5th position (from 3rd place in 2002) in Asia. More than the dotcom bust, this is perhaps due to the belated realisation that India remains an untested if not shaky market, and that success is often shaped by a combination of social circumstance and government role.

Take vaccines for instance, where a number of firms are in the race. On surface, the market opportunity looks huge; after all, infant mortality is high in India, over 3 million children under the age of five die each year and one in every 15 persons is a carrier of some immunisable disease. But while vaccine sales are robust and growing, around 20 per cent annually, they have hardly shown the dramatic growth that was projected by many venture capitalists.

Why? Because government is still the largest buyer. Official procurement remains mired in bureaucracy and corruption, while refrigeration and medical infrastructure needed for an effective immunisation programme simply does not exist in the far reaches of the country. The bottomline is that no matter how fantastic a discovery, a new vaccine will enjoy only limited market penetration due to the meagre resources of the public health system.

Venture and technology people (there is an 80 per cent overlap) are not stupid but they operate under far less checks and balances than do others. The business by its nature is very lonely, the rush to spot novel ideas and emerging technologies is both consuming and seductive, and there are few markers to help along the way. All these push VCs to believing in their own destiny. Confidence and risk-taking are essential for creating wealth, but not if you act as if you just had a conversation with God. Combined Indian industry estimates speak of reaching $1.5 billion financing in 2004, but more than quantity we need to focus on the quality and impact of this capital.

Venture Capital funding is different from traditional sources of financing. Finance innovation ideas have potential for high growth but with inherent uncertainties. This makes it a high-risk, high return investment for venture capitalists. Apart from finance, venture capitalists provide networking, management and marketing support as well. In the broadest sense, therefore,

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venture capital connotes risk finance as well as managerial support.

In the global venture capital industry, investors and funded firms work closely together in an enabling environment that allows entrepreneurs to focus on value creating ideas and venture capitalists to drive the industry by the levers of control in return for the provision of capital, skills, information and complementary resources. This very blend of risk financing and hand holding of entrepreneurs by venture capitalists creates an environment particularly suitable for 200,000 and so engineer graduates from Government and private-run colleges in India.

Scientific, technological and knowledge-based ideas properly supported by venture capital can be propelled into a powerful engine of economic growth and wealth creation in a sustainable manner. In various developed and developing economies venture capital has played a significant developmental role.

India, along with Israel, Taiwan and the United States, is recognized for its globally competitive high technology and human capital. The success India has achieved particularly in software and information technology against several odds such as inadequate infrastructure, expensive hardware, restricted access to foreign resources and limited domestic demand, is a pointer to the hidden potential it has in the field of knowledge and technology based industry.

India has the second largest English speaking scientific and technical manpower in the world. Some of the management (IIMs) and technology institutes (IITs) in India are globally known as centres of excellence. Every year thousands of young people specialize through diploma courses in computers and other technical areas. Management institutes produce 40,000 management graduates annually. Given this quality and magnitude of human capital India's potential to create enterprises is unlimited.

In Silicon Valley, these very Indians have proved their potential and have carved out a prominent place in terms of wealth creation as well as credibility. There are innumerable well-known success stories of successful Indians backed by a venture capital environment in Silicon Valley and elsewhere in US, supporting their innovation and invention. At least 30 percent of the start-up enterprises in Silicon Valley are started / backed by Indians.

With the inherent skills and manpower that India has, it can be easily predicted that software exports will thrive with an estimated 50 percent growth per annum. The market capitalization of the listed software companies comprises of approximately 25 percent of the total market capitalization. Also greater visibility of the Indian companies globally is evident.

Given such vast potential, which is, not only confined to IT and software but also in other sectors like biotechnology, telecommunications, media and entertainment, medical and health etc., venture capital industry is playing and shall continue to play a catalyst's role in industrial development.

Thus, venture capital is valuable not only because it makes risk capital available at the early stages of a project but also because of the expertise of venture capitalist that leads to superior product development. And the big focus of venture capital worldwide is - technology.

VCs as a whole invested US$ 79.9 billion in the first three quarters of 2000, a 137 percent increase over the corresponding period during 1999. Out of this, technology firms reportedly got around 75 percent. Besides this huge supply from organised venture funds there is an even larger pool of "angel" funds provided by private investors. In 2000, it was expected that angel investment would be of the order of US$ 105 billion, thus making the total "at-risk" investment of US$ 185 billion in high-end technology ventures in a single year.

By contrast, in India, cumulative disbursements to date are not more than US$ 950 million, of which technology firms have received about 52 percent.

Venture Finance Glossary

Angel Financing Capital raised for a startup company from angel investors. The capital is generally used as seed money.

Angel Investors Angels are individual who include professional investors, retired executives with business experience and money to invest, or high net worth individuals looking for investment opportunities.

Affiliate A venture firm that is an associate or subsidiary to commercial banks, investment banks or insurance company. They make investments on behalf of outside investors or parent company's client.

Balanced Funding A venture fund investment strategy that includes the investment in portfolio companies at a variety of stages of development.

Bootstrapping A means of finding creative ways to support a startup business until it turns profitable. This method may include negotiating delayed payment to suppliers and advances from potential partners and customers.

Business Plan It is a statement of goals, and how to achieve those goals, and rewards the business will reap when those goals are met.

Buyout Financing Investment intended to support the management acquire a product line or business.

Capital (or Assets) Under Management The amount of capital available to a fund management team for venture investments.

Corporate strategic investors When you enter into a strategic partnership with another corporation, which will then extend finance to you, the firm, which provides the finance, is known as a corporate strategic investor. Such business agreements are referred to as strategic alliances or corporate partnerships.

Corporate Venturing A form of investing by big corporations in opportunities that are congruent with its strategic mission or that will provide business synergy.

Cost of Capital The rate of return required by investors on the capital provided by them.

Early Stage Financing Financing in seed stage, startup stage or first stage of a project.

Entrepreneur One who pursues new business opportunities and assumes inherent risk.

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Equity Ownership in a company. While bonds represent debt, stocks represent equity.

Exit Option Options available for venture capital firms to liquidate its holdings to realize capital gains on their investment. Options depend on the exit climate including market conditions and industry trends.

Exit Strategy Strategy adopted by venture capitalists to liquidate its holding to realize capital gains on their investments. It includes providing for a stock buy-back by another firm, arranging a public offering of stock and providing for a merger with a larger firm.

Expansion Stage Financing Financing in second stage, third stage and mezzanine stage of a project.

First Stage Financing Financing provided when the firm has begun production and need additional fund for sales.

Flexibility This ability of a firm to raise further capital from any source it wishes to tap to meet the future financing needs.

Founder Capital It refers to the individuals own assets including bank balance, certificates of deposit, shares and bonds, cash value in insurance policies, real estate, pension funds, etc.

Fund Size The total amount of capital committed by the investors of a venture capital fund.

Initial Public Offering An issue of new stock by a once private company to transform itself into a publicly held one. Many entrepreneurs regard a successful initial public offering (IPO) as the conventional route to secure finance.

Institutional Investors Organizations whose primary purpose is to invest their own assets or those entrusted to them by others.

Interest The cost of borrowing money.

Investment The use of money for the purpose of making more money, to gain income or increase capital, or both.

Investment Philosophy The stated investment approach or focus of a fund manager/firm.

Later Stage Financing Financing in third stage and mezzanine stage of a project.

Leveraged Buyout (LBO) A takeover of a company, using a combination of equity and borrowed fund. Generally, the target company's assets act as the collateral for the loans taken out by the acquiring group. The acquiring group then repays the loan from the cash flow of the acquired company.

Love Money It is the finance obtained from family, relatives and friends. A common source of founder capital.

Mezzanine Financing Financing also called bridge financing, intended for additional expansion of market before the company goes public. Often this financing is structured so that it can be repaid from the proceeds of an IPO.

Partnering Partnering is a business arrangement with an investor, who intends to gain a quick access to new product/service.

Post-money Valuation The valuation of a company immediately after the most recent round of financing.

Pre-money Valuation The Valuation of a company just prior to the most recent round of financing.

Professionally Managed Pools A type of venture firm which functions in similar term as traditional partners do but the pool is made of institutional money. These funds are typically organized as fixed life partnerships, usually having a life of ten years.

Proposed Financing Statement of the amount of funds required to move the project from the initial concept stage till the revenue stage. It briefs on how money will be raised in parts and how the proceeds will be used.

Recapitalization The reorganization of a company's capital structure. It can be an alternative exit strategy for venture capitalists.

Seed Money The combination of founder capital and love money. Generally, the amount of seed money raised is small and is suitable for early stage financing.

Second Stage Financing Financing the working capital requirement for initial expansion of company that is producing and shipping.

Seed Stage Financing An investment of relatively small size, made at a very early stage of the project where typically a little more than a prototype exist. An investment before there is any real product.

Startup Financing Financing provided for those companies, ready with a business plan, to support product and market development works.

Third Stage Financing Financing provided for major expansion of company that is breaking even and is growing.

Traditional Partnership A type of venture firm wherein, wealthy individuals to manage a portion of their fund establish a partnership. These are private individual firms having no affiliation with any financial institution. Generally investments are made in small companies.

Turnaround Financing Financing with the intention of turning around the company at the time of financial or operational difficulty.

Venture capital A main source of financing used to fund startups that do not have access to capital markets. It involves investing in high risk and high return projects that are usually innovative in nature and involving lot of uncertainties.

Venture Capitalist These are individuals or firm managers who fund startups for equity stake in the business. These are professional investors with vast experience, good contacts and sound business skills, which they bring along with money. They often look for highly profitable businesses that guarantee an immediate return on their investment.

Yield The amount of money returned to investors on their investments. Also known as rate of return.

Venture Capital

Mr Ashish Gianani (Symbiosis Institute of Foreign Trade, Pune) conducted this study of behalf of India Infoline, as a part of his summer internship.

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Introduction

A number of technocrats are seeking to set up shop on their own and capitalize on opportunities. In the highly dynamic economic climate that surrounds us today, few 'traditional' business models may survive. Countries across the globe are realizing that it is not the conglomerates and the gigantic corporations that fuel economic growth any more. The essence of any economy, today is the small and medium enterprises. For example, in the US, 50% of the exports, are created by companies with less than 20 employees and only 7% are created by companies with 500 or more employees.

This growing trend can be attributed to rapid advances in technology in the last decade. Knowledge driven industries like info-tech, health-care, entertainment and services have become the cynosure of bourses worldwide. In these sectors, it is innovation and technical capability that are big business-drivers. This is a paradigm shift from the earlier physical production and 'economies of scale' model.

However, starting an enterprise is never easy. There are a number of parameters that contribute to its success or downfall. Experience, integrity, prudence and a clear understanding of the market are among the sought after qualities of a promoter. However, there are other factors, which lie beyond the control of the entrepreneur. Prominent among these is the timely infusion of funds. This is where the venture capitalist comes in, with money, business sense and a lot more.

What is Venture Capital?

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

Venture capitalists generally:

- Finance new and rapidly growing companies
- Purchase equity securities
- Assist in the development of new products or services
- Add value to the company through active participation
- Take higher risks with the expectation of higher rewards
- Have a long-term orientation

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. They also actively work with the company's management, especially with contacts and strategy formulation.

Venture capitalists mitigate the risk of investing by developing a portfolio of young companies in a single venture fund. Many times they co-invest with other professional venture capital firms. In addition, many venture partnerships manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development. (Source: National Venture Capital Association 1999 Yearbook).

In India, these funds are governed by the Securities and Exchange Board of India (SEBI) guidelines. According to this, venture capital fund means a fund established in the form of a company or trust, which raises monies through loans, donations, issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations. (Source: SEBI (Venture Capital Funds) Regulations, 1996)

Investment Philosophy

The basic principal underlying venture capital – invest in high-risk projects with the anticipation of high returns. These funds are then invested in several fledging enterprises, which require funding, but are unable to access it through the conventional sources such as banks and financial institutions. Typically first generation entrepreneurs start such enterprises. Such enterprises generally do not have any major collateral to offer as security, hence banks and financial institutions are averse to funding them. Venture capital funding may be by way of investment in the equity of the new enterprise or a combination of debt and equity, though equity is the most preferred route.

Since most of the ventures financed through this route are in new areas (worldwide venture capital follows "hot industries" like infotech, electronics and biotechnology), the probability of success is very low. All projects financed do not give a high return. Some projects fail and some give moderate returns. The investment, however, is a long-term risk capital as such projects normally take 3 to 7 years to generate substantial returns. Venture capitalists offer "more than money" to the venture and seek to add value to the investee unit by active participation in its management. They monitor and evaluate the project on a continuous basis.

The venture capitalist is however not worried about failure of an investee company, because the deal which succeeds, nets a very high return on his investments – high enough to make up for the losses sustained in unsuccessful projects. The returns generally come in the form of selling the stocks when they get listed on the stock exchange or by a timely sale of his stake in the company to a strategic buyer. The idea is to cash in on an increased appreciation of the share value of the company at the time of disinvestment in the investee company. If the venture fails (more often than not), the entire amount gets written off. Probably, that is one reason why venture capitalists assess several projects and invest only in a handful after careful scrutiny of the management and marketability of the project.

To conclude, a venture financier is one who funds a start up company, in most cases promoted by a first generation technocrat promoter with equity. A venture capitalist is not a lender, but an equity partner. He cannot survive on minimalism. He is driven by maximization: wealth maximization. Venture

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capitalists are sources of expertise for the companies they finance. Exit is preferably through listing on stock exchanges. This method has been extremely successful in USA, and venture funds have been credited with the success of technology companies in Silicon Valley. The entire technology industry thrives on it.

A Brief History

The concept of venture capital is not new. Venture capitalists often relate the story of Christopher Columbus. In the fifteenth century, he sought to travel westwards instead of eastwards from Europe and so planned to reach India. His far-fetched idea did not find favor with the King of Portugal, who refused to finance him. Finally, Queen Isabella of Spain, decided to fund him and the voyages of Christopher Columbus are now empanelled in history.

The modern venture capital industry began taking shape in the post – World War II years. It is often said that people decide to become entrepreneurs because they see role models in *other* people who have become successful entrepreneurs. Much the same thing can be said about venture capitalists. The earliest members of the organized venture capital industry had several role models, including these three:

American Research and Development Corporation, formed in 1946, whose biggest success was Digital Equipment. The founder of ARD was General Georges Doroit, a French-born military man who is considered "the father of venture capital." In the 1950s, he taught at the Harvard Business School. His lectures on the importance of risk capital were considered quirky by the rest of the faculty, who concentrated on conventional corporate management.

J.H. Whitney & Co, also formed in 1946, one of whose early hits was Minute Maid juice. Jock Whitney is considered one of the industry's founders.

The Rockefeller Family, and in particular, L S Rockefeller, one of whose earliest investments was in Eastern Airlines, which is now defunct but was one of the earliest commercial airlines.

The Second World War produced an abundance of technological innovation, primarily with military applications. They include, for example, some of the earliest work on micro circuitry. Indeed, J.H. Whitney's investment in Minute Maid was intended to commercialize an orange juice concentrate that had been developed to provide nourishment for troops in the field.

In the mid-1950s, the U.S. federal government wanted to speed the development of advanced technologies. In 1957, the Federal Reserve System conducted a study that concluded that a shortage of entrepreneurial financing was a chief obstacle to the development of what it called "entrepreneurial businesses." As a response this a number of Small Business Investment Companies (SBIC) were established to "leverage" their private capital by borrowing from the federal government at below-market interest rates. Soon commercial banks were allowed to form SBICs and within four years, nearly 600 SBICs were in operation.

At the same time a number of venture capital firms were forming private partnerships outside the SBIC format. These partnerships added to the venture capitalist's toolkit, by offering a degree of flexibility that SBICs lack. Within a decade, private venture capital partnerships passed SBICs in total capital under management.

The 1960s saw a tremendous bull IPO market that allowed venture capital firms to demonstrate their ability to create companies and produce huge investment returns. For example, when Digital Equipment went public in 1968 it provided ARD with 101% annualized Return on Investment (ROI). The US$70,000 Digital invested to start the company in 1959 had a market value of US$37mn. As a result, venture capital became a hot market, particularly for wealthy individuals and families. However, it was still considered too risky for institutional investors.

In the 1970s, though, venture capital suffered a double-whammy. First, a red-hot IPO market brought over 1,000 venture-backed companies to market in 1968, the public markets went into a seven-year slump. There were a lot of disappointed stock market investors and a lot of disappointed venture capital investors too. Then in 1974, after Congress legislation against the abuse of pension fund money, all high-risk investment of these funds was halted. As a result of poor public market and the pension fund legislation, venture capital fund raising hit rock bottom in 1975.

Well, things could only get better from there. Beginning in 1978, a series of legislative and regulatory changes gradually improved the climate for venture investing. First Congress slashed the capital gains tax rate to 28% from 49.5%. Then the Labor Department issued a clarification that eliminated the pension funds act as an obstacle to venture investing. At around the same time, there were a number of high-profile IPOs by venture-backed companies. These included Federal Express in 1978, and Apple Computer and Genetech Inc in 1981. This rekindled interest in venture capital on the part of wealthy families and institutional investors. Indeed, in the 1980s, the venture capital industry began its greatest period of growth. In 1980, venture firms raised and invested less than US$600 million. That number soared to nearly US$4bn by 1987. The decade also marked the explosion in the buy-out business.

The late 1980s marked the transition of the primary source of venture capital funds from wealthy individuals and families to endowment, pension and other institutional funds. The surge in capital in the 1980s had predictable results. Returns on venture capital investments plunged. Many investors went into the funds anticipating returns of 30% or higher. That was probably an unrealistic expectation to begin with. The consensus today is that private equity investments generally should give the investor an internal rate of return something to the order of 15% to 25%, depending upon the degree of risk the firm is taking.

However, by 1990, the average long-term return on venture capital funds fell below 8%, leading to yet another downturn in venture funding. Disappointed families and institutions withdrew from venture investing in droves in the 1989-91 period. The economic recovery and the IPO boom of 1991-94 have gone a long way towards reversing the trend in both private equity investment performance and partnership commitments.

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In 1998, the venture capital industry in the United States continued its seventh straight year of growth. It raised US$25bn in committed capital for investments by venture firms, who invested over US$16bn into domestic growth companies in all sectors, but primarily focused on information technology.

Venture Capital In India

Most of the success stories of the popular Indian entrepreneurs like the Ambanis and Tatas had little to do with a professionally backed up investment at an early stage. In fact, till very recently, for an entrepreneur starting off on his own personal savings or loans raised through personal contacts / financial institutions.

Traditionally, the role of venture capital was an extension of the developmental financial institutions like IDBI, ICICI, SIDBI and State Finance Corporations (SFCs). The first origins of modern Venture Capital in India can be traced to the setting up of a Technology Development Fund (TDF) in the year 1987-88, through the levy of a cess on all technology import payments. TDF was meant to provide financial assistance– to innovative and high-risk technological programs through the Industrial Development Bank of India. This measure was followed up in November 1988, by the issue of guidelines by the (then) Controller of Capital Issues (CCI). These stipulated the framework for the establishment and operation of funds / companies that could avail of the fiscal benefits extended to them.

However, another form of (ad?)venture capital which was unique to Indian conditions also existed. That was funding of green-field projects by the small investor by subscribing to the Initial Public Offering (IPO) of the companies. Companies like Jindal Vijaynagar Steel, which raised money even before they started constructing their plants, were established through this route.

The industry's growth in India can be considered in two phases. The first phase was spurred on soon after the liberalization process began in 1991. According to former finance minister and harbinger of economic reform in the country, Manmohan Singh, the government had recognized the need for venture capital as early as 1988. That was the year in which the Technical Development and Information Corporation of India (TDICI, now ICICI ventures) was set up, soon followed by Gujarat Venture Finance Limited (GVFL). Both these organizations were promoted by financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals. Though an attempt was also made to raise funds from the public and fund new ventures, the venture capitalists had hardly any impact on the economic scenario for the next eight years.

However, it was realized that the concept of venture capital funding needed to be institutionalized and regulated. This funding requires different skills in assessing the proposal and monitoring the progress of the fledging enterprise. In 1996, the Securities and Exchange Board of India (SEBI) came out with guidelines for venture capital funds has to adhere to, in order to carry out activities in India. This was the beginning of the second phase in the growth of venture capital in India. The move liberated the industry from a number of bureaucratic hassles and paved the path for the entry of a number of foreign funds into India. Increased competition brought with it greater access to capital and professional business practices from the most mature markets.

There are a number of funds, which are currently operational in India and involved in funding start-up ventures. Most of them are not true venture funds, as they do not fund start-ups. What they do is provide mezzanine or bridge funding and are better known as private equity players. However, there is a strong optimistic undertone in the air. With the Indian knowledge industry finally showing signs of readiness towards competing globally and awareness of venture capitalists among entrepreneurs higher than ever before, the stage seems all set for an overdrive.

The Indian Venture Capital Association (IVCA), is the nodal center for all venture activity in the country. The association was set up in 1992 and over the last few years, has built up an impressive database. According to the IVCA, the pool of funds available for investment to its 20 members in 1997 was Rs25.6bn. Out of this, Rs10 bn had been invested in 691 projects.

Certain venture capital funds are Industry specific(ie they fund enterprises only in certain industries such as pharmaceuticals, infotech or food processing) whereas others may have a much wider spectrum. Again, certain funds may have a geographic focus – like Uttar Pradesh, Maharashtra, Kerala, etc whereas others may fund across different territories. The funds may be either close-endedschemes (with a fixed period of maturity) or open-ended.

Classification

Venture funds in India can be classified on the basis of

Genesis

Financial Institutions Led By ICICI Ventures, RCTC, ILFS, etc.

- Private venture funds like Indus, etc.
- Regional funds like Warburg Pincus, JF Electra (mostly operating out of Hong Kong).
- Regional funds dedicated to India like Draper, Walden, etc.
- Offshore funds like Barings, TCW, HSBC, etc.
- Corporate ventures like Intel.

To this list we can add Angels like Sivan Securities, Atul Choksey (ex Asian Paints) and others. Merchant bankers and NBFCs who specialized in "bought out" deals also fund companies. Most merchant bankers led by Enam Securities now invest in IT companies.

Investment Philosophy

Early stage funding is avoided by most funds apart from ICICI ventures, Draper, SIDBI and Angels.

Funding growth or mezzanine funding till pre IPO is the segment where most players operate. In this context, most funds in India are private equity investors.

Size of Investment

The size of investment is generally less than US$1mn, US$1-5mn, US$5-10mn, and greater than US$10mn. As most funds are of a private equity kind, size of investments has been

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increasing. IT companies generally require funds of about Rs30-40mn in an early stage which fall outside funding limits of most funds and that is why the government is promoting schemes to fund start ups in general, and in IT in particular.

Value Addition

The venture funds can have a totally "hands on" approach towards their investment like Draper or "hands off" like Chase. ICICI Ventures falls in the limited exposure category. In general, venture funds who fund seed or start ups have a closer interaction with the companies and advice on strategy, etc while the private equity funds treat their exposure like any other listed investment. This is partially justified, as they tend to invest in more mature stories.

A list of the members registered with the IVCA as of June 1999, has been provided in the Annexure. However, in addition to the organized sector, there are a number of players operating in India whose activity is not monitored by the association. Add together the infusion of funds by overseas funds, private individuals, 'angel' investors and a host of financial intermediaries and the total pool of Indian Venture Capital today, stands at Rs50bn, according to industry estimates!

The primary markets in the country have remained depressed for quite some time now. In the last two years, there have been just 74 initial public offerings (IPOs) at the stock exchanges, leading to an investment of just Rs14.24bn. That's less than 12% of the money raised in the previous two years. That makes the conservative estimate of Rs36bn invested in companies through the Venture Capital/Private Equity route all the more significant.

Some of the companies that have received funding through this route include:

- Mastek, one of the oldest software houses in India
- Geometric Software, a producer of software solutions for the CAD/CAM market
- Ruksun Software, Pune-based software consultancy
- SQL Star, Hyderabad based training and software development company
- Microland, networking hardware and services company based in Bangalore
- Satyam Infoway, the first private ISP in India
- Hinditron, makers of embedded software
- PowerTel Boca, distributor of telecomputing products for the Indian market
- Rediff on the Net, Indian website featuring electronic shopping, news, chat, etc
- Entevo, security and enterprise resource management software products
- Planetasia.com, Microland's subsidiary, one of India's leading portals
- Torrent Networking, pioneer of Gigabit-scaled IP routers for inter/intra nets
- Selectica, provider of interactive software selection
- Yantra, ITLInfosys' US subsidiary, solutions for supply chain management

Though the infotech companies are among the most favored by venture capitalists, companies from other sectors also feature equally in their portfolios. The healthcare sector with pharmaceutical, medical appliances and biotechnology industries also get much attention in India. With the deregulation of the telecom sector, telecommunications industries like Zip Telecom and media companies like UTV and Television Eighteen have joined the list of favorites. So far, these trends have been in keeping with the global course.

However, recent developments have shown that India is maturing into a more developed marketplace, unconventional investments in a gamut of industries have sprung up all over the country. This includes:

Indus League Clothing, a company set up by eight former employees of readymade garments giant Madura, who set up shop on their own to develop a unique virtual organization that will license global apparel brands and sell them, without owning any manufacturing units. They dream to build a network of 2,500 outlets in three years and to be among the top three readymade brands.

Shoppers Stop, Mumbai's premier departmental store innovates with retailing and decides to go global. This deal is facing some problems in getting regulatory approvals.

Airfreight, the courier-company which has been growing at a rapid pace and needed funds for heavy investments in technology, networking and aircrafts.

Pizza Corner, a Chennai based pizza delivery company that is set to take on global giants like Pizza Hut and Dominos Pizza with its innovative servicing strategy.

Car designer Dilip Chhabria, who plans to turn his studio, where he remodels and overhauls cars into fancy designer pieces of automation, into a company with a turnover of Rs1.5bn (up from Rs40mn today).

Indian Scenario - A Statistical Snapshot

Contributors of Funds

Ciontrbutors	Rs mn	Per cent
Foreign Institutional Investors	13,426.47	52.46%
All India Financial Institutions	6,252.90	24.43%
Multilateral Development Agencies	2,133.64	8.34%
Other Banks	1,541.00	6.02%
Foreign Investors	570	2.23%
Private Sector	412.53	1.61%
Public Sector	324.44	1.27%
Nationalized Banks	278.67	1.09%
Non Resident Indians	235.5	0.92%
State Financial Institutions	215	0.84%
Other Public	115.52	0.45%
Insurance Companies	85	0.33%
Mutual Funds	4.5	0.02%
Total	25,595.17	100.00%

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Methods of Financing

Instruments	Rs million	Per cent
Equity Shares	6,318.12	63.18
Redeemable Preference Shares	2,154.46	21.54
Non Convertible Debt	873.01	8.73
Convertible Instruments	580.02	5.8
Other Instruments	75.85	0.75
Total	10,000.46	100

Financing by Investment Stage

Investment Stages	Rs million	Number
Start-up	3,813.00	297
Later stage	3,338.99	154
Other early stage	1,825.77	124
Seed stage	963.2	107
Turnaround financing	59.5	9
Total	10,000.46	691

Financing by Industry

Industry	Rs million	Number
Industrial products, machinery	2,599.32	208
Computer Software	1,832	87
Consumer Related	1,412.74	58
Medical	623.8	44
Food, food processing	500.06	50
Other electronics	436.54	41
Tel & Data Communications	385.09	16
Biotechnology	376.46	30
Energy related	249.56	19
Computer Hardware	203.36	25
Miscellaneous	1,380.85	113
Total	10,000.46	691

Financing by States

Investment	Rs million	Number
Maharashtra	2,566	161
Tamil Nadu	1531	119
Andhra Pradesh	1372	89
Gujarat	1102	49
Karnataka	1046	93
West Bengal	312	22
Haryana	300	22
Delhi	294	21
Uttar Pradesh	283	29
Madhya Pradesh	231	2
Kerala	135	15
Goa	105	16
Rajasthan	87	11
Punjab	84	6
Orissa	35	5
Dadra & Nagar Haveli	32	1
Himachal Pradesh	28	3
Pondicherry	22	2
Bihar	16	3
Overseas	413	12
Total	9994	691

Source IVCA

Problems with VCs in the Indian Context

One can ask why venture funding is so successful in USA and faced a number of problems in India. The biggest problem was a mindset change from "collateral funding" to high risk high return funding. Most of the pioneers in the industry were people with credit background and exposure to manufacturing industries. Exposure to fast growing intellectual property business and services sector was almost zero. All these combined to a slow start to the industry. The other issues that led to such a situation include:

License Raj and the IPO Boom

Till early 90s, under the license raj regime, only commodity centric businesses thrived in a deficit situation. To fund a cement plant, venture capital is not needed. What was needed was ability to get a license and then get the project funded by the banks and DFIs. In most cases, the promoters were well-established industrial houses, with no apparent need for funds. Most of these entities were capable of raising funds from conventional sources, including term loans from institutions and equity markets.

Scalability

The Indian software segment has recorded an impressive growth over the last few years and earns large revenues from its export earnings, yet our share in the global market is less than 1 per cent. Within the software industry, the value chain ranges from body shopping at the bottom to strategic consulting at the top. Higher value addition and profitability as well as significant market presence take place at the higher end of the value chain. If the industry has to grow further and survive the flux it would only be through innovation. For any venture idea to succeed there should be a product that has a growing market with a scalable business model. The IT industry (which is most suited for venture funding because of its "ideas" nature) in India till recently had a service centric business model. Products developed for Indian markets lack scale.

Mindsets

Venture capital as an activity was virtually non-existent in India. Most venture capital companies want to provide capital on a secured debt basis, to established businesses with profitable operating histories. Most of the venture capital units were offshoots of financial institutions and banks and the lending mindset continued. True venture capital is capital that is used to help launch products and ideas of tomorrow. Abroad, this problem is solved by the presence of 'angel investors'. They are typically wealthy individuals who not only provide venture finance but also help entrepreneurs to shape their business and make their venture successful.

Returns, Taxes and Regulations

There is a multiplicity of regulators like SEBI and RBI. Domestic venture funds are set up under the Indian Trusts Act of 1882 as per SEBI guidelines, while offshore funds routed through Mauritius follow RBI guidelines. Abroad, such funds are made under the Limited Partnership Act, which brings advantages in terms of taxation. The government must allow pension funds and insurance companies to invest in venture

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capitals as in USA where corporate contributions to venture funds are large.

Exit

The exit routes available to the venture capitalists were restricted to the IPO route. Before deregulation, pricing was dependent on the erstwhile CCI regulations. In general, all issues were under priced. Even now SEBI guidelines make it difficult for pricing issues for an easy exit. Given the failure of the OTCEI and the revised guidelines, small companies could not hope for a BSE/ NSE listing. Given the dull market for mergers and acquisitions, strategic sale was also not available.

Valuation

The recent phenomenon is valuation mismatches. Thanks to the software boom, most promoters have sky high valuation expectations. Given this, it is difficult for deals to reach financial closure as promoters do not agree to a valuation. This coupled with the fancy for software stocks in the bourses means that most companies are preponing their IPOs. Consequently, the number and quality of deals available to the venture funds gets reduced.

Regulatory Issues

This chapter aims to give a bird's eye's view of the various guidelines a venture fund has to adhere to in India. There are a number of rules and regulation for venture capital and these would broadly come under either of the following heads:

- The Indian Trust Act, 1882 or the Company Act, 1956 depending on whether the fund is set up as a trust or a company. (In the US, a venture capital firm is normally set up as a limited liability partnership)
- The Foreign Investment Promotion Board (FIPB) and the Reserve Bank of India (RBI) in case of an offshore fund. These funds have to secure the permission of the FIPB while setting up in India and need a clearance from the RBI for any repatriation of income.
- The Central Board of Direct Taxation (CBDT) governs the issues pertaining to income tax on the proceeds from venture capital funding activity. The long term capital gains tax is at around 10% in India and the relevant clauses to venture capital may be found in Section 10 (subsection 23).
- The Securities and Exchange Board of India has come out with a set of guidelines attached in the annexure.

In addition to the above there are a number of arms of the Government of India – Ministry of Finance that may have to be approached in certain situations. Also intervention allied agencies like the Department of Electronics, the National Association of Software and Computers (NASSCOM) and various taskforces and standing committees is not uncommon.

Probably this explains why most of the funds prefer to take the easy way out by listing as offshore funds operating out of tax havens like Mauritius (where the Avoidance of Double Taxation Treaty, incomes may be freely repatriated).

Global Scenario in Brief

In the UK, more than 16,500 companies have received venture capital backing since 1983. In a survey carried out by the British Venture Capital Association and Coopers & Lybrand (now Price Waterhouse Coopers, over a period of four years from 1990-91 to 1994-95, on an average, venture-backed companies:

- Sales rose by 34 per cent per annum (Five times faster than that of the FT-SE 100 companies)
- Exports grew by 29 per cent
- Investment increased by 28 per cent
- As much as 88 per cent said that they benefited from their venture capital backers who provided "more than just money"
- Almost 90 per cent venture backed companies would have disappeared or would have grown less rapidly without Venture Capital

In the US, in 1997 venture capitals invested a record, US$11.4bn in nascent companies. According to VentureOne, San Francisco, CA,

- The surge in investments represented a 16 per cent increase over 1996
- Venture capitalists invested in 1,848 companies over the year, 162 more than in 1996

The Venture Capital pool in Hong Kong is 5.5 per cent of the country's GDP, with similar figures in Singapore and South Korea. India, Malaysia and Thailand attract large-scale investible funds from abroad.

The prosperity of many rapidly growing Australian technology companies can be directly attributed to venture capitalists, according to a research conducted on behalf of Price Waterhouse Coopers. The findings of the survey, companies in the development/ expansion stage, where the majority of the venture capital funding is directed, exhibited increased:

- Employment at an average annual rate of 9.5 per cent between 1993 and 1997
- Sales at an average rate of 12.1 per cent
- Profits at 34.9 per cent
- Exports at 15.2 per cent
- 52 per cent of the respondents viewed the importance of venture capital to growth of business as crucial
- 56 per cent considered venture capitalists as being a 'real partner'

Angels

Angels are important links in the entire process of venture capital funding. This is because they support a fledging enterprise at a very early stage – sometime even before commercialization of the product or service offering. Typically, an angel is an experienced industry-bred individual with high net worth.

Angels provide funding by "first round" financing for risky investments – risky because they are a young /start-up company or because their financial track record is unstable. This venture capital financing is typically used to prepare the company for "second round" financing in the form of an initial public offering (IPO). Example – A company may need "first round" financing to develop a new product line, (viz a new drug which would require significant research & development funding) or

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make a strategic acquisition to achieve certain levels of growth & stability.

It is important to choose the right Angel because they will sit on your Board of Directors, often for the duration of their investment and will assist in getting "second round" financing. When choosing an 'Angel', it is imperative to consider their experience in a relevant industry, reputation, qualifications and track record.

Angels are people with less money orientation, but who play an active role in making an early-stage company work. They are people with enough hands-on experience and are experts in their fields. They understand the field from an operational perspective. An entrepreneur needs this kind of expertise. He also needs money to make things happen. Angels bring both to the table of an entrepreneur.

There are a number of professionally qualified people, especially from IITs who had migrated to USA. Some of them have made their millions riding the IT boom in Silicon Valley. Having witnessed the maturity of the Silicon Valley into the global tech hotspot and thrived in the environment there, these individuals are rich in terms of financial resources and experience. They are the latest angels in the Indian industry.

The IndUS Entrepreneurs (TiE), a networking society that brings together highly influential Indians across the US was set up in 1992. The aim of the organization is to get the community together and to foster entrepreneurs and wealth creation. The idea was sparked off in 1992, when a group of Silicon Valley entrepreneurs with roots in the Indian sub-continent met by chance for a meeting with a visiting dignitary from India. A delayed flight kept the group waiting, and provided an opportunity for people to get to know one another. It turned out that most of the assembled invitees to the meeting had achieved varying degrees of entrepreneurial success. The group saw value in getting together on a regular basis to network with one another. Thus, the idea of TiE was born as a mechanism for high achievement-oriented IndUS entrepreneurs to network.

Over the years, a core group of about 10-15 individuals worked hard to establish the organization. Meeting at least once a month, successful veteran entrepreneurs, contributed as speakers, participants and mentors. Gradually, the group started attracting greater participation, and the TiE concept started gaining momentum. TiE membership has now grown to over 600 members, and chapters in Boston, Austin and Los Angeles. TiE is also supported by over 20 institutions that include leading Silicon Valley venture capital investors, law firms, accounting firms and banks.

Fifty percent of business plans submitted to venture capitalists in the Valley and outside is now from Indians and TiE can take the lion's share of the credit for this. What's more? About 30 per cent of the projects that are funded, are headed by Indians. As of 1998, over two dozen start-up companies have benefited from TiE, and two have already made successful IPOs.

TiE isn't about venture capitalist funding. It's about angel investing. The issue here is to identify a good idea that hasn't attracted any money, and then fund it the money coming from the member's own pockets. The environment is traditional in the sense of it following a gurukul environment of sorts, where the gurus transfer knowledge on business plans, management strategies and survival kits to new TiE members.

Some of the famous names include

- **Vinod Dham**, father of the Pentium chip and now the CEO of the Silicon Spice, one of the most closely watched start-ups in the Silicon Valley today.
- **Sailesh Mehta**, CEO & President of the US$15bn Providian Financial and the man who is using technology to re-order consumer finance.
- **Kanwal Rekhi**, one of the first Indians to become a big name in the valley; founder of Excelan, past CTO and member of Novell's board, now invests in a number of new ventures. He is the current chairman of the TiE.
- **Prabhu Goel**, 'serial entrepreneur', who has started three hi-tech companies so far and is on the board of five other companies as a private investor.
- **Suhas Patil**, who founded the semiconductor company Cirrus Logic in 1984.
- **Prakash Agarwal**, whose NeoMagic integrates memory and logic on a single chip. The six year old company already has a market share of 50%.
- **K.B. Chandrashekhar**, heads the US$200mn Exodus Communications, whose fiber optic network carries 30% of all Internet content traffic and whose servers host such popular websites such as Yahoo, Hotmail and Amazon.

Corporate Venturing

Even though corporate venturing is an attractive alternative, most companies find it difficult to establish systems, capabilities and cultures that make good venture capital firms. Corporate managers seldom have the same freedom to fund innovative projects or to cancel them midstream. Their skills are honed for managing mature businesses and not nurturing start up companies. If a firm is to apply the venture capital model, it must understand the characteristics of the model and tailor its venture capital program to its own circumstances without losing sight of these essentials.

Success of venture capital firms rest on the following characteristics:

Focus on specific industry niches and look for business concepts that will

- Although corporate managers have a clear focus in their business, they run into ambiguity with venture programs. Their biggest challenge is to establish clear, prioritized objectives. Simply making a good financial return is not sufficient.
- Manage portfolios ruthlessly, abandon losers, whereas abandoning ventures has never been easy for large corporations, whose projects are underpinned by personal relationships, political concerns.
- Venture capital firms share several attributes with start up they fund. They tend to be small, flexible and quick to make decisions. They have flat hierarchies and rely heavily on equity and incentive pay.

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Apple Computers established a venture fund in 1986 with the dual objectives of earning high financial return and supporting development of Macintosh software. They structured compensation mechanisms, decision criteria and operating procedures on those of top venture capital firms. While they considered Macintosh as an initial screening factor, its funding decisions were aimed at optimizing financial returns. The result was an IRR of 90 per cent but little success in improving the position of Macintosh.

New ventures can be powerful source of revenues, diversification and flexibility in rapidly changing environments. The company should create an environment that encourages venturing. An innovative culture cannot be transplanted but must evolve within the company. Venture investing requires different mindset from typical corporate investors.

How relevant is corporate venturing in the Indian scenario? The firms, which launched the successful corporate ventures had created new products in the market operating at the higher end of the value chain and had attained a certain size in the market. Most Indian companies are yet to move up the value chain and consolidate their position as players in the global market. Corporate venturing models would probably benefit Indian companies who are large players in the Indian market in another five to 10 years by enabling them to diversify and at the same time help start up companies. Multinationals led by Intel are the best examples of corporate venturing in an Indian context.

Financing Options in General

The possibility of raising a substantial part of project finances in India through both equity and debt instruments is among the key advantages of investing in India.

The Indian banking system has shown remarkable growth over the last two decades. The rapid growth and increasing complexity of the financial markets, especially the capital market have brought about measures for further development and improvement in the working of these markets. Banks and development financial institutions led by ICICI, IDBI and IFCI were providers of term loans for funding projects. The options were limited to conventional businesses, ie manufacturing centric. Services sector was ignored because of the “collateral” issue.

Equity was raised from the capital markets using the IPO route. The bull markets of the 90s, fuelled by Harshad Mehta and the FIIs, ensured that (ad)venture capital was easily available. Manufacturing companies exploited this to the full.

The services sector was ignored, like software, media, etc. Lack of understanding of these sectors was also responsible for the same. If we look back to 1991 or even 1992, the situation as regards financial outlay available to Indian software companies was poor. Most software companies found it extremely difficult to source seed capital, working capital or even venture capital. Most software companies started off undercapitalized, and had to rely on loans or overdraft facilities to provide working capital. This approach forced them to generate revenue in the short term, rather than investing in product development. The situation fortunately has changed.

The Venture Capital Process

Venture capitalists are a busy lot. This chapter aims to highlight the approach to an investor and the entire process that goes into the wooing the venture capital with your plan.

First, you need to work out a business plan. The business plan is a document that outlines the management team, product, marketing plan, capital costs and means of financing and profitability statements.

The venture capital investment process has variances/features that are context specific and vary from industry, timing and region. However, activities in a venture capital fund follow a typical sequence. The typical stages in an investment cycle are as below:

- Generating a deal flow
- Due diligence
- Investment valuation
- Pricing and structuring the deal
- Value Addition and monitoring
- Exit

Generating a Deal Flow

In generating a deal flow, the venture capital investor creates a pipeline of ‘deals’ or investment opportunities that he would consider for investing in. This is achieved primarily through plugging into an appropriate network. The most popular network obviously is the network of venture capital funds/investors. It is also common for venture capitals to develop working relationships with R&D institutions, academia, etc, which could potentially lead to business opportunities. Understandably the composition of the network would depend on the investment focus of the venture capital funds/company. Thus venture capital funds focussing on early stage technology based deals would develop a network of R&D centers working in those areas. The network is crucial to the success of the venture capital investor. It is almost imperative for the venture capital investor to receive a large number of investment proposals from which he can select a few good investment candidates finally. Successful venture capital investors in the USA examine hundreds of business plans in order to make three or four investments in a year.

It is important to note the difference between the profile of the investment opportunities that a venture capital would examine and those pursued by a conventional credit oriented agency or an investment institution. By definition, the venture capital investor focuses on opportunities with a high degree of innovation.

The deal flow composition and the technique of generating a deal flow can vary from country to country. In India, different venture capital funds/companies have their own methods varying from promotional seminars with R&D institutions and industry associations to direct advertising campaigns targeted at various segments. A clear pattern between the investment focus of a fund and the constitution of the deal generation network is discernible even in the Indian context.

Due Diligence

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Due diligence is the industry jargon for all the activities that are associated with evaluating an investment proposal. It includes carrying out reference checks on the proposal related aspects such as management team, products, technology and market. The important feature to note is that venture capital due diligence focuses on the qualitative aspects of an investment opportunity.

It is also not unusual for venture capital fund/companies to set up an 'investment screen'. The screen is a set of qualitative (sometimes quantitative criteria such as revenue are also used) criteria that help venture capital funds/companies to quickly decide on whether an investment opportunity warrants further diligence. Screens can be sometimes elaborate and rigorous and sometimes specific and brief. The nature of screen criteria is also a function of investment focus of the firm at that point. Venture capital investors rely extensively on reference checks with 'leading lights' in the specific areas of concern being addressed in the due diligence.

A venture capitalist tries to maximize the upside potential of any project. He tries to structure his investment in such a manner that he can get the benefit of the upside potential ie he would like to exit at a time when he can get maximum return on his investment in the project. Hence his due diligence appraisal has to keep this fact in mind.

New Financing

Sometimes, companies may have experienced operational problems during their early stages of growth or due to bad management. These could result in losses or cash flow drains on the company. Sometimes financing from venture capital may end up being used to finance these losses. They avoid this through due diligence and scrutiny of the business plan.

Inter-Company Transactions

When investments are made in a company that is part of a group, inter-company transactions must be analyzed.

Investment Valuation

The investment valuation process is an exercise aimed at arriving at 'an acceptable price' for the deal. Typically in countries where free pricing regimes exist, the valuation process goes through the following steps:

- Evaluate future revenue and profitability
- Forecast likely future value of the firm based on experienced market capitalization or expected acquisition proceeds depending upon the anticipated exit from the investment.
- Target an ownership position in the investee firm so as to achieve desired appreciation on the proposed investment. The appreciation desired should yield a hurdle rate of return on a Discounted Cash Flow basis.
- Symbolically the valuation exercise may be represented as follows:

  NPV = [(Cash)/(Post)] x [(PAT x PER)] x k, where
- NPV = Net Present Value of the cash flows relating to the investment comprising outflow by way of investment and inflows by way of interest/dividends (if any) and realization on exit. The rate of return used for discounting is the hurdle rate of return set by the venture capital investor.
- Post = Pre + Cash
- Cash represents the amount of cash being brought into the particular round of financing by the venture capital investor.
- 'Pre' is the pre-money valuation of the firm estimated by the investor. While technically it is measured by the intrinsic value of the firm at the time of raising capital. It is more often a matter of negotiation driven by the ownership of the company that the venture capital investor desires and the ownership that founders/management team is prepared to give away for the required amount of capital
- PAT is the forecast Profit after tax in a year and often agreed upon by the founders and the investors (as opposed to being 'arrived at' unilaterally). It would also be the net of preferred dividends, if any.
- PER is the Price-Earning multiple that could be expected of a comparable firm in the industry. It is not always possible to find such a 'comparable fit' in venture capital situations. That necessitates, therefore, a significant degree of judgement on the part of the venture capital to arrive at alternate PER scenarios.
- 'k' is the present value interest factor (corresponding to a discount rate 'r') for the investment horizon.

It is quite apparent that PER time PAT represents the value of the firm at that time and the complete expression really represents the investor's share of the value of the investee firm. The following example illustrates this framework:

Example: Best Mousetrap Limited (BML) has developed a prototype that needs to be commercialized. BML needs cash of Rs2mn to establish production facilities and set up a marketing program. BML expects the company will go public in the third year and have revenues of Rs70mn and a PAT margin of 10% on sales. Assume, for the sake of convenience that there would be no further addition to the equity capital of the company.

Prudent Fund Managers (PFM) propose to lead a syndicate of like minded investors with a hurdle rate of return of 75% (discounted) over a five year period based on BML's sales and profitability expectations. Firms with comparable sales and profitability and risk profiles trade at 12 times earnings on the stock exchange. The following would be the sequence of computations:

In order to get a 75% return p.a. the initial investment of Rs2 million must yield an accumulation of $2 \times (1.75)^5$ = Rs32.8mn on disinvestment in year 5.

BML's market capitalization in five years is likely to be Rs (70 x 0.1 x 12) million = Rs84mn.

Percentage ownership in BML that is required to yield the desired accumulation will be (32.8/84) x 100 = 39%

Therefore the post money valuation of BML At the time of raising capital will be equal to Rs(2/0.39) million = Rs5.1 million which implies that a pre-money valuation of Rs3.1 million for BML

Another popular variant of the above method is the First Chicago Method (FCM) developed by Stanley Golder, a leading professional venture capital manager. FCM assumes three possible scenarios – 'success', 'sideways survival' and 'failure'.

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Outcomes under these three scenarios are probability weighted to arrive at an expected rate of return:

In reality the valuation of the firm is driven by a number of factors. The more significant among these are:

Overall economic conditions: A buoyant economy produces an optimistic long- term outlook for new products/services and therefore results in more liberal pre-money valuations.

- Demand and supply of capital: when there is a surplus of venture capital of venture capital chasing a relatively limited number of venture capital deals, valuations go up. This can result in unhealthy levels of low returns for venture capital investors.
- Specific rates of deals: such as the founder's/management team's track record, innovation/ unique selling propositions (USPs), the product/service size of the potential market, etc affects valuations in an obvious manner.
- The degree of popularity of the industry/technology in question also influences the pre-money. Computer Aided Skills Software Engineering (CASE) tools and Artificial Intelligence were one time darlings of the venture capital community that have now given place to biotech and retailing.
- The standing of the individual venture capital Well established venture capitals who are sought after by entrepreneurs for a number of reasons could get away with tighter valuations than their less known counterparts.
- Investor's considerations could vary significantly. A study by an American venture capital, VentureOne, revealed the following trend. Large corporations who invest for strategic advantages such as access to technologies, products or markets pay twice as much as a professional venture capital investor, for a given ownership position in a company but only half as much as investors in a public offering.
- Valuation offered on comparable deals around the time of investing in the deal.

Quite obviously, valuation is one of the most critical activities in the investment process. It would not be improper to say that the success for a fund will be determined by its ability to value/price the investments correctly.

Sometimes the valuation process is broadly based on thumb rule metrics such as multiple of revenue. Though such methods would appear rough and ready, they are often based on fairly well established industry averages of operating profitability and assets/capital turnover ratios

Such valuation as outlined above is possible only where complete freedom of pricing is available. In the Indian context, where until recently, the pricing of equity issues was heavily regulated, unfortunately valuation was heavily constrained.

Structuring a Deal

Structuring refers to putting together the financial aspects of the deal and negotiating with the entrepreneurs to accept a venture capital's proposal and finally closing the deal. To do a good job in structuring, one needs to be knowledgeable in areas of accounting, cash flow, finance, legal and taxation. Also the structure should take into consideration the various commercial issues (ie what the entrepreneur wants and what the venture capital would require to protect the investment). Documentation refers to the legal aspects of the paperwork in putting the deal together.

The instruments to be used in structuring deals are many and varied. The objective in selecting the instrument would be to maximize (or optimize) venture capital's returns/protection and yet satisfy the entrepreneur's requirements. The instruments could be as follows:

Instrument	Issues
Loan	clean vs secured
	Interest bearing vs non interest bearing
	convertible vs one with features (warrants)
	1st Charge, 2nd Charge,
	loan vs loan stock
	maturity
Preference shares	redeemable (conditions under Company Act)
	participating
	par value
	nominal shares
Warrants	exercise price, expiry period
Common shares	new or vendor shares
	par value
	partially -paid shares
Options	exercise price, expiry period, call, put

In India, straight equity and convertibles are popular and commonly used. Nowadays, warrants are issued as a tool to bring down pricing.

A variation that was first used by PACT and TDICI was "royalty on sales". Under this, the company was given a conditional loan. If the project was successful, the company had to pay a % age of sales as royalty and if it failed then the amount was written off.

In structuring a deal, it is important to listen to what the entrepreneur wants, but the venture capital comes up with his own solution. Even for the proposed investment amount, the venture capital decides whether or not the amount requested, is appropriate and consistent with the risk level of the investment. The risks should be analyzed, taking into consideration the stage at which the company is in and other factors relating to the project. (eg exit problems, etc).

Promoter Shares

As venture capital is to finance growth, venture capital investment should ideally be used for financing expansion projects (eg new plant, capital equipment, additional working capital). On the other hand, entrepreneurs may want to sell away part of their interests in order to lock-in a profit for their work in building up the company. In such a case, the structuring may include some vendor shares, with the bulk of financing going into buying new shares to finance growth.

Handling Director's and Shareholder's Loans

Frequently, a company has existing director's and shareholder's loans prior to inviting venture capitalists to invest. As the money from venture capital is put into the company to finance growth, it is preferable to structure the deal to require these loans to be repaid back to the shareholders/directors only upon

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IPOs/exits and at some mutually agreed period (eg 1 or 2 years after investment). This will increase the financial commitment of the entrepreneur and the shareholders of the project.

A typical proposal may include a combination of several different instruments listed above. Under normal circumstances, entrepreneurs would prefer venture capitals to invest in equity as this would be the lowest risk option for the company. However from the venture capitals point of view, the safest instrument, but with the least return, would be a secured loan. Hence, ultimately, what you end up with would be some instruments in between which are sold to the entrepreneur.

Monitoring And Follow Up

The role of the venture capitalist does not stop after the investment is made in the project. The skills of the venture capitalist are most required once the investment is made. The venture capitalist gives ongoing advice to the promoters and monitors the project continuously.

It is to be understood that the providers of venture capital are not just financiers or subscribers to the equity of the project they fund. They function as a dual capacity, as a financial partner and strategic advisor. Venture capitalists monitor and evaluate projects regularly. They keep a hand on the pulse of the project. They are actively involved in the management of the of the investee unit and provide expert business counsel, to ensure its survival and growth. Deviations or causes of worry may alert them to potential problems and they can suggest remedial actions or measures to avoid these problems. As professional in this unique method of financing, they may have innovative solutions to maximize the chances of success of the project. After all, the ultimate aim of the venture capitalist is the same as that of the promoters – the long term profitability and viability of the investee company.

Exit

One of the most crucial issues is the exit from the investment. After all, the return to the venture capitalist can be realized only at the time of exit. Exit from the investment varies from the investment to investment and from venture capital to venture capital. There are several exit routes, buy-buck by the promoters, sale to another venture capitalist or sale at the time of Initial Public Offering, to name a few. In all cases specialists will work out the method of exit and decide on what is most profitable and suitable to both the venture capitalist and the investee unit and the promoters of the project.

At present many investments of venture capitalists in India remain on paper as they do not have any means of exit. Appropriate changes have to be made to the existing systems in order that venture capitalists find it easier to realize their investments after holding on to them for a certain period of time. This factor is even more critical to smaller and mid sized companies, which are unable to get listed on any stock exchange, as they do not meet the minimum requirements for such listings. Stock exchanges could consider how they could assist in this matter for listing of companies keeping in mind the requirement of the venture capital industry.

Accessing Venture Capital

Venture funds, both domestic and offshore, have been around in India for some years now. However it is only in the past 12 to 18 months, they have come into the limelight. The rejection ratio is very high, about 10 in 100 get beyond pre evaluation stage, and 1 gets funded.

Venture capital funds are broadly of two kinds - generalists or specialists. It is critical for the company to access the right type of fund, ie who can add value. This backing is invaluable as focused/specialized funds open doors, assist in future rounds and help in strategy. Hence, it is important to choose the right venture capitalist.

The standard parameters used by venture capitalists are very similar to any investment decision. The only difference being exit. If one buys a listed security, one can exit at a price but with an unlisted security, exit becomes difficult. The key factors which they look for in

The Management

Most businesses are people driven, with success or failure depending on the performance of the team. It is important to distinguish the entrepreneur from the professional management team. The value of the idea, the vision, putting the team together, getting the funding in place are amongst others, some key aspects of the role of the entrepreneur. Venture capitalists will insist on a professional team coming in, including a CEO to execute the idea. One-man armies are passe. Integrity and commitment are attributes sought for. The venture capitalist can provide the strategic vision, but the team executes it. As a famous Silicon Valley saying goes “Success is execution, strategy is a dream”.

The Idea

The idea and its potential for commercialization are critical. Venture funds look for a scalable model, at a country or a regional level. Otherwise the entire game would be reduced to a manpower or machine multiplication exercise. For example, it is very easy for Hindustan Lever to double sales of Liril - a soap without incremental capex, while Gujarat Ambuja needs to spend at least Rs4bn before it can increase sales by 1mn ton. Distinctive competitive advantages must exist in the form of scale, technology, brands, distribution, etc which will make it difficult for competition to enter.

Valuation

All investment decisions are sensitive to this. An old stock market saying “Every stock is a buy at a price and vice versa”. Most deals fail because of valuation expectation mismatch. In India, while calculating returns, venture capital funds will take into account issues like rupee depreciation, political instability, which adds to the risk premia, thus suppressing valuations. Linked to valuation is the stake, which the fund takes. In India, entrepreneurs are still uncomfortable with the venture capital “taking control” in a seed stage project.

Exit

Without exit, gains cannot be booked. Exit may be in the form of a strategic sale or/and IPO. Taxation issues come up at the time. Any fund would discuss all exit options before closing a

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deal. Sometimes, the fund insists on a buy back clause to ensure an exit.

Portfolio Balancing

Most venture funds try and achieve portfolio balancing as they invest in different stages of the company life cycle. For example, a venture capital has invested in a portfolio of companies predominantly at seed stage, they will focus on expansion stage projects for future investments to balance the investment portfolio. This would enable them to have a phased exit.

In summary, venture capital funds go through a certain due diligence to finalize the deal. This includes evaluation of the management team, strategy, execution and commercialization plans. This is supplemented by legal and accounting due diligence, typically carried out by an external agency. In India, the entire process takes about 6 months. Entrepreneurs are advised to keep that in mind before looking to raise funds. The actual cash inflow might get delayed because of regulatory issues. It is interesting to note that in USA, at times angels write checks across the table.

Current Trends

Capital is Pouring into Private Equity Funds

The IPO boom and its exceptional returns to venture and other kinds of private equity investments have led institutional investors, pension funds and endowments to park their money in these investments.

Bigger is Better

The most established venture funds now have more partners and therefore are able to put more money to work effectively. Also, venture firms are doing less deal syndication, which enables them to put more money to work in a single deal. Thirdly, many traditional early-stage venture firms have shifted to a multi-stage investment approach. They will back companies in technologies and industries they know intimately, almost regardless of the stage.

First-time Firms Never Had It So Good

During the 1989-91 downturn, new venture capital firms faced a problem in raising partnership capital, as there was a 'flight to quality' among investors who backed established funds in the private equity market. However, developments over the past few years have demonstrated that investing with an established firm is no more a sure-bet than an investment in a 'first-time fund'.

The State Wants its Share of the Pie too

The Department of Electronics of the Government of India announced the creation of a Rs1bn IT fund. Many state governments are sponsoring the formation of new venture capital firms to spur the creation and growth of new business quickly followed this move. Andhra Pradesh, Karnataka, Kerala, Gujarat and West Bengal are among the states creating such programs. They are fairly controversial efforts, because they run the risk of sacrificing return for economic stimulus. Many would believe that they are not a good idea. However, some of them are better designed than others and few might actually work.

Venture Firms are Being Run More Like Businesses

One of the healthiest consequences of the growth in institutional funding has been increased scrutiny that venture firms have come under. Feedback from previous investments and suggestions from the investors in these funds are helping to increase the sense of professionalism in the industry.

No More Men in Gray Suits

Another trend that is emerging slowly is the change in the profile of a fund manager. The venture capitalist is no longer a hybrid investment banker trying to cash in on another market boom while still keeping his cards close to his chest. The new-age venture capitalist is industry-bred and highly regarded in the business and is fairly at ease with the technologies and processes in the market.

Tomorrow is Coming Faster

Rapid changes in technology have accelerated the pace and raised the efficiencies for getting from idea to market. Investors are specializing. Financing sources are becoming much more focused on their way to investment in today's competitive environment. Today, from venture capital firms to leveraged buyout (LBO) houses and corporations, investors are devising specific plans for industries and technologies they want to be in.

More Venture Funds are Seeking Traditional Businesses

More venture capital funds are going after low-tech or no-tech companies. For example, Draper International has picked up a stake in Shoppers Stop and Indus League Clothing.

Financing Sources are More Flexible

More companies are acquiring new ideas, products and complementary operations to capture growth and gain market share. This means financing must allow for covenants that permit mergers, acquisitions and continued investments.

Financing Sources and Companies are Building Partnering Relationships

Companies need financing sources that allow them to move quickly and will tolerate risk, including acquisitions. Although financing sources are risking more, the rewards of such a partnering relationship can grow and be profitable for all concerned.

Competition is Affecting Buyer Prices

Historically, there has been a big difference between strategic buyers who paid a premium for the potential of synergy and financial buyers and LBO houses. Today, the two factions are more directly competitive.

All businesses are not evaluated equally. Venture houses today are looking at what enhances the value of a company, with different 'value drivers' affecting various industry segments. For example, when evaluating a technology company, investors may care about a unique technology or process with great potential. They won't necessarily worry whether the company lacks audited financial statements or an organization structure. In a non-technology area, however, there must be more than a new idea; 'value drivers' might include historical performance, gross margins and return on investment.

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Adapted from 'Growing Your Business' a publication of PwC Entrepreneurial Advisory Services.

Annexure: Summary Research Findings

In order to supplement the study on venture capital, India Infoline carried out a survey of some of the leading players in the venture capital environment today. As a part of the research, carried out in May and June 1999, 15 investing firms and intermediaries were interviewed about their expectations from the market and 30 promoters, CEOs or CFOs of IT companies were interviewed about their awareness of and perceptions about VC funding. The study was conducted in three cities – Mumbai, Pune and Bangalore.

The sample comprised of companies engaged in the IT segment – job contracting software development, offshore services, on-site development, systems and application software, hardware services and vendoring and training institutes.

A combination of judgement and convenience sampling was used and questionnaires were administered to the respondents after taking a prior telephonic appointment. The age-profile of the companies is included below.

Company Age Profile

Years	No. of companies
<1	7
1-3	6
3-5	9
5-10	6
>10	4

What Do Entrepreneurs Expect in a Venture Capital Investment?

Venture capital investors boast of bringing 'more than money' to the projects that they fund. This part of the study aimed at eliciting a response from the promoters of the projects about their expectations of a 'helping hand'. Listed below are the most common responses among the sample of IT investors and the percentage of people who agreed with them.

Expectation	Per cent
Assistance in terms of marketing advice, leads, networking	70%
Follow on/later stage financing	66%
Financial management and strategy	63%
Non executive governance	57%
Manpower planning, recruitment of personnel	47%
Doing away with legal hassles, red tape, bureaucracy	33%
Transfer of technology	20%

What Attributes Do Venture Capitalists Look for in a Deal?

Unlike the entrepreneurs, the VCs seem to be more in unison as they agree on a few critical success parameters. The respondents have identified the following critical factors.

Attribute	Per cent
Management quality	100%
Promoter's credentials and track record	86%
A focused development strategy	80%
A strong proprietary and competitive position	73%
A scalable business model	60%
An innovative concept, breakthrough technology	40%
Measurable milestones in the development strategy	27%

What is the General Perception of Venture Capital Investors In India?

Entrepreneurs were asked to comment on the current scenario of venture capital and private equity activity in India, with their perceptions regarding the problems/pitfalls associated.

Perception	Per cent
Insensitive to very early stage projects	53%
'Bankers' with little practical technical knowledge	47%
Invest only in successful expanding companies	40%
Negotiations take too long	40%
Do not meet our funding needs (less then $1 million)	27%
Making an approach, business plan is difficult	27%
Valuations are unfair	7%

Would You Consider/have You Considered Venture Capital Funding as a Source of Capital for Your Project?

As pointed out earlier, a large number of these firms have been funded or are currently in the process of working out a deal with venture capital firms. Keeping this in mind, 93% of the respondents proved to be inclined towards venture capital. The alternative to venture capital, not surprisingly was the IPO route.

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LESSON 21:
INSURANCE SERVICES: AN INTRODUCTION

Lesson Objectives

- To understand the Concept of Insurance,
- Its development in India and
- Regulatory framework of insurance.

Introduction

Life is full of risks. Being a social animal and risk averse, man always tries to reduce risk. An age-old method of sharing of risk through economic cooperation led to the development of the concept of 'insurance'.

Insurance may be described as a social device to reduce or eliminate risk of loss to life and property. Insurance is a collective bearing of risk. Insurance spreads the risks and losses of few people among a large number of people, as people prefer small fixed liability instead of big uncertain and changing liability. Insur-ance is a scheme of economic cooperation by which members of the community share the unavoidable risks. The risks, which can be insured against include fire, the perils of sea, death, accidents, and burglary. The members of the community subscribe to a common pool or fund, which is collected by the insurer to indemnify the losses arising out of risks. Insurance cannot prevent the occurrence of risk but it provides for the losses of risk. It is a scheme, which covers large risks, by paying small amount of capital. Insurance is also a means of savings and investment.

Insurance can be defined as a legal contract between two parties whereby one party called insurer under-takes to pay a fixed amount of money on the happening of a particular event, which may be certain or uncer-tain. The other party called insured pays in exchange a fixed sum known as premium. The insurer and the insured are also known as Assurer, or Under-writer, and Assured, respectively. The document, which embodies the contract, is called the policy.

An insurance contract is based on some basic principles of insurance.

a. Principle of 'Uberrima Fides' or Principle of utmost good faith.
b. Principle of Indemnity.
c. Doctrine of Subrogation.
d. Principle of Causa Proxima.
e. Principle of insurable interest.

a. **Principle of utmost good faith:** It means "maximum truth". All material information regarding the subject matter of insurance should be disclosed by both the parties-the insurer and the insured. This duty of full disclosure rests more heavily on the insured than the insurer. The insurer has a right to avoid the contract if the insured fails to make the full disclosure.

b. **Principle of indemnity:** This means that if the insured suffers a loss against which the policy has been made, he shall be fully indemnified only to the extent ofloss. In other words, the insured is not entitled to make a profit on his loss.

c. **Doctrine of subrogation:** This means the insurer has the right to stand in the place of the insured after settlement of claims in so far as the insured's right of recovery from an alternative source is involved. The right may be exercised by the insurer before the settlement of the claim. In other words, the insurer is entitled to recover from a negligent third party any loss payments made to the insured. The purposes of subrogation are to hold the negligent person responsible for the loss and prevent the insured from collecting twice for the same loss.

d. **Principle of *causa proxima:*** The cause of loss must be direct and an insured one in order to claim for compensation.

e. **Principle of insurable interest:** The assured must have insurable interest in the life or property insured. Insurable interest is that interest which considerably alters the position of the assured in the event of loss taking place and if the event does not take place, he remains in the same old position. One who has to lose as a result of loss may be said to have insurable interest in the life or property insured. If this principle is absent, the insurance contract degenerates into a wagering contract. It is taken as given that an individual has insurable interest in his/her own life or property. Cases where no proof of insurable interest is required are that of a husband's interest in his wife's life and wife's interest in her husband's life. In cases of business and family relationships, proof of insurable interest is required.

Origin and Development of Insurance

The concept of insurance is believed to have emerged almost 4,500 years ago in the ancient land of Babylonia where traders used to bear risk of the caravan by giving loans, which were later repaid with interest when the goods arrived safely. In order to protect against the risk of loss of goods in transit, piracy and natural calamities like storms and so on, medieval guilds (trade associations) formed a common pool of funds, which was used as support in times of sickness and death and sometimes even offered as ransom for members held captive by pirates. The first insurance contract was entered into by European maritime nations in 1347 to accept marine insurance as a practice.

The concept of insurance as we know today took shape in 1688 at a place called Lloyd's Coffee House in London where risk bearers used to meet to transact business. This coffee house became so popular that Lloyd's became the one of the first modem insurance companies by the end of the eighteenth century.

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Marine insurance companies came into existence by the end of the eighteenth century. These companies were empowered to write fire and life insurance as well as marine. The Great Fire of London in 1966 caused huge loss of property and life. With a view to providing fire insurance facilities, Dr. Nicholas Barbon set up in1967 the first fire insurance company known as the Fire office.

The oldest life insurance company in existence today is the Society for the Equitable Assurance of Lives and Survivorship, known as 'Old Equitable'. It was established in England in 1756.

The mortality tables were constructed in the seventeenth century. The first mortality table was constructed by an astronomer Edmund Haley in 1693. This table provided a link between the life insurance premium and average life spans based on statistical laws of mortality and compound interest. In 1756, Joseph Dodson re-worked the table, linking insurance premium rate to age.

The infamous New York Fire and the great Chicago Fire in 1835 and 1871, respectively, created an awareness and need for insurance. The concept of reinsurance emerged to deal specifically for such situations. Industrialisation and urbanisation popularised the concept of insurance and growth in insurance led to the development of new insurance products.

History of Insurance in India

The early history of insurance in India can be traced back to the Vedas. The Sanskrit term 'Yogakshema' (meaning well being), the name of Life Insurance Corporation of India's corporate headquarters, is found in the Rig Veda. Some form of 'community insurance' was practiced by the Aryans around 1000 BC. The joint family system prevalent in India was an important form of social cooperation.

Life insurance in its modem form came to India from England in 1818. The Oriental Life Insurance Company was the first insurance company to be set up in India to help the widows of European community. The insurance companies, which came into existence between 1818 and 1869, treated Indian lives as sub-normal and charged an extra premium of 15 to 20 per cent. The first Indian insurance company, the Bombay Mutual Life Assurance Society, came into existence in 1870 to cover Indian lives at normal rates. Moreover, in 1870, the British Government enacted for the first time the Insurance Act, 1570. Other companies, such as the Oriental Government Security Life Assurance Company, the Bharat Insurance Company, and the Empire of India Life Insurance Company Limited, were set up between 1870 and 1900.

The Swadeshi movement of 1905-07, the non-cooperation movement of 1919, and Civil Disobedience Movement of 1929 led to an increase in number of insurance companies. In 1912, the first legislation regulat-ing insurance, the Life Insurance Companies Act, 1912, was promulgated. The growth of life insurance was witnessed during the first two decades of the twentieth century not only in terms of number of companies but also in terms of number of policies and sum assured. Indian Insurance Year Book was published for the first time in 1914.

The Insurance Act, 1938, the first comprehensive legislation governing both life and non-life branches of insurance was enacted to provide strict state control over insurance business. This amended insurance Act looked into investments, expenditure, and management of these companies. An office of the Controller of Insurance came into existence. The Controller of Insurance had wide-ranging powers, which included direct-ing, cautioning, advising, prohibiting, inspecting, investigating, searching, seizing, prosecuting, penalising, authorising, registering, amalgamating, and liquidating insurance companies.

By the mid-1950s, there were 154 Indian insurers, 16 foreign insurers, and 75 provident societies carry-ing on life insurance business in India. Insurance business flourished and so did scams, irregularities, and dubious investment practices by scores of companies. As a result, the government decided to nationalise the life assurance business in India. The Life Insurance Corporation of India (LIC) was set up in 1956 to take over 245 life companies. The nationalisation of life insurance was followed by general insurance in 1972. The General Insurance Corporation of India and its subsidiaries were set up in 1973. Most of the powers of the Controller of Insurance were taken away and vested in state-owned LIC and GIC for operational conven-ience. These nationalised companies enjoyed monopoly for decades. They did a commendable job in extend-ing the distribution network and successfully handled a large volume of business. But with only 20 per cent of the population insured there was a vast potential untapped. Besides, as a sequel to the reform process and to tap the insurance sector as a source of long-term funds, the government decided to introduce reforms in the insurance sector.

The Government set up, in 1993, a committee under the chairmanship of R N Malhotra, the former insur-ance secretary and RBI governor to evaluate the Indian insurance industry and recommend its future direction. This committee submitted its report in 1994 and suggested the re-opening up of the insurance sector to private players. This sector was finally thrown open to the private sector in 2000. The Insurance Regulatory and Development Authority (IRDA) was set up in 2000 as an autonomous insurance regulator. The government has entrusted IRDA with the responsibility for carrying out the reforms in this sector.

Opening Up of the Insurance Sector

The insurance industry till the nineties had only two nationalised players: Life Insurance Corporation (LIC) and General Insurance Corporation (GIC) and its four subsidiaries. These two players had a monopolistic control over the market. These nationalised insurance companies did a commendable job in terms of high growth in volume of business and reach. However, they were not consumer oriented, unwilling to adopt mod-em practices and technology to upgrade technical skills, and inefficient in operations. The growth in volume was mainly driven by income-tax considerations and hence a major portion of the vast rural area was untapped.

Moreover, with a population of more than one billion and savings rate of around 24 per cent, India has a vast market, which is untapped. The foreign insurance companies' external

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influence and pressure to open up the Indian insurance sector was high.

In 1993, the committee under the chairmanship of R N Malhotra, set up to evaluate the Indian Insurance industry and recommend its future direction, submitted its report in 1994 and its major recommendations revolved around the structure and regulation of insurance industry. The main recommendations were:

i. The government should bring down its stake in the insurance companies to 50 per cent.

ii. Private companies with a minimum paid-up capital of Rs 100 crore should be allowed to enter the industry.

iii. No single company should be allowed to transact business both life and general insurance business. The number of entrants should be controlled.

iv. Foreign companies may be allowed to enter the industry in collaboration with the domestic companies. The committee did not favor foreign companies operating in India through branches.

v. Postal Life Insurance should be allowed to operate in the rural markets.

vi. The mandatory investments of LIC Life Fund in government securities need to be reduced from 75 per cent to 50 per cent.

vii. The GIC and its subsidiaries should not hold more than 5 per cent in any company.

viii. The promoters' holding in a private insurance company should not exceed 40 per cent of the total. However, if the promoters wish to start with a higher holding, they should be permitted to do so pro-vided their holding is brought down to 40 per cent within a specified period of time through public offering. No person other than the promoters should be allowed to hold more than one per cent of the equity. Promoters should at no time hold less than 26 per cent of the paid-up capital.

ix. Regulatory and prudential norms as well as conditions for ensuring level-playing field among insurers should be finalised early so that intending entrants into the insurance business would be aware of the stipulations they would have to comply with. These conditions should aim to ensure that life insurers do not neglect the small man or the rural business and that the general insurers have balanced portfo-lios.

x. Though nationalised insurance companies are in a position to face competition, it is essential that they quickly upgrade their technology, reorganise themselves on more efficient lines, and are enabled to operate as board-run enterprises.

xi. As an interim measure, the office of Controller of Insurance should be restored its full functions under the Insurance Act and it should be set up as a separate office as a matter of high priority.

xii. Legislation and government notifications through which LIC and GIC were exempted from several provisions of the Insurance Act should be withdrawn.

xiii. A strong and effective insurance regulatory authority in the form of a statutory autonomous board on the lines of SEBI should be set up.

xiv. The state level cooperatives should be allowed to set up cooperative societies for transacting life insurance business in the state. There will not be more than one society for each state which will be subject to the regulations of Insurance Regulatory Authority.

xv. GIC should cease to be the holding company for its subsidiaries and the exclusive function of GIC should remain that of reinsurer.

xvi. When GIC ceases to be holding company of the four subsidiary companies, then the government should acquire GIC's stake, which is Rs 40 crore in every company. This share, then should be raised to Rs 100 crore for every company, the government holding 50 per cent and the rest being held by the public at large.

Recognising the global trend of competitive, market driven, insurance industry and the recommendations of the Malhotra Committee, the insurance industry was opened up in August 2000. There are at present 12 life insurance and 11 general insurance companies operating in India with more players expected to come in. The Insurance Regulatory and Development Authority (IRDA), constituted in April 2000 under the IRDA Act, 1999, is vested with the power to regulate and develop the insurance and reinsurance business.

Most of the foreign insurers have preferred to form joint ventures with Indian companies. Banks, financial institutions, and non-banking finance companies are permitted to enter the insurance sector. The Reserve Bank has issued guidelines regulating the degree of participation of banks, financial institutions and non-banking finance companies in the insurance business depending on balance sheet strength. The Reserve Bank accorded approval to five banks for joint ventures on risk participation basis while 18 banks and a subsidiary of a bank were given 'in principle' approval for agency business. The Reserve Bank has given permission to

a. five NBFCs to undertake insurance business as joint venture participants

b. one NBFC to engage in insurance agency business as well as to make strategic investment in equity of an insurance company

c two NBFCs to make only strategic investments

d. two NBFCs to undertake only insurance agency business.

The Insurance (Amendment) Act, 2002, has allowed cooperative societies to carry on insurance business with a view to enhancing coverage in rural areas. This Act deals in four broad areas, namely, broken regula-tion, corporate agent regulations, section 64VB that deals in payments to be made through credit card and internet, and section 49 that deals with the distribution of actuarial surpluses between the shareholder and policyholder. Corporate acting as corporate agents will have to surrender their licence to be brokers, as there is a conflict of interest between two parties. Banks will continue to be corporate agents and non-brokers. The designated person, acting on behalf of the corporate agent (like a bank) after leaving their jobs can be an

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agent without having to take further exams mandated by the regulator. The amended insurance act would form the future legal base for making the regulation on intermediaries.

Insurance Regulatory and Development Authority

The Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the business of insurance and re-insurance in India. The Authority was constituted on April 19, 2000, vide Government of India's notification No. 277.

The Insurance Regulatory and Development Authority Act, 1999, was enacted by Parliament in the fifti-eth year of the Republic of India to provide for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry, and for matters connected therewith or incidental thereto and further to amend the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972. The Act was approved in the Parliament in December 1999 and the insurance sector was thrown open for private licensees on August 15, 2000. IRDA was constituted in terms of the Insurance Regulatory and Development Authority Act, 1999, as the regulator of the Indian Insurance industry.

IRDA was set up in 1996 but it was formally constituted as a regulator of the insurance industry in April 2000. The regulator was initially known as the Insurance Regulatory Authority but was subsequently rechristened as Insurance Regulatory and Development Authority as it was provided that it had a broader role to perform in the Indian insurance market. It has not only to frame and issue statutory and regulatory stipulations, guidelines, and clarification but it has also to perform a developmental and promotional role. The developmental and promotional role of the regulator include facilitating the growth of the market by attracting large number of players, integrating of the insurance market with the domestic financial services market, and synchronising the Indian Insurance market with that of global insurance market. Thus, the objectives of IRDA are two fold: policyholder protection and healthy growth of the insurance market.

Key Market Indicators

Size of Market, Life and Non-Life	$8 Billion a year @
Rate of Annual Growth	Average of 20% for Life and 12% for Non-Life (1990-99)
Geographical Restriction for New Players	None. Players can operate all over the country.
Equity Restriction in a New Indian Insurance Company	Foreign promoter can hold upto 26%.
Registration Restriction	Composite Registration not available.
Market Opening	August 2000 with invitation for application for registration.

Number of Registered Companies

Type of Business	Public Sector	Private Sector	Total
Life Insurance	01	12	13
General Insurance	04	09	13
Reinsurance	01	0	01
Total	06	21	27

New Registration Awarded	Twenty-one New Registrations issued:
	Life Insurance
	1. Allianz Bajaj Life Insurance Company Limited. 2. *Birla Sun-Life Insurance Company Limited. 3. *HDFC Standard Life Insurance Company Limited. 4. *ICICI Prudential Life Insurance Company Limited. 5. ING Vysya Life Insurance Company Limited. 6. *Max New York Life Insurance Company Limited. 7. Metlife Insurance Company Limited. 8. Om Kotak Mahindra Life Insurance Company Ltd. 9. *SBI Life Insurance Company Limited. 10. *TATA AIG Life Insurance Company Limited. 11. AMP SAN MAR Insurance Company Limited. 12. Dabur CGU Life Insurance Company Private Ltd.
	General Insurance
	1. Bajaj Allianz General Insurance Company Limited. 2. ICICI Lombard General Insurance Company Ltd. 3. *IFFCO-Tokio General Insurance Company Ltd. 4. *Reliance General Insurance Company Limited. 5. *Royal Sundaram Alliance Insurance Company Ltd. 6. *TATA AIG General Insurance Company Limited. 7. Cholamandalam General Insurance Company Ltd. 8. Export Credit Guarantee Corporation Limited. 9. HDFC-Chubb General Insurance Company Limited.
Business of New Players	Expected to take up a market share of 4-5% in three years.

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* Insurers registered in 2000-01, others have been registered subsequently. Source: IRDA, Annual Report, 2000-01.

IRDA has a Chairman and four whole-time and four part-time members. IRDA has constituted the insurance Advisory Committee and in consultation with this committee has brought out seventeen regulations. A leading consumer activist has also been inducted into the Insurance Advisory Committee. In addition, representatives of consumers, industry, insurance agents, women's organisations, and other interest groups are a part of this committee. It has also formed a Consumer Advisory Committee and a Surveyor and Loss Assessors Committee. It has a panel of eligible Chartered Accountants to carry out investigation, inspection, and so on.

IRDA has till 2001 issued seventeen regulations in the areas of registration of insurers, their conduct of business, solvency margins, conduct of reinsurance business, licensing, and code of conduct intermediaries. It follows the practice of prior consultation and discussion with various interest groups before issuing regulations and guidelines.'"

Mission Statement of IRDA

- To protect the interest of and secure fair treatment to policyholders.
- To bring about speedy and orderly growth of' the insurance industry (including annuity and super-annuation payments) for the benefit of the common man, and to provide long-term funds for accelerating growth of the economy.
- To set, promote, monitor, and enforce high standards of integrity, financial soundness, fair dealing, and competence of those it regulates.
- To ensure that insurance customers receive precise, clear, and correct information about products and services and make them aware of their responsibilities and duties in this regard.
- To ensure speedy settlement of genuine claims, to prevent insurance frauds, and other malpractices and put in place effective grievance redressal machinery.
- To promote fairness, transparency, and orderly conduct in financial markets dealing with insurance and to build a reliable management information system to enforce high standards of financial soundness amongst market players.
- To take action where such standards are inadequate or ineffectively enforced.
- To bring about optimum amount of self-regulation in day-to-day working of the industry, consistent with the requirements of prudential regulation.

Duties, Powers and Functions of IRDA

Section 14 of IRDA Act, 1999, lays down the duties, powers, and functions of IRDA. Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote, and ensure orderly growth of the insurance business and re-insurance business. Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the authority shall include:

a. Issuing to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration.

b. Protection of the interests of the policy-holders in matters concerning assigning of policy, nomination by policy holders, insurable-interest, settlement of insurance claim, surrender value of policy, and other terms and conditions of contracts of insurance.

c. Specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents.

d. Specifying the code of conduct for surveyors and loss assessors.

e. Promoting efficiency in the conduct of insurance business.

f. Promoting and regulating professional organisations connected with the insurance and re-insurance business.

g. Levying fees and other charges for carrying out the purposes of this Act.

h. Calling for information from, undertaking inspection of, conducting inquiries and investigations, includ-ing audit of the insurers, intermediaries, insurance intermediaries, and other organisations connected with the insurance business.

i. Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938).

j. Specifying the form and manner in which books of account shall be maintained and statement of ac-counts shall be rendered by insurers and other insurance intermediaries.

k. Regulating investment of funds by insurance companies.

l. Regulating maintenance of margin of solvency.

m. Adjudication of disputes between insurers and intermediaries or insurance intermediaries.

n. Supervising the functioning of the Tariff Advisory Committee.

o. Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f).

p. Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and exercising such other powers as may be prescribed.

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LESSON 22:
INSURANCE SERVICES: REGULATORY FRAMEWORK - I

Lesson Objectives

- To understand the regulatory requirements of the insurance sector and role of IRDA in it.
- To understand about the Reinsurance business and regulations related to it.

Dear students, in last session we discussed about the origin of insurance, its position in India and had an introduction of IRDA. In today's session we are going to understand about the regulatory framework related to insurance sector. Since there are various rules and regulations, our discussion will continue for next two sessions in this regard.

Operations of IRDA

1. IRDA has developed its internal parameters to assess the promoters' credentials. The promoters' long -term commitment to stay in the market, their ability to bring in new techniques in insurance underwriting and administration are some of the parameters, which are assessed in the first phase. Subsequent to this preliminary assessment, IRDA conducts an in-depth assessment of the business plans submitted by the promoter.

   IRDA is the sole authority for awarding licenses. There is no restriction in the number of licenses it can issue, but licenses for life and non-life business are to be issued separately. Licenses are issued only on a national basis. The new players should commence business within 15-18 months of getting the license. A new applicant has to pay a registration fee of Rs 50,000. At the time of renewal of registration every year, a fee of 0.20 per cent of 1 per cent of the gross premium or Rs 50,000 whichever is higher, is levied on the insurers carrying out insurance business in India.

   IRDA has prescribed a 'file and use' procedure, according to which every insurer is required to file the product and pricing details alongwith copies of standard terms, conditions, and literature. In case of tariff products, the Tariff Advisory Committee is required to file product and pricing details with IRDA, like any other insurance company.

2. All insurance intermediaries, such as agents and corporate agents, have to undergo compulsory training prior to their obtaining a license. IRDA also specified the minimum educational qualifications for these intermediaries. IRDA conducts examinations and then issues licenses to these agents. IRDA believes that a well trained and informed intermediaries can service the consumers better. IRDA insured or re-newed 1,18,154 agents licenses by the end of March 2001. The licensing of Insurance Agents Regula-tions have specified the qualifications for an insurance agent: hundred hours pre-licensing training, fol-lowed by an examination. In addition, for new agents 25 hours training to keep knowledge updated has also been prescribed at the time of renewal of license

3. The Insurance Association and Life Insurance and General Insurance Councils have been revived and they are responsible for setting the norms for market conduct, ethical behaviour of the insurers, and breach of regulations. Continuous training has been stipulated to enhance the efficiency of the intermediaries. New players have set up call centres which are functioning on 24/7 basis.
4. IRDA has recognised the Actuarial Society of India and Insurance Institute of India as nodal organisations responsible for actuarial and insurance education. IRD A has drafted separate bills of the Actuarial Society of India and the Institute of Surveyors and Loss Assessors in order to grant them statutory status.
5. IRDA has also entered into an MOD with the Indian Institute of Management, Bangalore, to further its objective of insurance research and education. It has set up a risk management resource centre in Bangalore.
6. IRDA has come out with the Insurance Advertisement and Disclosure Regulations to ensure that the insurance companies adhere to fair trade practices and transparent disclosure norms while addressing the policy holders or the prospects.

Specified Percentage of Business to be done by an Insurer in the Rural Sector

In order to spread insurance to rural areas, IRDA has made it mandatory for every insurer to undertake business in social and rural sectors.

Every insurer, who carries an insurance business after the commencement of the IRDA Act, 1999, is required to ensure that the following obligations are undertaken during the first five financial years, in respect of the following:

a. Rural Sector (where the population is not more than 5,000, population density not more than 400 per sq km, and at least 75 per cent of male working population is engaged in agriculture).
   i. In respect of a life insurer:
      - 5 per cent in the first financial year.
      - 7 per cent in the second financial year.
      - 10 per cent in the third financial year.
      - 12 per cent in the fourth financial year.
      - 15 per cent in the fifth financial year of total policies written direct in that year.
   ii. In respect of a general insurer:
      - 2 per cent in the first financial year.
      - 3 per cent in the second financial year.
      - 5 per cent thereafter, of total gross premium income written direct in that year.

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b. Social Sector (includes unorganized-sector, informal sector, economically vulnerable or backward classes, and other categories of persons, both rural and urban areas) in respect of all insurers.
   - 5,000 lives in the first financial year.
   - 7,500 lives in the second financial year.
   - 10,000 lives in the third financial year.
   - 15,000 lives in the fourth financial year.
   - 20,000 lives in the fifth year.

In the case of government insurers, the quantum of insurance business to be done shall not be less than what has been recorded by them for the accounting year ended March 31, 2000.

IRDA relaxed stringent rural sector obligations in September 2002. It removed the strict rural sector definition that was acting as an impediment for new private sector insurance companies to meet their compulsory rural sector obligations. With this, the insurance companies will be allowed to follow the census of India style for identifying and tapping the rural business market. Henceforth, anything that is not urban will be rural.

	Population (in crore)		Percentage of
Census Year	Rural	Total	Rural to Total
1961	36.0	43.9	82.0
1971	43.9	54.8	80.1
1981	52.4	68.3	76.6
1991	62.9	84.6	74.3
1991 *	37.7	84.6	44.5

* As per IRDA. Source: The Economic Times, September 27,2002, p. 8.

Maintenance of Books of Accounts

The insurance companies and intermediaries are required to maintain their books of accounts and submit returns to IRDA as per the regulations prescribed in:

1. Preparation of Financial Statements and Auditor's Report of Insurance Companies Regulation, 2000.
2. Acturial Report and Abstract Regulations, 2000.
3. Assets, Liabilities and Solvency Margin of Insurers Regulations, 2000.
4. Insurance Surveyors and Loss Assessors (Licensing, Professional Requirements and Cede of Conduct) Regulations, 2000.
5. Investment Regulations, 2000 and Investment (Amendment) Regulations, 2001.

The public sector insurers have to switch to new regulations and requirements within a period of two years from the notification of these regulations.

Insurance Policyholders' Protection

In order to protect the interests of policyholders and build up their confidence in insurers, the institution of ombudsman has been set up. The Insurance Council is the administrative body of this institution and it has appointed 12 ombudsmen across the country. The insurance ombudsman is empowered to receive and con-sider written complaints in respect of insurance contracts on personal lines where the insured amount is less than Rs 20 lakh. The complaint can relate to:

a. Grievance against insurer.
b. Partial or total repudiation of claims by the insurer.
c. Dispute in regard to premium paid or payable in terms of the policy.
d. Dispute on the legal construction of the policy in so far as such dispute relate to claims.
e. Delay in settlement of claims.
f. Non-issue of any insurance document to customers after receipt of premium.

An ombudsman is entrusted with two functions—conciliation and award making. The awards passed by an ombudsman are binding on insurers and they are required to honor the awards within three months. The Insurance Ombudsman Scheme is complementary to the regulatory functions of IRDA.

IRDA has also proposed to set up two separate policy holder protection funds for general and life insurers. The insurers have been asked to contribute one per cent of their profits to the fund.

Exposure/Prudential Norms

IRDA has specified the exposure/prudential norms relating to investment. Every insurer shall limit his invest-ments based on the following exposure norms:

A. Exposure Norms

Type of Investment	Limit for Investee Company	Limit for the Entire Group to which the Investee Company Belongs	Limit for the Industry Sector to which the Investee Company Belongs
(a) Equity/Preference Shares / Convertible portion of Debentures at face value.	(1) As on any date-not exceeding 20% of the total capital employed:	(1) As on any date: Not exceeding 15% of the total capital employed* of the group companies.	
(b) Debentures- (face value) including privately placed non-convertible debentures (NCDs) and non-convertible portion of convertible debentures			Not exceeding 15% of the total capital employed* in all such companies.
(c) Short-/Medium-/Long-term Loans any other direct financial Assistance	(2) During the year-Not exceeding 5% of annual accretion of funds.	(2) During the year-not exceeding 10% of estimated annual accretion of funds.	

* Total capital employed means total of equity shares, preference shares, debentures, long-/medium-/short-term loans (excluding public deposits), free reserves but excluding revaluation reserves of the investee company, as shown in its last audited balance sheet.

B. Exposure Norms for Investment in Public Financial Institutions

Equity shares and Preference shares (at their face value).	Not exceeding 15% in general of the paid-up equity/ preference capital of the institution or the existing holding level, if higher.
Investment in Equity Capital, Bonds, Debentures, Term Loans.	Not exceeding 10% of the capital employed by an institution as per the last audited balance sheet.
Total Investment vis-a-vis Net Worth of the company.	Not exceeding 60% of the net worth of the institution.
Total Investment in a financial year.	75% of annual accretions.
Total Investments in all the Financial Institutions.	Annual aggregate financial assistance to all Development Financial Institutions put together in a single year shall not exceed 20% of the estimated annual accretions for the year.

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Note: Accretion of funds means investment income, gains on sale/redemption of existing investment and operating surplus.

C. Prudential Norms

The prudential norms for various instruments shall be as under:

Debentures: Norms for fully convertible debentures and partially convertible debentures: Investment decisions are related to attractiveness of equity shares to be received as a result of conversion.

Due consideration is also given to the factors, namely, rate of interest at the time of subscription to said debentures, appreciation, and dividend income to be received from the equity shares.

Similar considerations also apply for non-convertible debentures (NCDs) with detachable warrants attached to it.

Norms for non-convertible debentures and non-convertible debentures with warrants attached:

a. Working Capital Debentures: 20 per cent of the current assets, loans and advance minus outstanding amount of existing working capital non-convertible debentures.

b. Project Finance: As appraised by the Investment Committee.

c. Normal Capital Expenditure: As assessed by the Investment Committee.

Asset cover (as specified in Schedule Ill): First *paripassu* charge on fixed assets of the company offered as security with a minimum of 1.25 times including proposed borrowings (excluding revaluation of assets).

Debt-Equity Ratio (as specified in Schedule ill). Not to exceed 2: I including the proposed non-convertible debenture issue. However, in case of capital-intensive project debentures, higher ratio up to 4:1 may be considered.

Interest cover (as specified in Schedule III): Not less than 2 times for the latest year or on the basis of the average of the immediately preceding three years after including the interest on the proposed debentures at the applicable rate.

Dividend payout: Minimum dividend of 10 per cent in each of the two years out of the immediately preceding three years including the latest year.

Term Deposits and Loans with Non-Banking Companies

The insurer needs to place the deposits with a view to catering to working capital needs of the corporate sector. The placement of the deposit is to be decided after evaluating financial and non-financial assets of the performance parameters of the companies. The analysis needs to include study of financial position, track record, and other features such as quality of management, future prospects and market potential for the company's products. Credit rating of turnover should be uniformly maintained at a position which is indicative of a very strong financial position being not less than AA of Standard and Poor or equivalent rating of any other reputed and independent rating aging.

The maximum amount of short-term deposit that may be placed with any company is restricted to Rs 2 crore or 10 per cent of net worth whichever is less.

The various norms/parameters for the placement of term loans are as under:

Particulars	Limits
Unsecured borrowing as a Percentage of net worth	Not to exceed 25 per cent of net worth, including the proposed loan, subject to net worth of the borrowing company being not less than Rs 15 crore.
Interest cover	At least 2.5 times, including interest on proposed loans.
Debt/Equity Ratio	Not to exceed 2:1.
Current Ratio	Not less than 1.33:1.
Dividend Record	At least 10 per cent for the last 5 years or 15 per cent and above for 3 out of
	5 years.
Listing on an	Equity Shares of the company shall be listed on any recognised stock Exchange and the price should continuously be quoting above par at least for 12 months prior to the date of sanction of loan.
Collateral security	Cheques shall be obtained for principal and interest amount. Personal Guarantee of promoters and pledge of shares may be taken.

Infrastructure and Social Sector

In the case of projects/works in the infrastructure and social sector undertaken by a person other than a company, the norms indicated in the table above shall have to be met to the extent applicable.

Guidelines on Subscription to Preference Shares

They are:

a. Companies whose preference shares are selected for investment should have sound financial position and steady income earning capacity.

b. The dividend payable on the preference shares should be cumulative.

c. The preference shares shall be redeemable.

d. Preference capital after proposed issue shall not exceed 100 per cent of equity capital.

e. Dividend should have been paid on equity shares for two years out of immediately preceding three years.

f. Preference dividend should have been paid for 3 years or 3 out of 4 or 5 years, including latest 2 years if the preference shares are issued earlier.

g. Non-dividend paying preference shares should not be considered for investment.

h. Dividend cover on the basis of average profit of last 3 to 5 years should be 3 times.

Returns to be Submitted by the Insurer

Every insurer shall submit to IRDA the following returns within such time, at such intervals and verified/certified in such manner as indicated there against. These returns shall be in addition to those prescribed in Insurance Rules, 1999.

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Form No. as /Annexed to These Regulations	Short Description	Periodicity of Returns	Time limit for Submission	Verified/ Certified by
Form 1	Statement of Investment and income on investment	Yearly	Within 30 days from the date of Board approval of audited accounts	Principal Officer/Chief (Investment)
Form 2	Statement of Downgraded Investments	Quarterly	Within 21 days of the end of each quarter	Principal Officer/Chief (Investment)
Form 3A	Statement of Investment of Controlled Fund (Life)-Compliance Report	Quarterly	Within 21 days of the end of each quarter	Principal Officer/ Chief (Investments)
Form 3B	Statement of Investment of Total Assets (General)-Compliance Report	Quarterly	Within 21 days of the end of each quarter	Principal officer/ Chief (Investment)
Form 4	Prudential Investment Norms-Compliance Report	Yearly	Within 30 days from the date of Board approval of audited accounts	Principal Officer/ Chief (Investment)

IRDA may, by any general or special orders, modify or relax any requirement relating to the above. 'Principal Officer' means any person connected with the management of an insurer or any other person upon whom the Authority has served notice of its intention of treating him as the principal officer thereof.

Constitution of Investment Committee

Every insurer shall constitute an Investment Committee which shall consist of a minimum of two non-executive directors of the Insurer, the Principal Officer, Chiefs of Finance and Investment divisions, and wherever an appointed actuary is present, the Appointed Actuary. The decisions taken by the Investment Committee shall be properly recorded and be open to inspection by the Officers of the Authority.

International Presence of IRDA

IRDA is a member of the International Association of Insurance Supervisors, (IAIS) headquartered at Basel, Switzerland. The IAIS is an organisation set up by regulators and supervisors of insurance industry. The aims and objectives of the IAlS are to bring in prudential regulations, to prescribe guidelines for the insurance supervisors to observe the industry, to promote international co-operation and understanding among the supervisors, and to represent before world forums the cause of the insurance industry ailed the matter of its functioning and regulation. IRDA is a member of the Emerging Markets and Technical Committees. Its Chairman is also a member of the Accounting Sub-Committee and the Insurance Frauds Committee. IRDA is putting in efforts to bring the Indian insurance market to international standards in areas of financial viability, competence, technology and prudential regulations.

Health Insurance

There are three types of insurance-general, life, and health. In India, no company offers health insurance as a stand-alone product. Even after the opening up of the insurance sector there were no applications of companies to set up an exclusive health insurance business. The major impediment is the requirement of a minimum working capital of Rs 100 crore, which is considered to be too large for a stand-alone health insurance business.

Health Insurance, or Health cover, is defined in the Registration of Indian Insurance Companies Regulations, 2000, as the effecting of contracts which provide sickness benefits or medical, surgical, or hospital expense benefits, whether in-patient or out-patient, on an indemnity, reimbursement, service, prepaid, hospital or other plans basis, including assured benefits and long-term care.

IRDA has encouraged both life and general insurance companies, old and new, to go in for rider policies offering health covers. Many new companies have gone in for riders offering a variety of health products. Riders are add-on benefits attached to the main life policy. To attract players to health insurance, life insurance companies will have no cap on health riders. While the relaxation has been given on the health riders, the 30 per cent cap on the premium of the base policy continues for other riders.

Third Party administrators (TPAs) are distributors of insurance products in the health insurance sector. They facilitate the smooth operation of a health cover by acting as a link between the insurance companies and their clients and hospitals. IRDAhas set up the minimum cap of Rs 1 crore for TPAs. The Rs 300 crore health insurance sector is expected to jump to Rs 1,500 crore by 2005.

Reinsurance

In insurance, the insured transfers his risk to the insurer. This primary insurer transfers a part or all of the risks he has insured to another insurer to reduce his own liability (the risk that he has assumed). This is known as reinsurance. Reinsurance is primarily an insurance of risks assumed by the primary insurer known as the ceding company. This risk is shifted to another insurer known as the reinsurer. The ceding company may shift part or all of the insurance originally written to the reinsurer. The amount of the insurance retained by the ceding company for its own account is called the retention. Retention is the amount of risk that an insurer is prepared to take on his own account. The amount of the insurance ceded to the reinsurer is known as the cession. The proportion of risk to be retained by the ceding company depends on factors such as company's assets and investment income, portfolio of the risks premium levels, inflation, and reinsurance market conditions.

Reinsurance operates on the same principle as direct insurance, i.e., to spread sharing of risks as widely as possible. The insurers seek protection of their own risk by reinsuring with reliable reinsurers. Reinsurance evolved as a natural corollary to insurance. Reinsurance is used for several reasons:

- To increase the company's underwriting capacity which, in turn, would help to render improved service to the reinsured and expand the market.
- To spread the risks with as many insurers as possible.
- To obtain valuable advice and assistance with respect to pricing, underwriting practices, retention, and policy coverage.
- To stabilise profits by leveling out peak risks/losses.
- To provide protection against catastrophic losses arising due to natural disasters, individual explosions, airline disasters and so on.
- To retire from the business or class of business or territory.

The reinsurance business assumes greater importance in the event of war and natural calamities when the smaller insurance

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firms find themselves unable to take on the full risk due to their lower capital base.

Types of Reinsurance

There are two-types of reinsurance: (i) Facultative and (ii) Treaty.

Facultative reinsurance is a reinsurance in which the reinsurer can accept or reject any risk presented by the ceding company (insurance company seeking reinsurance). This means that it is not mandatory for the reinsurer to accept the cover and he will accept it after naming his price terms and conditions. The reinsurer has the freedom to reject sub-standard risks if it so desires. The reinsurer retains the flexibility to accept or reject each application for reinsurance. The ceding company also gets freedom in respect of the portions of the risk to be reinsured and the choice of the reinsurer. Before underwriting any insurance, the ceding company determines whether reinsurance can be obtained. It contacts several reinsurers and if a willing reinsurer is found, both (ceding company and reinsurer) enter into a valid contract. The ceding company must disclose full information relating to the risk concerned to ensure validity of the contract. Facultative insurance offers several advantages such as increasing flexibility and the underwriting capacity of the ceding company. It is frequently used when a large amount of insurance is to be written. It stabilises the insurer's profits by shifting large losses to the reinsurer. However, it creates a sense of insecurity, as the ceding company may not always be successful in insuring its business. This uncertainty leads to delay in the issue of policy.

Treaty reinsurance means the ceding company is obliged to cede and the reinsurer is obliged to accept an agreed share of all reinsurance of the type defined in the contract. Treaty insurance is automatic and certain as business that falls within the scope of the agreement is automatically reinsured, according to the terms of the treaty. The ceding company has not to shop around for reinsurance before the policy is written. This system is beneficial also to reinsurers as they are assured of a regular flow of business. However, reinsurers could incur losses if the ceding company writes bad business or charges inadequate rates.

Reinsurance Treaties Reinsurance treaties can be of different types such as quota-share treaty, surplus share treaty, excess of loss treaty, and reinsurance pool. Under a quota-share treaty, the ceding company and the reinsurer agree to share a fixed proportion of premium and losses. The ceding company retains for its own account a certain percentage of such risk. In other words, the ceding company's retention limit is stated as a fixed percentage. This treaty is popular among new and unknown insurers.

Under a surplus-share treaty, the reinsurer agrees to accept insurance in excess of the retention with the ceding company up to some maximum amount. The ceding company has complete discretion in respect. Eve retention. The ceding companies which are financially sound can afford to have substantial retentions. The premiums and losses are shared based on the fraction of total insurance retained by the ceding company and the reinsurer.

Under an excess-of-loss treaty, losses in excess of the retention limit are covered by the reinsurer up to some maximum limit. It is a blanket agreement where all the claims made on local companies, above a certain the limit, are reimbursed by the reinsurers. This treaty is useful for protection against catastrophic losses. At the beginning of every financial year, non-life insurance companies have to renew their excess of loss reinsurance in the international market.

A reinsurance pool is a pool of reinsurers who jointly underwrite insurance as it may not be possible for the single insurer alone to write large amounts of insurance.

The pricing and terms and conditions of reinsurance contract are based largely on the underwriting capacity as in the international market.

The two largest reinsurance companies Munich Re and Swiss Re, have combined stock market value ofi tnVi $50 bn (£33 bn) and are seen as bell-wethers for the reinsurance industry. Munich Re has its presence in India through two ventures with Paramount Healthcare who are in the business of third party administration and healthcare management.

Reinsurance Business in Life and General Insurance

Reinsurance of life insurance business is less complex as compared to general insurance business. The Life Insurance Corporation of India (LIC) has the financial strength and capacity to absorb risks fully. The number of life policies reinsured as well as the total sum of risk reinsured is quite insignificant.

The need for reinsurance is higher in case of general insurance as it involves complex risks. In the post- independence period, the Indian general insurers obtained the reinsurance cover from foreign reinsurance companies. This led to a drawing of foreign exchange. Hence, to maximise retention and to minimise the drain of foreign exchange, the general insurance business was nationalised.

In 2000, the outgo of premium money by way of reinsurance was around Rs 10 billion. In order to increase the retention of premia in India, the role of General Insurance Corporation of India (GIC) was reinforced as the official reinsurer by making an obligatory cession of 20 per cent of insurance business by the private insurance companies, written in India, to GIC.

IRDA has also issued regulations relating to both life and non-life reinsurance in 2000. To develop domestic reinsurance market capacity, IRDA stipulated that insurers should offer an opportunity to other Indian insurers to participate in facultative and treaty surpluses before placement of such cessions outside India.

Life Insurance-Reinsurance Regulations, 2000.

- Every life insurer shall draw up a program of reinsurance in respect of lives covered by him.
- The profile of such a program, which shall include the name(s) of the reinsurers with whom the reinsurer proposes to place business shall be filed with the Authority (IRDA) at least forty-five days before the commencement of each financial year, by the insurer. Provided that the Authority may, if it considers necessary, elicit from the insurer any additional information, from time to time, and the insurer shall furnish the same to the Authority forthwith.

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- The Authority shall scrutinise such a programme of reinsurance as referred to in sub-regulation (2) and may suggest changes, if it considers necessary, and the insurer shall incorporate such changes forthwith in his programme.
- Every insurer shall retain the maximum premium earned in India commensurate with this financial strength and volume of business.
- The reinsurer chosen by the insurer shall enjoy a credit rating of a minimum of BBB of Standard and Poor or equivalent rating of any international rating agency.

Provided that placement of business by the insurer with any other reinsurer shall be with the prior approval of the Authority, provided further that no program of reinsurance shall be on original premium basis unless the Authority approves such program. Provided further that no life insurer shall have reinsurance treaty arrangement with its promoter company or its associate/group company, except on terms which are commercially competitive in the market and with the prior approval of the Authority, which shall be final and binding.

Every insurer shall submit to the Authority statistics relating to its reinsurance transactions in such forms as it may specify, together with its annual accounts.

Inward Reinsurance Business

1. Every insurer who wants to write inward reinsurance business shall adopt a well-defined policy for underwriting inward reinsurance business.
2. An insurer shall ensure that decisions on acceptance of reinsurance business are made by persons with adequate knowledge and experience, preferably in consultation with the insurer's appointed actuary.
3. An insurer shall file with the Authority, at least 45 days before the commencement of each financial year, a note on its underwriting policy indicating the clauses of business, geographical scope, underwriting limits, and profit objective.

IRDA has issued the necessary directions for the reinsurance programme of every insurer. They are:

1. The reinsurance programme of every general insurer, carrying on general insurance business, shall be guided by the following objectives, namely:
   - to maximise retention within the country.
   - to develop adequate capacity.
   - to secure the best possible protection for the reinsurance costs incurred.
   - to simplify the administration of business.
2. Every insurer shall offer an opportunity to other Indian insurers, including the Indian reinsurer to participate in its facultative and treaty surpluses before placement of such cessions outside India.
3. Insurers shall place their reinsurance business outside India with only those reinsurers who have over a period of the past five years enjoyed a rating of at least BBB (with Standard and Poor) or equivalent rating of any other international rating agency. Placements with other reinsurers shall require the approval of IRD A. Insurers may also place reinsurance with Lloyd's Syndicates after taking care to limit placements with individual syndicates commensurate with the capacity of the syndicate.
4. Surplus over and above the domestic reinsurance arrangements class-wise can be placed by the insurer independently subject to a limit of 10 per cent of total reinsurance premium ceded outside India being placed with anyone reinsurer. Where it is necessary to cede a share exceeding such limit to any particular reinsurer, the insurer may seek the specific approval of IRDA.

IRDA has constituted the Reinsurance Advisory Committee consisting of five persons having special knowledge and experience of business of reinsurance. The Reinsurance Advisory Committee has pegged the compulsory cession to the Indian reinsurer by the insurers carrying on general insurance business at 20 per cent subject to limits in fire, engineering, and energy business. Cessions in respect of public and product liability business have also been pegged at 20 per cent on quota share basis without any limits. The Committee has also specified commissions and profit commissions for each class of business besides outlining the procedures for maintenance and settlement of accounts. Profit commissions shall be applicable on the aggregate results of statutory cessions portfolio at the rate of 20 per cent.

The reinsurance market in India is estimated at Rs 1500-1800 crore, with mc having a 40 per cent share. The domestic insurance companies reinsure the remaining 60 per cent in the global market through a reinsurance broker. The largest domestic reinsurance clients include ONGC, IOC, Indian Airlines and Air India.

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LESSON 23:
INSURANCE SERVICES: REGULATORY FRAMEWORK - II

Lesson Objectives

- To understand the regulatory requirements of the insurance sector and role of IRDA in it.

Dear students, we continue our discussion from last session, on regulatory framework of insurance services in India.

Regulatory Framework in Respect of Insurance

Contract of insurance may be looked upon as a special type of contract between two parties called 'the insurer' and 'the insured'. In this contract 'the insurer', for a premium, undertakes to pay to the 'insured' a fixed amount of money on the happening of certain event. Since it is a contract, it has to satisfy or meet all the requirements of a valid contract laid down in section 10 of the Indian Contract Act 1872, which states that, "all agreements are contracts, if they are made by free consent of the parties, competent to contract, for a lawful consideration and with a lawful object and which are not expressly declared to be void." Therefore, like all other contracts a contract of insurance shall also meet the following requirements:

a. agreement (offer & acceptance)
b. free consent of the parties
c parties must be competent to contract
d. there must be lawful consideration
e. the object must be lawful
f. it should not be expressly declared to be void

Further, contract of insurance should be based on the principles of insurance, specifically speaking the legal principles of insurance discussed earlier. In India, the contract of insurance should further comply with provisions of the Insurance Act 1938, regulatory provisions of Insurance Regulatory & Development Authority Act, 1999 and the Indian Stamps Act 1899.

Insurance Act, 1938

The Insurance Act, 1938 contains important provisions relating to insurance sector/ service in the country. Important provisions are discussed briefly in the following pages.

Eligibility

Any class of insurers can carryon insurance business in India unless he is-

i a public company
ii a society registered under the Co-operative Societies Act. 1912
iii a body corporate incorporated outside India other than a private company.

Registration

i. Every person who is desirous of doing particular class of insurance business shall obtain a certificate of registration from the Authority.
ii. A person who is carrying on any class of insurance business in India, on or before the commencement of the IRDA Act. 1999 shall make an application for such resgistration within 3 months from the date of commencement of such Act.

Documents to be filed. Every application for registration shall be accompanied by the following documents.

i. A certified copy of the memorandum and articles of association.
ii. Name and address of the directors and their occupation.
iii. A statement of the class or classes of insurance business done or to be done. A certificate from RBI showing that the requisite amount required to be deposited u/s 7 has been deposited.
    a. In case of life insurance business a sum equal to I % of his total gross premium written in India not exceeding 10 crores.
    b. In case of general insurance business a sum equal to 3 % of his total gross premium written in India not exceeding Rs. 10 crores.
    c In case of re-insurance business a sum of Rs. 20 crores.
    d. In case of marine insurance Rs. 100,000 only.
iv. A declaration verified by on affidavit made by the principal officer of insurer authorised in that behalf that the requirement as to paid up equity capital or working capital have been complied with.
    a. In case of life insurance or general insurance paid up capital required is Rs. 100 crore.
    b. In case reinsurance business. Rs. 200 crore.
v. A certified copy of published prospectus and standard policy forms of the insurer, terms and conditions offered in connection with insurance policies, statements of the assured rates along with a certificate from the actuary certifying that such rates, terms and conditions are workable and sound. But in case of general insurance business other than motor car insurance and workman compensation, the above requirement should be complied with only if they are available.
vi. The receipt showing payment of fee of Rs. 50,000 for each class of business.

Grant of Certificate. After satisfying itself as to the soundness of the management of the applicant, volume of its business, adequacy of the earning prospects and that the interest of the public would be served and all other requirements of registration are complied with the Authority may register the applicant and grant a certificate of registration.

Cancellation of Registration. The Authority may cancel the registration of an insurer if he fails to comply with requirements of deposits with RBI, transfer his business, contravenes

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any requirement of the Insurance Act, do not pay any claim within 3 months of final court judgment or defaults in complying any of the provisions of UC Act/GIC Act/ Companies Act/FEMA.

Renewal of Registration. The insurer has to file an application for renewal before 31st December of preceding year along with evidence of payment of requisite fee.

Fee. Fees may vary according to total gross premium written direct in India during the proceeding year of application subject to 1/4th percent of such premium income or Rs. 5 crore' whichever is less, and a minimum of Rs. 50,000 for each class of business. In case of reinsurance business, the total premium in respect of reinsurance accepted by him in India would be taken into account instead of total gross premium written direct in India. The authority may impose penalty in case application is not filed within the specified date.

Capital Requirement. The capital of life insurance companies should consist of only ordinary shares each of which has a single face value. The paid-up amount should be same for all shares whether existing or new. The company should maintain a register of shareholders containing their names, addresses. IRDA's approval is required if the holding of transferee company is likely to exceed 2.5% or 5% of paid up capital or where nominal value of shares exceeds 1% of the paid up capital of the insurance company.

Financial Statements. Every insurer is required to prepare a balance sheet, a profit and loss account, a receipts and payments account, a revenue account at the end of each financial year in accordance with regulations of IRDA Act in respect of financial statements. Separate funds accounts of shareholders and policy-holders should be maintained.

Investigation by Actuary. Every insurer who is carrying on life insurance business should get the investigation, done by an actuary, into financial conditions including a valuation of liabilities. An actuary should submit his report in the form of an extract made in accordance with the manner specified by the IRDA. A statement in prescribed form and manner should be appended to every such abstract at least once every three years.

Insurance Business in Rural/Social Sector. The Insurance Act, 1938 requires all insurers to undertake such % age of their insurance business including insurance for crops, in the rural social sector as specified by the IRDA. Also they should provide life/general insurance services in the form of policies to

1. the persons residing in the rural sector;
2. working in the unorganised sector;
3. economically weaker/backward classes of society;
4. to other categories as specified by the IRDA.

Registration of Principal/Chief/Special Agent(s). For an insurer to be a principal agent, chief agent or special agent it is necessary to get himself registered with IRDA. Principal agent is not an employee of the insurer. He performs administrative and organising functions for a commission, secures general insurance business, wholly or in part, through insurance agents on behalf of the insurer. The chief agent performs the same functions as are performed by principal agent. Special agent is a person who does not perform any administrative function but who procures insurance business for a commission.

Application has to be filed, in the prescribed form along with requisite fee of Rs. 25 for principal/chief agent and Rs. 10 for a special agent, to the IRDA. The certificate will be granted provided he fulfils the eligibility criteria. The certificate remains valid for 1 year after which it has to be renewed against the payment of a fee. The certificate may be cancelled if the principal agent/chief special agent fails to comply with or contravenes any of the eligibility criteria.

Regulation of Employment of Principal/Chief/Special Agents. Terms and conditions relating to the employment of principal agent as agreed between the insurer and the agent should be written down in writing. A copy of the contract, duly certified should be furnished by the insurer, to the IRDA within 30 days of entering into such contracts. The insurer must maintain a register containing the names, addresses, date of appointment in respect of principal agents and chief/special agents.

Similarly the contact between (i) a life insurer and a chief agent (ii) life insurer and special agent (iii) a chief agent and special agent should be in writing. A copy of the contract to be submitted within 30 days to IRDA. The contract remains valid for 10 years. The chief agent should maintain a register containing the particulars of special agents appointed by him.

Licensing of Surveyors and Loss Assessors. Any person who is desirous of acting as a surveyor/loss assessor in respect of general insurance business can apply to IRDA by making payment. The licence is valid for 5 years and has to be renewed again for 5 years against a payment as specified by IRDA not exceeding Rs. 200. The applicant should fulfill any of the following criteria in order to be eligible:

i. has practised as a surveyor/loss assessor;
ii. holds a degree in any branch of engineering of a recognized university;
iii. be a fellow/associate member of ICW A/ICAI ;
iv. possess actuarial qualifications/hold a degree or diploma of any recognised university/institute in relation to insurance;
v. hold a diploma in insurance granted/recognised by the government;
vi. possess such other technical qualifications as may be specified by the IRDA.

If the holder of licence makes any false statement with regard to the eligibility or suffer from any of the disqualifications mentioned above, then his licence may be cancelled by authority. IRDA has laid down code of conduct to be followed by the surveyors/loss assessors.

The IRDA, Act

The Insurance Act, 1938 provided comprehensive regulation of the insurance business in India. It created a powerful supervisory authority in the Controller of Insurance. The Controller of Insurance had the powers to direct, advice, caution, investigate, inspect, search, seize, amalgamate, authorise, register and liquidate insurance companies. However after the nationalisation of life insurance, in 1956 and General Insurance

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in 1972, the applicability of these provisions was extremely diluted. Due to nationalisation, most of the powers of the Controller of Insurance got vested in the LIC and GIC.

In 1993, Govt. of India, with a view to examine the structure of the Insurance industry and to recommend changes to make it more competitive and efficient, in the light of structural changes in the other segments of the financial system, appointed a committee under the chairmanship of former Governor of Reserve Bank of India, Sh. R.N. Malhotra. The committee submitted its report, in January 1994. It recommended setting up of an independent Insurance Regulatory Authority on the lines of Securities and Exchange Board of India. The Govt. accepted the recommendation and in January 1996 established an interim Insurance Regulatory Authority. In 1999 the bill titled as Insurance Regulatory and Development Authority Bill 1999 was introduced in the parliament along with three schedules containing the amendments to the Insurance Act, 1938, Life Insurance Corporation Act, 1956, and General Insurance Business, (Nationalisation Act, 1972). After discussion and debate the Bill became an Act known as Insurance Regulatory and Development Authority (IRDA) Act, 1999.

The Salient Features Of IRDA, Act

Following are the salient features of the Act:

1. Act to Establish the Regulatory Authority

The preamble of the Act states that it is, "An Act, to provide for the establishment of an authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the Insurance Industry and for matters connected there with or incidental thereto." It is clear from the preamble that the Act is to establish authority which will:

a. Protect the interests of holders of insurance policies;

b. Regulate, promote and ensure orderly growth of Insurance Industry;

c and other matters which may be connected with or incidental to the above mentioned purposes.

Section 3 of the Act, ,provides that the authorities shall be a Body Corporate with the name "The Insurance Regulatory Authority". It also provides that it , shall have the perpetual' succession and a common seal. Subject to the Act, it shall have the power to acquire, hold and dispose of the property both movable and immovable. It shall have contractual authority as well as power to sue and be sued.

2. Composition of Authority

Section 4 of the Act, lays down the Composition of the Authority to be as follows:

The Authority shall consist of the following members, namely:

a. a Chairperson; ,

b. not more than five whole-time members;

c not more than four part-time members;

to be appointed by the Central Government from amongst persons of ability, integrity and standing who have knowledge or experience in life insurance, general insurance, actuarial science, finance, economics, law, accountancy, administration or any other discipline which would, in the opinion of the (Zentral Government, be useful to the Authority.

Provided that the Central Government shall, while appointing the Chairperson and the whole-time members, ensure that at least one person each is a person having knowledge or experince in life insurance, general insurance or actuarial science, respectively.

The Chairman and every other whole time member shall hold an office for a term of five years from the date of his joining and shall be eligible for reappointment. The age of retirement for whole time members is sixty two years and for the Chairperson sixty five years. Similarly, there can be part time members.

The Chairman and the whole time members are barred from taking up an employment within two years from leaving the office under Central Govt., State Govt. or an insurance company except with the approval of the Central Govt.

3. Insurance Advisory Committee

Section 25 of the Act provides that an Insurance Advisory Committee consisting of not more than twenty five members (including ex-officio) wilt be constituted. The members will represent the interest of commerce, industry, transport, agriculture, consumer forum, surveyers, agents, inter-mediaries, organisations engaged in safety and loss prevention, research bodies and employees' association of the Insurance sector. The Chairperson and the members of the Authority shall be ex officio members of the committee.

The Authority in consultation with the committee can make regulations to achieve its objectives. In exercise of this authority IRDA has framed a number of regulations. The salient features emerging out of these regulations are discussed in -subsequent parts.

4. Ending the Monopoly of LIC and GIC

Section 30, 31, & 32 of the IRDA Act have amended certain provisions of the Insurance Act, 1938, LIC Act of 1956 and the General Insurance Business (Nationalisation) Act, 1972 in line with First, Second and third schedule of the Act.

These amendments have ended the exclusive privilege of LIC, GIC and its subsidiaries to carry on life and general insurance business respectively. Thus, it has allowed the entry of private sector into life and non-life insurance.

5. The Insurance Business Opened to Indian Companies Only

The business has been opened to Indian Companies only. The Indian Company for the purpose has been defined by Section 2 of the Insurance Act, 1938, as follows.

An Indian insurance company has been defined in Section 2 as an insurer being a company:

a. formed and registered under the Companies Act, 1956;

b. in which the aggregate holdings of equity shares by foreign company either by itself or through its subsidiary companies or nominees do not exceed 26 % of paid up equity share capital of such Indian Insurance Company;

c The sole purpose is to carry on life insurance or general insurance or re-insurance business.

As per Clause 11 of the IRDA (Registration of Indian Insurance Companies) Regulations 2000, the quantum of paid up equity capital held by the foreign company either by itself or

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through its subsidiary company or its nominees, foreign investors, non- resident Indians, overseas corporate bodies and multinational agencies will be considered for determining 26 % of the paid up equity capital held by the foreign company.

6. Registration

Section 3 of the Insurance Act, 1938 read with IRDA (Registration of Indian Insurance Companies) Regulations, 2000 provide that any applicant desirous of carrying on Insurance business in India shall make a requisition for registration application in Form IRDA/RI. The applicant shall make a separate requisition for registration application for each class of business of insurance i. e. life insurance business consisting of linked business, non-linked business or both, or general insurance business including health insurance business.

The applicant shall be an Indian insurance company who shall submit along with the application:

i. certified copy of the memorandum and articles of association;

ii. names, addresses and occupations of the directors and principal officer;

iii. a statement of class(es) of insurance business proposed to be carried on;

iv. a statement indicating the sources that will contribute the share capital.

The authority on being satisfied may accept the application. In case if it rejects, the applicant may be given reasonable opportunity to represent his case. Alternatively, he may approach the authority with fresh request for registration after a period of two years from the data of rejection with a new set of promoters.

An applicant whose requisition for registration application has been accepted by the Authority shall make an application in Form IRDA/R2 for grant of certificate of registration. The application shall be accompanied by:

a. documentary proof evidencing the making of deposit under Section 7 of Act;

b. evidence of having paid up equity capital of Rs. 100 crores or more in case of life insurance or general insurance business;

c. evidence of having paid up equity capital of Rs. 200 crores or more in case of reinsurance business;

d. an affidavit by the principal officer and the promoters of the applicant certifying that the requirements of paid up share capital and deposits referred in Section 6 and 7 have been satisfied. Principal Officer means any person connected with the management of the applicant or any person upon whom the Authority has served notice of its intention of treating him as the principal officer thereof;

e. a statement indicating the distinctive numbers issued to each promoter and shareholder in respect of share .capital of the applicant;

f. an affidavit by the Principal Officer and the promoters of the applicant certifying that paid up equity capital of the foreign company does not exceed 26 %.

g. a certified copy of the published prospectus, if any;

h. a certified copy of the standard forms of the insurer and statement of assured rates, advantages, terms and conditions to be offered in connection with the insurance policies together with a certificate by an actuary in case of life insurance business that such rates, advantages, terms and conditions are workable and sound;

i. a certified copy of the memorandum of understanding entered into between the Indian promoters and the foreign promoters;

j. original receipt showing payment of fee of Rs. 50,000/- for each class of business. This fee shall be remitted by a bank draft issued by any scheduled bank in favor of the Insurance Regulatory and Development Authority payable at New Delhi;

k. a certificate from a practicing Chartered Accountant or practicing Company Secretary certifying that all requirements relating to registration fees, share capital, deposits and other requirements of the Act have been complied with.

The Authority shall consider the following matters before grant of a certificate to the applicant:

i. record of the performance of each of the promoters in the fields of business/profession they are engaged in;

ii. record of performance of the directors and persons in management of the promoters;

iii. capital structure.

iv. nature of insurance products;

v. extent of obligations to provide life insurance or general insurance policies to persons residing in rural sector, workers in unorganized sector, informal sector or economically vulnerable or backward classes of the society;

vi. organisation structure;

vii. the planned infrastructure including branches in rural areas to effectively carry out insurance business;

viii. the level of actuarial and other professional expertise with the management.

The Authority will grant a certificate of registration in IRDA/R3 and shall give preference to those applicants who propose to carry business of providing health cover to the individuals. An existing Insurance Company i.e. Life Insurance Corporation of India, General Insurance Corporation of India, its four subsidiaries will also require registration under the Act. It shall make an application within three months of the commencement of IRDA Act, 1999.

7. Renewal of Registration

An insurer who has been granted a certificate shall make application in Form IRDA/R5 for renewal of certificate before the 31st of December each year and such application shall be accompanied by evidence of payment of fee which shall be higher of the following:

a. Rs. 50,000/- for each class of Insurance business and

b. One fourth of one percent of total gross premium written direct by an insurer in India during the financial year proceeding the year in which the application for renewal is

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required to be made or Rs. 5 crore whichever is less (in case of general or life insurance business).

8. Capital Adequacy Requirement

Any Insurance company carrying the business of life insurance, general insurance or re-insurance shall not be registered unless it has paid up equity capital of Rs. 100 crores in case of a person carrying life insurance or general insurance business and a paid up equity capital of Rs. 200 crores in case of a Company carrying business exclusively as reinsurer.

In terms of section 6AA of the Insurance Act, 1938, a promoter shall not at any time hold more than 26% of the paid up equity capital in an Indian insurance company. In case where it holds more than 26%, it shall divest in a phased manner the share capital in excess of 26 % after the period of ten years from the date of commencement of business.

9. Deposits

Section 7 of the Act provides that an insurance company shall in respect of the insurance business carried by it in India deposits and keep deposited with the Reserve Bank of India either cash or approved securities.

a. In the case of life insurance business, a sum equivalent to one percent of his total gross premium written in India in any financial year and not exceeding Rupees ten crores.
b. In the case of general insurance business, a sum equivalent to three percent of his total gross premium written in India in any financial year not exceeding Rs. ten crores.
c. In case of re-insurance business, a sum of Rupees twenty crores.

If at any time, any part of the deposit is used in discharge of any liability of the insurer, the insurer shall deposit such additional sum in cash or approved securities estimated at the market value of the securities on the day of deposit or partly in cash and partly in such securities to make good the amount so used. This deposit shall be deemed to be a part of the assets of the insurer and shall not be susceptible to any assignment or charge nor shall it be available for discharge of any liability of the insurer other than liabilities arising out of policies of insurance. It shall also not be liable to attachment in execution of any decree except a decree obtained by a policy- holder.

10. Accounts and Balance Sheet

Section 11 of the Insurance Act, 1938 provides that an insurance company shall at the -expiry of each financial year, prepare:

a. Balance sheet in accordance with the regulations and form set in Part I and Part II of the first schedule.
b. Profit and Loss Account in the regulations and form set forth in second schedule.
c. A Revenue Account in respect of each class of Insurance business in accordance with the regulations and form set forth in third Schedule.
d. Receipt and payments Account.

A Life Insurance Company carrying insurance business shall in each year cause an investigation to be made by an actuary into the financial condition of the life insurance business carried by the Company including valuation of its liabilities and shall cause an abstract of the report of such actuary to be made. Actuarial Report and abstract shall be made in accordance with the regulations and requirements in conformity with fourth schedule. The abstract of the report shall be made in the manner specified by the IRDA (Actuarial Report) Regulations, 2000.

Besides this, an Insurer carrying life insurance or general insurance business shall comply with the requirements of schedule A or schedule B of the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. The accounts and statements will be signed by the chairman, if any and two directors and the principal officer of the company and will be accompanied by a statement containing the names, description and occupations of and the directorships held by persons in charge of the management. The audited accounts, statements and the abstracts shall be printed and four copies shall be filed with the Authority within six months.

11. Investment of Assets

Section 27 provides that the Authority shall in the interest of policy holders, by means of regulations, specify the time, manner and conditions of investments of assets in the infrastructure and social sector. Under the new norms at least 50% of the funds will be parked in the government securities and insurers can invest up to 20 % of their funds in corporate debts in addition to 15 % in market investment. Infrastructure has been included in the social sector, where companies have to mandatorily invest at least 15% of their funds.

Infrastructure facility means:

i. road, highway, bridge, airport, port, railways, road transport systems, water supply project, irrigation project, industrial, parks, water treatment systems, .sanitation and sewage. systems;
ii. generation or distribution or transmission. of power;
iii. telecommunication;
iv. housing project;
v. any other public facility of a similar nature.

An insurer shall not directly or indirectly invest outside India, the funds of the policy holders.

12. Insurance Business in Rural or Social Sector

In terms of Section 32B and Section 32C, every insurance company shall discharge the obligations to provide life insurance or general insurance policies to the persons residing in the rural sectors, workers in the unorganized or informal sector or for economically vulnerable or backward classes of society and other categories of persons as may. be specified by regulations made by the authority and such insurance policies shall include insurance for crops. The Regulatory Authority has issued the IRDA (Obligations of Insurer to Rural or Social Sector) Regulations, 2000. Rural sector has been defined as any place which as per the latest census has a:

i. a population of not more than five thousand;
ii. a density of population is not more than 400 persons per sq. km.;

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iii. at least seventy-five percent of the male working population is engaged in agriculture.

"Social sector" includes unorganized sector, informal sector. economically vulnerable or backward classes and other categories, both in rural and urban areas.

"Unorganized sector" includes self-employed workers such as agricultural labourers, bidi workers, carpenters, construction workers, fishermen, handicraft artisans, khadi workers, lady tailors etc.

"Economically vulnerable or backward classes" means persons living below the poverty line.

Every insurer carrying on insurance business shall undertake to perform:

a. the following obligations in the rural sector
   i. In case of life insurer
      - 5 % in the first financial year
      - 7 % in the second financial year
      - 10% in the third financial year
      - 12 % in the fourth financial year
      - 15% in the fifth financial year of total policies written direct in that year.
   ii. In respect of a general insurer
      - two per cent in the first financial year
      - three per cent in the second financial year
      - five per cent thereafter, of total gross premium income written direct in that year.

b. Social sector, in respect of all insurers:
   - 5000 lives in the first financial year
   - 7500 lives in the second financial year
   - 10,000 lives in the third financial year
   - 15,000 lives in the fourth financial year
   - 20,000 lives in the fifth financial year

13. Power of investigation and Inspection

The Authority may by. an order direct any person to investigate the affairs of the insurer and to report to it. It may take the services of auditor or-actuary for the purpose of assisting him in any investigation. The authority on receipt of the report may require the insurer to take such action in respect of any matter arising out of the report or cancel the registration of the insurer or direct any person to apply to the court for the winding of the insurer.

14. Limitation of Expenditure on Commission

The insurer shall not pay to an insurance agent by way of remuneration or commission in respect of any policy of life insurance, an amount exceeding:

a. where the policy grants an immediate annuity or a deferred annuity in consideration of a single premium, 2% of that premium;

b. where the policy grants a deferred annuity in consideration of more than one premium, 72 per cent of first year's premium and 2% of each renewal premium payable on the policy;

c. In any other case, 35 % of the first year's premium, 72 per cent of the second and third year's renewal premium and thereafter five per cent of each renewal premium payable on the policy;

d. where the policy relates to fire, marine or misc. insurance, total commission paid shall not exceed 15% of the premium payable on the policy.

15. Licensing of Insurance Agents

Section 42 of the Insurance Act, 1938 read with the IRDA (Licensing of Insurance Agents) Regulations, 2000 provides that any person desiring to obtain a licence to act as an insurance agent or as a composite insurance agent shall make an application to the designated person in form IRDA-Agents-V A, if the applicant is an individual and in Form IRDA-Agents~ VC, if the applicant is a firm or company. The regulations have defined the term 'person' as

i. an individual -

ii. a firm

iii. a Company, formed under the Companies Act 1956 and includes a banking company.

A designated person is an officer-in-charge of marketing operations as specified by the insurer and authorized by the Authority to issue or renew licences under these regulations. Insurance agent is a person who receives payments by way of commission or any other remuneration in consideration of his soliciting or procuring insurance business including business relating to the continuance, renewal or revival of the policies of insurance.

An applicant desirous to be composite insurance agent will have to submit two separate applications. Composite Insurance Agent is a person who holds a licence to act as an insurance agent for a life insurer and general insurer. The designated person may on receipt of application along with a fee of Rs. 250/-satisfy himself that the applicant possesses:

a. Requisite qualification. He should have a minimum qualification of 12th standard pass or equivalent examination where the applicant resides at a place with a population of five thousand or more as per the last census. In cases where the applicant resides in any other place, the qualification shall be 10th standard or an equivalent examination.

b. Practical training. Practical training includes orientation particularly in the area of insurance sales, service and marketing through training manuals as approved by the Authority. The applicant should have completed from an approved institution at least 100 hours practical training in life or general insurance business. It may be spread over three to four weeks. In case of composite insurance business, the applicant shall have completed from an approved Institution, at least 150 hours practical training which may be spread over six to eight weeks. Approved Institution is an institution engaged in education and/or training particularly in the area of insurance sales, service and marketing approved and notified by the Authority.

Where the applicant happens to be an Associate/fellow member of the Insurance Institute/C.A. Institute/C.S.

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Institute / ICW A Institute or MBA or any other qualification recognized by the Central Government or State Government, the applicant should have completed at least 50 hours of practical training from an approved institute and in case of composite insurance agent he shall have completed at least 70 hours of practical training in cases.

c. ***Examination.*** The applicant has passed the pre-recruitment examination in life or general insurance business conducted by the Insurance Institute of India, Mumbai or any other examination body. Examination Body means an institute which conducts pre-recruitment test for insurance agent and which is duly recognized by the Authority.

d. has furnished the application completed in all respects.

e. has the requisite knowledge to solicit and procure insurance business and

f. is capable of providing necessary services to the policyholders.

In case of corporate agents, all directors of the company or in a finn, all its partners must possess the requisite qualifications, practical training and should have passed examination. Licence issued shall remain in force for a period of three years and may be renewed for a further period of three years at anyone time.

The functions of an insurance agent shall include:

- identify himself and the insurance company of which he is an agent, disclose his licence to the prospect. Prospect means a potential purchaser of an insurance product,
- disseminate information in respect of insurance products offered for sale,
- disclose the scales of commission in respect of the insurance product to the prospect,
- indicate the premium to be charged by the insurer. Premium is theprice for the risk undertaken by the insurers,
- explain to the prospect the nature of information required in the proposal form by the insurer,
- bring to the notice of insurer any adverse habits or income inconsistency of the prospect through a report called insurance agent confidential report,
- inform promptly the prospect about the acceptance or rejection of the proposal by the insurer,
- to render necessary assistance to the policyholders or claimants in complying with the requirements for settlement of claims. .

The provisions relating to qualifications, practical training and examination shall not apply to existing agents. Notes to Form V A provide that an insurance agent shall work exclusively for one insurance company i.e. for one life insurer. one general insurer or both. However, the application form of a corporate insurance agent does not specify any such limitation. Section 42 of the Insurance Act, 1938 prescribes certain disqualifications for an insurance agent:

a. the person is minor;

b. the person is of unsound mind;

c. guilty of misappropriation;

d. he does not possess prescribed qualifications and practical training;

e. has not passed examination as specified by the Authority;

f. violation of code of conduct.

Every insurance company employing insurance agents shall maintain a register disclosing the name and address of every agent appointed by him, the date of appointment, date of cessation of appointment.

16. Issue of Licence to Insurance Intermediary

Section 42D of the Act provides that the Authority shall have the power to issue licence to other intermediaries in the insurance segments and this licence will be valid for a period of three years. The Insurance Regulatory and Development Authority have framed draft broker regulations: Insurance brokers will be regulated in the following areas: -

- registration,
- experience, training and qualification and othe;r restrictions on entry into the, profession,
- solvency requirements,
- professional indemnity or a minimum level of errors.

There is also a central fund to protect clients against broker malpractice.

a. ***Categories of Brokers.*** Clause 2(d) defines an Insurance broker as a person to whom licence has been granted by the authority to act as an insurance broker. The regulations have classified the insurance broker into four categories. Category lA shall be Direct General Insurance Broker engaged in insurance business but not reinsurance business. Category 1 B shall be a Direct Life Insurance Broker engaged in life insurance business but not in reinsurance business. Category II shall be a Reinsurance Broker while Category III shall be a Composite Broker whose functions will include Direct Insurance Broker and Reinsurance Broker. Category IV shall be an insurance consultant for risk management consultation.

b. Functions of General and Life Insurance Broker.

- Obtaining detailed knowledge of the client's business and philosophy.
- Maintaining clear records of the client's business.
- Provision of providing technical advice to the client and advise on developments in insurance market and law.
- Maintaining a detailed knowledge of available markets.
- Selection and recommendation of an insurer or group of insurers.
- Negotiating with insurer on the client's behalf.
- Acting promptly on client's instructions and providing written acknowledgements and progress report.
- Collecting and remitting premiums and claims.
- Provide insurance consultancy services, risk management services.
- Assisting in the negotiation of claims.
- Maintaining precise records of past claims.

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c. Criteria for Grant of Licence. The Authority while examining the application for grant of licence shall, *inter alia*, consider the following: -

a. the infrastructure of the applicant include adequate office space, equipment and manpower to effectively discharge his activities.

b. the applicant in his employment a minimum of two persons who have the experience to conduct the business of insurance broker;

c. the applicant has minimum of two Directors possessing:

i. A minimum qualification of an Associate of the Insurance Institute of India or equivalent or any professional qualification from the institutions recognized by the Government in finance, law, engineering or business management.

ii. Practical training for specified period conducted by the National Insurance Academy, Pune. .

d. Capital adequacy requirement.

The draft regulations also specify capital adequacy requirement of the applicants seeking grant of licence.

Application for licence will be made in form B as mentioned in the draft regulations. The applicant shall on grant of licence be liable to pay fee to the Authority in accordance with the Schedule II of these regulations. A licence granted to an insurance broker, in terms of these regulations shall remain valid for a period of three years from the date of issue thereof.

d. Cancellation of Licence. A licence of an insurance agent may be cancelled if the insurance agent suffers from any disqualifications mentioned in section 42(4) of the Act. His licence and the identity card issued will be recovered from him by the designated person.

e. Code of Conduct. Every insurance agent shall:

a. identify himself and the insurance company of whom he is an insurance agent;

b. disclose his licence to the prospect on demand;

c. disseminate the requisite information in respect of insurance products offered for sale by his insurer and take into account the needs of the prospect while recommending a specific insurance plan;

d. disclose the scales of commission in respect of the insurance product offered for sale, if asked by the prospect;

e. indicate the premium to be charged by the insurer for the insurance product offered for sale;

f. explain to the prospect the nature of information required in the proposal form by the insurer, and also the importance of disclosure of material information in the purchase of an insurance contract;

g. bring to the notice of the insurer any adverse habits or income inconsistency of the prospect, in the form of a report (called "Insurance Agent's Confidential Report") along with every proposal submitted to the insurer, and any material fact that may adversely affect underwriting decision of the insurer as regards acceptance of the proposal, by making all reasonable enquiries about the prospect;

h. inform promptly the prospect about the acceptance or rejection of the proposal by the insurer.

i. obtain the requisite documents at the time of filling the proposal form with the insurer; and other documents subsequently asked for by the insurer for completion of the proposal;

j. render necessary assistance to the policyholders or claimants or beneficiaries in complying with the requirements for settlement of claims by the insurer;

k. advise every individual policyholder to effect nomination or assignment or change of address or exercise of options. as the case may be. and offer necessary assistance in this behalf, wherever necessary;

ii. No insurance agent shall,-

a. solicit or procure insurance business without holding a valid licence;

b. induce the prospect to omit any material information in the proposal form;

c. induce the prospect to submit wrong information in the proposal for all or documents submitted to the insurer for acceptance of the proposal;

d. behave in a discourteous manner with the prospect;

e. interfere with any proposal introduced by any other insurance agent;

f. offer different rates, advantages, terms and conditions other than those offered by his insurer;

g. demand or receive a share of proceeds from the beneficiary under an insurance contract;

h. force a policyholder to terminate the existing policy and to effect a new proposal from him within three years from the date of such termination;

i. have, in case of a corporate agent, a portfolio of insurance business under which the premium is in excess of fifty per cent of total premium procured, in any year, from one person (who is not an individual) or one organisation or one group of organisations ;

j. apply for fresh licence to act as an insurance agent, if his licence was earlier cancelled by the designated person, and a period of five years has not elapsed from the date of such cancellation;

k. become or remain a director of any insurance company;

iii. Every insurance agent shall with a view to conserve the insurance business already procured through him, make every attempt to ensure remittance of the premiums by the policyholders within the stipulated time, by giving notice to the policyholder orally and in writing.

f. Remuneration of Brokers. Clause 15 provides for remuneration to be paid to brokers. According to it, the remuneration to brokers will be determined by market forces except in case of life and non life insurance who will

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be paid by way of brokerage an amount not exceeding 17.5 % of the premium payable on the policy. The brokerage levels prescribed may not, work in case of life' insurance brokers as here the policy continues for a certain number of years. The broker should be given brokerage as certain percentage of premium of first year and percentage on renewal premium also. The code of conduct as provided in the regulations provide that the broker must disclose all the fee or charges (not commission) which he proposes to charge from the client which will be in addition to the insurance premium. The broker shall advise the client in writing of the insurance premium, any fee or charges separately and the purpose related to services.

g. Segregating Insurance Money. Clause 17 of the draft regulations provide that every insurance broker must treat all money received from or on behalf of insured as insurance money and that this shall be kept in a Insurance Bank Account with one or more approved scheduled banks. The broker shall ensure that all money received for or on behalf of insured is paid to the Insurance Bank Account and will remain there until it is passed on to the Insurance company. The insurance broker shall only remove from the insurance bank account, charges, fees to commission and interest received from any funds comprising the account. The regulations, however, are silent on the time frame within which the funds ought to be transferred from the Banker's Insurance Bank Account' to the Insurance Company.

h. Solvency Requirement. The Insurance broker shall throughout the licence period maintain an excess of the value of assets over the amount of liabilities as solvency and shall vary according to the category of licence.

The insurance broker is required to furnish to the Authority the statement certified by the auditor that solvency requirement has been maintained.

i. Professional Indemnity Insurance. Every Insurance broker shall take out and maintain a professional indemnity insurance cover throughout the validity of the period of licence granted by the Authority. This cover must indemnify the insurance broker. For instance; the Composite Insurance Broker will have to take a cover equivalent to four times of brokerage and fees in a year subject to minimum limit of Rs. 6.00 crores. The brokers will be under obligation to maintain books of accounts, records, documents, i.e. book ledger, client ledger bank accounts, brokerage note etc. He shall prepare the balance sheet, profit and loss account, statement of fund flow which will be submitted to the Authority along with the auditor's report within 90 days of the close of the accounting year. The Insurance Broker shall furnish to the Authority un-audited financial results within 30 days of the close of the half year.

Besides this, the Authority has the right to inspect/suspend/ cancel the licence, hold an enquiry before suspension, issue show-cause notices and orders levy penalties etc.

17. Tariff Advisory Committee

Section 64U provides that a Tariff Advisory Committee shall control and regulate the rates, advantages, terms and conditions that may be offered by that insurer in respect of general insurance business.

This Tariff Advisory Committee shall consist of members including chairman of the Authority, a senior officer of the office of the authority nominated to be as vice chairman of the committee and not more than 14 representatives of the insurance companies.

18. Licensing of Surveyors and Loss Assessors

Section MUM provides that a person shall not act as surveyors or loss assessors in respect of general insurance unless he holds a valid licence issued to him by the authority. Every person who attempts to act as a surveyor or loss assessor shall have to make an application to the authority and licence will be issued to him for a period of five years.

No claim in respect of a loss which has occurred in India which exceeds Rs. 20,000 in value or any policy of insurance shall be admitted in payments by 'the insurer, unless he obtains report on the loss from a person who holds the licence to act as a surveyor or loss assessor.

19. Sufficiency of Assets (Section 64 VA)

An insurer shall maintain, at all times an excess of assets over its liabilities of not less than the amount in case of an insurer carrying general insurance business, the solvency margin shall be the highest of the following:

a. fifty crores Rupees (Rs. one hundred crores in case of reinsurer): or

b. a sum equivalent to 20% of net premium income: or

c a sum equivalent to 30% of net incurred claims.

Net incurred claims means the average of net incurred claims during the specified period, not exceeding three proceeding financial years.

20. No Risk to Assume Unless Premium Received in Advance An insurance company shall not assume any risk in respect of any insurance business of which premium payable is received by him or is guaranteed to be paid by a person within such time or unless and until deposit of such amount is made in advance in the prescribed manner. Risk may be assumed not earlier than the date on which premium has been paid in cash by the insurer. Where the premium is tendered .by means of postal money order or cheque sent by post, risk may be assumed on the date on which money order is booked or cheque is posted.

21. Reinsurance

If the insurers find that they have entered into a contract of insurance which is an expensive proposition for them or if they wish to minimize the, clearances of any possible loss, without at the same time, giving up the contract, resort is to have reinsurance. It is basically the practice of insuring again. The Company with which the public insurer is called a direct or ceding office and the Company accepting business from ceding office is called a reinsurer.

So, today we end our discussion here. You come prepared after studying the next chapter, which continues our discussion on regulatory framework of insurance services in India.

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LESSON 24:
INSURANCE SERVICES: REGULATORY FRAMEWORK - III

Lesson Objectives

- To understand the regulatory requirements of the insurance sector and role of IRDA in it.

Dear students, we continue our discussion on regulatory framework in this session also.

Irda (Life Insurance Reinsurance) Regulations, 2000

The Insurance Regulatory and Development Authority Act, 1999 in consultation with the Insurance Advisory Committee has made following regulations with regard to life insurance-reinsurance business.

A. Procedure to be Followed for Reinsurance Arrangements Draw Programme

i. Every life insurer shall draw up a programme of reinsurance in respect of lives covered by him. The programme shall include the names of the programme shall be filed with the Authority, at least 45 days before the commencement of each financial year.

ii. ***Authority's powers***. (a) The authority may seek any additional information from the insurer, and the insurer shall furnish the same. (b) The Authority may suggest changes, if it considers necessary, and the insurer shall have to incorporate such changes in his programme.

iii. ***Credit rating***. The re-insurer shall have a credit rating of a minimum of BBB of Standard and Poor or equivalent rating of any international agency.

iv. ***Premium.*** Every insurer shall retain the maximum premium earned in India commensurate with his financial strength and volume of business.

v. ***Filing of statistics.*** Every insurer shall submit to the Authority statistics relating to its reinsurance transactions in such form as it may specify, together with its annual accounts.

B. Inward Reinsurance Business

i. Every insurer who wants to write inward reinsurance business shall adopt a well-defined underwriting policy for underwriting inward reinsurance business.

ii. An insurer shall file with the Authority, at least 45 days before the commencement of each financial year, a note on its underwriting policy indicating the clauses of business, geographical scope, underwriting limits and profit objective.

iii. An insurer shall also file any changes in the underwriting policy, if any.

Irda (General Insurance Reinsurance) Regulations, 2000

Insurance Regulatory and Development Authority has, in consultation with the Insurance Advisory committee, framed following regulations with regard to general insurance-reinsurance business.

A. Procedure to be Followed for Reinsurance Arrangements

i. ***Objectives of re-insurance***. The reinsurance program shall aim at achieving following objectives
   - maximise retention within the country;'
   - develop adequate capacity;
   - secure the best possible protection for the reinsurance costs incurred;
   - simplify the administration of business.

ii. ***Justify retention policy***. The authority may require an insurer to justify its retention policy and may make directions to ensure that Indian insurer is not merely fronting for a foreign insurer.

iii. ***Reinsurance as per Insurance Act***. Every insurer shall cede such percentage of the sum assured on each policy for different classes of insurance written in India to the Indian reinsurer as may be specified by the Authority in accordance with the provisions of Part IV A of the Insurance Act, 1938.

iv. ***Submission of reinsurance programme***. The reinsurance programme of every insurer shall commence from the beginning of every financial year and every insurer shall submit to the Authority, his reinsurance programmes for the forthcoming year, 45 days before the commencement of each financial year.

v. ***Filing of reinsurance treaty slip***. Within 30 days of the commencement of the financial year, every insurer shall file with the Authority a photocopy of every reinsurance treaty slip and excess of loss cover, cover note in respect of that year together with the list of reinsurers and their shares in the reinsurance arrangement;

vi ***Business outside India***. Insurers shall place their reinsurance business outside India with only those reinsurers who have over a period of the past five years counting from the year preceding for which the business has to be placed, enjoyed a rating of at least BBB (with Standard and Poor) or equivalent rating of any other international rating agency" Placements with other reinsurers shall require the approval of the authority.

vii ***Retention of business within India***. The Indian Reinsurer shall organise domestic pools for reinsurance surpluses in fire, marine hull and other classes in consultation with all insurers on basis, limits and terms which are fair to all insurers and assist in maintaining the retention of business within India as close to the level achieved for the year 1999-2000 as possible. The arrangements so made shall be

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submitted to the Authority within three months of these regulations coming into force, for approval.

viii. ***Limit on reinsurance***. Surplus over and above the domestic reinsurance arrangements class-wise can be placed by the insurer independently with any of the reinsurers subject to a limit of 10% of the total reinsurance premium ceded outside India being placed with anyone reinsurer. Where it is necessary in respect of specialised insurance to cede a share exceeding such limit to any particular reinsurer, the insurer may seek the specific approval of the Authority giving reasons for such cession.

B Inward Reinsurance Business

Every insurer wanting to write inward reinsurance business shall have a well defined underwriting policy for underwriting inward reinsurance business. The insurer shall file with the Authority a note on its underwriting policy stating the classes of business, geographical scope, underwriting limits and profit objective. The insurer shall also file any changes to the note as and when a change in underwriting policy is made.

IRDA (Appointed Actuary) Regulation, 2000

IRDA Regulations, 2000 in respect of an appointed actuary require every insurer, registered to carryon insurance business in India, to appoint an actuary, who shall be known as the' Appointed Actuary' for the purposes of the Act.

Eligibility

A person shall be eligible to be appointed as an appointed actuary for an insurer, if he or she shall be- .

i. ordinary resident in India

ii. a Fellow Member of the Actuarial Society of India;

iii. an employee of the life insurer, in case of life insurance business;

iv. an employee of the insurer or a consulting actuary, in case of general insurance business; .

iva. a person who has not committed any breach of professional conduct;

v. a person against whom no disciplinary action by the Actuarial Society of India or any other actuarial professional body is pending;

vi. not an appointed actuary of another insurer; .

vii. a person who possesses a Certificate of Practice issued by the Actuarial Society of India; and

viii. not over the age of seventy years.

Approval from Authority

An insurer shall seek the approval of the Authority for the appointment of appointed actuary, submitting the application in Form IRDA-AA-I. The Authority shall, within thirty days from the date of receipt of application, either accept or reject the same. If an insurer does not receive approval within 30 days of the receipt of such application by the authority, the insurer shall deem that the approval has been granted by" the authority.

Powers of Actuary Appointed

An appointed acturary shall have the following powers.

i. access to all information or documents in possession or under control of insurer;

ii. seek any information from any officer or employee of the insurer;

iii. to attend all meetings of the management;

iv. to speak and discuss on any matter;

v. to attend any meeting of the shareholders or the policy holders of the insurer.

General Duties and Obligations

Duties and obligation of the Appointed Actuary include:

i. rendering actuarial advice to the management of the insurer, in particular in the areas of product design and pricing, insurance contract wording, investments and re-insurance ;

ii. ensuring the solvency of the insurer at all times;

iii. certification of assets and liabilities that have been valued;

iv. maintenance of required solvency margin;

v. ensuring that provisions of the Act have been complied with and nothing is in contravention of the act or against the interest of the policy holders;

vi. complying with Authority's directions from time to time.

Duties of the Insurer Carrying on Life Insurance Business

a. certify the acturial report and abstract;

b. recommend interim bonus or bonuses payable by life insurer to policy holders whose policies mature for payment by reason of death or otherwise,

c. to ensure that all requisite records required for actuarial valuation have been obtained by him;

d. ensure that premium rates of the insurance products are fair;

e. to certify that mathematical reserves have been determined on the basis of guidance notes issued by Actuarial Society of India;

f. to submit actuarial advice in the interests of insurance industry and the policy holders.

Duties of Insurer Carrying on General Insurance Business

Appointed actuary is to perform the following duties in the case of the insurer carrying on general insurance business. He is to ensure

i. that the rates are fair in respect of those contracts that are governed by the insurer's in-house tariff;

ii. that the actuarial principles, in the determination of liabilities have been used in the calculation of reserves for incurred but not reported claims (IBNR) and other reserves where actuarial advice is sought by the Authority.

Irda (Protection of Policy- Holders' Interests) Regulations, 2002

IRDA (Protection of Policyholders Interest Regulations) 2002 establish benchmarks in the quality of sales as well as service in life insurance and requires that every employee and agent in the organisation is fully aware of the regulations as well as their

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implications. Some of the important regulations are discussed below.

1. Prospectus to contain details of insurance product. A prospectus of any insurance product shall clearly state

- the scope of benefits
- the extent of insurance cover
- conditions of insurance cover
- whether the product is participating (with profits) or non-participating the rider or riders attached to a life policy.

In no case, the premium relatable to all the riders put together shall exceed 30 % of the premium of the main product.

2. Information to the prospect. An insurer or its agents shall provide all material information in respect of a proposed insurance product to the prospect and advise him dispassionately. He should get the form signed from the prospect that he has fully understood the significance of the proposed product.
3. Agents to follow code of conduct. The regulations require the insurer or the agent to follow, the code of conduct prescribed by the Authority. the councils. the recognised professional body or association of which he is a member, in the process of sale.
4. Proposal to be accepted on proposal form. A proposal for the grant of a cover either for life business or for general business must be evidenced by a written document except in case of marine insurance cover. It is the duty of an insurer to furnish to the insured free of charge, within 30 days of the acceptance of a proposal a copy of the proposal form.
5. Onus of proof lies with insurer. Where a proposal form is not used, the insurer shall record the information obtained orally or in writing and confirm it within a period of 15 days there of with the proposer and incorporate the information in its cover note or policy. The onus of proof shall rest with the insurer in respect of any information not so recorded, where the insurer claims that the proposer suppressed any material information or provided misleading or wrong information on any matter material to the grant of a cover.
6. Processing with speed and efficiency. Proposal shall be processed by the insurer with speed and efficiency and all decisions there of shall be communicated by it in writing within a seasonal period not exceeding 15 days from receipt of proposals by the insurer.
7. Grievance redressal procedure. Every insurer shall have in place proper procedures and effective mechanism to address complaints and grievances of policy-holders efficiently and with speed.
8. Matters to be stated in life insurance policy.
   a. A life insurance policy shall clearly state:
      i. the name of the plan governing the policy, its terms and conditions;
      ii. whether it is participating in profits or not;
      iii. the basis of participation in profits such as cash bonus, deferred bonus, simple or compound reversionary bonus,
      iv. the benefits payable and the contingencies upon which these are payable and other terms and conditions of the insurance contract;
      v. the details of the riders attaching to the main policy (vi) the date of commencement of risk and the date of maturity of date (s) on which the benefits are payable.
      vii. the premiums payable, periodicity of payment, grace period allowed, the date of last installment.
      viii. the age at entry and whether the same has been admitted.
      ix. the policy requirements for conversion of the policy into paid up policy, surrender, non-feiture, and revival of lapsed policies.
      x. the provisions for nomination, assignment, loans on security of the policy
      xi. the documents that are required to be submitted by a claimant in support of a claim under the policy.
   b. the insurer shall inform by letter forwarding the policy that he has a period of 15 days from the date of receipt of the policy document to review the terms and conditions of the policy and where the insured disagrees to any of those terms and conditions he has the option to return the policy. The insured, then shall be entitled to refund of the premium paid.
9. Matters to be stated in general insurance policy.
   a. A general insurance policy shall clearly state:
      i. the names(s) and address(es) of the insured and of any bank (s) or any other person having financial interest in the subject matter of insurance;
      ii. full description of the property or interest insured
      iii. sum insured;
      iv. period of insurance;
      v. perils covered and not covered;
      vi. premium payable;
      vii. policy terms, conditions and warranties;
      viii. action to be taken by the insured upon occurrence of a contingency likely to give rise to a claim under the policy
      ix. the obligations of the insured
      x. provision for cancellation of the policy on grounds of mis-representation, fraud, non-disclosure of material facts or non- cooperation of the insured.
      xi. the details of the riders attached to the main policy.
   b. Every insurer shall inform and keep informed periodically the insured on the requirements to be fulfilled by the insured regarding loading of a claim. Claims procedure in respect of life insurance policy
      i. A life insurance company, upon receiving a claim, shall process the claim without delay. Any queries

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or requirement of addition, documents, to the extent possible, shall be raised all at once and not in piece meals with in a period of 15 days of the receipt of the claim.

ii. A claim under a life policy shall be paid or be disputed giving all the relevant reasons, with in 30 days from the date of receipt of all relevant papers and clarifications required. Where an investigation is required, the company shall initiate it not later than 6 months from the time of lodging the claim.

iii. Where a claim is ready for payment but the payment can not be made due to proper identity of the payee, the life insurer shall hold the amount for the benefit of the payee

iv. Where there is a delay on the part of the insurer in processing the claim, the life insurance company shall pay interest on the claim amount at a rate, which is 2 % above the bank rate prevalent at the beginning of the financial year in which the claim is reviewed by it.

Claim Procedure in Respect of a General Insurance Policy

i. An insured or the claimant shall give notice to the insurer of any loss arising under contract of insurance at the earliest or within such extended time as maybe allowed by the insurer. The company shall appoint a surveyor for assessing the loss/claim with in 72 hours of the receipt of intimation from the insured.

ii. The surveyor has to follow the code of conduct laid down by the authority while assessing the loss and shall submit his report with in 30 days of his appointment. A copy of report shall also be furnished to the insured. .

iii. If the survey report submitted by surveyor is found to be incomplete regarding certain specific issues, then the insurer may request to submit an additional report on such issues within 15 days of the receipt of the original survey report.

iv. The surveyor shall submit an additional report within 3 weeks of the date of receipt of intimation from the insurer.

v. An insurer shall within a period of 30 days of receiving the reports offer a settlement of the claim to the insured.

vi. Upon acceptance of an offer of settlement by the insured the payment of the amount due shall be made within 7 days from the date of acceptance of the offer by the insured. Delay in the payment imposes penalty on the insurer at a rate of 2 % above the bank rate of interest.

Duties, Powers and Functions of Authority

The IRDA Act lays down the duties, powers and functions of the Authority. These are given in section 14 of the Act, which runs as follows:-

1. Subject to the provision of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure

2. Without prejudice to the generality of the provisions contained in sub-section (1) the powers and functions of the Authority shall include-

a. issue to the applicant a certificate of registration, renew, modify withdraw, suspend or cancel such registration;

b. protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest. settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;

c. specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents:

d. specifying the code of conduct for surveyors and loss assessors;

e. promoting efficiency in the conduct of insurance business;

f. promoting and regulating professional organisations connected with the insurance and re-insurance business;

g. levying fees and other charges for carrying out the purposes of this Act;

h. calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers intermediaries, insurance intermediaries and other organisations connected with the insurance business;

i. control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64 U of the Insurance Act, 1938 (4 of 1938);

j. specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

k. regulating investment of funds by insurance companies:

l. regulating maintenance of margin of solvency;

m. adjudication of disputes between insurers and intermediaries or insurance intermediaries;

n. supervising the functioning of the Tariff Advisory Committee:

o. specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organizations referred to in clause (j);

p. specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and

q. exercising such other powers as may be prescribed.

In view of the duties assigned to it and powers given under the Act. The Authority has notified number of regulations to

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discharge of its function. These notifications have been discussed earlier.

Finance Accounts and Audit

The provisions regarding Finance, Accounts and Audit are contained in chapter V of the Act. The main provisions are-

1. ***Grants by Central Government*** The Central Government may after due appropriation made by Parliament by law in this behalf, make to the Authority grants of such sums of money as the Government may think fit for being utilised for the purposes of this Act.

Thus, the grants from the Central Govt. are one of the main sources of funds for the Authority at least to begin with.

2. ***Constitution of Funds*** There shall be constituted a fund to be called "the Insurance Regulatory and Development Authority Fund" and there shall be credited thereto-

a. all Government grants, fees and charges received by the Authority;

b. all sums received by the Authority from such other source as may be decided upon the Central Government;

c. the percentage of prescribed premium income received from the insurer. "

3. ***Application of Fund*** The Fund shall be applied for meeting-

a. the salaries, allowances and other remuneration of the members, officers and other employees of the Authority;

b. the other expenses of the Authority in connection with the discharge of its functions and for the purposes of this Act.

4. ***Accounts***. The Authority shall maintain proper accounts and other relevant records and prepare an annual statement of accounts in such form as may be prescribed by the Central Government in consultation with the Comptroller and Auditor-General of India. .

5. ***Audit***. (1) The accounts of the Authority shall be audited by the Comptroller and Auditor-General of India at such intervals as may be specified by him and any expenditure incurred in connection with such audit shall be payable by the Authority to the Comptroller and Auditor- General.

(2) The Comptroller and Auditor-General of India and any other person appointed by him in connection. with the audit of the accounts of the Authority shall have the same rights, privileges and authority in connection with such audit as the Comptroller and Auditor-General generally has in connection with the audit of the Government accounts and, in particular, shall have the right to demand the production of books of account, connected vouchers and other documents and papers and to inspect any of the offices of the Authority.

(3) The accounts of the Authority as certified by the Comptroller and Auditor-General of India or any other person appointed by him in this behalf together with the audit-report thereon shall be forwarded annually to the Central Government and that Government shall cause the same to be laid before each House of Parliament.

Powers of Central Govt. to Issue Directions

Section 18 of the Act given in chapter VI lays down the Powers of the Central Govt to issue directions as follows:-

1. Without prejudice to the foregoing provisions of this Act, the Authority shall, in exercise of its powers or the performance of its functions under this Act, be bound by such directions on questions of policy, other than those relating to technical and administrative matters, as the Central Government may give in writing to it from time to time:

   Provided that the Authority shall, as far as practicable; be given an opportunity to express its views before any direction is .given under tl~is sub-section.

2. The decision of the Central Government, whether a question is one ;of policy or not, shall be final.

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LESSON 25:
INSURANCE SERVICES: POSITION IN INDIA, PRIVATE INSURANCE COMPANIES IN INDIA

Lesson Objectives

- To know the position of insurance services in India,
- To understand operations of private insurance companies in India.

Introduction

We all are exposed to various risks in our daily life. Even the wisest and cleverest person cannot provide for or avoid all risks. Nobody can predict or foresee the calamity he may suffer in future. Everybody on the road, whether on foot or in a vehicle carries some risk of accident which may result into serious injury, loss of limb impairing ability to earn livelihood, or even death. One may take precautions against such risk, but the risk cannot be eliminated. Similarly, there can be loss due to fire, floods, earthquakes, burglaries, illness etc. Every loss causes human suffering.

It is possible to take precautions against such even/s, but the possibility of such happenings cannot be completely ruled out. One can also make provision for coping up with such events, but cannot eliminate the chance of such happening. For example, security can be increased in a particular area in view of increased burglaries, however, burglary can still happen. One can increase life expectancy by proper health and medical care, however death will still happen. Efficient fire service can minimise the loss due to fire but cannot prevent the occurrence of fire. In short, risks can be reduced but not eliminated.

A risk involves loss. Not all, but most of the losses can be expressed in terms of money. A person exposed to some risk may incur a loss. If loss is small he may bear it alone. If loss is huge he may not be able to bear it alone. Society may have to render help to enable the sufferer to cope up with the situation. Example, the help rendered to the victims of earthquake in Gujarat. However, it will be better if a device or system is developed to provide help to those who happen to suffer a loss. Such a device is 'insurance'.

Insurance is a co-operative device, which spreads, the loss caused by a particular risk to some persons, over a number of persons who are exposed to, same or similar risk and who agree to 'insure' against that risk.

Definition

There can be two approaches for defining insurance. One is functional approach other is contractual approach.

Functional Definitions

The functional approach definitions discussed below are note worthy. According to Encyclopaedia Britannica, "Insurance may be defined as a social device whereby a large group of individuals, through a system of equitable contributions, may reduce or eliminate measurable risk of economic loss common to all members of the group." In similar sense Disnadle has defined that, "Insurance is an instrument of distributing the loss of few among many." Allen.

C. Mayerson states that, "Insurance is device for the transfer to an insured of certain risks of economic loss that would otherwise be borne by the insured."

From the above definitions, it emerges clearly that the functional definition has the following features:

- it is a co-operative device,
- it spreads the risk over a large number of persons who are insured against the risk,
- it provides security to the insured.

Contractual Definitions

In contractual sense the following definitions are noteworthy. According to Justice Tidal, "Insurance is a contrast in which a sum of money is paid to the assured in consideration of insurer'~ incurring the risk of paying a large sum upon a given contingency." In the words of E. W. Patterson, "Insurance is a contract by which one party, for a consideration called premium, assumes a particular risk of the other party and promises to pay to him or his nominee a certain or ascertainable sum of amount on a specified contingency." The contractual approach definitions highlight the following features:

- It is a contract,
- Where by insurer assumes the risk of insured,
- And promises to pay a specified or ascertainable amount,
- On the happening of a specific event,
- In consideration of the premium paid by the insured,
- The person who seeks protection against a risk is known as 'insured'. The person who provides protection is 'insurer' (i.e. insurance company). The document containing terms and conditions of contract in called 'policy' or 'insurance policy'. The consideration from the insured' is called premium.

Principles of Insurance

Like definition of insurance two approaches can be followed for principles

Basic Principles

The concept of insurance is based on two basic principles:

a. *Principle of Co-operation*: Insurance can be described as highest degree of Co-operation. The insurance company or insurer collects premium from large number of insured persons and puts the premium in pool. The claims of those who actually suffer loss are paid out of the pool. The insured are co-operating by paying premium in advance to strengthen the pool.

b. *Principle of Probability:* Without premium, co- operation is not possible and premium can not be determined without applying theory of probability. The occurrence of risk in each type of insurance can be estimated with the help of theory of probability. The probability tells about the

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chances and amount of loss. The theory or inertia of large numbers is applied for calculating the probability. The companies collect the data of previous happenings over a large number of years to form an idea about the probability of incidence in future. Similarly, life insurance companies prepare and use the mortality table to determine the premium.

Legal Principles

Legal principles, with the exception of principle 0(, indemnity which is not applicable in case of personal insurance, are common for all types of insurance. These principles are discussed below.

i. *Principle of Uberrimae Fedai (utmost good faith):* Contracts of insurance are based on mutual trust and faith. It is a contract which requires Uberrimae Fedai i.e. utmost good faith. In accordance with this principle, the insured must make full disclosures regarding the material facts. The material facts in such contracts are those, which are rein event for the insurer to evaluate the risk of the insured e.g. nature of the risk and character of the insured.

However, there is no obligation to disclose which are of public knowledge, do not increase, are contained in the documents, cannot be noticed in survey etc. A non-disclosure, concealment, mis-representation, or fraudulent representation will make the contract either void or voidable at the option of the insured.

ii. *Principle of Insurable Interest*: In a contract of insurance the insured must possess an insurable interest in the subject matter. In other words, he should have an interest in the non-happening of the contingency or event causing the loss. His relationship with the subject matter is such that he suffers loss or damage, if contingency happens and is benefited if it does not happen. It is pecuniary or monetary in nature and only emotional. The insurable must be recognised so by the law of the country concerned. It should normally satisfy the following conditions:

1. There must be a subject matter (e.g. goods, liability) etc.;
2. Subject matter must be exposed to some risk;
3. The insured must have a legally recognised relationship or interest in the subject matter,
4. The insured should have beneficial interest in the safety of the subject matter, or the non-happening of the risk event,
5. The risk or loss should be measurable in terms of money (except life insurance),
6. The point of time when insurable interest should be in existence differs with the kind of insurance. The position is as follows:

Life insurance: Insurable interest must exist at the time of entering into insurance contract.

Marine insurance: It must exist at the time of loss.

Fire insurance: It must exist at the time of entering into contract as well as at the time of loss.

iii. *Principle of Indemnity:* The principle is applicable in non-life insurance 'only. The loss due to loss of a life cannot be measured in terms of money. Therefore, there has to be a prior agreement regarding amount. However, in non-life insurance the principle of indemnity is very important as it determines the quantum of liability.

Indemnity, in simple words is promise to compensate the loss. This principle ensures that the insured is indemnified' to the extent he suffers loss, but he should not make any profit out of the event. Thus, if a fire insurance policy for goods is taken up for Rs. 2,00,000, but the actual loss in the incidence of fire is Rs. 50,000 only the insurer can be called upon to pay the actual loss suffered i.e. Rs. 50,000 and not the policy amount of Rs. 2,00,000. In simple words:

- There must be actual loss;
- The loss should have occurred from the risk insured;
- The loss should be measurable in terms of money.
- The compensation can not exceed the actual loss;
- The compensation will be paid by the insurer.

iv. *Principle of Causa Proxima:* The prWCIple of 'causa proxima' lays down that the proximate cause (nearest cause) is to be the basis of determining the liability of the insurer and not the remote cause. Thus, where immediate cause of the loss is insured risk, the insured will be indemnified for the loss. The remote cause is not to be taken into consideration. Thus, where fire is caused by short- circuiting destroying the godown. The fire insurance amount will be paid as fire is the proximate cause of loss. The insurer can not escape liability by pleading that the loss is caused by short circuiting which is not ensured risk. Short circuiting is the remote cause, fire is the proximate cause. In other words, when the insured risk is not the proximate cause of loss no compensation will be paid.

v. *Principle of Subrogation*: Principle of subrogation supplements the principle of indemnity. Subrogation means stepping into shoes of another. In simple words it means inheriting the right available to an individual. Once the insurer compensates the insured for the loss suffered by him, he will inherit all the rights available to the insured against the third parties with regard to the subject matter of the insurance. Subrogation means:

- the insurer compensates the insured for the actual loss;
- having compensated the insured, he steps into his shoes to claim his rights against the concerned third parties;
- however, if he gets more than the compensation given to the insured, the surplus will have to be given to the insured and the insurer can not retain it;

Like principle of indemnity, it is not applicable to personal insurance.

vi. *Principle of Contribution.* Principle of contribution also is an off- shoot of the principle of indemnity. When the insured has taken more than one policy for the same subject matter against the same risk during the same period, the liability of insurers will be determined on pro-rata basis. Principle of

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contribution gives right to an insurer, who has fully compensated the insured, to seek pro-rata contribution from the other insurers. However,

1. all the policies must relate to the same period;
2. the subject matter must be the same;
3. the protection sought must be against the same risk;
4. policies must be in force at the time of loss;
5. the insured must be the same.

Being off-shoot of the principle of indemnity, this principle also is not applicable to personal insurance.

Kinds of Insurance

Insurance can be mainly classified into two categories.

1. Life Insurance

The subject matter of this type of insurance is human life. Most of the insurance policies are combination of savings and security. The insured is promised by the insurance company that during the tenure of insurance in case of his death, his nominee will be paid the insurance amount According to section 2(ii) of Insurance Act 1938, "Life insurance is the business of effecting contracts of insurance upon human life including any contract, whereby the payment of money is assured on death except death by accident on the happening of any contingency dependent on human life and any contract which is subject to the payment of premium for a term dependent on human life. In case he survives the term of the policy, he will be paid an amount as per terms of the policy.

2. General Insurance

All other types of insurance are called general insurance or non-life insurance. The common type of general insurances are discussed below:

a. *Marine Insurance.* It is oldest type of insurance. It covers the sea or marine perils. Peril is the cause of loss or hazard which is a condition that may increase the chance of the loss. Marine insurance is protection against marine perils like loss or sinking of the ship, sea piracy, capture by enemy etc. The loss could be of ship, cargo or freight. Marine insurance will cover such risks.

b. *Fire Insurance.* It covers the loss due to fire to the property like houses, shops, goods factories or god own etc. It covers loss from fire and the consequent loss from such fire i.e. the loss of work due to stoppage of work due to fire.

c. *Liability Insurance.* This type of insurance covers the risk of liability against third parties, which an insurer might have to pay under certain circumstances. For example, injury to the property and/or person of a third person in road accident or employer's liability for an injury or death ot a worker while performing duty etc.

d. *Social Insurance.* This insurance: is aimed at providing social security to the weaker sections of the society. It may take the shape of pension plans, disability or sickness benefits etc. The premium may come from Govt. or employee and may also be shared by beneficiary.

e. *Other Insurances.* All other type of general insurances can be placed under this category e.g. theft insurance, earthquake insurance, flood insurance, crop insurance, personal accident insurance, cattle insurance or livestock insurance, guarantee insurance etc.

Certain other types of insurance, one may come across are:

i. *Double Insurance.* It implies that the subject matter of insurance has been insured with two or more insurers or with the same insurer under more than one policy. In case of life insurance, all the amounts can be claimed separately, if the need arises.

However, general insurance is contract of indemnity, where the maximum amount payable by the insurer can not exceed the actual amount of loss. Thus, even if one covers through different policies with same or different insurers, he can not recover more than the loss incurred, which is to be contributed on pro-rate basis by different insurers. Thus, here is no benefit to the insured due to any over insurance.

ii. *Reinsurance.* Reinsurance is insurance of a part of the risk insured by an insurer with no other insurer. The concept of insurance is based on spreading of risk. Someti es an insurance company may get a profitable opportunity to insure a huge rperty. In the process it can expose itself to a major risk, which it may not be in a position to bear. In such a situation it can resort to reinsurance with other companies. Thus a part of the risk gets transferred to other companies.

Therefore, in this situation there are two contracts for the same subject matter. The first one is a direct insurance between direct insurer and the insured. The second one is between insurer and other insurers as now the insurer has acquired insurable interest in the same subject matter.

iii. *Over insurance.* When the total insurance taken under one or more policies is more than the value of the subject matter. It is called over insurance. The over insurance is not at all advantageous as under the principle of indemnity, only the actual loss will be compensated.

iv. *Underinsurance* When the total insurance undertaken under a policy or policies is less than the value of the subject matter, the situation is called under insurance. The insurance companies, in such case, penalize the insured by invoking the 'average clause' of the policy. Under this the claim payable by the insurance company is in proportion of the insured sum and the value of the subject matter. Is there any distinction between Insurance and Assurance?

In the literature of insurance one comes across two terms i.e. insurance and assurance. These two terms are used interchangeably in the market. Technically, there is no difference between the two terms.

However, if one tries to make distinction between the two, following distinctions can be made out:

- the term 'assurance' should be used for life contract and 'insurance' for general insurance or contracts of indemnity (but in India the terms have been used just the opposite way)
- when the risk is certain but time of occurrence is not known, it may be called assurance (e.g. life insurance).

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When risk is probable and uncertain term insurance may be used,

- 'Insurance' means 'indemnity' assurance means loss can not be estimated,
- In assurance, claim is certain, in insurance claim is uncertain,
- Assurance is the principle and insurance is the practice,
- However, technically and in practice there is no difference between two terms.

Rationale for Opening up of Insurance Sector to the Private "Sector

After banking, insurance is the most important segment of the financial sector, capable of providing huge funds for the economic development of the economy. The stakes involved called for regulation of this important sector by the state in one form or the other. The first important step in this direction was in 1928, when Indian Insurance Companies Act, was enacted. This enabled the Govt. to put together information regarding life and non-life insurance business. At that time both Indian and foreign insurers were in the business. The Act was amended completely in 1938.

In 1956, the management of all 245 Indian and foreign insurers was taken over by the Govt. of India and thereafter, the business was nationalised and Life Insurance Corporation of India was set up. In 1972, one hundred and seven Indian and foreign general insurance companies were merged into four companies. The general insurance business was nationalised and the four companies were made subsidiaries of General Insurance Corporation of India.

Malhotra Committee

In the beginning of 1990's, Government of India, in the light of the developments in the rest of the world decided to globalise Indian economy. The policy involved deregulation and privitisation of sector which were controlled by the Government While for the banking sector Narsimaham Committee was appointed, a committee under the Chairmanship of Mr. R.N. Malhotra, former Governor RBI was set up for the insurance sector. The genesis of opening up of the Indian insurance sector to the private sector lies in the recommendation of Malhotra Committee. The Committee was to examine the issues of

- increasing the search of insurance industry
- improving the customer service. The Committee was of the opinion that these objectives can be achieved through privatisation of the sector or by allowing participation of the private sector companies.

Following are the grounds on the basis of which the opening up of the insurance sector to private sector can be justified:

- Size of the Market. The potential market is estimated at 312 million people. Some estimates suggest that only 25 percent insurable population has taken up the insurance policies. According to National Council for Applied Research, 50 million people have the capacity to pay an annual premium of Rs. 10,000, 100 million have the capacity to pay annual premiums of Rs. 7,000 and another 50 million have the capacity to pay Rs. 3,500 per annum. Thus, there is a huge market to be tapped.
- Enough for All Companies. There is no reason for LIC & GIC to worry about their future. There is enough market for everyone to work upon. Each has to create their own place in the insurance market.
- Low Penetration Ratio. The penetration ratio is extremely low in India. Per Capita insurance premium in India, in 1999, was $ 8 only as against $ 4,800 in Japan. In the year before that the per capita long term insurance was estimated at $ 5 (Rs. 202) only. The life insurance premium was only 1.4 percent of GDP. The penetration of non-life business is still lower at Rs. 81.26 or 0.56 per cent of GDP. LIC and GIC have been able to tap only 10 per cent of the market and 90 per cent of the market is still untapped.
- Growth in Economy & Insurance Business. The economy has grown at the rate of 5.6 per cent per annum during 1990's. The gross domestic savings are around 25 per cent, which has the potential to grow to 45 per cent. The Insurance business life and non life has been showing growth rate of 17 and 12 percent respectively. Therefore, there is need to have more players in the field.
- Good Prospects for Rural & Social Sector. The IRDA through its notification has ensured that the insurers do not ignore the rural and social sectors. Since, they have statutory obligation to do business in these sectors. the two sectors will get benefit.
- Funds for Development of Economy. Insurance funds are a good source for longterm needs of funds in an economy. The untapped market has great potential for providing funds for the long term projects, particularly, in the infrastructure.
- The Regulatory Framework. The insurance sector was opened by the Government in 1998. The requisite regulatory framework, has been put in place by IRDA, through various notifications. The IRDA and advisory committee have started functioning, therefore, the private sector will work according to the guidelines given to them.
- More Products Required. With the large potential customer base, it is required that the products tailor made for requirement of customers should be introduced. This will be possible only when, there will be, competition in the market.
- Employment Generation. When the economies grow, the contribution of the services to the GDP increases. This trend has also been observed in India. There is great potential of growth in employment through insurance and insurance related 'services. As a result of the opening up of the sector, the following insurers have already registered with IRDA:

Life Insurance

- LIC of India
- HDFC Standard Life Insurance Company Ltd.
- Max New York Life Insurance Company Ltd.
- ICICI Prudential Life Insurance Company Ltd.

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- Om Kotak Mahindra Life Insurance Company Ltd.
- Birla Sun Life Insurance Company Limited.
- Reliance Life Insurance Company Ltd.
- Tata AIG Life Insurance Company Ltd.
- SRI Life Insurance Company Ltd.

General Insurance

- New India Assurance Company Ltd.
- United India Assurance Company Ltd.
- Nationai Insurance Company Ltd.
- Oriental Insurance Company Ltd.
- Royal Sundaram Alliance Insurance Ltd.
- Reliance General Insurance Company Ltd.

Insurance Policies

Like any other contract, a contract of insurance must be clear and not vague or ambiguous. Therefore, the various terms and conditions of contract between 'the insurer' and 'the insured' need to be determined and laid down clearly to minimise the chances of dispute. These terms and conditions are laid down in a document, known as 'policy'. The insurance policies are divided into two broad categories:

1. Life insurance policies.
2. General Insurance i.e. Marine, fire and accident insurance policies.

Before the opening up to private sector, insurance business was being carried out by LIC and GIC only. But with the coming of IRDA Act, insurance sector has been opened up to private sector and many private companies are already into the field selling insurance services / products.

Insurance and India

Summary

Despite innumerable delays the sector has finally opened up for private competition. The threat of private players shaking and giving the run for incremental market share for the Public Sector mammoths has been overplayed. The number of potential buyers of insurance is certainly attractive but much of this population might not be accessible New insurers must segment the market carefully to arrive at the appropriate products and pricing. Since distribution will be a key determinant of success for all insurance companies regardless of age or ownership we can expect a total change of the distribution network. As the product move towards the mature stages of commodization (increased awareness and popularity) they could then a host of new channels like grocery stores, direct mails would emerge. . Regulators must formulate strong and fair guidelines and ensure that old and new players are subject to the same rules and at the same time the government should ensure that the IRA does not become yet another toothless tiger like CEA or TRAI.

Main Article

Insurance – On Threshold

The liberalization of the Indian insurance sector has been the subject of much heated debate for some years. The policy makers where in the catch 22 situation wherein for one they wanted competition, development and growth of this insurance sector which is extremely essential for channeling the investments in to the infrastructure sector. At the other end the policy makers had the fears that the insurance premia, which are substantial, would seep out of the country; and wanted to have a cautious approach of opening for foreign participation in the sector.

As one of the rare occurrences the entire debate was put on the back burner and the IRDA saw the day of the light thanks to the maturing polity emerging consensus among factions of different political parties. Though some changes and some restrictive clauses as regards to the foreign participation were included the IRDA has opened the doors for the private entry into insurance.

Whether the insurer is old or new, private or public, expanding the market will present multitude of challenges and opportunities. But the key issues, possible trends, opportunities and challenges that insurance sector will have still remains under the realms of the possibilities and speculation. What is the likely impact of opening up India's insurance sector?

Broadening of Benefits

The large scale of operations, public sector bureaucracies and cumbersome procedures hampers nationalized insurers. Therefore, potential private entrants expect to score in the areas of customer service, speed and flexibility. They point out that their entry will mean better products and choice for the consumer. The critics counter that the benefit will be slim, because new players will concentrate on affluent, urban customers as foreign banks did until recently. This seems to be a logical strategy. Start-up costs-such as those of setting up a conventional distribution network-are large and high-end niches offer better returns. However, the middle-market segment too has great potential. Since insurance is a volumes game. Therefore, private insurers would be best served by a middle-market approach, targeting customer segments that are currently untapped.

Unrealistic - Fears

An often-voiced concern is that private players, especially foreign ones, will swamp the market, grabbing a large share. A similar threat was overplayed in the case of basic telephone services and when the private players started their operations the dominance and might of DoT has remain unaltered. This hypothesis that the private players would swamp the market has been disproved in many emerging markets worldwide not only in case of the insurance but in numerous different sectors (Power, Energy, Telecom, Insurance etc.).

Yet, multinational insurers are keenly interested in emerging insurance because their home markets are saturated while emerging countries have low insurance penetrations and high growth rates. International insurers often derive a significant part of their business from multinational operations. As early as 1994, many of the UK's largest life and general insurers derived 40% to 60% of their total premia from outside their home markets. Though the global operations of the multinational insurers have an immense impact on their typically

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foreign insurers take only a small share of an individual country's market. For example in Taiwan the foreign companies took only a 3% share even seven years after opening up while in Korea, their share was barely 1% after 20 years. Moreover India is a large, quite diverse and complex market thus private insurers will have to learn and unlearn quite a few things before they can make any headway to grab the market share. Yet for the new entrants this small share of a large and growing market can be profitable.

Untapped Opportunities

There is no doubt that the potential market for the buyers of insurance is significant in India and offers a great scope of growth. First, while estimating the potential of the Indian insurance market we often tempt to look at it from the perspective of macro-economic variables such as the ratio of premium to GDP which is indeed comparatively low in India. For example, India's life insurance premium as a percentage of GDP is 1.3% against 5.2% in the US, 6.5% in the UK or 8% in South Korea. But the fact is that the large part of the India's, (the number of potential buyers of insurance) is certainly attractive. However, this ignores the difficulties of approaching this population. New entrants in other mass industries such as consumer products or retail banking have discovered this after burning their fingers. Much of the demand may not be accessible because of poor distribution, large distances or high costs relative to returns.

Secondly most new entrants have a tendency to target the business of existing companies rather than expanding the market, this is myopic. This not only leads to intense competition for the new players and their much of their efforts is spent on trying to capture existing customers by offering better service or other advantages. Yet, the benefits of this strategy are likely to be limited. For example, 50% of the current demand for general insurance comes from the corporate segment. The corporates are likely to shop around for the best rates, products and service. Nevertheless, the corporate segment, as a whole will not be a big growth area for new entrants. This is because penetration is already good, companies receive good service because of their size and rates are tariff-governed. In both volumes and profitability therefore, the scope for expansion is modest. A better approach may be to examine specific niches where demand can be met or stimulated.

Key - Innovation and Variety of Products

The new entrants would be best served by micro-level two pronged strategies. First, is to introduce innovative products offering a right mix of flexibility/risk/return depending which will suit the appetite of the customers and the secondly they would target specific niches, which are poorly served or are not served at all

The first prong of a new insurer's strategy could be to stimulate demand in areas that are currently not served at all. For example, Indian general insurance focuses on the manufacturing segment. However, the services sector is taking a large and growing share of India's GDP This offers immense opportunities for expansion opportunities. For example, revenue from remote processing activities in information technology is estimated at USD 50 billion in the next ten years. Insurers could respond with various liability covers.

Being the agrarian economy again there are immense opportunities for the new entrants to provide the liability and risks associated in this sector like weather insurance, rainfall insurance, cyclone insurance, crop insurance etc.

Next, the financial sector is aggressively targeting retail investors. Housing finance, auto finance, credit cards and consumer loans all offer an opportunity for insurance companies to introduce new products like creditor insurance etc. Similarly, organized sector sales of TVs, refrigerators, washing machines and audio systems in 1998 was around Rs.110 billion. Only a negligible portion of these purchases was insured. Potential buyers for most of this insurance lie in the middle class. Existing players can also profitably exploit these areas.

In case there are products, which are not serving adequately new products many of them, which are already prevalent in different markets can be customized to the Indian markets and used to expand the markets. For example life insurance products provide a good example. Life Insurance products have to compete with savings and mutual funds hence should offer various dimensions of risk/return/flexibility so they can be linked to stock market indices, inflation etc. making them more competitive and appropriate risk/return appetite for different investors at present there are no such products. Similar problems apply to pensions. For instance, pure protection products like term assurance account for up to 20% of policies sold in developed countries. In India, the figure is less than one percent because policies are inflexible. They compete with investment and savings options like mutual funds. It is imperative that they should offer comparable returns and flexibility and there is immense scope of developing pure insurance products with flexibility.

The lack of a comprehensive social security system combined with a willingness to save means that Indian demand for pension products will be large. However, current penetration is poor. Making pension products into attractive saving instruments would require only simple innovations already prevalent in other markets. For example, their returns might be tied to index-linked funds or a specific basket of equities. Buyers could be allowed to switch funds before the annuities begin and to invest different amounts at different times

Health insurance is another segment with great potential because existing Indian products are insufficient. By the end of the GIC's Mediclaim scheme covered only 2.5 million people. Indian products do not cover disability arising out of illness or disability for over 100 weeks due to accident. Neither do they cover a potential loss of earnings through disability

Distribution – A Paradigm Shift

Since distribution will be a key determinant of success for all insurance companies regardless of age or ownership. The nationalized insurers currently have a large reach and presence. New entrants cannot-and does not-expect to supplant or duplicate such a network. Building a distribution network is expensive and time consuming. Yet, if insurers are to take advantage of India's large population and reach a profitable

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mass of customers, new distribution avenues and alliances will be imperative. This is also true for the nationalized corporations, which must find fresh avenues to reach existing and new customers. There would be substantial shifts in the distribution of insurance in India. Many of these changes will echo international trends. Worldwide, insurance products move along a continuum from pure service products to pure commodity products then they could be sold through the medical shops, groceries, novelty stores etc.. Once commodization, popularity and awareness of the products is attained then the products can move to remote channels such as the telephone or direct mail. In the UK for example, retailer Marks & Spencer now sells insurance products. At this point, buyers look for low price. Brand loyalty could shift from the insurer to the seller. Recognizing this trend, the financial services industry worldwide has success-fully used remote distribution channels such as the telephone or the Internet to reach more customers, cut out intermediaries, bring down overheads and increase profitability.

The Trinity of IT – Distribution - Training

Most of the opportunities and challenges that we have discussed apply equally to existing and new insurers. It must be emphasized that the opening of the insurance market is far from a bad thing for nationalized insurers. With a strong presence, a wide network and considerable brand equity, they are in a good position to tap the very same segments profitably, while improving their product and service offerings. All insurers in a liberalized Indian market will have to address a host of other issues. They will have to:

- Leverage information technology to service large numbers of customers efficiently and bring down overheads. Technology can complement or supplement distribution channels cost-effectively. It can also help improve customer service levels considerably.
- Use data warehousing, management and mining to gauge the profitability and potential of various customer and product segments and ensure effective cross selling. Understanding the customer better will allow insurance companies to design appropriate products, determine pricing correctly and increase profitability.
- Ensure high levels of training and development not just for staff but for agents and distribution organisations. Existing organisations will have to train staff for better service and flexibility, while all companies will have to train employees to cope with new products and an intensive use of information technology.
- The importance of alliances and tie-ups means that companies will have to integrate related but separate providers into their systems to ensure seamless delivery.
- Build strong relationships with intermediaries such as agents.

Regulation – The Catalyst

Indian insurance is on the threshold of deep and fundamental changes. The life insurance industry was nationalized in 1956 and the general insurance industry in 1972. Before that India had a thriving and competitive insurance industry with hundreds of private and foreign operators. Indian companies held a 60% market share even then. Yet, insufficient regulation also meant that there were a number of abuses. In a reopened Indian insurance market, regulators must formulate strong fair and transparent guidelines and make sure that old and new players are subject to the same rules. Companies meanwhile must be prepared to set and meet high standards for themselves. The big challenge for both companies and regulators is to ensure that they replicate the benefits of the past while eliminating its ills

Insurance as a Promoter of Social and Economic Well-being

Preliminary

This subject is of much practical significance to all persons engaged in any form in insurance as a career. It reminds me of a quote from Alfred Adler. He says, “The only worthwhile achievements of man are those which are socially useful.” In the rough and tumble of our workday world we should never lose sight of our goal to achieve a worthwhile and soul satisfying life. Insurance career has the potential to provide it for you.

It is sad but true that insurance is associated with disasters, calamity, and loss and suffering, large and small, which inflicts pain on industry, commerce, community or an individual person and/or his family. The very raison d’etre of insurance industry is to compensate the sufferer. Insurance comes into play only after there is some loss, sustained by somebody or some firm. It is a remedy. It seeks to restore the original position fully, or partly to the extent it can within the bounds of insurance contract entered into with the client.

The contribution insurance makes to the society is to lift the scene from a negative station to which it has been depressed by the risk undertaken to be protected having materialized and brings it back to par. So, how can you say that it produces any positive effect? Does it really promote well-being?

By using funds the insurance has gathered and nurtured, out of insurance premium collected as fee for insurance service offered, he can and does help lift the economy, the Adam Smith way. Of course, the total resources required by economy are much too large in comparison with financial assets provided by insurance industry. Secondly, insurance is the latest happening. Few centuries back it was not there. In the Shakespeare’s play ‘The Merchant of Venice’, Antonio, the celebrated merchant, tells us that ‘ my ventures are not in one bottom trusted, nor to one place nor is my whole estate, upon the fortunes of this present year’ he knew well how to spread his risks but not how to transfer them to someone else’s shoulder in exchange for a small fee, called insurance premium. For centuries, empires did rise, civilizations thrived, and commerce and trading was existent, current people lived, prospered, and died without the presence of insurance industry at their service. Compare electricity, which too arrived in late 19th century. You can manage without both insurance and electricity but will lose some quality of your life in bargain.

Well-being

Against the above canvass as a background painted here are a number of aspects which describes how the society and the economy today, derive the benefit of well being through the

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operation of the insurance industry which now is in our very midst and well entrenched at that.

The concept of well being is explained in the Webster dictionary as a state of being happy, healthy or prosperous, well to do. Another meaning is stated as welfare. The word welfare is itself defined as a state of being happy; and, secondly, as relief, aid of money or necessities for those in need. The word social welfare is somewhat different. It's meaning is given as assistance of disadvantaged groups through public or private social services.

Does insurance address any of these concepts? What does insurance actually do besides, of course, provide jobs for a few hundred thousand and dispensing dividend income to their shareholders? But remember we are not looking for material prosperity.

The Magic of Insurance

Insurance is defined as transfer of risk for a consideration. The clients have risks of various kinds and magnitudes. They divert their attention from their normal businesses. Secondly they do sometimes land him into monetary loss. By transferring his risk to insurers, clients free themselves from these anxieties and can devote full attention to their pursuits. But how does the insurer keep his cool accepting risk and the attendant losses that must be borne by him? The magic lies in estimating and correcting the chance of a risk actually materializing and then putting an appropriate price tag for that risk to meet the cost of insurance service and his profit margin.

The Insurance Firm at Work

The insurer has two occupations to indulge in; he must sell and collect money from a large number of clients so that he gets average results. Where the number is not that large he had better transfer that risk to a reinsurer who generally operates worldwide and may gather enough numbers. If not, the reinsurer will decline and so will the insurer decline to accept that particular risk. Secondly the insurer does not know when the risk will befall. The timing is uncertain. So he will use the collected premium fund/money for investment. Since it must be readily available when required to settle sudden claims from his clients he will not lock them up unwisely. There have to be assets and expected liability inflows to match. Further the money must be placed in safe outlets. He must also try to get the highest return subject to these required constraints of liquidity and safety. He has to quote competitive terms, so he must procure highest yield. He has also to declare adequate dividend so he can be certain of the capital market supporting him when he needs additional capital.

The need for capital arises because there is volatility in year-to-year results. If the chance of the loss incidence is 1 in 25 or 4%, it is small. But if I have invested my 20 lacs and these go in the air, it is no solace to me that there are 24 others whose 480 lacs worth funds are safe. The insurer may charge 6% or 1.2 lacs per annum as premium. I should prefer that to loosing 20 lacs in one go. The extra 2% is not completely the insurer's profit margin. There are the running expenses and infrastructure causes. But what about annual claims outgo? It would not be uniform every year.

Suppose 4% comes to 100, there being 2500 policy holders. Over 10 years the claims may be exact 1000, but the individual figures of the 10 years may be 75, 120, 40,140,65,200,80,90,110 and 80, say total 1000. The insurer must have funds to meet such volatility. That is he must have risked base capital. And when you have capital, it must be serviced. If the capital is not well serviced, in the event of need of further capital, the market will refuse or dictate harsh terms. Your issue manager will tell you what! If the capital is low it may even lead to the company being taken over by someone who has the money to pay and the desire to do so.

Thus from the time premium is collected to the time of incidence of the risk befalling the insurer the fund has to be used. When the claim arises the money passes from the insurer to the claimant, who will use it to recoup from the loss and get back to his earlier situation. It is in this way that economic well being is materialized through insurance. Well being, we know, is a state i.e. a mental state. But it will help the individual, the firm, or the community meeting their demands from life in a better, calm, collected way and enjoy doing so.

Types of insurance

Before we examine the social well being feature, we must learn about the three different types of insurance businesses. These are long term, short term and social insurance.

Life insurance and pension funds comprise long term insurance businesses. Their policy contracts are mostly long term with fixed premiums and certain benefits. They have to accumulate and husband their funds for long periods. They can therefore invest in long-term projects, support share markets and the issues floated by governments, infrastructure corporations and the like; and also housing finance.

Short term insurance covers risks on property and liability. They issue insurance contracts of indemnity from year to year. They keep large funds to meet larger volatility in their business and can finance on short-term basis only.

Health insurance contracts are of either type, short as well as long. Both life as well as non- life insurers transact this type of business each selling products that suit their province.

Social insurance is a class apart. The state shares a part of the premium with the insured person or where he is employed, with him and his employer. This insurance is of compulsory nature and is offered because most people are unable to afford price of insurance on their own. Depriving them totally or altogether from insurance, leads to privation and ultimately social costs. In developed economies the social insurance covers extends from birth through unemployment, sickness and lifelong pensions to right upto funeral expenses. It is provided at a low level. The government must afford it. The better off can add more insurance on their own by going to the insurance companies, if the benefits are inadequate for them.

Social well-being

"For ye have the poor always with you; but me ye have not always" told Jesus.

Those who are not covered by social insurance, the destitute, those who will not afford even the subsidized premium for social insurance are provided social assistance by the state.

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Absence of insurance to some others due to their negligence, even though affordable, pricks conscience. Suppose your neighbor did not provide life insurance or had it at marginal level. In the event of his untimely death how would you like to live as neighbors with his family? They are of course in distress and may remain so at least for some years; but you too cannot live in a happy frame of mind, especially during festivals. Suppose there are several industries - small and medium in a row or block in an industrial estate. There is a wild fire. One out of the affected industries had not taken fire insurance. The others get money, use it, and within a short time are back in business mostly to their normal. What about the one who is left out because of his own imprudence - though it be? It does leave a bad taste and uneasiness in everyone else's life.

In a similar way, the society feels about the left outs from its social insurance net. For them social assistance is given free. Food, accommodation will allow them just to keep body and soul together. They can of course avail of training and other facilities and make efforts to come out of their wretched social strata and move upwards; get out of sustenance on charity. 20% (or less) of the population gets social assistance because the rest of them, the 80% (or more) are under social insurance. It is because machinery is already setup and is in operation that the downtrodden too, get social relief as well as welfare measure. The presence of insurance cover for many and absence for some generates a frame of mind where there is a consensus in society permitting use of taxpayers' money for this social assistance. Similarly social insurance itself was born because normal insurance was well taken care of by the growing 'well-to-do' members of the society. But well being sought through insurance by 'criminally-inclined' definitely needs to be stamped out.

Insurance V/s Generosity

Criminal minded people are known to try to steal insurance claims, which are unwarranted. A person or a firm must not be better off after a loss has visited him or them. How would you like to settle claim of a murderer husband as heir to his wife's life insurance policy? Or where illness was hidden and a policy was wangled at disproportionately low premium, say, for a cancer patient? Moral hazards exist and need to be crushed, eliminated, for insurance business to remain worthy.

What about someone getting a new flat free after burning his establishment and making a fire insurance claim? Or someone getting his whole car painted out of a motor insurance claim from minor accident? Or was this accident self-inflicted?

Now generosity must not wink at such cheating under the alleged umbrella of social or economic well being. Insurance contracts are carefully drafted and need to be wisely interpreted. Shall I quote from holy Bible once again? It says "But we know that the law is good, if a man uses it lawfully."

The cost angle

In India, 3% of GDP or less goes on insurance. In USA, the world's largest user of insurance service has it at over 12% of their GDP. Is it worth it or is it a waste incurred to pamper a sense of well being or security to fulfill a psychological need?

We may take the reduction ad absurdom route to answer this issue. Can we do without insurance as they did before the 17th century? Some of our projects cost so much today that no one will venture producing goods by incurring that high an investment - if insurance cover is not there. The examples are aeroplanes, petrol refinery, oil tankers, steady satellites for TV and other communication, even large electricity generation plants etc. Is it not preferable to have insurance as well as giant projects than drop them both?

Social welfare is the end product we derive from the presence of insurance industry though it appears to need expenditure of high costs. Insurance costs a lot - about 20% of price is expenses.

Insurance they say has failed to give protection against inflation. I would say all wrong acts of governments including wars are out of bounds for grants of insurance cover. It is also a moral hazard.

Finally a loss means some resources have not performed. These resources cannot be conjured by insurance industry. You cannot replace the same husband. So prevention of loss is the first responsibility of the society and its citizens. That is why loss prevention association is sponsored by insurance industry.

How do we conclude? With all its constraints and limitations, insurance certainly is contributing in a small but irreplaceable way to social and economic life of the society. Insurance men and women must understand and appreciate all its plus and minus points and noticing the overwhelming presence of the plus side, work with all attachment, devotion and love. I assure every insurance man and woman that a well-contented retirement will be the end result you will be endowed with resorting to a devoted insurance career.

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LESSON 26:
INSURANCE SERVICES: POSITION IN INDIA AND PRIVATE INSURANCE COMPANIES IN INDIA

Lesson Objectives

- To make all aware of position of insurance services in India and working of private insurance companies in India.

In recent past, various private sector companies have started their operations in India. With combined efforts and due to increased competition, it has become a HOT sector of the economy.

You are required to submit an electronic presentation and write up on position of insurance sector in India and Working of Private Insurance Companies in India (in both life and non-life sectors).

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LESSON 27:
MUTUAL FUNDS: AN INTRODUCTION

Lesson Objectives

- To understand the Concept of mutual funds,
- Its development in India and
- Mutual fund schemes.

Introduction

A mutual fund is a financial intermediary that pools the savings of investors for collective investment in a diversified portfolio of securities. A fund is "mutual" as all of its returns, minus its expenses, are shared by the fund's investors.

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 defines a mutual fund as a 'a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments'.

According to the above definition, a mutual fund in India can raise resources through sale of units to the public. It can be set up in the form of a Trust under the Indian Trust Act. The definition has been further extended by allowing mutual funds to diversify their activities in the following areas:

- Portfolio management services
- Management of offshore funds
- Providing advice to offshore funds
- Management of pension or provident funds
- Management of venture capital funds
- Management of money market funds
- Management of real estate funds

A mutual fund serves as a link between the investor and the securities market by mobilising savings from the investors and investing them in the securities market to generate returns. Thus, a mutual fund is akin to portfolio management services (PMS). Although, both are conceptually same, they are different from each other. Portfolio management services are offered to high net worth individuals; taking into account their risk profile, their investments are managed separately. In the case of mutual funds, savings of small investors are pooled under a scheme and the returns are distributed in the same proportion in which the investments are made by the investors/unit-holders.

Mutual fund is a collective savings scheme. Mutual funds play an important role in mobilising the savings of small investors and channelising the same for productive ventures in the Indian economy.

Benefits of Mutual Funds

An investor can invest directly in individual securities or indirectly through a financial intermediary. Globally, mutual funds have established themselves as the means of investment for the retail investor.

1. **Professional management:** An average investor lacks the knowledge of capital market operations and does not have large resources to reap the benefits of investment. Hence, he requires the help of an expert. It, is not only expensive to 'hire the services' of an expert but it is more difficult to identify a real expert. Mutual funds are managed by professional managers who have the requisite skills and experience to analyse the performance and prospects of companies. They make possible an organised investment strategy, which is hardly possible for an individual investor.
2. **Portfolio diversification**: An investor undertakes risk if he invests all his funds in a single scrip. Mutual funds invest in a number of companies across various industries and sectors. This diversification reduces the riskiness of the investments.
3. **Reduction in transaction costs**: Compared to direct investing in the capital market, investing through the funds is relatively less expensive as the benefit of economies of scale is passed on to the investors.
4. **Liquidity**: Often, investors cannot sell the securities held easily, while in case of mutual funds, they can easily encash their investment by selling their units to the fund if it is an open-ended scheme or selling them on a stock exchange if it is a close-ended scheme.
5. **Convenience:** Investing in mutual fund reduces paperwork, saves time and makes investment easy.
6. **Flexibility**: Mutual funds offer a family of schemes, and investors have the option of transferring their holdings from one scheme to the other.
7. **Tax benefits** Mutual fund investors now enjoy income-tax benefits. Dividends received from mutual funds' debt schemes are tax exempt to the overall limit of Rs 9,000 allowed under section 80L of the Income Tax Act.
8. **Transparency** Mutual funds transparently declare their portfolio every month. Thus an investor knows where his/her money is being deployed and in case they are not happy with the portfolio they can withdraw at a short notice.
9. **Stability to the stock market** Mutual funds have a large amount of funds which provide them economies of scale by which they can absorb any losses in the stock market and continue investing in the stock market. In addition, mutual funds increase liquidity in the money and capital market.
10. **Equity research** Mutual funds can afford information and data required for investments as they have large amount of funds and equity research teams available with them.

History of Mutual Funds

The history of mutual funds, dates back to 19th century Europe, in particular, Great Britain. Robert Fleming set up in 1868 the first investment trust called Foreign and Colonial

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Investment Trust which promised to manage the finances of the moneyed classes of Scotland by spreading the investment over a number of different stocks. This investment trust and other investment trusts which were subsequently set up in Britain and the US, resembled today's close-ended mutual funds. The first mutual fund in the US, Massachusetts Investors' Trust, was setup in March 1924. This was the first open-ended mutual fund.

The stock market crash in 1929, the Great Depression, and the outbreak of the Second World War slackened the pace of growth of the mutual fund industry. Innovations in products and services increased the popularity of mutual funds in the 1950s and 1960s. The first international stock mutual fund was introduced in the US in 1940. In 1976, the first tax-exempt municipal bond funds emerged and in 1979, the first money market mutual funds were created. The latest additions are the international bond fund in 1986 and arm funds in 1990. This industry witnessed substantial growth in the eighties and nineties when there was a significant increase in the number of mutual funds, schemes, assets, and shareholders. In the US, the mutual fund industry registered a ten fold growth in the eighties (1980-89) only, with 25% of the household sector's investment in financial assets made through them. Fund assets increased from less than $150 billion in 1980 to over $4 trillion by the end of 1997. Since 1996, mutual fund assets have exceeded bank deposits. The mutual fund industry and the banking industry virtually rival each other in size.

Growth of Mutual Funds in India

The Indian mutual fund industry has evolved over distinct stages. The growth of the mutual fund industry in India can be divided into four phases: Phase I (1964-87), Phase II (1987-92), Phase III (1992-97), and Phase IV (beyond 1997).

Phase I: The mutual fund concept was introduced in India with the setting up of UTI in 1963. The Unit Trust of India (UTI) was the first mutual fund set up under the UTI Act, 1963, a special act of the Parliament. It became operational in 1964 with a major objective of mobilising savings through the sale of units and investing them in corporate securities for maximising yield and capital appreciation. This phase commenced with the launch of Unit Scheme 1964 (US-64) the first open-ended and the most popular scheme. UTI's investible funds, at market value (and including the book value of fixed assets) grew from Rs 49 crore in1965 to Rs 219 crore in 1970-71 to Rs 1,126 crore in 1980-81 and further to Rs 5,068 crore by June 1987. Its investor base had also grown to about 2 million investors. It launched innovative schemes during this phase. Its fund family included five income-oriented, open-ended schemes, which were sold largely through its agent network built up over the years. Master share, the equity growth fund launched in 1986, proved to be a grand marketing success. Master share was the first real close-ended scheme floated by UTI. It launched India Fund in 1986-the first Indian offshore fund for overseas investors, which was listed on the London Stock Exchange (LSE). UTI maintained its monopoly and experienced a consistent growth till 1987.

Phase II: The second phase witnessed the entry of mutual fund companies sponsored by nationalised banks and insurance companies. In 1987, SBI Mutual Fund and Canbank Mutual Fund were set up as trusts under the Indian Trust Act, 1882. In 1988, UTI floated another offshore fund, namely, The India Growth Fund which was listed on the New York Stock Exchange (NYSB). By 1990, the two nationalised insurance giants, LIC and GIC, and nationalised banks, namely, Indian Bank, Bank of India, and Punjab National Bank had started operations of wholly-owned mutual fund subsidiaries. The assured return type of schemes floated by the mutual funds during this phase were perceived to be another banking product offered by the arms of sponsor banks. In October 1989, the first regulatory guidelines were issued by the Reserve Bank of India, but they were applicable only to the mutual funds sponsored by FIIs. Subsequently, the Government of India issued comprehensive guidelines in June 1990 covering all 'mutual funds. These guidelines emphasised compulsory registration with SEBI and an arms length relationship be maintained between the sponsor and asset management company (AMC). With the entry of public sector funds, there was a tremendous growth in the size of the mutual fund industry with investible funds, at market value, increasing to Rs 53,462 crore and the number of investors increasing to over 23 million. The buoyant equity markets in 1991-92 and tax benefits under equity-linked savings schemes enhanced the attractiveness of equity funds.

Phase III: The year 1993 marked a turning point in the history of mutual funds in India. Tile Securities and Exchange Board of India (SEBI) issued the Mutual Fund Regulations in January 1993. SEBI notified regulations bringing all mutual funds except UTI under a common regulatory framework. Private domestic and foreign players were allowed entry in the mutual fund industry. Kothari group of companies, in joint venture with Pioneer, a US fund company, set up the first private mutual fund the Kothari Pioneer Mutual Fund, in 1993. Kothari Pioneer introduced the first open-ended fund Prima in 1993. Several other private sector mutual funds were set up during this phase. UTI launched a new scheme, Master-gain, in May 1992, which was a phenomenal success with a subscription of Rs 4,700 crore from 631akh applicants. The industry's investible funds at market value increased to Rs 78,655 crore and the number of investor accounts increased to 50 million. However, the year 1995 was the beginning of the sluggish phase of the mutual fund industry. During 1995 and 1996, unit holders saw an erosion in the value of their investments due to a decline in the NA V s of the equity funds. Moreover, the service quality of mutual funds declined due to a rapid growth in the number of investor accounts, and the inadequacy of service infrastructure. A lack of performance of the public sector funds and miserable failure of foreign funds like Morgan Stanley eroded the confidence of investors in fund managers. Investors perception about mutual funds, gradually turned negative. Mutual funds found it increasingly difficult to raise money. The average annual sales declined from about Rs 13,000 . crore in 1991-94 to about Rs 9,000 crore in 1995 and 1996.

Phase IV: During this phase, the flow of funds into the kitty of mutual funds sharply increased. This significant growth was aided by a more positive sentiment in the capital market, significant tax benefits, and improvement in the quality of

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investor service. Investible funds, at market value, of the industry rose by June 2000 to over Rs 1,10,000 crore with UTI having 68% of the market share. During 1999-2000 sales mobilisation reached a record level of Rs 73,000 crore as against Rs 31,420 crore in the preceding year. This trend was, however, sharply reversed in 2000-01. The UTI dropped a bombshell on the investing public by disclosing the NAV of US-64-its flagship scheme as on December 28,2000, just at Rs 5.81 as against the face value of Rs 10 and the last sale price of Rs 14.50. The disclosure of NAV of the country's largest mutual fund scheme was the biggest shock of the year to investors. Crumbling global equity markets, a sluggish economy coupled with bad investment decisions made life tough for big funds across the world in 2001-02. The effect of these problems was felt strongly in India also. Pioneer m, JP Morgan and Newton Investment Management pulled out from the Indian market. Bank of India MF liquidated all its schemes in 2002.

The Indian mutual fund industry has stagnated at around Rs 1,00,000 crore assets since 2000-01. This stagnation is partly a result of stagnated equity markets and the indifferent performance by players. As against this, the aggregate deposits of Scheduled Commercial Banks (SCBs) as on May 3, 2002, stood at Rs 11,86,468 crore. Mutual funds assets under management (AUM) form just around 10% of deposits of SCBs.

The Unit Trust of India is losing out to other private sector players. While there has been an increase in AUM by around 11% during the year 2002, UTI on the contrary has lost more than 11% in AUM. The private sector mutual funds have benefited the most from the debacle ofUS-64 of UTI. The AUM of this sector grew by around- 60% for the year ending March 2002.

Types of Mutual Fund Schemes

The objectives of mutual funds are to provide continuous liquidity and higher yields with high degree of safety to investors. Based on these objectives, different types of mutual fund schemes have evolved.

Types of Mutual Fund Schemes

Functional	*Portfolio*	*Geographical*	*Other*
Open-Ended Event	Income Funds	Domestic	Sectoral Specific
Close-Ended Scheme	Growth Funds	Off-shore	Tax Saving
Interval Scheme	Balanced Funds		ELSS
	Money Market		Special
	Mutual Funds		Gilt Funds Load Funds Index Funds
			ETFs PIE Ratio Fund

Functional Classification of Mutual Funds

1. **Open-ended schemes**: In case of open-ended schemes, the mutual fund continuously offers to sell and repurchase its units at net asset value (NAV) or NAV-related prices. Unlike close-ended schemes, open-ended ones do not have to be listed on the stock exchange and can also offer repurchase soon after allotment. Investors can enter and exit the scheme any time during the life of the fund. Open-ended schemes do not have a fixed corpus. The corpus of fund increases or decreases, depending on the purchase or redemption of units by investors.

   There is no fixed redemption period in open-ended schemes, which can be terminated whenever the need arises. The fund offers a redemption price at which the holder can sell units to the fund and exit. Besides, an investor can enter the fund again by buying units from the fund at its offer price. Such funds announce sale and repurchase prices from time-to-time. UTI's US-64 scheme is an example of such a fund.

   The key feature of open-ended funds is liquidity. They increase liquidity of the investors as the units can be continuously bought and sold. The investors can develop their income or saving plan due to free entry and exit frame of funds. Open-ended schemes usually come as a family of schemes which enable the investors to switch over from one scheme to another of same family.

2. **Close-ended schemes**: Close-ended schemes have a fixed corpus and a stipulated maturity period ranging between 2 to 5 years. Investors can invest in the scheme when it is launched. The scheme remains open for a period not exceeding 45 days. Investors in close-ended schemes can buy units only from the market, once initial subscriptions are over and thereafter the units are listed on the stock exchanges where they dm be bought and sold. The fund has no interaction with investors till redemption except for paying dividend/bonus. In order to provide an alternate exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. If an investor sells units directly to the fund, he cannot enter the fund again, as units bought back by the fund cannot be reissued. The close-ended scheme can be converted into an open-ended one. The units can be rolled over by the passing of a resolution by a majority of the unit--holders.
3. **Interval scheme**: Interval scheme combines the features of open-ended and close-ended schemes. They are open for sale or redemption during predetermined intervals at NAV-related prices.

Portfolio Classification

Here, classification is on the basis of nature and types of securities and objective of investment.

1. **Income funds**: The aim of income funds is to provide safety of investments and regular income to investors. Such schemes invest predominantly in income-bearing instruments like bonds, debentures, government securities, and commercial paper. The return as well as the risk are lower in income funds as compared to growth funds.
2. **Growth funds**: The main objective of growth funds is capital appreciation over the medium-to-long- term. They invest most of the corpus in equity shares with significant growth potential and they offer higher return to investors in the long-term. They assume the risks associated with equity investments. There is no guarantee or assurance of returns. These schemes are usually close-ended and listed on stock exchanges.

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3. **Balanced funds**: The aim of balanced scheme is to provide both capital appreciation and regular income. They divide their investment between equity shares and fixed nice-bearing instruments in such a proportion that, the portfolio is balanced. The portfolio of such funds usually comprises of companies with good profit and dividend track records. Their exposure to risk is moderate and they offer a reasonable rate of return.
4. **Money market mutual funds**: They specialise in investing in short-term money market instruments like treasury bills, and certificate of deposits. The objective of such funds is high liquidity with low rate of return.

Geographical Classification

1. **Domestic funds**: Funds which mobilise resources from a particular geographical locality like a country or region are domestic funds. The market is limited and confined to the boundaries of a nation in which the fund operates. They can invest only in the securities which are issued and traded in the domestic financial markets.
2. **Offshore funds**: Offshore funds attract foreign capital for investment in 'the country of the issuing company. They facilitate cross-border fund flow which leads to an increase in foreign currency and foreign exchange reserves. Such mutual funds can invest in securities of foreign companies. They open domestic capital market to international investors. Many mutual funds in India have launched a number of offshore funds, either independently or jointly with foreign investment management companies. The first offshore fund, the India Fund, was launched by Unit Trust of India in July 1986 in collaboration with the US fund manager, Merril Lynch.

Others

1. **Sectoral:** These funds invest in specific core sectors like energy, telecommunications, IT, construction, transportation, and financial services. Some of these newly opened-up sectors offer good investment potential.
2. **Tax saving schemes:** Tax-saving schemes are designed on the basis of tax policy with special tax incentives to investors. Mutual funds have introduced a number of tax-saving schemes. These are close--ended schemes and investments are made for ten years, although investors can avail of encashment facilities after 3 years. These schemes contain various options like income, growth or capital application. The latest scheme offered is the Systematic Withdrawal Plan (SWP) which enables investors to reduce their tax incidence on dividends from as high as 30% to as low as 3 to 4%.
3. **Equity-linked savings scheme (ELSS):** In order to encourage investors to invest in equity market, the government has given tax-concessions through special schemes. Investment in these schemes entitles the investor to claim an income tax rebate, but these schemes carry a lock-in period before the end of which funds cannot be withdrawn.
4. **Special schemes:** Mutual funds have launched special schemes to cater to the special needs of investors. UTI has launched special schemes such as Children's Gift Growth Fund, 1986, Housing Unit Scheme, 1992, and Venture Capital Funds.
5. **Gilt funds:** Mutual funds which deal exclusively in gilts are called gilt funds. With a view to creating a wider investor base for government securities, the Reserve Bank of India encouraged setting up of gilt funds. These funds are provided liquidity support by the Reserve Bank.
6. **Load funds:** Mutual funds incur certain expenses such as brokerage, marketing expenses, and communication expenses. These expenses are known as 'load' and are recovered by the fund when it sells the units to investors or repurchases the units from withholders. In other words, load is a sales charge, or commission, assessed by certain mutual funds to cover their selling costs.

   Loads can be of two types-Front-end-load and back-end-load. Front-end-load, or sale load, is a charge collected at the time when an investor enters into the scheme. Back-end, or repurchase, load is a charge collected when the investor gets out of the scheme. Schemes that do not charge a load are called 'No load' schemes. In other words, if the asset management company (AMC) bears the load during the initial launch of the scheme, then these schemes are known as no-load schemes. However, these no-load schemes can have an exit load when the unit holder gets out of the scheme before a I stipulated period mentioned in the initial offer. This is done to prevent short-term investments and redemptions. Some funds may also charge different amount of loads to investors depending upon the time period the investor has stayed with the funds. The longer the investor stays with the fund, less is the amount of exit load charged. This is known as contingent deferred sales' charge (CDSL). It is a back-end (exit load) fee imposed by certain funds on shares redeemed with a specific period following their purchase and is usually assessed on a sliding scale.
7. **Index funds:** An index fund is a mutual fund which invests in securities in the index on which it is based BSE Sensex or S&P CNX Nifty. It invests only in those shares which comprise the market index and in exactly the same proportion as the companies/weightage in the index so that the value of such index funds varies with the market index. An index fund follows a passive investment strategy as no effort is made by the fund manager to identify stocks for investment/dis-investment. The fund manager has to merely track the index on which it is based. His portfolio will need an adjustment in case there is a revision in the underlying index. In other words, the fund manager has to buy stocks which are added to the index and sell stocks which are deleted from the index.

   Internationally, index funds are very popular. Around one-third of professionally run portfolios in the US are index funds. Empirical evidence points out that active fund managers have not been able to perform well. Only 20-25% of actively managed equity mutual funds out-perform benchmark indices in the long-term. These active fund managers park 80% of their money in an index and do active management on the remaining 20%. Moreover, risk

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averse investors like provident funds and pension funds prefer investment in passively managed funds like index funds.

8. **PIE ratio fund:** PIE ratio fund is another mutual fund variant that is offered by Pioneer IT! Mutual Fund. The PIE (Price-Earnings) ratio is the ratio of the price of the stock of a company to its earnings per share (EPS). The PIE ratio of the index is the weighted average price-earnings ratio of all its constituent stocks.

   The PIE ratio fund invests in equities and debt instruments wherein the proportion of the investment is determined by the ongoing price-earnings multiple of the market. Broadly, around 90% of the investible funds will be invested in equity if the Nifty Index PIE ratio is 12 or below. If this ratio exceeds 28, the investment will be in debt/money markets. Between the two ends of 12 and 28 PIE ratio of the Nifty, the fund will allocate varying proportions of its investible funds to equity and debt. The objective of this scheme is to provide superior risk-adjusted returns through a balanced portfolio of equity and debt instruments.

9. **Exchange traded funds:** Exchange Traded Funds (ETFs) are a hybrid of open-ended mutual funds and listed individual stocks. They are listed on stock exchanges and trade like individual stocks on the stock exchange. However, trading at the stock exchanges does not affect their portfolio. ETFs do not sell their shares directly to investors for cash. The shares are offered to investors over the stock exchange. ETFs are basically passively managed funds that track a particular index such as S&P CNX Nifty.

   Since they are listed on stock exchanges, it is possible to buy and sell them throughout the day and their price is determined by the demand-supply forces in the market. In practice, they trade in a small range around the value of the assets (NAV) held by them.

ETFs offer several distinct advantages.

- ETFs bring the trading and real time pricing advantages of individual stocks to mutual funds. The ability to trade intra-day at prices that are usually close to the actual intra-day NAV of the scheme makes it almost real-time trading.
- ETFs are simpler to understand and hence they can attract small investors who are deterred to trade in index futures due to requirement of minimum contract size. Small investors can buy minimum one unit of ETF, can place limit orders and trade intra-day. This, in turn, would increase liquidity of the cash market.
- ETFs can be used to arbitrate effectively between index futures and spot index.
- ETFs provide the benefits of diversified index funds. The investor can benefit from the flexibility of stocks as well as the diversification.
- ETFs being passively managed, have somewhat higher NAV against an index fund of the same portfolio. The operating expenses of ETFs are lower than even those of similar index funds as they do not have to service investors who deal in shares through stock exchanges.
- ETFs can be beneficial for financial institutions also. Financial institutions can use ETFs for utilizing idle cash, managing redemptions, modifying sector allocations, and hedging market exposure.

The first exchange traded fund-Standard and Poor's Depository Receipt (SPDR-also called Spider)-was launched in the US in 1993. ETFs have grown rapidly with around US$100 billion in assets as on December 2001. Today, about 60% of trading value on the American Stock Exchange (AMEX) is from ETFs. ETFs were launched in Europe and Asia in 2001. Currently, more than 120 ETFs are available in US, Europe, Singapore, Hongkong, Japan, and other countries. Among the popular ones are SPDRs (Spiders) based on the S&P 500 Index, QQQs (cubes) based on the Nasdaq-100 Index, i SHARES based on MSCI Indices and TRAHK (Tracks) based on the Hang Seng Index. The ETF structure has seen over $120 bn pouring into it in more than 220 funds. It has become the fastest growing fund structure. In year 2001 alone, the number of funds doubled from 100 to 200.

The first ETF to be introduced in India is Nifty Bench mark Exchange-Traded Scheme *(Nifty* BeES). It is an open-ended ETF, launched towards the end of 2001 by Benchmark Mutual Funds. The fund is listed in the capital market segment of the NSE and trades the S&P CNX Nifty Index. The Benchmark Asset Management Company has become the first company in Asia (excluding Japan) to introduce ETF.

Net Asset Value The net asset value of a fund is the market value of the assets minus the liabilities on the day of valuation. In other words, it is the amount which the shareholders will collectively get if the fund is dissolved or liquidated. The net asset value of a unit is the net asset value of fund divided by the number of outstanding units.

Thus NAV = Market Price of Securities + Other Assets - Total Liabilities + Units Outstanding as at the NAV date.

NAV = Net Assets of the Scheme + Number of units outstanding, that is, Market value of investments + Receivables + Other Accrued Income + Other Assets - Accrued Expenses - Other Payables - Other Liabilities + No. of units outstanding as at the NAV date.

A fund's NAV is affected by four sets of factors: purchase and sale of investment securities, valuation of all investment securities held, other assets and liabilities, and units sold or redeemed.

SEBI has issued guidelines on valuation of traded securities, thinly traded securities and non-traded securities. These guidelines were issued to streamline the procedure of calculation of NAV of the schemes of mutual funds. The aggregate value of illiquid securities as defined in the guidelines shall not exceed 15% of the total assets of the scheme and any illiquid securities held above 15% of the total assets shall be valued in the manner as specified in the guidelines issued by the SEBI. Where income receivables on investments has accrued but has not been received for the period specified in the guidelines issued by SEBI, provision shall be made by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by SEBI.

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Mutual funds are required to declare their NA V s and sale-repurchase prices of all schemes updated daily on regular basis on the AMFI website by 8.00 p.m. and declare NA V s of their close-ended schemes on every Wednesday.

According to SEBI (Mutual Funds) (Second Amendment) Regulations, 2000, a mutual fund can now invest up to 5% of its NAV in the unlisted equity shares or equity related instruments in case of open-ended schemes; while in case of close-ended schemes, the mutual fund can now invest up to 10% of its NAY.

Mutual Fund Investors

Mutual funds in India are open to investment by

a. Residents including
   - Resident Indian Individuals, including high net worth individuals and the retail or small investors. Indian Companies
   - Indian Trusts/Charitable Institutions
   - Banks
   - Non-Banking Finance Companies
   - Insurance Companies
   - Provident Funds

b. Non-Residents, including
   - Non-Resident Indians
   - Other Corporate Bodies (OCBs)

c. Foreign entities, namely, Foreign Institutional Investors (FIIs) registered with SEBI. Foreign citizens/ entities are however not allowed to invest in mutual funds in India.

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LESSON 28:
MUTUAL FUNDS: SEBI AND REGULATORY FRAMEWORK

Lesson Objectives

- To learn about the organization and working of mutual funds with respect to UTI,
- SEBI and other regulatory framework for mutual fund.

Organization of a Mutual Fund

Three key players namely sponsor, mutual fund trust, and asset management company (AMC) are involved in setting up a mutual fund. They are assisted by other independent administrative entities like banks, registrars, transfer agents, and custodians (depository participants).

Sponsor

Sponsor means any person who acting alone or with another body corporate establishes a mutual fund. The sponsor of a fund is akin to the promoter of a company as he gets the fund registered with SEBI. SEBI will register the mutual fund if the sponsor fulfills the following criteria:

- The sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions. This means that the sponsor should have been doing business in financial services for not less than five years, with positive net worth in all the immediately preceding five years. The net worth of the immediately preceding year should be more than the capital contribution of the sponsor in AMC and the sponsor should show profits after providing depreciation, interest, and tax for three out of the immediately preceding five years.
- The sponsor and any of the directors or principal officers to be employed by the mutual fund, should not have been found guilty of fraud or convicted of an offence involving moral turpitude or guilty of economic offences.

The sponsor forms a trust and appoints a Board of Trustees. He also appoints an Asset Management Company as fund managers. The sponsor, either directly or acting through the Trustees, also appoints a custodian to hold the fund assets. The sponsor is required to contribute at least 40% of the minimum net worth of the asset management company.

Mutual Funds as Trusts

A mutual fund in India is constituted in the form of a public Trust created under the Indian Trusts Act, 1882. The sponsor forms the Trust and registers it with SEBI. The fund sponsor acts as the settler of the Trust, contributing to its initial capital and appoints a trustee to hold the assets of the Trust for the benefit of the unit- holders, who are the beneficiaries of the Trust. The fund then invites investors to contribute their money in the common pool, by subscribing to 'units' issued by various schemes established by the Trust as evidence of their beneficial interest in the fund. Thus, a mutual fund is just a 'pass through' vehicle. Most of the funds in India are managed by the Board of Trustees, which is an independent body and acts as protector of the unit -holders' interests. At least, 50% of the trustees shall be independent trustees (who are not associated with an associate, subsidiary, or sponsor in any manner). The trustees shall be accountable for and be the custodian of funds/property of respective scheme.

Asset Management Company

The trustees appoint the Asset Management Company (AMC) with the prior approval of SEBI. The AMC is a company formed and registered under the Companies Act, 1956, to manage the affairs of the mutual fund and operate the schemes of such mutual funds. It charges a fee for the services it renders to the mutual fund trust. It acts as the investment manager to the Trust under the supervision and direction of the trustees. The AMC, in the name of the Trust, floats and then manages the different investment schemes as per SEBI regulations and the Trust Deed. The AMC should be registered with SEBI. The AMC of a mutual fund must have a net worth of at least Rs 10 crore at all times and this net worth should be in the form of cash. It cannot act as a trustee of any other mutual fund. It is required to disclose the scheme particulars and base of calculation of NAY. It can undertake specific activities such as advisory services and financial consultancy. It must submit quarterly reports to the mutual fund. The trustees are empowered to terminate the appointment of the AMC and may appoint a new AMC with the prior approval of the SEBI and unit-holders. At least 50% of the directors of the board of directors of AMC should not be associated with the sponsor or its subsidiaries or the trustees.

Obligations of an AMC An AMC has to follow a number of obligations. They are:

- The AMC shall take all the reasonable steps and exercise due diligence to ensure that any scheme is not contrary to the Trust deed and provisions of investment of funds pertaining to any scheme is not contrary to the provisions of the regulations and Trust deed.
- The AMC shall exercise due diligence and care in all its investment decisions. The AMC shall be responsible for the acts of commission or commissions by its employees or the persons whose services have been procured.
- An AMC shall submit to the trustee's quarterly reports.
- The trustees at the request of an AMC can terminate the assignments of the AMC.
- An AMC shall not deal in securities through any broker associated with a sponsor or a firm which is an associate of sponsor beyond 5% of the daily gross business of the mutual fund.
- No AMC shall utilize services of the sponsor or any of its associates, employees, or their relatives for the purpose of any securities transaction and distribution and sale of

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securities, unless disclosure is made to the unit-holders and brokerage/commission paid is disclosed in half-yearly accounts of the mutual fund.

- No person, who has been found guilty of any economic offence or involved in violation of securities law, should be appointed as key personnel. . The AMC shall abide by the code of conduct specified in the fifth schedule. The registrars and share transfer agents to be appointed by AMC are to be registered with SEBI.

SEBI regulations (2001) provide for exercise of due diligence by asset management companies (AMCs) in their investment decisions. For effective implementation of the regulations and also to bring about transparency in the investment decisions, all the AMCs are required to maintain records in support of each investment decision, which would indicate the data, facts, and other opinions leading to an investment decision. While the AMCs can prescribe broad parameters for investments, the basis for taking individual scrip-wise investment decision in equity and debt securities would have to be recorded. The AMCs are required to report its compliance in their periodical reports to the trustees and the trustees are required to report to SEBI, in their half-yearly reports. Trustees can also check its compliance through independent auditors or internal statutory auditors or through other systems developed by them.

The unclaimed redemption and dividend amounts can now be deployed by the mutual funds in call money market or money market instruments and the investors who claim these amounts during a period of three years from the due date shall be paid at the prevailing net asset value. After a period of three years, the amount can be transferred to a pool account and the investors can claim the amount at NAV prevailing at the end of the third year. The income earned on such funds can be used for the purpose of investor education. The AMC has to make a continuous effort to remind the investors through letters to take their unclaimed amounts. In case of schemes to be launched in the future, disclosures on the above provisions are required to be made on the offer documents. Also, the information on amount unclaimed and number of such investors for each scheme is required to be disclosed in the annual reports of mutual funds.

SEBI issued a directive during 2000-01 that the annual report containing accounts of the asset management companies should be displayed on the websites of the mutual funds. It should also be mentioned in the annual report of mutual fund schemes that the unit-holders, if they so desire, can request for the annual report of the asset management company.

Mutual funds earlier were required to get prior approval of the board of trustees and AMCs to invest in un-rated debt instruments. In order to give operational flexibility, mutual funds can now constitute committees who can approve proposals for investments in un-rated debt instruments. However, the detailed parameters for such investments must be approved by the AMC boards and trustees. The details of such investments are required to be communicated by the AMCs to the trustees in their periodical reports and it should be clearly mentioned as to how the parameters have been complied with. However, in case a security does not fall under the parameters, the prior approval of the board of the AMC and trustees is required to be taken. .

SEBI issued guidelines for investment/trading in securities by employees of AMCs and mutual fund- trustee companies, so as to avoid any conflict of interest or any abuse of an individual's position and also to ensure that the employees of AMCs and trustee companies should not take undue advantage of price sensitive information about any company.

SEBI issued directives that the directors' of AMCs should file with the trustees the details of their purchase and sale transactions in securities on a quarterly basis. As in the case of trustees, they may report only those transactions which exceed the value of Rs 1 lakh. Following representations from AMFI, SEBI notified the Mutual Funds (Amendment) Regulations, 2002, whereby the requirement of publishing of scheme-wise annual report in the newspapers by the mutual funds was waived. However, mutual funds shall continue to send the annual report or abridged annual report to the unit -holders. Further, all mutual funds were advised to display the scheme-wise annual reports on their websites to be linked with AMFI website so that the investors and analysts can access the annual reports of all mutual funds at one place.

To provide the investors an objective analysis of the performance of the mutual funds schemes in comparison with the rise or fall in the markets, SEBI decided to include disclosure of performance of benchmark indices in case of equity-oriented schemes and subsequently extended to debt-oriented and balanced fund schemes in the format for half-yearly results. In case of sector or industry specific schemes, mutual funds may select any sectoral indices published by stock exchanges and other reputed agencies.

In pursuance with the proposals in the Union Budget 2002-03, SEBI allowed the mutual funds to invest in foreign debt securities in the countries with full convertible currencies and with highest rating (foreign currency credit rating) by accredited/registered credit rating agencies. They were also allowed to invest in government securities where the countries are AAA rated.

To bring, uniformity in calculation of NAVs of mutual fund schemes, SEBI issued guidelines for valuation of unlisted equity shares.

SEBI clarified that the service charge of five% on the management fees of AMCs imposed in the Union Budget 2002-03 can be charged to the schemes as an item of general expenditure without imposing an additional burden on unit-holders.

SEBI advised mutual funds that the non-performing or illiquid assets at the time of maturity/closure of schemes but realised within two years after the winding up of the scheme, should be distributed to the old investors if the amount is substantial. In case the amount is not substantial or it is realised after two years it may be transferred to the Investor Education Fund maintained by each mutual fund.

Mutual funds can enter into transactions relating to government securities only in dematerialised form. SEBI clarified that the SEBI (Insider Trading) (Amendment) Regulations, 2002, should be followed strictly by the trustee companies, AMCs and their employees and directors.

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SEBI (Mutual Funds) Regulations, 1996 The provision of this regulation pertaining to AMC are:

- All the schemes to be launched by the AMC need to be approved by the trustees and copies of offer documents of such schemes are to be filed with SEBI.
- The offer documents shall contain adequate disclosures to enable the investors to make informed decisions.
- Advertisements in respect of schemes should be in conformity with the SEBI prescribed advertisement code, and disclose the method and periodicity of valuation of investment sales and repurchase in addition to the investment objectives.
- The listing of close-ended schemes is mandatory and every close-ended scheme should be listed on a recognised stock exchange within six months from the closure of subscription. However, listing is not mandatory in case the scheme provides for monthly income or caters to the special classes of persons like senior citizens, women, children, and physically handicapped; if the scheme discloses details of repurchase in the offer document; if the scheme opens for repurchase within six months of closure of subscription.
- Units of a close-ended scheme can be opened for sale or redemption at a predetermined fixed interval if the minimum and maximum amount of sale, redemption, and periodicity is disclosed in the offer document.
- Units of a close-ended scheme can also be converted into an open-ended scheme with the consent of a majority of the unit-holders and disclosure is made in the offer document about the option and period of conversion.
- Units of a close-ended scheme may be rolled over by passing a resolution by a majority of the shareholders.
- No scheme other than unit-linked scheme can be opened for subscription for more than 45 days. . The AMC must specify in the offer document about the minimum subscription and the extent of over- subscription, which is intended to be retained. In the case of over-subscription, all applicants applying up to 5,000 units must be given full allotment subject to over subscription.
- The AMC must refund the application money if minimum subscription is not received, and also the excess over subscription within six weeks of closure of subscription.
- Guaranteed returns can be provided in a scheme if such returns are fully guaranteed by the AMC orsponsor. In such cases, there should be a statement indicating the name of the person, and the manner in which the guarantee is to be made must be stated in the offer document.
- A close-ended scheme shall be wound up on redemption date, unless it is rolled over, or if 75% of the unit-holders of a scheme pass a resolution for winding up of the scheme; if the trustees on the happening of any event require the scheme to be wound up; or if SEBI, so directs in the interest of investors.

Investment Objectives and Valuation Policies The price at which the units may be subscribed or sold and the price at which such units may at any time be repurchased by the mutual fund shall be made available to the investors.

General Obligations These obligations are:

- Every asset management company for each scheme shall keep and maintain proper books of accounts, records, and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund and intimate to the Board the place where such books of accounts, record, and documents are maintained.
- The financial year for all the schemes shall end as of March 31 of each year. Every mutual fund or the asset management company shall prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.
- Every mutual fund shall have the annual statement of accounts audited by an auditor who is not in any way associated with the auditor of the asset management company.

Procedure in Case of Default On and from the date of the suspension of the certificate or the approval, as the case may be, the mutual fund, trustees or asset management company, .shall cease to carry on any activity as a mutual fund, trustee or asset management company, during the period of suspension, and shall be subject to the directions of the Board with regard to any records, documents, or securities that may be in its custody or control, relating to its activities as mutual fund, trustees, or asset management company.

SEBI Guidelines (2001-02) Relating to Mutual Funds

- A common format is prescribed for all mutual fund schemes to disclose their entire portfolios on half- yearly basis so that the investors can get meaningful information on the deployment of funds. Mutual funds are also required to disclose the investment in various types of instruments and percentage of investment in each scrip to the total NAV, illiquid and non-performing assets, investment in derivatives and in ADRs and GDRs.
- To enable the investors to make informed investment decisions, mutual funds have been directed to fully revise and update offer document and memorandum at least once in two years.
- Mutual funds are also required to
  - i. bring uniformity in disclosures of various categories of advertisements, with a view to ensuring consistency and comparability across schemes of various and mutual funds.
  - ii. reduce initial offer period from a maximum of 45 days to 30 days.
  - iii. dispatch statements of account once the minimum subscription amount specified in the offer document is received even before the closure of the issue.
  - iv. invest in mortgaged backed securities of investment grade given by credit rating agency.
  - v. identify and make provisions for the non-performing assets (NPAs) according to criteria for classification of

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NPAs and treatment of income accrued on NPAs and to disclose NPAs in half- yearly portfolio reports.

vi. disclose information in a revised format on unit capital, reserves, performance in terms of dividend and rise/ fall in NAV during the half-year period, annualised yields over the last 1, 3, 5 years in addition to percentage of management fees, percentage of recurring expenses to net assets, investment made in associate companies, payment made to associate companies for their services, and details of large holdings, since their operation.

vii. declare their NA V s and sale/repurchase prices of all schemes updated daily on regular basis on the AMFI website by 8.00 p.m. and declare NA V s of their close-ended schemes on every Wednesday.

- The format for un-audited half-yearly results for the mutual funds has been revised by SEBI. These results are to be published before the expiry of one month from the close of each half-year as against two months period provided earlier. These results shall also be put in their websites by mutual funds.
- All the schemes by mutual funds shall be launched within six months from the date of the letter containing observations from SEBI on the scheme offer document. Otherwise, a fresh offer document along with filing fees shall be filed with SEBI.
- Mutual funds are required to disclose large unit-holdings in the scheme, which are over 25% of the NAY.

Association of Mutual Funds in India

The Association of Mutual Funds in India (AMFI) was established in 1993 when all the mutual funds, except the UTI, came together realising the need for a common forum for addressing the issues that affect the mutual fund industry as a whole. The AMFI is dedicated to developing the Indian mutual fund industry on professional, health, and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit-holders.

Objectives of AMFI

To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.

- To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management, including agencies connected or involved in the field of capital markets and financial services.
- To interact with the SEBI and to represent to SEBI on all matters concerning the mutual fund industry.
- To represent to the government, Reserve Bank of India and other bodies on all matters relating to the mutual fund industry.
- To develop a cadre of well trained agent distributors and to implement a programme of training and certification for all intermediaries and others engaged in the industry.
- To undertake nationwide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.
- To disseminate information on mutual fund industry and to undertake studies and research directly and! or in association with other bodies.

AMFI continues to play its role as a catalyst for setting new standards and refining existing ones in many areas, particularly in the sphere of valuation of securities. Based on the recommendations of AMFI, detailed guidelines have been issued by SEBI for valuation of unlisted equity shares.

A major initiative of AMFI during the year 2001-02 was the launching of registration of AMFI Certified Intermediaries and providing recognition and status to the distributor agents. More than 30 corporate distributors and a large number of agent distributors have registered with AMFI. The AMFI Guidelines and Norms for Intermediaries (AGNI) released in February 2002, gives a framework of rules and guidelines for the intermediaries and for the conduct of their business.

AMFI maintains a liaison with different regulators such as SEBI, IRDA, and RBI to prevent any over -regulation that may stifle the growth of the industry. AMFI has set up a working group to formulate draft guidelines for pension scheme by mutual funds for submission to IRDA. It holds meetings and discussions with SEBI regarding matters relating to mutual fund industry. Moreover, it also makes representations to the government for removal of constraints and bottlenecks in the growth of mutual fund industry.

AMFI recently launched appropriate market indices which will enable the investors to appreciate and make meaningful comparison of the returns of their investments in mutual funds schemes. While in the case of equity funds, a number of benchmarks like the BSE Sensex and the S&P CNX Nifty are available, there was a lack of relevant benchmarks for debt funds. AMFI took the initiative of developing eight new indices jointly with Crisil.com and ICICI Securities. These indices have been constructed to benchmark the performance of different types of debt schemes such as liquid, income, monthly income, balanced fund, and gilt fund schemes. These eight new market indices are Liquid Fund Index (Liqui fex), Composite Bond Fund Index (Compbex), Balanced Fund Index (Balance EX), MIP Index (MIPEX), Short Maturity Gilt Index (Si-Bex), Medium Maturity Gilt Index (Mi-Bex), Long Maturity Gilt Index (Li-Bex) and the Composite Gilt Index.

In the case of liquid funds, the index comprises a commercial paper (CP) component with a 60% weightage and an inter-bank call money market component with a 40% weightage. The CP component of the index is computed using the weighted average issuance yield on new 91 days CPs issued by top rated manufacturing companies. In the case of bond funds, the index comprises a corporate bond component with a 55% weightage, gilts component with a 30% weightage call component with 10% weightage and commercial paper with 5% weightage. The index's 55% bond component is split based on a 40 point share of AA rated bonds, and 15 points share of AA rated bonds.

Mutual funds have now to disclose also the performance of appropriate market indices along with the performance of

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schemes both in the offer document and in the half-yearly results. Further, the trustees are required to review the performance of the schemes on periodical basis with reference to market indices. These indices will be useful to distribution companies, agents/brokers, financial consultants, and investors.

AMFI conducts investor awareness programmes regularly. AMFI also conducts intermediary's certification examination. As of July 2002, 2,140 employees and 3,200 distributors have passed the certification examination conducted by AMFI.

AMFI is in the process of becoming a self- regulatory organisation (SRO). It has set up a committee to set the norms for AMFI to become an SRO.

Unit Trust of India

Unit Trust of India (UTI) is India's first mutual fund organisation. It is the single largest mutual fund in India, which came into existence with the enactment of UTI Act in 1964.

The economic turmoil and the wars in the early sixties depressed the financial markets, making it difficult for both existing and new entrepreneurs to raise fresh capital. The then Finance Minister, T T Krishnamachari, set up the idea of a Unit Trust which would mobilise savings of the community and invest these savings in the capital market. His ideas took the form of the Unit Trust of India, which commenced operations from July 1964 'with a view to encouraging savings and investment and participation in the income, profits and gains accruing to the Corporation from the acquisition, holding, management and disposal of securities'. The regulations passed by the Ministry of Finance (MOF) and the Parliament from time to time regulated the functioning of UTI. Different provisions of the UTI Act laid down the structure of management, scope of business, powers and functions of the Trust as well as accounting, disclosures, and regulatory requirements for the Trust.

UTI was set up as a trust without ownership capital and with an independent Board of Trustees. The Board of Trustees manages the affairs and business of UTI. The Board performs its functions, keeping in view the interest of the unit-holders under various schemes.

UTI has a wide distribution network of 54 branch offices, 266 chief representatives and about 67,000 agents. These Chief representatives supervise agents. UTI manages 72 schemes and has an investor base of 20.02 million investors. UTI has set up 183 collection centres to serve investors. It has 57 franchisee offices which accept applications and distribute certificates to unit-holders.

UTI's mission statement is to meet the investor's diverse income and liquidity needs by creation of appropriate schemes; to offer best possible returns on his investment, and render him prompt and efficient service, beyond normal customer expectations.

UTI was the first mutual fund to launch India Fund, an offshore mutual fund in 1986. The India Fund was launched as a close-ended fund but became a multi-class, open-ended fund in 1994. Thereafter, UTI floated the India Growth Fund in 1988, the Columbus India Fund in 1994, and the India Access Fund in 1996. The India Growth Fund is listed on the New York Stock Exchange. The India Access Fund is an Indian Index Fund, tracking the NSE 50 index.

UTI's Associates

UTI has set up associate companies in the fields of banking, securities trading, investor servicing, investment advice and training, towards creating a diversified financial conglomerate and meeting investors' varying needs under a common umbrella.

UTI Bank Limited UTI Bank was the first private sector bank to be set up in 1994. The Bank has a network of 121 fully computerised branches spread across the country. The Bank offers a wide range of retail, corporate and forex services.

UTI Securities Exchange Limited UTI Securities Exchange Limited was the first institutionally sponsored corporate stock broking firm incorporated on June 28, 1994, with a paid-up capital of Rs 300 millions wholly owned by UTI and promoted to provide secondary market trading facilities, investment banking, and other related services. It has acquired membership of NSE, BSE, OTCEI, and Ahmedabad Stock Exchange (ASE).

UTI Investor Services Limited UTI Investor Services Limited was the first institutionally sponsored Registrar and Transfer agency set up in 1993. It helps UTI in rendering prompt and efficient services to the investors.

UTI Institute of Capital Markets UTI Institute of Capital Market was set up in 1989 as a non-profit educational society to promote professional development of capital market participants. It provides specialised professional development programmes for the varied constituents of the capital market and is engaged in research and consultancy services. It also serves as a forum to discuss ideas and issues relevant to the capital market.

UTI Investment Advisory Services Limited UTI Investment Advisory Services Limited, the first Indian investment advisor registered with SEC, US, was set up in 1988 to provide investment research and back office support to other offshore funds of UTI.

UTI International Limited UTI International Limited is a 100% subsidiary of UTI, registered in the island of Guernsey, Channel Islands. It was set up with the objective of helping in the UTI offshore funds in marketing their products and managing funds. UTI International Limited has an office in London, which is responsible for developing new products, new business opportunities, maintaining relations with foreign investors, and improving communication between UTI and its clients and distributors abroad.

UTI has a branch office at Dubai, which caters to the needs of NRI investors based in six Gulf countries, namely, UAE, Oman, Kuwait, Saudi Arabia, Qatar, and Bahrain. This branch office acts as a liaison office between NRI investors in the Gulf and UTI offices in India.

UTI has extended its support to the development of unit trusts in Sri Lanka and Egypt. It has participated in the equity capital of the Unit Trust Management Company of Sri Lanka.

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Promotion of Institutions

The Unit Trust of India has helped in promoting/co-promoting many institutions for the healthy development of financial sector. These institutions are:

- Infrastructure Leasing and Financial Services (ILFS).
- Credit Rating and Information Services Limited (CRISIL).
- Stock Holding Corporation of India Limited (SHCIL).
- Technology Development Corporation of India Limited (TDCIL).
- Over the Counter Exchange of India Limited (OCEI).
- National Securities Depository Limited (NSDL).
- North-Eastern Development Finance Corporation Limited (NEDFCL).

Product Range

UTI offers a wide variety of schemes to investors. Apart from equity, debt, and balanced schemes, UTI offers schemes which meet specific needs like low cost insurance cover (Unit Linked Insurance Plan), monthly income needs of retired persons and women, income and liquidity needs of religious and charitable institutions and trusts, building up of funds to meet cost of higher education and career plans for children, future wealth and income needs of the girl child and women, building savings to cover medical insurance at old age, and wealth accumulation to meet income needs after retirement.

Schemewise Assistance Sanctioned and Disbursed to the Corporate Sector by UTI

(Rs in crore)

Form of Assistance	*Sanctions*						*Disbursements*					
	1996-97	1997-98	1998-99	*1999-2000*	*2000-01*	*Cumulative upto end March 2001*	1996-97	1997-98	1998-99	*1999-2000*	*2000-01*	*Cumulative upto end March 2001*
Direct Finance												
A. Project Finance												
i) Loans	-	-	-	-	-	11,253.60	17.44	8.71	6.13	-	-	8,341.85
ii) Underwriting and direct subscriptions	3,346.15	4,471.48	3,898.58	6,737.15	3,505.14	45,864.40	3,061.82	3,402.75	3,429.78	5,069.87	3,021.36	34,406.88
iii) Deferred payment Guarantees	-	-	-	-	2,459.15	2,459.15	-	-	-	-	1,570.51	1,570.51
Sub-Total (A)	3,346.15	4,471.44	3,898.58	6,737.15	5,964.29	59,577.15	3,079.26	3,411.46	3,435.91	5,069.87	4,591.87	44,319.24
B. Non-Project Finance												
i) Working Capital Short-Term Loans	286.90	117.00	91.50	100.25	8.00	-	140.00	87.50	62.00	92.00	8.00	-
ii) Equipment Leasing	-	-	-	-	-	-	-	-	-	-	-	-
iii) Investments	-	-	.50	7.50	-	8,785.15	18.00	-	.30	.20	-	7,950.55
Sub-Total (B)	286.90	117.00	92.00	107.75	8.00	8,785.15	158.00	87.50	62.30	92.20	8.00	7,950.55
Total	3,633.05	4,588.44	3,990.58	6,844.90	5,972.29	68,362.30	3,237.26	3,498.96	3,498.21	5,162.07	4,599.87	52,269.79

Source: I DBI, *Report on Development Banking in India, 2000-01.*

Employment of Funds by UTI

(Rs in crores)

Type of Investment	*As on end June*									
	1997		1998		1999		*2000*		*2001*	
	Amount	*% to total*	*Amount*	*% to total*	*Amount*	*% to total*	*Amount*	*% to total*	*Amount*	*% to total*
A. In Corporate Sector										
1. Equity Shares	28,132.12	49.2	32,134.00	52.5	33,838.60	54.5	42,690.26	56.8	40,251.59	57.3
2. Preference Shares	40.00	0.1	25.00	-	127.00	0.2	430.36	0.6	467.90	0.7
3. Debentures	16,396.00	28.7	19,233.00	31.4	18,839.90	30.3	23,209.99	30.9	22,886.37	32.6
4. Advance Deposit against investment commitments	-	-	-	-	-	-	1.50	-	-	-
5. Fixed Deposits with companies	1,094.81	1.9	. 683.64	1.1	135.10	0.2	82.53	0.1	909.50	1.3
6. Application money for shares and debentures	-	-	188.10	0.3	57.00	0.1	78.67	0.1	-	-
7. Term Loans	3,308.00	5.8	2,843.00	4.6	1 ,953.80	3.1	1,577.88	2.1	922.93	1.3
Sub Total (A)	48,970.93	85.7	55,106.74	90.1	54,951.40	88.5	68,071.19	90.6	65,438.29	93.2
B) Other Investments										
8. Deposits and other investments with banks	3,649.00	6.4	3,541.00	5.8	1,870.60	3.0	1 ,985.53	2.6	151.42	0.2
9. Government Securities	4,505.00	7.9	2,517.00	4.1	5,263.60	8.5	5,102.57	6.8	4,611.87	6.6
Sub Total (B)	8,154.00	14.3	6,058.00	9.9	7,134.20	11.5	7,088.10	9.4	4,763.29	6.8
Grand Total (A + B)	57,124.93	100.0	61,164.74	100.0	62,085.60	100.0	75,159.29	100.0	70,201.58	100.0

Source: IDBI, *Report on Development Banking in India, 2000-01.*

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UTI's popular open-ended equity schemes include Grand Master 1993, Master Gain 1992, Equity Tax Saving Plan, Unit Growth Scheme 10000, Master Growth Unit Scheme 1993, Master Plus 1991, Master Index Fund, and Nifty's Index Fund. The open-ended balanced schemes offered b)' UTI are Unit Scheme 1964 (US 64), US 95 Open Ended Balanced-Income Option, US 95 Open-Ended Balanced-Growth Option, Charitable and Religious Trust Societies 1981, Children's Career Plan, UTI Variable Investment Scheme, and Unit Scheme 2002. UTI also offers Money Market Fund schemes such as UTI Money Market Fund (Income Option) and UTI Money Market Fund (Growth Option).

Assistance to the Corporate Sector

The Unit Trust of India helps in industrial growth through sanctioning and disbursing assistance under project and non-project finance. It also provides to the corporate sector financial services, including underwriting to the corporate sector.

Sanctions and disbursements by UTI declined by 12.7% and 10.9%, respectively during 2000-01 (Table 17.1). The total investable funds of UTI also declined by 6.6% during 2000-01 as compared to a growth of 21.1% in the previous year. The corporate sector accounted for 93.2% of UTI's aggregate investments. UTI's investment is highest in equity (57.3%), followed by debentures (32.6%), and government securities (6.6%). UTI's total income declined by 62.8% in 2000-01, which led to a decline in the net amount transferred to revenue appropriation account. UTI's total assets declined by 1.8%, while its investments rose by 2.8% in 2000-01. The reserves and surplus turned negative during 2000-01. UTI's exposure to the equity market increased in the nineties. Since last five years, both the primary and secondary segments of the capital market are in a depressed state. The chances of generating good returns to pay high dividends have reduced. In spite of this, UTI paid high dividends to its investors from its reserves, which resulted in negative reserves of Rs 75,900 crore in 2000-01.

The Unit Trust of India has taken certain initiatives in the areas of investor service and efficient fund management. These are:

i. making US-64 NAV-based effective January 1,2002;
ii. disclosure of portfolio for all schemes, including US-64 on a monthly basis;
iii. daily announcement of NAVs;
iv. introduction of special repurchase facility with monthly increasing price support for investments up to 3,000 units per investor from August 1,2001, and up to 5,000 units per investor from January 1,2002;
v. price support of Rs 10 per unit from May 31, 2003, for holdings in excess of 5,000 units per investor;
vi. issue of detailed investment manual and comprehensive delegation of powers;
vii. setting up of a Risk Management department;
viii. setting up of Asset Reconstruction Fund for focused effort for recovery of NPAs;
ix. performance-linked incentives for officers;
x. commissioning of Central Processing Centre and Central Data Centre and centralisation of all back office functions;
xi. implementation of integrated front office automation system.

US-64

UTI launched its first scheme, Unit Scheme 1964 (US-64), with the aim of inculcating the habit of saving among households. The initial sponsors of the scheme were the RBI, LIC, State Bank of India (SBI), and other scheduled banks, including a few foreign banks. They contributed-to its initial capital of Rs 5 crore. In February 1976, RBI's contribution was taken up by the IDBI. These institutions were provided representation on the Board of the Trustees of UTI. The US-64 is the flagship scheme of UTI which commands around one-fifth of UTI's total assets. Around 20 million investors have invested in the scheme. This scheme ran into trouble in 1998.

The US-64 was launched as a debt fund as the equity markets were not developed in the sixties. Its repurchase and sale price are administered, that is, fixed by UTI at the beginning of its financial year (July for UTI). Both the repurchase and sale price used to consistently increase by the end of the year, irrespective of the actual returns generated and assets under management. This administered pricing was not a problem in a bullish market but if the markets turned bearish, this high price was paid out of reserves. The government came up with a bailout package in the form of Special Unit Scheme (SUS-1999). In 1999, the UTI issued to the government special units of SUS-99 worth the book value. In turn, the government issued dated securities worth Rs 3,300 crore to take over the scrips of Public Sector Undertakings (PSU s) from US-64 scheme. The government lost Rs 1,000 crore due to the depreciation in the value of public sector undertakings stocks that were exchanged during the bailout under the SUS-99. This bailout improved the NAV of US-64 but highlighted the inherent problems of UTI such as political interventions in the investment decisions of UTI and a total lack of accountability.

UTI is governed by a special act and hence did not come under the purview of SEBI. There was no regulator to ensure the soundness of UTI's investment decisions. The small investors' interest in the scheme was mainly due to the higher returns it generated and dividends it declared and, above all, backed by the government. They were never bothered about the functioning of UTI. UTI never made it a practice to disclose any qualitative information to the investors. In fact, UTI continued to float a series of schemes with assured returns and followed liberal dividend policies. These assured return schemes with high dividend pay-out were no longer practical.

Dividend History of US-64

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Date	*Dividend (in %)*	*Rights / Bonus*
30.6.91	19.50	
30.6.92	25.00	Preference offer @ 11.20 (July 1992)
30.6.93	26.00	2:5 Rights @ 12.80 (July 1993)
30.6.94	26.00	1.5 Rights @ 14.80 (September 1994)
30.6.95	26.00	1:10 Bonus Issue
30.6.96	20.00	
30.6.97	20.00	
30.6.98	20.00	
30.6.99	13.50	
30.6.00	13.75	
30.6.01	10.00	

Source: Capital Market, July 9-22, 2001.

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In 1993-94, the income from the US-64 scheme was Rs 3,538 crore while the dividend outflow was Rs 3,128 crore. However, the dividend outflow started exceeding its income from the financial year 1994-95 and continued till 1996-97. In 1994-95, the dividend outflow was Rs 3,973 crore as against the income of Rs 3,287 crore. This depleted the reserves of UTI which dropped from Rs 5,842 crore in 1993-94 to Rs 1,778 crore in 1996-97 and finally turned negative by Rs 1,098 crore in 1998. With a view to building up reserves, UTI reduced its dividend rate from 20% to 13.5% in 1998-99. The 10% dividend that UTI declared in 2001 was the least dividend, it had declared in the last two decades. The scheme's equity investment had increased to 64% in the late nineties from a mere 26% in 1990. Both the primary and secondary segments of the capital market were in a depressed state, which reduced the chances of generating good returns to pay high dividends.

The government appointed a high-level committee under the chairmanship of Deepak Parekh, Chairman of HDFC, for restructuring UTI. The Committee came up with 19 suggestions which included increasing the debt component in investments of the scheme, bringing the scheme under the purview of SEBI, and the most prominent being to convert the US-64 into an NA V driven scheme within a period of three years. UTI failed to tap the opportunity of converting this scheme into NAV driven during 1999-2000 when the capital market was bullish. The failure of UTI to implement the recommendations of Deepak Parekh Committee led to an eruption of another crisis in 2001.

UTI freeze the repurchase and sale ofUS-64 units in July 2001, shattering investors' trust. On the NSE, the fund was trading far below the repurchase price of Rs 13.20 and dipped to a low of Rs 9.60 within a week. The corporates had anticipated this well in advance and withdrew their funds before the crisis struck. To help out the small investors, the government provided Rs 300 crore support to bridge the gap between NAV and the administered repurchase price of US-64 units.

The government set up a committee under the Chairmanship of former RBI Deputy Governor, S S Tarapore, to investigate into the commercial aspects and investment decisions of the fund. The Tarapore Committee called for an inquiry into more than 19 investment decisions of the Trust. It suggested creating three AMCs to handle growth funds, income funds, and Units Scheme, 64, and introducing performance-linked management. According to the committee, the UTI Bank could hold 49% of the capital of the three AMCs and this would, over time, enable greater private participation in UTI. It further recommended that only individual investors should be allowed to invest in US-64. Corporations and institutions should not be allowed to invest in US-64.

The Malegam Committee, which was formed by the Board of Trustees of UTI at the instance of the government, recommended a three-tier structure in line with SEBI regulations comprising a sponsor, a trustee company, and an Asset Management Company (AMC). It suggested that the government should limit its stake through IDBI, SBI, and other government-backed financial institutions to 40% and the rest 60% could be offered to a sponsor or strategic partner. The Trustee company should be a fully owned subsidiary of sponsor company and shareholding of sponsor company in the AMC should be restricted to 40% with the balance to be offered to public. The Committee further recommended that the UTI Act should be repealed and replaced by a new enactment. The government must be completely distanced from UTI. US-64 should be net asset value based before restructuring of UTI is attempted. Provisions should be made for contingent liabilities, if any, arising out of the gap between the available assets of US-64 and guaranteed price to individual unit-holders owning up to 3,000 units.

In view of these recommendations, UTI took a decision to skip dividend for the first time in 2001—02 and to incorporate professionals on its board. The US-64 scheme moved to the NAV basis on January 1,2002. The US-64 NAV is hovering around Rs 6 a unit which has eroded the investors' confidence in the scheme.

In the year 2002, problems of liquidity and redemption pressures on the schemes surfaced again. Earlier it was US-64, the new problems related to 17 assured monthly income plans (MIPs) of UTI which had negative reserves. For instance, MIP 97 III had negative reserves of Rs 260.1 crore, MIP 97 IV had negative reserves of Rs 296.8 crore, MIP 97 V had negative reserves of Rs 170 crore while MIP 98 had negative reserves of Rs 296.8 crore. UTI met the redemption of the first MIP 97, which matured in June by dipping into its reserves. MIP 97 alone had a shortfall of Rs 402 crore due to the large gap between its assured redemption price of Rs 10 and the March 31, 2002, NAV of Rs 6.39. The Development Reserve Fund which guarantees its assured return schemes was pegged at about Rs 1,800 crore and the gap in its assured return schemes was in excess of Rs 3,000 crore. Seeing the financial strain of UTI, the government provided it a partial guarantee for Rs 1,000 crore. On the basis of this guarantee, UTI borrowed Rs 1,500 crore from State Bank of India (SBI) to meet its payment obligation on two monthly income plans.

The Finance Minister, Jaswant Singh, announced another bailout package for UTI. This package amounted to Rs 14,561 crore and led to UTI bifurcating into UTI-I and UTI-II. The government handed over one part, comprising the 43 net asset value based schemes (UTI-II) to a company floated by LIC, SBI, Punjab National Bank, and Bank of Baroda. UTI-II started operations from February 1, 2003. UTI-II has become a SEBI -compliant mutual fund with a three-tier structure, comprising the board of trustees, sponsors, and an asset management company with a paid-up capital of Rs 10 crore. The four players have invested Rs 2.5 crore each. The government will continue to run the Rs 31,000 crore worth UTI-I, comprising the flagship scheme US-64 and other assured return schemes. The government has appointed one administrator and four advisors for the ailing UTI-I.

The government has repealed the UTI Act through an ordinance. Both UTI-I and UTI-II will comply with the requirements of SEBI. The government will issue 10-year, tax-free bonds to banks and financial institutions to raise Rs 10,000 crore to meet the shortfall in the NAV and the declared repurchase price of US-64. Those bonds will carry a coupon rate

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of 7 to 7.5 per annum and could be redeemed in the last three years before maturity. Dividend reinvestment option under the income plan of US-64 will be discontinued. Investors will have the option either to encash their holdings at the declared, predetermined price or to convert the existing units with assured repurchase price into NAV-based prices or to invest in the tax-free bonds. The government has assured a repurchase price of Rs 12 per unit in respect of holding up to 5,000 units and Rs 10% in respect of holding above 5,000 units and this administered price will continue even after May 2003. Dividend income from Unit-64 is tax free and profit on the sale of US-64 units is exempted from capital gains tax and dividend received in UTI-I from its investments will be passed on to the investors after administrative expenses.

Growth and Performance of Mutual Funds in India

The Indian Mutual Fund industry has grown tremendously in the last decade. There are 34 mutual funds with assets under management of around Rs 1 lakh crore. Assets under Management (AUM) crossed Rs 1,00,000 crore during the year 1999-2000 recording a growth rate of 65%. Besides, vast majority of equity schemes out-performed the market. However, in the subsequent year, that is, 2000-01, AUM sharply declined by about 20% to Rs 90,587 crore due to extreme volatility in the market and depressed equity market conditions. The mutual fund industry witnessed such a sharp decline for the first time in the last two decades. There was a turnaround in the year 2001-02. The AUM grew by 11% to Rs 1,00,594 crore. During the year 2001-02 while there was an increase in AUM by around 11%, UTI lost more than 11% in AUM. It is evident that UTI is losing out to other private sector players. The AUM of private sector mutual funds rose by around 60% during the year 2001-02.

During the year 2001-02, 90 new schemes were launched-74 of which were open ended and 16 close ended. Income schemes predominated with 53 schemes collecting Rs 2,744 crore which accounted for 82% of total collection of Rs 3,355 crore from new schemes. Almost 96% of the money raised from new scheme launches were invested in the debt/money market. Sales under Growth, Balanced, and ELSS schemes declined during the year.

Assets under Management

(Rs in crore)

Category		1997-98	1998-99	*1999-2000*	*2000-01*	*2001-02*
1. Unit Trust of India		57,554	53,320	76,547	58,017	51 ,434
	Growth (%)	-	-7.34	+43.56	-24.21	-11.35
	% to Total	83.4	77.87	67.74	64.05	51.13
2. Bank Sponsored (4)		4,872	5,481	7,842	3,333	3,970
	Growth (%)	-	+12.5	+43.08	-57.50	+19.11
	% to Total	7.06	8.00	6.94	3.68	3.95
3. Institutions (4)		2,472	2,811	3,570	3,507	4,234
	Growth (%)	-	+13.71	+27.00	-1.76	+20.73
	% to Total	3.58	4.11	3.16	3.87	4.21
4. Private Sector		4,086	6,860	25,046	25,730	40,956
	(a + b + c)	-	+67.90	+265.10	+2.73	+59.18
% to Total		5.90	10.02	22.16	28.40	40.71
	(a) Indian (7)	1,031	1,016	2,331	3,370	5,177
	Growth (%)	-	-1.50	129.43	+44.57	+53.62
	% to Total	1.50	1.48	2.06	3.72	5.15
(b) JV-Predominantly						
	Indian (8)	1,583	3,040	9,724	8,620	15,502
	Growth (%)	-	+92.04	+219.87	-11.35	+79.84
	% to Total	2.30	4.44	8.60	9.52	15.41
(c) JV-Predominantly						
	Foreign (10)	1,472	2,804	12,991	13,740	20,277
	Growth (%)	-	+90.5	+363.30	+5.77	+47.58
	% to total	2.13	4.10	11.50	15.17	20.16
Total (1 + 2 + 3 + 4)		68,984	68,472	1,13,005	90,587	1 ,00,594
Growth (%)		-	-0.75	+65.04	-19.84	+ 11.05
Total	100.00	100.0	100.0	100.0	100.0	100.00

Note: Figures in brackets denote number of funds. *Source:* AMFI

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Conclusion

In India, mutual funds have a lot of potential to grow. Mutual fund companies have to crate and market innovative products and frame distinct marketing strategies. Product innovation will be one of the key determinants of success. The mutual fund industry has to bring many innovative concepts such as high yield bond funds, principal protected funds, long short funds, arbitrate funds, dynamic funds, precious metal funds, and so on. The penetration of mutual funds can be increased through investor education, providing investor oriented value added services, and innovative distribution channels. Mutual funds have failed during the bearish market conditions. To sell successfully during the bear market, there is need to educate investors about risk-adjusted return and total portfolio return to enable them to take informed decision. Mutual funds need to develop a wide distribution network to increase its reach and tap investments from all corners and segments. Increased use of internet and development of alternative channels such as financial advisors can play a vital role increasing the penetration of mutual funds. Mutual funds have come a long way, but a lot more can be done.

Threats to Mutual Funds Posed by E-broking

Equity markets for a long time were a bastion for institutional investors and high net worth individuals only. The high risk-return profile of equity investments was an attraction for retail investors as well. But it was only with the advent of mutual funds that they entered the stock markets in a big way. Mutual funds in India, and all over the world, have been a hit with small investors. They have provided a better yielding avenue to such investors who want to invest in the stock markets, but are not backed by substantial savings to do so. Earlier investors had to buy a minimum of 5,10, 50 and 100 shares, depending on the face value and the company, if they made an investment in the equity markets, and this foreboded small middle class investors whose requirement was to make investment out of their small savings. Though the situation has changed now, with dematerialization of shares, allowing investors to buy and sell a single share, the high prices of a few shares like Infosys, and Wipro don't allow the investors to take advantage of such attractive investments. But trading of fractional share, as has been already permitted in the US, will do away with that constraint too.

Internet trading in stocks eliminates the hassles of running around the broker, uncertainty over the exact price of purchase, writing out cheques and giving instructions to depository participants (a broker with a demat account). An investor can do his own research on the Net before making a deal. The websites offering e-broking have all the information needed to make an informed purchase or sale. Till recently, such information was the exclusive preserve of big investors. Internet trading in India is expected to account for 10 per cent of the trading volume of the stock exchanges in a year and would grow to 25 to 30 per cent in the next few years.

The sale or purchase of shares involve three steps: placement of order (for sale or purchase), payment (for purchase) and delivery of shares. Since payments through the Internet are not yet legally valid in India, for most small investors e-trading is currently restricted to the placement of order. However, once cyber laws are passed by Parliament — which is likely to happen in a couple of months — entire trading could happen online. Says D.R. Mehta, chairman of the Securities and Exchange Board of India (SEBI): "The complete cycle of Internet trading, from booking orders to payments, will go online only after cyber laws are passed by Parliament."

A mutual fund is a corporation, which pools together investor's money, and buys stocks or bonds on their behalf. Investors participate in it by purchasing shares of the entire pool of assets, to diversify their investments. The Capital gains or dividends from these securities are then distributed to unit holders or the investors of the Fund.

Mutual funds in India were brought in by the government in 1964 as UTI, the largest mutual fund in the country, to encourage small investors in the equity market. UTI has an extensive marketing network of over 35, 000 agents spread over the country. The UTI funds have performed relatively well in the market, as compared to the Sensex trend. However, the same cannot be said of all mutual funds.

Nowadays, an average person / investor is more aware and educated about the equity markets than ever before. The stock markets have become a regular topic of discussion in many parties. Hence, the advantage that mutual funds provided of the fund manager's expertise in investing, is no longer the mutual funds' selling proposition. The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US-64 scheme. The Indian public are largely unaware of the nuances of mutual fund schemes. This debacle proved that even fund managers who should know better get swayed by movements in capital markets and take investment decisions which go awry when the mood in the market changes. Though this scheme was bailed out with considerable cost to exchequer, not every mutual fund may be as big and fortunate that the government has no option but to bail out the scheme, as UTI. We will know over the next few years whether UTI will be able to regain the almost blind faith that investors had reposed in the institution. Another factor that may adversely affect UTI is the expected demise of regular income schemes wherein the returns are guaranteed. Many funds currently have NAV less than the face value, partly reflective of the fact that mutual funds are not as fool proof as was earlier believed.

Hence, investors have to be careful with their investment decisions, as they are not guaranteed by the Government, Reserve Bank of India or any other government agency. Number of such schemes have run into trouble, and though mutual fund industry is in the growth phase, with many new entrants and mergers between existing players, investors need to keep a wary eye on developments as their own money is involved.

Most people invest in mutual funds for one simple reason. They are a convenient and cost effective method of obtaining diversification and professional management. The risk factor is also considerably low. This is because mutual funds hold anywhere from a few securities to several thousand, over a number of investments. What's more, mutual funds generally

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buy and sell securities in volume, which allow investors to benefit from lower trading, management and research costs.

It is also felt that many investors invest in MFs more for convenience than to avail themselves of the fund managers' expertise. Studies in the US show that well-managed funds get good inflows of money and grow rapidly, though interestingly, poorly managed funds, while not getting funds, also did not lose money. This is indicative of a built-in inertia in the investors' attitude. With folio services like allowing the investor to buy fractional shares, trade execution and accounting function of a MF can be automated and become very convenient for investors. Since providing these services is not expensive, one might see these functions becoming highly commoditised. And in the demat environment, there is no reason why fractional shares cannot be processed. With technology, today an investor also has access to key information, which was earlier only a manager's privilege. Investors maybe more inclined to invest in select portfolios rather than to go by the MF route.

The table shows the investments in Mutual Funds, with the break-up in various schemes.

Fund Mobilization (August'2000)

	Sale						
New scheme	Existing scheme	Total					
A Unit Trust of India	1	0.4	6.1	6.5	10.3	-3.8	671.9
B Bank Sponsored (7)	-	-	1.2	1.2	1.6	-0.4	63.7
C Institutions (4)	-	-	1	1	1.2	-0.2	30.1
D Private sector							
I Indian (5)	-	-	21.7	21.7	9.5	12.2	38.4
II Joint Venture:							
Predominantly Indian (7)	-	-	8.1	8.1	10.2	-2.1	90.8
III Joint Venture:							
Predominantly Foreign (9)	2	0.4	31.2	31.6	30.6	1	133.6
TOTAL (I+II+III)	2	0.4	61	61.4	50.3	11.1	262.7
Grand Total (A+B+C+D)	3	0.8	69.3	70.1	63.4	6.7	1029

Though the spread of the Internet has been slow in India, players are catching on fast, at least in the online stock trading business. Internet trading or e-broking seems to have passed through its teething troubles and more players are now entering the fray. Given the suitability of the product and rising demand, therefore, it is no surprise that E-broking has captivated the imagination of the consumer and created a new breed of investor - the day-trader -whose impulse to buy, own and sell is, and must be, matched by swift transaction processes. Online brokerage houses aim to provide real-time quality information and research, high transaction efficiency and customer service. This include stock analysis tools like technical analysis charts provided by ICICIdirect, stock tips, latest research reports, company analysis, trends in the market, real-time market commentary, market scoops and breaks etc. all these tools will help in making the investor better informed and better equipped to make intelligent investments.

While volumes are still low at the Rs 100 million a day mark compared to the combined turnover of Rs 90 billion a day on the Bombay Stock Exchange and the National Stock Exchange, e-brokers have already announced price cuts that have been unheard of for the Indian trader. Investors and traders have never had it so good as trading commissions and brokerage rates are declining steeply. E-broking has triggered off a price war with each player valiantly trying to outdo the other. Every broker has offered a service or a price to differentiate itself from the rest of the fray.

Online brokerage houses in India might offer folio services sooner than most people expected. It is predicted that with net trading becoming important, we could be a year away from active trading. And another year away from online traders moving into sophisticated activities like folio services.

Online brokerage houses abroad are already offering folio services. Foliofn.com, a foreign online brokerage firm, for instance, allows its investors to buy fractional shares and treats a portfolio trade as a single order. Unlike the conventional portfolio management services, these are less expensive. These are charged like any other stock trading services.

While substantial progress has been made by stock exchanges and SEBI with screen based trading and dematerialization, a typical retail investors still feels the pinch of high brokerage. With his regular broker, sitting in and brick and mortar set-up , he did not have access to real time, quality research and information. E-broking is yet another milestone in trading, which has substantially reduces brokerage charges and transaction costs to the investors. The online brokerage houses play on volumes, not margins and brokerage.

Flexible systems with high levels of connectivity are vital to e-broking. But with increasing bandwidth and laying of optical fibres for transmission of data, this problem will also solved.

Traditional broking was previously a personalised industry with individual brokers operating through firms. Then the business went through a process of corporatisation.

According to Forrester Research, by 2003, 9.7 million US households will manage more than $3 trillion in 20.4 million on-line accounts. Jupiter Communications estimates that, by 2003, 20.3 million households will trade on-line and also puts total on-line account assets at more than $3 trillion.

Professional Management

Mutual Funds provide the services of experienced and skilled professionals, backed by a dedicated investment research team that analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme. But the failure of many mutual funds in the past has proved that even fund managers are not fully immune to market vagaries despite their knowledge and experience. Further with the regulation of sharing all information given to analysts,with the general public, the information edge of the institutions has disappeared.

Diversification

Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. Investors can achieve this diversification through a Mutual Fund with far less money than they can on their own. But sector based funds like Birla IT fund, Kotak Mahindra K Technology, Kothari Pioneer Pharma

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fund- have been very polular with investors, indicating their willingness to take exposure in a specific sector to reap the benefits if high growth rate of the sector, hence achieving high returns.

Here, mutual fund does score over the online brokerage but in recent times investors have referred high returns to diversification.

Return Potential

Over a medium to long-term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities. But for short term investors, mutual funds are not such an attractive avenue. Here online brokerage houses havea big advantage over the mutual funds. They have led to the birth of a new class of investors hitherto unknown in India: day traders.

Low Costs

Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors. There is 1% expense fee levied in the investment, along with custodial, asset management and other fees. But with the brokerages falling through the roof the ost advantage of mutual funds is also lost. Online brokerages in Inda are among the lowest the world over.

Liquidity

In open-end schemes, the investor gets the money back promptly at net asset value related prices from the Mutual Fund. In closed-end schemes, the units can be sold on a stock exchange at the prevailing market price or the investor can avail of the facility of direct repurchase at NAV related prices by the Mutual Fund, though very few close ended schemes are in existence now. Trading in open-ended schemes is not an issue as they can be sold to the scheme itself anytime the investor wants to liquidate his position. But with online broking, and dematerialised environment in the capital markets now, liquidity of stocks is no more a problem.

Transparency

Though mutual fund managers promise regular information on the value of the investment in addition to disclosure on the specific investments made by the scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook, this has not been a common practice. The example of UTI illustrates this point. This works as a big disincetive to the people planning to invest in mutual funds.

Flexibility

Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, investor can systematically invest or withdraw funds according to his needs and convenience in mutual funds. But what more ease then to do the trade yourself without any human interaction. Online brokerage offers you the service of being able to do all the trading as per your own wishes without any human interface.

Affordability

Investors individually may lack sufficient funds to invest in high-grade stocks. A mutual fund because of its large corpus allows even a small investor to take the benefit of its investment strategy.

Choice of Schemes

Mutual Funds offer a family of schemes to suit your varying needs over a lifetime. There is a variety of schemes available like Gilt funds, equity linked saving schemes, sector funds, income funds, balanced funds etc. This is a big advantage and investors can match the type of schemes to their risk profiles, liquidity preference and interests.

Therefore, if one online broker starts providing these services at low cost, others could follow suit since online broking is very competitive. The costs to a broker to provide these services through a software program in computer and with the prices of computer and its products getting cheaper by the day, are not a barrier. Online banks might also enter the fray. This kind of business models of folio services abroad have recently started and are still in their infancy. The MFs will have to be on their toes. If a MF is concentrating on the functions that can be automated, they might see a decline in their revenues. Therefore they should concentrate on functions, which cannot be automated.

Now looking at an MF, their core function is fund management and the other functions are trade execution and accounting functions. A prudent MF should focus more on fund management and become knowledge-intensive. Personal relationship with high networth clients is another area where technology cannot pose a big threat. Wherever technology has a potential to reduce cost, MFs will have to use it.

The ease of setting up on-line broking operations has driven down commissions. Even though online brokerage houses are making losses in the short run, they are confident of the future of e-broking. Also, most of the online brokerage houses have been set up by existing brick-and-mortar brokers, to supplement their existing business and increase their reach. Currently, Indian broking firms charge an average of 0.85 to 1.25 per cent as commission, which is lower than in many other markets.

The fierce competition in on-line broking and the increase in trading volumes are certain to drive these rates down further. The transaction costs will be significantly lower. The first clutch of brokers are charging between 0.75 per cent and 0.40 percent for delivery trades depending on the size of transactions.

The discount brokers

ICICI Direct (www.icicidirect.com) was the first broker to introduce a brokerage of 0.85 per cent per trade. ICICI's differentiators are an integrated service encompassing broking, banking and depository services from ICICI Bank. ICICI Direct's pricing structure depends on how much the investor trades and ranges between 0.85 per cent and 0.4 per cent as trade volumes increase.

In July, Probity's 5paisa (www.5paisa.com) was the next one introducing a brokerage rate, probably the lowest in India, of 0.05 per cent a trade. Last week, stockbroker S S Kantilal Ishwarlal's Sharekhan (www.sharekhan.com) turned the fee structure of the broking industry upside down in July by introducing a trade-as-much-as-you-want scheme of Rs 1,000 a month. Sharekhan is the first broker in the country to introduce

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flat-fee broking. On August 9, Kotak Securities introduced e-broking with the option of trading against securities. Other players will inevitably introduce further innovations in the near future.

Apparently, Sharekhan is targeting the high volume trader with its fee structure that is not a percentage of transaction value. If a trader crosses monthly volumes of Rs 2 million, Sharekhan is the cheapest broker. (At a volume of Rs 2 million, the 5paisa.com brokerage works out to Rs 1,000.) Reacting to the cut-rate discounts, ICICI Direct has reduced its minimum brokerage per trade from Rs 100 to Rs 25 and the minimum trade size from Rs 6,000 to Rs 1,000.

Each player is supremely confident of the success of his respective pricing strategy and revenue model, even though the services they are offering at such attractive rates sem impractical and unsustainable. Only time will tell whether the confidence is misplaced or not.

All the online brokers are targeting large volumes of trade to make money. While some of them admit they will make losses in the short-term, they remain optimistic about overcoming them with sufficient volumes.

To survive, brokers must specialise, diversify, or face being swallowed by retail banks or sunk by market forces. Thus, successful on-line brokers may be the ones that are niche providers, aiming their specialised products at highly profitable segments like high net worth active traders or, alternatively, those who decide to become infomediaries, offering a wide range of products and services. The winners will be those brokerage houses that provide an entire spectrum of products and services for the investor, and have the technology to scale up their systems to cope with the increasing volumes of trades on-line.

The stock exchanges too are gearing up their infrastructure to facilitate Internet trading. The NSE has not just put a comprehensive e-trading system in place, it is in the process of connecting the system to the bank interface for online payments. The stock exchange of Mumbai (erstwhile BSE) is in the process of finalising its e-trading module and has informed its 300 member-brokers of the rules for Net trading prescribed by SEBI. Says M. Vaishya, director in charge of e-trading in BSE: “Internet trading will lead to a tremendous spurt in the total trading volumes, involving wider retail participation. “

The outpouring of small investor interest testifies that. The website of Motilal Oswal Securities, one of the firms licensed to provide online broking, gets 7,000-8,000 enquiries a month about online trading. This shows the rising interest of retail investors in using the facility of e-broking. The firm expects at least 25 per cent of these enquiries to convert into clients. The investors will gain from a fall in brokerage fee from 1-2 per cent (of the purchase or sale deal) to just 0.75 per cent. E-broking will take the stock markets right to the small investors' doorstep.

But the real winner in the cyber-broking sweepstakes will, of course, be the investor who can, more easily than ever before, not only know where to put his money, but when and why. And all of this with just a few clicks of the mouse.

In smaller towns another trend has been observed. In smaller towns like Kota etc., brokers charge on an average of 5% brokerage. Now, the investors are taking advantage of on-line broking. To give an example, a few shopkeepers together hire a person who does nothing but place orders through an on-line account for this group of people. He is paid say about 2% charge on the trades, additional to the online brokerage of about .85% (inclusive of transaction fee). Still the brokerage charges workout to be much lower than the traditional broker.

In most cases of online brokerage houses, only one leg is e-enabled.i.e. only order placement and execution is carried out through the internet (the customer logs on to the broker's website to check share prices and related information. He then places a purchase order through authorised secure user id and password. Order is routed through the broker to the stock-exchange server and he gets confirmation of the deal in a few minutes.) . But the payment is not. They payment for the securities, and delivery of shares, has to be collected the traditional way. Payment for the securities as of now is not being taken through credit cards. This may be to curb speculation during the credit period. Also the merchant, in this case the brokerage house, will have to pay a fee (about 2%) to the card issuer bank, which will increase their costs.

In US both legs are e-enabled on most cases. For example for Indiabulls, the investor places his order online in real-time, and the execution of his order is carried out. The investor, incase he does not have an existing savings account, is required to open an account with UTI Bank, Barakhamba Branch. Another route Indiabulls has been following is that when the Delhi-based customer takes delivery of shares, Indiabulls sends its representative to the customer within an hour to collect the payment, whether in cash or cheque. The credibility of the customer is verified before he is allotted his trading account with Indiabulls, by verifying his saving bank statement, ration card, passport, license etc. to validate his identity. Which means that the active trader has to be located in Delhi or else he cant trade on a daily basis. Once payment on the Internet is allowed, payment amount will get deducted from the investor's online bank account (with which the broker has tied up). The purchased shares will be credited to the online demat account in no time.

Only ICICI (with ICICIdirect) and HDFC (which will soon start its online broking facility) have an advantage in this aspect, having both legs e-enabled, since they have a strong backbone with payment gateways, as they are networked with other banks. Thus even investors based in smaller towns can use their brokerage services.

Right now only ICICIDirect has the infrastructure to provide complete online trading on the Net to retail investors. It has a broking arm, an online banking facility which offers demat account for trading in shares. ICICIDirect allows it's customers to have an account with any bank and allows them to take maximum exposure equal to the amount they have in their account. The client first opens a brokerage account with ICICIDirect by filling a form online and paying a fee, which ranges from Rs 550 to Rs 800. Opening a brokerage account entitles the client to a savings bank account and a demat account (required for trading in demat — paperless — shares). With

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these three accounts, the investor can place the order for purchase or sale, pay from his online account and get the transaction credited to his demat account.

Regulatory issues

All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI. Broker, on the other hand, can invest as he pleases

Conclusion

Hence, an informed investor who is looking for convenience in active day trading will find online brokerage services of great use. But investors looking for medium term an long tem horizons may still be willing to put their money in hands of mutual fund managers or investing through their local brokers.

The mode of payment and fund transfer still remains an issue to be tackled in e-broking.

Best Funds 2004

Find out where your scheme stands in our comprehensive annual ranking of mutual funds

Kayezad E. Adajania, 16 Mar 2004

IF YOU'D gotten on board a mutual fund to trawl the financial markets through 2003, you probably enjoyed the ride. Chances are you'd be smug in the knowledge that your investments have gone far–farther than you probably expected. In the short history of mutual funds in the country, last year was one of the best ever. They were helped, in no small measure, by the favourable conditions in the two financial markets. The stock market staged a smart rally on the strength of attractive valuations, strong economic growth, encouraging corporate results and foreign funds. The debt market too offered ample opportunity to maximise gains, and though returns were lower than the year before, they were reasonable.

Endings and beginnings. Amid the euphoria over an outstanding year, many events of importance to the mutual fund industry slipped by. The revamp of UTI, the country's largest mutual fund, was finally completed. In other endings, Zurich Mutual Fund sold out to HDFC Mutual Fund and IL&FS is in the process of being acquired by UTI, continuing the process of consolidation in the industry.

Meanwhile, two global financial powerhouses, HSBC and Deutsche Bank, entered the fray, and word is that ABN-Amro and Fidelity are likely to soon follow suit. As the industry continues to evolve, so does its bouquet of products. Several new kinds of schemes hit the market–floating rate income funds, bond index funds and funds of funds. This year, we've seen funds dedicated to international stocks being launched and now there's talk of assured return funds. Mandatory certification for distributors to sell mutual funds and more stringent pricing norms made mutual fund buying and selling more fair and transparent.

But let's move on to the real point of interest here: performance. When it comes to mutual funds, a year-end is not the finishing line, it merely signals the end of a period of time. But it's also a good time to take stock, of how good or bad the journey this far has been, of whether to continue on the existing path or to make mid-course corrections. Just how did your scheme fare in 2003, in relation to the market conditions it had to operate under and its peers? Who were the toppers in the eight fund categories? What's the outlook in 2004 for the various kinds of schemes? Which schemes should you board and which ones should you desert? The answers are all there in Outlook Money's annual ranking of mutual funds in the country.

Equity Funds Full Steam Ahead

Without doubt, 2003 was the Year of the Bull. There were many factors that made the market's turnaround sweet and memorable for investors. It is after three-and-a-half long, sometimes bitter, years that the market is shining again. It wasn't the least bit expected to go up this fast, this soon. And from the look of things, it's not a flash in the pan either. This is not a rally that's riding the next new faddish sector; it is broadbased and looks set to endure.

The BSE (Bombay Stock Exchange) Sensex–the commonly used benchmark to assess the performance of equity funds–rose 70 per cent in 2003. By comparison, actively managed equity funds, on average, returned 102 per cent. Fund managers picked their stocks well, used the rising market to churn portfolios, all in an attempt to beat the market. Commendably, many managed that with elan.

Making money from the market in 2004 won't be as easy as last year, widespread opinion says. Says Rajat Jain, chief investment officer, Principal India Mutual Fund: "We expect equity to return 15 per cent in 2004." Although the market has run up and is presently locked into a narrow range, it still has plenty going for it. Market players say foreign funds are keen to invest more, political uncertainty is dismissed as a non-factor, as the BJP is expected to win hands down. The key to the market's growth lies in sustaining the current rate of economic and corporate growth, continuing with reforms, and withstanding competition from other emerging Asian economies. The outlook for equities remains positive. Even if the market moves in a narrow range, well-managed diversified funds should deliver decent returns.

Diversified equity funds. One statistic tells just how rewarding–and easy–a year it was for diversified equity funds. Of the 44 schemes that made our cut, just one, GIC Growth Plus II, failed to beat the Sensex, that too only just. As a group, diversified equity funds gained 110 per cent, which lifted their five-year averages. For instance, our top-performing fund, Reliance Vision Fund, on the strength of 155 per cent jump in NAV, boosted its five-year average from 18.6 per cent in 2003 to 45.5 per cent this year. Just goes to show how one good year can compensate for a few bad ones, and why we keep iterating that stocks have to be seen as long-term investments, not short-term flings.

The usual suspects–Templeton and HDFC schemes–feature prominently at the top. Diversified funds that ventured beyond the index and large-cap stocks gained the most. Like Franklin India Prima Fund, which returned 177 per cent last year alone. Or, the topper, Reliance Vision. Sometime in 2002, this fund took to mid-cap stocks. Says Madhusudan Kela, head-equity

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management: "We buy out-of-fashion stocks because that's when we'll get the right valuations." As it turned out, Reliance Vision timed its entry well, as mid-caps stocks started rising soon after and continued into 2003–the S&P CNX Midcap gained 134 per cent that year.

Every fund can ride a good market. Often, it's how it does in sluggish and bad markets that shows its mettle, which is borne out in the five-year averages. The compounded annual returns range from -3.2 per cent (Franklin India Vista Fund) to 46.5 per cent (ironically, another Templeton fund, Franklin India Prima Fund). While choosing a scheme, give more weight to a fund's performance over many years and many kinds of markets, rather than go by just the immediate period of reference.

Outlook 2004: upside: 15-20 per cent downside: 5-10 per cent

Equity-linked savings schemes (ELSS). The performance of ELSS was much on the same lines as diversified equity funds–strong returns during the year, propping up five-year averages. HDFC Tax Saver, formerly Zurich Tax Saver, retained its top position–the only fund to do so in the eight categories. Part of the credit should go to Zurich, and Chirag Setalvad, the scheme's new fund manager, agrees. Having said that, HDFC's good record in equities augurs well for the scheme.

If HDFC-Zurich is an example of how to manage a transition, Sun F&C's takeover of the two Jardine Fleming schemes bring out the ugly side of mergers and acquisitions in mutual funds. Take Sun F&C Personal Tax Saver, formerly JF Personal Tax Saver. Since its inception in 1996 till it was taken over in August 2002, it returned a strong compounded annual 28 per cent. Things changed after coming into Sun F&C's fold (minus its fund manager)–the fund has consistently underperformed its peers. And though it comes in it at number four, it's more a legacy of the past. Good reason to review your investment in a fund when it changes hands.

ELSS, by its very nature, is different from conventional diversified funds, in two ways. One, if your annual income is up to Rs 5 lakh, investments in an ELSS up to Rs 10,000 a year entitle you to a tax rebate under Section 88. Two, investments in an ELSS are subject to a lock-in of three years, which helps fund managers plan portfolios with a relatively longer horizon in mind. If you are inclined towards equities and need to save tax, maxing your ELSS limit in a good scheme remains a worthwhile proposition, especially when the market is down.

Outlook 2004: upside: 15-20 per cent; downside: 5-10 per cent

Sector funds. In a deviation from the past, instead of looking at all sector funds (dedicated to whichever sector) under a single umbrella, starting this year, we have segregated them further on the basis of sectors they invest in; funds that have an interest in multiple sectors or whose target investment is ambiguous have been classified under 'others'.

The extremes in performance of sector funds–lowest one-year return: 37.4 per cent (Franklin Infotech) and highest: 154 per cent (Alliance Basic Industries)–underline their inherently risky profile, and lend credence to the view that they are meant only for the savvy investor. Oil and gas funds again struck it rich in 2003, as the government flip-flop on divestment in oil PSUs kept investor interest in these stocks alive. More action is expected in this sector this year, as the PSU divestment gathers momentum.

Generally speaking, though, there weren't many hot sector stories happening. Pharma had another solid year, while FMCG was a letdown yet again. The outlook for both these sectors remains the same as their performances last year. Pharma companies are moving up the value chain and making inroads into new markets, which bodes well for them. FMCG companies, meanwhile, are fighting weak demand, rising competition from small players and severe price undercutting.

Seen against a backdrop of a racy market, technology funds disappointed. The topper among IT funds, Tata Life Sciences & Technology Fund, did deliver a one-year return of 120 per cent and a three-year return of 25.9 per cent, but it did something other IT funds didn't do. It ventured into non-IT stocks, which helped. Later this month, another IT fund, Franklin India Internet Opportunities Fund, will convert itself to a diversified fund. Most IT funds were launched at the height of the IT boom, and so continue to languish on a three-year return basis. Looking ahead, prospects for IT sector look good, though how soon it will trickle down to valuations is hard to say.

Debt Funds Slow and Steady

Last year's performance of debt funds, when read along with the happenings unfolding in the debt market, merely confirms what we've been saying for a while: the party is over. Equity-like returns of 15, 20, 25 per cent a year from debt funds are now a statistic, not a realistic expectation. It comes back to that oft-mentioned inverse relationship between interest rates and bond prices. When interest rates fall, bond prices go up, and vice versa. For some years now, noticeably since July 2000, interest rates have been spiralling downwards, resulting in extraordinary gains for debt funds. But now, market players feel we're in for a period of lull, a period of small cuts or small rises, if at all. No more jumps in bond prices and debt fund NAVs.

Returns from debt funds are expected to track returns from the instruments they choose to invest in more closely than before. To some extent, this trend set in last year itself. Income funds, as a group, returned 8.3 per cent in 2003, half of the 16.7 per cent they delivered in 2002. Lower, stable interest rates impacted performance of gilt funds (down from 16 per cent to 10 per cent) and liquid funds (7.2 per cent to 5.3 per cent) also, though it's still fairly good value for your savings in the present environment of falling interest rates.

Income funds. A majority of three-, four- and five-star income funds handled the tricky investment conditions prevailing in the debt market well, returning 7-9 per cent last year. Their three-year returns made for outstanding reading, thanks to buoyancy from previous years. Even amid such constancy, there was change aplenty on the upper echelons. None of the top five schemes of last year–JM Income, K Bond Wholesale, Sundaram Bond Saver, Chola Triple Ace, and Templeton Income–made it back. However, this had less to do with their performance, which was fairly respectable, and more to do with the volatility in their return patterns.

PNB Debt Fund was a surprise winner, jumping 20 places. Its secret of success: an aggressive strategy that revolved around

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holding an unusually large chunk of its corpus in government securities (G-secs). Typically, income funds have been seen to invest up to 35 per cent of their corpus in G-secs and the balance in corporate paper. PNB Debt Fund, however, loaded its portfolio with gilts–87 per cent, as of 31 December 2003. Although interest earnings from corporate debt is more than G-secs, the latter are more actively traded and show greater volatility, thus presenting investors with more opportunities to make trading gains. The magnitude of change also tends to be more pronounced in G-secs.

Among income funds, PNB Debt Fund was pretty much a lone ranger in stocking up on gilts. Explains fund manager S.K. Zutshi: "Bonds these days give 5-5.5 per cent, the same as gilts. So, why should I invest in bonds? Moreover, not many bonds are actively traded and they also carry some default risk, which gilts don't." The high returns given by Escorts Income Bond and Cancigo need to be qualified: nothing exceptional about their fund management, the high returns are due to the write-back of previously non-performing assets or investments in stocks.

Given the expectations that interest rates will hold, or rise a tad, a gilt-driven strategy may not be the prudent option for income funds this year. Those inclined towards greater safety should board income funds with a minority, not majority, gilt holding. Currently, the highest-safety, five-year corporate paper trades at a yield of around 5.7 per cent. At worst, an income fund should match that; at best, it should earn a handful of percentage points on account of trading gains.

Outlook 2004: 6-9 per cent.

Gilt funds. Aided by the downward push in interest rates and marked volatility in government debt paper, gilt funds outperformed close cousin income funds handsomely. While the best income fund gave 9.6 per cent, the top seven gilt funds delivered 11-16 per cent. Alliance Government Securities Fund (LT) came out on top. Badrish Kulhalli, its fund manager, attributes his scheme's success to a small corpus of Rs 13.6 crore, which is a fraction of the Rs 183 crore average among gilt funds. With liquidity in the debt market drying up, a smaller corpus meant the fund was able to react quickly to market events and moves–crucial in a price-sensitive and finely-priced marketplace like the debt mart. Explains Kulhalli: "Many big-sized funds find it difficult to change their maturity profile when interest rates rise or fall. By the time they manage to do so, the interest rate movement is over."

Kulhalli feels that for gilt funds, corpus size will be a bigger factor this year, as interest rates are expected to float within a narrow band of a percentage point. There might be merit in having a small corpus, but that alone doesn't guarantee success for a gilt fund. Quality of fund management remains the biggest, and irreplaceable, virtue. It's why the top seven funds delivered an above-average return. It's why Tata Gilt Securities Fund made 15 positions over last year to slide into the second spot. It's also why a middle-of-the-road scheme like Sundaram Gilt Fund earned an embarrassing 4 per cent over the past year and 6.3 per cent over the past two years: inexplicably it holds 80 per cent in a single security.

Compared to last year, the risk in gilt funds has increased. They will probably have to manage greater volatility in the days to come, and risk management could well determine who sinks and who swims. If you're looking for lower returns volatility, consider switching to an income fund invested in high-rated paper.

Outlook 2004: 6-8 per cent

Liquid funds. Liquid funds aim to return more than short-term bank deposits while offering an instant, hassle-free, zero-cost exit. To that extent, liquid funds have stayed faithful to their mandate, and delivered. Most funds returned between 5 per cent and 6 per cent–1-2 percentage points more than what banks offer on similar tenures. There's little to choose between the top liquid funds. Two relatively new funds–First India Liquid Fund and Canliquid–occupied the top slots, but by a wafer-thin margin over the subsequent 12 funds.

Generally speaking, since liquid funds are separated by fractional returns, they are trying to squeeze out whatever they can from their investments. Devendra Nevgi, vice-president and fund manager (fixed income), First India Liquid Fund, attributes his fund's good showing to strong cash management skills. In functional terms, this means having adequate cash to meet daily redemptions, but also not holding more than necessary as this cash earns nothing and returns then start to suffer. Says Nevgi: "What's the point in locking money for 90 days if an investor demands his money back after 45 days?" Other liquid funds are also optimising their cash holdings, in some form or the other, in varying degrees.

Since 2000, due to the declining trend in interest rates, average returns of liquid funds have been falling 1-2 percentage points every year. This year, also, their returns range is likely to see a drop-down, though of a smaller magnitude than in previous years.

Outlook 2004: 4-5.5 per cent

Balanced Funds a Fine Balance

Helped by the strong stocks showing, balanced funds turned in a strong performance in 2003, with the average being 55 per cent. Most balanced funds skewed their portfolio towards equities, going up to 75 per cent. The debt-equity allocation influenced, in part, the performance of balanced funds–typically, greater the equity holding, greater the returns. For example, Templeton India Pension Plan, a debt-oriented fund returned 42.2 per cent in 2003, while HDFC Prudence, an equity-oriented scheme gave 92 per cent. Of course, quality of fund management also played its part, with funds like HDFC eking out extra returns through active fund management.

Principal Child Benefit Fund, a children's plan, occupied the top position. Its one-year returns don't stand up against many others of its ilk, but it scores top marks for low volatility and consistency in returns over a three-year period, which explains its top ranking. This year too, equities should drive returns of balanced funds. The schemes in the market offer a range of equity exposure - typically between 50 per cent and 75 per cent. Keep your risk profile in mind while choosing your asset allocation.

Outlook 2004: upside: 12 per cent; downside: 10 per cent

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MIPs Turnaround Story

Monthly income plans are back in demand, thanks to a favourable confluence of investment conditions. MIPs load up on debt, but also park some of their corpus–up to 30 per cent–in stocks to add pop to returns. When share prices were down, MIPs found it difficult to consistently pay dividends at levels expected of a debt fund, and they fell out of favour. But with the market rising, and equity not perceived to be as risky as before, MIPs began to be looked at as an alternative to income funds–more rewarding, without a significant increase in risk.

MIPs, as a group, gained 13.1 per cent last year. Although Alliance Monthly Income, with its high equity holding, gave the highest one-year return of 20.1 per cent, the top honours went to Birla MIP Plan C for its consistency. Says fund manager K. Ramanathan: "The equity component means there's already a price risk in the portfolio. So, we play it safe with debt, investing mostly in high-safety paper with a low maturity profile." Adds co-fund manager A. Balasubramanian, who manages the scheme's equity portion: "We cap our sector exposure at 20 per cent of our equity portfolio." The three MIPs that yielded mid single-digit returns were debt-biased plans.

The present debt-equity nature of MIPs is not the ideal mix if you seek steady monthly income, as the uncertain nature of equities could mean some absentee periods and shortfalls. But if you are looking to cash in on prevailing investment conditions without stretching yourself unduly on risk, they are worth a look-see.

Outlook 2004: 8-10 per cent;

History of the Indian Mutual Fund Industry

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and Reserve Bank the. The history of mutual funds in India can be broadly divided into four distinct phases

First Phase – 1964-87

Unit Trust of India (UTI) was established on 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs.6,700 crores of assets under management.

Second Phase – 1987-1993 (Entry of Public Sector Funds)

1987 marked the entry of non- UTI, public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first non- UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990. At the end of 1993, the mutual fund industry had assets under management of Rs.47,004 crores.

Third Phase – 1993-2003 (Entry of Private Sector Funds)

With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993.

The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996.

The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1,21,805 crores. The Unit Trust of India with Rs.44,541 crores of assets under management was way ahead of other mutual funds.

Fourth Phase – since February 2003

In February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs.29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund Ltd, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs.76,000 crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth. As at the end of October 31, 2003, there were 31 funds, which manage assets of Rs.126726 crores under 386 schemes.

The graph indicates the growth of assets over the years.

Growth in Assets under Management

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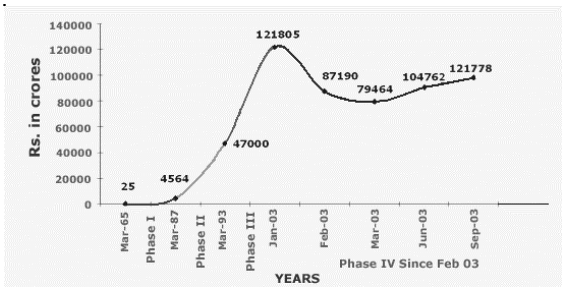

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Note: Erstwhile UTI was bifurcated into UTI Mutual Fund and the Specified Undertaking of the Unit Trust of India effective from February 2003. The Assets under management of the Specified Undertaking of the Unit Trust of India has therefore been excluded from the total assets of the industry as a whole from February 2003 onwards.

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LESSON 29:
DEVELOPMENT FINANCIAL INSTITUTIONS: AN INTRODUCTION

Lesson Objectives

- To understand the working of Development finance institutions, their role in industrial development,
- Governments policy for DFIs.

Introduction

The economic development of any country depends on the extent to which its financial system efficiently and effectively mobilizes and allocates resources. There are a number of banks and financial institutions that perform this function; one of them is the development bank. Development banks are unique financial institutions that perform the special task of fostering the development of a nation, generally not undertaken by other banks.

Development banks are financial agencies that provide medium- and long-term financial assistance and act as catalytic agents in promoting balanced development of the country. They are engaged in promotion and development of industry, agriculture, and other key sectors. They also provide development services that can aid in the accelerated growth of an economy.

The objectives of development banks are:

i. to serve as an agent of development in various sectors, viz. industry, agriculture, and international trade

ii. to accelerate the growth of the economy

iii. to allocate resources to high priority areas

iv. to foster rapid industrialization, particularly in the private sector, so as to provide employment opportunities as well as higher production

v. to develop entrepreneurial skills

vi. to promote the development of rural areas

vii. to finance housing, small scale industries, infrastructure, and social utilities

In addition, they are assigned a special role in:

i. planning, promoting, and developing industries to fill the gaps in industrial sector

ii. coordinating the working of institutions engaged in financing, promoting or developing industries, agriculture, or trade

iii. rendering promotional services such as discovering project ideas, undertaking feasibility studies, and providing technical, financial, and managerial assistance for the implementation of projects

Evolution of Development Banks

The concept of development banking originated during the post Second World War period. Many countries of Europe were in the stage of industrial development and special financial institutions known as development banks were set up to foster industrial growth. In the US, development finance institutions came into existence for special purposes such as economic rehabilitation and filling gaps in the traditional financing pattern. Not only developed countries, but several underdeveloped countries in Asia, Africa, and Latin America established special financial institutions to hasten the pace of industrialisation and growth.

The International Bank for Reconstruction and Development (IBRD) known as the World Bank and the International Monetary Fund (IMF) are examples of development banks at the international level. The major objective of the World Bank is to promote world development and perform the task of transfer of enormous financial and technical resources from the developed to developing nations. The IMF performs a special function of providing financial assistance to private sector projects in developing countries.

Development Financial Institutions in India The need for development financial institutions was felt very strongly immediately after India attained independence. The country needed a strong capital goods sector to support and accelerate the pace of industrialisation. The existing industries required long-term funds for their reconstruction, modemisation, expansion and diversification programmes while the new industries required enormous investment for setting up gigantic projects in the capital goods sector. However, there were gaps in the banking system and capital markets which needed to be filled to meet this enormous requirement of funds.

i. Commercial banks had traditionally confined themselves to financing working capital requirements of trade and industry and abstained from supplying long-term finance.

ii. The managing agency houses, which had served as important adjuncts to the capital market, showed their apathy to investment in risky ventures.

iii. Several malpractices, such as misuse of funds, excess speculation, and manipulations were unearthed. Owing to this, the investors were not interested in investing in the capital market.

iv. There were a limited number of issue houses and underwriting firms that sponsored security issues.

Hence, to fill these gaps, a new institutional machinery was devised-the setting up of special financial institutions, which would provide the necessary financial resources and know-how so as to foster the industrial growth of the country.

The first step towards building up a structure of development financial institutions was taken in 1948 by establishing the Industrial Finance Corporation of India Limited (IFCI). This institution was set up by an Act I of Parliament with a view to providing medium- and long-term credit to units in the corporate sector and industrial concerns.

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In view of the immensity of the task and vast size of the country, it was not possible for a single institution to cater to the financial needs of small industries spread in different states. Hence, the necessity for setting up I regional development banks to cater to the needs of small and medium enterprises was recognized. Accordingly, the State Financial Corporations Act was passed in 1951 for setting up state financial corporations (SFCs)in different states. By 1955-56, 12 SFCs were set up and by 1967-68, all the 18 SFCs now in operation came I into existence. SFCs extend financial assistance to small enterprises.

Even as the SFCs were being set up, a new corporation was established in 1955 at the all-India level r known as the National Small Industries Corporation (NSIC) to extend support to small industries. The NSlC ; is a fully government owned corporation and is not primarily a financing institution. It helps small scale I industries (SSls) through various promotional activities, such as assistance in securing orders, marketing the products of SSls, arranging for the supply of machinery, and training of industrial workers.

The above institutions had kept themselves away from the underwriting and investment business as these were considered to be risky. Due to the absence of underwriting facilities, new entrepreneurs and small units could not raise equity capital nor could they get loan assistance owing to this weak financial position. To fill this gap, the Industrial Credit and Investment Corporation of India Limited (ICICI) was set up in January 1955 as a joint stock company with support from the Government of India, the World Bank, the Commonwealth Development Finance Corporation, and other foreign institutions. The ICICI was organised as a wholly privately owned institution; it started its operation as an issuing-cum-lending institution. It provides term loans and takes an active part in the underwriting of and direct investments in the shares of industrial units.

In 1958, another institution, known as the Refinance Corporation for Industry (RCI) was set up by the Reserve Bank of India (RBI), the Life Insurance Corporation of India (LIC), and commercial banks with a view to providing refinance to commercial banks and subsequently to SFCs against term loans granted by hem to industrial concerns in the private sector. When the Industrial Development Bank of India (IDBI) was Jet up in 1964 as the central coordinating agency in the field of industrial finance, the RCI was merged with it.

At the state level, another type of institution, namely, the State Industrial Development Corporation (SIDC) was established in the sixties to promote medium and large scale industrial units in the respective states. The SIDCs promoted a number of projects in the joint sector and assisted in setting up industrial units. In recognition of the crucial role played by them in the promotion of industries in different states, the SIDCs were made eligible for IDBI refinance facilities in 1976. Thus, they became an integral part of the development banking system of the country.

The State Small Industries Development Corporations (SSIDCs) were also established to cater to the requirements of the industry at the state level. They helped in setting up and managing industrial estates, supplying of raw materials, running common service facilities, and supplying machinery on hire-purchase basis.

By the early sixties, a plethora of financial corporations catering to the financial needs of a variety of industries had come into existence. However, the need for an effective mechanism to coordinate and integrate the activities of the different financial institutions was increasingly felt. Furthermore, many gigantic projects of national importance were held up as these financial institutions were not able to supply the necessary capital in view of their own limited resources. Hence, the establishment of a financial institution with a substantially large amount of capital resource and capable of functioning independently, unhindered by statutory rigidities, became inevitable.

The Industrial Development Bank of India (IDBI) was set up in 1964 as an apex institution to establish an appropriate working relationship among financial institutions, coordinate their activities, and build a pattern of inter-institutional cooperation to effectively meet the changing needs of the industrial structure. IDBI was set up as a wholly owned subsidiary of the Reserve Bank of India. The IFCI became a subsidiary of the IDBI so that it might play an enlarged role. In February 1976, the IDBI was restructured and separated from the control of the RBI.

An important feature of industrial finance in the country is the participation of major investment institutions in consortium with other all India financial institutions. The Unit Trust of India (UTI), established in 1964, the Life Insurance Corporation of India (LIC), established in 1956, and the General Insurance Corporation of India (GIC), established in 1973, work closely with other all India financial institutions to meet the financial requirements of the industrial sector.

Specialized institutions were also created to cater to the needs of the rehabilitation of sick industrial units, export finance, and agriculture and rural development. In 1971, the Industrial Reconstruction Corporation of India Limited (IRCI) was' set up for the rehabilitation of sick units. In January 1982, the Export-Import Bank of India (EXIM Bank) was set up. The export finance operations of the IDBI were transferred to the EXIM Bank with effect from March 1, 1982. With a view to strengthening the institutional network catering to the credit needs of the agricultural and rural sectors, the National Bank for Agriculture and Rural Development (NABARD) was set up in July 1982.

The country is being served by 57 financial institutions, comprising 11 institutions at the national level and 46 institutions at the state level. These financial institutions have a wide network of branches and are supported by technical consultancy organisations with IDBI acting as the apex institution for coordinating their diverse financing and promotional activities. Their strategies, policies, and industrial promotional efforts subserve the national objectives of rapid industrial growth, balanced regional development, creation of a new class of entrepreneurs, and providing self employment opportunities.

The national level institutions, known as All India Financial Institutions (AIFIs), comprise six All India Development Banks (AIDBs), two specialised financial institutions (SFIs) and three investment institutions. The AIDBs are IDBI, IFCI,

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ICICI, Industrial Investment Bank of India Limited (IIBI), Infrastructure Development Finance Company Limited (IDFC) and SIDBI.

At the state level; there are 18 State Financial Corporations (SFCs) and 28 State Industrial Development Corporations (SIDCs).

The Specialised Financial Institutions (SFIs) comprise Export-Import Bank of India (EXIM Bank) and National Bank for Agriculture and Rural Development (NABARD). Hitherto, SFIs included three institutions, namely, IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Company Limited, and Tourism Finance Corporation of India Limited. However, due to the tiny nature of their operations, these institutions have been excluded from the category of SFIs.

The investment institutions are Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), and Unit Trust of India (UTI).

Changing Role of Development Financial Institutions

The financial institutions were functioning in a highly regulated regime up to 1991. The DFIs were mostly engaged in consortium lending and they offered similar services at uniform prices. In the administered interest rate regime, the cost of borrowings of DFIs was substantially lower than the return on financing (lending). Long-term lending involves uncertainties and to handle this, the DFIs used to get concessional funds up to the nineties. The Reserve Bank and the Central Government used to finance these institutions by subscribing to the share capital, allowing them to issue government guaranteed bonds and extending long-term loans at concessional rates. However, this concession all ending was phased out in the 'nineties' with the initiation of financial sector reforms. Interest rates were deregulated and the facility of issuing bonds eligible for SLR investments was withdrawn. Now, these financial institutions have to rely on equity and debt markets for financing their needs. These DFIs have resorted to market-based financing by floating a number of innovative 1ebt and equity issues. They also raise resources by way of term deposits, certificates of deposits and borrowings from the term money market within the umbrella limit fixed by the Reserve Bank in terms of net owned funds. Wore stringent provisioning norms have come into operation. Many of the DFIs including IDBI have lost heir tax-exempt status.

Moreover, with deregulation, the distinction between different segments of financial intermediaries has blurred. The commercial banks are now financing the medium- and long-term capital needs of the corporate sector and the DFIs have started extending short-term/working capital finance. This has led to a stiff competition)between banks and DFIs. As a result, the focus of DFIs has shifted from the purpose for which they were set up.

With globalisation and liberalisation, the financing requirements of the corporate sector has undergone a tremendous change. Many foreign players entered into strategic alliances with Indian firms. There was an increase in research and development activities as well as the diversification plans of firms. Investment in technology and infrastructure became crucial. With a view to taking advantage of the new opportunities, the financial institutions started offering a wide range of new products and services. These DFIs set up several subsidiaries/associate institutions which offer various services such as commercial banking. consumer finance-, investor and custodial services, broking, venture capital finance. Infrastructure financing, registrar and transfer services, and e-commerce.

DFIs are in the process of converting themselves into universal banks. ICICI has become a universal bank by a reverse merger with its subsidiary ICICI Bank. IDBI is in the process of transforming itself into a universal bank. The Reserve Bank of India has issued guidelines for DFIs to become commercial Banks. These guidelines are the same as for commercial banks under the Banking Regulation Act. It is envisaged that will be only two types of financial intermediaries in future, that is, commercial banks and non-banking ace companies (NBFCs).

Universal Banking

Universal banking is a one-stop shop of financial products and services. Universal banks provide a complete range of corporate financial solutions under one roof —everything from term finance, working capital, project advisory services, and treasury consultancy. Universal banking encompasses commercial banking and Investment banking, including investment in equities and project finance. It refers to a bank undertaking all types of business-retail, wholesale, merchant, private, and others under one organisational roof. It means a complete breakdown of barriers between different categories of financial intermediaries such as commercial banks, FIs and NBFCs.

Universal banking helps the service provider to build up long-term relationships with the client by catering his different needs. The client also benefits as he gets a whole range of services at low cost under one roof. Globally, banks such as Deutsche Bank, Citibank, and ING Bank, are universal banks.

In India, the trend towards universal banking began when financial institutions were allowed to finance working capital requirements and banks started term financing. This trend got a momentum with the report of Narasimham Committee II, suggesting that development finance institutions should convert ultimately into commercial banks or non-bank finance companies (NBFCs). The Khan Committee, which was set up by RBI to examine the harmonisation of business of banks and development financial institutions, endorsed this conversion. It was of the view that DFIs should be allowed to become banks at the earliest. The committee recommended a gradual move towards universal banking and an enabling framework for this purpose should be evolved. In January 1999, the Reserve Bank of India (RBI) released a "Discussion Paper" for wider public debate on universal banking. The feedback indicated the desirability of universal banking from the point of view of efficiency of resource use. In the mid-term review of monetary and credit policy (1999-2000), the RBI acknowledged that the principle of universal banking "is a desirable goal". In April 2001 it set out the operational and regulatory aspects of conversion of DFIs into universal banks.

ICICI was the first financial institution to convert itself into a truly universal bank. The concept of universal banking provides the financial institutions an access to the retail market wherein

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high margins are involved. This concept is slowly gaining popularity among banks as the interest spread has squeezed in the past few years and non-performing assets (NPAs) have increased in banking activity. A foray into universal banking would help the banks to diversify beyond the traditional portfolio of loans and investment and extend to treasury, capital market operations, infrastructure finance, retail lending, and advisory services.

Policy Measures Relating to DFIs

The change in the role of DFIs, the South-East Asian crisis and the general economic slowdown necessitated introduction of policy measures and regulation. In November 1994, the Board for Financial Supervision (BFS) was constituted under the aegis of the Reserve Bank for comprehensive and integrated regulation and supervision over commercial banks. Financial Institutions (FIs) and Non-Banking Finance companies have been brought under the purview of the Board. The scope and coverage of the FIs inspection are very limited, unlike that of NBFCs, and are not as rigorous as that of banks.

Select FIs such as IDBI, ICICI Ltd., IFCI Ltd., IIBI Ltd., NABARD, NHB, EXIM Bank, TFCI, SIDBI and IDFC have been brought under the supervisory purview of the Reserve Bank to enhance the transparency in their performance and maintain systemic stability.

Policy Measures

i. Financial institutions were permitted to include the "general provision on standard assets" in their supplementary (tier II) capital with a stipulation that the provisions on standard assets along with other "general provisions and loss reserves" should not exceed 1.25% of the total risk-weighted assets.

ii. An asset would be treated as non-performing, if interest and/or installment of principal remain overdue for more than 180 days with effect from the year ending March 31, 2002. A non-performing asset is that part of a financial institution's asset that is currently yielding no return and on which none is expected.

iii. FIs have to assign a 100 percent risk weight only on those state government guaranteed securities which were issued by the defaulting entities.

iv. FIs are required to assign a risk weight of 2.5% for market risk in respect of investments in all securities from March 31,2001. This risk weight would be in addition to 20%/ 100% risk weight already assigned for credit risk in non-government/non-approved securities.

v. In order to bring about uniformity in the disclosure practices adopted by the FIs and with a view to improving the transparency in their affairs, FIs were advised to disclose certain important financial ratios/data with effect from the financial year 2000-01. These disclosures pertain to capital-to-risk weighted assets ratio (CRAR), Core CRAR, supplementary CRAR, amount of subordinated debt raised/ outstanding as tier II capital, risk weighted assets, shareholding pattern, asset quality and credit concentration, maturity pattern of rupee and foreign currency assets and liabilities, and details on operating results. Besides, separate details on loan assets arid substandard assets which have been subject to restructuring, and so on, would also need to be disclosed.

vi. Capital to risk-weighted Asset Ratio (CRAR) should be 9% of risk weighted assets (RWA) on an ongoing basis. CRAR represents the amount of capital maintained in consonance with the risk-adjusted aggregate of funded and non-funded assets of an FI. The risk-adjusted asset is arrived at by multiplying each asset with its corresponding risk weight in the case of funded assets. Conversion factors are assigned in case of non-funded assets apart from weights. CRAR includes core capital (tier I) and supplementary capital (tier II). Tier I capital includes paid up capital, statutory reserves, and other disclosed free reserves, if any. Certain Government of India grants and reserves held under section 36(1)(viii) of the Income Tax Act, 1961 are treated as capital. Besides capital reserves, equity investment in subsidiaries, intangible assets, gaps in provisioning, and losses in the current period and those brought forward from the previous period will be deducted from tier I capital. The core CRAR should not be less than 50% of CRAR at any point of time. Supplementary CRAR, or tier II capital, includes undisclosed reserves and cumulative preference shares, revaluation reserves, general provisions and reserves, hybrid debt capital instruments, and subordinated debt. The supplementary capital is limited to a maximum of 100% of tier I capital.

vii. Since June 2000, FIs need not seek the Reserve Bank's issue-wise prior approval/registration for raising resources through either public issue or private placement if (a) the minimum maturity period is 3 years, (b) where bonds have call/put or both options, the same is not exercisable before expiry of one year from date of issue, (c) yield to maturity (YTM) offered at the time of issue of bonds, including instruments having call/put options, does not exceed 200 basis points over that on government securities of equal residual maturities, and (d) 'exit' option is not offered prior to expiry of one year, from date of issue. The outstanding total resources mobilised at any point of time by an individual FI including funds mobilised under the 'umbrella limit' as prescribed by the Reserve Bank should not exceed 10 times its net owned funds as per the latest audited balance sheet.

viii. The rating for the term deposits accepted by FIs was made mandatory effective November 1,2000.

ix. FIs are required to classify entire investment portfolio from March 31, 2001, under three categories, viz., (a) held to maturity, (b) available for sale, and (c) held for trading. Investments under (b) and (c) are to be marked-to-market as prescribed or at more frequent intervals, while those under (a) need not be marked-to-market and should not exceed 25% of total investments.

x. Looking to the deteriorating financial position of FIs, it was decided that the inspection of all the FII would be undertaken by the Reserve Bank on an annual basis with effect from March 31,2001.

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xi. The Reserve Bank introduced a CAMELS based supervisory rating model for the FIs effective March 31,2002.

The above mentioned policy initiatives were undertaken by the RBI for strengthening the regulation and supervision of select all India financial institutions in the context of their financial performance, the market conditions for resource mobilisation and increasing competition from banks.

Now we will look into the working of few major DFIs.

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LESSON 30:
DEVELOPMENT FINANCIAL INSTITUTIONS: MAJOR PLAYERS

Lesson Objectives

- To know in short about specific DFIs and their working.
- Role of major DFIs in Industrial Growth

Dear friends, in the last session we took a look into the evolution of DFIs in India and about their importance in development activity. Now in today's and next session we are going to discuss about the specific major DFIs in India.

Industrial Finance Corporation of India Limited

Industrial Finance Corporation of India Limited (IFCI), India's first DFI, was established on July 1, 1948, under the Industrial Finance Corporation Act as a statutory corporation. It was set up to provide institutional credit to medium and large industries.

With a view to imparting greater operational flexibility and enhancing its ability to respond to the needs of the changing financial system, IFCI was converted from a statutory corporation to a public limited company. It was the first institution in the financial sector to be converted into a public limited company on July 1, 1993. IFCI is a board-run company and its directors are elected by shareholders.

IFCI's principal activities can be categorised into financing and promotional activities.

Financing Activities

IFCI's financing operations include project financing, financial service and corporate advisory services.

i. ***Project financing***: Project financing is the core business of IFCI. The main' objective behind the incorporation of the DFI was to fund green-field projects. Financial assistance is provided by way of mediumllong-term credit for setting up new projects, expansion/diversification schemes, modernisationl balancing schemes of existing projects.

Financial assistance is provided by way of rupee loans, loans in foreign currencies, underwriting ofl direct subscription to shares and debentures, providing guarantee for deferred payments and loans.

ii. ***Financial services***: IFCI provides tailor-made assistance to meet specific needs of corporate through specifically designed schemes. The various fund-based products offered are equipment finance, equipment credit, equipment leasing, supplier's/buyer's credit, leasing and hire purchase concerns, working capital term loans, short-term loans, equipment procurement, installment credit, and others. The fee-based services offered by it are guarantees and letters of credit.

iii. ***Corporate advisory services***: IFCI provides advisory services in the areas of projects, infrastructure, corporate finance, investment banking, and corporate restructuring. It also acts as a catalyst in channelising foreign direct investments (FDIs) and provides a range of services to prospective foreign investors. FCI also provides consultancy services on certain policy-related technical and financial matters to regulatory agencies in different infrastructure sectors, namely, electricity, telecom, oil and gas, insurance, education, and so on.

iv. ***Corporate advisory services to foreign investors***: IFCI provides a whole range of services to prospective foreign investors, namely, facilitating the foreign business entities through information services; necessary office infrastructure for the start-up operations of the organisation; coordination for obtaining the required approvals/clearances from the government departments/ regulators/ statutory agencies; inputs on markets, materials, and manpower available in the country; inputs on available manufacturing facilities; syndication services for obtaining the required capital; research inputs and information regarding tax incentives; tariff protections, and opportunities available for acquisitions, mergers, and amalgamations.

Promotional Activities

Over the years, IFCI has set up several subsidiaries/associate companies in the financial sector offering custodial services, investor services, rating services, and venture capital services.

Shareholding Pattern of IFCI's Equity Share Capital

Public	25.82%
Government owned and controlled banks/organizations	56.32%
Other corporate bodies	6.98%
MFs/UTI	4.73%
Other banks	6.15%

Financial Highlights of IFCI Profit after Tax

Year ending	Profit after tax (Rs in crore)
March 1997	218.56
March 1998	83.50
March 1999	(-267.70)
March 2000	(-191.81)
March 2001	(-265.93)
March 2002	(-884.7)
Quarter ending June 2002	(-221.56)

Source: IFCI.

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Financial Ratios of IFCI

Particulars	Year ending				
	March 1997	March 1998	March 1999	March 2000	March 2001
PAT/Networth	14.50	5.37	-16.95	-11.58	17.49
PAT/ Total assets	1.44	0.44	-1.24	-0.85	-1.19
PBDT/ Total asets	2.24	1.05	-01.04	-0.62	-0.98
PBDT/Capital employed	2.49	1.13	-1.12	-0.67	-1.05
EPS (Rs)	10.7	10.3	-0.1	0.1	-4.2
Debt Equity Ratio	9.4	11.6	12.6	12.2	15.6
Capital adequacy ratio	10.1	11.6	8.4	8.8	6.2

Source: IDBI, Report on Development Banking in India, 2000-01.

Asset Classification of IFCI

(In percentage)

	2000	2001	2002
Standard assets	80.7	80.9	77.5
Sub-standard assets	11.1	5.0	5.1
Doubtful assets	8.2	14.1	17.4
Total	100.0	100.0	100.0

Source: IDBI, Report on Development Banking in India, 2000-01.

Since 1998-99, the assistance sanctioned and disbursed by IFCI has declined. During 2000—01, sanction! and disbursements under direct finance constituting 99.4% and 99.5% of overall sanctions an(disbursement declined by 10.8% and 35.3%, respectively. Sanctions and disbursements under project finance accounting for 97.5% and 94.7% of the total sanctions and disbursement! declined by 8.3% and 30%, respectively in 2000-01. The decline was recorded across all the products under project finance.

IFCI started reporting losses from 1999. In 1999, it reported a loss of Rs 267.70 crore which increased to Rs 884.7 crore in 2001-02. Spreads (the difference between interest income and expense) have begun to narrow across the financial sector due to stiff competition. This has had an impact on the profitability of FCI The non-performing assets (NPAs) of the company at Rs 3,937.2 crore have touched 46% of its total assets of Rs 8,183.2 crore. Its capital adequacy ratio is just 3%, way below the stipulated 12% In the first quarter of April-June 2002, IFCI reported a loss of Rs 221 crore as against a loss of Rs 27.8 crore in the same period of the previous year. Interest expenses for the quarter moved up drastically to Rs 606.: crore, as against Rs 163 crore in the same period of the previous year, while interest income dwindled by 30% to Rs 445.3 crore.

IFCI's financial health has deteriorated and the present state of affairs displays a dismal picture of the company. The reasons attributable to this dismal state of affairs of the company are:

i. ***Operational inefficiency*** : The cost of borrowing has exceeded the income from operations.

ii. ***Political interference*** : IFCI has been used as a handmaiden of politicians and most of the loans have been sanctioned under political pressures.

iii. ***Traditional sector financing*** : IFCI has sanctioned majority of the loans in traditional sectors such as iron and steel, textiles, synthetic fibres, cement, synthetic resins, plastics, and so on. These traditional sectors are facing rough times due to demand recession, price fluctuations, abolition of import controls, gradual reduction of tariffs, among others. Hence, this has led to a rise in NPAs of IFCI.

iv. ***Higher provisioning for non-performing assets*** : Project financing is the major activity of IFCI and revenue arising from this activity constitutes a substantial portion of its revenues. These projects have. a long gestation period. RBI has tightened the provisioning norms for NPAs and stipulated that loans related to projects under implementation have to be classified as NPA. Hence, the company has to make larger provision at the end of the year, dampening the net profit level.

These huge NPAs have made IFCI terminally ill. IFCI has raised Rs 1237 crore through public issue and Rs 13,689 crore in private placements for lending operations. This amount has to be paid back to public. sector banks, mutual funds, trusts, and provident funds that invested in these tax-free instruments. IFCI has: Rs 900 crore redemption obligation on bonds, guarantee commitments of Rs 800 crore, foreign currency loan of $100mn and rupee loans of Rs 300 crore. Any default can cause systemic risks and could weaken confidence in the system. IFCI's rating has plummeted to default category, which means it cannot raise fun to lend profitably. .

GOI, based on the recommendations of Basu Committee appointed for suggesting a restructuring plan for IFCI, declared a Rs 1,000 crore package for IFCI in late 2001. This package consisted of two parts: Rs 400 crore were given by the Government by way of subscription to long-term convertible debentures and the remaining Rs 600 crore were contributed by the government controlled institutional shareholders of IFCI on pro-rata basis. IDBI is the principal shareholder of IFCI with 31.71% shareholding and it had to make the largest contribution among the FIs. But IDBI itself is in trouble and the government is drawing out a bailout package for it also. In this situation, the SBI lent a helping hand by contributing towards IDBI's share. But this package also could not save IFCI from the burgeoning NPAs and declining capital adequacy ratio.

Steps taken for Revival

IFCI constituted an expert committee in 2001 to formulate a medium- to long-term strategic plan for IFCI in the emerging new business environment. The committee has laid down the road map/action plan for the next five years. The committee has made recommendations covering a wide range of structural and operational areas.

IFCI is concentrating on its core competence and is focusing on lending to established clients with a sound track record. It has strengthened its risk management techniques and is putting in efforts to bring down the NPAs to a manageable level, through corporate debt structuring.

The company has initiated the process of restructuring of liabilities and is negotiating with the investors for reduction of interest rate on deposits and bonds. IFCI has initiated action against defaulters and has filed suits against. defaulter companies.

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In spite of all these efforts, the financial state of affairs of the company has not improved.

The Government's Bailout Plans

The government appointed the international consulting giant McKinsey to suggest the amount of funds needed to revive IFCI and a course of action to get the company back into profit zone.

McKinsey suggested that IFCI should be divided into two companies: one with good assets and the other with bad assets. The company with good assets would provide financing to mid-sized companies and undertake fee-based services. The business model for the good bank entails merger with a potential universal bank. An asset reconstruction company should be set up with a capital of Rs 200 crore to take care of the bad loans worth Rs 4,000 crore. The bailing out would cost the government around Rs 5.26 billion to Rs 88 billion and the cost of liquidation would be between Rs 88-122 billion. The one-time cost to the government for bailing out the institution is pegged at Rs 11,200 crore.

The government's bailout package includes a Rs 8,100 crore infusion of funds, converting the financial institution into an asset reconstruction company (ARC) without engaging in any borrowing or lending, and changes in the top management of the organisation. The Rs 8,100 crore package will be utilised to redeem the bonds issued to government provident funds, nationalised banks and pension funds.

Conclusion

The oldest development financial institution is facing rough weather and the future looks grim. IFCI is the worst hit by the NPA problem. It is in the process of restructuring its liabilities and has set up an asset reconstruction company, namely, Assets Care Enterprises Limited (ACE) with an initial authorised capital of Rs 20.00 crore. ACE has prepared an initial business plan and it envisages a gradual build-up of business to maximise recovery in non-performing assets.

Now let us look into the another major DFI and its working.

Industrial Development Bank of India

The Industrial Development Bank of India (IDBI) was established in 1964 by Parliament as a wholly owned subsidiary of Reserve Bank of India. In 1976, the Bank's ownership was transferred to the Government of India. It was accorded the status of the Principal Financial Institution for coordinating the working of institutions at national and state levels engaged in financing, promoting, and developing industries.

IDBI has provided assistance to development-related projects and contributed to building up substantial ~opacities in all major industries in India. IDBI has directly or indirectly assisted all companies that are Presently reckoned as major corporate in the country. It has played a dominant role in balanced industrial development.

In 1982, IDBI transferred its International Finance Division to Export-Import Bank of India, which was established as a wholly owned corporation of Government of India under Export Import Bank of India Act, 1982.

IDBI set up the Small Industries Development Bank of India (SIDBI) as a wholly owned subsidiary to cater to specific the needs of the small-scale sector. In 2001, IDBI reduced its shareholding in SIDBI to 49%.

IDBI has engineered the development of capital market through helping in setting up of the Securities exchange Board of India (SEBI), National Stock Exchange of India Limited (NSE), Credit Analysis and research Limited (CARE), Stock Holding Corporation of India Limited (SHCIL), Investor Services of India limited (ISIL), National Securities Depository Limited (NSDL), and Clearing Corporation of India Limited CCIL).

In 1992, IDBI accessed the domestic retail debt market for the first time by issuing innovative bonds known as the Deep Discount Bonds. These new bonds became highly popular with the Indian investor.

In 1994, the IDBI Act was amended to permit public ownership upto 49%. In July 1995, it raised over Rs 20 billion in its first Initial Public Offer (IPO) of equity, thereby reducing the government stake to '2.14%. In June 2000, a part of government shareholding was converted to preference capital. This capital was redeemed in March 2001, which led to a reduction in government stake. The government stake currently is 58.47%.

In August 2000, IDBI became the first All India Financial Institution to obtain ISO 9002: 1994 Certification for its treasury operations. It also became the first organisation in the Indian financial sector to obtain ISO 001: 2000 Certification for its forex services.

In March 2001, IDBI set up the IDBI Trusteeship Services Limited under the Companies Act, 1956, to provide technology driven information and professional services to subscribers and issuers of debentures.

IDBI has undertaken several initiatives to reposition itself as a universal bank. In April 2001, IDBI appointed Boston Consulting Group India Private Limited (BCG) as consultant to draw up a road map for conversion into a universal bank. The other initiatives include formation of a high level Risk Management committee to develop overall risk management policy. The bank has constituted a Credit Risk Management group to evaluate credit risk both at the transaction level as also at the portfolio level. In March 2002, the tovernment of India announced proximate corporatisation of IDBI.

Subsidiaries

i. In 1993, IDBI set up IDBI Capital Market Services Limited (ICMS) as wholly owned stock broking company. It commenced operations as a primary dealer in November 1999. In the private placement market, it acts as an arranger for several institutions and corporate users. As a depository participant, the company offers institutional and retail clients the facility to maintain their investments and securities in electronic form.

ii. In 1994, IDB! set up the IDBI Bank Limited, a private sector commercial bank. IDBI's shareholding in this bank is 57.14%. The Bank provides a complete range of banking facilities supported by a technology intensive environment. It is a leading player in depository participation services.

iii. In 1999, IDBI set up the IDBI Investment Management Company Limited as a wholly owned subsidiary. It entered

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into a joint venture agreement with Principal Financial Group, USA, for participation in equity and management of this subsidiary.

iv. In March 2000, IDBI set up the IDBI Intech Limited as a wholly owned subsidiary to undertake captive IT-related activities.

v. In March 2001, IDBI set up the IDBI Trusteeship Services Limited under Companies Act, 1956, to provide technology driven information and professional services to subscribers and issuers of debentures.

Shareholding Pattern of IDBI's Equity Share Capital

Individuals	16.72%
Corporate Bodies	4.75%
Others	0.14%
Banks and PIs	19.92%
Government	58.47%
	100.00%

Products and Services

Over the years, IDBI has enlarged its basket of products and services to industrial concerns. IDBI provides financial assistance both in rupee and foreign currency for greenfield projects, expansion, modernisation, and diversification.

In order to cater to the diverse needs of corporate clients, IDBI has structured various products such as equipment finance, asset credit, corporate loans, direct discounting, and working capital loans to finance acquisition of equipments and capital assets and to meet capital expenditure and/or incremental long-term working capital requirements. It also offers structured products such as lines of credit to meet the funding requirements for execution of turnkey contracts.

IDBI also provides indirect financial assistance through refinancing of loans extended by primary financial institutions and by way of rediscounting bills of exchange arising out of sale of indigenous machinery on deferred payment terms.

In 2001, IDBI launched an equity support scheme to facilitate early financial support to deserving assisted projects which are unable to tap the capital market. IDBI also introduced a new scheme for financing the film industry pursuant to the industry status being given to the entertainment industry.

IDBI also provides merchant banking and a wide array of corporate advisory services as part of its fee based activities. These include professional advice and services for issue management, private placement of equity/debt instruments, project evaluation, credit syndication, share valuation, corporate restructuring- including mergers and acquisitions, and divestment of equity. The Bank also offers a number of forex-related services on a commission basis, including opening of letters of credit and remittances of foreign currency on behalf of its assisted companies for import of its goods and services.

FY ended March 31	1998	1999	2000	2001	2002
Sanctions	20,632	20,842	23,712	25,418	16,034
Disbursements	15,369	14,473	17,063	17,474	11 ,158
Profit before tax	1,800	1,301	1,027	734	415
Net profit after tax	1,501	1,259	947	691	424
Dividend	303	303	303	294	98
Dividend in percentage	(45)	(45)	(45)	(45)	(15)

Operational Highlights of IDBI

FY ended March 31	1998	1999	2000	2001	2002
Sanctions	20,632	20,842	23,712	25,418	16,034
Disbursements	15,369	14,473	17,063	17,474	11 ,158
Profit before tax	1,800	1,301	1,027	734	415
Net profit after tax	1,501	1,259	947	691	424
Dividend	303	303	303	294	98
Dividend in percentage	(45)	(45)	(45)	(45)	(15)

Source: IDBI.

Financial Highlights of IDBI

As on March 31	1998	1999	2000	2001	2002
Capital	659	659	659	653	653
Reserves	7,344	8,034	8,366	8,474	6,001
Net owned funds	8,003	8,693	9,025	9,127	6,654
Tier I capital bonds	-	-	-	-	2,130
Borrowings	45,520	52,968	57,178	56,419	51,752
Assets	59,957	69,144	72,285	71,783	66,643
Net NPA (% of total assets)	10.1	12.0	13.4	14.8	11.7
Capital adequacy ratio	13.7	12.7	14.5	15.8	17.9
Debt equity ratio	6.1	6.5	6.8	6.7	6.3
EPS (Rs)	22.3	18.70	10.32	9.37	6.50

Source: IDBI.

The table reveals a sharp decline in sanctions and disbursement in the year 2001-02. Sanctions t, infrastructure sector which were Rs 3,145 crore in 2001-02, constituted 20% of overall sanctions. Th profit before tax and profit after tax have consistently declined since 1997-98.

Trends in Returns and Cost of IDBI

	1997-98	1998-99	1999-2000	2000-01	2001-02
Average return	12.6	11.6	11.1	10.4	10.4
Average cost	8.7	9.0	9.2	9.0	9.2
Margin	3.9	2.6	1.9	1.4	1.2

The table reflects a declining trend in margins. There has been a pressure on margins due to declining interest rates and increasing competition. The other factors responsible for a decline in profits are industrial slowdown, lack of good proposals, disinter mediation and exit of good clients, and the changing business environment.

Out of its total assets of Rs 66,643 crore assets, 11.7% are non-performing. IDBI has classified Rs 4,350.70 crore as NPA for the year 2002.

Asset Quality of IDBI

	2000-01	2001-02
Standard	85%	88%
Doubtful	10%	7%
Substandard	5%	5%

Source: 1081.

During 2001-02 an accelerated provisioning of Rs 2,500 crore brought down the level of NPAs to 11.7% in 2001-02 from 14.8% in 2000-01. The steel sector accounts for the highest NPA of IDBI. IDBI has NPA of Rs 838.50 crore in iron and steel sector contributing 15.5% of the total NPA for the year March 31, 2002. The steel sector was followed by the textile sector, which accounted for 13.70 percent of the total NPA. The other major sectors are food processing, metal and metal products,

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and drugs and pharmaceuticals. This exposure to the problematic commodity sector makes a turn around unlikely.

IDBI is rated AA lower than the AAA rating of the corporate it wishes to lend to. Hence, it cannot raise funds to lend profitably. IDBI is under severe stress with so high NPAs.

IDBI has raised Rs 13,012 crore in public issues and has privately placed debt worth Rs 16,788 crore. This amount has to be paid back to investors such as public sector banks, mutual funds, trusts, and provident funds. Any default would again pose a systemic risk.

The Government's Bailout Plans

The government is keen on structurally transforming IDBI. The structural reforms options being considered include granting IDBI a banking license and enabling it to enter into an alliance with either a public or private sector bank or roping in a strategic partner. The government has repealed the IDBI Act, 1964, thus providing for the corporation of the Industrial Development Bank of India. While retaining its character as a development financial institution, a new legislation would turn it into a banking company, thus facilitating availability of finance at concessional rates. The government is not providing it with a money package but it would stand surety of upto Rs 2,500 crore over a period of five years.

Conclusion

IDBI's objective is to position itself as India's premier wholesale bank, providing a full range of wholesale products through an integrated group structure. For accomplishing this, it has laid down its short-term and long-term strategies.

The short-term strategy would revolve around business growth of acceptable quality, reduction in costs, and improved risk management practices. Hence, the bank's priorities would be NPA containment and diminution along with recovery maximisation, reducing the average cost of funds, fresh borrowings at optimum combination of cost and maturity, retail funding through its fixed deposit scheme to ensure access to stable source of funds and broad-basing the ambit of its fee-based activities. IDBI is placing more emphasis on non--project loans.

As part of its long-term strategy, IDBI has chosen universal banking as its basic business model. IDBI is currently undertaking calibrated measures to move towards universal banking.

Industrial Investment Bank of India Limited

Industrial Investment Bank of India Ltd. (IIBI) was set up as a company, under the Companies Act, 1956, in March 1997 by converting the erstwhile Industrial Reconstruction Bank of India. The Industrial Reconstruction Bank of India (IRBI) was set up in 1985 under the IRBI Act, 1984, as the principal credit and reconstruction agency for rehabilitation of sick and closed industrial units. With a view to providing IRBI with adequate operational flexibility and financial autonomy and converting it into a full-fledged all-purpose financial institution, IRBI was incorporated as IIBI, with headquarters in Calcutta.

As per the Memorandum and Articles of Association, IIBI can

a. provide financial assistance, with or without security, in the form of short, medium, long-term loan, demand loan, working capital facilities, equity participation, asset credit, and equipment finance.
b. invest in capital market instruments such as shares, debentures, bonds, and also money market instruments.
c. underwrite and extend guarantees.
d. engage in leasing and hire purchase finance.
e. act as a Trustee of any deed securing any investment.
f. provide consultancy and merchant banking, warehousing, factoring, depository, and custodial services.
g. set up subsidiaries in the form of an investment company to deal in capital and money market instruments.
h. operate as an authorised dealer in foreign exchange.

IIBI is the only all-India financial institution (API) wholly owned by the Government of India. IIBI is exempted from payment of income tax for the first five years of its operations as per the Industrial Reconstruction Bank (Transfer of Undertaking and Repeal) Act, 1997. It is now an API with a well diversified portfolio spread over a wide range of industrial segments.

Services Provided by IIBI

IIBI provides project finance, short duration non-project asset-backed finance and working capital/short- term loans to companies. Since 2000-01, IIBI has diversified into investment in rated debentures bonds of corporate and sovereign state government guaranteed debt papers. These accounted for 58.4% of its investment asset portfolio as on March 31,2001. Due to its diversification into investments, the percentage share of loans in the outstanding portfolio declined from 82% as on March 31, 2000, to 66.4% on March 31, 2001.

Besides these, it provides various services as deferred payment guarantee, loan syndication, merchant banking services such as issue management, underwriting and guarantees, project/ reconstruction one-time settlement consultancy/ appraisal.-

IIBI's Business Strategy

IIBI's business strategy aims at improving asset quality and generating profits. To attain these objectives, IIBI has placed emphasis on modem risk assessment and monitoring systems and organisation restructuring.

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IIBI-Assistance Sanctioned and Disbursed Schemewise

Particulars	Sanctions						Disbursements					
	1996-97	1997-98	1998-99	1999-2000	2000-01	Cumulative upto end March 2001	1996-97	1997-98	1998-99	1999-2000	2000-01	Cumulative upto end March 2001
Direct Finance												
A. Project Finance	665.36	884.79	1,172.56	1,057.27	902.00	5,369.03	418.17	424.41	806.25	570.44	748.96	4,906.08
B. Non-Project Finance	150.65	1,176.25	841.65	1,207.90	637.00	3,400.06	131.43	728.77	721.28	796.23	443.46	3,284.44
Tota1816.01	2,061.04	2,014.21	2,265.17	1,539.00	8,769.09	549.60	1,153.18	1,527.53	1,366.67	1,192.42	8,190.52	
Loans and Investments in shares/bonds of Fls	-	-	160.95	72.91	121.72	380.82	-	-	160.95	72.91	121.72	372.54
Secondary market operations	-	-	-	-	441.54	441 .54	-	-	-	-	395.61	395.61
Grand total	816.01	2,061.04	2,175.16	2,338.08	2,102.26	9,591.51	549.60	1,153.18	1,688.48	1,439.58	1,709.75	8,958.67

Source: IDBI, Report on Developml3nt Banking in India, 2000-01.

Financial Highlights of IIBI

	1999-2000	2000-2001
Gross income	520.16	587.00
Surplus before provision	96.24	139.61
Capital adequacy	9.70	13.28*
Earnings per share (Rs)	0.27	9.57
Book Value per Share (Rs)	31.32	28.55
NPA (%)	17.03	22.9
Profit after tax to average networth (%)	4.6	16.3
Profit after tax to average assets (%)	0.8	2.8
Debt equity ratio	5.3	4.7

* This has been obtained after setting aside, Rs 245 million as asset value fluctuation reserve. Source: IDBI, Report on Developing Banking in India, 2000-01.

IIBI'S Net NPA as% of Net Loans

	1999-2000	2000-01	2001-02
Net NPA/Net Loans	17.0	22.9	24.1

Source: RBI, Report on Trend and Progress of Banking in India, 2001-02.

The above table reflects a decline in sanctions but an increase in disbursements in 2000-01. An increase of 18.8 percent in IIBI's disbursement during 2000-01 was mainly due to 31.3 percent growth in disbursements under project finance. This growth was supported by 87.3% rise in disbursements under underwriting and direct subscription. Disbursements were higher in case of infrastructure, transport equipment, and chemicals and chemical product industries. Both the private sector and the joint sector accounted. for a larger share in disbursements. During 2000-01, 63.5% of total sanctions Were granted for modernisation/ balancing equipment and 36.5% of the total sanctions were granted to companies facing cash crunch. There was a record increase of 66.9% in loans and investment in shares / bonds of FIs.

IIBI's total income increased by -12.9% in 2000-01 due to increase in income from lending, investments/deposits, and other income resulting from profit on sale of fixed assets and lower provisions due to recovery of NPAs. As IIBI is exempted from payment of income tax for the first five years of its operations, a net profit of Rs 110 crore implied a return on average net worth of 16.3% in 2000-01.

As-on March 31, 2001, IIBI's net NPAs constituted 22.9% of its net loan and investment portfolio. These NPAs increased further to 24.1% in 2001-02. IIBI ranks the first in the problem of non-performing assets among all-India financial institutions.

Conclusion

IIBI has a track record of profitability growth in operating income and dividend payment since its inception in 1997. IIBI aims to build business around a niche network of clients and investors, intermediating as intellectual resource and information centre and spearhead new ways of doing business. Hence, it is continuously upgrading the process, systems, and structures to build capabilities of integrated management, risk assessment, and risk control.

Small Industries Development Bank of India

The Small Industries Development Bank of India (SIDBI) was set up in 1990 under an Act of Parliament- the SIDBI Act, 1989. The Charter establishing SIDBI envisaged SIDBI to be "the principal financial institution for the promotion, financing and development of industries in the small scale sector and to coordinate the functions of other institutions engaged in similar activities."

SIDBI commenced its operations on April 2, 1990, by taking over the outstanding portfolio and activities of IDBI pertaining to the small scale sector. In pursuance of the SIDBI (Amend-

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ment) Act, 2000, and as approved by the Government of India, 51.1 % equity shares of SIDBI held by IDBI have been transferred to public sector banks, LIC, GIC, and other institutions owned and controlled by the central government. Presently SIDBI has 35 banks, insurance companies, investment and financial institutions as its shareholders in addition to IDBI, which continues to hold 49 % share in SIDBI.

Four basic objectives are set out in the SIDBI Charter. They are:

a. Financing
b. Promotion
c. Development
d. Coordination for orderly growth of the small scale industrial sector

SSI are the industrial units in which the investment in plant and machinery does not exceed Rs 10 million. The SSI sector, consisting of 3.1 million units, forms the backbone of the Indian economy, contributing to around 40% of India's total manufacturing sector output, around 35% of total exports and providing employment to nearly 19 million persons. The major issues hindering the growth of small scale industries are technology obsolescence, managing inadequacies, delayed payments, poor quality, incidence of sickness, lack of appropriate infrastructure, and lack of marketing network. This sector needs to be nurtured and provided strong support services for its long-term profitable growth. SIDBI tries to strike a balance between financing and providing support services for the development of SSI sector.

As an apex institution, SIDBI makes use of the network of the banks and state financial institutions, which have retail outlets for coordinating the development of the small scale sector. It has initiated a system of dialogue and obtaining feedback from the representatives of institutions of SSIs who are on the SIDBI's National Advisory Committee and Regional Advisory Committees. SIDBI has entered into (MOUs) with 18 banks, government agencies, international agencies, development institutions, and industry associations to facilitate a coordinated approach for the development of the SSI sector.

Financial Products Offered by SIDBI

SIDBI offers a chain, of financial products covering micro-finance, business, incubation, venture capital, project finance, assistance for technology development and marketing of small scale industries products, export finance, bills finance, factoring, guarantees for loans, and so on. SIDBI also provides support services such as training, market information, and advice for enhancing the inherent strength of small scale units.

Products and Services

- Direct Finance Schemes
- Bills Finance Schemes
- Refinance Schemes
- International Finance Schemes
- Marketing Finance and Development Schemes (Marketing Schemes)
- SIDBI Foundation for Micro Credit
- Other Schemes
- Promotional and Development Activities (P&D Activities)
- Fixed Deposit/Bonds

Direct Finance Schemes

1. Credit Linked Capital Subsidy (CLCS)
2. Scheme for Development of Industrial Infrastructure for SSI Sector (IID)
3. Equipment Finance Scheme (EFS)
4. Fast Track Financing Scheme (FTFS)
5. Scheme of Integrated Infrastructure Development (IID)
6. ISO 9000 Scheme (ISO 900)
7. Project Finance Scheme (PFS)
8. Tannery Modernisation
9. Technology Development and Modernisation Fund Scheme (TDMFS)
10. Technology Upgradation Fund Scheme for Textile Industries (TUFS)
11. Vendor Development Scheme (VDS)
12. Working Capital Term Loan (WCTL)

Bills Finance Schemes

1. Bills Rediscounting Scheme-Equipment (BRS-E).
2. Bills Rediscounting Scheme-Inland Supply Bill.
3. Direct Discounting Scheme-Components (DDS-C).
4. Direct Discounting Scheme-Equipment (DDS-E)

Refinance Schemes

1. Refinance Scheme for Acquisition of ISO Series Certification, by SSI Unit (RISO 9000)
2. Composite Loan Scheme (CLS)
3. Credit Linked Capital Subsidy Scheme for Technology Upgradation of Small Scale Industries (CLCSS)
4. For Term Loan-Non-SSI
5. General Refinance Scheme (GRS)
6. Mahila Udyam Nidhi (MUN)
7. National Equity Fund Scheme (NEF)
8. Refinance Scheme for Rehabilitation of Sick Industrial Units (RSR)
9. Self Employment for Ex-Servicemen Scheme (SEMFEX)
10. Single Window Scheme (SWS)
11. Refinance for Small Road Transport Operators (SRTOs)
12. Refinance Scheme for Tannery Modernisation (RTM)
13. Refinance Scheme for Technology Development and Modernisation (RTDM)
14. Refinance Scheme for Textile Industry under Technology Up-gradation Fund (RTUF)

International Finance Schemes

1. Booking of Forward Contract
2. Foreign Currency Term Loan Scheme (FCTL).
3. Line of Credit Foreign Currency (LOCFC)
5. Opening of Foreign Letters of Credit (FLC)

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6. Post-Shipment Credit in Rupees
7. Pre-Shipment Credit in Foreign Currency (PCFC)

Marketing Schemes

1. Marketing Fund for Women
2. Marketing of SSI Products

SIDBI Foundation for Micro Credit

1. SIDBI Foundation for Micro Credit

Other Schemes

1. Scheme for Domestic Factoring (FAC)
2. Scheme for Invoice Discounting (IDS)

Promotional and Development Activities

1. Mahila Vikas Nidhi
2. Rural Industries Programme
3. Entrepreneurship Development Programme
4. Management Development Programmes
5. Technology Upgradation Development Programmes
6. Quality and Environment Management

Fixed Deposits/Bonds

1. Fixed Deposit Scheme
2. Capital Gains Bond
3. SIDBI's financial assistance to small scale sector is channelised through:
4. Indirect assistance to primary lending institutions (PUs)
5. Direct assistance to small units

Indirect assistance is extended by way of refinance, granting of line of credit (LOC) in lieu of refinance to and rediscounting of bills of exchange to eligible PUs including banks, state financial corporations, and state industrial development corporations having over 65,000 branches all over the country. The total number of eligible PUs as at the end of March 2001 stood at 910.

SIDBI refinances loans sanctioned and disbursed by PUs to set up new SSI projects and for expansion, technology, up-gradation, modernisation, quality promotion, diversification by existing units, and rehabilitation of sick SSI units. This refinance assistance flows to the transport, health, and tourism sectors and also to professional and self-employed persons setting up small-sized professional ventures.

SIDBI extends short-term loans to scheduled banks in respect of their outstanding portfolio relating to SSI sector against which no financial support has been availed from other institutions.

SIDBI rediscounts bills of SSI suppliers and bills arising out of sale/purchase of machinery discounted by scheduled commercial banks.

Subsidiaries

To facilitate the creation of an environment for self-sustaining and growing SSI units and to provide a completed range of services, SIDBI has set up

i. Credit Guarantee Fund Trust for Small Industries
ii. SIDBI Venture Capital Limited
iii. Technology Bureau for Small Enterprises
iv. SIDBI Foundation for Micro credit

The Credit Guarantee Fund Trust for Small Industries (CGTSI) has implemented a credit guarantee fund scheme for small industries to facilitate collateral free and third party guarantee-free credit facilities (both' long-term and working capital) from scheduled commercial banks and select regional rural banks to new and existing units in the SSI sector, including units in the information technology and software industry. The Credit Guarantee Fund Trust for Small Industries, which guarantees collateral free/third party guarantee-free loans upto Rs 25 lakh per SSI borrower is an important credit facilitating initiative.

SIDBI's Venture Capital Limited provides venture funds for various activities such as software services and education, product development, internet services, and so on.

The Technology Bureau for Small Enterprises has been set up in association with United Nations, and Asia Pacific Centre for Transfer of Technology (APCTT). The Technology Bureau for Small Enterprises assists small enterprises in accessing the latest technologies in diverse industrial fields, both from within and outside India.

SIDBI Foundation for Micro Credit (SFMC) is creating a national network of strong, viable, and sustainable micro-finance institutions from the informal and formal financial sectors to provide micro-finance services to the poor, especially women, for setting up micro enterprises.

Besides these, SIDBI is the co-promoter of IDBI Bank Ltd., North-Eastern Development Financial Institutions (NEDFIs), SBI Factors, and Canbank factors.

Consequent upon amendments to the State Financial Corporations (SFCs) Act, State Financial Corporations have been brought under the ambit of SIDBI.

SIDBI is among top 30 development banks of the world. As per the May 2001 issue of The Banker, London, SIDBI ranked twenty-fifth both in terms of capital and assets.

Financial Results of SIDBI for the Year Ended March 31, 2002

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(Rs in crore)

Particulars	Year ended 31.03.2002	Year ended 31.03.2001
1. Income from Operations	1,553	1,606
2. Other Income	6	13
Total Income (1 + 2)	1,559	1,619
3. (a) Establishment Expenses (Staff Cost)	32	39
(b) Other Expenses	45	50
4. Interest Expenses	1,069	1,044
Total Expenditure (3 + 4)	1,146	1,133
5. Depreciation	8	9
6. Profit before Tax (1 + 2 - 3 - 4 - 5)	405	477
7. Provision for Taxation	-	-
Current	-152	-
Deferred	29	-
8. Net Profit (6 - 7)	282	477
9. Paid Up Share Capital (comprising equity shares having face value of Rs 10 each)	450	450
10. Reserves (excluding revaluation reserves)	3,501	3,321
11. Earning Per Share (Rs)	6.27	10.60
12. Shareholding	No. of Shares	% of Shareholding
Financial Institutions	24,00,00,000	53.34
Insurance Companies	6,00,00,000	13.33
PSU Banks	15,00,00,000	33.33
Total	45,00,00,000	100.00

Source: SIDBI.

Resources Raised by SIDBI

SIDBI has been raising resources through international and domestic markets. It has raised borrowings from Japan Bank for International Cooperation and KfW Germany. It also raises taxable priority sector bonds from domestic markets as also deposits from foreign banks. As per the provisions of Union Budget 2002-03, SIDBI has been allowed to raise capital gains bonds. The Government of India converted SIDBI's borrowings from the Reserve Bank of India into bonds of 20 years tenure issued to GOL These bonds are eligible for inclusion in Tier - I Capital. This increased the capital adequacy ratio of the Bank from 28% in 2000-0 I to 45% in 2001-02.

SIDBI Overall Assistance: Product Groupwise

(Rs in crore)

Scheme		1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-200C	2000-01	2001-02
Refinance													
(including LOCs in	S	2,052.2	2,299.0	2,026.8	1,766.5	1,672.2	2,609.1	2,451.0	3,171.8	4,743.8	6,353.3	8,088.0	6,375.0
lieu of refinance)	D	1,561.5	1,634.5	1,450.0	1,390.9	1,235.5	2,123.7	1,941.7	2,640.2	3,247.3	4,138.1	4,411.6	4,144.5
Bills financing	S	266.0	463.2	753.6	1,076.9	1,642.3	2,079.7	2,008.8	1,625.8	1,678.6	1,503.5	880.5	782.4
	D	198.7	348.8	609.3	910.8	1,442.7	1,825.8	1,771.4	1,459.8	1,484.8	1,313.7	778.6	711.3.
Resource Support													
to Institutions	S	80.5	58.8	101.3	411.3	888.9	1,091.0	1,406.1	1,447.7	1,465.4	1,320.5	792.2	492.0
	D	72.8	31.3	75.1	329.5	584.0	713.8	660.5	677.7	958.7	692.2	437.5	451.7
Project related													
Financing	S	3.0	13.3	16.7	93.4	489.9	267.9	583.1	1,192.6	943.6	1,021.7	995.6	1,276.2
	D	0	3.0	3.4	34.9	118.2	127.8	187.5	430.4	562.8	768.3	771.0	550.7
Equity assistance	S	7.1	11.7	9.9	5.9	6.0	8.0	22.7	31.1	24.8	35.6	20.2	54.3
	D	5.5	9.7	8.0	5.2	4.8	5.0	16.8	26.4	22.2	32.1	16.9	36.0
Promotional and													
Development													
Assistance	S	1.3	1.0	.9	2.3	7.0	9.9	13.6	15.2	23.6	30.1	44.0	45.7
	D	.3	.7	.5	1.4	4.6	4.7	6.8	6.2	9.4	19.1	25.8	25.3
Total	S	2,410.1	2,847.0	2,909.2	3,356.3	4,706.3	6,065.6	6,485.3	7,484.2	8,879.8	10,264.7	10,820.6	9,025.5
	D	1,838.8	2,028.0	2,146.3	2,672.7	3,389.8	4,800.8	4,584.7	5,240.7	6,285.2	6,963.5	6,441.4	5,919.3

S = Sanctions / Approvals D = Disbursement / Payments

Source: SIDBI.

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Financial Highlights of SIDBI

In its twelve years of operations, the aggregate sanctions of SIDBI declined for the first time during the year 2001-02. (Table 15.13) The aggregate sanctions of SIDBI during 2001-02 amounted to Rs 9,025 crore as against Rs 10,821 crore in the previous year. Disbursements were also lower at Rs 5,919 crore as against Rs 6,441 crore in the previous year. The decline in off-take of refinance was mainly due to a slowdown in the growth of the industrial sector, moderate services sector performance, and comfortable liquidity in the banking sector. The cumulative sanctions and disbursements of SIDBI since inception stood at Rs 75,255 crore and Rs 52,312 crore showing a compounded growth rate of 13% and 11%, respectively.

SIDBI's overall operations under promotional and development assistance have shown an increasing trend and have further increased in 2001-02. The micro-finance activities registered a significant growth. I This growth was a result of financial assistance received from Department for International Development, Government of UK. SIDBI has been granted a substantial line of credit by the International Fund for Agriculture Development, Rome, a United Nations outfit, for upscaling micro-credit operations.

As regards financial performance, the income of the Bank declined in the year 2001-02. The income of the Bank was Rs 1560 crore in 2001-02 as against Rs 1,619 crore in 2000-01. The profit before tax in 2001--02 was lower at Rs 405 crore as against Rs 477 crore in 2000-01 owing to a decline in interest rates. Effective IFY 2002, SIDBI has been brought under the purview of taxes and hence it had to pay Rs 152 crore in the form I of taxes. This led to a reduction in profit after tax and earnings per share in 2001-02. The earnings per share declined to Rs 6.27 for the year ended March 31, 2002, from Rs 10.60 for the previous year. The Bank's net worth increased to Rs 3,951 crore as at end March 2002 from Rs 3,771 crore as at end March 2001. The net NPAs of the Bank increased to 3% on March 31, 2002, from 1.2% on March 31, 2001.

Conclusion

After making a beginning as essentially a refinance institution SIDBI has grown into a multifaceted organisation. It has served the small sector well by providing a wide range of products and resource support services-in its twelve years of existence. It will, however, have to change its operational strategy in view of declining interest rates and availing of refinance by"banks. SIDBI should endeavour to contain non-performing assets and build quality long-term assets and thereby become a strong and vibrant financial institution.

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LESSON 31:
DEVELOPMENT FINANCIAL INSTITUTIONS: MAJOR PLAYERS

Lesson Objectives

- To know in short about specific DFIs and their working.
- Role of major DFIs in Industrial Growth

We continue our discussion in this session about specific DFIs.

Infrastructure Development Finance Company Ltd

Infrastructure Development Finance Company Limited (IDFC) was set up on the recommendations of the Expert Group on Commercialisation of Infrastructure Projects under the Chairmanship of Dr. Rakesh Mohan. The group identified the need for a specialised financial intermediary for infrastructure to professionalise the process of infrastructure development in the country. IDFC was incorporated on January 30, 1997, with an initial paid up capital of Rs 1,000 crore. The Government of India and the Reserve Bank of India have contributed Rs 650 crore by way of subordinated debt, raising its total capitalisation to Rs 1,650 crore. Domestic financial institutions such as HDFC, ICICI Ltd., IFCI Ltd., SBI, and UTI have contributed 20% of the share capital; foreign shareholding is 40%; and government shareholding constitutes 40% of the total capital.

IDFC was set up to facilitate the flow of private finance to commercially viable infrastructure projects. The traditional sources of finance could not meet the financing needs of such projects as the risk profile of infrastructure projects is unique. IDFC has designed innovative products and services to address the specific needs of infrastructure financing. The mission of IDFC is leading private capital to commercially viable infrastructure projects by advocating solutions that deliver efficient services to consumers.

Initially, IDFC focused on power, roads, ports, and telecommunications. Now it has broadened this focus to the framework of energy, telecommunications and information technology, integrated transportation, urban infrastructure, and food and agri-business infrastructure.

IDFC has been assigned lead manager mandates and key advisory assignments. In its role as policy advisor, IDFC provides leadership in rationalising policy and regulatory frameworks and removes impediments to the movement of capital to infrastructure sectors. To facilitate the role of policy advisor, IDFC identifies best products, draws on the expertise of policy advisory boards and promotes policy dialogue amongst key players in the various infrastructure projects. IDFC also provides finance by way of equity and debt support. It also strengthens links between financial institutions and infrastructure projects by encouraging financial institutions to participate in infrastructure projects.

IDFC's Operations

Energy : IDFC provides consultancy and advisory services to state governments for formulating a power sector strategy. It prepares road maps for reform initiatives in respect of the policy framework governing the power sector with a belief that its multi-pronged and focused approach to reforming the power sector would ultimately translate into desired investment opportunities. It also acts as a lead arranger and financier for power projects.

IDFC played a pivotal role in the preparation of the report of the Government of Karnataka's High Level Committee on Escrow cover to Independent Power Projects. IDFC is part of the consortium acting as a privatisation consultant to Karnataka Power Transmission Company Limited, the monopoly state public sector company engaged in transmission and distribution of power. IDFC has provided financial advisory services and prepared a detailed fuel study for the Torrent Group's proposed power generation plant. It also interacts with and responds to documents released by the Central Electricity Regulatory Commission (CERC) and various State Electricity Regulatory Commissions.

As on June 30, 2002, Rs 4,122 crore were approved to 37 projects and Rs 779 crore were disbursed to 13 projects.

Food and Agriculture Business Infrastructure : This initiative was launched in August 2000. IDFC entered this sector with a belief that this sector has immense growth potential and the private sector has an important role to play to complement initiatives of the government. It has entered into a strategic alliance with Rabo bank, the Netherlands, a pioneer in the food and agriculture business, to provide the F&A industry in India with unique solutions for the development of its infrastructure.

Integrated Transportation IDFC views integrated transportation as an integrated logistics chain with parts not only complementing each other but also competing with each other. Hence roads, railways, pipelines, waterways, ports, and airports are links of a chain and not stand alone, independent entities.

IDFC has approved Rs 1,980 crore to 24 projects and has disbursed Rs 758 crore to ten projects till June 30, 2002.

Telecommunications and IT Infrastructure : IDFC has provided financial assistance to various telecom services projects in the areas of cellular mobile, basic national long distance, cable and broad band, and satellite services provision. IDFC's major clients are private sector telecommunication service players. It has provided assistance on a non- or limited-recourse basis, with project sizes ranging from Rs 20 crore to Rs 5,000 crore and loan periods varying from one to ten years.

IDFC has consolidated its operations in cellular industry with 60% of assistance provided to cellular mobile telephony service providers. It has played a key role in the two initial public offers by the new telecom companies as underwriter and anchor investor. It also provides performance and financial guarantees.

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Telecom and IT assets comprised 50% of IDFC's total assets as on March 31,2002.

Urban Infrastructure : IDFC provides financing and project advisory services for the development of urban infrastructure. It helps the state governments to prepare a road map for private sector participation in the development of urban infrastructure. IDFC played a key role in the Committee for Operation and Maintenance of Rural and Urban Water Supply Schemes constituted by the Government of Maharashtra. It has also entered into an agreement with the Asian Development Bank for a line of credit amounting to US $30 million for financing urban and environmental infrastructure projects. It is also a member of the Steering Committee for financing bankable solutions for waste-to-energy projects in Mumbai. IDFC has so far approved Rs 372 crore to eight projects and disbursed Rs 38 crore to five projects.

Environment Management : IDFC recognised the importance of environment risk management for infrastructure project financing and set up a separate Environmental Management Group (EMG) to help projects address environment risks.

Decentralised Infrastructure and New Technologies : IDFC created a decentralised infrastructure and new technologies group to undertake initiatives such as identification of new technologies for application, development of financial models with the help of a local service partner, and initiating dialogue with donor agencies, relevant ministries, and multi-lateral agencies to enable and stimulate commercially viable decentralised development.

3i Network : It has set up 3J Network comprising of university network including lIT, Kanpur, and TIM, Ahmedabad, to harness the best academic expertise for developing and strengthening the infrastructure framework in the country.

Infrastructure Finance Company (Gujarat) Limited : This is a company set up in Gujarat by IDFC, Gujarat Industrial Investment Corporation (GIIC), and AIA Capital of the USA. This company is intended to be a conduit to direct funds by way of equity and debt, from the capital market to infrastructure projects in Gujarat. IFC(G) will act as an asset management company with the mandate to raise Rs 4,500 crore for infrastructure projects in the state over the next five years. It will manage the Gujarat Infrastructure Fund (GIF), which has incorporated an Equity Fund and a Debt Fund under the Indian Trusts Act.

Financial Highlights of IDFC

Financial Performance of IDFC

(Rs in crore)

	FY 2002	FY 2001	FY 2003
	For the year ended 31.3.2002	For the year ended 31.3.2001	For the period 1.4.02 to 30.6.02
Total Income	405.30	314.90	95.74
Less: Total Expenses	203.67	158.46	47.16
Profit before Tax	201.63	156.44	48.58
Less: Provision for Tax	15.00	16.00	5.00
Profit after Tax	186.63	140.44	43.58
Add: Balance Brought Forward	342.23	305.13	-
Total Available for Appropriation	528.86	445.57	-

Source: IDFC

15.15 Operational Highlights of IDFC

(Rs in crore)

	FY 2001		FY 2002		FY 2003	
	Approvals	Disbursements	Approvals	Disbursements	Approval	Disbursements
Energy	1,041	222	382	156	80	3
Telecommunications And LT.	1,660	495	1,545	817	0	105
Integrated Transportation	539	42	803	496	200	47
Urban infrastructure	27	4	278	32	0	2
Total	3,267	763	3,008	1,501	280	157

Source: IDFC.

IDFC's Exposure to Various Sectors (2001-02)

	(In percentage)
Telecommunication	37.26
Energy	29.43
Transportation	27.70
Urban Infrastructure	5.61

Source: IDFC

IDFC's Sanctions and Disbrsements

Year	Sanctions (Rs in crore)	Growth rate (in percentage)	Disbursement (Rs in crore)	Growth rate (in percentage)
1997-98	295.00	-	-	-
1998-99	1,682.00	470.2	375.00	-
1999-2000	1 ,866.00	10.9	642.00	71.2
2000-01	2,467.00	32.2	762.00	18.7
2001-02	3,008.00	21.9	1,501.00	96.9
Cumulative up to end March 2002	10,123.40 (including performance .and financial guarantees for 86 projects)			

Source: IDFC.

Financial Ratios of IDFC

	Financial Year 2002	2001
Interest Income as a Percentage to Average Working Funds	11.74	10.59
Non Interest Income as a Percentage to Average Working Funds	1.10	1.22
Operating Profit As a Percentage to Average Working Funds	6.62	6.43
Return. On Average Assets (in percentage)	5.91	5.26
Net Profit Per Employee (in rupee crores)	1.61	1.35

Source: IDFC

IDFC's approvals and disbursements have increased in its five years of existence. IDFC's disbursements have almost doubled in the year 2001-02 as compared to 2000-01. The total disbursements amounted to Rs 1,501 crore for 24 projects during 2001-02 as against Rs 763 crore from 15 projects in 2000-01.

The outstanding disbursements as on March 31, 2002, were Rs 2,851 crore. Its exposure to Gujarat was the highest (Rs 1,662 crore) followed by Maharashtra (Rs 802 crore) and Andhra Pradesh (Rs 536 crore). IDFC's sanctions and disbursements to telecommunications and information technology was the highest. Its exposure to telecommunications and information technology increased 37.26% in 2001-02.

The profits before tax and after tax increased in the year 2001-02. This increase was mainly due to rise in operating and interest income. The total assets of IDFC increased from Rs 27,822 million in 2000-01 to Rs 31,189 million in 2001-02. As on March 31, 2002, IDFC had nil non-performing assets.

Conclusion

IDFC has evolved a vision for core sectors such as power, ports, roads and telecom where cost-effective services to the end user is

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the ultiinate goal of infrastructure provision. This vision is based on its belief that the key to reform in infrastructure is in introducing competition. It has successfully financed innovative projects in its five'years of existence. In order to provide a thrust to the infrastructure financing programme, IDFC will be merged with the Infrastructure Leasing and Financial Services (IL&FS). This new company will be the country's biggest infrastructure financing company.

The Export-import Bank of India

The Export-Import Bank of India (Exim Bank) is a public sector financial institution created by an Act of Parliament-the Export-Import Bank of India Act, 1981. It commenced its business operations in March 1982. It is wholly owned by the Government of India and was set up for the purpose of financing, facilitating, and promoting foreign trade in India. Exim bank is the principal financial institutions in the country for coordinating working of institutions engaged in financing exports and imports.

Exim Bank is an apex institution which promotes foreign trade. Its head office is Mumbai. It has a network of 13 offices in India and overseas.

Objectives

a. Financing, facilitating, and promoting India's foreign trade.

b. Creating export capability by arranging competitive financing at various stages of the export cycle.

c. Developing commercially viable relationships with a target set of externally oriented companies by offering them a comprehensive range of products and services, aimed at enhancing their internationalisation efforts. The vision of Exim Bank is "To offer best-in-class services to our customers in their globalisation efforts through the creation of an environment for our people that rewards excellence, initiative and innovation."

Exim Bank: Business Profile

The operations of the Bank are grouped as below:

Export Credits

The Bank provides export credit on deferred payment terms on exports of Indian machinery, manufactured goods, consultancy, and technology services.

Lines of credit/buyer's credits are extended to overseas entities, that is, governments, central banks, commercial banks, development finance institutions, regional development banks for financing export of goods and services from India.

The Bank also provides:

i. Project Finance

ii. Trade Finance

Export Capability Creation

- Export product development
- Export marketing finance
- Export oriented units
  - i. Project finance
  - ii. Working capital
  - iii. Production equipment finance
- European Community Investment Partners (ECIP)
- Asian Country Investment Partners (ACIP)
- Overseas Investment Finance
- Export facilitation programs
  - i. Software training institutes
  - ii. Minor ports development

Export Services

In addition to finance, the Bank provides a range of information and advisory services to Indian companies to supplement their efforts aimed at globalisation of Indian business.

Supporting Groups

1. Planning and research
2. Accounts/MISIEDP
3. Legal
4. Coordination
5. HRD
6. Establishment

Exim Bank provides a range of programs which can be classified into

i. Financing programs

ii. Export services and export promotion programs

Financing Programmes : Exim Bank provides financial assistance to Indian companies by way of a variety of lending programmes, namely, non-funded and funded lending programmes. Non-funded lending programmes include bid bond, advance payment guarantee, performance guarantee, guarantee for release of retention money, guarantee for raising borrowings overseas, and other guarantees. Funded lending programmes include pre shipment rupee credit, post-shipment rupee credit, foreign currency loan, overseas buyers credit, lines of credit, loan under FREPEC Programme, and refinance of export loans.

Exim Bank also provides financial assistance to Indian companies for export capability creation by way of a lending programme for export oriented units, production equipment finance programme, import finance, export marketing finance programme, software training institutes, financing, research and development, and programme for export facilitation. The programme for export facilitation includes port development, export vendor development lending programme, foreign currency pre-shipment credit, and working capital term loan programme for export oriented units.

Export Services and Export Promotion Programmes Exim Bank provides a range of export- related services. The Bank's fee-based services help identify new business propositions, source trade, and investment -related information, create and enhance presence through joint network of institutional links across the globe, and assist externally oriented companies in their quest for excellence and globalisation. It also provides services such as search for overseas partners, identification of technology suppliers, negotiating alliances, and development of joint ventures in India and abroad. The Bank also supports Indian project exporters and consultants to participate in projects funded by multilateral funding agencies.

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It also extends assistance to Indian promoter companies in setting up of joint ventures through the Overseas Investment Finance Programme (OIF) and the Asian Countries Investment Partners (ACIP) programme.

Exim Bank plays the role of an intermediary for facilitating the forfaiting transaction between the Indian exporter and the overseas forfaiting agency. It also set up a new company, the Global Trade and Finance Private Limited in association with West LB, Germany, and IFC Washington to offer export factoring and forfaiting to Indian exporters.

The Bank undertook new initiatives during 2000-01. It launched a new programme in association with EBRD, London, to support Indian exports to 26 countries. It also entered new businesses like venture capital finance and brand promotion in Europe.

Financial Highlights of Exim Bank

Sanctions and Disbursements by EXIM Bank

Year	Sanctions		Disbursements	
	Funded Assistance (Rs in crore)	Guarantees (Non-funded Assistance)	Funded assistance (Rs in crore)	Guarantees (Non-funded assistance)
1996-97	1,242.1	136.5	1,256.6	148.1
1997-98	1,840.6	402.4	1,370.4	191.2
1998-99	1,838.0	263.5	1,270.7	247.4
1999-2000	2,831.8	440.4	1,729.6	301.7
2000-01	2,174.3	211.8	1,896.4	174.1
2001-02	4,241.0	545.0	3,453.0	416.0

Source: IDBI, Report on Development Banking in India, 2000-01 and EXIM Bank.

Income and Expenditure Account of EXIM Bank

(Rs in crore)

	1999-2000	*2000-01*
A. Expenditure		
1. Payment of interest	364.49	451.98
2. Other expenditure	33.81	36.74
3. Tax	62.25	50.55
4. Profit after tax	165.05	154.15
Total	625.60	693.42
B. Income		
1. Interest and discount	602.01	673.95
2. Exchange, commission, brokerage, and fees	22.51	17.93
3. Others	1.08	1.54
Total	625.60	693.42

Asset Classification of EXIM Bank

(In percentage)

	1999-2000	2000-01	2001-02
Standard assets	92.7	91.9	92.6
Substandard assets	3.9	4.7	7.4
Doubtful assets	3.4	3.45	-
Total	100.0	100.0	100.0

Source: EXIM Bank.

Financial Ratios of EXIM Bank

		1996-97	1997-98	1998-99	1999-2000	2000-01
1	Profit after tax to average net worth (%)	15.5	17.9	13.0	11.4	9.9
2	Profit after tax to average assets (%)	3.4	4.0	3.1	2.6	2.1
3	Average cost of funds (%)	5.9	5.6	5.4	5.8	6.3
4	Average return of funds (%)	9.8	10.0	10.3	9.9	9.6
5	Margin (%)	3.9	4.4	4.9	4.1	3.3
6	Debt equity ratio	2.9	2.5	2.6	2.9	2.8
7	Capital adequacy ratio (%)	31.5	30.5	26.6	24.4	23.8

Source: IDBI, Report on Developing Banking in India, 2000-01.

The sanctions and disbursements under various financing programmes were the highest in the year 2001-02. During 2001-02, the Bank sanctioned Rs 4,241 crore under various lending programmes as against Rs 2,174 crore in the year 2000-01, registering a growth of 95.1%. Disbursements during the year 2001-02 were Rs 3,453 crore as against Rs 1,896 crore during 2000-01 representing a growth of 82.1%. Outstanding disbursements as at end March 2002 were Rs 6,610 crore registering an increase of 17.1% over the previous year.

The Bank sanctioned guarantees aggregating Rs 545 crore during 2001-02 as against Rs 212 crore during 2000-01. Guarantees issued amounted to Rs 416 crore during 2001-02 as against Rs 174 crore during 2000-01. The outstanding guarantees as at end March 31, 2002, amounted to Rs 1,127 crore. These guarantees related to overseas projects in sectors such as telecommunication, power generation, transmission and distribution, oil exploration, cement and petrochemicals.

During the year 2001-02, total 59 contracts worth Rs 4,162 crore covering 26 countries, were secured by 34 Indian exporters, with the Bank's support as against 38 contracts worth Rs 1,833 crore covering 23 countries during 2000-01. The contracts consisted of 27 turnkey contracts valued at Rs 3,051 crore, 19 supply contracts at Rs 703 crore, 11 service contracts valued at Rs 274 crore and 2 construction contracts at Rs 134 crore.

The Bank registered profit before tax (PBT) of Rs 221 crore during 2001-02 as against Rs 205 crore during 2000-01. The profit after tax (PAT) amounted to Rs 171 crore during 2001-02 as against Rs 154 crore during 2000-01, registering a growth of 11%. Its net assets grew by 17% during the year 2001-02. The Bank paid a dividend of Rs 42 crore to the government in the year 2002.

Conclusion

Exim Bank has reoriented its strategies looking to the changing dynamics of international trade and global environment. It caters not only to the financing needs of exporters and importers but also supports Indian companies in their effort to globalise their business. These new initiatives have helped the exporters and importers to secure more business which, in turn, has led to an increase in the Bank's assets and profits.

National Bank for Agriculture and Rural Development (NABARD)

The National Bank for Agriculture and Rural Development (NABARD), a development bank, came into existence on July 12, 1982, under an Act of Parliament with an initial capital of Rs 100 crore. It is an apex institution set up for providing and regulating credit and other facilities for the promotion and development of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts, and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas and for matters connected therewith or incidental thereto.

NABARD took over the functions of the erstwhile Agricultural Credit Department (ACD) and Rural Planning and Credit Cell (RPCC) of REI and Agricultural Refinance and Development Corporation (ARDC). Its subscribed and paid up capital was Rs 100 crore which was enhanced to Rs 500 crore, contributed by the Government of India (GOI) and the Reserve Bank of

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India (RBI) in equal proportions. The capital is now enhanced to Rs 2,000 crore.

Functions of NABARD

i. It serves as an apex refinancing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas.

ii. It takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, and so on.

iii. It coordinates and supervises the rural financing activities of all institutions engaged in developmental work at the field level and maintains liaison with the Government of India, state governments, Reserve Bank of India, and other national level institutions concerned with policy formulation.

iv. It undertakes monitoring and evaluation of projects refinanced by it.

   i. It promotes research in the fields of rural banking, agriculture, and rural development.

   ii. It prepares annual rural credit plans for all districts in the country which form the base for annual credit plans of all rural financial institutions.

NABARD operates throughout the country through its 28 regional offices and one sub-office, located in the capital of all the states/union territories. It has 320 district offices across the country and one special cell at Srinagar. It has also set up five training centres.

Refinance : NABARD's mission is accelerated capital formation to promote sustainable and equitable agriculture and rural prosperity with refinance as lever.

The institutions eligible for refinance are state cooperative agricultural and rural development banks (SCARBs), regional rural banks (RRBs), state cooperative banks (SCBs), commercial banks (CBs) state agricultural development finance companies (ADFCs), and primary urban cooperative banks.

NABARD extends refinance for both farm and non-farm sector. Long-term investment for farm sector includes investment on agriculture and allied activities such as minor irrigation, farm mechanisation, land development, soil conservation, dairy, sheep rearing, poultry, piggery, plantation, horticulture, forestry, fishery, storage and market yards, biogas and other alternate sources of energy and so. Non-farm sector includes investment activities of artisans, SSI, tiny sector, village and cottage industries, handicrafts, handlooms, and others. NABARD extends automatic refinance facility for refinance limit up to Rs 20 lakh.

NABARD's special focus is on the removal of regional/sectoral imbalance and hence gives preference to the needs of north-eastern states in terms of allocation of resources, quantity of refinances, and so on. Besides this, its focus is on hi-tech and export-oriented projects. It has issued guidelines for formation of hi-tech and export-oriented projects in farm and non-farm sectors. It also undertakes consultancy work for projects. It has set up ADFCs in Andhra Pradesh, Tamil Nadu and Karnataka for financing hi-tech/commercial ventures. NABARD is the chief promoter of these ADFCs with a holding of 26% equity.

NABARD provides short-term refinance for various types of production/ marketing/ procurement activities. NABARD provides refinance facilities to:

i. SCBs and RRBs for financing seasonal agricultural operations (SAOs), which include plugging and preparing land for sowing and weeding, and labor for all operations in the fields for raising and harvesting the crops.

ii. SCBs/CBs for financing the requirements of Primary Weavers' Cooperative Societies (PWCS), Apex Regional Weavers Societies, and State Handloom Development Corporations (SHDCs) to benefit the weavers outside the cooperative fold.

iii. RRBs for financing artisans and village/cottage/tiny sector industries as also for financing persons, belonging to the weaker sections and engaged in trade/business/service.

iv. SCBs on behalf of District Central Cooperative Banks (DCCBs) for (a) financing farmers to hold on to their produce till they get remuneration price of their produce (b) procurement, stocking, and wholesale distribution by apex societies and retail distribution of fertilisers to farmers.

Other refinance facilities include conversion assistance in case of natural calamity, long-term loans to state governments, financing of state handicrafts development corporations, financing of industrial cooperative societies and forest labour cooperative societies, and medium-term credit limits to SCBs and RRBs.

Types of Refinance Facilities

Agency	*Credit Facilities*
Commercial Banks	. Long-term credit for investment purposes . Financing the working capital requirements of Weavers' Cooperative Societies (WCS) and State Handloom Development Corporations
Short-term Co-operative	. Short-term (crop and other loans)
Structure (State Cooperative banks. District Central	. Medium-term (conversion) loans . Term loans for investment purposes
Cooperative Banks, Primary Agricultural Credit Societies)	. Financing WCS for production and marketing purposes . Financing State Handloom Development Corporations for working capital by State Cooperative Banks
Long-term Cooperative Structure (State Cooperative Agriculture and Rural Development Banks, Primary Cooperative Agriculture and Rural Development Banks)	. Term loans for investment purposes
Regional Rural Banks (RRBs)	. Short-term (crop and other loans) . Term loans for investment purposes
State Governments	. Long-term loans for equity participation in cooperatives . Rural Infrastructure Development Fund (RIDF) loans for infrastructure projects
Non-Governmental Organisations (NGOs)-Informal Credit Delivery System	. Revolving Fund Assistance for various micro-credit delivery innovations and promotional projects under Credit and Financial Services Fund (CFSF) and Rural Promotion Corpus Fund (RPCF), respectively

NABARD also extends refinance to banks for financing government-sponsored programmes such as Swamajayanti Gram Swarozgar Yojana, Prime Minister's Rozgar Yojana, action plans of SC/ST Development Corporations, and for development of non-conventional energy sources.

Rural Infrastructure Development Fund

The development of a strong rural infrastructure is a prerequisite for increasing productivity of land, capital and labour, improving the quality of life, and reducing vulnerability of rural

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power. Rural infrastructure includes irrigation structures, rural lands, bridges, water supply, sanitation, rural energy, rural market yards, education, health, communication, and information technology. Investment in rural infrastructure creates new economic opportunities and activities, generates additional employment and income, and facilitates and improves delivery of other rural services.

Investment in rural infrastructure declined in the eighth five year plan period. The state governments failed to develop and maintain rural infrastructure due to resource crunch. Moreover, the commercial banks which were to channelise at least 18% of their total lending to agriculture were unable to fulfill their commitment. To provide loans to state governments for the creation of rural infrastructure at reasonable rates, RIDF was set up in 1995-96 under the initiative of the Central Government. The scheme is operationalised by NABARD. Under the scheme, the central government through budgetary outlays, contributes to the corpus fund of RIDE

RIDF was set up with an initial amount of Rs 2,000 crore, (RIDF I). The Tranche-I was made up of contributions by way of deposits from scheduled commercial banks operating in India to the extent of shortfall in their agriculture lending, subject to a maximum of 1.5% of the net bank credit. In the years 1996-97 and 1997-98, the Union Budgets allocated Rs 2,500 crore. In the subsequent tranches, this amount was raised to Rs 3,000 crore in 1998-99, Rs 3,500 crore in 1999-2000, Rs 4,500 crore in 2000-01, Rs 5,000 crore in 2001-02 and Rs 5,500 crore in 2002-03. In order to encourage commercial banks to directly lend to priority sector, interest rates earned by commercial banks on RIDF deposits are kept inversely related to the shortfall in lending to agriculture. Further, credit risk weights for both direct priority sector lending and RIDF deposits had been fixed at 100%.

The Corpus, Amount Sanctioned, Phased and Disbursed under RIDF

(Rs in crore)

RIDF Tranche	Corpus	Amount Sanctioned	Amount phased	Amount Disbursed
RIDFI	2,000	1,911	1,911	1,761
RIDF II	2,500	2,620	2,620	2,250
RIDF III	2,500	2,693	2,693	2,183
RIDF IV	3,000	2,988	2,988	1,863
RIDFV	3,500	3,568	3,568	1,969
RIDFVI	4,500	4,586	3,872	1,899
RIDFVII	5,000	5,066	1,479	1,117
Total	23,000	23,432	19,131	13,042

Excluding Schemes Withdrawn

Source: RBI, Report on Trend and Progress of Banking in India, 2001-02.

The corpus of RIDF I to VII taken together amounted to Rs 23,000 crore as on March 31, 2002. Cumulative amounts of deposits mobilised, loans sanctioned, and fund disbursed under RIDF as on March 31, 2002, were Rs 12,288 crore, Rs 23,432 crore, and Rs 13,042 crore, respectively.

RIDF is used to finance incomplete or ongoing projects in minor, medium, and major irrigation along with flood protection, watershed management, and soil conservation. It also includes activities such as construction of rural roads and bridges, harvesting of rain water and construction of terminal rural markets, fish jetties and cold storage, primary school buildings, primary health centres, village haats, anganwadi centres, shishushiksha kendras, forest management, mini hydel and system improvement projects under power sector, rural drinking water supply, and citizens' information centres under IT sector..

Loans under RIDF are sanctioned up to 90% of the project cost. Ongoing incomplete projects and projects with shorter gestation period are accorded priority. 43,478 projects involving a loan amount ofRs 5,066 crore were sanctioned under RIDF during 20014>2. Rural roads and bridges accounted for 48.4% of the amount sanctioned while irrigation accounted for 23.6%. The total amounted sanctioned till July 5, 2002, was Rs 24,398.35 crore wherein roads and bridges accounted for 52.31%, irrigation accounted for 34.36%, watershed 1.64% and others 11.69%. As at the end of March 2002, of the 2,33,235 projects sanctioned, 1,34,636 projects were completed.

Other Schemes

i. Kisan Credit Card (KCC) Scheme : This scheme was started in 1998-99 to grant credit to farmers. During the year 2001-02, 83.821akh cards were issued by cooperative banks, RRBs and CBs. Since inception up to the end of March 2002; 2.32 crore KCCs have been issued of which RRBs and cooperative banks issued 1.65 crore KCCs involving a credit limit of Rs 33,994 crore.

Loans disbursed under KCCs have been brought under Rashtriya Krishi Bima Yojana of the General Insurance Corporation. KCC holders are also being provided personal accident insurance cover of Rs 50,000 for death and Rs 25,000 for disability.

ii. Watershed development fund : This fund was created in NABARD in 1999-2000 with a corpus of Rs 200 crore contributed equally by the Government of India and NABARD for implementing watershed projects in 100 priority districts of 14 states. This programme includes the improvement of productivity of land, groundwater recharge, and conservation of soil and moisture. As on March 31, 2002, 119 Capacity Building Phase Projects have been sanctioned in 9 states. During the year 2001-02,106 new projects involving a grant support of Rs 5.44 crore were approved.

iii. Scheme for setting up of agri-clinic and agriculture centers : During the year 2001-02, NABARD formulated a scheme for financing agriculture graduates for setting up agri-clinics and agribusiness centers.

iv. Scheme for financing farmers for purchase of land for agricultural purposes.

v. Scheme for ex-servicemen taking up self-employment activities under SEMFEXII.

vi. In 1998, the GOI in collaboration with NABARD launched a central sector capital subsidy scheme (Investment Promotion Scheme) for development of privately owned non-forest wastelands in the country.

vii. Refinance scheme for financing farmers' service centres set up in collaboration with Mahindra Shubhlabh Services

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Limited (MSSL) for providing various extension services to farmers, including supply of agri inputs.

viii. Micro finance development fund: NABARD has set up a Micro Finance Development Fund with an amount of Rs 100 crore, in pursuance of the proposal contained in the Union Budget 20004>1. The Fund has received an initial contribution of Rs 100 crore contributed by the RBI, NABARD, and 11 Public Sector Commercial Banks. NABARD has further contributed Rs 6 crore from its surpluses to the fund. This fund helps in furthering the cause of banking with the poor. Over 7.9 million poor households have gained access to the formal banking system through 458 thousand Self-Help Groups (SHGs) More than 90% SHGs have exclusively women members. SHG-bank linkage programme covered 488 districts in 30 states and union territories (UTs). During the year 2001-02, Rs 5,454.59 trillion were disbursed by banks as loans to SHGs. Cumulatively, as on March 31,2002, banks have disbursed more" than Rs 1,000 crore as loans to about 4.6 lakh SHGs and availed of Rs 794 crore as refinance from NABARD. On-time repayment of bank loan was above 95% from SHG members. NABARD has provided upto March 31, 2002, Revolving Fund Assistance (RFA) of Rs 104 million to 26 NGOs, SHG Federations, and credit unions for on-lending to SHGs and to build their financial intermediation capacities.

The SHG bank linkage programme is perhaps the largest micro-finance programme of the world in terms of its outreach. Today, over 2000 non-government organisations (NGOs) and 17,000 branches of 444 banks re associated with the programme. Cumulatively, over 50,000 bank officers and 1,200 faculty members of training colleges of banks have been trained by NABARD.

Amendments to NABARD Act, 1981

Comprehensive amendments to NABARD Act, 1981, were made to provide operational flexibility to the bank in meeting the changing requirements of the rural sector. These amend-ments were made effective from February 1, 2001. The amendments relate to explicit reference to NABARD as a development bank, Enhancement of capital limit from Rs 500 crore to Rs 5,000 crore, allowing holding of private equity up to 49 % with a minimum of 51% by the Government of India and RBI, flexibility in resource mobilisation ld credit-delivery by the bank, introduction of new products, and setting up of subsidiaries.

NABARD as a Consultant

NABARD has recently (2003) set up its own consulting wing called NAB CON for loan seekers. The new wing is established to provide information, technical guidance, critical ideas and consultancy services to the entrepreneurs, banks, co-operatives, government and non-government organisations. The bank's wing in India as well as in the international level has on date projects worth about $200 million under consultancy, or in active consideration.

NABARD as a Regulator

NABARD was set up under the aegis of RBI for supervision and refinance of rural cooperatives. It presently supervises 29 state cooperative banks (SCB), 367 district central cooperative banks, (DCCB), 804 primary agricultural societies, and 196 regional rural banks (RRBs).

Financial Highlights of NABARD

The profits before tax during 2001-02 were Rs 1,481 crore representing a 9.4% increase over last year. le profit after tax during the year 200 1-02 was lower than the previous year due to provision for tax. NABARD was exempted from income tax on its income U/s. 55 of NABARD Act, 1981, till March 31, 2001.

During the year 2001-02, the aggregate financial support provided to banks and state governments reached a new height of about Rs 21,146 crore compared to Rs 19,518 crore during the previous year. Investment ~dit constituted Rs 6,682.77 crore, production credit Rs 9,396.76 crore and RIDF Rs 5,066.12 crore.

Under investment credit, SCARDBs availed the highest amount of refinance (42% of total disbursements), followed by commercial banks at 24%, RRBs at 18%, and SCBs at 16%. among the states, UP availed the highest amount of refinance followed by Maharashtra, Andhra Pradesh,

Financial Highlights of NABARD for the Year Ended March 31, 2002

(Rs in crore)

	Year ended 31.3.2002	Year ended 31.3.2001
Particulars		
1. Income from Operations	3,636.38	3,036.50
2. Other Income	22.28	8.50
3. Total Expenditure		
(a) Staff Cost	194.87	171.96
(b) Other Expenditure	84.00	76.54
4. Interest Expenses	1,869.11	1,415.23
5. Depreciation	30.01	27.17
6. Gross Surplus before Taxation (1 + 2 - 3 - 4 - 5)	1,480.67	1,354.10
7. Provision for Taxation	365.00	0.00.
8. Surplus after Taxation (6 - 7)	1,115.67	1,354.10
9. Contribution to NRC Funds and Special Reserve U/s. 36(1)(viii) of IT Act, 1961 # 1005.001200.00	1,005.00	1,200.00
10. Surplus after Contribution to NRC Funds and Special Reserve 110.67154.10	11 0.67	154.10
11. Paid Up Capital	2,000.00	2,000.00
12. Reserves (excluding revaluation reserve)		
(a) General Reserve	2,757.11	2,583.06
(b) Other Reserves	908.21	365.70
(c) National Rural Credit Funds	13,975.00	13,438.00

* NABARD was exempted from income tax on its income u/s. 55 of NABARD Act, 1981, till March 31, 2001. # There is no outside obligation on these funds.

Source: NABARD.

Tamil Nadu, and Punjab. Purpose-wise, farm mechanisation's share was the highest (20%) followed by non-farm sector (16%), dairy development (10%), and minor irrigation (10%).

The total assets of NABARD as on March 31, 2002, were Rs 45,099 crore representing a 16.2 percent growth over the previous year. The net NPAs were Rs 0.93 crore forming 0.0001% of its loans and advances.

NABARD has played a key role as an apex level development finance institution committed to rural prosperity. its perfor-

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mance has been satisfactory in all areas of its operations. It has introduced new schemes and chalked out new strategies for better achievements in future.

Industrial Credit and Investment Corporation of India Limited (ICICI)

ICICI was among the first development banks in the world to be set up in the private sector. It was formed in 1955 at the initiative of the World Bank, the Government of India, and representatives of Indian industry. The principal objective was to create a development financial institution for providing medium-term and long-term project financing to Indian business.

ICICI played a catalytic role in the industrial development of India. It became a major source of foreign currency loans from multilateral agencies and international financial markets. ICICI was the first Indian borrower to raise the West German loan of DM 5 million from Kredianstalt (KfW) without a Gal guarantee in 1961, European currency units in 1982, and ADB loans in 1986. ICICI was the first Indian entity to float in 1986 a public issue of 75 million Swiss francs in the Swiss capital markets. It signed a loan agreement in 1987 for 10 million sterling with Commercial Wealth Development Corporation (CDC), the first loan by CDC for financing projects in India. ICICI was the first Indian financial company to raise Global Depository Receipts (GDR) in 1996 and the first financial institution from non-Japan Asia to list on the New York Stock Exchange (NYSE) through an issue of American Depository Shares (ADS) in 1999.

In 2001, ICICI raised a foreign currency loan of USD 75 million at LIB OR plus 70 basis points, setting a new benchmark for a five year borrowing by an Indian entity in the international markets after the Asian currency crisis.

ICICI successfully raised funds from the domestic market also. ICICI made its first debenture issue of Rs 6 crore in 1967 which was oversubscribed. ICICI raised financial resources from retail investors through various public offerings of bonds.

Following the economic liberalization of the Indian economy, ICICI Limited has renamed itself as ICICI.

Institutes Promoted by ICICI

ICICI initiated setting up of development institutions in the field of housing and state level industrial development. ICICI promoted specialised institutions in the areas of credit rating, venture capital, investment banking, and asset management.

ICICI promoted Shipping Credit and Investment Company of India Limited (SCICI) in 1986 which was later merged with ICICI in 1996. ICICI along with UTI set up the Credit Rating Information Services of India Limited (CRISIL), India's first professional credit rating agency, in1986. In 1988, ICICI promoted TDICI India's first venture company limited. In 1996, ICICI set up, ICICI Securities and Finance Company Limited in joint venture with J P Morgan. In 1994, ICICI promoted the ICICI Bank, marking its first foray into retail banking. ICICI diversified into merchant banking and leasing operations. ICICI took over ITC Classic Finance and Anagram Finance in 1997 and 1998, respectively. In 2000, ICICI acquired the Bank of Madura Limited to increase its retail deposit base.

The year 2002 marked a turning point in the history of the ICICI group. ICICI Limited was merged with ICICI Bank. ICICI, ICICI Personal Financial Services Limited (ICICI PFS), and ICICI Capital Services Limited (ICICI Capital) were amalgamated with the bank with effect from March 30, 2002. ICICI PFS, a subsidiary of ICICI, was acting as a focal point for marketing, distribution and servicing the retail product portfolio of ICICI, including auto loans, commercial vehicle loans, credit cards, and consumer loans. ICICI Capital, a subsidiary of IClCI, was engaged in sales and distribution of various financial and investment products such as ICICI Bonds, Fixed Deposits, Demat Services, and Mutual Funds. ICICI was the first to start internet banking and web-based securities trading through its subsidiary ICICI Web Trade Limited.

Merger of ICICI with ICICI Bank

ICICI and ICICI Bank, alongwith other ICICI group companies, were operating as a virtual universal bank offering a wide range of financial products and services. In the context of the move towards universal banking and the stiff competitive scenario in the Indian banking industry, both the entities were merged. The merged entity has now an access to low-cost deposits, higher income and participation in the payments system, entry into new business segments, higher market share in various segments especially in fee-based services and vast talent pool of ICICI and its subsidiaries which, in turn, would enhance the value for ICICI Bank shareholders. The merger has resulted in the integration of the retail finance operations of ICICI and its two merging subsidiaries and ICICI Bank into one entity, creating an optimal structure for the retail business. The share exchange ratio approved for the merger was one fully paid-up equity share of ICICI Bank for two fully paid-up equity shares of ICICI. The merger was approved by the shareholders of both companies in January 2002, by the High Court of Gujarat in March 2002, and by the High Court of Judicature at Mumbai and the Reserve Bank of India (RBI) in April 2002. ICIClcould successfully meet the statutory reserve requirements applicable to banks within the target date of March 30, 2002. While the merger became effective on May 3, 2002, in accordance with the provision of the Scheme of Amalgamation and the terms of approval of RBI, the appointed date for the merger was March 30, 2002. The merger created India's first universal bank and the second largest bank in the country with total assets of about Rs 1 trillion and about 540 branches and offices and over 1000 ATMs. ICICI Bank's equity shares are listed in India on stock exchanges at Chennai, Delhi, Kolkata, Mumbai, and the National Stock Exchange of India Limited.

ICICI Bank's American Depository Receipts (ADRs) are listed on the New York Stock Exchange (NYSE). It is the first commercial bank from India to list its stock on NYSE in 2000. ICICI has successfully transformed itself from a financial institution under indirect government control to a universal bank.

Subsidiaries and Affiliate Companies

Consequent to the merger of ICICI with ICICI Bank, ICICI's subsidiary companies have become subsidiaries of the bank. On March 31, 2002, ICICI Bank had eleven subsidiaries.

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Principal subsidiaries

ICICI Securities and Finance Company Limited

ICICI Venture Funds Management Company Limited

ICICI Prudential Life Insurance Company Limited

ICICI Lombard General Insurance Company Limited

ICICI Home Finance Company Limited

Other subsidiaries

ICIC Brokerage Services Limited ICICI Securities Holdings Inc. ICICI Securities Inc.

ICICI International Limited

ICICI Investment Management Company Limited ICICI Trusteeship Services Limited

Affiliate companies

i. ICICI Infotech Services Limited

ii. ICICI Web Trade Limited (iii) ICICI One Source Limited

ICICI Securities and Finance Company Limited : The company was set up in 1993~94 to provide investment banking services. It addresses the critical financial requirements of companies, governments, and institutional investors, advising on corporate strategy, capital structure, and capital raising. It also acts as an advisor for mergers and amalgamations. It is a primary dealer in the government securities market. The company has one subsidiary in India, namely, ICICI Brokerage Services Limited and two subsidiaries in the US, namely, ICICI Securities Holdings Inc. and ICICI Securities Inc. ICICI Securities Holdings Inc. was incorporated in 2000-01 to provide investment banking services to the investors in the US who wish to enter the Indian financial market and Indian investors who wish to enter the financial market in the US. ICICI Securities Inc. was formed in 2000-01 to provide brokerage, research, and investment banking services to investors in the US who wish to invest in the Indian financial market.

ICICI Venture Funds Management Company Limited : The company was set up in 1988 and specialises in making equity investments spanning a company's business lifecyc1e from Venture Capital (VC) to Private Equity (PE) with an ultimate aim of generating superior financial returns for its investors. It is the equity investment arm of ICICI Bank. It not only provides funds for financing of new business ventures or expanding privately held business ventures but also provides business skills. It is the oldest and most successful firm in India in both VC and PE investing.

ICICI Prudential Life Insurance Company Limited : The company was incorporated on July 20, 2000, and commenced its operations in January 2001. The principal shareholders of the company are ICICI Limited (74%) and Prudential Corporation Holdings Limited (26%). The company's life insurance business comprises of non-linked participating, non-linked non-participating annuities and linked policies. It has emerged as a leading private life insurer in India in a short span of 15 months since it commenced its operations.

ICICI Lombard General Insurance Company Limited : The company commenced its commercial operations on August 31, 2001. The principal shareholders are ICICI Limited (74%) and Lombard Canada Limited (26%). The company received the license on August 3, 2001, from the Insurance Regulatory and Development Authority (IRDA) to undertake general insurance business.

ICICI Home Finance Company Limited : The company commenced its operations in 1999-2000. It provides home loans and other related services. It was the first housing finance provider to introduce floating rate loans. It has expanded into fee-based property services for both corporate and retail customers.

ICICI International Limited : This company was incorporated in the Republic of Mauritius on January 18, 1996, as an Investment and Fund Management Company.

ICICI Investment Management Company Limited : This is an asset management company of ICICI Securities Fund, a mutual fund registered with SEBI.

ICICI Trusteeship Services Limited : The company's role is to serve as a trustee for enterprises, transactions, or arrangements of strategic or significant business importance to the ICICI Bank group.

Organisation Structure of ICICI Bank

The organisation structure is designed to support its business goals and is divided into five principal groups: I retail banking, wholesale banking, project finance and special assets management, international business, and corporate centre.

Retail Banking The retail business is the key driver of ICICI Bank's growth strategy. ICICI Bank is I today a retail financial supermarket, selling an entire range of credit, investment products, and various banking I services. ICICI Bank's retail portfolio (including the portfolio of ICICI Home Finance Company Limited, its wholly owned subsidiary) on March 31, 2002, was over Rs 76 billion as compared to the combined retail portfolio of ICICI and ICICI Bank of about Rs 29 billion on March 31, 2001. Its retail asset products include mortgages, automobile and two-wheeler loans, commercial vehicles and construction equipment financing, I consumer durable loans, personal loans, and credit cards. ICICI Bank emerged as a leading player in the mortgages business and consolidated its position as market leader in automobile loans during 2001-02.

Wholesale Banking Wholesale banking comprises corporate banking, treasury, structured finance, and credit portfolio management. ICICI Bank now focuses on working capital finance for highly rated clients, structured transactions, and channel financing. It offers structuring and advisory services for the public sector disinvestments process. It also offers transaction banking services such as cash management and non-fund I based facilities, including letters of credit and bank guarantees to increase market share in banking fees and commissions. The total volumes in cash management services have touched a new high of Rs 1.72 trillion during 2001-02. ICICI Bank provides internet banking services to its wholesale banking clients through ICICImarkets.com. The corporate banking business is organised into special relationship groups for the government and public sector, large corporates, emerging corporates, and agri business. ICICI Bank's Structured Products and Portfolio Management Group have access to expertise in financial structuring and related legal, accounting, and tax issues. This group actively supports business groups in designing financial

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products and solutions, and manages the asset portfolio by structuring portfolio buyouts and selldowns.

Treasury activities include management ofliquidity and exposure to market risks, mobilisation of resources from domestic and international financial institutions and banks, proprietary trading, and capital markets and custodial services operations.

Project Finance and Special Assets Management Project finance activities include financing new projects as well as capacity additions in the manufacturing sector and structured finance to the infrastructure and oil, gas, and petrochemicals sector. ICICI has developed considerable expertise in financing complex projects. Its role is not merely to provide finance but also to arrange and facilitate creation of appropriate financing structures that may serve as financing and investment vehicles for a wider range of market participants.

The Special Assets Management Group is responsible for large non-performing loans and accounts under watch.

International Business The International Business Group is responsible for ICICI Bank's international operations as well as coordinating the international strategies and alliances of its subsidiaries and affiliates.

Corporate Centre The Corporate Centre comprises all shared services and corporate functions, including finance and secretarial investor relations, risk management, legal, human resources, corporate branding, and communications. In 1998, ICICI introduced the new logo symbolising a common corporate identity for the ICICI group.

ICICI also provides micro financial services to enable the poor to reduce their economic vulnerability and participate in the growth process. ICICI's Rural Micro Banking Group is engaged in delivering microfinance to self-help groups of rural women.

Financial Highlights of ICICI

(Rs in crore)

Year	*Sanctions*	*Growth Rate* (%)	*Disbursements*	*Growth rate* (%)
1991-92	4,094.9	9.4	2,351.3	19.5
1992-93	5,771.8	41.0	3,315.2	41.0
1993-94	8,491.4	47.1	4,413.3	33.1
1994-95	14,527.9	71.1	6,879.3	55.9
1995-96	14,594.9	0.5	7,120.4	3.5
1996-97	14,083.8	-3.5	11,180.9	57.0
1997-98	24,717.5	75.5	15,806.9	41.4
1998-99	32,370.6	31.0	19,225.1	21.6
1999-2000	42,522.8	34.5	25,835.7	34.4
2000-01	56,092.0	28.9	31,964.6	23.7
Cumulative upto end March 2001	2,47,558.5		1,46,167.2	

Source: IDBI, Report on Development Banking in India, 2000-01.

Income and Expenditure Account of ICICI

(Rs in crore)

	1999-2000	*2000-01*
A. Expenditure		
1. Payment of Interest	5,785.23	6,376.78
2. Other Expenditure	412.74	572.84
3. Depreciation on Assets Given on Lease	366.92	349.63
4. Provision for Interest Tax	112.00	-
5. Bad Debts Written Off and Provision for Restructured and Standard Assets	461.75	1,421.53
6. Provision for Taxation	122.00	40.00
7. Profit after Tax	1 ,205.75	537.27
Total	8,466.39	9,298.05
B. Income		
1. Interest on Loans	5,190.66	6,057.94
2. Income from Investments	1 ,206.70	1,162.66
3. Income from Leasing and Other Operations	1,720.07	1,615.57
4. Others/Profit on Sale of Investment and Other Income)	348.96	461.88
	8,466.39	9,298.05

Source: IDBI, Report on Development Banking in India, 2000-01.

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Asset Classification (Net of Provisions)

(In percentage)

	AssetClassificaffon	1999-2000	20001
1.	Standard Assets	92.4	94.8
2.	Substandard Assets	3.4	1.5
3.	Doubtful Assets	4.2	3.7
	Total	100.0	100.0

Source: IDBI, Report on Development Banking in India, 2000-01.

Financial Ratios of ICICI

Financial Ratios	1996-97	1997-98	1998-99	1999-2000	200CHJ1
Profit After Tax to Average Net Worth (%)	20.5	24.3+	20.3	16.8	16.4-
Profit After Tax to Average Assets (%)	2.5	2.8+	2.1	2.1	2.1-
Earnings Per Share (Rs)	15.9	21.1+	18.2	14.0	17.0-
Book-value (Rs)	85.9	91.3	100.3	98.0	97.5
Average Cost of Funds (%)	11.8	11.6	12.1	12.1	11.7
Average Return on Funds (%)	15.3	14.9	14.6	13.9	13.5
Margin (%)	3.5	3.3	2.5	1.8	1.8
Debt-equity Ratio	6.0	5.7	5.7	4.1	4.7
Capital Adequacy Ratio (%)	13.2	12.9	12.5	17.3	14.7

* After adding accelerated provisions and write-ofts to profit after tax during the year. + Includes profit on sale of real asset.

Source: IDBI, Report on Development Banking in India, 2000-01.

Assistance sanctioned and disbursed by ICICI during 2000-01 increased by 28.9% and 23.7%, respectively Assistance outstanding amounting to Rs 63,786.9 crore as on March 31, 2001 grew by 16.9% as compared to a growth of 15.9% in 1999-2000. Sanctions increased in respect of industries such as infrastructure, metal products, paper and paper products, electronic equipment, cement, services, crude petroleum and petroleum refining and chemicals and chemical products. Purpose-wise assistance sanctioned and disbursed by ICICI indicated a clear shift towards financing of new projects, working capital margin loans, corporate loans and retail finance. Expansion/diversification projects and rehabilitation projects recorded a decline.

A slowdown in the industrial activities affected the total income and profits of ICICI. Profit after tax (PAT) declined by 55.4% during 2000-01 due to higher bad-debts write-offs and provisions. The net NPAs declined to 5.2% as at end-March 200 1 from 7.6% as at end-March 2000 due to accelerated provisions. Total assets increased by 12.3% in 2000-01. Capital adequacy ratio was lower at 14.7% in March 2001 partly due to growth in assets.

The merger of ICICI and its two subsidiaries with ICICI Bank took place in March 2002. The pre-merger profits of ICICI Limited before additional provision for tax was Rs 1,332 crore for the year 2002 as compared to Rs 1,390 crore for the year 2001. The profit after additional provisions and tax increased by 25% to Rs 670 crore for the year 2002 from Rs 537 crore for the year 2001. The ratio of net non-performing assets to net customer assets of the merged entity was 4.7% on March 31, 2002.

Conclusion

ICICI is India's best-managed financial institution, catering to the needs of different customers. It has successfully transformed itself from a single product company to a multi-group financial services group. The merger of ICICI and its two subsidiaries with ICICI Bank has led to the creation of the largest private sector bank in the country with a highly diversified asset base. ICICI has geared itself to compete effectively in the competitive world of commercial banking.

State Industrial Development Corporations

The State Industrial Development Corporations (SIDCs) were established under the Companies Act, 1956, as wholly owned undertakings of the state governments. They act as catalysts for the promotion and development of medium and large enterprises in their respective states/union territories. They act as nodal agencies of state governments for promotion of industrial growth and development of infrastructure facilities.

There are 28 SIDCs in the country. Of the 28 SIDCs, 11 also function as State Financial Corporations (SFCs) to provide assistance and act as promotional agencies for small and medium enterprises. These are in Andaman and Nicobar, Arunachal Pradesh, Daman and Diu and Dadra and Nagar Haveli, Manipur, Meghalaya, Mizoram, Nagaland, Tripura, Goa, Pondicherry, and Sikkim.

SIDCs encourage setting up of projects in the joint/assisted sector in collaboration with private entrepreneurs. The competition among states to attract fresh investment has increased. SIDCs have undertaken the role of marketing their states as favourable investment destinations. To attract investment, SIDCs provide. tax benefits under the state government's package scheme of incentives. SIDCs undertake a variety of promotional activities such as preparation of feasibility reports, conducting industrial potential surveys, entrepreneurship training and development programmes, and developing industrial areas/estates. Some SIDCs also offer a package of developmental services that include technical guidance, assistance in plant location and coordination with other agencies. SIDCs are also conduits of IDBI/SIDBI for operating their seed capital schemes. With a view to keeping pace with the changing environment, many SIDCs have diversified into new fee-based services and widened the scope of fund-based activities.

SIDCs extend financial assistance in the form of rupee loans, underwriting and direct subscription to shares/debentures, guarantees, inter-corporate deposits and also open letter of credit on behalf of their borrowers.

SIDCs raise resources through refinance from IDBI/SIDBI, the government, and banks. They can also borrow funds by way of issue of bonds/debentures. They also receive subsidies/incentives from government for disbursements. SIDCs accept deposits to meet their fund requirements. SIDCs come under the purview of the Department of Company Affairs.

During 2000—01, financial assistance sanctioned and disbursed by SIDCs increased by 29.9% and 3.1% respectively, as against a decline in sanctions and disbursements of 29.8% and 25.8% in 1999-2000 respectively.

Direct finance constitutes a major proportion of overall sanctions. The share of project finance constitutes more than 50% of the total direct finance. Most of the SIDCs have poor asset quality, which has affected their financial health.

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Conclusion

The SIDCs act as catalysts for the promotion and development of medium and large enterprises in their respective states. They have a major development banking role to perform in the states. With pressures and challenges of economic liberalisation, they have not only to grow but they have to maintain their financial health. They need to undertake a market-oriented approach without forgetting their developmental role.

State Financial Corporations

Following the enactment of the State Financial Corporations Act in 1951, State Financial Corporations (SFCs) were established in various states. They meet the financial requirements of small and medium enterprises. Presently there are 18 SFCs operating in their respective states or union territories, of which 17 were set up under the SFCs Act, 1951. Even before the SFCs Act came into force on August 1, 1952, the Madras Industrial Corporation was already set up in 1949 under the Companies Act. It was later renamed as Tamil Nadu Industrial Investment Corporation Limited which now functions as a State Financial Corporation (SFC). Punjab Financial Corporation was the first SFC to come into existence in February 1953, followed by SFCs in Mumbai, Kerala and West Bengal. A separate SFC for Gujarat was set up in May 1960 through bifurcation of the Bombay SFC. The SFCs in Delhi, Haryana and Himachal Pradesh were carved out of Punjab Financial Corporation in 1968.

Under the provisions of the SFCs Act, SFCs are authorised to raise resources by issue of capital, issue bonds and debentures guaranteed by the state governments, accept medium- and long-term deposits from the public, and borrow from other financial institutions. A majority of fund mobilisation by SFCs is through refinance from SIDBI and IDBI

The SFCs provide financial assistance by way of term loans, direct subscription to equity/debentures, guaranteeing loans/deferred payments of industrial concerns, discounting of bills of exchange and seed! special capital. The SFCs operate a number of schemes of refinance and equity-type assistance on behalf of IDBI/SIDBL The operational policies of SFCs have been geared to assist artisans, tiny village and small industries, develop backward regions and promote new entrepreneurs. SFCs operate special schemes for special target groups such as SC/ST, women, ex-servicemen, and physically handicapped.

The SFCs (Amendment Act, 2000), which became effective in September 2000, provides greater flexibility to the SFCs to cope with the challenges of economic liberalisation strongly impacting the financial sector. All the 18 SFCs come under the purview of Small Industries Development Bank of India (SIDBI). SIDBI has not stipulated any capital adequacy requirement or prudential norms for SFCs.

Financial Highlights of SFCs

Assistance Sanctioned and Disbursed by SFCs

(Rs in crore)

Year	Sanctions	Growth rate	Disbursements	Growth rate
1990-91	186.39	23.1	1 ,270.8	9.9
1991-92	2,190.3	17.5	1,536.8	20.9
1992-93	2,015.3	-8.00	1,557.4	1.3
1993-94	1,908.8	-5.3	1 ,563.4	0.4
1994-95	2,702.4	41.6	1,880.9	20.3
1995-96	4,188.5	55.00	2,961.1	57.4
1996-97	3,544.8	-15.4	2,782.7	-6.0
1997-98	2,626.1	-25.9	2,110.2	-24.2
1998-99	1 ,864.2	-29.0	1,624.7	-23.0
1999-2000	2,237.8	20.0	1 ,825.1	12.3
2000-01	2,790.0	24.7	2,005.1	9.9
Cumulative upto end March 2001	35,888.7		29,284.3	

Source: IDBI, Report on Development Banking in India, 2000-01.

Assistance sanctioned and disbursed by SFCs have registered an increase in the last two years, namely, 1999-2000 and 2000-01. During 2000-01, out of 18 SFCs, 11 SFCs recorded an increase in sanctions. In terms of absolute sanctions, the top 5 SFCs were those in Karnataka, Andhra Pradesh, Kerala, Gujarat, and Tamil Nadu.

SFCs sanctioned assistance to industries such as food products, chemicals, textiles, services and other industries. Sanctions to small scale sector comprising Small Scale Industries (SSIs) and Small Road Transport Operators (SRTOs) increased. New projects accounted for majority of total assistance sanctioned following by expansion/diversification.

Conclusion

SFCs are facing stiff competition from commercial banks and other state level institutions. They need to restructure themselves to face this competition. The Government of India has set up a Committee headed by Shri G P Gupta, the ex-Chairman and Managing Director, Industrial Development Bank of India, for looking into the functioning of SFCs and making recommendations for their restructuring and revitalisation. As per the Gupta Committee Report, the net worth of 11 SFCs was negative. The capital adequacy ratio of 12 SFCs was negative while it was below 9% in case of three SFCs. The Gupta Committee estimated that Rs 2,04,468 crore is required for NPA provisioning for all the 18 NPAs. The recommendations are under consideration of the Central Government. For survival and growth, SFCs have to carve out a niche for themselves by specialising in financing and development of SSI sector.

Asset-liability Management in Development Financial Institutions : The Tasks Ahead

Divided into four sections, this paper begins with an exploration of the historical trends in business and funding pattern of development financial institutions that have an important bearing on risk incidence; describes the recent changes in risk profile of these institutions in the next section; reviews asset-liability management guidelines issued by RBI in the third; and in the concluding section, highlights opportunities and

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challenges faced by DFIs in management of market risks in a competitive and globalize market environment.

Broadly defined, asset-liability management is financial intermediation that includes activities of institutions that seek to maximize their net interest income and reduce volatility therein. It is, therefore, a process of planning to direct and control structure of assets and liabilities in terms of their level, currency composition, cost / yield and maturity pattern. These activities are crucially important for the business and profitability of each financial intermediary. All lending institutions, of course, face credit risk : the risk of default.

Incidence of credit risk is important. It needs to be measured, monitored, and managed. Asset-liability management is generally associated with identification, measurement, and monitoring of risks other than credit risk. These are also called market risks and signify interest rate, foreign exchange risk, and liquidity risk. While it is analytically important to identify market risks as distinct from credit risk, it is necessary that banks and financial institutions adopt an integrated view of risk management.

Asset-liability management is getting focused attention only now because of the deregulation of financial markets. Even on a global scale, foreign exchange rates were freed only in the1970s. Control on movement of capital was present even in several developed countries till mid 1985 (in some countries up to the early 1990s). A shift from asset management to liability management became noticeable. It is now making way for an integrated view of assets and liabilities. Asset-liability management thus gains importance as market risks such as interest rate risk, and foreign exchange risk becomes important as markets are liberated and integrated.

As part of the economic reform program initiated since June 1991, several measures were introduced to deregulate the financial sector in India. The reforms program facilitated development of the capital market both in equity and debentures, modernization of stock exchanges by introduction of modern technology, and increased competition between different participants in the financial sector. As part of its efforts to enable different constituents of the financial sector face challenges confronted by competitive financial system, RBI introduced guidelines on asset-liability management for commercial banks and development financial institutions.

The main purpose of the guidelines is to “sensitize the management of financial institutions to the need for a formally structured management of the liquidity and interest rate risk of their portfolios” as also to enforce the discipline of risk management (the need to identify and assess the risks before these are taken on books). While the guidelines issued for DFIs are yet to be finalized, it will be instructive to assess the challenges these institutions will face in management of market risks (which is slated to increase as commodity and financial markets in India become competitive and get integrated with world markets).

Section I: Business and funding patterns

Development financial institutions were established to support establishment of industrial projects in the absence of well-developed capital markets, which could provide long-term funds for such projects. Commercial banks were funding working capital requirements and perhaps unwilling to undertake the risk associated with project financing. As a result, a network of financial institutions was established in the post-independence period to provide long term-loans to industrial projects of different size and category. State-level institutions catered to the needs of small and medium industrial units, while all-India financial Institutions such as IDBI, ICICI & IFCI funded large-scale projects on a consortium basis.

In several cases, equity support came from the government or RBI. RBI also provided long-term loans. Lines of credit from multilateral lending agencies were made available to development financial institutions, which had government guarantee. Government also provided guarantee to bonds floated by these organizations for a longer duration at a relatively low cost. Such bonds were eligible securities for statutory liquidity ratio to be maintained by commercial banks and also treated as approved investment for insurance companies. As bulk of the funds were lent directly or indirectly by the government, the cost of funds was controlled by the government and had an element of concession in it. Government, in turn stipulated a lending rate for these institutions to ensure that funds are lent to industrial projects at reasonable rates of interest.

From the business perspective of development financial institutions, these arrangements represented a situation where each institution has guaranteed business and profits. Each institution had access to an exclusive niche market. This was a result of the market sharing arrangement prevalent among different lending institutions. Secondly, as the lending and borrowing rates were fixed by the government, profit margin for these institutions was also ensured in the process. In such an environment, there was very little scope for competition among different institutions.

From the risk perspective, stipulation of lending rates for different categories of borrowers meant that it was not possible for the financial institutions to charge a risk-related interest rate. In fact, concession rates of interest were stipulated for projects located in backward areas, projects promoted by new entrepreneurs and projects in the small-scale industries segment. It may be conceded that all these categories of projects would represent higher than average risk class but the rates charged on such loans were lower than the normal rates. The rates stipulated by the government were lower than similarly stipulated rates of interest on working capital loans provided by commercial banks. Again, from the risk perspective, rates on long-term loans should have been higher than rates on shorter-term loans, as long-term would signify higher risk.

The government, however, stipulated a lower rate on term loans with a view to promote fixed capital expenditure. Thus, on the risk perspective the business and operating environment faced by banks and financial institutions was such that there was little scope to undertake risk analysis covering its various dimensions - credit risk, interest rate risk, liquidity risk and foreign exchange risk. This is illustrated below in the context of development financial institutions:

***Credit Risk*:** While credit risk is basic to all lending institution under a licensing regime, allocation of credit depended on

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procurement of industrial licensing by the borrower. The licensing decision taken by government implicitly decided most, if not all, parameters of credit risk that development financial institutions would take on their books. The industrial licensing would determine production, scale, technology, location of the plant, and also the borrower client itself. In the context of import substitution strategy of industrialization followed in India, high import duty rates and control of fresh capacity creation through licensing mechanism ensured market and profitability for domestic industries. This indirectly took care of several problems associated with credit risk. Its hardly surprising that the need for an explicit analysis of credit risk or to make efforts to manage it was felt.

Interest rate risk: Interest rate risk arises when impact of changes in interest rates is asymmetric in the sense that this impact is not uniform on assets and liabilities. This could happen if maturities of assets and liabilities are different and interest rates differ according to maturity. Secondly, the interest rates on lending and borrowing may show different trends. However, as both lending rates and borrowing rates faced by development financial institutions were controlled by the government, these were indirectly protected from interest rate risk as well.

Liquidity risk: Liquidity risk arises when a financial institution is unable to meet its obligations to a client or borrower on the due date. Liquidity risk can be minimized by maintaining a balance between maturing assets and liabilities. This aspect was indirectly taken care of as resource support from governmental sources, besides being at concession rates, was also for a longer term – typically for a period of 15-20 years. As financial institutions normally gave loans for a period of 8-10 years, it was possible for them to recycle these funds two or three times before which borrowing became due for repayment. The maturity differential thus ensured that development financial institutions would generally not face a liquidity problem.

Foreign exchange risk: Foreign exchange risk is another important dimension of market risk that development financial institutions would face as foreign exchange markets are deregulated. Financial institutions have been extending foreign currency loans even in the past. They have mobilized funds from multilateral lending agencies such as The World Bank and Asian Development Bank and also raised funds through external commercial borrowings. However, in the case of several multilateral loans, the Government of India has borne the foreign exchange risk. Financial institutions have not assumed any foreign exchange risk even on funds raised through other sources. Foreign currency loans were given in the same currency and loan repayment profile was exactly matching with the debt repayment schedule an institution is required to follow. In the process, clients would at times have to face a loan repayment schedule not synchronized with cash flows from assisted projects. This difficulty is mitigated by creation of a single currency pool wherein funds borrowed in particular currency will be pooled together and loans from this pool would be extended to clients on the basis of repayment schedule, which is consistent with projected cash flows. It, however, needs to be noticed that even under this arrangement the lending institution is not assuming any foreign currency risk. Such a risk arises only if currency composition of loans is different from currency composition of its borrowing.

It thus becomes clear that historically development financial institutions' exposure to market risks was almost zero. As regards maturity pattern of assets and liabilities, assets had shorter maturity period as compared to maturity period of liabilities. This situation ensured that development financial institutions would be shielded from incidence of liquidity risk as well. Under the industrial licensing system and policy to protect domestic industries had a significant effect on even the credit risk profile faced by the development financial institutions.

Section II: Changing risk profile

With the introduction of economic reforms, credit and non-credit risks faced by development financial institutions underwent metamorphic changes, which has effected both the real sectors as well as financial sectors. It has had a significant impact on the business opportunities and funding pattern of development financial institutions. Firstly, with a view to reduce its fiscal deficit, the central government has phased out resource support it traditionally extended to development financial institutions. The loans out of RBI's National Industrial Credit (long-term operations) fund were suspended and are now available only to Small Industrial Development Bank of India (SIDBI). The quota of government guaranteed bonds (commonly known as SLR Bonds) has been completely phased out.

As a result, development financial institutions are required to meet their resource requirements by raising funds from capital market on market-related terms and conditions. In general, a shift to market based funding has resulted in an increase in the cost of funds and also a decrease in the average maturity thereof. The decline in maturity is the outcome of reluctance on part of investors to block their funds for longer duration. When future interest rates are more uncertain, higher is the maturity period. Moreover, for longer maturities, higher compensation would be necessary to induce the investors to bear the increased risk associated with long-term investment. The institutions, thus, are faced with a trade off between liquidity risk and higher profitability.

As long as interest rates were regulated, institutions did not face any interest rate risk. However, with progressive liberalization, interest rates are likely to move both ways (go up or go down). While it is true that the same process of interest rate liberalization has also allowed development financial institutions to charge a risk related interest rate on their loans, their exposure to interest rate risk has definitely increased in the process. The process of liberalization has also resulted in more competition between different segments of the financial system as also among different entities within a segment. Commercial banks are now extending term loans while development financial institutions are diversifying into non-project lending by offering short-term products including working capital loans.

Capital markets have grown phenomenally since early 1980s and have emerged as important source of funds for corporate sector in general and blue chip companies in particular. Moreover, liberalization of controls on foreign exchange transaction and

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facilities offered for foreign investors to invest in India and also for Indian companies to raise funds from overseas markets has widened the funding menu of the Indian corporate sector. It is now possible for a profit making company to have a wider choice of avenues to raise funds to fund its capital expenditure plans.

In such a situation, lending organizations have to compete among themselves as also with capital market itself while offering corporate finance products. The competition takes a form of price competition, by way of lower interest cost and it also touches non-price dimensions. The range of products offered by organizations, the ability to respond quickly to the needs of the corporate sector and offer a wider range of products that meet client requirements becomes extremely important. This situation is under sharp contrast in relation to pre-reform period where development financial institutions had almost an assured market and profit margin.

The process of competition has forced development financial institutions to offer a wider range of products. While several institutions have added shorter term lending products, intense competition from capital markets and banks have made it necessary to adopt a flexible approach. Under such circumstances, every deal is a uniquely structured deal with a view to improve the level of client satisfaction. Thus the rate of interest, the repayment profile of the loan, security offered, currency offered, in effect each and every aspect of the lending product, becomes negotiable. It would be possible to compete to meet client needs on the basis of each of these factors.

It, therefore, becomes essential that lending institutions are able to raise funds that are suitable to meet the client requirements as also protect profit margins in a competitive marketplace. In such a competitive marketplace, clients would tend to shop around to get the best possible terms for their requirement. For example, clients may get a loan sanctioned but may not use the facility if they find another cost effective alternative source of funding. Or, they may, in turn, decide to use the sanctioned facility depending on the anticipated changes in interest rate environment. In such a situation, managing liquidity risk becomes more challenging.

Till now financial institutions have not assumed direct foreign exchange risk. However, as and when the Indian Rupee becomes convertible on capital account, financial institutions and corporate would have wider options regarding fund-raising. They could borrow in different currencies after taking into account combined cost of interest rate and anticipated changes in the exchange rate. In such a situation, it would be essential to have a mechanism by which foreign exchange risks are measured and monitored on a regular basis. It thus becomes clear that the level of market risk faced by development financial institutions has increased significantly.

In recent years financial institutions, on their part, have responded to these challenges by offering different products for their borrowers and lenders. For example, floating rate products enable a financial institution to limit its exposure to interest rate risk. As a result of the shift to market based funding, financial institutions were finding it difficult to raise funds for longer duration. In response, financial institutions have tried to reduce the average maturity on their lending by offering short-term, non-project finance products. Similarly, exposure to foreign exchange risk can be hedged naturally by extending such loans to exporters whose income is denominated in foreign currencies.

In developed capital markets, different types of risk are hedged through derivative products. For example, interest rate risk can be managed through interest rate swaps. Similarly, foreign exchange risk can be hedged through currency swaps. The use of derivative is the off balance sheet way of managing market risk. Use of such derivative products in India will depend on development of such products, which, in turn, is linked to development of the secondary debt market. Till such time these markets develop, banks and institutions would need to manage different types of market risks through acquisition of incremental assets and liabilities of appropriate maturity/interest rate/currency.

Section III: The need for asset-liability management

The need for asset-liability management was formally stressed by RBI through the draft guidelines it issued first for commercial banks in September 1998 and subsequently for development financial institutions in April 1999. Both sets of guidelines are quite similar and would help banks and financial institutions adopt a comprehensive asset-liability management view of activities: information system, organization, and process.

The guidelines stress the need to put in place the management information system that would capture information on such aspects of assets and liabilities that are relevant for measurement of market risks. These would include remaining maturity of debt/loan, interest rate, interest-reset dates if interest rate is floating, interest and installment payment dates, etc. Data needs to be collected accurately and in a timely manner. The guidelines also recommend an Asset Liability Committee organization pattern and delineate the responsibilities of the board (set risk philosophies and tolerance limits for different types of risks), the committee (monitor risk limits and formulate business strategy), and support group (gather the information and prepare papers for discussion at committee level).

The asset-liability management process comprises risk identification, risk measurement, setting tolerance limits, and risk management. The guidelines are focused primarily on liquidity and interest risks. The guidelines prescribe generation of gap reports for measurements of liquidity risk (liquidity gap report) and interest rate risk (interest rate gap) in the prescribed formats. The report covers all assets and liabilities covering on and off balance sheet items. The guidelines aim to make these reports very comprehensive.

It prescribed 10 time buckets, which cover periods over 10 years. It not only covers items already on balance sheet but would also include assets, which would be created in future through undisbursed loan commitments. For the sake of completeness, it becomes imperative to take into account the future inflows (by way of interest and installment receipts) arising from such future loan disbursements. One wonders whether by focusing on completeness, these guidelines miss the immediate relevance of the report.

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While it is true that suggested risk measures– liquidity gap and interest rate gap– are very preliminary, these have been presumably chosen because this is indeed the initial stage of practicing asset-liability management. Moreover, given the predominance of loans on portfolios of development financial institutions and the current state of secondary debt market (particularly non-government paper), the usage of sophisticated tools of risk measurement would indeed be limited. However, certain observations could nevertheless be offered with a view to improving the significance of such guidelines:

The buckets: The guidelines suggest a total of ten time buckets, which would cover full maturity period of asset/liability. Of which, the first two time buckets are of 14-day duration each, the next time buckets are 29 days to three months, 3-6 months, 6 months to 1 year, 1-3 years, 3-5 years etc. The last time bucket is over 10 years and above. The first two time buckets are, perhaps, linked with the reporting frequency for commercial banks. The same time buckets are prescribed even for development financial institutions partly because these are slowly entering into businesses that were traditionally identified with commercial banking. In addition, RBI would get data on liquidity, which can be easily aggregated only if the formats are similar. However, the inflows and outflows of development financial institutions are quite discreet: these have specific maturity dates unlike bank assets (cash credit) and liabilities (savings or demand deposits). Hence, to account for uneven inflow/outflow patterns, the negative gap limit could have been prescribed for a wider time bucket (say up to three months).

Gap limit: For the liquidity gap report, the guidelines prescribe a negative gap limit of 5% of the projected outflows in the first two time buckets i.e. 1-14 days and 15-18 days. It is also stipulated that cumulative gap up to 1 year should not exceed 10% of the projected outflows. For commercial banks, this limit has been set at 20%. The logic for lower limit for development financial institutions is perhaps due to their inability to raise short-term funds at short notice. Liquidity risk needs to be kept at a minimum level with which the management is comfortable. RBI could have asked development financial institutions (and banks) to set acceptable limits depending on their risk appetite and preferences. Instead, the guidelines prescribe a uniform limit for all development financial institutions. Moreover, the negative gap limit could have been linked to borrowing capacity of the organization (say to level of debt-equity ratio), which would have remained stable. Instead, the guidelines link it to the outflows during the relevant time bucket, which would fluctuate from fortnight to fortnight depending on anticipated outflow of funds. RBI is perhaps also looking at this exercise from systemic liquidity and it has set a limit only for negative gap. However, from business profitability as also interest rate perspective, even positive gap should be subject to prudential limits. The anticipated inflows need to be recorded in a particular, prescribed manner. For standard loans, the inflows are to be bucketed based on the due dates of payments. For sub-substandard assets, the guidelines suggest an elongated time pattern. But when the time buckets are as short as a fortnight, the receipts could be delayed (up to 6 months) without change in asset classification but the anticipated inflows and gaps would be affected. While it is true that as long as funds are received regularly, the levels of inflows would not be significantly affected. However, over short intervals it could make substantial difference. Similarly, instead of a prescribing fixed formula to treat receipts from non-performing assets, the lending institution could have been allowed to bucket these payments based on the realistic payment dates, which would be case specific.

It is indeed surprising that neither any gap limit nor a threshold level for non-institutional investors is stipulated for interest rate sensitivity report. While it could be argued that RBI has left these matters to the discretion of respective bank/development financial institution management, by the same logic even the task of setting up liquidity gap limit could have been left at their discretion. It could be argued that by asking bank/development financial institution management to set tolerable risk limits of their choice and ensuring strict adherence to such limits, would have helped in creating risk management awareness among them.

Section IV: Challenges and opportunities

The draft asset-liability management guidelines definitely mark a useful starting point. The guidelines raise certain pertinent issues about the need for an effective management information system. This is closely related to level of computerization in an organization. There are quite obvious hardware and software issues linked to design an information system to generate consolidated reports in a timely manner to be used by asset-liability committees. There are, however, several other important issues that need to be effectively addressed for propagation of asset-liability management. Some of which include:

Risk Limits: At this initial stage of introducing asset-liability management, RBI has prescribed a limit on negative gap. However, it is likely that in course of time acceptable level of risk would be decided by managements themselves even if these were not made public. Certain reports about gaps, duration or value at risk would be made available to the public but the level of acceptable risk would need to be decided by individual organizations. Such tolerable limits could change over time and in response to market volatility, etc. In fact, in these matters institution's view on future market movement would be equally relevant. For example, when interest rates are expected to go up, higher positive gaps could be targeted and when rates are expected to go down, lower positive gaps or negative gaps would be targeted. It would be necessary for development financial institutions to help generate a truly institutional view, which would guide the activities of the organization.

Risk management and business strategy: Once the risk measures and tolerance levels are decided, the next task is to manage the risk with the set norms. This could be done through on balance sheet as also off balance sheet methods. The former tries to choose incremental assets and liabilities with preferred characteristics so that overall risk is kept at desired levels. The latter makes use of derivative products like interest rate/currency swaps. The use of derivative product would depend on market development. But market would, in turn, develop on asset-liability structures of different institutions and

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the proactive approach adopted by market participants. Even if development financial institutions are to adopt on balance sheet methods, the imbalances would enable them to offer derivative product to their clients which besides meeting client needs helps balance the asset liability structure. For example, anticipated negative gaps say one year ahead could create an opportunity to offer short-term loans. Or if an organization has floating rate liabilities and fixed rate assets, it could offer fixed to floating rate swaps to its clients.

Reorganizing credit decision process: Once it is accepted that interest rate and liquidity risks are quite distinct from credit risk which normally gets assessed in credit sanction and monitoring process, setting interest rate on a loan and term for which it is extended are considered from profitability and/or client needs perspective. Such decisions are made on a case-to-case basis. Whereas from liquidity risk or interest rate risk management perspective it is desirable to adopt a portfolio approach, it is true that even credit risk management dictates to adopt a portfolio approach. But this requires that existing credit decision process is modified to accommodate the factors dictated by asset-liability management considerations. The issue is to ensure that the regularly generated asset-liability management reports become integral parts of credit decision process and do not remain new but independent activities. All this would necessitate different functionaries are taking independent stance and undertake business activities which are linked to that stance. The asset-liability management processes would facilitate setting up limits and periodically revising them. But ultimately identification of job responsibilities, performance measurement and follow up and possibly providing a link between performance and pay would be required to empower employees to assume business risk.

In the past, risks were simple and limited. Government ownership of most of the banks and development financial institutions and a market sharing arrangement that prevailed till recently, helped to have similar risk preference and policies across organizations. It would be difficult to have similar arrangements in future as risks are increasing and competition is becoming more intense. It is quite common that any analysis of risk management is usually focused on probabilities (of risk) and prices (necessary to buy risk cover). The discussion centers on what is the probability of risk and the proper price to pay for hedging that risk. However, risk preference is an equally important parameter, which also needs as much attention.

It would thus become necessary for development financial institutions to evolve a distinct risk preference (including risk aversion). To achieve this would be a crucial task of organizational restructuring. While problems associated with information gathering, information processing, devising an appropriate risk measurement tool, among others, is certainly important but the true challenge is to facilitate necessary organizational changes, which would facilitate dealing with risk in a mature professional manner. Unless this is achieved, asset-liability management may remain an isolated peripheral exercise.

Rebuilding of Indian Development Financial Institutions

Introduction

Special industrial financing institutions were set up during the post-World War II period in both developed and underdeveloped countries with the specific purpose of providing long term funds to new industrial enterprises. Their tale was, however, more pronounced in the developing countries as in these countries the government had taken upon themselves the responsibility of mobilising resources for much desired industrialisation.

These special industrial financing institutions do not compete with other agencies of industrial finance as they are assigned the role of "gap fillers". Since these institutions operate with a special purpose (and an instrument of State policy) they make significant contribution to the process of industrial development. They are also recognized as "Development Banks" or "term lending institutions" or "specialised development financial institution".

There are a number of Development Financial Institutions that were set up in India during the planning era. Let us now turn to a discussion of the main industrial finance institutions operating in India.

Role of Development Financial Institutions

1. **Providing Finance:** The DFIs provide medium term and long term finance to industry. Since 1997, some of the DFIs have also started to provide working capital requirements to large industries.

   The long-term loans are provided for the purpose of setting up new projects, for expansion and modernisation, for mergers, etc.

2. **Guarantee of Loans:** The DFIs provide guarantee of loans raised by industrial concerns in India, provided by commercial banks, cooperative banks, and others.

3. **Project Promotion:** The DFIs facilitate project promotion. They have set up project promotion departments. The project promotion involves:
   - Making available information on specific products or processes and relevant economic data to entrepreneurs
   - Prepares project reports
   - Conducts industrial potential surveys
   - Assisting state-level financial institutions like SFCs in their training and development program.

4. **Refinancing:** The DFIs like SIDBI, IDBI, etc undertake refinancing functions. They refinance the commercial banks and others who have earlier provided loans to the industrial concerns.

5. **Revival of Sick Units:** The DFIs work out a financial package to revive potentially viable sick units. The package includes:
   - Injecting more funds
   - Rescheduling of principal and interest payments
   - Writing off a part of interest and loan

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- Appointment of DFIs on the Board.

We shall now discuss the 3 major DFIs in India and critically examine their progress over the years.

Industrial Finance Corporation of India

Soon after independence, the Government felt a need to cover the institutional gap in the capital market to provide medium and long-term credit to the industry. IFCI was the first Development Financial Institution (DFI) set up by the Government in 1948, under the IFCI Act.

It grants financial assistance in the following forms:

- Granting loans or advances both in rupees and foreign currencies repayable within 25 years
- Guaranteeing rupee loans floated in the open market by industrial concerns
- Underwriting of shares and debentures of the industrial concerns
- Providing merchant banking services and lease finance

Critical Appraisal

Opinions differ sharply in respect of the IFCI's working over the past decade. Some of the criticisms are:

- The IFCI lending operations have encouraged concentration of wealth and capital.
- The IFCI has done little to remove regional disparities in the country.
- The IFCI has not also upheld the national priorities is respect of financial assistance as stated in the plan documents
- The IFCI has quite often offered assistance to undertakings which could easily raise resources from the capital market
- The IFCI has failed to exercise necessary control over the defaulting borrower.

The Industrial Credit and Investment Corporation of India Ltd.

The Industrial Credit and Investment Corporation of Indian Ltd (ICICI) was the second all India DFIs to be established in the country. It was set up in January 1995 and it commenced business in March the same year. Unlike IDBI and IFCI, ICICI is a private sector development bank. It provides assistance in the various forms, like

- Long or medium term loans or equity participation
- Guaranteeing loans from other private investment sources
- Subscription to ordinary or preference capital and underwriting of new issues of securities
- Rendering consultancy service to Indian industry in the form of managerial and technical advice.

Critical Appraisal

The ICICI in the 4 and half decades of its existence has played and important role in providing assistance to industrial enterprises in India. Its pioneer work in underwriting has been widely acclaimed. However, it has been criticized for assisting mainly the large units. It has not done much to remove regional disparities and has not funded for the growth of backward areas. Due to the increase competition in the financial markets and fund based business getting affected by lower margins and higher level of NPAs, the company is trying to get a major share in the retail segment where the margins are better. This has been made possible through the various subsidiaries, which the company has floated, and through expansion of the distribution network

The Industrial Development Bank of India (IDBI)

Post second 5-Year plan, need for an apex institution to coordinate workings of other financial institutions and help in the country's industrial development was felt. Therefore, IDBI was established in 1964 as a wholly owned subsidiary of the Reserve Bank of India. In the initial years IDBI received RBI's financial support and experience. In 1976, the Government of India de-linked IDBI from RBI and assumed its total ownership by an Act of Parliament. The international finance division was hived off from IDBI in 1982 as a new company EXIM Bank. In 1992, IDBI's portfolio relating to small-scale industrial sector was transferred to Small Industrial Development Bank of India (SIDBI), set up as IDBI's wholly owned subsidiary.

Critical Appraisal

The IDBI was set up more than 3 decades ago to function as an apex institution in the field of development finance. Judged by its assistance measured in quantitative terms, its performance is very impressive. However, the IDBI has failed to develop itself as a true development bank. It has failed in developing the capital markets. Its distribution of financial assistance is also not very healthy, as the largest chunk has gone to big industrial concerns. The IDBI also did not concentrate itself on providing promotional and consultancy work. Thus there is need for a change in the approach of the IDBI towards industrial development.

Financial Analysis

We shall analyze the current financial position of the DFIs and throw light on the different problems and impediments, which have wrecked these institutions and it, could wreck the entire financial system. We have to ascertain whether these DFIs are actually doing what they were set up for?

If we take a look at the IFCI, the net Non-Performing Assets (NPAs) amounted to Rs 41026mn in FY2000 and comprised of 20.7% of the total net assets of 198.4bn. The IFCI is close to bankruptcy. In 1999-2000, the IFCI had an income of Rs 2,899.7 crore and earned a net profit of Rs 59.3 crore. Next year, on an income of Rs 2,890.3 crore, the institution showed a loss of Rs 265 crore.

Meanwhile the IDBI's net NPAs to total assets rose to 14% from 12% in last year. One out of every seven rupees lent out by IDBI to companies may not be paid unless the NPA problem is sorted out in quick time. The concern for the bank on its NPAs stems from the high exposure levels to the Iron & Steel and the cotton textiles industry, which together contributed to 23.5% to its total NPAs as on year end 1999-2000. It is today asking the government for a bailout.

ICICI has transformed itself from the role of a FI to a Universal bank. The company is making constant efforts to take first mover advantage in the technology-related businesses. The

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net profit of the company reduced by 55% in FY2001 to Rs5372.7mn from Rs.12057.5mn in FY2000. Mainly due to heavy provision made to cover the NPL (Non performing loans). The net NPA ratio has fallen from 7.6% to 5.2%. Gross Non-performing loans has reduced to Rs59.88bn in FY2001 from Rs60.18bn in FY2000

From the above analysis it is quite evident that high NPA level is a core problem for the DFIs. There are many reasons that contribute to NPAs. They can be broadly classified as Macro-Economic factors and Micro-Economic Factors.

Macro-Economic Factors

These are factors that affect the economy as a whole. After the opening of the Indian economy, several Indian companies, were suddenly pitted against international players with a strong financial and technological muscle. The license era of pre-liberalization days attempted to ensure a match between the supply and demand situations in the economy. Thus if you were granted a license the system implicitly ensured your economic viability. This protection no longer exists. Low customs duties on imports also facilitated cheaper imports, strongly affecting industries like steel and textiles.

Microeconomic Factors

These are the factors that essentially reflect the risks specific to the business enterprise. Some of these may be Product failure, product obsolescence, strained labor relations, inappropriate technology, raw material shortage, power shortage and price escalation. A striking example of this is the textile industry of Mumbai.

The factors causing NPAs may be further classified as factors internal and external to the lender.

Internal Factors

Inadequate credit appraisal and monitoring systems followed by the lenders may lead to advances in excess of those merited by the project. Also there are avoidable inadequacies in the follow up process, thus delaying timely intervention. The unwillingness of the DFIs to share credit information with each other is another hindrance.

External Factors

The Indian legal system has also been a major impediment in reducing the NPA levels. The existing framework is sympathetic towards the borrowers and works against the FDI's interest. Despite most of their loans being backed by security, FDI's are unable to enforce their claims on collateral, when the loans turn non-performing, and therefore, loan recoveries have been insignificant. There are different clauses that exist for DFIs that says that the debtor-creditor relationship is confidential. There isn't any need felt by the DFIs to disclose the debtors. Most of the DFIs take a long time to classify their a particular account as a NPA. Therefore there is a clear case of lack of transparency on the part of the DFIs.

Company Name	Family Group	Loan Rs (cr)	Institution	Terms of debt were eased as follows:
Essar Steel	Ruai	1900	ICICI,IDBI,LIC	Reduction of interest from 17% to 14%
Jindal Strips	O.P.Jindal	350	ICICI,IFCI,GIC	Reduction of interest from 20% to 14%
Jindal Vijaynagar Steel	Jindal	2693	ICICI,IDBI,LIC	Debt partly converted to equity
Indo Rama Synthetics	O.P.Lohia	1000	IFCI,IFC,IDBI,ICICI	Loan moratorium of 2 years

Besides NPAs there are other obstacles that have hampered the performance and role of the DFIs over the years. They are:

High Borrowing Costs

Government guaranteed SLR and other bonds, which used to be the pre-dominant source of funding till 1993, has been phased out in accordance with the reform process. These account for less than 10% of asset base of DFIs and are due for repayment within 3-4 years. The DFIs now face a lot of pressure on their borrowing costs as banks are competing in each area (banks have a much wider access to deposits, especially low cost demand deposits). As a result the spreads are under pressure, and thus the long term outlook looks unfavorable. The DFIs don't have any access to generation of funds from the retail sources like fixed deposits, and thus they generally borrow at 10-11 percent by issue of bonds.

Inefficiency and Corruption

Inefficiency and Corruption has been one of an age-old problem for most of the financial institutions in India. Most of their employees lack proper training, work culture, and attitude. At times, they accept bribes and get involved in under hand dealings. They lack the touch of professionalism, which is present in private sector companies. Most of the problems faced by the DFIs are due to inefficiency and corruption. There is corruption not only at the lower levels but also at the executive levels.

Competition

The DFIs face competition from commercial banks in financing. The large commercial banks also provide medium term and long term loans, especially, since 1997. The DFIs are also facing competition from the corporate customers who seem to have found cheaper avenues to borrow funds from. Most of the corporate are approaching the markets directly for loans, and therefore the DFIs are facing more competition. The fund based income is thus under severe pressure. The DFIs like the ICICI are thus looking to cater to retail consumers and focus more on fee-based income.

Lack of Transparency

In India, secrecy has always been a tradition. If partial disclosure sounds bad enough, how about not revealing anything at all. Walk into the office of a large Financial Institution and , ask for a balance sheet, and you are informed by a senior executive that the institution publishes "only one balance sheet , and that goes to Parliament. From 1998, the central bank has started to put on its web site a list of willful defaulters compiled from information submitted by the DFIs. Once you read through the list you shall realize that the small companies are mentioned, but what about the big company. Due to lack of

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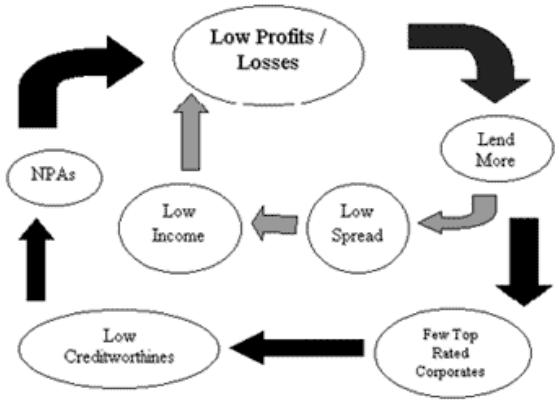
transparency, there is no accountability and therefore results in a misappropriation of funds for vested interest.

Interference by Government

There has always been to much interference by the government in the working of these institutions. There are many rules and regulations set by the government which have to be followed. These institutions have to lend a fix portion of their advances to the priority sector. Over the years these advances to the priority have accounted for at least 50-60% of the NPAs.

The problems faced by the DFIs can be illustrated with the help of a vicious circle:

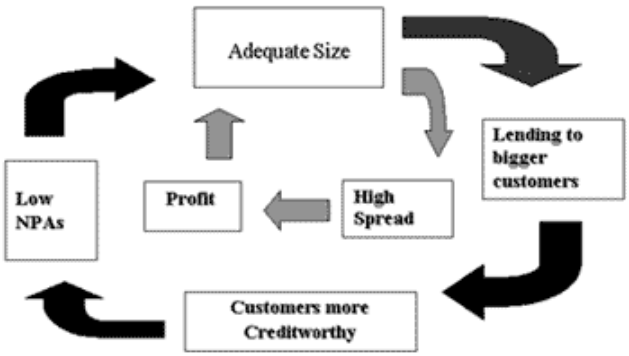
The Vicious



If we take a look at the above diagram, the DFIs are currently making low profits and losses. To improve their financial position they want to lend more. The problem they face at this step is that, their cost of borrowings is very high, as they don't have access to the retail sources. Banks have a privilege as they can raise money at around 7-8% from the public deposits, whereas the DFIs have to be content with raising funds at 10%. As a result their spreads get affected and also they don't get an opportunity to lend to the top rated corporate who have cheaper avenues to raise money from. In today's scenario, the tops rated corporate have an excellent standing and they can approach the markets directly. As a result they have to lend to the lesser rated corporate and thus their asset quality gets affected and results in an increase in the net NPAs of the DFIs which in turn affects the profitability.

A possible way to break away from this vicious circle is explained below with the help of a diagram.

A Universal Bank



As shown by the above diagram, the DFIs, converting themselves into a Universal Bank, will be able to lower their cost of borrowings as they have access to retail sources. As a result of the reduced cost of borrowings they can reduce their lending rates and thus attract more top rated corporate and thus improve their NPA position and thus the profitability. Their total asset base will also increase as in the case of ICICI whose total asset base is Rs 95,000 crore. As a result the ratio of Net NPAs to Total Assets will also decrease, thus giving them a better valuation in the market. Being a universal bank, they not only have fund-based income but also fee based like auto loans, credit cards, home loans, etc. They will thus be a one stop financial superstore catering to the diverse needs of numerous individuals.

ICICI Universal Banking model: The new model of ICICI under the holding company structure has an asset base of approx. 95000 crores with 9 million Customers. The ICICI Bank functioning as a one stop financial store now specializes in different products. The products offered range from insurance, filing tax returns, stock trading to issuing petro-cards, which form the basic necessities of any individual. Thus ICICI today figures along with market leaders across all sectors who have gained a huge market share in their category.

Universal Banking

Meaning: The term 'universal banks' in general refers to the combination of commercial banking and investment banking, i.e., issuing, underwriting, investing and trading in securities. In a very broad sense, however, the term 'universal banks' refers to those banks that offer a wide range of financial services, beyond commercial banking and investment banking, such as, insurance. However, universal banking does not mean that every institution conducts every type of business with every type of customer. Universal banking is an option; a pronounced business emphasis in terms of products, customer groups and regional activity can, in fact, be observed in most cases. In the spectrum of banking, specialised banking is on the one end and the universal banking on the other.

Advantages

1. **Greater economic efficiency:** The main argument in favor of universal banking is that it results in greater economic efficiency in the form of lower cost, higher output and better products. This logic stems from the reason that when sector participants are free to choose the size and product-mix of their operations, they are likely to configure their activities in a manner that would optimize the use of their resources and circumstances.
2. **Reducing Risks:** Due to various shifts in business cycles, the demand for products also varies at different points of time. It is generally held that universal banks could easily handle such situations by shifting the resources within the organisation as compared to specialised banks. Specialised firms are also subject to substantial risks of failure, because their operations are not well diversified. By offering a broader set of financial products than what a specialised bank provides, it has been argued that a universal bank is able to establish long-term relationship with the customers

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and provide them with a package of financial services through a single window.

3. **Cross Selling:** The universal banking concept helps in the cross selling strategy by helping both the financial institutions and the banks to target their end customers.
4. **Focus on retail:** This concept focuses on retail business by offering a wide range of products thereby ensuring a steady flow of income over the corporate clients.

Disadvantages of Universal Banking

1. **Systemic Risk:** The larger the banks the greater the effects of their failure on the system. The failure of a larger institution could have serious ramifications for the entire system in that if one universal bank were to collapse, it could lead to a systemic financial crisis. Thus, universal banking could subject the economy to the increased systemic risk.
2. **Monopoly:** Historically, an important reason for limiting combinations of activities has been the fear that such institutions, by virtue of their sheer size, would gain monopoly power in the market, which can have significant undesirable consequences for economic efficiency. Two kinds of concentration should be distinguished, *viz*., the dominance of universal banks over non-financial companies and concentration in the market for financial services. The critics of universal banks blame universal banking for fostering cartels and enhancing the power of large non-banking firms.
3. **Bureaucratic and inflexible:** Some critics have also observed that universal banks tend to be bureaucratic and inflexible and hence they tend to work primarily with large established customers and ignore or discourage smaller and newly established businesses. Universal banks could use such practices as limit pricing or predatory pricing to prevent smaller specialised banks from serving the market. This argument mainly stems from the economies of scale and scope.
4. **Conflict of interests:** Combining commercial and investment banking gives rise to conflict of interests as universal banks may not objectively advise their clients on optimal means of financing or they may have an interest in securities because of underwriting activities. These conflicts could be between the investment banker's promotional role and the commercial banker's obligation to provide disinterested advice or using the bank's securities department or affiliate to issue new securities to repay unprofitable loans etc

Road Map

1. **Convert the financial institution into a bank over a period of time:** It is recommended that a full banking license be eventually granted to DFIs. In the interim, DFIs may be permitted to have banking subsidiaries (with holdings up to 100 per cent), while the DFIs themselves may continue to play their existing role. It also recommended that management and shareholders of banks and DFIs should be permitted to explore and enter into gainful mergers. These mergers should be possible not only between banks but also between banks and DFIs. There would then be only two forms of intermediaries, viz., banking companies and non-banking finance companies. If a DFI does not acquire a banking license within a stipulated time it would be categorized as a non-banking finance company. A DFI, which converts into a bank, can be given some time to phase in reserve requirements in respect of its liabilities to bring it on par with the requirements relating to commercial banks. Similarly, as long as a system of directed credit is in vogue a formula should be worked out to extend this to DFIs, which have become banks.
2. **Mergers based on synergies and location, and business specific**: Mergers between banks and DFIs and NBFCs need to be based on synergies and location and business specific complementarities of the concerned institutions and must obviously make sound commercial sense. Mergers between strong banks/FIs would make for greater economic and commercial sense and would be a case where the whole is greater than the sum of its parts and have a "force multiplier effect".
3. **System of regulation and supervision:** It recommended that the banks/DFIs should be supervised on a consolidated basis. Future accounting standards must consequently include rules on consolidated supervision for financial subsidiaries and conglomerates. Further, as domestic financial entities assume an international character, banking supervisors should adopt global consolidated supervision (instead of mere national regulation). For meaningful consolidated supervision – both domestic and global we recommend the development of a "risk-based supervisory framework. For effective supervision, it observed that there is a need for formal accession to 'core principles' announced by the Basle Committee. The Narasimham Committee had recommended that the RBI should direct banks to publish, in addition to financial statements as independent entities, a consolidated balance sheet to reveal the true financial position of the group. Full disclosure would also be required of connected lending and lending to sensitive sectors. Furthermore, it should also ask banks to disclose loans given to related companies in the banks' balance sheets. Full disclosure of information should not be only a regulatory requirement. It would be necessary to enable bank's creditors, investors and rating agencies to get a true picture of its functioning – an important requirement in a market driven financial sector. This observation of the Narasimham Committee is equally applicable to DFIs, especially when there is a bank directly under its umbrella
4. **Machinery for Debt recovery:** There should be a proper framework adopted through agencies who support in ensuring steady recovery of loans given by financial institutions. This mechanism should be able to ensure recovery of past debts along with a credit appraisal system for the lending fresh in the market.
5. **Organizational Redesign:** Best practices in the area of corporate governance such as imparting full operational autonomy and flexibility to management's and Boards of

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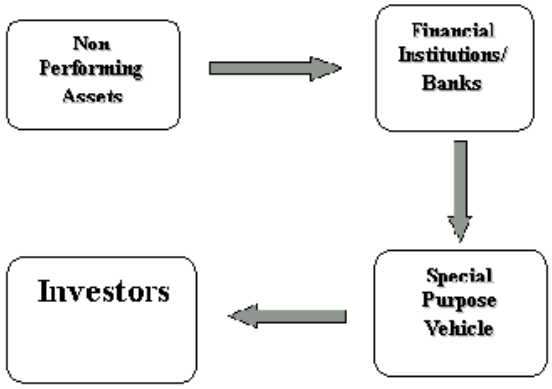
Banks and DFIs should be implemented. A complete redesign of the business system of banks/DFIs, with the Top Management spelling out the strategic objectives for principal stakeholders (clients, employees, shareholders, etc.), a proactive relationship-based approach in corporate culture, a consensus-driven committee-based approach for loan sanctions and decisions on organisation structure based purely on commercial judgment.

6. **Human Resource development:** There should be broad-based recruitment's, both at entry level from campus as well as lateral entry of professionals at higher levels to fill skill gaps in critical areas. They should have systematic training programs, skill building and upgradation workshops, market-based compensation packages along with a viable and enforceable exit option for employees. A Special Vigilance Machinery exclusively for the financial sector on the lines of Serious Fraud Office (SFO) of the U.K may be set up.

Securitisation: Once these DFIs have converted themselves into Universal Banks, there still exist the problem of the current NPA level. In the Indian banking scenario, immediate attention needs to be diverted at increasing level of threat provided by the high amount of NPA.. This labyrinth leads us a glimmer of hope in the form of Securitisation of Non Performing Assets.

By the process of Securitisation bank can get rid of the NPAs and avoid the recapitalisation need by reducing the size of their balance sheet. This will lead to substantial release and generation of funds, which can then be applied for generation of productive assets. The assets are transferred by way of a true sale to a *SPV (Special Purpose Vehicle)*, which in turn raises funds in the capital market by issuing securities on the basic of these assets. These securities could be in the form of a 3-5 year Bonds carrying a suitable interest rate. The government at this stage only needs to guarantee a steady return to the investors and capital redemption on maturity thus avoiding the need for immediate capital infusion.

Model for Securitisation



The cash flows from the restructured NPAs should take care of the return and capital needs relieving the Government. Even if a portion is not recovered despite all attempts, the Government will need to pull out its coffers only after 3-5 years. Avoidance of this calls for strong structural and legal background, which has to be provided. With the world identifying Securitization as a potential for solving the Non Performing Loan problem Indian cannot keep its eyes shut for long.

Valuation of Assets

Valuation of assets is a very crucial matter in the securitization process. If the SPV is government owned the issue should not cause much impediment as a mutually agreed valuation can be arrived at. However pricing assumes greater proportions when the assets are transferred to private players. It is very necessary to bifurcate the assets in three categories which would attract different coupon rates. The three categories being

1. Sub-Standard Assets
2. Doubtful Assets
3. Loss Assets.

Conclusion

Given the laxity of the government in implementation of corrective measures the success of the securitization measure remains only a hypothesis. Securitization will require an overhauling of the entire banking structure backed by a strong legal and regulatory framework. More than anything else this will require strong will on the part of the government. Till then the Indian banks will continue to pile up heaps of NPAs and economy wait for the disaster to strike.

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LESSON 32:
MUTUAL FUNDS AND DEVELOPMENT FINANCIAL INSTITUTIONS: WHAT'S HAPPENING?

Lesson Objectives

- To make aware of latest in the field of mutual funds and development financial institutions with respect to operations, players and government policy.

Dear Students, we have discussed a lot about the working of DFIs and MFs, and as you are aware, lot of changes have taken place in the governments policy and market scenario, since the above chapters were written few months back and till today.

Purpose of this session is to make you aware of latest in the DFIs and MFs sector. So, to achieve our purpose, you all have to make small groups of four members each and collect all possible latest information regarding DFIs and MFs including news clippings, government policy changes, merger and acquisition news, and any other relevant information, which you consider is worth discussing in a group to share knowledge.

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LESSON 33:
TUTORIAL

Lesson Objectives

- To clear all the doubts of the students related to concepts covered in various topics so far covered

Dear Students, so far we have covered around two third of the total course of this particular subject. We have made all efforts to enable you to understand the concepts and their practical usage as an aspiring manager / entrepreneur.

Today's session is just to solve all your difficulties in topics so far covered. If you have any doubt or require any clarification on any topic, lets discuss that.

I also want you to get more and more involved in information sharing. This serves two purposes – you get more knowledge and your communication improves. So, collect information, discuss that with your colleagues and if you have any doubts, your faculties are there to help you.

The purpose of our study is not just to learn the theoretical concept, but also to understand their practical / actual usage in day to day life. Hence it is very important for you to collect such information and share / discuss it with your colleagues.

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LESSON 34: ISSUE MANAGEMENT: ISSUE RELATED ACTIVITIES AND SEBI GUIDELINES

Lesson Objectives

- To understand the process of issue management and SEBI guidelines related to issue management activity.

Introduction

Issue management, now days, is one of the very important fee based services provided by the financial institutions. In recent past various companies have entered into issue management activities. Still there are very few large scale and specialized issue management agencies in the country. With the growth of stock market and opening up of economy, the scope for issue management activity is widening day by day. To protect the investors' interest and for orderly growth and development of market, SEBI has put in place guidelines as ground rules relating to new issue management activities. These guidelines are in addition to the company law requirements in relation to issues of capital / securities.

Financial instruments can be classified into two main groups – share capital and debt capital. There are various other classifications in each of the two categories. Also, there are various types of company's i.e. listed, unlisted, public, private etc. For each of them SEBI has issued comprehensive guidelines, related to issue of financial instruments.

Let us discuss all these issue management activities in detail, one by one.

Eligibility Norms

To make an issue, the company must fulfill the eligibility norms specified by SEBI and Companies Act. The companies issuing securities through an offer document, that is (a) prospectus in case of public issue or offer for sale and (b) letter of offer in case of right issue, should satisfy the eligibility norms as specified by SEBI, below:

Filing of Offer Document: In the case of a public issue of securities, as well as any issue of security, by a listed company through rights issue in excess of Rs. 50 lakh, a draft prospectus should be filed with SEBI through an eligible registered merchant banker at least 21 days prior to filing it with ROC. Companies prohibited by SEBI, under any order/direction, from accessing the capital market cannot issue any security.

The companies intending to issue securities to public should apply for listing them in recognized stock exchange(s). Also, all the issuing companies must (a) enter into an agreement with a depository registered with SEBI for dematerialization of securities already issued / proposed to be issued and (b) give an option to subscribers / shareholder / investors to receive security certificates or hold securities in a dematerialized form with a depository.

Public issue / Offer for sale by Unlisted Companies: An unlisted company can make a public issue / offer for sale of equity shares / security convertible into equity shares on a late date if it has in three out of preceding five years (a) a pre issue net worth of Rs. 1 crore (b) a track record of distributable profit in terms of Sec. 205 of the Companies Act. The size of the issue should not exceed five times of the pre-issue net worth as per last available audited accounts either at the time of filing of offer or at the time of opening of issue.

There are separate norms for companies in the information technology sector and partnership firms converted into companies or companies formed out of a division on an existing company.

If the unlisted company does not comply with the aforesaid requirement of minimum pre-issue net worth and track record of distributable profits or its proposed size exceeds five times its pre-issue net worth, it can issue shares / convertible security only through book building process on the condition that 60% of the issue size would be allotted to qualified institutional buyers (QIB) failing which the full subscription should be refunded.

Public issue by listed companies: All listed companies are eligible to make a public issue of equity shares/ convertible securities if the issue size does not exceed five times its pre-issue net worth as per the last available audited accounts at the time of either filing of documents with SEBI or opening of the issue. A listed company which does not satisfy this condition would be eligible to make issue only through book building process on the condition that 60% of the issue size would be allotted to QIBs, failing which full subscription money would be refunded.

Exemption: The eligibility norms specified above are not applicable in the following cases:

- Private sector banks
- Infrastructure companies, wholly engaged in the business of developing, maintaining and operating infrastructure facility within the meaning of Sec. 10(23-G) of the Income Tax Act (a) whose project has been appraised by a public financial institution / IDFC/ILFS and (b) not less than 5% of the project cost has been financed by any of the appraising institutions jointly / severally by way of loan / subscription to equity or combination of both and
- Rights issue by a listed company.

Credit Rating for Debt Instruments: A debt instrument means an instrument / security which creates / acknowledges indebtedness and includes debentures, bonds and such other securities of a company whether constituting charge on its assets or not. For issue, both public and rights, of a debt instrument, including convertibles, credit rating – irrespective of the maturity or conversion period – is mandatory and should be disclosed. The disclosure should also include the unaccepted credit rating. Two ratings from two different credit rating

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agencies registered with SEBI should be obtained in case of public/rights issue of Rs.100 crore and more. All credit ratings obtained during the three years preceding the public/rights issue for any listed security of the issuing company should also be disclosed in the offer document.

Outstanding Warrants / Financial Instruments: An unlisted company is prohibited from making a public issue of shares / convertible securities in case there are any outstanding financial instruments / any other rights entitling the existing promoters / shareholders any option to receive equity share capital after the initial public offering.

Partly Paid-up Shares: Before making a public / rights issued of equity shares / convertible securities, all the existing partly paid up shares should be made fully paid up or forfeited if the investor fails to pay call money within 12 months.

Pricing of Issues

A listed company can freely price shares/convertible securities through a public/ rights issue. An unlisted company eligible to make a public issue and desirous of getting its securities listed on a recognized stock exchange can also freely price shares and convertible securities. The free pricing of equity shares by an infrastructure company is subject to the compliance with disclosure norms as specified by SEBI from time to time. While freely pricing their initial public issue of shares/ convertible, all banks require approval by the RBI.

Differential Pricing: Listed/unlisted companies may issue shares/convertible securities to applicants in the firm allotment category at a price different from the price at which the net offer to the public is made, provided the price at which the securities are offered to public.

A listed company making a composite issue of capital may issue securities at differential prices in its public and rights issue. In the public issue, which is a part of a composite issue, differential pricing in firm allotment category vis-à-vis the net offer to the public is also permissible. However, justification for the price differential should be given in the offer document in case of firm allotment category as well as in all composite issues.

Price Band: The issuer / issuing company can mention a price band of 20% (cap in the price band should not exceed 20% of the floor price) in the offer document filed with SEBI and the actual price can be determined at a later date before filing it with the ROC. If the BOD of the issuing company has been authorized to determine the offer price within a specified price band, a resolution would have to be passed by them to determine such a price. The lead merchant banker should ensure that in case of listed companies, a 48 hours notice of the meeting of BOD for passing the resolution for determination of price is given to the regional stock exchange. The final offer document should contain only one price and one set of financial projections, if applicable.

Payment of Discount / Commissions: Any direct or indirect payment in the nature of discount / commission / allowance or otherwise cannot be made by the issuer company / promoter to any firm allottee in a public issue.

Denomination of Shares: Public / rights issue of equity shares can be made in any denomination in accordance with Sec. 13(4) of the Companies Act and in compliance with norms specified by SEBI from time to time. The companies which have already issued shares in the denominations of Rs. 10 or Rs. 100 may change their standard denomination by splitting / consolidating them.

Promoters' Contribution and Lock-in Requirements

Regulations regarding promoters' contribution are discussed as under:

Public issue by unlisted companies: The promoters should contribute at least 20% and 50% of the post issue capital in public issue at par and premium respectively. In case the issue size exceeds Rs. 100 crores, their contribution would be computed on the basis of total equity to be issued, including premium at present and in the future, upon conversion of optionally convertible instruments, including warrants. Such contribution may be computed by applying the slab rated mentioned below:

Size of Capital Issue (including premium)	Percentage of contribution
On first Rs. 100 crores	50
On next Rs. 200 crores	40
On next Rs. 300 crores	30
On balance	15

While computing the extent of contribution, the amount against the last slab should be so adjusted that on an average the promoters' contribution is not less than 20% of post issue capital after conversion.

Offer for sale by unlisted companies: The promoters' shareholding, after offer for sale, should at least 20% of the post issue capital.

Public issue by listed companies: The participation of the promoters should either be (i) to the extent of 20% of the proposed issue or (ii) to ensure shareholding to the extent of 20% of the post-issue capital.

Composite issue by Listed Companies: At the option of the promoters, the contribution would be either 20% of the proposed public issue or 20% of the post-issue capital, excluding rights issue component of the composite issue.

Public Issue by unlisted infrastructure companies at premium: The promoters contribution, including contribution by equipment suppliers and other strategic investors, should be at least 50% of the post-issue capital at the same or a price higher than the one at which the securities are being offered to public.

Securities Ineligible for computation of promoters contribution: The securities specified below acquired by / allotted to promoters would not be considered for computation of promoters' contribution:

- Where before filing the offer document with SEBI, equity shares were acquired during the preceding three years (a) for consideration other than cash and revaluation of assets / capitalization of intangible assets is involved in such transactions and (b) from a bonus issue out of revaluation reserves or reserves without accrual of cash revenues;

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- In the case of a public issue by unlisted companies, securities issued to promoters during the preceding one year at a price lower than the price at which equity is offered to the public.
- The shares allotted to promoters during the previous year out of funds brought in during that period in respect of companies formed by conversion of partnership firms where the partners of the firm and the promoters of the converted company are the same and there is no change in management unless such shares have been issued at the same price at which the public offer is made. However, if partners' capital existed in the firm for a period exceeding one year on a continuous basis, the shares allotted to promoters against such capital would be eligible.

  The ineligible shares specified in the above three categories would, be eligible for computation of promoters contribution if they are acquired in pursuance of a scheme of merger/ amalgamation approved by a high court.
- Securities of any private placement made by solicitation of subscription from unrelated persons either directly or through an intermediary; and
- Securities for which a specific written consent has not been obtained from the respective shareholders for inclusion of their subscription in the minimum promoters contribution.

Issue of convertible security: In the case of issue of convertible security, promoters have an option to bring in their subscription by way of equity or subscription to the convertible security being offered so that their total contribution would not be less than the required minimum in cases of (a) par/ premium issue by unlisted companies (b) offer for sale, (c) issues/ composite issue by listed companies and (d) public issue at premium by infrastructure companies.

Promoters Participation in Excess of Required Minimum: In a listed company participation by promoters in excess of the required minimum percentage in public/ composite issues would be subject to pricing of preferential allotment, if the issue price is lower than the price as determined on the basis of preferential allotment pricing.

Promoters' contribution before public issue: Promoters should bring in the full amount of their contribution, including premium, at least one day before the public issue opens/ issue opening date which would be kept in an escrow account with a bank and would be released to the company along with the public issue proceed.

Exemption from Requirement of Promoters' Contribution: The requirement of promoters contribution is not applicable in the following three cases, although in all the cases, the shareholders should disclose in the offer document their existing shareholding and the extent to which they are participating in the proposed issue:

a. Public issue by a company listed on a stock exchange for at least three years and having a track record of dividend payment for at least three immediately preceding years. However, if the promoters' participate in the proposed issue to the extent greater than higher of the two options available, namely, 20% of the issue or 20% of the post-issue capital, the excess contribution would attract pricing guidelines on preferential issues if the issue price is lower than the price as determined on the basis of the guidelines on preferential issue.

b. Where no identifiable promoter / promoter group exists.

c Rights issue.

Lock-in requirements of Promoters' contribution: Promoters' contribution is subject to a lock-in period as detailed below:

Lock-n of Minimum Required Contribution: In case of any (all) issues of capital to the public, the minimum promoters' contribution would be locked in for a period of three years. The lock-in period would start from the date of allotment in the proposed issue and the last date of the lock-in period would be reckoned as three years from the date of commencement of commercial production or the date of allotment in the public issue, or whichever is later.

Lock-in excess promoters contribution: In the case of public issue by an unlisted company, excess promoters' contribution would be locked in for a period of one year. The excess contribution in a public issue by a listed company would also be locked in for a period of one year as per the lock-in provisions.

Securities issued last to be locked in first: The securities, forming part of the promoters' contribution issued last to them, would be locked in first for the specified period. However, if securities were issued last to financial institutions as promoters, these would not be locked in before the shares allotted to other promoters.

Lock-in of Pre-issue share capital of an unlisted company: The entire pre-issue share capital, other than locked in as promoters' contribution, would be locked-in for one year from the date of commencement of commercial production or the date of allotment in the public offer whichever is later.

Lock-in of securities issued on firm allotment basis: Securities issued on firm allotment basis would be locked in for one year from the date of commencement of commercial production, or date of allotment in public issue, whichever is later.

Other requirements in respect of Lock-in: The other requirements relating to the lock-in of promoters' contribution is discussed hereunder:

Pledge of securities: Locked-in securities held by the promoters may be pledged only with banks/financial institutions, as collateral security for loans granted by them provided the pledge of shares is one the terms of the sanction of the loan.

Inter-se transfer of Securities: Transfer of locked in securities amongst promoters as named in the offer document can be made subject to lock-in being applicable to the transferees for the remaining lock-in period.

Inscription of Non-transferability: The securities, which are subject to a lock-in period, should carry inscription 'non-transferable', along with duration of specified non-transferable period mentioned in the face of the security certificate.

Issue Advertisement

The term advertisement is defined to include notices, brochures, pamphlets, circulars, show cards, catalogues, placards, posters,

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insertions in newspapers, pictures, films, cover pages of offer documents or any other print medium, radio, television programs through any electronic media.

The lead merchant banker should ensure compliance with the guidelines on issue advertisement by the issuing companies.

Issue of Debt Instruments

A company offering convertible/non-convertible debt instruments through an offer document should, in addition to the other relevant provisions of these guidelines, complies with the following provisions:

Requirement of credit rating: A public or rights issue of debt instruments (including convertible instruments) in respect of their maturity or conversion period can be made only if the credit rating has been obtained and disclosed in the offer document. For all issues greater than or equal to Rs.100 crore, two ratings from two different credit rating agencies should be obtained.

Requirements in Respect of Debenture Trustees: In the case of issue of debentures with maturity of more than 18 months, the issuer should appoint debenture trustees whose name must be stated in the offer document. The issuer company in favor of the debenture trustees should execute a trust deed within six months of the closure of the issue.

Creation of Debenture Redemption Reserves (DRR): A company has to create DRR in the case of the issue of debentures with maturity of more than 18 months.

Distribution of Dividends: In the case of new companies, distribution of dividends would require the approval of the trustees to the issue and the lead institution, if any. In case of existing companies, prior permission of the lead institution for declaring dividend, exceeding 20% as per the loan covenants, is necessary if the company does not comply with institutional condition regarding interest and debt service coverage ratio.

Redemption: The issuer company should redeem the debentures as per the offer documents.

Disclosure and Creation of Charge: The offer document should specifically state the assets on which the security would be created as also the ranking of the charge(s). In the case of second/residual charge or subordinated obligation, the risks associated with should clearly be stated.

Filing of Letter of Option: A letter of option containing disclosures with regards to credit rating, debentures holders resolution, option for conversion, justification for conversion price and such other terms which SEBI may prescribe from time to time should be filed with SEBI through an eligible merchant banker, in case of a roll over of non-convertible portions of PCD/NCDs, etc.

Book Building

Book-building means a process by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of notice/ circular / advertisement/ document or information memoranda or offer document. A company proposing to issue capital through book-building has to comply with the requirements of SEBI in this regard. These are discussed here.

75% Book Building Process: The option of book-building is available to all body corporate which are eligible to make an issue of capital to the public as an alternative to and to the extent of the percentage of the issue, which can be reserved for firm allotment. The issuer company can either reserve the securities for firm allotment or issue them through book-building process. The issue of securities though book-building route should be separately identified/indicated as 'placement portion category' in the prospectus. The securities available to the public should be separately identified as 'net offer to the public'. The requirement of minimum 25% of the securities to be offered to the public is also applicable. Underwriting is mandatory to the extent of the net offer to the public. The draft prospectus containing all the details except the price at which the securities are offered should be filed with SEBI. The issuer company should nominate one of the lead merchant bankers to the issue as book runner, and his name should be mentioned in the prospectus. The copy of the draft prospectus, filed with SEBI, should be circulated by the book runner to the institutional buyers, who are eligible for firm allotment, and to the intermediaries, eligible to act as underwriters inviting offers for subscription to the securities.

100% Book Building Process: In an issue of securities to the public through a prospectus, the option for 100% book building is available to any issuer company. The issue of capital should be Rs. 25 crore and above. Reservation for firm allotment to the extent of the percentage specified in the relevant SEBI guidelines can be made only to promoters, 'permanent employees of the issuer company and in the case of new company to the permanent employees of the promoting company'. It can also be made to shareholders of the promoting companies, in the case of new company and shareholders of group companies in the case of existing company either on a competitive basis or on a firm allotment basis. The issuer company should appoint eligible merchant bankers as book runner(s) and their names should be mentioned in the draft prospectus. The lead merchant banker should act as the lead book runner and the other eligible merchant bankers are termed as co-book runner. The issuer company should compulsorily offer an additional 10% of the issue size offered to the public through the prospectus.

IPO Through Stock Exchange On-line System (E-IPO)

In addition to other requirements for public issue as given in SEBI guidelines wherever applicable, a company proposing to issue capital to public through the on-line system of the stock exchange for offer of securities has to comply with the additional requirements in this regard. They are applicable to the fixed price issue as well as for the fixed price portion of the book-built issues. The issuing company would have the option to issue securities to public either through the on-line system of the stock-exchange or through the existing banking channel. For E-IPO the company should enter into agreement with the stock-exchange(s) and the stock-exchange would appoint SEBI registered stockbrokers of the stock exchange to accept applica-

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tions. The brokers and other intermediaries are required to maintain records of (a) orders received, (b) applications received, (c) details of allocation and allotment, (d) details of margin collected and refunded and (e) details of refund of application money.

Issue of Capital by Designated Financial Institutions

Designated financial institutions (DFI), approaching the capital market for fund though an offer document, have to follow following guidelines.

Promoters' contributions: There is no requirement of minimum promoters' contribution in the case of any issue by DFIs. If any DFI proposes to make a reservation for promoters, such contribution should come only from actual promoters and not from directors, friends, relatives and associates, etc.

Reservation for employees: The DFIs may reserve out of the proposed issues for allotment only to their permanent employees, including their MD or any fulltime director. Such reservations should be restricted to Rs. 2000 per employee, subject to five percent of the issue size. The shares allotted under the reserved category are subject to a lock-in for a period of three years.

Pricing of the issue: The DFIs, may freely price the issues in consultation with the lead managers, if the DFIs have a three years track record of consistent profitability out of immediately preceding five years, with profit during last two years prior to the issue.

Preferential Issue

The preferential issue of equity shares/ fully convertible debentures (FCD)/ partly convertible debentures (PCDs) or any other financial instruments, which would be converted into or exchanged with equity shares at a later date by listed companies to any select group of persons under section 81(1A) of the Companies Act, 1956 on a private placement basis, are governed by the following guidelines:

Pricing of issue: The issue of shares on a preferential basis can be made at a price not less than the higher of the following: (i) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange and (ii) The average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

Pricing of Shares arising out of warrants: Where warrants are issued on a preferential basis with an option to apply for and be allotted shares, the issuer company should determine the price of the resultant shares in accordance with the provisions discussed in the above point.

Pricing of shares on Conversion: Where PCDs/FCDs/ other convertible instruments are issued on a preferential basis, providing for the issuer to allot shares at a future date, the issuer should determine the price at which the shares could be allotted in the same manner as specified for pricing of shares allotted in lieu of warrants.

Currency of Financial Instruments: In the case of warrants / PCDs / FCDs / or any other financial instruments with a provision for the allotment of equity shares at a future date, either through conversion or otherwise, the currency of the instruments cannot exceed beyond 18 months from the date of issue of the relevant instruments.

Non-transferability of Financial Instruments: The instruments allotted on a preferential basis to the promoters / promoter groups are subject to a lock-in period of three years from the date of allotment. In any case, not more than 20% of the total capital of the company, including the one brought in by way of preferential issue would be subject to a lock-in period of three years from the date of allotment.

Currency of Shareholders' Resolutions: Any allotment pursuant to any resolution passed at a meeting of shareholders of a company granting consent for preferential issues of any financial instrument, should be completed within a period of three months from the date of passing of the resolution.

Certificate from Auditors: In case every issue of shares/ FCDs/PCDs/ or other financial instruments has the conversion option, the statutory auditors of the issuer company should certify that the issue of said instruments is being made in accordance with the requirements contained in these guidelines.

OTCEI Issues

A company making an initial public offer of equity shares / convertible securities and proposing to list them on the Over The Counter Exchange of India (OTCEI) has to comply with following requirements:

Eligibility Norms: Such a company is exempted from the eligibility norms applicable to unlisted companies, provided (i) it is sponsored by a member of the OTCEI and (ii) has appointed at least two market makers. Any offer of sale of equity shares / convertible securities resulting from a bought out deal registered with OTCEI is also exempted from the eligibility norms subject to the fulfillment of the listing criteria laid down by the OTCEI.

Pricing norms: Any offer for sale of equity shares or any other convertible security resulting from a bought out deal registered with OTCEI is exempted from the pricing norms specified for unlisted companies, subject to following conditions: (a) The promoters after such issue would retain at least 20% of the total issued capital with a lock-in of three years from the date of the allotment of securities in the proposed issue and (b) at least two market makers are appointed in accordance with the market making guidelines stipulated by the OTCEI.

Projection: In case of securities proposed to be listed on the OTCEI, projections based on the appraisal done by the sponsor who undertakes to do market-making activity can be included in the offer document subject to compliance with the other conditions relating to the contents of offer documents.

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LESSON 35:
ISSUE MANAGEMENT: INTERMEDIARIES, REGULATIONS AND SEBI GUIDELINES

Lesson Objectives

- To understand the role of intermediaries in the issue management activity and
- SEBI norms for intermediaries in relation to issue management activities.

Introduction

The new issue market / activity was regulated by the Controller of Capital Issues (CCI) under the provisions of the Capital Issues (Control) Act, 1947 and the exemption orders and rules made under it. With the repeal of the Act and the consequent abolition of the office of the CCI in 1992, the protection of the interest of the investors in securities market and promotion of the development and regulation of the market/ activity became the responsibility of the SEBI. To tone up the operations of the new issues in the country, it has put in place rigorous measures. These cover both the major intermediaries as well as the activities.

So, we will discuss here, various intermediaries, their regulation and SEBI guidelines related to them.

Merchant Bankers

In modern times, importance of merchant banker is very much, because it the key intermediary between the company and issue of capital. Main activities of the merchant bankers are – determining the composition of the capital structure, drafting of prospectus and application forms, compliance with procedural formalities, appointment of registrars to deal with the share application and transfer, listing of securities, arrangement of underwriting / sub-underwriting, placing of issues, selection of brokers, bankers to the issue, publicity and advertising agents, printers and so on.

Due to overwhelming importance of merchant banker, it is now mandatory that merchant banker(s) functioning as lead manager(s) should manage all public issues. In case of rights issue not exceeding Rs.50 lakh, such appointments may not be necessary. The salient features of the SEBI framework, related to merchant bankers are discussed as under.

Registration : Merchant bankers require compulsory registration with the SEBI to carry out their activities. Previously there were four categories of merchant bankers, depending upon the activities. Now, since Dec. 1997, there is only one category of registered merchant banker and they perform all activities.

Grant of Certificate : The SEBI grants a certificate of registration to applicant if it fulfills all the conditions like (i) it is a body corporate and is not a NBFC (ii) it has got necessary infrastructure to support the business activity (iii) it has appointed at least two qualified and experienced (in merchant banking) persons (iv) its registration is in the general interest of investors.

Capital Adequacy Requirement : A merchant banker must have adequate capital to support its business. Hence SEBI grants recognition to only those merchant bankers who have paid up capital and free reserves of minimum Rs. 1 crore.

Fee: A merchant banker has to pay a registration fee of Rs. 5 lakh and renewal fees of Rs. 2.5 lakh every three years from the fourth year from the date of registration.

Code of Conduct : Every merchant banker has to abide by the code of conduct, so as to maintain highest standards of integrity and fairness, quality of services, due diligence and professional judgment in all his dealings with the clients and other people. A merchant banker has always to endeavor to (a) render the best possible advice to the clients regarding clients needs and requirements, and his own professional skill and (b) ensure that all professional dealings are effected in a prompt, efficient and cost effective manner.

Restriction on Business : No merchant banker, other than a bank/public financial institution is permitted to carry on business other than that in the securities market w.e.f. Dec.1997. However a merchant banker who is registered with RBI as a primary dealer/satellite dealer may carry on such business as may be permitted by RBI w.e.f. Nov.1999.

Maximum number of lead managers : The maximum number of lead managers is related to the size of the issue. For an issue of size less than Rs. 50 crores, two lead managers are appointed. For size groups of 50 to 100 crores and 100 to 200 crores, the maximum permissible lead managers are three and four respectively. A company can appoint five and five or more (as approved by SEBI) lead managers in case of issue sizes between Rs.200 to 400 crores and above Rs.400 crores respectively.

Responsibilities of Lead Managers : Every lead manager has to enter into an agreement with the issuing companies setting out their mutual rights, liabilities and obligation relating to such issues and in particular to disclosure, allotment and refund. A statement specifying these is to be furnished to the SEBI at least one month before the opening of the issue for subscription. It is necessary for a lead manager to accept a minimum underwriting obligation of 5% of the total underwriting commitment or Rs. 25 lakh whichever is less.

Due diligence certificate : The lead manager is responsible for the verification of the contents of a prospectus / letter of offer in respect of an issue and the reasonableness of the views expressed in them. He has to submit to the SEBI at least two weeks before the opening of the issue for subscription a due diligence certificate.

Submission of documents : The lead managers to an issue have to submit at least two weeks before the date of filing with the ROC/regional SE or both, particulars of the issue, draft prospectus/ letter of offer, other literature to be circulated to the investors / shareholders, and so on to the SEBI. They have to ensure that the modifications/ suggestions made by it with

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respect to the information to be given to the investors are duly incorporated.

Acquisition of Shares : A merchant banker is prohibited from acquiring securities of any company on the basis of unpublished price sensitive information obtained during the course of any professional assignment either from the client or otherwise.

Disclosure to SEBI : As and when required, a merchant banker has to disclose to SEBI (i) his responsibilities with regard to the management of the issue, (ii) any change in the information/ particulars previously furnished which have a bearing on the certificate of registration granted to it, (iii) names of the companies whose issues he has managed or has been associated with (iv) the particulars relating to the breach of capital adequacy requirements and (v) information relating to his activities as manager, underwriter, consultant or advisor to an issue.

Action in case of Default : A merchant banker who fails to comply with any conditions subject to which the certificate of registration has been granted by SEBI and / or contravenes any of the provisions of the SEBI Act, rules or regulations, is liable to any of the two penalties (a) Suspension of registration or (b) Cancellation of registration.

Underwriters

Another important intermediary in the new issue/ primary market is the underwriters to issue of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Though underwriting is not mandatory after April 1995, its organization is an important element of primary market. Underwriters are appointed by the issuing companies in consultation with the lead managers / merchant bankers to the issues.

Registration : To act as underwriter, a certificate of registration must be obtained from SEBI. On application registration is granted to eligible body corporate with adequate infrastructure to support the business and with net worth not less than Rs. 20 lakhs.

Fee : Underwriters had to pay Rs. 5 lakh as registration fee and Rs. 2 lakh as renewal fee every three years from the fourth year from the date of initial registration. Failure to pay renewal fee leads to cancellation of certificate of registration.

General Obligations and responsibilities

Code of conduct : Every underwriter has at all times to abide by the code of conduct; he has to maintain a high standard of integrity, dignity and fairness in all his dealings. He must not make any written or oral statement to misrepresent (a) the services that he is capable of performing for the issuer or has rendered to other issues or (b) his underwriting commitment.

Agreement with clients : Every underwriter has to enter into an agreement with the issuing company. The agreement, among others, provides for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by/on behalf of the issuer, the amount of commission/brokerage, and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations.

General responsibilities : An underwriter cannot derive any direct or indirect benefit from underwriting the issue other than by the underwriting commission. The maximum obligation under all underwriting agreements of an underwriter cannot exceed twenty times his net worth. Underwriters have to subscribe for securities under the agreement within 45 days of the receipt of intimation from the issuers.

Bankers to an Issue

The bankers to an issue are engaged in activities such as acceptance of applications along with application money from the investor in respect of capital and refund of application money.

Registration : To carry on activity as a banker to issue, a person must obtain a certificate of registration from the SEBI. The applicant should be a scheduled bank. Every banker to an issue had to pay to the SEBI an annual free for Rs. 5 lakh and renewal fee or Rs. 2.5 lakh every three years from the fourth year from the date of initial registration. Non-payment of the prescribed fee may lead to the suspension of the registration certificate.

General Obligations and Responsibilities

Furnish Information : When required, a banker to an issue has to furnish to the SEBI the following information : (a) the number of issues for which he was engaged as banker to an issue (b) the number of applications / details of the applications money received (c) the dates on which applications from investors were forwarded to the issuing company / registrar to an issue (d) the dates / amount of refund to the investors.

Books of account/record / documents : A banker to an issue is required maintain books of accounts/ records/ documents for a minimum period of three years in respect of, inter alia, the number of applications received, the names of the investors, the time within which the applications received were forwarded to the issuing company / registrar to the issue and dates and amounts of refund money to investors.

Agreement with issuing companies : Every banker to an issue enters into an agreement with the issuing company. The agreement provides for the number of collection centers at which application/ application money received is forwarded to the registrar for issuance and submission of daily statement by the designated controlling branch of the baker stating the number of applications and the amount of money received from the investor.

Code of Conduct : Every banker to an issue has to abide by a code of conduct. He should observe high standards of integrity and fairness in all his dealings with clients/ investors/ other members of the profession. He should exercise due diligence. A banker to an issue should always endeavor to render the best possible advice to his clients and ensure that all professional dealings are effected in a prompt, efficient and cost-effective manner.

Brokers to the Issue

Brokers are persons mainly concerned with the procurement of subscription to the issue from the prospective investors. The appointment of brokers is not compulsory and the companies

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are free to appoint any number of brokers. The managers to the issue and the official brokers organize the preliminary distribution of securities and procure direct subscription from as large or as wide a circle of investors as possible. A copy of the consent letter from all the brokers to the issue, should be filed with the prospectus to the ROC.

The brokerage applicable to all types of public issue of industrial securities is fixed at 1.5%, whether the issue is underwritten or not. The listed companies are allowed to pay a brokerage on private placement of capital at a maximum rate of 0.5%. Brokerage is not allowed in respect of promoters' quota including the amounts taken up by the directors, their friends and employees, and in respect of the rights issues taken by or renounced by the existing shareholders. Brokerage is not payable when the applications are made by the institutions/ bankers against their underwriting commitments or on the amounts devolving on them as underwriters consequent to the under subscription of the issues.

Registrars to an Issue and Share Transfer Agents

The registrars to an issue, as an intermediary in the primary market, carry on activities such as collecting applications from the investors, keeping a proper record of applications and money received from the investors or paid to the sellers of securities and assisting companies in determining the basis of allotment of securities in consultation with the stock exchanges, finalizing the allotment of securities and processing / dispatching allotment letters, refund orders, certificates and other related documents in respect of the issue of capital.

To carry on their business, the registrars must be registered with the SEBI. They are divided into two categories : (a) Category I, to carry on the activities as registrar to an issue and share transfer agent; (b) Category II, to carry on the activity either as registrar or as a share transfer agent. Category I registrars mush have minimum net worth of Rs. 6 lakhs and Category II, Rs. 3. Category I is required to pay a initial registration fee of Rs. 50,000 and renewal fee of Rs.40,000 every three years, where as Category II is required to pay Rs.30,000 and Rs. 25,000 respectively.

Code of Conduct : The registrars to an issue and the share transfer agents have to maintain high standards of integrity and fairness in all dealings with their clients and other registrars to the issue and share transfer agents in the conduct of the business. They should endeavor to ensure that (a) enquiries from investors are adequately dealt with, and (b) adequate steps are taken for proper allotment of securities and refund of application money without delay and as per law. Also, they should not generally and particularly in respect of any dealings in securities to be a party to (a) creation of false market, (b) price rigging or manipulation (c) passing of unpublished price sensitive information to brokers, members of stock exchanges and other intermediaries in the securities market or take any other action which is not in the interest of the investors and (d) no registrar to an issue, share transfer agent or any of its directors, partners or managers managing all the affairs of the business is either on their respective accounts, or though their respective accounts, or through their associates or family members, relatives or friends indulges in any insider trading.

Debenture Trustees

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company. To act as a debenture trustee a certificate from the SEBI is necessary. Only scheduled commercial banks, PFIs, Insurance companies and companies are entitled to act as a debenture trustees. The certificate of registration is granted to suitable applicants with adequate infrastructure, qualified manpower and requisite funds. Registration fee is Rs. 5 lakh and renewal fee is Rs. 2.5 lakh every three years.

Responsibilities and obligations : Before the issue of debentures for subscription, the consent in writing to the issuing company to act as a debenture trustee is obligatory. He has to accept the trust deed which contains matters pertaining to the different aspects of the debenture issue.

Duties : The main duties of a debenture trustee include the following :

i. Call for periodical report from the company.
ii. Inspection of books of accounts, records, registration of the company and the trust property to the extent necessary for discharging claims.
iii. Take possession of trust property, in accordance with the provisions of the trust deed.
iv. Enforce security in the interest of the debenture holders.
v. Carry out all the necessary acts for the protection of the debenture holders and to the needful to resolve their grievances.
vi. Ensure refund of money in accordance with the Companies Act and the stock exchange listing agreement.
vii. Exercise due diligence to ascertain the availability of the assets of the company by way of security as well as their adequacy / sufficiency to discharge claims when they become due.
viii. Take appropriate measure to protect the interest of the debenture holders as soon as any breach of trust deed/ law comes to notice.
ix. Ascertain the conversion / redemption of debentures in accordance with the provisions / conditions under which they were offered to the holders.
x. Inform the SEBI immediately of any breach of trust deed / provisions of law.

In addition, it is also the duty of trustees to call or ask the company to call a meeting of the debenture holders on a requisition in writing signed by debenture holders, holding at least one-tenth of the outstanding amount, or on the happening of an event which amounts to a default or which, in his opinion, affects their interest.

Portfolio Managers

Portfolio manager are defined as persons who in pursuance of a contract with clients, advise, direct, undertake on their behalf the management/ administration of portfolio of securities/ funds of clients. The term portfolio means the total holdings of

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securities belonging to any person. The portfolio management can be (i) Discretionary or (ii) Non-discretionary. The first type of portfolio management permits the exercise of discretion in regard to investment / management of the portfolio of the securities / funds. In order to carry on portfolio services, a certificate of registration from SEBI is mandatory.

The certificate of registration for portfolio management services is granted to eligible applicants on payment of Rs.5 lakh as registration fee. Renewal may be granted by SEBI on payment of Rs. 2.5 lakh as renewal fee (every three years).

Contract with clients : Every portfolio manager is required, before taking up an assignment of management of portfolio on behalf of the a client, is enter into an agreement with such clients clearly defining the inter se relationship, and setting out their mutual rights, liabilities and obligations relating to the management of the portfolio of the client. The contract should, inter alia, contains :

i. The investment objectives and the services to be provided.

ii. Areas of investment and restrictions, if any, imposed by the client with regards to investment in a particular company or industry.

iii. Attendant risks involved in the management of portfolio.

iv. Period of the contract and provisions of early termination, if any.

v. Amount to be invested.

vi. Procedure of setting the clients' account including the form of repayment on maturity or early termination of contract.

vii. Fee payable to the portfolio managers

viii. Custody of securities.

The funds of all clients must be placed by the portfolio manager in a separate account to be maintained by him in a scheduled commercial bank. He can charge an agreed fee from the clients for rendering portfolio management services without guaranteeing or assuring, either directly or indirectly, any return and such fee should be independent of the returns to the client and should not be on a return sharing basis.

Investment of Clients money : The portfolio manager should not accept money or securities from his clients for less than one year. Any renewal of portfolio fund on the maturity of the initial period is deemed as a fresh placement for a minimum period of one year. The portfolio funds and be withdrawn or taken back by the portfolio clients at his risk before the maturity date of the contract under the following circumstances :

a. Voluntary or compulsory termination of portfolio management services by the portfolio manager.

b. Suspension or termination of registration of portfolio manager by the SEBI.

c. Bankruptcy or liquidation in case the portfolio manager is a body corporate.

d. Permanent disability, lunacy or insolvency in case the portfolio manager is an individual.

The portfolio manager can invest funds of his clients in money market instruments or as specified in the contract, but not in bill discounting, badla financing or for the purpose of lending or placement with corporate or non-corporate bodies. While dealing with client's money he should not indulge in speculative transactions.

Reports to be furnished to the Clients : The portfolio manager should furnish periodically a report to the client, agreed in the contract, but not exceeding a period of six months containing the following details :

a. The composition and the value of the portfolio, description of security, number of securities, value of each security held in portfolio, cash balances aggregate value of the portfolio as on the date of report.

b. Transactions undertaken during the period of report including the date of transaction and details of purchases and sales.

c. Beneficial interest received during that period in respect of interest, dividend, bonus shares, rights shares and debentures,

d. Expenses incurred in managing the portfolio of the client and details of risk relating to the securities recommended by the portfolio manager for investment or disinvestments.

So, we discussed so far the intermediaries in security market. Next task of yours would be to submit in writing the latest regulations of SEBI in the regards to various intermediaries.

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LESSON 36:
MERGERS AND AMALGAMATION : AN INTRODUCTION AND SEBI GUIDELINES

Lesson Objectives

- To understand the process of terms mergers and amalgamation.
- Government and SEBI regulations related to M&A activity.

Introduction

Following the economic reforms in India in the post – 1991 period, there is a discernible trends among promoters and established corporate groups towards consolidation of market share and diversification into new areas through acquisition / takeover of companies but in a more pronounced manner through mergers / amalgamations. Although the economic considerations in terms of motive and effect of these are similar, the legal procedures involved are different. The merger and amalgamation of corporate constitutes a subject matter of the Companies Act, the courts and law and there are well-laid down procedures for valuation of shares and rights of investors. The acquisition/ takeover bids fall under the purview of SEBI. The terms mergers and amalgamations on the one hand and acquisitions and takeovers on the other are treated here synonymously/ interchangeably. Section one of the chapter covers the framework of mergers/ amalgamations including financial evaluation. The regulatory framework governing acquisition/ takeovers is described in Section two. The main points are summarized in Section three.

Mergers/Amalgamations

The terms merger and amalgamation are used interchangeably as a form of business organization to seek external growth of business. A merger is a combination of two or more firms in which only one firm would survive and the other would cease to exist, its assets / liabilities being taken over by the surviving firm. An amalgamation is an arrangement in which the assets / liabilities being taken over by the surviving firm. An amalgamation is an arrangement in which the assets / liabilities of two or more firms become vested in another firm. As a legal process, it involves joining of two or more firms to form a new entity or absorption of one/ more firms with another. The outcome of this arrangement is that the amalgamating firm is dissolved / wound-up and loses its identing and its shareholders become shareholders of the amalgamated firm. Although the merger / amalgamation of firms in India is governed by the provisions of the companies Act, 1956, it does not define these terms. The Income Tax Act, 1961, stipulates two pre-requisites for any amalgamation through which the amalgamated company seeks to avail the benefits of set-off / carry forward of losses and unabsorbed depreciation of the amalgamating company against its future profits under Section 72-A, namely,

i. all the property and liabilities of the amalgamated company / companies immediately before amalgamation should vest with / become the liabilities of the amalgamated company and

ii. the shareholders other than the amalgamated company / its subsidiary(ies) holding at least 90 percent value of shares / voting power in the amalgamating company should become shareholders of the amalgamated company by virtue of amalgamation. The scheme of merger, income tax implications of amalgamation and financial evaluation are discussed in this section.

Scheme of Merger / Amalgamation

Wherever two/ more companies agree to merge with each other, they have to prepare a scheme of amalgamation. The acquiring company should prepare the scheme in consultation with its merchant banker(s) / financial consultants. The main contents of a model scheme, inter-alia, are as listed below.

- Description of the transfer and the transferee company and the business of the transferor.
- Their authorized, issued and subscribed / paid –up capital.
- Basis of scheme : Main terms of the scheme in self-contained paragraphs on the recommendation of valuation report, covering transfer of assets / liabilities, transfer date, reduction or consolidation of capital, application to financial institutions as lead institution for permission and so on.
- Change of name, object clause and accounting year.
- Protection of employment.
- Dividend position and prospects.
- Management : Board of directors, their number and participation of transferee company's directors on the board.
- Application under section 291 and 394 of the Companies Act, 1956, to obtain Higher Court's approval.
- Expenses of amalgamation.
- Conditions of the scheme to become effective and operative, effective date of amalgamation.

The basis of merger / amalgamation in the scheme should be the reports of the valuers of assets of both the merger partner companies. The scheme should be prepared on the basis of the valuer's report, reports of chartered accountants engaged for financial analysis and fixation of exchange ratio, report of auditors and audited accounts of both the companies prepared up to the appointed date. It should be ensured that the scheme is just and equitable to the shareholders, employees of each of the amalgamating company and to the public.

Essential Features of Scheme of Amalgamation : The essential features r pre-requisites for any scheme of amalgamation are as enumerated below.

Determination of Transfer Date (Appointed Date) : This involves fixing of the cut-off date from which all properties, movable as well as immovable and rights attached thereto are sought to be transferred from amalgamating company to the

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amalgamated company. This date is known as transfer date or the appointed date and is normally the first day of the financial year preceding the financial year for which the audited accounts are available with the company.

Determination of Effective Date by when all the required approvals under various statutes, viz, the Companies Act 1956. The Companies (Court) Rules 1959, Income Tax Act, 1961. Sick Industrial Companies (Special Provisions) Act, 1985, would be obtained and the transfer and vesting of the undertaking of amalgamating company with the amalgamated company would take effect. This date is called effective date. A scheme of amalgamation normally should also contain conditions to be satisfied for the scheme to become effective.

The effective date is important for income tax purposes the Companies Act does not provide for such a date but it is a practical necessity so that a court passing an order under Section 394(2) dealing with vesting of properties in the transferee company has before it a meaningful date contained in the scheme serving the purpose and in the contemplation of the applicant companies who are free to choose any date which will be binding one. While sanctioning the scheme the court also approves this date. The effective date may be either retrospective or prospective with reference to the application to the court. The effect of the requirement is that a mere order for the transfer of the properties / assets and liabilities to the transferee company would cause the vesting only from the date of that order. For tax considerations, the mention in the order of the date of vesting is of material consequences.

i. The scheme should state clearly the arrangements with secured and unsecured creditors including the debenture – holders.

ii. It should also state the exchange ratio, at which the shareholders of the amalgamating company would be offered shares in the amalgamated company. The ratio has to be worked out based on the valuation of shares of the respective companies as per the accepted methods of valuation, guidelines and the audited accounts of the company.

iii. The scheme should also provide for transfer of whole or part of the undertaking to the amalgamated company, continuation of level proceedings between the amalgamating and the amalgamated companies, absorption of employees of the amalgamating company, obtaining the consent of dissenting shareholders and so on.

Approvals for the Scheme The scheme of merger / amalgamation is governed by the provisions of Section 391-394 of the Companies Act. The legal process requires approval to the schemes as detailed below.

Approvals from Shareholders In terms of Section 391, shareholders of both the amalgamating and the amalgamated companies should hold their respective meetings under the directions of the respective high courts and consider the scheme of amalgamation. A separate meeting of both preference and equity share holders should be convened for this purpose. further, in terms of Section 81(1A), the shareholders of the amalgamated company are required to pass a special resolution for issue of shares to the shareholders of the amalgamating company in terms of the scheme of amalgamation.

Approval from Creditors / Financial Institutions / Banks Approvals are required from the creditors, banks and financial institutions to the scheme of amalgamation in terms of their respective agreements / arrangements with each of the amalgamating and the amalgamated companies as also under Section 391.

Approval from Respective High Court(s) Approvals of the respective high court(s) in terms of Section 391-394, confirming the scheme of amalgamation are required. The courts issue orders for dissolving the amalgamating company without winding-up on receipt of the reports from the official liquidator and the regional director, Company Law Board, that the affairs of the amalgamating company have not been conducted in a manner prejudicial to the interests of its members or to public interests.

Now let us discuss step-wise procedure for amalgamation.

Object Clause The first step is to examine the objects clauses of the memorandum of association of the transferor and the transferee companies so as to ascertain whether the power of amalgamation exists or not. The objects clause of transferee company should allow for carrying on the business of the transferor company. If it is not so, it is necessary to amend the objects clause. Similarly, it should be ascertained whether the authorized capital of the transferee company would be sufficient after the merger / amalgamation. If is not so, this clause should also be amended. Suitable provisions for these could be incorporated in the scheme itself.

Preparation of a scheme of amalgamation on the lines explained earlier.

Meetings / Information

i. Holding of meeting of the board of directors of both the transferor and the transferee companies (a) to decide the appointed date and the effective date, (b) to approve the scheme of amalgamation and exchange ratio and (c) to authorize directors / officers to make applications to the appropriate high court for necessary action

ii. Inform the stock exchanges concerned about the proposed amalgamation immediately after the board meetings.

iii. The shareholders and other members of the companies should also be informed through press release.

iv. The transferor the and transferee companies should inform the financial institutions, bankers / debenture- trustees at least 45 days before the board meeting so that their approval is available to the proposed amalgamation at the time of board meeting.

Application for Amalgamation An application for amalgamation can be submitted by the company, members or even any of the creditors. A member, in this context means any person who has agreed to be a member and whose name appears on the register of members. A creditor includes all persons having pecuniary claims against the company for some amount whether present or future, definite or contingent. Even one member or one such creditor can make an application for amalgamation. Where the application is proposed to be made

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by the company, only a person authorized by the company in this behalf can make an application for amalgamation. It is, therefore, essential that the company should authorize the director(s) or other officer (s) to make an application to the appropriate high courts and take necessary action as may be required from time to time. The directors can, however, apply for amalgamation only when requisite power appears in the articles of association originally or by way of amendment. Separate applications under Section 291 are required to be submitted to the appropriate high courts by the amalgamating and the amalgamated companies for the purpose of the respective high courts issuing directions to convene meetings of shareholders separately for preference and equity shareholders to approve the scheme of amalgamation. It is incumbent on both the transferor and the transferee companies to obtain sanction of high courts having jurisdiction over them. However, where both the companies are under the jurisdiction of the same high court, a joint-application may be made. Such an application can be moved even when an order for winding up has been made. However, the transferee company need not obtain approval under Section 391 when the transferor company is a wholly-owned subsidiary of the transferor company.

Procedure for Application to the High Court The procedure for making application to the high court has been laid down under the Companies (Court) Rules, 1959. An application under section 391 (1) for an order convening a meeting of creditors and/or members or any class of them should be by a judge's summons supported by an affidavit. A copy of the proposed compromise or arrangement should be annexed to the affidavit as an exhibit. The summons should be moved ex parte. Where the company is not the applicant, a copy of the summons and of the affidavit should be served on the company, or where the company is being wound-up, on its liquidator, not less than 14 days before the date fixed for the hearing of the summons. On receipt of the application by the high court, a hearing takes place in the judge's chamber, and after the hearing the judge may either dismiss the summons or order a meeting of the members or may give such directions as he may think necessary. But it is incumbent on the court to be satisfied that prima facie the scheme is genuine, banafide and largely in the interest of company and its members. On being not satisfied with the scheme, the court may not even order the calling of meeting of creditors even if the consent of the creditors has been withheld or malafide or arbitrary even if the court considers the scheme reasonable and beneficial to the creditors. The court may dispense with the requirement of convening a meeting where all the members of a particular class have consented to the scheme and have entered into necessary agreement with the transferee company. Having known. Having known the proposed meeting the creditors may also move the court for rejection of the scheme and the court may entertain such an application and after reasonable scrutiny may call off the meeting.

Holding of Meeting The net step is to hold separate meetings of the shareholders and creditors of the company to seek approval to the scheme. The resolution approving the scheme may be passed by voting in person or by proxy as per the directions of the high court. At least three-fourth in value of the members or class of members or creditors must vote in favour of the resolution approving the scheme of amalgamation.

The members and the creditors are required to be classified into different classes for the purpose of convening meetings. This process has to be followed immediately on receipt of application under section 391 (1). If meetings of incorrect classification are convened and objection is taken with regard to any particular creditor of having interest competing with others, the company runs the risk of the scheme being dismissed. After classification, the court may order convening of the respective meetings of members and/or creditors.

For the purpose of convening meetings the court may give directions as it may deem fit regarding the following :

i. Fixing the time and place of such meetings(s);
ii. Determining the class or classes of creditors and/or members have to be held for considering the proposed compromise or arrangement;
iii. Appointing a chairman or chairmen for the meeting(s) to be held, as the case may be;
iv. Fixing the quorum and the procedure to be followed at the meeting(s) including voting by proxy;
v. Determining the values of creditors and/or the members of any class, as the case may be, whose meetings have to be held;
vi. Notice to be given of the meeting(s) and the advertisement of such notice;
vii. The time within which the chairman of the meeting is to report to the court the results of the meeting; and such other matters as the court may deem necessary.

The notice of the meetings of members and/or creditors, should be:

a. sent to the members / creditors;
b. sent to them individually by the chairman appointed for the meeting or if the court so directs, by the company or any other person as the court may direct, by post under certificate of posting to the last known address at least 21 clear days before the date of the meeting;
c. accompanied by a copy of the proposed scheme of compromise or arrangement and of the statement required to be furnished under section 393 and also a form of proxy.

The approval of the registrar of the appropriate high court should be obtained in respect of notice and explanatory statements, specifying the particulars prescribed under section 393 and in accordance with the directions issued by the court.

The notice of the meeting must be advertised in the prescribed form in such paper(s) as the court may direct, not less than 21 clear days before the date fixed for the meeting. In case of default, the summons should be posted before the court for such orders as it may think fit to make.

Report of Chairman to the Court The chairman of the meeting must within the time fixed by the court or where no time is fixed within 7 days of the date of the meeting, report the result of the meeting to the court. The report should state accurately the number of creditors or class of creditors or the

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numbers of members or class of members, as the case may be, who were present and who voted at the meeting either in person or by proxy, their individual values and the way the voted.

Presenting Petition Before the Court After the proposed scheme is agreed to with or without modification in terms of section 391(2), the company must within seven days of the filing of the report by the chairman, present a petition to the court for confirmation of the compromise or arrangement. A copy of the petition should also be submitted to the regional director, company law board and others as directed by the court. The court would not sanction a scheme simply because it is recommended by the board of directors and approved by a statutory majority of the company. The court would have to see itself whether the scheme is reasonable and fair to all parties. A scheme which is proper on the face of it and in respect of which no fraud is alleged would not be rejected unless the objector shows any valid ground against it.

Under Section 394 (A), the court should give notice of every application made to it under Section 391 or 394 to the central government/regional directors of company law board and take into consideration the representations, if any, made to it by the government before passing any order. However, the court is not bound to go by the opinion of the government / regional director as to the matters of public interest; rather it can form its independent opinion over the matte.

Where the company fails to present the petition for confirmation of the proposed scheme, it is open to any creditor or contributory, with the leave of the court, to present the petition and the company would be liable for cost. Where no such petition is presented for confirmation, the report of the chairman as to the result of the meeting must be placed for consideration before the judge for such orders as may be necessary. Such a petition must be moved within 7 days of the filling of the report by the chairman.

Once the scheme has been approved by the members of a company in a duly convened and held meeting, the petition filed for confirmation of the same cannot be withdrawn. The only course of action that may be followed is to appear before the court and raise the objections when the scheme comes up for consideration. In such a case, the scheme may not be sanctioned and the court may order for holding meetings of the members again. However, there is noting to prevent a company from requisitioning a meeting to consider a proposed modification in the scheme.

The court would fix a date for hearing of the petition and a notice of the hearing must be advertised in the same newspapers in which the notice of the meeting was advertised or in such other papers as the court may direct not less than 10 days before the date fixed for the hearing.

The order of the court on the petition confirming the scheme should contain such directions in regard to any matter and such modifications in regard to compromise or arrangement as the judge may think fit to make for the proper working of the compromise or arrangement. The order must direct that a certified copy of the same should be filed with the registrar of companies within 14 days from the date of the order or such other time as may be fixed by the court.

The court while sanctioning the scheme should consider (i) that the provisions of the Act have been complied with; (ii) those who took part in the proceedings at the meetings are representatives of the class to which the meeting belongs and that the majority of them acted bonafide; and (iii) having regard to the object, background and other conditions of the scheme, the scheme on the whole is reasonable.

The high court may also direct the official liquidator for submission of reports after scrutiny of the books and papers of the amalgamating company. If the report indicates that the affairs of the company have not been conducted in a manner prejudicial to the interest of the public and the shareholders, the court may issue orders for winding up with dissolution.

Application for Direction If necessary, an application for direction of the court to provide for all or any matters indicated in Section 394(1) These are :

i. The transfer to the transferee company of the whole or any part of the undertaking, property or liabilities of any transferor company;

ii. The allotment or appropriation by the transferee company of any shares, debentures, policies, or other like interests in that company which, under the compromise or agreement, are to be allotted or appropriated by that company to or for any person;

iii. The continuation by or against the transferee company of any legal proceedings pending by or against any transferor company;

iv. The dissolution, without winding-up, of any transferor company;

v. The provision to be made for any persons who, within such time and in such manner as the court directs, dissents from the compromise or arrangement; and

vi. Such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation would be fully and effectively carried out.

The court would pass an order. Alternatively, by adding a suitable prayer in the main application, the court could be requested to give direction in regard to the above. In fact, such a course would provide for expeditious completion of amalgamation formalities.

Certificate A certified copy of the order of the court dissolving the amalgamating company or giving approval to the scheme of merger, should be filed with the Registrar of Companies concerned within 30 days of the date of the court's order.

Court Order A copy of the order of the court should be to attached to the memorandum and articles of association of the transferee company [Section 39 391(4)].

As soon as the scheme of amalgamation has become effective, the members should be intimated through the press. Government authorities, banks, creditors, customers and others should also be informed.

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Financial Framework

The financial framework of a merger decision covers three inter-related aspects : (i) determining the value of the amalgamating firm (ii) financing techniques in merger, and (iii) analysis of merger as a capital budgeting decision.

Determining the Firm's Value The first problems in analyzing a potential merger involves determining the value of the acquired firm. The value of a firm depends not only upon its earnings but also upon the operating and financial characteristics of the acquiring firm. It is, therefore, not possible to place a single value for the acquired firm. Instead, a range of values is determined that would be economically justifiable to the prospective acquirer. The final price within this range is negotiated by the two firms. To determine an acceptable price for a firm, a number of factors, quantitative as well as qualitative, are relevant. However, placing a value on qualitative factors such as managerial talent, strong, sales staff, excellent production department, and so on is difficult. Therefore, the focus of determining the firm's value is on several quantitative variables. The quantitative factors relate to (a) the value of the assets and 9b0 the earnings of the firm. Based on the assets values and earnings, these factors include book value, appraisal value, market value and earnings per share.

Book Value The book of a firm is based on the balance sheet value of the owner's equity. It si determined dividing net worth, by the number of equity shares outstanding. The book value, as the basis of determining a firm's value, suffers from a serious limitation as it is based on the historical costs of the assets of the firm. Historical costs do not bear a relationship either to the value of the firm or to its ability to generate earnings. Nevertheless, it is relevant to the determination of a firm's value for several reasons: (i) it can be used as a starting point to be compared and complemented by other analyses, (ii) in industries where the ability to generate earnings requires large investments in fixed assets, the book value could be critical factor where especially plant and equipment are relatively new, (iii) a study of firm's working capital is particularly appropriate and necessary in mergers involving a business consisting primarily of liquid assets such as financial institutions.

Appraisal Value Appraisal value as another measure of determining a firm's value is acquired from an independent appraisal agency. This value is normally based on the replacement costs of assets. The apprais-al value has several merits. In the first place, it is an important factor in special situations such as in financial companies, natural resource enterprises or organisations that have been operating at a loss. For instance, the assets of a financial company largely consist of securities. The value of the individual securi-ties has a direct bearing on the firm's earning capacity. Similarly, a company operating at a loss may only be worth its liquidation value which would approximate the appraisal value. Secondly, the appraisal by independent appraisers may permit the reduction in accounting goodwill by increasing the recognised worth of specific assets. Goodwill results when the purchase price of a firm exceeds the value of the individual assets. Third. appraisal by an independent agency provides a test of the reasonableness of results obtained through methods based upon the going-concern concept. Further. the appraiser may identify strengths and weaknesses that otherwise might not be recognised such as in the valuation of patents, partially completed research and development expenditure. On the other hand, this method of analysis is not adequate by itself since the value of individual assets may have little relation to the firm's over-all ability to generate earnings and thus the going concern value of the firm. In brief, the appraisal value procedure is useful if carried out in conjunction with other evaluation processes. In specific cases, it is an important instrument for valuing a firm.

Market Value The market value as reflected in the stock market quotations comprises another approach for estimating the value of a business. The justification of market value as an approximation of true worth of a firm is derived from the fact that market quotations by and large indicate the consensus of investors as to the firm's earning potentials and the corresponding risk. The market value approach is one of the most widely-used in determining value specially of large listed firms. The market value of a firm is determined by investment as well as speculative factors. This value can change abruptly as a result of change not only in the analytical factors but also purely speculative influences and is subject to market sentiments and personal decisions. Nevertheless, the market value provides a close approximation of the true value of a firm. In actual practice, a certain percentage premium above the market is often offered as an inducement for the current owners to sell their shares.

Earnings Per Share Yet another basis to place a value on a firm is the earnings per share (EPS). According to this approach, the value of a prospective acquisition is considered to be a function of the impact of the merger on the EPS. In other words, the analysis would focus on whether the acquisition will have a positive impact on the EPS after merger or it will have the effect of diluting it. The future EPS will affect the firm's share prices which is a function of price-earnings (PIE) ratio and EPS.

To summarize the discussion relating to earnings per share approach to determine the value of a firm, when the share exchange ratio is in proportion to the EPS, there is no effect on the EPS of the acquiring! surviving firm as well as the acquired firm (Table 16.1). When, however, the exchange ratio is different, it may result into dilution in the EPS of the acquiring firm (Table 16.2) and accretion in the EPS of the acquired firm. For management of a firm considering to acquire another firm, a merger that results in dilutions in EPS should be avoided. However, the fact that the merger immediately dilutes a firm's current EPS need not necessarily make the transaction undesirable. Such a criterion places undue emphasis upon (he immediate effect of the prospective merger on the EPS. In examining the consequences of merger upon the surviving concern's EPS, the analysis should be extended into future periods and the effect of the expected future growth rate in earnings should also be included in the analysis (Table 16.3).

Financing Techniques in Mergers After the value of a firm has been determined on the basis of the preceding analysis, the next step is the choice of the method of payment to the acquired firm. The choice of financial instruments and tech-

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niques in acquiring a firm usually has an effect on the purchasing agreement. The payment may taken the form of either cash or securities, that is, ordinary shares, convertible securities, deferred payment plans and tender-offers.

Ordinary Shares Financing When a company is considering to use common shares to finance a merger, the relative price-earnings (PIE) ratios of two firms are an important consideration. For instance, for a firm having a high PIE ratio, ordinary shares represent an ideal method for financing mergers and acquisitions. Similarly, the ordinary shares are more advantages for both companies when the firm to be acquired has low PIE ratio.

Debt and Preference Shares Financing From the foregoing it is clear that financing of mergers and acquisitions with equity shares is advantageous both to the acquiring firm and the acquired firm when the PIE ratio is high. Since, however, some firms may' have a relatively lower PIE ratio as also the requirement of some investors might be different, the other types of securities, in conjunction with/in lieu of equity shares may be used for the purpose. In an attempt to tailor a security to the requirement of investors who seek dividend/interest income in contrast to capital appreciation/growth, convertible debentures and preference shares might be used to finance merger. The use of such sources of financing has several advantages. namely, (i) Potential earning dilution may be partially minimised by issuing a convertible security. For example, suppose the current market price of the shares of an acquiring company is Rs 50 and the value of the acquired firm is Rs 50,00,000. If the merger proposal is to be financed with equity, 1,00,000 additional shares will be required to be issued. Alternatively, convertible debentures of the face value of Rs 100 with conversion ratio of 1.8, which would imply conversion value of Rs 90 (Rs 50 x 1.8) may be issued. To raise the required Rs 50,00,000, 50,000 debentures convertible into 90,000 equity shares would be issued. Thus, the number of shares to be issued would be reduced by 10,000, thereby reducing the dilution in EPS that could ultimately result, if convertible security in place of equity shares was not resorted to; (ii) A convertible issue might serve the income objective of the shareholders of target firm without changing the dividend policy of the acquiring firm; (iii) Convertible security represents a possible way of lowering the voting power of the target company; (iv) Convertible security may appear more attractive to the acquired firm as it combines the protection of fixed security with the growth potential of ordinary shares.

In brief, fixed income securities are compatible with the needs and purposes of mergers and acquisitions. The need for changing the financing leverage and for a variety of securities is partly resolved by the use of senior securities.

Deferred Payment Plan Under this method, the acquiring firm, besides making initial payment, also undertakes to make additional payment in future years to the target firm in the event of the former is able to increase earnings consequent to merger. Since the future payment is linked to the firm's earnings, this plan is also known as earn-out plan. There are several advantages of adopting such a plan to the acquiring firm: (i) It emerges to be an appropriate outlet for adjusting the difference between the amount of shares the acquiring firm is willing to issue and the amount the target firm is agreeable to accept for the business; (ii) In view of the fact that fewer number of shares will be issued at the time of acquisition, the acquiring firm will be able to report higher EPS immediately; (iii) There is built-in cushion/protection to the acquiring firm as the total payment is not made at the time of acquisition; it is contingent to the realisation of the potential projected earnings after merger.

Notwithstanding the above benefits, there are certain problems of this mode of payment. The important ones are: (i) The target firm must be capable of being operated as an autonomous business entity so that its contribution to the total projects may be determined; (ii) There must be freedom of operation to the management of the newly acquired firm; (iii) On the part of the management of the acquiring firm, there must be willing co-operation to work towards the success and growth of the target firm, realising that only by this way the two firms can gain from merger.

There are various types of deferred payment plan in vogue. The arrangement eventually agreed upon depends on the imagination of the management of the two firms involved. One of the often-used plans for the purpose in *Base-period earn-out.* Under this plan the shareholders of the target firm are to receive additional shares for a specified number of future years, if the firm is able to improve its earnings *vis-a-vis* the earnings of the base period (the earnings in the previous year before the acquisition). The amount becoming due for payment in shares in future years will primarily be a function of excess earnings, price -earnings ratio and the market price of the share of the acquiring firm. The basis for determining the required number of shares to be issued in as per following equation.

$$\frac{\text{Excess earnings} \times \text{P / E ratio}}{\text{Share price (acquiring firm)}}$$

Illustration

Company A has purchased company B in the current year. Company B had its base year earnings of Rs 3,00,000. At the time of merger its shareholders received initial payment of 75,000 shares of Company A. The market value of the Company A's share is Rs 30 per share and the PIE ratio is 8. The Projected post- merger earnings of Company B for next three years are Rs 3,30,000, Rs 3,90,000, Rs 4,14,000. Assuming no changes in share prices and PIE ratio of Company A, determine the number of shares required to be issued to the shareholders of Company B during three years.

Solution

Number of Shares

Year 1:	Rs 30,000 x 8 / Rs30	= 8,000
Year 2	Rs 90,000 x8 / Rs. 30	= 24,000
Year 3:	Rs 1,14,000 x 8 / Rs. 30	= 30,400

Thus, the shareholders of company B will receive a total of 1,37,400 shares (75,000 initial + 62,400 in subsequent three years).

To conclude, the deferred-plan technique provides a useful means by which the acquiring firm can eliminate part of the

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guess-work involved in purchasing a firm. In essence, it allows the merging manage-ment the privilege of hindsight.

Tender Offer An alternative approach to acquire another firm is the tender offer. A tender offer, as a method of acquiring firms, involves a bid by the acquiring firm for controlling interest in the acquired firm. The essence of this approach is that the purchaser approaches the shareholders of the firm rather than the management to encourage them to sell their shares generally at a premium over the current market price.

Since the tender offer is a direct appeal to the shareholders, prior approval of the management of the target firm is not required. In case, the management of the target firm does not agree with the merger move, a number of defensive tactics can be used to counter tender offers. These defensive tactics include White Knights and PAC-Mans. A white knight is a company that comes to the rescue of a firm that is being targeted for a take-over. Such a company makes its own tender offer at a higher price. Under Pac-mans form of tender offer the firm under attack becomes the attacker.

As a form of acquiring firms, the tender offer has certain advantages and disadvantages. The disadvan-tages are: (i) If the target firm's management attempts to block it, the cost of executing offer may increase substantially; (ii) the purchasing company may fail to acquire a sufficient number of shares to meet the I objective of controlling the firm. The major advantages of acquisition through tender offer include: (i) If the offer is not blocked, it may be less expensive than the normal route of acquiring a company. This is so because it permits control by purchasing a smaller proportion of the firm's shares; (ii) The fairness of the I purchase price is not questionable as each shareholder individually agrees to part with his shares at the I negotiated price.

Merger As a Capital Budgeting Decision Like capital budgeting decision, merger deci-sion requires comparison between the expected benefits [measured in terms of the present value of expected benefits/cash inflows (CFAT) from the merger] with the cost of the acquisition of the target firm. The acquisition costs include the payment made to the target firm's shareholders, payment to discharge the external liabilities of the acquired firm less cash proceeds expected to be realised by the acquiring firm from the sale of certain asset(s) of the target firm. The decision criterion is 'to go for the merger' if net present value (NPV) is positive; the decision would be 'against the merger' in the event of the NPV being negative.

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WITH A FOREWORD BY RON SANDLER

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Foreword

By Ron Sandler

There is an urgent need to upgrade standards of financial literacy. This was one of the principal messages arising from the Savings Review that I led recently on behalf of the UK Government. Finding ways to deliver effective financial education represents one of the most important challenges that we face if consumers are ever to become empowered to make informed financial decisions about their future. It is equally important that those involved in developing and marketing financial products and services are properly alert to the interests of their customers. This textbook represents an important step in seeking to align the interests of the financial services consumer, be that a private individual or a business customer, with those of the financial services provider.

The financial services industry across the globe has a pivotal role to play in facilitating economic development, eradicating the joint scourges of poverty and exploitation, and safeguarding the well-being of all of human kind. These aspirations will only be realized if products and services are designed such that they meet the genuine needs of customers. Amongst other things, this calls for product design that emphasizes simplicity and ease of understanding; communication that is concise and clear; and the provision of advice and information by knowledgeable and confident staff. All of these features must be bound together by a coherent marketing strategy.

This book has been conceived and written to improve the quality of financial services marketing. It is intended to have equal value as a core text in a university setting, and as a training resource in the world of the practitioner. I sincerely hope you gain personally from studying it and, as a result, are able to contribute further to the development of a financial services sector that functions well and efficiently, with all the wider societal benefits that this brings.

Ron Sandler is chairman of **pfeg**, a charity created to deliver personal finance education in schools. In 2001/02, at the request of the Chancellor, he led an independent review of the long-term savings industry in the UK. In his business career, he has been Chief Executive of Lloyd's of London and Chief Operating Officer of NatWest Group.

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Preface

A formal approach to the marketing of financial services is a relatively recent phenomenon, even within the developed nations of the world. The marketing of packaged goods, such as confectionery, food, soft drinks and toiletries, has been subject to an enormous investment in classical marketing skills and capabilities since the early part of the twentieth century. A continuity of investment in marketing has enabled brands such as Coca Cola, Wrigleys, Gillette, Campbells and Cadbury to become, and remain, leading brands in their respective sectors from the 1920s and onwards into the twenty-first century. Competitive pressures have played a major role in sharpening the marketing appetites of the packaged goods sector. Additionally, the relative simplicity of the products and the transparency associated with them have also been catalysts for the development of marketing edge. Cost proximity and the need for economies of scale have added further impetus to the development of the marketing skills of this product area.

The financial services sector, on the other hand, has not been subjected to the same market pressures in order to survive and prosper. Until comparatively recently, the financial services industry in many countries has operated within a comparatively benign market environment and, in some instances, has been substantially state managed and controlled. In contrast to the packaged goods arena, rivalry amongst financial services providers has tended to be more collegiate than competitive. Diversity of supply and relatively low individual company market shares have been particular features of many sectors of financial services. For example, in spite of the received wisdom of mergers and acquisitions, there were 613 companies authorized to carry on general insurance business in the United Kingdom in 2004, compared with 627 some 11 years earlier.

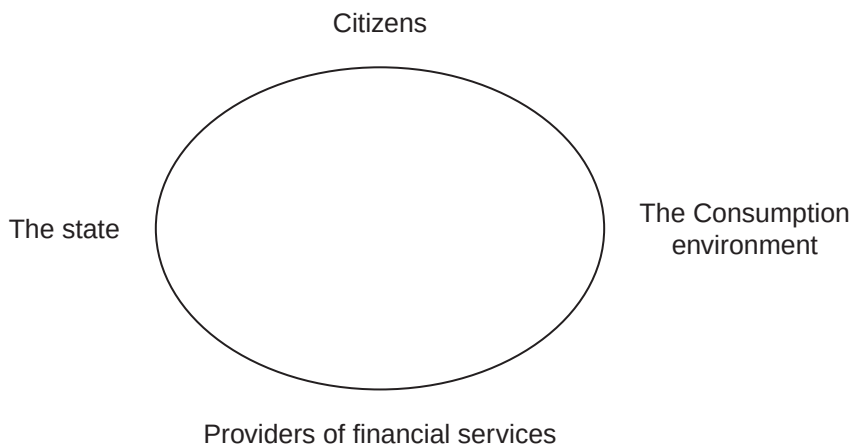
Financial services products, in general, are far more complex than their packaged goods counterparts. It is fair to say that consumers evidence low levels of knowledge and self-confidence when it comes to comparing and contrasting the range of products on offer. The issues associated with product transparency serve to further weaken consumer power, resulting in a less vigorous form of competition. The drive for economies of scale has been far less of a feature of financial services, and this too has lessened the need to be at the leading edge of marketing.

Two further factors of note that have played a part in lessening the need for state-of-the-art marketing are the influence of government, and consumers' attitudes towards financial products. In many respects, governments have played a crucial role in the development of new products and the associated promotion of those products. This is in marked contrast to the packaged goods industry. The introduction of personal pensions and tax-advantaged savings schemes has presented the industry

with major new business opportunities. It is salutary to note how, in the case of personal pensions in the UK, this government-initiated product resulted in wholesale abuse and long-term damage to the reputation of the industry. Arguably, this arose because the industry was far too sales-orientated and insufficiently customer-orientated. It certainly shows up the marketing shortcomings of the sector. Similarly, the government-induced withdrawal of products and the lessening in tax favourability have acted as highly potent sales promotions.

Turning to consumer attitudes, it is in the nature of financial services products that consumers do not gain explicit enjoyment from their consumption. On the contrary, a great many financial services products involve a reduction in current consumption pleasure, because money is diverted from such consumption as a contingency for some future event. You might even say that financial products are not only boring but also lessen the pleasure to be had from consuming other products that do offer explicit enjoyment. The absence of consumption-associated pleasure and the general level of consumer disinterest have therefore served to reduce the importance of marketing within the financial services industry.

All too often one senses that, at least for some financial services organizations, marketing is a term that applies to a department that produces promotional material. As will be seen in this book, marketing is (or should be) a broad cultural and philosophical approach to overall organizational behaviour, and not some narrow field of functional competence. This book sets out to present financial services marketing as an overarching set of processes that aim to achieve a balance between the key components of the wider environment.



For this reason, this book comprises three core parts. Part I is devoted to the strategy and planning elements associated with marketing. Here, we examine the complex inter-relationships that exist between the financial services industry, the state and the citizen. A theme that runs throughout this entire text is that a positive-sum game should be at play in which all three parties are mutually advantaged through their interactions. Across the globe, we see evidence of financial services industries that appear to be engaged in a perpetual struggle for the trust of consumers and confidence of government and regulators. The present authors argue in favour of a

marketing approach that is consumer-centric and founded upon core values of value for money, integrity, trust, security and transparency. In our view, the adoption of such values is axiomatic of good marketing practice and a prerequisite for the development of successful financial services industries throughout the world.

Additionally, Part I describes the participants that comprise the financial services marketplace. This provides the context necessary for a full understanding of how the marketplace operates in servicing the needs of customers. Included in this part are details of the product ranges that comprise the financial services domain. All too often, both students and those employed in financial services display a lack of breadth concerning financial services products and providers; this book aims to provide the necessary knowledge.

Importantly, Part I provides concrete approaches to the processes associated with developing marketing strategies and plans. These approaches will not only equip students with a solid grounding in the disciplines associated with strategy, but also be of real practical value to those actively engaged in working within financial services organizations.

Part II focuses upon the principles and practices that are associated with becoming a customer of a financial services provider. Traditionally, this has been the primary focus of general marketing textbooks; indeed, it is a key element of this present one. However, it is grounded in good practices that are in evidence both in the financial services domain as well as in other commercial marketplaces. Of particular note are the vignettes that have been sourced from organizations throughout the world.

Part III is dedicated to the principles and practices that concern the development of customer relationships over time. This is of particular importance in the context of financial services. The incidence of short-term organizational gain, to the long-term detriment of the consumer, has been far too prevalent in the past. Insufficient attention has been given to how to manage existing customer relationships in favour of new customer acquisition, and this book hopes to help redress the balance. Again, examples of good practice from a range of countries are given to make the concepts and principles more concrete.

In conclusion, this is a book that will help both the student and the practitioner to develop a firm grounding in the fundamentals of financial services strategy, customer acquisition and customer development. It draws upon both relevant conceptual and theoretical models as well as relevant practical applications. Every effort has been taken to adopt a style of English that will make this text accessible to the widest possible audience. Of course, there is a role for special marketing-related terms; however, these are used within a written context that seeks to be straightforward and free of 'corporate speak'.

Many people have helped with the development of this book, and we are grateful for their contributions. In addition to the various organizations that have provided information and insights into their marketing practices, we also wish to thank Anna Fabrizio and her colleagues at Elsevier, who provided support and enthusiasm through the process, and, last but not least, Miranda Hancock and Gerardine McCullough, who both deserve our gratitude for sterling work in the preparation of the manuscript. Thank you!

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Part I

Context and Strategy

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1

The role, contribution and context of financial services

Learning objectives

By the end of this chapter you will be able to:

- understand the economic and social significance of the financial services sector
- recognize the diverse ways in which financial services can impact on key aspects of everyday life.

1.1 Introduction

Product and market context exert a significant influence on the nature and practice of marketing. Marketing activities that are effective for fast-moving consumer goods may be wholly inappropriate when marketing fine art. What works in Canada may be ineffective in China. Accordingly, an appreciation of context is essential in order to understand the practice of marketing. Nowhere is this more evident than in the financial services sector. Social, political, economic and institutional factors create a complex context in which financial services organizations (FSOs) and their customers interact, and, of course, these in turn may vary considerably across countries. All too often, discussions of marketing practice fail to recognize the importance of explaining and understanding these contextual influences. The purpose of this current chapter is to provide an overview of the context in which financial services are

marketed and to explain the economic significance of the sector. Further detail on the nature of the sector itself is provided in Chapter 2.

The following sections outline aspects of social and economic activity where the financial services sector has a key role to play and where its activities have significant implications for economic and social well-being. We begin with a discussion of the potential contribution of the sector to economic development in general. The subsequent sections go on to explore the role of the financial services sector in welfare provision, in income smoothing and in the management of risk. We then explore the significance of financial exclusion and its potential impact on the welfare of the poorer groups in society, before reviewing distinctive features of the financial services industry – namely the coexistence of mutual and joint stock companies. Finally, there is an overview of the issues relating to the regulation of financial services.

1.2 Economic development

Although economic and political theorists sometimes have very different opinions on the nature and value of economic development, there is a widely accepted view that controlled, managed economic development is, on the whole, a desirable means of furthering the well-being of humankind. Moreover, economic development that combines the positive aspects of the market economy (particularly innovation and resource efficiency), with the collectivist instincts and community focus of state legislatures is, arguably, most likely to serve the common good.

Economic development is being pursued by governments throughout the world, with varying degrees of success. Access to investment capital facilitates economic development, and a vibrant banking sector has a pivotal role to play in this regard. The liberalization of financial services in the former Communist countries of Eastern Europe has enabled inward investment to occur that has allowed many of them to be successful in joining the European Union. Similarly, many of the rapidly developing economies of Asia are focusing attention on liberalization of their financial sectors as an aid to economic growth and development.

As well as the provision of investment capital through competitive banking systems, the development of stock markets has provided a further means for the raising of capital. In turn, this has broadened the classes of assets that are available in which financial organizations and individuals can invest.

In addition to its significance at the macro-level in facilitating the process of economic development, the financial services sector also plays an important role in delivering social well-being through its impact on the provision of welfare, as the next section explains.

1.3 Government welfare context

The welfare of humankind, at least for the vast majority of the world's inhabitants, is significantly influenced by financial well-being. At a macro-level, nation states, organizations and individuals all require access to the financial resources necessary

to safeguard their rights of self-determination. Ever since the time of Bretton Woods, at which the International Monetary Fund was established, countries that have sought support from global financial institutions have had to cede an element of, at least, economic autonomy to such institutions. Similarly, companies that fail to safeguard their solvency and capital adequacy find themselves subjected to the constraints imposed by the financial institutions from which they seek assistance.

However, it is at the level of the individual citizen that we see the relationship between financial assets and autonomy most acutely. As individuals progress through the various stages of life, the balance between income/financial assets and expenditure will vary. In childhood we require money to fund education and health requirements in addition to the expenses necessary to support everyday life. At the other end of the lifetime continuum, in old age we require relatively high levels of healthcare provision in addition to the money needed to support the necessities of life. Both of these extremes of the human lifecycle are typically associated with the individual not being engaged in paid employment – at least, not in the developed countries of the world.

Throughout history, the family has acted as a mechanism for addressing the challenges posed by income and expenditure discontinuities. A feature of the developed countries of the world is that the family has become of lesser importance regarding this role. Family size, structures and role definitions have undergone rapid change since the Second World War in countries such as Italy, the Netherlands and the USA. Indeed Italy now has the lowest birth rate in the European Union, with around 1.3 children born per female. The diminution in the relative importance of the family as a self-sustaining welfare system has evolved in parallel with the expansion of welfare systems organized, provided and funded by the state in much of the developed world. Quite how causality and correlation are at play in this development is a source of much deliberation and debate. What is not open to debate is that the role of the state, in matters concerning welfare, advanced significantly during the course of the twentieth century in countries such as the United Kingdom and USA. Individual needs such as income during periods of unemployment or retirement, healthcare and education, were progressively transferred from the private and voluntary domains to the public sector.

Thus, across the world governments have, to a greater or lesser extent, assumed a significant role in safeguarding the welfare needs of their citizens. During the period of Communist rule in Eastern European countries, the state was all-pervasive with regard to the provision of welfare services. While the transition process undoubtedly reduced the role of the state, it certainly did not eliminate its responsibility for aspects of individual welfare. However, in many developing countries the state remains more at the periphery of welfare provision, primarily as a consequence of limited resources. In such places, the family – and especially the extended family unit – continues to perform the primary welfare role for its members. It is interesting to note that the respective contributions made by state and citizen are not static but dynamic. For example, although the public sector continues to play a significant role, recent years have seen a notable reduction in state welfare provision in many developed economies and a tendency to redistribute responsibility back to the private sector. This has significant implications for the financial services sector, and particularly for products designed to provide benefits such as income protection or payment for medical expenses.

A range of factors has exerted influence in the relationship between public and private sectors in terms of welfare provision, but one of particular note is what might be termed consumerism. This is allied to the growth of consumer cultures throughout the world, which has been driven by a growth in real earnings, increased competition, product innovation, greater sophistication in marketing practice, and changes in culture and value systems.

The practical consequence of the growth of consumer cultures is that citizens have become increasingly accustomed to receiving choice, quality, convenience and value from their experiences as consumers in the marketplace. Thus, consumer expectations have been fuelled predominantly by private-sector suppliers of consumer goods and services. For the state, this has posed two particular problems. First, citizens are increasingly coming to expect the same standards of consumption experiences from state-provided services as they obtain from the private sector. It is proving to be increasingly costly and difficult for state bureaucracies to live up to such expectations. There is the ever-present concern of two-tier delivery of welfare services such as education and healthcare. It is acknowledged that great disparities exist in respect of the differentials between state- and privately-funded provision. For example, the health services provided by, say, France and Germany through their socially-funded systems are the envy of many other parts of the world. Nevertheless, those with money can, as a rule, enjoy the freedom to source a much wider array of health and education facilities than those without. Secondly, the state has to struggle to maintain standards of living that are increasingly defined by a culture of consumption. This places growing strain on the ability of governments to use their social welfare budgets to fund appropriate lifestyles for claimants such as those of retirement age. In recognition of this difficulty, the Thatcher government of 1980s Britain severed the link between increases in the basic retirement pension and the index of average earnings. Instead, it reviewed pension increases in line with the (lower) index of retail prices. This in turn forced many individuals to reconsider the effectiveness of their pension provision, and was one of a number of developments that stimulated the growth of the private pensions industry.

In summary, then, welfare provision underpins the economic well-being of society. Its provision is increasingly based around a complementary mix of public- and private-sector activity. Private-sector welfare provision is predominantly dependent on the financial services sector, and thus the efficiency and effectiveness of this sector has important implications for the economic and social health of an individual country. This is a theme to which we will refer at various points. For the moment, it is perhaps most pertinent to note that one essential element of welfare provision is the concept of income smoothing, and the role of the financial services sector in this process is explored more fully in the next section.

1.4 Lifetime income smoothing

Both the state and the financial services industry work in a complementary manner to facilitate the smoothing of income flows throughout an individual's lifetime. Typically, during childhood individuals are acquiring the knowledge and skills upon which their future employment will be based. This is a period in life which is

all about cost in the absence of any income. Although the family is the principal source of money during childhood and adolescence, the state plays a significant role in financing the costs associated with this life-stage. The intergenerational transfer of funds from adulthood (as parents) to one's children forms part of the income smoothing process.

Towards the later stages of life, people (at least in the developed nations of the world) cease participating in the labour force. As with childhood, this is a period characterized by considerable cost and no income from employment. This concept of retirement is a generalization that is becoming challenged to an increasing extent in countries from the USA to Australia. The stereotypical model of retirement holds that money is transferred to the pensioner in one of two principal ways. First, there is a generational transfer of funds via the taxation system (this refers to taxation in the round, and includes all government-related levies such as National Insurance in the UK) whereby today's workers pay taxes that, in part, contribute to the pensions of those in retirement. Secondly, and to an increasing extent, income in retirement is funded out of the money that individuals have saved during the course of their working life in the form of a pension. Importantly, employer-sponsored occupational pension schemes have made a growing contribution to individual's pension entitlements during the course of the second half of the twentieth century. In simple terms, a funded pension scheme involves the transfer of income from an individual's years in paid employment to the post-employment years. Thus it is a form of income smoothing that comprises elements of state- and privately-organized money management.

In many parts of the world life is more challenging, and old age can be simply a continuation of the toil of an individual's earlier working life. Again, in many developing countries the family is often the only significant vehicle for supporting the elderly.

The need to provide an appropriate level of income in retirement is rising up the agendas of virtually every country. A number of factors have contributed to this phenomenon, the most significant of which are demographic. In essence, the proportion of the world's population that is older than 65 years is growing. The principal drivers of this ageing effect are the extension in life expectancy and lower birth rates. In the UK, for example, the birth rate has fallen more or less continuously since the mid-1960s, as can be seen in Table 1.1.

The reduction in birth rate appears to be a consistent feature of most countries as they become more economically developed. This is a consequence of a range of social, economic and cultural factors, and the changing nature of lifestyle choices that are in evidence. In contrast, many (but not all) developing economies have much higher birth rates and relatively young populations, although, as levels of

Table 1.1 UK total fertility rates, 1960–2005

Fertility rate	(%)
1960–1965	2.8
1995–2000	1.7
2000–2005	1.6

Source: Willetts (2003), p 50.

development increase, the number of children per family does tend to fall. An exception is China which, despite its relatively early stage in the development process, has a relatively low birth rate, largely as a consequence of deliberate policies to control the size of the population.

A major consequence of the ageing effect in developed economies is that the dependency ratio is growing in countries across the globe. This refers to the ratio of dependants (i.e. individuals who have ceased work) to people in the labour force. With more retired people and fewer workers, the flow of funds from those in employment that is needed to support those in retirement is increasingly under pressure. This issue is set to grow in importance, as currently available projections indicate a continuing trend in the proportion of the population that is elderly.

Another challenge to income smoothing in developed countries is that people's working lives have shortened in recent times. Figures released by the National Audit Office (NAO) in the UK in September 2004 illustrate vividly the growing trend in labour force inactivity in the years before the age of 65, especially among men. Whereas more than 70 per cent of men in the age group 60–64 years were in employment in 1974, that figure has now dropped to just 40 per cent. Thus, not only is the dependency ratio increasing, but the proportion of an individual's lifetime spent in employment is also reducing. Altman (www.rosaltmann.com) indicates that within a comparatively short timescale this has fallen from 67 per cent of an individual's life being spent in employment to 55 per cent. Arguably, Altman's analysis is unduly conservative, as it assumes that individuals retire at the age of 65. On the basis of the NAO data, the average male productivity quotient has fallen to the order of 47 per cent.

A range of possible solutions is in prospect to address what has been called the retirement savings gap. However, these boil down to some basic options, namely that people will have to work for an additional number of years or save more money, or, more likely, a combination of the two. In any event, the government and private sector have to work together to address this particular feature of income smoothing.

Having talked about smoothing income flows during childhood and retirement, what about the in-between period when people are in employment? This represents a period of challenge and opportunity for the financial services industry. Notwithstanding societal and cultural variations, consumer needs vary substantially during the early, middle and late career periods of working life.

Indebtedness has assumed an increasing significance for people in the early stages of their working lives, and this seems likely to become ever more acute. The growth of the credit-card culture has served to increase young people's indebtedness across countries. The problem is being further exacerbated by the rising incidence of student debt. In the UK, it is estimated that the typical graduate begins working life with debts in the order of £12 000. Figure 1.1 illustrates the typical profile of financial assets during an individual's period in employment.

Figure 1.1 illustrates a typical asset profile, and shows how substantial net assets only really begin to accumulate relatively late in an individual's working life. The financial services industry has an increasing role to play in providing the wide range of products and services that are necessary to smooth income and expenditure flows throughout that working life.

Alongside the important issues that arise in relation to the variability of assets, income and expenditure over a lifetime, consumers also face a variety of

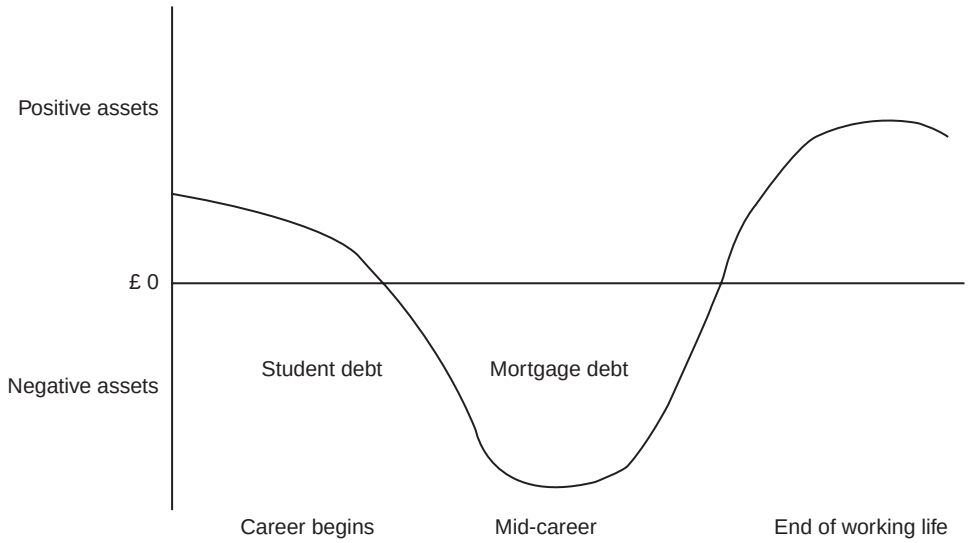

Figure 1.1 Marketing as a facilitator of balance.

short-term risks. The ability to protect or insure against the adverse consequences of those risks has important implications for social and economic well-being. Section 1.5 explores the role of the financial services sector in managing risk.

1.5 The management of risk

An important aspect of how financial services organizations further the cause of economic development is through the provision of the means to manage risk. In simple terms, this is the role played by insurance. General insurance (e.g. insuring risks to property and possessions), health insurance and life assurance are effective means of enabling individuals and organizations alike to take on risks associated with economic advancement. For example, a bank will be unwilling to lend money to a businessman who wants to invest in additional manufacturing capacity without some form of security. A common type of security is some form of life insurance that will enable the bank loan to be repaid in the event of the death of the borrower.

In many developing parts of the world we are seeing the development of what is called *micro-insurance*. Typically, this refers to general insurance cover of a very basic level that can provide security from the risks that apply to relatively low-cost yet high-impact assets. For example, micro-insurance is enabling home-workers in India to afford to insure productive assets such as sewing machines, as shown in Case study 1.1. To the Westerner this may not seem a big deal, but an entire family's livelihood may depend upon this fairly basic piece of equipment. A common cause of poverty among the rural poor of countries such as Cambodia is the forced sale of land to pay for unexpected medical expenses. Again, low-cost forms of health insurance can make a huge contribution to human well-being.

Case study 1.1 Insurance to improve the lives of poor women in India

The Self-Employed Women's Association (SEWA) in India is a trade union with 700 000 members – all poor working women in the informal economy – in seven Indian states. SEWA started in 1972 in Gujarat, the western part of India, as a union seeking to unite urban and rural women informal workers on the issue of 'full employment', which SEWA defines as work, income, food and social security. The second objective of SEWA is to make its members self-reliant, both individually and collectively, not only economically but also in decision-making. It has also promoted similar movements in countries like South Africa, Yemen and Turkey.

SEWA's experience of years of working at the grass-roots level with women in the informal economy has shown that social needs, such as health, childcare, education and housing, are all linked to economic capabilities of the women workers. They need economic security – a continuous flow of employment through which they can earn enough in terms of cash and kind to meet their needs. They also need social security to combat the chronic risks faced by them and their families. Social security has four main components – healthcare, childcare, shelter and insurance. The insurance programme of SEWA is called Vimo SEWA (*Vimo* is a local word for insurance).

In 1992 SEWA started its insurance scheme, which provides insurance for natural and accidental death, hospitalization expenses and asset insurance to SEWA members. The primary policyholder will always be the SEWA member. A husband cannot enrol in the programme unless his spouse is an enrolled SEWA member. Children can also be enrolled by paying additional premiums. Women must be 18–58 years of age to enrol for annual membership. Life insurance coverage terminates at the age of 70 years.

Vimo SEWA offers two types of payment schemes to its insurance members. Members can either pay their premium annually or through a fixed deposit with the SEWA Bank. Under the fixed deposit option, members deposit a lump sum in a fixed deposit at the SEWA Bank and the interest accrued on this deposit goes towards the annual premium. Thus, a woman gets continuous insurance coverage and obtains much-needed, long-term social protection.

As SEWA works with poor, self-employed, informal-sector women workers who don't have any income security or work security, they live on a daily basis. It is very difficult to explain the risk-sharing and risk-pooling aspects of insurance to individuals and convince them of the benefits. Furthermore, regular contact with ever-growing numbers of the women poses a big challenge, spread out as they are over a geographically dispersed area.

Vimo SEWA has developed a cadre of local village-level community leaders for the marketing and education for its insurance programme. In fact, they are the real workforce of SEWA insurance and also the real hand-holders of insured members. They organize village or area meetings to explain the importance of insurance in poor, vulnerable women's lives and also how the schemes work. Moreover, when required, they also help the members in collecting required

Case study 1.1 Insurance to improve the lives of poor women in India—cont'd

documentation for submitting claims. Currently VIMO SEWA has around 100 such leaders, who are called 'spearhead aagewans' (leaders in our language).

After 15 years of experience in insurance, SEWA wants to form its own women-owned and managed life-insurance co-operative. To achieve this, SEWA is trying to step towards viability through growing the scale of the business and cost control. According to the projections made with the help of a Canadian actuary, viability can be achieved by the year 2010.

Source: Shilpa Pandya, Self-Employed Women's Association.

Finally, it is worth pointing out that governments make extensive use of financial services instruments as a means of managing public finances. Virtually all countries use government bonds as a means of raising money. In the UK, National Savings & Investments is a government-owned organization that promotes a wide range of retail financial services products that play a role in the government's fiscal strategy.

1.6 Financial exclusion

A key tenet of the United Nations is that the citizens of the world be relieved of the scourge of poverty. Indeed, the relief of poverty has been of fundamental concern to communities for centuries. In Britain, the nineteenth century saw a rapid acceleration of poverty up the agenda of all political parties. It was also a period of rapid development of charitable and philanthropic endeavours to address the poverty so graphically commented upon by Marx and Engels and depicted in the works of Dickens. While Europe may have emerged from the worst of the poverty associated with industrialization in the nineteenth century, the problem persists throughout the globe and remains a daunting challenge to national and international policy-makers.

As will be discussed in Chapter 2, easing poverty depends not just on the creation of an income stream, but also on the creation of assets. Exploring the development of the financial services sector in the UK during the nineteenth century provides an illustration of the positive impacts associated with the provision of these services. Nineteenth-century Britain was witness to the development and growth of building societies and friendly societies. The former aimed at helping ordinary people to build and own their own homes, whilst the latter were often initially formed to ensure that working people could afford a dignified burial. In York in 1902, Joseph Rowntree commenced his pioneering work to help improve the quality of life of the slum dwellers of that city. The Joseph Rowntree Foundation was founded in 1904, and in 2004, its centenary year, poverty remained a fundamental aspect of its activities.

In spite of the economic progress seen in countries such as the USA and Great Britain, these societies remain highly polarized in terms of the gap between rich

and poor. This issue continues to exercise governments mindful that increasing affluence has not eradicated poverty. Indeed, in 1997 the incoming Labour government of Tony Blair set out to eliminate child poverty in Britain within a 20-year timeframe. Darton *et al*. (2003) illustrate graphically that the poorest groups in society have missed out on the economic growth of the 1980s and 1990s. Their analysis points to a near-doubling of the number of people in relative poverty in Britain in the 20 years from 1981, to 13–14 million people by 2001.

Britain is not alone in displaying a significant degree of relative poverty, although it is towards the upper end of the range in OECD countries. OECD figures suggest that poverty in member countries ranges from 10 per cent in Sweden to almost 24 per cent in the USA (Foster, 2000). Geography is a significant factor in poverty, with wide variations in evidence both within and between countries. For example, GDP per head of population in the town of Acortes in Portugal is less than 25 per cent of that for Brussels.

In the context of financial services, there are real concerns regarding the incidence of financial exclusion. By financial exclusion, we mean the lack of access to and usage of mainstream financial services products and services in an appropriate form (Panigyrakis *et al*., 2003). No textbook on financial services marketing would be complete without paying due regard to this phenomenon. As commented upon already, financial services perform a key enabling role in advancing economic development and well-being.

There is a real danger of financial services being increasingly the prerogative of the relatively affluent sections of world societies. In part, this is a consequence of the rising costs of serving customers. Take the UK as an example. Throughout the twentieth century, working-class communities in Britain were able to gain access to a range of saving, investment and insurance products through what were termed the Home Service distribution arms of mainstream providers such as Prudential Plc, the Co-operative Insurance Society and Liverpool Victoria Friendly Society. Home Service was based upon having agents who called at the homes of customers to collect payments, often cash, and to provide information and advice. As Knights *et al*. (2004: 14) point out, Home Service continued to thrive:

> until Financial Services Authority regulations combined with intensified competition in the sector in the 1990s and began to threaten the viability of its expensive, labour-intensive door-to-door operations. By late 2003, all Home Service insurance companies had abandoned new industrial branch business.

In addition to the withdrawal of Home Service insurance facilities, poor neighbourhoods and rural communities in the UK have seen a reduction in the availability of bank branches. Put bluntly, the pressure to deliver maximum growth in shareholder value has rendered it uneconomic for mainstream banks to serve an increasing number of people. In particular, recent research has shown that the number of bank branches in the UK fell by some 32 per cent between 1989 and 2003, down from 12 775 to 8681. The highest rate of closure occurred in areas described as 'multicultural metropolitan'. These are characterized by high unemployment and having a higher than average proportion of people identifying themselves as black, Indian, Pakistani or Bangladeshi (Leyshon *et al*., 2006).

Thus, a number of contemporary insurance and banking practices are excluding many thousands of citizens from essential financial services. The Office of Fair Trading has observed (OFT, 1999) that:

> Such people are being left behind in an expanding market where choice is between a range of complex and highly regulated products primarily aimed at well-off and low risk consumers.

This results in financially excluded individuals falling prey to non-mainstream organizations that exploit the vulnerability of such consumers. This is particularly in evidence with regard to credit and loans, where Knights *et al*. (2003) refer to APRs being charged in a range of 116.5–276.4 per cent. Credit unions offer a viable alternative to many such consumers. Unfortunately, all too often they have neither the resources required to provide the necessary infrastructure nor sufficient promotional muscle. Ideally, financial services should be viewed as providing an inclusive means for improving the financial well-being of all. That is not to say that companies should be expected to become unreasonably philanthropic to the detriment of key stakeholders – indeed, it is perfectly legitimate for a provider to operate on a niche or 'preferred lives' basis. However, the means exist to adopt an inclusive approach to financial services that obviates the need for exploitation of the vulnerable. Policy-makers and regulators must focus on the need for inclusiveness and avoidance of exploitation within their goals for the development of the financial services industry.

1.7 Mutual and proprietary supply

Financial services organizations present themselves in two forms as far as ownership is concerned: mutual and proprietary. In simple terms, proprietary companies are owned by shareholders while mutual suppliers are owned by their customers. However, this is indeed an oversimplification and, in the UK, a review of the governance of mutual insurance companies carried out by Paul Myners (2004) found the precise definition of mutuality a rather more complex issue.

A substantive body of literature exists which sets out to compare the operations of, and outcomes associated with, proprietary and mutual forms of supply. A particular area of focus has been the relative expenses and payouts associated with life insurance firms. Of particular note are the studies carried out by Armitage and Kirk (1994), Draper and McKenzie (1996), Genetay (1999), Hardwick and Letza (2000) and Ward (2002). These and other studies concern the merits and demerits of mutual and proprietary forms. Underlying many of these studies is the presumption that the form of ownership is independently implicated in corporate performance. This is based upon a view that there is an inherent conflict of interest between the interests of shareholders and those of consumers. Therefore, mutuals may be at liberty to concentrate more effectively on meeting the needs of consumers.

Supporters of the mutual form point to the tangible performance benefits of mutuality as well as its philosophical advantages. Fundamental to the former is the argument that the absence of the need to pay a dividend results in tangible benefits

to customers. Analysis by the Building Societies Association (2001) in the UK indicates that building societies (mutuals) display lower operating cost ratios, lower rates of interest charged to borrowers and higher rates of interest paid to depositors than do the so-called mortgage banks that had previously operated under the mutual form. Analysis performed by the International Co-operative and Mutual Insurers Federation (ICMIF) compares and contrasts the performance of mutual with proprietary organizations. The analysis is based upon a sample of 105 insurance companies operating in 11 European countries (ICMIF, 2003). The sample includes both life and general insurance companies, and is based upon performance data covering the period from 1995 to 2001. The measures of performance assessed by the study include:

- growth in new premium income
- expense ratios
- claims ratios
- investment returns
- solvency.

The report's authors conclude that mutuals outperform their proprietary counterparts on almost all measures of performance studied. In addition to the tangible performance advantages claimed for mutual providers there is the philosophical advantage. The argument centres on the claimed absence of conflict between the interests of customers and shareholders. Mutuals claim that their single-minded focus on the consumer is embedded in their culture, and this results in a range of corporate behaviours that engender consumer trust.

Supporters of the proprietary form point to the powerful influence of shareholders, especially institutional shareholders with their substantial voting power, in exerting pressure on boards of directors to perform. The argument runs that the members of mutual organizations lack the power required to bring due influence to bear on boards of directors, and that this results in the potential for underperformance and, possibly, the abuse of power. At worst, the CEO could run the firm like some form of personal fiefdom. Indeed, critics of mutuality will often cite the difficulties of Edinburgh-based Equitable Life as an example of how the governance shortcomings of mutuals can have a devastating impact upon consumer interests.

There is also a view that proprietaries enjoy high levels of consumer trust. Research conducted by the Citigate Group shows that mutuals featured only twice in the top-20 trusted investment brands; Standard Life at number 11 and Royal London at number 20. Interestingly, the brands positioned as numbers 1, 2 and 4 (Halifax, Norwich Union and Scottish Widows) were all mutuals until comparatively recently. Critics of this piece of research argue that it confuses familiarity with trust. Undoubtedly, there is reason to believe that consumers do tend to view being a well-known household name as implying trustworthiness. Research carried out by the Financial Services Consumer Panel in the UK appears to bear out the point that consumers use brand presence as a proxy for trustworthiness. Thus, because proprietaries are large organizations with substantial marketing communications budgets, they appear to enjoy a greater degree of consumer trust than do mutuals which, because of their size, are unable to invest in brand-building to

the same degree. There is no doubt that branding is becoming increasingly important in financial services, and the creation of global power brands is likely only to be achieved by major proprietary concerns. The recent attempt by Aviva to spend £17bn acquiring Prudential is clear evidence of intent to create a major global insurance brand. Attractive synergies are to be seen between the two, and Prudential's strength in Asia and the USA would complement Aviva's position in Europe.

In Britain, steps have been taken to address the concerns regarding the governance of mutuals as a result of the Myners' review. For example, the Association of Mutual Insurers was created in 2004, and one of its first tasks was to draft a code of conduct for the governance of its members. This code takes as its core the rules for governance set down by the FSA, which are proprietary-focused, with its explicit references to shareholders and shareholder interests. It adds additional requirements aimed at safeguarding the interests of both members (with ownership and voting rights) and policyholders (who do not enjoy membership rights).

Arguably, there is a role for both proprietary and mutual providers of financial services; both forms provide for the diversity necessary to solve the requirements of the marketplace as it continually evolves. The evidence does seem to support the view that demutualization has not necessarily been in the long-term interests of consumers as a totality. There have been short-term gains to directors in the form of share options, and windfall payouts to those with membership rights. In practical terms, typical forms of mutual providers that are encountered are as follows:

- credit unions
- building societies
- mutual insurers
- co-operative insurers
- friendly societies.

Case study 1.2 provides an overview of how one mutual provider of financial services operates. Both mutual and proprietary forms of financial services supply are to be found in most parts of the world; however, there has been a trend of mutuals converting to proprietary status, most notably in the English-speaking countries of North America, Australia and UK in recent years. Table 1.2 shows the composition of the US insurance market in terms of ownership form.

Table 1.2 Life insurers doing business in the United States*

In business at year's end	2002	2003
Stock	1,060	1019
Mutual	99	92
Other	12	12
Total	1171	1123

*Source: American Council of Life Insurers.

Case study 1.2 Police Mutual Assurance Society Limited (Police Mutual)

Police Mutual provides financial services to the police family. Originally that meant just serving officers, but as the police service has changed so has Police Mutual, and today membership of the Society is open to serving and retired police officers and police staff and their families (which includes partners, children, parents, and brothers and sisters). In essence, it operates as an affinity group-based organization and is a compelling example of how cost-effective and efficient such a model can be. In spite of what would appear to be its somewhat limited market potential, Police Mutual has 176 000 members and manages funds of the order of £1.2 billion.

Police Mutual uses a form of governance that is based upon the delegate method, and has a President, Vice President and Chairman as well as an 80-strong delegate body drawn from the police service. The Society displays an array of significant relative competitive advantages that arise from its affinity-based model. Of particular note is the strength of real democratic involvement in the policy-making of the Society through its delegate conference, as well as the involvement in more operational decision-making through the role played by the Committee of Management. These structures, and their associated processes, facilitate the development of extremely close bonds and relationships between the Society and those it seeks to serve.

The strength of relationships between the Society and its membership is instrumental in supporting its core means of distribution. Its range of savings, investments, pensions, mortgages and insurance services are distributed largely on a direct-offer basis (the launch of an advice service aimed at retiring officers is the only variant from this model), and distribution is via a number of channels, such as direct mail, on-line, phone-based and through a business development team, but also, uniquely, via a network of volunteers known as Authorized Officers (AOs). There are over a thousand AOs, the vast majority of whom are serving police officers, and they perform largely a communication role in displaying and distributing promotional material and directing people to Police Mutual's head office if they have any queries. This role is unpaid and, as a consequence, Police Mutual has extremely low business acquisition costs. Its cost–ratio benefits are reduced further by receiving the majority of its premium contributions by payroll deduction.

The Society has an extremely good record with regard to persistency. In the last FSA survey, the industry 3-year average persistency level for regular premium endowment plans was 84.9 per cent for direct-offer business; Police Mutual achieved persistency of 90.5 per cent. Industry average figures for other distribution methods are even lower, at 81.2 per cent for Independent Financial Advisers and 75.3 per cent in respect of company representatives.

A particular feature of Friendly Societies is their ability to 'go beyond contract'. What this means is that their philosophy and style of mutuality permits them to provide benefits to members under certain circumstances that do not strictly accord with the terms and conditions of any specific policy contract.

Case study 1.2 Police Mutual Assurance Society Limited (Police Mutual)—cont'd

A case in point concerns when the 'Troubles' of Northern Ireland caused police casualties that affected morbidity and mortality experience. It was put to the delegates that this ought to result in members of the Police Service of Northern Ireland (formerly known as Royal Ulster Constabulary) having their premiums rated to reflect the higher risk. In the event, the Society decided to maintain a policy of treating them in the same way as all other members.

It is also important for Police Mutual to be able to react to the needs of the police market, and, perhaps uniquely, it considers wider issues within the police family and provides help and assistance where it thinks it will make a positive difference, even if there isn't necessarily a direct link to current products. Affordable Housing is one such example. The cost of housing in the south-east of England has been a cause for concern for many years. Police Mutual used their financial expertise to develop a solution to this problem, which affects many police officers and staff. Funding was secured from business partners and the scheme helped over 300 people to purchase their homes.

Police Mutual is flexible and innovative, and introduced a stakeholder pension in April 2001 and a Child Trust Fund in April 2005 – both very soon after legislation allowed this. Over the past few years Police Mutual has expanded its own product offerings as well as those offered by business partners, and these relationships have enabled Police Mutual to provide members of the police family with access to exclusive, competitive products.

Police Mutual shows the capability of the friendly society model to provide low-cost, high-value financial services within a highly participative and democratic regime of governance.

1.8 Regulation of financial services

The need to safeguard the interests of key stakeholders in the financial services domain has been an important force driving new approaches to regulation around the world. Governments, trading blocs and various inter-governmental and non-governmental organizations have been pursuing economic growth and trade liberalization for at least the past two decades. There has been a desire to encourage the efficient operation of the financial services marketplace through the removal of traditional sector boundaries and the encouragement of competition. In the UK, the mid-1980s was a watershed in the restructuring of the financial services marketplace and the approach to regulation.

Before this point in time there were quite clear lines of demarcation between the range of products and services that were supplied by banks, insurance companies and building societies. New legislation resulted in the removal of the previous sector boundaries. In this new unbounded marketplace, banks were free to operate insurance companies and insurance companies could apply for banking licences.

During the second half of the 1980s, the government of Margaret Thatcher initiated an ongoing programme of legislation aimed both at the liberalization and regulation of the financial services marketplace. The Financial Services Act 1986 was aimed at defining and regulating investment business, as well as promoting competition in the marketplace for savings. The focus of the FSA 1986 was the conduct of investment business and the accompanying provision of advice. As such, it excluded products such as mortgages, credit card loans, general insurance and short-term deposits, which were subject to separate legislation. In May 1997 the then Chancellor of the Exchequer, Gordon Brown, announced his decision to merge banking supervision and investment services regulation into the Securities and Investment Board (SIB). Later that same year, the SIB was renamed the Financial Services Authority (FSA). In December 2001 the Financial Services and Markets Act was implemented, whereby the FSA became the UK's highest single financial services regulator. As well as being responsible for the regulation of banks and securities, it also assumed responsibility for the following organizations:

- Building Societies Commission
- Friendly Societies Commission
- Investment Management Regulatory Organization
- Personal Investment Authority
- Register of Friendly Societies
- Securities and Futures Authority.

The scope of the FSA was widened further with responsibility for the regulation of mortgages in 2004 and general insurance in 2005. The FSA is an independent non-governmental body which operates as a company limited by guarantee and is financed by the financial services industry. The FSA has a Board which is appointed by Her Majesty's Treasury, and the FSA is accountable to Treasury Ministers and, through them, to Parliament. The Financial Services and Markets Act lays down four statutory objectives for the FSA, namely:

1. Market confidence – maintaining confidence in the financial system
2. Public awareness – promoting public understanding of the financial system
3. Consumer protection – securing the appropriate degree of protection for consumers
4. Reduction of financial crime – reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

The FSA seeks to achieve its objectives by way of a vast array of rules and directives, the contravention of which can result in a range of penalties. It is of the essence that all those involved in financial services provision have a sound grasp of the rules that apply to their particular product sector and functional discipline. The rulebook of the FSA spans an enormous gamut from issues of strategic, overarching significance, such as solvency margins, to matters of fine detail, such as the nature and wording of individual advertisements.

An area of particular significance in a marketing context concerns the development of regulations regarding the distribution and sale of financial services and the integral issue of financial advice. The 1986 Act led to the introduction of what might

be termed the doctrine of polarization. In practice, this meant that financial advice, and any resulting sale, must be provided by one of two variants of advisers. Thus, the concepts of Independent Financial Advisers (IFAs) and Tied Agents (TAs) was initiated. IFAs were to act as *de facto* agents of the consumer, and were bound to give 'best advice' in response to the consumers' financial needs from all possible sources of supply in the marketplace. At the other 'pole of advice' were the TAs, who could give advice and sell products purely from one company. TAs were of two primary forms, namely Company Representatives (CRs) and Appointed Representatives (ARs). The CRs worked directly for the financial services company upon whose products they gave advice and sold products. This could be either as a salaried employee or as an adviser paid on a commission-only basis. Appointed representatives, on the other hand, were staff under the control of a separate company that had a distribution agreement with a given life insurance company. For example, The Cheshire Building Society is an AR of Norwich Union, which means that the financial advisers employed by the Cheshire can only give advice on the products supplied by Norwich Union.

Through polarization, it was intended that the consumer interest would be best served in that consumers would have absolute certainty whether they were receiving completely independent advice or advice on the product of just one company. Prior to this time there was a plethora of *ad hoc* distribution arrangements, and consumers were often unclear regarding the degree of independence that was attached to the advice they received. In practice, the introduction of polarization resulted in a somewhat unedifying scramble for distribution as life companies vied with each other to attract AR and CR arrangements. In the short term, it did nothing to reduce the costs associated with advising on and selling investment products. Moreover, the need for each company with a TA form of distribution to have a full product range available for its agents to advise on and sell did nothing to improve the efficiency of the industry. Arguably, the reverse happened as companies filled out their product ranges with products, some of which were sold in extremely low volumes and offered relatively poor value for money. Standards of financial advice were also slow to respond to the spirit of regulation. Indeed, the mis-selling of personal pensions was at its height between 1987 and 1991, resulting in the so-called 'pension mis-selling scandal' which to date has cost the industry in the order of £15bn in compensation and allied administration costs. Other examples of consumer detriment have arisen since the 1986 Act, including the mis-selling of mortgage endowments and a number of investment schemes.

In 2005, following a lengthy period of consultation, the polarization rules were revised to permit a form of multi-tied distribution. To quote the FSA (www.fsa.gov.uk):

> from 2005, tied advisers selling any type of investment (not just stakeholder schemes) will be able to offer the products of more than one provider if they are tied to a company which has adopted the products of other providers in its range.

A critical step forward in improving the consumer interest was the introduction of new rules regarding the training and competence of advisers in the early 1990s. This acted as a watershed for the industry by introducing more exacting standards

of knowledge that financial advisers and their managers could demonstrate. It also resulted in a significant increase in the costs of employing an adviser. As a consequence, there was a dramatic fall in the number of people involved in advising and selling life and pension products between 1991 and 1996. Some estimates have suggested that this number collapsed from the order of 220 000 to about 50 000 during the 5-year period. This has had the effect of forcing incompetent and unproductive advisers out of the industry, and has thus raised the standard of professionalism of the typical financial adviser.

The preceding commentary and views of just one narrow aspect of financial services regulation are intended to demonstrate the paramount importance that the authors attach to students and practitioners having a sound appreciation of the regulations that apply in their respective countries and industry sectors. Some examples of how the regulation of insurance business is approached in a number of other countries are given in Box 1.1.

Box 1.1 International approaches to insurance regulation

USA: In the USA, each individual state has its own regulator. Their titles vary, depending on the state, and include commissioner, superintendent or director. In some states, governors appoint the commissioner; in others, the general public elects commissioners. The commissioners from the various states together form the National Association (NAIC) to promote uniformity in regulation. Other officials with some oversight functions include the representatives of guaranty funds and certain federal government agencies.

Australia: In Australia, the APRA, or Australian Prudential Regulatory Authority, is the integrated prudential regulator of the Australian financial services industry. It was set up in 1988, and oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance companies, friendly societies and most members of the superannuation industry. The APRA is funded primarily by the industries it supervises.

Singapore: In Singapore, the Insurance Supervision Department is the primary regulator of the Monetary Authority of Singapore (MAS). The Insurance Supervision Department (ISD) administers the Insurance Act, its main objective being the protection of policyholders' interests. ISD adopts a risk-focused approach in the prudential and market conduct supervision of insurance companies. ISD carries out its responsibilities by way of both off-site surveillance and on-site examination, and works with foreign supervisors as part of a holistic supervisory approach. In its standards development role, ISD works closely with industry associations to promote the adoption of best practices by the industry.

South Africa: The Financial Services Board (FSB) was established as a statutory body by the Financial Services Board Act (No. 97 of 1990) and is financed by the financial services industry itself, with no contribution from government. It supervises the control over the activities of non-banking financial services and acts in an advisory capacity to the Minister of Finance.

Box 1.1 International approaches to insurance regulation—cont'd

India: In 1999, the Insurance Regulatory and Development Authority (IRDA) was set up to regulate, promote and ensure orderly growth of the insurance business and reinsurance business.

Source: Faye Lageu, Vice President, Intelligence Unit ICMIF.

1.9 Summary and conclusions

The financial services industry has a vital role to play in safeguarding the prospects for economic development across the globe. At the micro-level, financial services underpin the overall well-being of individuals. The challenge is for standards of marketing within the financial services domain to reflect the necessary degree of market and consumer orientation. An appreciation of the potential offered by financial services marketing requires it to be placed within the context of government-sponsored welfare systems on a country-by-country basis. The state and private sectors of financial services have to work in a complementary manner if aggregate stakeholder interests are to be optimized. Finally, financial services ought to be provided for the benefit of all, not just the affluent few.

Review questions

1. Identify and critically evaluate the respective roles of the state and private sectors in the provision of healthcare, education and welfare in your country. To what extent do you consider that the two sectors complement or compete with each other?
2. What forms of mutual financial services provision take place in your country? Compare and contrast the ways in which mutuals and proprietary providers serve the needs of your country's citizens.
3. Which body (or bodies) is responsible for the regulation of financial services in your country? What are its principal goals, and to what extent do you think it is successful in achieving them?
4. How are the provision of financial advice and sale of financial services products regulated in your country? To what extent do you think those regulations safeguard the interests of private consumers and business customers?
5. Some people would argue that the resources devoted to corporate social responsibility (CSR) represent theft from the shareholder. How do you feel that CSR impacts upon the interests of various stakeholder groups?

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2

The financial services marketplace: structures, products and participants

Learning objectives

By the end of this chapter you will be able to:

- identify the different types of organizations engaged in the provision of financial services
- understand the range and diversity of financial services and how they relate to customer needs
- comprehend the complexity of the industry.

2.1 Introduction

All too often difficulties are encountered associated with the overall use of the term financial services. A large proportion of the general public – including many consumers – has a limited appreciation of the geography of the financial services landscape. This is partly because of the complexity of the industry and partly because, for many people, financial services are intrinsically uninteresting. Poor knowledge and understanding of the sector as a whole and of the product sectors it comprises also applies to those employed in the area. Research conducted by Alferoff *et al*. (2005) revealed that the knowledge base of the typical financial services employee was limited to his or her narrow field of task expertise:

> Many front-line and back office staff did not understand some or all of the range of investment products. They were in fact little more knowledgeable than

> non-financial services respondents and even less knowledgeable than those from the Chamber of Commerce or MBA students (other groups comprising the sample frame of the study).

Equally, there are people within practitioner communities who display only a partial knowledge of the big picture beyond their functional area.

This chapter aims to provide an overview of the financial services sector from two perspectives. First, it will set out to describe the geography of supply. The early sections will seek to identify the major groupings of organizations that make up the significant forms of product/service supply. Secondly, the chapter will seek to provide a solid grounding in the products that comprise financial services. It does not set out to discuss every possible product type and variant that may be encountered in all parts of the world; rather, it seeks to identify the major product variants that are commonly encountered. Prior to exploring the marketplace in detail, the chapter begins by providing some historical context for the industry.

2.2 Some historical perspectives

Whilst various forms of financial services provision can be traced back many centuries, the development of commercial organizations of substance and scale coincided with the expansion of international trade as the eighteenth century progressed. Indeed, economic development is inextricably linked to the development of allied financial instruments. Banks grew in response to the need for services such as loans, safe deposit and financing of consignments of exported and imported goods. Commercial banking in the UK originated in London, based largely upon the growth of goldsmith bankers in the mid-seventeenth century. A century later, the number of provincial banks was still in single figures. However, by 1784 the number had grown to 119 and by 1810 had expanded to some 650 (information provided courtesy of the Royal Bank of Scotland). Banking grew similarly apace in Scotland in response to rapidly expanding trade, and similar trends were in evidence throughout Europe. Interestingly, the great majority of these banks were based upon just one branch; the consolidation process had yet to commence. The proliferation of banking firms resulted in the need for the creation of a clearing house in London for the settlement of inter-bank payments.

Numerous sources across the globe attest to the link between economic development and the expansion of a financial services sector. The changing needs of commerce required banking to adapt. Trinidad is cited as an example of the need for greater flexibility going back to the latter part of the nineteenth century (Paria Publishing Co. Ltd, 2000):

> In that time of economic growth the Colonial Bank's old way of doing business in the West Indies was challenged by the West Indian Royal Commission for their excessively restrictive lending policies. The commission was told by several peasant witnesses, black people and 'cocoa pa-ols' of the necessity for loans to expand their small operations.

In Iran, banking in its modern form also began to emerge in the mid-nineteenth century. It was not until 1925 that the first bank was established with Iranian capital in the form of the Bank Pahlavi Qoshun. In Ethiopia, the Bank of Abyssinia was inaugurated in 1906 and was given a 50-year concession period. In short, throughout the world there are well-documented examples of the development of commercial banking from the nineteenth century onwards.

As with banking, insurance too can be traced back to seventeenth-century London. The Great Fire of London in 1666 must have acted as a major catalyst for the provision of a suitable form of insurance for perils of this nature. *The History of Insurance* (Jenkins and Yoneyama, 2000) observes that some of the earliest companies identified include the Sun Fire Office, Royal Exchange Assurance and Hand in Hand. In its commentary on the historical development of insurance, the Insurance Bureau of Canada (www.ibc.ca/gii_history) observes that:

> The history of insurance is the story of Western society's development. As agriculture gave way to industrial growth it became clear that expansion depended on capital money that would be risked for the profit it offered. For those risk-takers, insurance provided a guarantee that all would not be lost through error, bad judgement or bad luck.

It was during the sixteenth century that the forerunners of Lloyd's of London met in Lloyd's coffee house and devised the means by which risk could be mitigated. Again, the need to protect the risks associated with international trade was the primary catalyst for this development. The eighteenth century saw the development of general insurance in what is now the USA. Indeed, Benjamin Franklin, one of the signatories to the US Declaration of Independence in 1776, was also the founder of the Philadelphia Contributorship for the Insurance of Houses from Loss by Fire in 1752. The closing years of the eighteenth century saw the birth in England of a type of insurance company called a friendly society. Friendly societies grew apace during the nineteenth century; many of them began as burial societies and, as the name implies, set out to provide the funds for a respectable burial for their members. By 1910, almost 7 million British citizens were policyholders in friendly societies.

In common with friendly societies, the later part of the eighteenth century saw the initiation of building societies in Britain. The first known society began in 1775. It was known as Richard Ketley's Building Society, and its members met at the Gold Cross Inn in Birmingham. By 1860 there were in excess of 750 societies in London alone, and a further 2000 outside of the capital (Building Societies Association, 2001). Building societies arose and prospered from the desire of ordinary women and men to finance the purchase of their own homes. The twentieth century saw building societies go through a process of consolidation into fewer but larger organizations. Subsequently, during the course of the final decade of the twentieth century, a number of societies (notably the larger ones) converted to become shareholder-owned proprietary companies. Thus, names such as the Halifax, Abbey National, Alliance and Leicester, Northern Rock, Woolwich, Cheltenham and Gloucester, and Bradford and Bingley are no longer building societies but operate as quoted banking companies on the London Stock Exchange or have been taken over by other banking organizations. The Building Societies Association identifies that, as at 2002, its members numbered some 65 societies with combined assets of over £170bn.

In an era of suspicion and mistrust of the financial services industry, it is easy to lose sight of the fact that the product and services it provides make a major contribution to the well-being of citizens across the globe. Economic development and prosperity cannot flourish in the absence of a suitable infrastructure of financial services provision. Indeed, it is interesting to note the desire of the Syrian government to promote economic development by breaking the monopoly of its state bank in 2003 with the award of licences to three privately owned banks, namely the Banque de Syrie et d'Outre Mer, The International Bank for Trade and Finance and the BEMO-Saudi-Fransi bank. This is a measured and creative means of introducing competition in a sector characterized by state control. It is expected that this process will be replicated elsewhere in the world as currently underdeveloped countries seek to embrace economic progress.

2.3 The geography of supply

The structure of financial services marketplaces around the world varies according to local environmental characteristics. Factors such as the stage of economic development, government policy on competition, and regulation all exert an influence on local market structures. Physical geography, logistics and infrastructural features such as telecommunications also have a part to play in determining the local evolution of financial services, as do social, religious and cultural factors.

A feature of the recent financial services landscape has been the breaking down of boundaries between historical lines of demarcation of supply. Deregulation of markets, such as that which occurred in the UK in the mid-1980s, has blurred the lines that hitherto separated the domains of banking, insurance and mortgage lending. The Financial Services Act 1986 had two primary purposes: first, it set out to define and regulate investment business; and secondly, it sought to promote a greater degree of competition in the market for savings products. The practical consequence of this and other related legislation, such as the Building Societies Act 1986, was to create what might be termed 'unbounded' financial services markets. No longer would the current account be the sole domain of the traditional high-street banks, or mortgages for residential property be limited to building societies, or life assurance and pensions be supplied solely by insurance companies. Instead of product supply silos we have witnessed the metamorphosis of banks, building societies and insurance companies into financial services organizations spanning the range of core money management, loan, pension and investment products. Worldwide, the most obvious manifestation of this process has been the emergence of *bancassurance* (or allfinanz), a distribution system which involves partnerships between banks and insurers to make insurance products available via bank networks.

The idea of retailers selling insurance has not been a significant feature in other countries. For example, in the US, regulation is such that it is not allowed. In France, it is argued that such an approach would not sit well culturally. To the best of the authors' knowledge, banks are really the only alternative channel for the rest of the world. Bancassurance has had major take-up in most European countries. In Canada, however, by law, any bank selling insurance in its branch is still required to have a separate sales counter.

However, in spite of the breaking down of legal lines of product demarcation, banks, building societies and insurance companies have retained a degree of core competence that reflects their historical strengths. Thus, breadth and depth is still vested in the product set of the company's heritage. For example, whilst Barclays provides a vast array of retail financial services, it retains a wealth of expertise in core banking skills which the banking arm of, say, an insurance company would not typically possess. Barclays can offer a far wider range of business-related banking services than can, for example, Standard Life Bank. Moreover, in spite of remote forms of banking (such as the telephone and Internet), bank branches remain an important part of the banking proposition that non-branch based organizations cannot fulfil.

In a similar way, insurance companies retain a degree of capability that the insurance arm of, say, a building society is unlikely to possess. For example, flexibility has become a growing requirement for the pensions industry, and features such as pension drawdown and Self-Invested Pensions Plans are a common need of Independent Financial Advisers (IFAs). Companies such as Legal and General and Friends Provident have such facilities as part of their core product set. On the other hand, the Nationwide Building Society has a more basic approach to pensions (industry jargon often refers to 'vanilla' or 'plain vanilla') and does not currently provide that degree of sophistication within its range of pension products. Equally, the Nationwide offers much wider range of deposit-based savings options than does, say, Skandia Life.

In simple terms, the geography of product providers is based upon the core elements outlined in Table 2.1.

As already discussed, the marketplace is far more complex than it has been historically, with large, diversified financial services groups spanning many of the above core product domains. Nonetheless, many companies can be found that are specialists with a narrow product focus. Sometimes these are specialist arms of larger organizations – such as the Zurich Financial Services subsidiary Navigators and General, which specializes in insuring small boats. Equally, there are independent companies that retain a discrete niche focus – such as Cattles Plc, which specializes in providing unsecured loans to the near prime market.

Table 2.1 The geography of supply

Type of activity	Specific forms
Banking	Retail banks/Commercial banks
Savings and Loans	Building Societies (UK)
	Credit Unions
	National Savings
Insurance	Life Insurers
	General Insurers
	Friendly Societies (UK)
	Health Insurers
	Lloyd's syndicates
Investment companies	Mutual fund/Unit Trust Companies
	Investment Trusts
	Pensions providers

A further feature of the geography of supply is the evolution of what are often termed 'new entrants', although they are no longer quite so new. This term refers to providers with no historical pedigree as suppliers of financial services. For these companies, the move into financial services is part of an overarching strategy of brand stretch as a means of diversification. Examples of such 'new entrants' in the UK include Virgin, Marks and Spencer, and leading supermarkets Asda, Tesco and Sainsbury.

The 'new entrants' tend to be based upon fairly simple products that are, typically, bought rather than sold. Examples include general insurance products, such as motor, travel and home contents insurance, which are commonly found in display racks at the checkouts in supermarkets. There is a feeling that there are limits to the extent to which the core brand can extend into financial services (Devlin, 2003), and that consumers form a view on the saliency of certain brands and supplier types. Thus, for example, consumers might feel comfortable with purchasing a basic general insurance product from a supermarket, but may have reservations about purchasing a more complex, specialist financial service (such as a pension) from such a non-specialist provider. Consumer perceptions of an organization's core competences have important implications for the marketing strategies of those involved with the supply of financial services.

A further complication concerns the issue of distribution. Whilst many services are provided to consumers on what might be termed a direct basis, third-party distribution arrangements are often an important feature of financial services. In the UK, for example, the Financial Services Act 1986 led to the creation of IFAs and Appointed Representatives (ARs). IFAs and ARs are deemed to represent either end of a polarized form of financial advice. At one end of the pole is the IFA, who acts as the agent of the consumer and must give product recommendations that represent best advice from sources of supply. At the other end is the AR, who must give best advice based upon the products of just one provider company. The AR may be a member of a distribution network owned by the product provider, such as Nationwide Life (part of the Nationwide Building Society); alternatively, the AR could be a third-party organization that has an agreement to advise solely on the investment products of a separate insurance company. An example of this latter arrangement is to be found in Barclays, which is an AR of Legal and General. Thus, no understanding of the geography of supply would be complete without taking due account of organizations involved in product distribution.

2.4 An outline of product variants

The purpose of this section is to provide a solid grounding of the key product variants that comprise the domain of retail financial services. Readers wishing to learn about aspects of the wholesale market are referred to Pilbeam (2005).

It is arguable whether this issue should be addressed from the perspective of specific products, or the needs such products seek to satisfy. The adoption of a pure product focus is problematic on both philosophical and practical grounds. From a philosophical viewpoint, it places undue focus upon the products provided rather

than the needs of consumers. In so doing, it offends the sensibilities of those who place consumer needs, as opposed to products supplied, as the fulcrum of a marketing orientation. For such individuals, any intimation of 'product orientation' is to be avoided wherever possible. At the practical level, it is just not feasible to identify every possible product variant from around the globe in a text of this nature. Therefore, a pragmatic approach has been adopted whereby significant mainstream consumer needs are presented together with typical product solutions that are widely encountered. This approach is summarized in Table 2.2.

The needs and product solutions given in Table 2.2 are representative of those that are typically encountered throughout the world. It does not set out to be exhaustive, but gives a sound overview of generally expressed needs and the means of addressing them. The following sections of this chapter set out to tie together consumer needs with product solutions and the means of supply in order to enable the reader to develop some sense of the real world of financial services.

2.5 Banking and money transmission

Until the latter part of the twentieth century, the provision of current account services was the sole prerogative of the high-street clearing banks. The current account represents the primary means by which salaried employees receive payroll credits from their employers and manage payments and cash withdrawals. The extent of current account penetration in a given country typically reflects the proportion of the population paid by salary. Thus, in the UK some 95 per cent of the population have bank accounts, while in India the proportion is probably around 15 per cent and in South Africa it is estimated to be between 30 per cent and 40 per cent ((http://in.rediff.com and www.euromonitor.com, both accessed January 2005).

In addition to the traditional high-street banks, building societies in the UK also often provide current accounts. Indeed, those building societies that demutualized, such as Alliance and Leicester, the Halifax and Bradford and Bingley, became known collectively as mortgage banks. This term reflects the relative importance still attached to the provision of residential mortgages, and their orientation towards the retail sector. As yet, the mortgage banks have not made any material impact upon the business and corporate banking arena. As previously observed, there is a saliency issue in that businesses do not yet view mortgage banks as being credible suppliers of business banking services. Competitive pressure has been responsible for a great deal more price-competition for personal current accounts. The payment of interest on current account balances was almost unheard of in the UK until the second half of the 1980s. It could be argued that the rate of interest paid on the typical current account is so derisory that many consumers benefit from such payment to only a limited degree.

Current account supply has broadened ever further in recent years as a consequence of factors such as technological development and the arrival of the so-called 'new entrants'. Initially, telephone banking, pioneered in the UK by First Direct, facilitated lower-cost current account provision and the payment of interest on current account positive balances. Costs have been lowered further still by the advent

Table 2.2 Customer needs and product solutions

Consumer need	Product solution
A secure depository for readily accessible cash	Current accounts
A means of managing receipts of funds and payment of expenses (money transmission)	Current accounts
A secure depository for cash that pays interest	Current accounts Deposit accounts Credit Union deposits
A simple means of accumulating a fund of cash on which interest is paid	Deposit Accounts High-Interest Current Accounts
Tax-advantaged cash savings for the medium term	Cash ISA[5] (Individual Savings Account)
A means of accumulating a lump sum in the medium to long term	Regular Saving endowments Regular saving mutual funds, such as OEICS[6] and Unit Trusts
A means of investing a lump sum for long-term growth	Mutual Accumulation funds Investment Bonds Investment Trusts Corporate Bonds Government bonds
A means of investing a lump sum to generate income	Mutual Income Funds Income Bonds Corporate Bonds Annuities
A means of saving for retirement	Occupational Pension Schemes Personal Pensions 401k Savings Schemes[7] Central Provident Fund[8]
A means of deriving income from a Pension Fund	Annuities Income drawdown[9]
A means of financing current consumption from future earnings or income	Credit cards Unsecured loans Secured loans
A means of financing home purchase	Residential mortgages
A means of releasing liquid funds from one's residential property	Equity release schemes
A means of protecting outstanding loans	Payment protection insurance Mortgage indemnity guarantees
A means of protecting tangible assets from fire, theft, accidental damage and perils of nature	General insurance
A means of protecting people and organizations from claims for pecuniary loss arising from negligence, oversight or non-performance of duties	Liability insurance
A means of protecting human assets from risks associated with death, illness and medical conditions	Life Assurance Critical illness insurance Health insurance Permanent Health insurance

Box 2.1 Price competition among Internet banking providers in the UK

When Sainsbury's bank launched its current account in 1992, it offered an interest rate of 6 per cent on positive current account balances. This sparked something of a current account interest rate war, with Tesco offering 6.5 per cent when it subsequently launched its high-interest rate current account, only to be topped by the Prudential offshoot, Egg, when it launched in 1995. At the time of writing, Egg is the highest-paying current account provider, paying a gross rate of 5.50 per cent. However, Egg is solely an Internet bank, and consumers must judge the extent to which this offsets the disadvantages of not having access to a branch network.

of Internet banking. This new technology has enabled new entrants to offer so-called high-interest current accounts, as illustrated in Box 2.1.

Technology and changing consumer tastes have also facilitated greater diversity regarding money transmission and payments. The usage of cheques has declined significantly in recent years owing to factors such as the growing use of debit and credit cards. According to the British Bankers Association, the number of cheques handled by the clearing system has fallen from a peak of 4.472bn in 1990 to 2.454bn by 2004. Cheque usage fell by 39 per cent between 1994 and 2004, and is predicted to fall a further 44 per cent by 2014. This has made it easier for new entrants and virtual banks to compete in the market for current accounts.

The introduction of interest-bearing current accounts has served to drive margin out of these aspects of banking. It could be argued that it has also acted as a catalyst for suppliers to become increasingly stealthy in terms of how they levy charges. UK banks and others have come in for growing criticism regarding what are often considered to be opaque charging practices. Charges for services such as unauthorized overdrafts and the presentation of cheques on accounts with insufficient funds have added to a popularly held sense of mistrust in the banks. The counter-argument is that financial institutions have to find a means of covering the costs of providing current accounts, given that they are now interest-bearing. Admittedly, providers of current accounts do advise their customers of their menu of charges from time to time – indeed, they are obliged to do so by law. However, the overall approach to charging acts to favour the financially astute and well-off, whilst penalizing those who are less affluent and less financially aware.

The current account has increasingly become a 'loss-leader' – that is, it is seen as acting as a gateway for the sale of other products that offer meaningful margin potential. Indeed, it has been suggested that the majority of current accounts held by the typical clearing bank are loss-making. This has resulted in the need to cross-sell other products and services via what are termed customer relationship management (or marketing) programmes (CRM for short). This particular marketing phenomenon will be addressed in full in Part III of this book.

2.6 Lending and credit

The provision of loans is one of the oldest financial services, dating back thousands of years. In a sense, it performs a key role as a facilitator of income smoothing by enabling consumers to enjoy current consumption from future earnings. Such a process seems entirely defensible under circumstances where there is an expectation of future income surpluses to fund prior income deficits. Equally, it makes eminent sense in respect of purchases of a magnitude well beyond current income, such as residential property mortgages. The difficulties arise when there is a mismatch between current consumption expectations and future income surpluses. In short, the affordability of credit has become a major concern through the world. For example, in May 2004 the *Straits Times* in Singapore ran a series of features highlighting the problems of over-indebtedness, especially with regard to young people.

In addition to affordability, there is a somewhat philosophical concern regarding the relationship between the timescale of the consumption experience and the repayment of any accompanying form of loan or credit. The traditional view was that short-term loans and credit should apply to short-term forms of consumption. Examples of this are, say, loans of up to 12 months' duration to pay for a holiday, or short-term credit to fund clothing purchases. The corollary to these are long-term loans, such as 25-year mortgages to fund home purchase. In between lie intermediate loans for purchases of cars and consumer durables such as furniture. Traditional practice has been for consistency between the purpose of loan (in terms of timescale of the consumption experience) and the duration of the repayment period. In recent years there has been a weakening in this relationship, principally by individuals obtaining long-term loans for short-term consumption. Indeed, the Halifax was criticized on the BBC Radio 4 programme *Moneybox* (29 January 2005) for a direct mail exercise that offered a mortgage repayment holiday of up to six months to allow customers to enjoy additional current consumption. Critics of the promotion were concerned at the lack of transparency regarding the long-term impact upon interest payments. In effect, there were concerns that short-term consumption pleasure would be at the expense of long-term interest repayments.

Consumers face an enormous array of loan and credit arrangements. In simple terms, a loan represents the granting of a specific sum of money to an individual or organization for them to spend personally in respect of some specific, previously agreed item. Credit, on the other hand, refers to a means of financing an item or items of expenditure whereby the funds are transferred to the product provider directly by the source of credit. In this way, the consumer receiving the goods or services financed by the credit undertakes to reimburse the credit provider for the principal sum plus any interest that may be due.

The principal types of loans encountered are shown in Table 2.3.

A mortgage may appear to be a straightforward product, simple in design and pricing structure. In practice, the range of mortgages available has become increasingly complex. In February 2005, the Portman, based in Bournemouth in the UK, had some eleven separate mortgage products in its home-loan range, as shown in Table 2.4.

Table 2.3 Types of loan

Loan type	Key characteristics
Unsecured loan	Relatively high interest rates to compensate lender for lack of security.
Secured loan	Usually secured on the borrower's residential property equity via a second (or subsequent) charge, these are known as second mortgages. Relatively low interest rates charged owing to the presence of the security.
Mortgages	A loan made for the purpose of purchasing one's home. Typically a long-term loan which is at a relatively low rate of interest and is secured upon the property. In the UK most mortgages are variable, whereby the rate of interest charged fluctuates as base rates vary. Many other countries favour the certainty of fixed-rate mortgages.
Re-mortgage	This too applies to situations in which a homeowner wishes to replace an existing mortgage with one from another lender. This normally occurs because the borrower can obtain a home loan at a lower rate from an alternative lender.
Equity release schemes	These are loans that are secured upon residential property for older people. There are two principal variants one by which the lender secures an interest in the property and the other which does not.

Consumers are therefore presented with an array of mortgage offers with different terms and conditions and different prices, and Table 2.4 demonstrates the complexity associated with what might be expected to be a relatively straightforward product. It must be said that the degree of complexity grows when other mortgage variants are added to the array of possibilities, such as endowment, interest-only and deferred-interest mortgages.

Business loans are also to be found in both secured and unsecured forms. In contrast to personal loans, business secured loans will consider a much wider range of assets as potential sources of security.

Principal forms of personal unsecured credit are as follows:

- credit cards
- storecards
- unsecured loans
- credit vouchers and cheques
- pawn-broking
- home credit
- overdrafts.

The scale of the growth in credit has been dramatic in the UK during this decade, so far. Total net outstanding lending to individuals broke through the £1 trillion barrier in 2005 and, as can be seen from Table 2.5, has continued to grow.

Secured/unsecured credit provision has grown dramatically in the UK since 1994, and reached outstanding balances of £1 trillion in 2003. The scale of outstanding loans was equivalent to £17 000 of debt for every man, woman and child. Put another way, this level of debt exceeds the whole external debt of Africa and South America combined. The growth of indebtedness is to be found in many countries, as

Table 2.4 Portman Building Society mortgage products, 2005

Product	Initial interest rate (%)	Changing to for rest of term (%)	Overall cost rate (%)	Further terms and conditions
2-year fixed	2.35%	6.74%	6.3%	£500 acceptance fee
2-year fixed	4.48%	6.74%	6.7%	£399 acceptance fee
2-year fixed cashback	4.85%	6.74%	6.7%	£250 cash back for valuations up to £500,000
3-year fixed	4.79%	6.74%	6.7%	£499 acceptance fee
3-year fixed cash back	4.95%	6.74%	6.6%	No acceptance fee, free valuation and £250 cash back for valuations up to £500,000
5-year fixed	4.89%	6.74%	6.6%	No acceptance fee, free valuation and £250 cash back for valuations up to £500,000
5-year fixed cash back	4.99%	6.74%	6.35%	No acceptance fee, free valuation and £250 cash back for valuations up to £500,000
2-year discount	4.48%	6.74%	6.7%	£399 acceptance fee
2-year discount cash back	4.85%	6.74%	6.7%	No acceptance fee, free valuation and £250 cash back for valuations up to £500,000
Flexible tracker	4.99%	5.50%	5.7%	£399 acceptance fee, interest calculated monthly with daily adjustment, no early repayment charge.
2-year base-rate tracker	4.69%	5.50%	5.7%	£399 acceptance fee, Early repayment charge of 4% of balance on which interest is charged until 31.03.2007

The published terms and conditions specified that:

ALL PRODUCTS (EXCEPT CASH BACK AND EASY REMORTGAGE) AVAILABLE UP TO 95 per cent WITH A HIGHER LENDING CHARGE PAYABLE OVER 90 per cent.

Table 2.5 Net lending to individuals

	£ millions			% changes on year; seasonally adjusted		
	Secured	Unsecured	Total	Secured	Unsecured	Total
2002 Jan	595,856	142,070	737,927	10.2	14.5	11.0
2003 Jan	682,417	157,778	840,195	13.6	15.0	13.9
2004 Jan	782,665	167,627	950,292	15.0	13.8	14.8
2005 Jan	882,812	183,946	1,066,758	12.5	14.2	12.8
Apr	902,964	186,858	1,089,822	11.3	13.5	11.7
Jul	924,633	189,367	1,114,001	10.4	12.0	10.7
Oct	947,797	191,112	1,138,909	10.1	10.7	10.2
2006 Jan	974,582	193,183	1,167,765	10.6	8.7	10.3

Source: Bank of England.

the consumer culture extends its spread. Figures from the Bank of England suggest that the ratio of household debt to household income in 2003 was around 200 per cent for the Netherlands; around 140 per cent for the UK, the USA and Australia; around 120 per cent for Japan; and fractionally above 100 per cent for Germany.

2.7 Saving and investing

2.7.1 Background

Saving and investing represents the reciprocal of lending and credit. Whereas the latter concerns the allocation of elements of future income in order to finance current consumption, the former concerns sacrificing present consumption in order to provide for some future consumption event or requirement. It is interesting to note that disagreements exist between various groups of practitioners regarding the exact definition of these terms. One group, typically those in the life-assurance sector, regards *saving* as referring to a process whereby sums of money are contributed to some form of saving scheme on a regular basis in order to accumulate a large capital sum at a future point in time. This process of accumulation could see the contributions credited to any of the array of asset classes that are available. The asset classes could include cash-based deposit accounts, such as bank or building society accounts, or pure equity-based vehicles, such as a mutual-fund saving product. In other words, it is the *process* of making a regular contribution that is deemed to be saving rather than the characteristics of the asset class into which the contributions are made. This group of practitioners regards *investment* as the process by which lump sums, which have already been accumulated, are deployed to achieve one of two goals: generation of income or further capital growth. Again, the nature of the underlying asset class is not the issue, as it could be anything from cash to equities.

By contrast, there is another group, typically found in the banking community, that uses *saving* not as a verb but rather to describe a certain class of asset – namely, those that are cash-based. *Investment*, on the other hand, concerns the accumulation and deployment of funds into non-cash asset classes such as bonds, equities and property.

Throughout this book, the term 'savings' will be used to describe a process associated with the accumulating of a larger fund through regular contributions, while the term 'investment' will be used to describe the process of managing a lump sum for the purpose of income or further capital growth.

Numerous studies have pointed to the benefits that accrue to individuals from having recourse to some form of financial assets, however modest. In the USA, Page-Adams and Sherraden (1996) reviewed the finding of 25 studies that addressed the personal and social effects of asset-holding, including: personal well-being, economic security, civic behaviour and community involvement, women's status, and the well-being of children. The studies that were analysed indicate the positive effects that assets have on life satisfaction, reduced rates of depression and alcohol misuse. It was noted that assets appear to be associated with an individual's sense of self-direction and being orientated towards the future. In discussing the beneficial impact of the Central Provident Fund in Singapore, Waite (2001) noted that there is a positive association between assets and higher levels of social status for women in particular.

Of particular note is the evidence that points to the beneficial effects of asset-holding on children, especially with regard to children from low-income families. The USA introduced the Assets for Independence Act in 1998, which has served as a catalyst for the majority of states to introduce asset-accumulation programmes. The Act was an attempt to address poverty by building wealth among the poorer sections of society rather than just by redistributing income.

The notion that the encouragement of personal financial assets, albeit of quite modest proportions, represents a social policy goal has resonated with governments across the globe. In Singapore, the government has introduced an analogue to America's IDA called the Children's Development Co-Savings Scheme. Introduced in April 2001, this new approach to saving comprises two elements: the Baby Bonus and the Children's Development Account (CDA), known as 'tier one' and 'tier two' respectively. Under the provisions of the Baby Bonus scheme, parents receive a cash payment of $500S for their second child and $1000S for their third. Every year for the next five years, the parents will receive an additional $500S and $1000S respectively for the second and third children. Thus, there will be payments totalling $3000S and $6000S for the second and third children of the family respectively. In commenting on this scheme, Sherraden observes:

> In domestic policy, it {Singapore} is probably the most innovative nation on the planet ... the baby Bonus and CDA policy is a bold and positive step forwards.

Also in Asia, the Taiwanese government introduced the Family Development Account in June 2000. The FDA is a matched savings scheme aimed at low-income families, and forms part of the government's strategy to relieve poverty.

Research in the UK by Brynner and Despotidou (2000) has corroborated evidence from the USA regarding the impact of financial assets on life outcomes. Their study has played a role in the decision by the British government of Tony Blair to introduce the Child Trust Fund and saving gateway. The Child Trust Fund is a scheme whereby children born after September 2002 are eligible to receive a lump sum from the government – £500 for those from less affluent families, or £250 for those from more affluent families. The scheme went live with effect from April 2005, and Case study 2.1 outlines the responses of one provider, Family Investments.

Thus there is a growing realization of the benefits to be gained from encouraging the saving habit. The remainder of this section provides some perspectives on the nature of the savings and investment markets and producers.

Case study 2.1 Family Investments and the Child Trust Fund – an example of private-sector support for public policy

The Child Trust Fund (CTF) represents the UK government's most radical initiative to date in the area of asset-based welfare. The principal aim of the CTF is to provide every child in the country with a nest egg of savings when they reach adulthood at age 18. All children born on or after 1 September 2002 and whose parents or guardians are in receipt of child benefit are included in the CTF scheme.

Case study 2.1 Family Investments and the Child Trust Fund – an example of private-sector support for public policy—cont'd

The mechanics of the CTF are as follows; when a parent registers for child benefit, he or she also receives a CTF voucher worth £250, an Inland Revenue booklet explaining the CTF scheme, and a list of companies which are involved in its provision. The parent then contacts a CTF provider to set up a CTF account for the child and sends the voucher to the provider, who then claims the money from the Inland Revenue to invest in the particular CTF account. Once this has been done, voluntary savings of up to £1200 per annum can be added to the account by parents, grandparents or indeed anyone involved in the financial welfare of the child. The government automatically sets up CTF accounts for children whose parents do not do so. The money placed into a CTF account accumulates free of income and capital gains tax, and may be invested into various asset classes, including equities, bonds and cash.

A key feature of the scheme is that money deposited in a CTF account is owned by the child and will be locked in the account until he or she reaches 18. Only in extreme cases involving the death or terminal illness of the child can the money be accessed before the age of 18.

According to Family Investments:

> As the leading provider of long-term tax exempt savings for children, Family Investments sees the CTF as an exciting addition to our product range.

Our analysis of the market is that, as with anything new, it will take time for the public to get used to the CTF, especially because of its universal nature, which means that over half the parents involved will be new to long-term savings in any form, let alone saving specifically for children. On the other hand, with an official launch date of 6 April 2005 but eligibility backdated to 1 September 2002, some 1.6 million vouchers have been issued in the first quarter of 2005, giving a massive kick-start to the CTF scheme.

Despite the best endeavours of the Revenue, which has issued a comprehensive brochure explaining the CTF, many parents remain confused by the choices available to them. Our approach has been to keep our proposition as simple as possible. This we have done by solely promoting the CTF stakeholder account, which we believe over 18 years carries the best balance of risk and return on the money invested.

Secondly, we have used our existing expertise in the children's savings market to put our proposals to parents at the right time using our established marketing style involving the Mr Men characters, with which many parents are familiar.

Thirdly, we have partnered with a number of well-known and trusted brands whose endorsement will provide confidence to people entering the savings

Continued

Case study 2.1 Family Investments and the Child Trust Fund – an example of private-sector support for public policy—cont'd

market for the first time. Our present partnerships include Barclays, Sainsbury's Bank and the Post Office, and altogether Family's CTF has exposure through more than 18 000 high-street outlets, making it easily the most widely available CTF.

Finally, we have devised a number of ways to encourage voluntary savings which we believe are simple to understand and use. We see this as a vital part of the overall scheme because unless as a provider we are able to help more people to save, the scheme will have limited meaning.

Our long-term aim is to make the Family CTF as recognizable, as available and as easy to use as, say, Heinz Baked Beans. These are early days, but the signs are encouraging.

Source: John Reeve, Chief Executive, Family Investments.

2.7.2 Saving

Deposit accounts

The accumulation of a larger sum from small contributions can be accomplished in a wide variety of ways. The simplest vehicle for savings is some form of cash-based deposit account, such as those offered by a wide range of providers in countries across the world – including post offices, banks, building societies, credit unions and some of the newer entrants, such as retailers like Sainsbury in the UK. It is worth pointing out that product innovation has somewhat blurred the boundaries between current and deposit accounts in recent years. Indeed, many high-interest current accounts offer significantly higher rates of interest to depositors than those offered by traditional deposit accounts.

The typical deposit account might be considered to be a somewhat passive approach to saving in that additional contributions tend to be made on a largely *ad hoc* basis. Whilst the facility exists for arrangements such as direct debits to be used to make regular contributions into a deposit account, this is not the norm. Cash deposits act as a default option for individuals who either do not want a more disciplined approach to saving or feel ill-equipped to pursue a more sophisticated approach to saving for the future.

Pensions

Saving cash sums in a deposit account on an *ad hoc* basis represents the simplest form of saving, whereas pensions represent arguably the most complex form of saving. Indeed, a pension is nothing more than a form of saving for a future event. The event in question is the time at which an individual ceases full-time employment.

It is normal for there to be some form of incentive from the government to engage in this form of saving. The rationale is simple: the greater the extent to which individuals provide for their own retirement needs, the less will be the burden placed on state finances and the taxpayer.

It is customary to conceptualize pensions as being either personal or occupational. Whereas the former is a scheme which is entered into on behalf of the individual, typically by that individual, the latter is a group scheme run on behalf of an employer.

Occupational pension schemes (OPSs) are principally of two types: defined benefit (also known as final salary) and defined contribution (also known as money purchase). Defined benefit schemes enable employees to accumulate a pension entitlement that is based upon a proportion of their salary in the 12 months leading up to their date of retirement, hence the term 'final salary'. In the typical scheme, each year of pensionable service will entitle employees to a pension equivalent to one-sixtieth of their final salary. Such a scheme would be termed a 'sixtieth' scheme. Less generous employers may offer an 'eightieth' scheme, whereas more generous firms may offer a 'fortieth' scheme. There are usually rules that limit the maximum number of pensionable years too; in the case of the UK, this is a pension equivalent to two-thirds of the employees' final salary. For example, individuals working for a company with a sixtieth scheme would have to work for the firm for 40 years to be in receipt of the maximum pension of two-thirds of their final salary.

A crucial feature of the defined benefits scheme is that the risk for meeting future pension liabilities rests with the employer. The drop in share prices between 2000 and 2003 has resulted in many OPSs experiencing severe funding difficulties. For this reason, there has been a marked shift away from defined benefit and towards defined contribution schemes. The latter variant has much in common with personal pensions in that contributions from the employee and employer are credited to the employee's individual pension account. Upon retirement, the employee will receive a pension which is based upon the value of his or her personal fund as at the date of retirement. Thus, the fund will reflect the value of contributions made and the performance of the assets into which the contributions have been allocated. Accordingly, the risk is shifted from the employer to the employee. This benefits the employer by introducing control and certainty, as its pension liabilities are discharged fully on the basis of any contributions that it makes on behalf of its staff. In a typical OPS employees contribute in the order of 5 per cent of their wages to the pension scheme, whereas the employer might contribute of the order of 7.5 per cent – the actual amount varies considerably from employer to employer.

An associated form of further pension saving within OPSs are AVCs – Additional Voluntary Contributions. These may be linked to the company's pension scheme (known as in-house AVCs) or be a stand-alone arrangement contributed to an independent insurance company (so-called Free-Standing AVCs, or FSAVCs). In-house AVCs usually offer low costs in a limited range of funds, and are relatively inflexible. The FSAVC usually offers access to a wider range of funds and gives a greater degree of individual control; however, these benefits come at the cost of higher charges.

Personal pensions operate in a similar way to defined contribution OPS schemes. Individuals select a pension provider and then make contributions to a fund of their choice made available by that provider. At the date of retirement the fund so accumulated is used to purchase an annuity, and this becomes the source of income

in retirement. Thus individuals will not be certain of the value of their ultimate pension until they reach retirement, as it will be a function of investment performance and prevailing annuity rates. This is a simplification of the variants to be found in the field of pensions. No reference has been made to features such as income drawdown and withdrawal of tax-free lump sums. Details vary enormously from country to country, depending upon local tax regimes and prevailing legislation and rules. However, it does capture the essence of the major forms of this vital form of saving.

Savings endowments

A savings endowment is a form of regular saving that in the UK is offered by companies authorized to offer life assurance contracts. Indeed, a defining characteristic of the savings endowment is that lump sum is payable to the beneficiary in the event of the death of the customer before the targeted maturity date of the contract. Most countries have an endowment type of product, although often described under another name. In Germany, in particular, mortgages and life plans are very heavily based upon endowment-type vehicles.

Sales of this type of savings scheme have fallen dramatically during the past 10 years in the UK. A major reason for this decline has been the sharp reduction in commission-paid direct sales forces, for which this type of product played a core role. At the same time, there was a growing view that the high front-end loaded charging structure made the product poor value for money. This charging structure meant that initial payments into the scheme were used to cover the costs of providing the scheme – including commissions to salespeople. As a consequence, it was common for the break-even point between contributions made and value of fund not to be reached until the policy was at least 7 years old. Prior to this point, savers would have done better had the money simply been saved in a deposit account, although they would have benefited from the lump-sum death payment in the event that they died before the break-even point was reached. Indeed, the product has experienced high rates of early surrender, which usually results in customers receiving less back than they paid in because of the high up-front costs – much of which arose from the commissions that were paid to salespeople.

A variant on the savings endowment is the *mortgage endowment*, a product which has been widely sold in the UK. This has a structure which is virtually identical to the savings endowment. However, as the name implies, this form of saving performs the dual roles of building up a fund, the value of which is intended to be equivalent to the mortgage sum provided by the mortgage lender, and acting as a means of repaying the mortgage in full should the customer die prior to the contractual maturity date of the loan. In common with the savings endowment, sales of mortgage endowments have fallen dramatically during the past 10 years. The rationale of this reduction in sales relates to high charges (again to pay for commission) and a sharp worsening in investment returns, as shown in Case study 2.2.

Collective savings variants

Individuals can save on a regular or periodic basis by making contributions to some form of a collective savings scheme. Examples of this include:

Case study 2.2 The performance of mortgage endowments in the UK

Mortgage endowments are designed to build a fund, typically over a 25-year term, that will match the debt at maturity and thereby ensure the mortgage is fully discharged. For the duration of the term the borrower typically merely pays interest on the loan outstanding to the lender of the mortgage funds. The achievement of the target fund value is based upon assumptions regarding contributions from the customer, fund performance, and associated charges. As might be imagined, fund performance represents the major imponderable. In the UK, the FSA lays down standards for projected future fund growth. For life products, such as savings and mortgage endowments, provider companies may use annual investment growth rates in the range of 5–8 per cent. However, between January 2000 and January 2005 the FTSE 100 (the index of the leading 100 UK companies ranked by market capitalization) fell by approximately 29 per cent. Set against this fall, a mortgage endowment may well have been assumed to achieve fund growth of the order of 35 per cent during the same 5-year period. This leaves a performance gap of some 64 per cent. The effect of this performance gap has been to reduce projected maturity values to an extent that many savers are likely to experience a shortfall in fund value and have insufficient funds to repay their mortgage debt. Many thousands of consumers have been notified by their endowment providers that they face the probability of a deficit in fund value at maturity. The shortfall can be made up by increasing the amount saved into the endowment policy, or by the customer finding an alternative source of funds at maturity.

There have been many cases of mortgage endowments having been sold to people in inappropriate circumstances. This had led to what has been termed the 'endowment mis-selling scandal'. The consumers' organization *Which?* has been especially vocal on this matter, and has set up a website that consumers can use to register their concerns and seek guidance regarding how to investigate claims for compensation. Well over half a million hits have been registered by the website, an indication of the extent of consumer concern.

Mortgage endowments performed well in the past, especially when they attracted tax concessions, resulting in customers experiencing windfalls when funds actually performed better than their assumed growth rates. However, they are now considered too much of a risk for the typical consumer who is risk-averse and is unwilling to engage in what might be considered a gamble.

- unit trusts (mutual funds)
- investment trusts
- open-ended investment schemes (OEICS).

In a number of countries there may be preferential tax allowances that governments provide in order to incentivize the savings habit. In the UK, the ISA (Individual Savings Account) is just such an arrangement.

These types of savings schemes are largely based upon contributions being made into stock that is traded on the world's stock markets. As such, savers make their contributions on the basis that share prices can fall as well as rise, and thus the schemes carry a degree of risk. For this reason they are not generally suitable for savers who are either highly risk averse or are saving on a fairly short-term timescale. By contributing on a regular monthly basis, savers can mitigate fluctuations in share prices. When share prices fall, a given contribution level buys more units in a fund then when share prices rise. This process is called pound-cost-averaging.

2.7.3 Investing

The present authors consider 'investing' to more properly refer to the process of how to deploy a lump sum for the purposes of capital growth or income generation. By convention, the typical investment vehicles and their underlying assets are specified in Table 2.6.

No discussion of investment would be complete without reference to investment in property. In many countries, residential property equity represents a substantial proportion of domestic assets. In short, residential property equity represents the most significant form of personal financial assets in the UK. This has been a key driver of contemporary saving behaviour, as the evidence shows that individuals are choosing to invest in property in preference to other forms of investment and saving such as pensions and the stock market.

Table 2.6 Investment vehicles and asset classes

Investment vehicle	Underlying asset classes
Deposit account	Cash deposits that pay interest
Direct share holding	Shares from which income is derived in the form of the dividend and rising share values provide for capital growth
Unit trust/mutual fund	A collective investment medium whereby risk is spread through the investment of the lump sum in the shares of a range of stock markets and companies; Assets may also comprise property and cash
Investment trust	Another form of collective investment whereby the bundle of assets are used to create a closed company
Insurance bond	Typically a form of packaged investment comprising equities, usually presented as income bonds or equity growth bonds
Corporate bond	This is a loan that the bond holder makes to the bond issuer; interest is paid periodically at a given rate, known as the coupon; the principal is repaid at a specified time
Government bond	This is a loans made to the government (and sometimes to municipalities) like corporate bonds, interest and principal are paid/repaid according to agreed rates and time
Premium bond	An open-ended non-interest-bearing loan to the government where cash prizes are paid in lieu of interest.

Table 2.7 International life insurance market 1998

	Premium (US$m)	World market share	Premium per capita US$
North America	368032	29.1	1224
Latin America	10693	0.9	21
Europe	402348	31.8	361
Asia	439020	34.7	24
Africa	21668	1.7	27
Oceania	22396	1.8	842
Total	1264156	100	145

2.8 Life insurance

The term *life insurance* is somewhat ambiguous in that it is often used to denote the range of product groups that are supplied by the life insurance industry. As such, it comprises life and health protection and savings products, pensions and collective investment schemes. Table 2.7 shows the international life insurance market (1998) from data supplied by Swiss Reinsurance to the American Council of Life Insurers.

Table 2.7 shows graphically how the global insurance market is dominated by the continents of North America, Asia and Europe. Within those continents, a few countries are of particular significance. According to data supplied by SIGMA, Swiss Re (UK), the top five markets by premium income in 2003 were the USA, Japan, the UK, France and Germany (see Table 2.8).

It is customary for the life insurance market to be segmented according to whether products are provided on an individual or a group basis. Quite simply, the former related to policies priced, provided and paid for at the individual consumer level. The latter refers to pooled arrangements – typically schemes that are provided to an employer and which provide a given level of cover to all members of staff, such as a death-in-service benefit of, say, three-and-a-half times salary.

The major categories of protection products are as follows:

1. Life insurance
   - whole of life
   - level term
   - decreasing term

Table 2.8 Leading life insurance markets

Country	$USbn
USA	480919
Japan	381842
UK	154842
France	105436
Germany	76738

2. Health insurance
   - critical illness
   - sickness and disability (in the UK this is usually referred to as permanent health insurance, or PHI)
   - private medical health insurance (this is usually treated as a form of general insurance)
   - long-term care.

2.8.1 Life insurance

As the name indicates, a *whole-of-life* policy provides for the payment of an agreed sum-assured upon death on an open-ended basis. On the other hand, a *term life* policy provides for the payment of a given sum-assured upon the death of the life-assured within a specified number of years – for example, within a 10-year period in the case of a 10-year term policy. Compared with whole-of-life, term insurance is normally considerably cheaper, and thus provides relatively high levels of cover for comparatively low premiums.

A variant of term insurance is *decreasing term insurance*. This provides for a sum-assured to be paid upon death that gradually reduces as the term progresses. Most commonly, it is used as a form of mortgage protection where the customer is gradually paying off the debt through what is called a capital repayment mortgage.

2.8.2 Health insurance

Critical illness insurance was first devised in South Africa in the 1970s, and pays out an agreed sum-assured upon the diagnosis of a life-endangering illness such as cancer or coronary heart disease. It can be bought as a stand-alone policy or as an added feature to, say, a term insurance policy, as a means of guarding against a range of risks.

Permanent health insurance (PHI) is a form of policy that provides for the replacement of lost income should the policyholder be unable to work as a result of an acute illness or chronic disability. This is particularly important for individuals who are self-employed or do not enjoy generous sickness benefits from their employers. In recent years it has been suggested that the policy has been abused by people who use it as a means of facilitating early retirement.

Private health insurance provides the policyholder with cover in respect of medical costs. The insurer either reimburses the policyholder for costs incurred, or makes direct payment to the medical services provider up to an agreed limit. The nature and extent of private health insurance is closely linked to the state-provided health services of any given country. For example, the scope of private health insurance in the UK is comparatively limited, given the role played by the National Health Service (NHS). In the USA, on the other hand, there is an enormous private medical health insurance sector whereby more than half of all healthcare funding is provided by the private insurance sector, compared with just 15 per cent in the UK. France sits somewhere between the two, with about 28 per cent of healthcare being funded by the private insurance sector.

Long-term care insurance is a form of insurance that pays toward the costs associated with long-term nursing care for the elderly. As with private medical insurance, the extent of demand for this type of insurance is heavily dependent upon the scope and extent of provision made by individual countries' welfare systems. Even within the UK, long-term care costs are state financed in Scotland and Wales but not in England.

2.8.3 Annuities

An annuity is the means by which a lump sum, typically a maturing pension fund, is converted into regular income. Once entered into, it pays a regular monthly income until death. This is an open-ended arrangement which involves the pooling of thousands of customers' funds to arrive at a given level of income. Therefore, consumers (annuitants) bear the risk of losing the bulk of their pension fund if they die soon after retiring as their surplus fund then remains part of the general pool. As might be imagined, this is becoming an increasingly contentious matter as people choose to avoid taking such a risk with their long-term savings.

The level of annuity payable is determined by actuarial calculations, and is a function of variables such as the age at which the annuity commences, gender and health status. Additionally, there are variations such as whether the annuity is level, escalating or indexed.

2.9 General insurance

In simple terms, whereas life insurance provides benefits in the event of human death or illness during a prolonged contract period (possibly for the whole of an individual's life), general insurance provides for the payment of benefits in respect of risks to tangible and intangible non-human assets. The typical range of general insurance risks is as follows:

- motor vehicles
- property
- personal possessions
- liability
- financial loss
- creditor
- marine, aviation and transport
- accident and health.

General insurance is normally based upon annual contracts, whereby the premium is paid in respect of a 12-month period of cover. Thus the cover expires at the end of 12 months, and in order to maintain cover the customer must then either renew the policy for the next 12-month period or seek cover from another supplier.

General insurance tends to be more price-led than life insurance, and is a fiercely competitive marketplace. In the UK it remains a highly diverse sector; there were

some 613 companies authorized to transact general insurance in 2004. In Australia, with a population less than one-third of that of the UK, there were some 112 general insurers as at June 2005, according to the Australian regulator APRA.

Motor vehicle insurance has become fiercely competitive, and the introduction of the telephone and Internet as means of transacting business has served to heighten the intensity of competition in this price-driven market.

Box 2.2 outlines one form of insurance that is less well known but is of considerable importance – namely reinsurance. This is relevant to all forms of insurance, both life and general.

Box 2.2 Reinsurance – what is it and how does it work?

Introduction

In simple terms, reinsurance is insurance for the insurance providers. The obvious question is, why should an insurer, whose business is to underwrite risk, wish to insure some of the risks that it has accepted?

When it is pricing the risks that it insures, the insurer will rely on historic claims data and trends in the claims data to derive its best estimate of the future claims experience. It will rely on its underwriters to ensure that the premiums charged for insurance are in line with the risks presented. However, even if the pricing and underwriting processes are properly carried out, this will not guarantee that a portfolio of insurance business will be profitable.

By its very nature, insurance business is unpredictable, and random variations from the pricing basis in either the number of claims or the average claim size (or both) can have a very significant effect on the profitability of the portfolio. Reinsurance can protect an insurer's portfolio from these sources of variability, and hence provide a more stable claims experience.

How does reinsurance work?

A portfolio of insurance business is made up of many policies covering broadly similar risks (in terms of the events covered). If the insured event occurs, the insurer is liable to make a payment to the policyholder and reinsurance does not affect this liability. Reinsurance works by reimbursing part of each claim to the insurer under a reinsurance arrangement (often referred to as a reinsurance treaty). The agreement will specify:

- the group of policies to which the treaty applies
- the rights and obligations of each party under the treaty
- what proportion of each claim is payable by the reinsurer
- how the reinsurance premium is calculated.

Where a treaty is in place and a policy falls within the group of policies covered by the treaty, then the insurer must reinsure the business and the reinsurer is obliged to accept the business.

Box 2.2 Reinsurance – what is it and how does it work?—cont'd

What types of treaty are there?

Treaties are either proportional or non-proportional.

Under a *proportional treaty*, any claim is shared in the same proportions between insurer and reinsurer. This is often referred to as *quota share reinsurance*. This will damp down (but not eliminate) the effect of the claims frequency being higher than expected, or the average claim amount being higher than expected.

There are three situations where quota share reinsurance is common:

1. Where the insurer is expanding into a new business line and has little or no practical experience of the line. The reinsurer often has knowledge, pricing data and expertise, and can provide technical help to the insurer as well as helping to limit the insurer's risk exposure.
2. Where the insurer wishes to write greater volumes of business to reduce claims volatility and to increase the portfolio of business across which it spreads its fixed costs. However, it may have capital constraints (in the form of solvency requirements imposed by the regulator). By reinsuring part of the risk, the insurer is able to reduce the capital it needs to hold to cover the same volumes of business and hence can write higher volumes of business.
3. Where the reinsurer has a lower cost of capital. This may be because it has surplus capital and is willing to accept a lower return than the insurer, or because it has a regulatory advantage in terms of the amount of capital it needs to hold to cover the same amount of risk as an insurer. The latter often happens, as reinsurers have much larger risk pools than the insurers and hence lower claims volatility. Regulators therefore require reinsurers to hold lower margins against an adverse claims experience than their insurer counterparts.

If the insurer's claims frequency is as predicted, the claims experience can still be poor if the average claim amount is higher than expected. This can arise either because all claims are higher than expected by roughly the same amount, or because there is a disproportionate number of large claims. Non-proportional reinsurance provides effective protection against the effect of a disproportionate number of large claims.

Under a *non-proportional treaty*, the reinsurer reimburses the amount of any claim in excess of a limit defined in the treaty. This limit is known as the insurer's retention, and is usually the same for all policies covered under the treaty. As such the proportion of the total claim that is covered by the reinsurer will vary from claim to claim, and hence the name 'non-proportional'. Non-proportional treaties are often referred to as *surplus* or *excess-of-loss* treaties.

There is often a limit on the amount that the reinsurer will reimburse. Once this limit is reached the insurer may meet the rest of the claim, or there may be additional layers of reinsurance with other reinsurers.

Continued

Box 2.2 Reinsurance – what is it and how does it work?—cont'd

A different type of non-proportional treaty can protect the insurer from the effect of catastrophes. A catastrophe is defined as a single event giving rise to a large number of claims (for example, 9/11 in 2001, the European floods in 2002, Hurricane Katrina in 2005). Under a catastrophe excess-of-loss treaty, the reinsurer will reimburse the insurer once claims arising from a catastrophe reach a certain level (the retention level). Again, there is usually a limit on the amount that the reinsurer will reimburse. Once this limit is reached the insurer may meet the rest of the claims, or there may be additional layers of reinsurance with other reinsurers.

The reinsurance market

The global reinsurance market writes in excess of £100 billion in premiums. This covers both life and non-life reinsurance business. The top five global players are Munich Re, Swiss Re, Lloyd's, Hannover Re and Allianz Re. In the UK, the top five non-life reinsurers are Munich Re, Swiss Re, Faraday, Transatlantic and XL Re.

The top five life insurers are Munich Re, Swiss Re, GE Insurance Solutions, XL Re and Revios. The purchase of GE Insurance solutions by Swiss Re, effective in 2006, brings Hannover Re into the top five.

Source: Will Adler, Head of Marketing, Munich Reinsurance.

2.10 Summary and conclusions

This chapter has outlined the diverse range of organizations involved in the provision of financial services and provided an introduction to different types of products that these organizations offer. As such, it provides the background against which the marketing of financial services takes place. Financial services are provided by many different organizations, and traditionally, specific organizations such as banks specialized in the provision of specific services (i.e. banking services). Increasingly, across the world, these institutional boundaries have begun to break down, and while organizations continue to be defined by their type (bank, insurance company) they increasingly offer a much broader range of financial services.

The products described as 'financial services' are many and varied, and while this chapter has only provided a brief introduction to how these products work, it should be apparent that they are designed to meet a range of very different financial needs and that many are highly complex. It is perhaps unsurprising, then, that many actual and prospective customers find such products difficult to understand. As will be explained further in Chapter 3, the complexity of the product creates important marketing challenges.

Review questions

1. What is meant by the term gateway product, and to what extent do you believe that the current account performs such a role in your marketplace?
2. In what ways has the business-customer sector benefited from new forms of competitor in the fields of banking and insurance?
3. How has technological innovation impacted upon product supply and services delivery in your country?
4. What incentives does your government give to encourage its citizens to save for their future?

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3

Introduction to financial services marketing

Learning objectives

By the end of this chapter you will be able to:

- identify how and why services in general and financial services in particular are different from goods
- understand the implications of these differences for marketing practice
- understand the way in which services can be classified and the position of different types of financial services within this classification.

3.1 Introduction

Marketing is an approach to business which focuses on improving business performance by satisfying customer needs. As such, it is naturally externally focused. However, marketing cannot just focus on consumers; good marketers must also be aware of and understand the activities of their competitors. To deliver what the customer wants and do so more effectively than the competition also requires an understanding of what the organization itself is good at; the resources and capabilities it possesses and the way in which they can be deployed to satisfy customers. While, in very general terms, marketing processes and activities (such as environmental analysis, strategy and planning, advertising, branding, product development, channel management, etc.) are relevant to all organizations, we should still note that services in general and financial services in particular are rather different from many other physical goods. As a consequence, the focus of attention in the marketing process will be different, as will the implementation of marketing activities. The kind of advertising that works for Coca Cola is probably not right for

Aetna, and the selling strategy used for Ford cars would not work for a Citibank Unit Trust.

The purpose of this chapter is to outline how both services and financial services differ from physical goods, and to explore the implications of these differences for the process of marketing. The chapter begins by defining financial services; it then examines, from a marketing perspective, the differences between goods and services. Building on this discussion, the next section explains the distinctive characteristics of financial services and their marketing implications. As part of the discussion, a number of generic principles are identified which can be used to guide financial services marketing. The chapter concludes with an examination of service typologies, and considers their relevance to financial services.

3.2 Defining financial services

As discussed in Chapter 2, financial services are concerned with individuals, organizations and their finances – that is to say, they are services which are directed specifically at people's intangible assets (i.e. their money/wealth). The term is often used broadly to cover a whole range of banking services, insurance (both life and general), stock trading, asset management, credit cards, foreign exchange, trade finance, venture capital and so on.

These different services are designed to meet a range of different needs, and take many different forms. They usually require a formal (contractual) relationship between provider and consumers, and they typically require a degree of customization (quite limited in the case of a basic bank account, but quite extensive in the case of venture capital).

The marketing issues that arise with such a variety of products are considerable:

- Some financial services may be very short term (e.g. buying and selling stocks), while others are very long term (mortgages, pensions)
- Products vary in terms of complexity; a basic savings account for a personal consumer may appear to be a relatively simple product, whereas the structuring of finance for a leveraged buy-out may be highly complex
- Customers will vary in terms of both their needs and their levels of understanding – corporate customers may have considerable expertise and knowledge in relation to the types of financial services they wish to purchase, while many personal customers may find even the simplest products confusing.

With so much variety and so many different types of financial service, it may appear to be difficult to make general statements about marketing financial services. Indeed, not all marketing challenges are relevant to all types of financial services, and not all solutions will work in every situation. The art of marketing is to be able to understand the challenges that financial services present and to identify creative and sensible approaches which fit to the circumstances of a particular organization, a particular service and a particular customer.

3.3 The differences between goods and services

Financial services are, first and foremost, services, and thus are different from physical goods. Like many things, services are often easy to identify but difficult to define. In one of the earliest marketing discussion of services, Rathmell (1966) makes a simple and rather memorable distinction between goods and services. He suggests that we should recognize that 'a good' is a noun while 'service' is a verb – goods are things while services are acts.

However, perhaps the easiest definition to remember is that proposed by Gummesson (1987):

> Services are something that can be bought and sold but which you cannot drop on your foot.

Fundamentally, services are processes or experiences – you cannot own a bank account, a holiday or a trip to the theatre in the same way as you can own a car, a computer or a bag of groceries (see, for example, Bateson, 1977; Shostack, 1982; Parasuraman *et al*., 1985; Bowen and Schneider, 1977). Of course, we can all talk about services in a possessive sense (my bank account, my holiday, or my theatre ticket), but we do not actually possess the services concerned; the bank account represents our right to have various financial transactions undertaken on our behalf by the account provider, while the holiday ticket gives us the right to experience some mixture of transportation, accommodation and leisure activities. Thus, despite these apparent signs of ownership, financial services themselves are not possessions in any conventional sense (according to some writers, this absence of ownership rights with respect to a service is one of the key factors which distinguishes physical goods from services). The bank account details and the holiday ticket are, in effect, merely 'certificates of entitlement' to a particular experience or process.

It is equally possible to argue that most physical goods are simply there to provide a service, and that the entertainment provided by a TV or the cleansing provided by washing powder is as much of a process as is using a bank account or going to the theatre. This argument in itself is something that few would disagree with. However, it does not automatically discount the case for treating goods and services as being distinct. Although we can recognize the service element in many (if not all) physical goods, the ownership distinction remains and the process or experience element is much greater in the case of services.

It is the fact that services are predominantly experiences that leads to their most commonly identified characteristic – services are *intangible*. That is to say, they lack physical form and cannot be seen or touched or displayed in advance of purchase. As a consequence, customers only become aware of the true nature of the service once they have made a decision to purchase. Indeed, the service does not exist until a customer wishes to consume a service experience, and this is the next characteristic of services – *inseparability*. Services are produced and consumed simultaneously, and often (but not always) in the presence of the consumer. One particular consequence of this characteristic is that services are *perishable* – they cannot be inventoried. The fact that customers' service needs are different and that service consumption involves interaction between customers and producers also tends to

lead to a much greater potential for variability in quality (*heterogeneity*) than is the case with physical goods.

This approach to categorizing the distinctive characteristics of services is sometimes referred to by the acronym IHIP (Intangibility, Heterogeneity, Inseparability, Perishability). Although widely used in services marketing, it has attracted criticism in recent years. For example, Lovelock and Gummesson (2004) argue that the framework has serious weaknesses. Intangibility, they argue, is ambiguous. Many services involve significant tangible elements and significant tangible outcomes. Heterogeneity (variability) is seen to be less effective at distinguishing goods from services because variability persists in many physical goods and is being reduced in many services as a consequence of greater standardization in systems and processes. Inseparability, though important, is not thought to be able to differentiate goods from services, as an increasing number of services can be produced remotely and thus are in fact separable. Similarly, it is argued that some services are not perishable and some goods are. Thus, Lovelock and Gummesson suggest that the IHIP simply does not adequately distinguish between goods and services. They argue instead for a focus on ownership (or lack of it) and the idea that services involve different forms of rental (rental of physical goods, of place and space, of expertise, of facilities or of networks). Vargo and Lusch (2004) are similarly critical, and also highlight the inability of IHIP to distinguish between goods and services.

While recognizing that the IHIP framework is open to criticism, it is probably the dominant paradigm in services marketing and, provided that it is used sensibly, it remains a useful framework for understanding the differences between goods and services. Each of the IHIP characteristics will be explored in greater detail in the following sections in relation to financial services, but at this point it is important to emphasize that it could be misleading simply to view services and physical goods as complete opposites. While seeking to maintain a distinction between the two types of product, many services marketers recognize the existence of a goods–services continuum with highly intangible services (such as financial advice, education or consultancy services) at one extreme and highly tangible goods (such as coffee, sports shoes or kitchen utensils) at the other extreme. Then, towards the centre of this continuum there are many goods which are similar to services (such as cars) and many services which are similar to goods (such as fast food). Grönroos (1978), however, is rather critical of this notion because it has the potential to distract from the idea that fundamental differences do exist between goods and services. He suggests maintaining a much sharper distinction to enable academics and practitioners to recognize the need for rather different marketing approaches. As Box 3.1 shows, this idea has been recognized for almost as long as we have acknowledged the existence of services marketing.

3.4 The distinctive characteristics of financial services

The discussion above briefly outlined some of the areas in which services are different from physical goods and introduced some of the basic features of financial services. This section explores the characteristics of services in more depth and considers

Box 3.1 G Lynn Shostack - 'Breaking free from product marketing'

Lynn Shostack's paper in the *Journal of Marketing* in 1977 is one of the formative articles in the development of services marketing. Shostack starts by noting the problems experienced by practising marketers who have switched from product to services marketing. Academic marketing appeared to have no readily available frameworks which could guide marketing practice in these environments. Shostack's response is to emphasize the importance of intangibility, not just as a modifier but as a fundamental characteristic of services – she notes that no amount of physical evidence (however provided) can make something as fundamentally intangible as entertainment or advice into something tangible. A service is an experience rather than a possession.

Of course, physical goods do provide a service, but the distinction between the two is illustrated with the example of cars and airlines. Both provide a transport service, but the former is fundamentally tangible but with an intangible dimension, while the latter is intangible but with tangible dimensions. The car provides transport but is also something that the customer can own; the airline also provides transport but without any ownership element.

Thus, Shostack argues that we should view goods and services as existing on a continuum from intangible dominant to tangible dominant. She supports this framework with a molecular model of products which comprises a core or nucleus and several external layers. The nucleus represents the core benefits provided to the consumer, while the layers deal with the way in which the product is made available to the consumer – including price, distribution and market positioning via marketing communications. The nucleus for air travel is predominantly intangible, while that for the car is predominantly tangible.

Finally, Shostack considers the marketing implications of her analysis. She suggests that the abstract nature of services requires the marketing processes to emphasize concrete, non-abstract images or representations of the service to provide consumers with a tangible representation of the service which will make sense to them. By contrast, because consumers can see, picture and feel physical goods, such tangible images are far less important and marketing programmes can therefore concentrate much more on abstract ideas and images to attract consumers' attention.

Source: Shostack, G. L. *(1977).* Breaking free from product marketing. *Journal of Marketing*, ***47****, 73–80*

specifically their implications in the context of financial services. In what follows, intangibility is considered as the dominant service characteristic; intangibility then leads to inseparability and this in turns results in perishability and variability (heterogeneity). Finally, three further characteristics are introduced which relate specifically to financial services – fiduciary responsibility, duration of consumption and contingent consumption – and their marketing implications are discussed.

3.4.1 Intangibility

Since services are processes or experiences, intangibility is generally cited as the key feature that distinguishes services from goods. In practice, this means that services are impalpable – they lack a substantive physical form and so cannot be seen, touched, displayed, felt or tried in advance of purchase. A customer may purchase a particular service, such as a savings account, but typically has nothing physical to display as a result of the purchase. In some cases, services may also be characterized by what Bateson (1977) and others have described as 'mental intangibility' – i.e. they are complex and difficult to understand.

From the customer perspective, these characteristics have important implications. Physical intangibility (impalpability) and mental intangibility (complexity) mean that services are characterized by a predominance of experience and credence qualities, phrases used to describe attributes which can either only be evaluated once they have been experienced or even when experienced cannot be evaluated. Physical goods, by contrast, are characterized by a predominance of search qualities, which are attributes that can be evaluated in advance of purchase. Thus, the potential purchaser of a car may take a test drive, the buyer of a TV can examine the quality of the picture, and a clothes shopper can check fit and style before buying.

In comparison, the service offered by a financial adviser can only really be evaluated once the advice has been experienced, leaving customers with the problem that they do not really know what they're going to get when they make the purchase decision. Even more difficult from the consumers' perspective is not being able to evaluate the quality of the service. The technical complexity of many services may hinder consumer evaluation of what has been received; a lack of specialist knowledge means that many consumers cannot evaluate the quality of the financial advice they have received, and only the most fanatical investment enthusiast would really be able to determine whether a fund manager has made the best investment decisions in a particular market.

Of course, it is possible to argue that, ultimately, a consumer can evaluate financial advisers or investment managers based on the performance of a portfolio or a particular product. However, inadequacies in either service may take time to come to light, and even when a particular outcome occurs – for example, the value of a portfolio of assets falls – how certain can the consumer be that this failure was due to poor advice or to unforseeable market problems? In contrast, with relatively complex products such as a PDA or a TV there are visible manifestations of the quality of the product (information stored and retrieved by the PDA, pictures displayed on the TV screen), giving the consumer something tangible to evaluate and potentially a clearer idea of the relationship between cause and effect – a poor-quality picture is most likely to represent a problem with the performance of the TV set.

Overall, the predominance of experience and credence qualities means that financial services consumers are much less sure of what they are likely to receive and, consequently, rather more likely to experience a significant degree of perceived risk when making a purchase decision. Thus, financial services marketing must pay particular attention to ways in which the buying process can be facilitated. The following issues may be particularly important:

1. Providing physical evidence or some physical representation of the product. Physical evidence *per se* may take the form of items directly associated with

a service (e.g. the policy documentation that accompanies an insurance policy) or the environment in which the service is delivered (e.g. the rather grand premises in prime locations occupied by banks). An alternative or even a complement to actual physical evidence is to create a tangible image such as '*Citibank – where money lives*', or to offer physical gifts to prospective consumers.

2. Placing particular emphasis on the benefits of the service – customers do not want a mortgage as such, but they do want to own a house; they do not want a savings account, but they do want to be able to pay for their child's education. Thus, for example, the Malaysian bank, Maybank, promotes its Platinum Visa card with an illustration of a Korean vase bought using the card. Similarly, in Hong Kong, HSBC promotes its PowerVantage banking service as '*Helping you build better returns on your life ... on your money ... on your time ... on your opportunities*'.
3. Reducing perceived risk and making consumers feel less uncertain about the outcome of their purchase, perhaps by encouraging other customers to act as advocates for the service, by seeking appropriate endorsements or even by offering service guarantees. For example, the State Bank of India Mutual Fund reassures prospective customers by drawing attention to its links with the State Bank of India – '*India's premier and largest bank*'. In the US, US Bank promotes itself with the slogan '*Other Banks Promise Great Service, US Bank Guarantees It*'.
4. Building trust and confidence to reassure consumers that what they receive will be of the appropriate quality. Many financial services organizations make particular efforts to emphasize their longevity – the fact that they have been in business for, in some cases, hundreds of years serves as a mechanism for signalling their reliability and trustworthiness. In the US, Bank of America's private banking arm emphasizes its longevity as a means of building confidence – '*For more than 150 years, The Private Bank has been the advisor of choice for the affluent*'. Others, such as HSBC and Axa Insurance, emphasize their worldwide coverage and the size of the organization in order to reassure customers that their money and business will be safe and secure.

3.4.2 Inseparability

The nature of services as a process or experience means that services are inseparable – they are produced and consumed simultaneously. As Zeithaml and Bitner (2003: 20) put it:

> Whereas most goods are produced first, then sold and consumed, most services are sold first and then produced and consumed simultaneously.

A service can only be provided if there is a customer willing to purchase and experience it. Thus, for example, financial advice *per se* can only be provided once a specific request has been made; until that request is made, the advice does not exist – there is only the potential for that advice embodied in the mind of the adviser. The provision of a service will typically also require the involvement of the consumer to a greater degree than would be the case with physical goods. As few services are totally standardized, the minimum input from the consumer would be

information on needs and wants. For example, an investment adviser would, as a minimum, need to know an individual's attitude to risk, and whether that individual wants to invest for capital growth or income, before advice could be given. In many instances, the input from the customer will need to be more extensive. Because the customer actively engages and interacts with the provider, services are often described as interactive processes. While this interaction has traditionally been face-to-face, developments in telephone and information technology mean that an increasing amount of customer provider interaction is taking place remotely.

As a consequence of the interactive nature of services, the way in which the service is performed may be as significant to customers as the actual service itself. A financial services provider's staff may be of particular importance in this process. As the group with whom the customer has greatest involvement, the staff can and do play a decisive role in customer evaluations of the service experience.

From a marketing perspective, then, inseparability presents some interesting challenges. Given the interactive and inseparable nature of service provision, the following issues will be of particular significance:

1. Ensuring that the processes of service delivery are clearly specified and customer orientated – in effect, the service should be designed to suit the customer rather than to suit the organization. For example, many banks might find it preferable to have product specialists – i.e. staff who focus attention only on specific products – but a customer with multiple services from a particular company will much prefer to deal with a single individual. Westpac Banking Corporation in New Zealand stresses to its business customers that it offers '*One number for all your banking needs*'. United Overseas Bank of Malaysia promotes its 'Privilege' banking service, emphasizing that '*you need to only deal with one person*'.
2. Ensuring that all staff involved in service provision appreciate the importance of a customer-orientated approach and are empowered to be responsive and flexible in customer interactions. Pacific Crest Savings Bank in the US reassures its customers that '*Premier customer service is delivered by a staff empowered to make decisions. The Pacific Crest service guarantees ensure that customers receive the high level of service they are promised*.'
3. Identifying methods of facilitating customer involvement in a way which will enhance the quality of the service provided. This may be as simple as making clear exactly what information is required from the customer, or may extend to outlining and explaining the responsibilities of the customer. Most financial services providers have terms of use which outline customer responsibilities, although often these are presented in the style of legal documents, which may limit the extent to which customers really understand their responsibilities.

3.4.3 Perishability

The fact that services are produced and consumed simultaneously also means that they are perishable. Services can only be produced when consumers wish to buy them, and when there is little or no demand the service producers cannot 'manufacture' surplus services for sale when demand is high. Thus services are perishable

and cannot be inventoried. If an investment adviser's time is not taken up on one particular day, it cannot be saved to provide extra capacity the next day. If the counter staff in a bank have a quiet period with no customers, they cannot 'save' that time to use when queues build up.

This characteristic of perishability presents marketing with the task of managing demand and supply in order to make best use of available capacity. Issues that require particular consideration include:

1. Assessing whether there are identifiable peaks and troughs in consumer demand for a particular financial service. Bank branches, for example, may be particularly busy during lunch breaks, while tax advisers may experience a peak in the demand for their services as the end of a tax year approaches.
2. Offering mechanisms for reducing demand at peak times and increasing it at off peak times. Tax advisers, for example, might consider offering discounted fees for customers who use their services well in advance of tax deadlines.
3. Assessing whether there is the opportunity to adjust capacity such that variability in demand can be accommodated (either through changing work patterns or some degree of mechanization). Many banks employ part-time staff to boost capacity during periods of heavy customer demand, and ATMs provide many standard banking services quickly as an alternative to queuing for face-to-face service.

3.4.4 Heterogeneity

The inseparability of production and consumption leads to a fourth distinctive characteristic of services: variability or heterogeneity.

Service variability can be interpreted in two ways. The first interpretation is that services are not standardized – different customers will want and will experience a different service. This source of variability essentially arises from the fact that customers are different and have different needs. To varying degrees, services will be tailored to those needs, whether in very simple terms (such as the amount a consumer chooses to invest in a savings plan) or in very complex ways (such as the advice provided by accountants, consultants and bankers to a firm undertaking a major acquisition).

The second interpretation of variability is that the service experienced may vary from customer to customer (even given essentially similar needs), or may vary from time to time for a particular customer. In effect, this type of variability arises not because of changing customer needs; it is primarily a consequence of the nature of an interaction between customer and service provider, but may be influenced by events outside the control of the service provider.

The first source of variability is easily understandable as a response to differences in customer needs. The obvious implications for marketing are as follows:

1. Service processes need to be flexible enough to adapt to different needs, and the more varied are customer needs and the higher customer expectations, the greater the need for flexibility. Thus, for example, business banking for small and medium-sized enterprises will need to accommodate the needs of the long-established small, local shop and of the fast-growing biotechnology company which

primarily sells in international markets. Equally, brokers may need to be able to adapt their service to the person who buys and sells stock infrequently on a small scale and the enthusiast who tracks the market and trades frequently and/or in volume.

2. It is becoming increasingly important that staff are empowered to respond to different needs and situations, so that processes can be adapted as and when necessary. Typically, this implies decentralizing service systems and delegating authority such that non-contentious modifications to a service can be dealt with by customer-contact staff. Thus, for example, a bank may delegate a range of lending powers to account managers such that every requested change in the normal terms of a loan to a small business does not always require head office approval.

The second form of variability provides more problems as it represents fluctuations in the level of quality that the consumer receives, rather than variations in the type of service. Essentially, this form of heterogeneity arises as a consequence of inseparability and the importance of personal interaction, but may also be influenced by external events. Customers are different and so are service providers; customer contact staff are people rather than machines, and will experience the same range of moods and emotions as everyone else. Differences arise between individuals (from one employee to another) and within individuals (from one day to another). The service provided by an account manager who is feeling happy, relaxed and positive at the start of a new week will almost certainly be better than that provided by the same account manager at the end of a long day, suffering from a headache and feeling undervalued.

From the consumer side, quality variability within and between service experiences may also arise if customers are not able to articulate their needs clearly. The greater the willingness of customers to supply appropriate information about their needs and circumstances, the more likely it is that they will receive the quality service they expect. Customers who are able to explain clearly their risk preferences, the purpose of their investment and the characteristics of the rest of their portfolio are likely to get better advice than customers who simply request advice on an investment that will give a 'decent return'.

In addition to the impact of personal factors on quality, it is important also to recognize that there are many factors which are outside the control of a service provider but which may have a significant effect on the overall service experience and the quality of the service product. The performance of an investment fund, for example, may be influenced by broad macro-economic forces which fund managers cannot change. The major fall in stock markets during the early 2000s had a significant negative impact on the performance of many personal pensions and equity-based investment products, but was outside the immediate control of the institutions which supplied these products (although many UK-based financial services providers were criticized following these events for having raised customer expectations by assuming continued rapid growth in stock markets).

Thus, both personal interactions and uncontrollable external factors can result is consumers feeling that they have experienced considerable variability in the service and in some case, an unsatisfactory experience. To address this aspect of variability, service marketers may need to pay particular attention to the following issues:

1. Motivating and rewarding staff for the provision of good service and encouraging consistency in approach. Internal marketing campaigns to emphasize the

importance of good customer service may be one aspect of this – equally important may be the way in which staff are treated and rewarded. A reward mechanism based simply on the number of calls taken by a customer service agent for a telephone banking service may create an incentive for the service agent to close calls as quickly as possible (to maximize throughput) rather than properly addressing the customer's needs (which would take longer and mean a lower call throughput).

2. Identifying ways of trying to persuade customers to articulate their needs as clearly as possible, whether by identifying scripts for use by the service provider or through marketing communications which specifically ask customers to share information. The growth in on-line provision of services and on-line quotations has helped this process by structuring and clarifying the types of information that customers need to provide – at least for some of the more straightforward financial services such as insurance quotations and standard loans.
3. If a service is relatively simple from the consumer perspective, considering mechanization to limit quality variability. ATMs and self-service banking over the Internet are one example of this process of mechanization. Automated telephone banking is another.
4. Considering carefully how a service is presented to customers; being explicit about the factors which can affect the performance of a product. Most equity-based products do highlight to customers that the value of investments can go down as well as up, but often such warnings are presented in small print and it is debatable whether customers read or understand these warnings. It is common to see companies relying on past performance figures as a way of signalling the quality of their product, despite the fact that these are largely unreliable as indicators of future performance. Furthermore, research has suggested that the way in which such past performance information is presented may have a significant impact on risk perceptions and consumer choice (Diacon, 2006).

3.4.5 Fiduciary responsibility

Fiduciary responsibility refers to the implicit responsibility which financial services providers have in relation to the management of funds and the financial advice they supply to their customers. Although any business has a responsibility to its consumers in terms of the quality, reliability and safety of the products it supplies, this responsibility is perhaps much greater in the case of a financial service provider. There are probably two explanations for this.

First, many consumers find financial services difficult to comprehend. Understanding financial services requires a degree of numeracy, conceptual thinking and interest. Many consumers are either unable or unwilling to try to understand financial services. For example, a recent study undertaken on behalf of the FSA in the UK (Atkinson *et al*., 2006) reported that, in total, 20 per cent of respondents did not understand the relationship between inflation and interest rates, with the lack of understanding being much greater among younger and lower-income consumers. Some customers rely on a professional – whether a bank, an investment company, an insurer or a financial adviser – to provide them with appropriate financial services; others rely upon the advice they receive from members of their reference group, such as family members, friends and work colleagues.

Secondly, the 'raw materials' used to produce many financial products are consumers' funds; thus, in producing and selling a loan product, the bank has a responsibility to the person taking out a loan but at the same time also has a responsibility to the individuals whose deposits have made that loan possible. Similarly, insurance is based on pooling risk across policyholders. When taking risks (selling insurance) and paying against claims, an insurer has a responsibility to both the individual concerned and to all other policyholders.

Thus, rather than just having to consider responsibility to the purchaser, many financial services organizations must also be aware of their responsibility to their suppliers – indeed, it is conceivable that the needs of suppliers may take precedence over the demands of a customer. For example, because of its responsibilities to its existing car-insurance customers, an insurer may feel that it cannot respond to a demand from a customer considered to be high risk. Similarly, a bank may decide not to offer credit to a borrower if it is concerned that the granting of a loan simply allows that borrower to build up an even greater volume of debt. Indeed, a failure fully to appreciate this responsibility has led to heavy criticism of credit card companies in the UK for providing credit cards to individuals who have little prospect of repaying their debt.

From a marketing perspective, this presents the rather unusual problem of customers wishing to purchase a particular product (e.g. a loan, insurance, credit card, etc.) and the organization turning them away and refusing to supply that product because they are considered too risky.

To recognize the issue of fiduciary responsibility, it is important to consider the following issues:

1. The process of segmentation, targeting and positioning should be assessed to ensure that products are not targeted at customers who are unlikely to be eligible. Careful market targeting can help prospective customers to judge whether the product is appropriate for them. If market segmentation is clear, this can be a relatively straightforward process – for example, the motor insurer 'Sheilas' Wheels' makes it very clear that it is an insurance company targeting female drivers (see Figure 3.1). If segmentation is more complex, then targeting the right group can be more challenging.
2. Staff involved in selling financial services to customers must be clearly aware of their responsibilities not to sell products that are inappropriate to the customer's needs. Probably one of the most damaging experiences for the financial services sector in the UK was the extensive mis-selling of personal pensions to people who could not afford them or did not need them. When the scandal came to light, it cost the industry billions of pounds in compensation and probably more in loss of reputation.

3.4.6 Contingent consumption

It is in the nature of many financial services products that money spent on them does not yield a direct consumption benefit. In some cases it may create consumption opportunities in the future; in other cases it may never result in tangible consumption for the individual who made the purchase. Saving money from current income reduces present consumption by the same amount, and for many

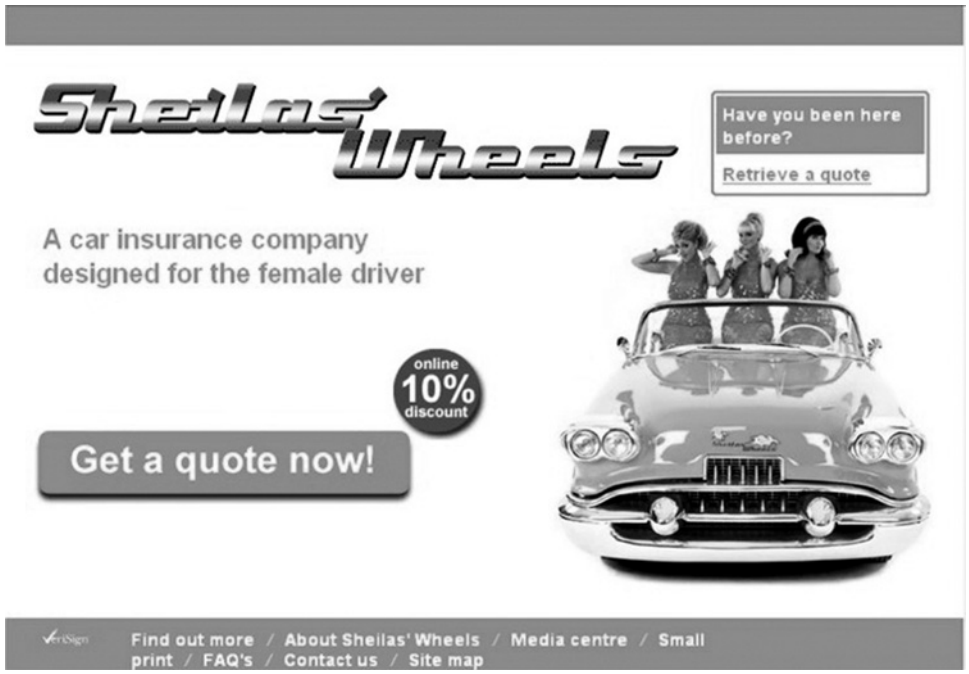

Figure 3.1 Car insurer 'Sheilas' Wheels' makes the nature of its target market very clear.

people present consumption is far more enjoyable than saving. For some individuals, the level of contributions required to build up a reasonable pension fund at retirement requires just too much foregone pleasurable consumption to provide the necessary motivation.

In the case of general insurance, most customers would not wish to consume many aspects of the service – they would hope never to have to make a claim against a given policy. Similarly, in the case of life insurance, consumers will never be the recipient of the financial benefits of the contract, given that their payment will only occur upon their death. Of course, in both cases consumers buy more than just the ability to make a claim against the insured event; they buy peace of mind and protection. However, these latter two benefits are particularly intangible, and consumers may still be left questioning the benefits that they receive compared to the prices they pay.

Such contingent consumption presents major challenges to marketing executives as they seek to market an intangible product that reduces current consumption of consumer goods and services for benefits that may never be experienced. To address the issue of contingent consumption, the following may be helpful:

1. The benefits associated with the product must be clearly communicated and in as tangible a form as possible. Marketing strategies for long-term savings plans (including pensions) might seek to demonstrate the significant benefits and pleasure associated with future consumption while also demonstrating that losses in current consumption are minimal. Similarly, insurance providers seek to convince

policyholders that they receive the benefit of peace-of-mind from having been prudent enough to safeguard the financial well-being of their dependents or their assets.
2. Issues relating to product design which might increase the attractiveness of products designed for the longer term should be considered. For example, some flexibility in payments, the ability temporarily to suspend payments or even the ability to make short-term withdrawals may help to reduce consumers' concerns about their ability to save on a regular basis.

3.4.7 Duration of consumption

The majority of financial services are (or have the potential to be) long term, either because they entail a continuing relationship with a customer (current accounts, mortgages, credit cards) or because there is a time lag before the benefits are realized (long-term savings and investments). In almost all cases this relationship is contractual, which provides the organization with information about customers and can create the opportunity to build bonds with them that will discourage switching between providers. The long-term relationship between customer and provider creates considerable potential for cross-selling, reinforced by the amount of information that providers have about their customers. However, for such a relationship to be beneficial and for cross-selling opportunities to work, the organization has to work at the relationship – simply ignoring customers for several years and then expecting them to make further purchases is unlikely to be effective.

From a marketing perspective, this suggests that the following areas will require particular attention:

1. Manage relationships carefully. If the product is long term, then regular contact between organization and customer can help to maintain a positive relationship. If the product is one that is continuous (e.g. a mortgage), regular communication is probably an integral feature of the product but should still be managed carefully to ensure that forms of customer contact are appropriate. In both cases there may be opportunities for cross-selling, but bombarding customers with lots of different products may be far less effective than carefully targeting a smaller number of offers.
2. Be prepared to reward loyalty, where appropriate. Valued customers that the organization wishes to retain should be treated as such.
3. Respect customer privacy and ensure that data that are collected relating to customers are managed appropriately.

3.5 The marketing challenge

In the discussion above, we have identified a range of marketing challenges which confront services marketers. Perhaps one of the most commonly recurring

themes in this discussion has been the importance of people and the ways in which the service delivery process is managed. In contrast with a discussion of physical goods, we have placed much less emphasis on the conventional forms of marketing which involve communications (in their broadest sense) from the organization to the customer. That is not to imply that the more traditional forms of marketing are not relevant; they most certainly are, but there are other dimensions of marketing that are equally important to services marketing. These are neatly summed up by Philip Kotler in his services marketing triangle, shown in Figure 3.2 (Kotler, 1994). Service marketing requires external marketing (from the organization to the customer) to present the nature and attributes of the service offer. It also requires internal marketing to ensure that staff have the motivation and information to deliver the service offered. Of course, interactive marketing between customer and employee also takes place during every service interaction; in many respects, any service organization employees who come into contact with a customer will find themselves in a marketing role. The intrinsic quality of the core service is important, but so is the way in which a service is delivered, and the nature of the service interaction may have a significant impact on the customer's evaluation of the overall experience.

3.6 Classifying services

From the discussion so far, it should be clear that there are a number of important differences between physical goods and services. However, as was emphasized earlier, these differences appear to exist not so much as absolute differences but

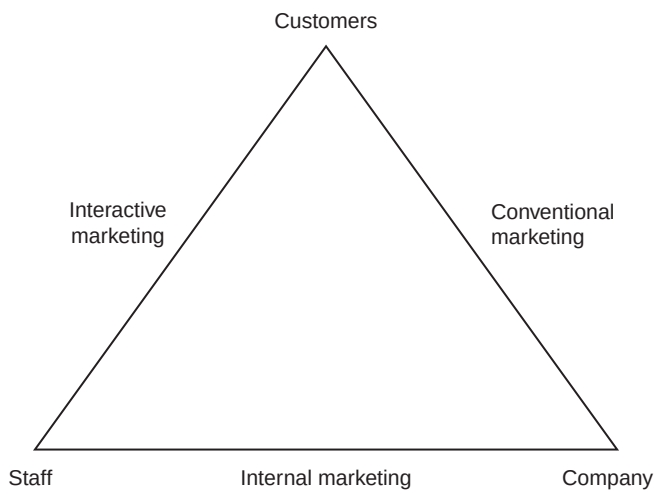

Figure 3.2 Services marketing triangle.

rather as points on a continuum. Even in that part of the continuum which we would classify as services, there is considerable variety among different types of services. In so far as we have argued that many marketing activities are context-specific, it would be misleading not to discuss some aspects of these variations. After all, services with different sets of characteristics will present different types of marketing problems.

Recognizing this issue has encouraged many service marketers to search for systematic approaches to classification in order to provide further guidance on the conduct of marketing. Indeed, this process dates back to the early days of services marketing. The resulting classification schemes are many and varied, and make distinctions such as:

- professional services versus other services
- individual customers versus organizational customers
- people-based versus equipment-based services
- high or low customer-contact services
- public sector or private sector/profit v. non-profit.

Probably one of the most comprehensive attempts to categorize and classify services was provided by Lovelock (1983). He produced five different classification schemes:

1. The nature of the service act (whether it involves tangible or intangible actions) and the recipient of the service (people versus things)
2. The nature of the relationship with the service provider (formal or informal) and whether the service is delivered continuously or on discrete basis
3. The degree of standardization or customization in the core service and the extent to which staff exercise personal judgement in service delivery
4. The capacity to meet demand (with/without difficulty) and the degree to which demand fluctuates
5. The number of outlets and the nature of the interaction between customer and service provider.

The difficulty with Lovelock's initial framework is that it results in five different systems for classification, and it may not always be clear which is the best to use for any given situation. More recently, Lovelock and Yip (1996) produced a much simpler classification in which they distinguished between the following:

1. People processing services, which are services that are directed towards people (e.g. healthcare, fitness, transport) and typically require the consumer to be physically present in order for the service to be consumed.
2. Possession processing services, which are services (such as equipment repair and maintenance, warehousing, dry cleaning) that focus attention on adding value to people's possessions. These require the service provider to be able to access those possessions, but there is often rather less reliance on the consumers' physical presence for the full service to be delivered.
3. Information processing services, which are services that are concerned with creating value through gathering, managing and transmitting information. Obvious examples include the media industry, telecommunications, consulting and

most financial services. Although inseparability may be important in some applications (e.g. consultancy, financial services), there is much greater potential for remote delivery because there is a reduced dependence on physical interactions.

Financial services are essentially directed towards individuals' assets, and so in that sense they may be partly possession processing services; some financial services may also be directed to people (tax advice, financial advice). Most financial services have the potential to be considered as information-based in the sense that they can effectively be represented as information and delivered remotely. For example, an individual can withdraw money from a bank account in Germany using an ATM in Australia because information can be conveyed to the Australian bank that there are sufficient funds available to allow the cash withdrawal to be made via the Australian bank's system, which is then credited with the appropriate sum by the German bank. As we shall see in Chapter 6, the idea that many financial services are essentially information processing services can have important implications for the ways in which services businesses internationalize.

3.7 Summary and conclusions

Any product, whether it is a physical good, a service or some combination of the two, exists to provide some mix of functional and psychological benefits to consumers. Through providing benefits to consumers and delivering long-term satisfaction, such products should enable organizations to achieve their stated goals. In that sense, services and physical goods have much in common. They also display some very important differences, and those differences have significant marketing implications. Services are processes, deeds or acts – they are not something that the consumer possesses, rather they are something that the consumer experiences. In essence, services are intangible – they lack any physical form. As a consequence they are also inseparable, being produced and consumed simultaneously, with the customer involved in the production or delivery of the service. Inseparability in turn leads to perishability and quality variability.

As a consequence of these characteristics, services marketing must pay particular attention to tangibilizing the services and reducing consumer perceived risk. Furthermore, the process of service delivery also attracts marketing attention because the involvement of the consumer in the process suggests that the nature of delivery may have a significant impact on consumer evaluation of the service. Finally, within that process the 'people' element may be of considerable significance, because it is typically the service provider's staff with whom the customer interacts. The rather different elements of marketing in a service business are neatly summed up by Philip Kotler, who stresses a need for not only external marketing but also internal marketing and interactive marketing.

Inevitably, not all services are the same, and the degrees of intangibility, inseparability, perishability and heterogeneity will vary considerably. In fact, most service marketers would probably recognize goods and services as existing along a continuum rather than as polar extremes. Many attempts have been made to classify services according to the characteristics they possess and their marketing implications.

While such schemes are necessarily crude, they do provide useful insights into both current marketing challenges and areas for new service development.

Review questions

1. Choose a financial services provider and look at examples of how it markets its services. How does this provider seek to address the issues of intangibility, inseparability, perishability and heterogeneity?
2. What are the differences between external marketing, internal marketing and interactive marketing?
3. Look at the way in which three insurance companies market life insurance products. How effective are these insurers in conveying the benefits of risk reduction and peace of mind?
4. Look at the way in which three pension providers market personal pensions. How effectively do these marketing campaigns deal with the fact that pensions are long-term products characterized by considerable potential uncertainty?

4

Analysing the marketing environment

Learning objectives

By the end of this chapter you will be able to:

- understand the key elements of the marketing environment and evaluate their impact on financial services providers
- analyse key elements in the macro, market and internal environments
- understand the process of SWOT analysis and its role in making sense of information about the marketing environment.

4.1 Introduction

In Chapter 3, marketing was described as being concerned with satisfying customer needs, trying to do so more effectively than the competition, and making appropriate use of the organization's own resources and capabilities in this process. Accordingly, one of the first stages in any marketing process is to understand the environment in which an organization operates. Indeed, the concept of being 'market orientated', originally championed by Kohli and Jaworski (1990) and Narver and Slater (1990), has at its heart the ideas of gathering, sharing and responding to information relating to both customers and competitors. Like many other organizations, providers of financial services operate in a rapidly changing environment. Globalization and developments in information and communications technology (ICT) combined with changes in customer needs and government policies create increasing degrees of complexity and uncertainty. Marketing forces organizations to look outside and to develop an awareness and understanding of the environment in which they operate. An organization that understands and responds to its operating environment

should be able to deliver superior performance through its ability to satisfy customers more effectively than the competition and to anticipate changes and developments in its key markets. However, an analysis of the external environment must be accompanied by a good understanding of the internal environment to enable an organization to deploy its resources and capabilities most effectively in meeting the challenges posed by the changing marketplace.

Historically, the financial services sector had always been thought of as very stable. Heavily regulated, the marketplace did change, but slowly and predictably; competition was limited and the types of financial services required by, and offered to, customers were relatively simple. In such an environment marketing was largely a tactical activity, concerned with determining how best to advertise and sell the existing set of services. Indeed, in many cases financial services organizations had Advertising and Sales Departments rather than Marketing Departments. As the pace of change accelerated and uncertainty increased, the marketing function had to take a more active role in understanding the changing environment and identifying implications for the products and services offered by its particular organization.

This chapter will introduce the key elements of environmental analysis that are relevant to financial services providers. The term 'marketing environment' is used to describe the range of external and internal factors that affect the way in which an organization interacts with its markets. As such it is very broad, and any analysis of the environment will generate a large volume of information. Thus, effective environmental analysis must be able to distinguish the more important factors from the less important ones. That is to say, analysing the environment involves first of all identifying and understanding what is happening, and then assessing which developments are most important to the organization concerned.

The chapter will begin by defining the elements that comprise the marketing environment. Subsequent sections will review the process of analysing the external environment (both at a macro- and a market level) and then explore the analysis of the internal environment, focusing particularly on resources and capabilities. Finally, the nature of SWOT analysis will be explained as a method for summarizing information about the marketing environment and identifying options for future strategy. By its very nature, the process of analysing the environment and attempting to anticipate how a market will develop in the future is not a one-off but, rather, a continuous process. The nature of the operating environment and the ways in which it changes is one of the main sources of uncertainty confronting marketing planners. Environmental analysis cannot remove this uncertainty, but it can help to reduce it.

4.2 The marketing environment

There are several components in the overall marketing environment. At the simplest level, we can distinguish between the internal environment (conditions within the organization) and the external environment (conditions outside the organization).

The external environment can then be divided into the macro-environment and the market environment. The macro-environment is concerned with broad general trends in the economy and society that can affect all organizations, whatever their line of business. The market environment describes those factors that are specific to the particular market in which the organization operates. The external environment may create opportunities for the organization to exploit, or may pose threats to current or planned activities. An outline of the key elements of the marketing environment is presented in Figure 4.1.

Marketing as a strategic activity is concerned with managing the relationship between the organization and its environment. This may mean adjusting and adapting the organization's marketing activities to respond to external changes in the environment. It may also mean trying to change the environment to make it better suited to what the organization wishes to do. That is to say, the environment should not be viewed simply as a constraint; rather, it should be viewed as something which can, if necessary, be influenced and changed by an organization. Lobbying for changes to the regulatory framework is one very obvious example of an attempt to change the external environment. Equally, mergers and acquisitions serve as a means of altering patterns of competition and changing the resources and capabilities available to a particular organization. Some forms of marketing communications may be employed to influence customer needs and expectations, while branding decisions and distribution strategies can sometimes be used to build barriers to market entry by potential competitors. The extent to which aspects of the environment can be managed varies. Typically, macro-environmental factors are seen as being least controllable, while market environmental factors are most controllable.

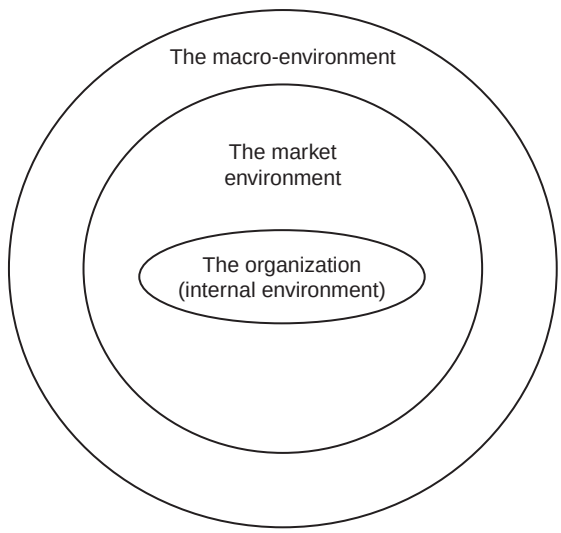

Figure 4.1 The marketing environment.

4.3 The macro-environment

The macro-environment is concerned with broad general trends within the economy and society. The macro-environment is typically of much greater relevance when considering the development of broad strategies, while the market environment is much more important when considering the development of specific business/product strategies. Traditionally, the analysis of the macro-environment was referred to as PEST or STEP analysis, where:

- PEST = Political, Economic, Social, Technological
- STEP = Social, Technological, Economic, Political.

More recently, these acronyms have been extended to include, for example:

- STEEP = Social, Technological, Economic, Environmental, Political
- SLEPT = Social, Legal, Economic, Political, Technological
- PESTLE = Political, Economic, Social, Technological, Legal, Environmental.

These different acronyms simply serve as an easy way of remembering which factors to cover. What is most important is that any analysis of the macro-environment is comprehensive and includes all the factors likely to affect an organization. The following discussion is structured around the PEST framework, for simplicity. This framework is shown in Figure 4.2 and discussed in more detail below.

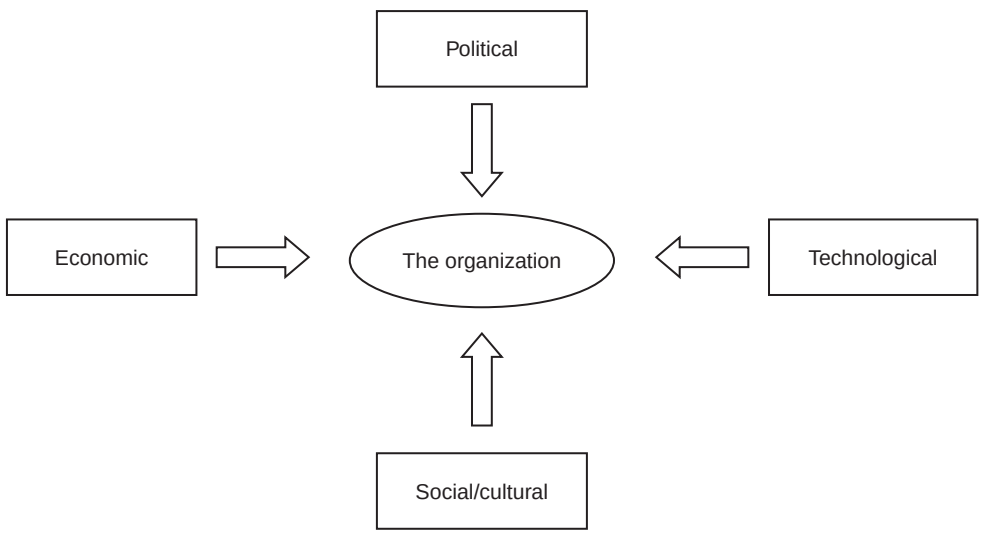

Figure 4.2 The macro-environment.

4.3.1 The political environment

The term 'political environment' is used to cover a range of issues, including party politics, the political character of the government itself, and also the legal and regulatory system. The financial services sector is, perhaps, one of the more politically sensitive sectors of any economy because of its role in the economic development and economic well-being of a country (explained in Chapter 1). The risks, complexities and importance associated with financial services also mean that it is one of the most heavily regulated sectors of an economy.

The political character of a government, and the potential for change, can have important implications for business both nationally and internationally. Some political parties may be more favourable to the business community than others, and this attitude is often reflected in legislation and regulation. The importance of government macro-economic policies is mentioned later, but there is a wide range of government activities that affect the financial sector, including sector-specific policy formulation, legislation, decisions on government spending, and partial privatization. For example, the policy of privatizing a range of previously state-owned industries in the UK during the 1980s is widely credited with having changed public attitudes to share ownership and created demand for small-scale share-dealing services.

Two aspects of the political environment, defined in its broadest sense, are of particular relevance to financial services – namely, industry regulation and consumer protection. Regulation generally refers to a set of rules and legal requirements that guide the operation of the industry and the conduct of firms within the industry. As such, it is specific to financial services. *Financial regulation* is typically concerned with licensing providers, guiding the conduct of business, enforcing relevant laws, protecting customers, and preventing fraud and misconduct. *Consumer protection* refers to a regulatory system which focuses specifically on the rights and interests of consumers in their interactions with businesses and other entities. Typically, consumer protection legislation applies across all sectors of the economy and, consequently, there will be some overlap between industry-specific regulation and economy-wide consumer protection systems.

Some aspects of financial services regulation were discussed in Chapter 1. In the UK, for example, the Financial Services Authority is the highest single financial services regulator with responsibility for building market confidence and public awareness, providing consumer protection and reducing financial crime across the sector. Its rule books and directives provide detailed guidance on all aspects of the conduct of business, and including product design and marketing. It is responsible for the regulation of deposit-taking, mortgage lending, insurance, investments and financial advice. However, Britain is also a member of the European Union, and financial services providers must also be aware of, and understand, the regulations relating to the single European market in financial services.

In contrast, in the US the responsibility for regulation is effectively split between the Securities and Exchange Commission (SEC), which regulates all aspects of the securities industry, and both the Federal Reserve System (FRS) and the Federal Deposit Insurance Commission (FDIC), which regulate most of the banking sector. (The term 'security' is usually used to refer to any readily transferable investment and includes company stocks and shares, corporate bonds, government (sovereign)

bonds, mutual funds and a range of other financial instruments. Typically, such products are represented by some form of certificate.) The SEC has as its mission 'to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation' (SEC, undated). It places particular emphasis on informed decision-making, and requires all public companies to disclosure any meaningful information so that that all investors have access to the same pool of knowledge on which to base purchase decisions. The Federal Reserve is the central bank of the US and has, as one of its responsibilities, the supervision and regulation of the banking and financial system. It has particular responsibility for domestic banks that choose to become members of the Federal Reserve, and for foreign banks. The FDIC is the primary regulator of banks that are chartered by individual states but which choose not to be members of the Federal Reserve. Its primary function is to promote public confidence in the financial system of the USA, and one of its best-known policy instruments is deposit insurance (to a maximum of ($100 000). A similar split arrangement operates in Australia, where the Australian Prudential Regulation Authority (APRA) is responsible for the supervision of banks, insurers, credit unions, building societies, friendly societies and superannuation funds. The APRA seeks to establish and enforce appropriate standards to create an efficient, stable and competitive financial system and, as with the FSA, relies on an approach which is essentially self-regulation – i.e. senior management in regulated institutions is responsible for compliance with APRA requirements. The Australian Securities and Investments Commission (ASIC) is responsible for regulating financial markets, securities, futures and corporations in order to protect customers, investors and creditors.

Regulations relating to consumer protection cover a wide range of topics, including (but not necessarily limited to), information provision (particularly advertising), product liability, privacy rights, unfair business practices, fraud, misrepresentation, and other forms of interaction between businesses and consumers. Regulations for consumer protection vary considerably across countries. In the UK, national priorities regarding consumer protection are set by the Office of Fair Trading (OFT) and enforced locally by Trading Standards offices throughout the country. The OFT is also responsible for regulating one major area of financial services that is not covered by the FSA – namely consumer credit. All businesses offering credit or lending to customers have to be licensed by the OFT and are required to make certain specified types of information available to consumers to aid with decision-making and to clarify their roles and responsibilities. Similar systems operate in many other countries. For example, in the US, the Federal Trade commission and the US Department of Justice have responsibility for enforcing federal legislation, and there are parallel organizations at state level. In Australia, the Trade Practices Act 1974 and related consumer protection legislation is enforced by the Australian Competition and Consumer Commission (ACCC), and its work is supplemented by equivalent state level agencies. In Singapore, the Consumer Protection (Fair Trading) Act of 2004 is a major component of the consumer protection regime. Its aim was to create a much fairer trading environment by identifying a series of unfair trading practices where consumers would have recourse to the law.

With growing economic integration, the analysis of the political environment must also consider the role of supra-national organizations such as ASEAN

(the Association of South East Asian Nations), APEC (the Asia Pacific Economic Community), NAFTA (the North American Free Trade Area) and the EU (European Union). As Case study 6.2 in Chapter 6 outlines, the EU has been active in trying to create a single market for financial services in Europe with a view to increasing competition in enhancing consumer choice. Similarly, the moves by ASEAN and the General Agreement on Trade in Service (GATS) to liberalize the financial sectors of South East Asian economies is often cited as one of the factors that contributed to the need for much greater consolidation in the domestic banking and insurance sectors. Specifically in the banking sector, the Basel Committee on Banking Supervision, which comprises central bankers from thirteen countries, has developed international standards for measuring the adequacy of a bank's capital with a view to creating greater consistency in the management of risk across banking systems. The resulting standards, enshrined in the Basel II Accord, can have important implications for lending decisions.

Of course, when thinking about the political and legal environment we should also recognize other more general provisions that might affect the operation of financial services organizations, including health and safety legislation and employment legislation. Not all aspects of work-related legislation and regulation will directly affect marketing, but good environmental analysis will at least allow awareness of their existence and their potential impact.

4.3.2 The economic environment

The economic environment covers all aspects of economic behaviour at an aggregate level, and includes consideration of factors such as growth in income, interest rates, inflation, unemployment, investment and exchange rates. Government economic policy (both actual and intended) is typically a central component of the macro-environment because of its impact on economic performance. The nature of consumer demand for financial services will inevitably be affected by economic performance; higher levels of economic growth will result in higher levels of demand for existing financial services, as well as creating demand for new ones. The growth in equity investments by private consumers and the increased demand for mutual funds is one aspect of this change in patterns of demand. In addition to the level of income and rate of growth, the proportion of income that is saved is likely to be another key consideration. For example, the US is currently reporting a national savings rate of less than 14 per cent, with household savings at less than 1 per cent of income. In contrast, national savings rates are estimated at around 20 per cent in Europe, 25 per cent in Japan and close to 50 per cent in China (www.businessweek.com/magazine, accessed 27 February 2006). As well as affecting overall economic performance, the savings rate provides an indicator of the potential size of the market for savings and investment products.

Equally important macro-economic influences will be interest rates and inflation. High real interest rates (based on the difference between inflation and nominal interest rates) may encourage savings; low real interest rates will tend to encourage borrowing. Equally, the current low interest rate and low inflation environment in the UK and the US constrains the extent to which cost increases can be passed on to consumers in the form of higher prices.

Often it is not sufficient to consider individual economic variables by themselves, as the interaction between variables can be important. It would be easy to assume that a fall in interest rates will increase demand for mortgages, but if those low interest rates are accompanied by either rising unemployment or falling average incomes then the expected change in demand may not materialize. Conversely, just because aggregate income rises we cannot assume that aggregate savings will also rise, because the savings decision will also be affected by other factors – including prevailing interest rates and taxation.

4.3.3 The social environment

The social environment is extremely broad and covers all relevant aspects of a society, including demographics, culture, values, attitudes, lifestyles, etc. The following discussion will highlight those aspects that may be of particular significance in relation to the financial services sector.

Demographics

The demographic environment encompasses all factors relating to the size, structure and distribution of the population. The potential market for any product is affected not only by the number of individuals within the population but also by the age structure and regional distribution of that population. Although world population is growing, the pace of change in many Western economies is slow, and in some cases virtually zero. Population changes depend on both birth and death rates, and while death rates have been falling worldwide, the fall in birth rates in many economies has largely counteracted this effect. For example, the birth rate (number of births per 1000 people) in the UK was estimated at 7.80 for 2005; for Hong Kong SAR the figure was 7.26 and for the United States, 14.14 (*CIA World Fact Book*, accessed on-line at www.cia.gov/cia/publications, March 2006). Countries with low birth rates typically have ageing populations – a feature that may have important implications for pension products, health insurance and long-term care insurance. In contrast, other countries are experiencing rapid growth in population, largely as a consequence of high birth rates and falling death rates. For example, Oman has a birth rate of 36.73, Pakistan has a birth rate of 30.42 and Paraguay has a birth rate of 29.43. Even allowing for falling death rates, such countries will have a very young population and potentially a very different profile of demand for financial services.

There are several other aspects of population structure that might be relevant to financial services. The regional distribution of the population, and particularly the balance between urban and rural areas, may be important – particularly so in relation to retail banking and the distribution of branches. Household structure is also relevant; in many Western economies such as the UK there has been a tendency towards a declining household size and an increase in the number of single-person households as individuals leave home but delay marriage. This trend will have implications for mortgage products and life insurance products – single mortgage-holders may feel less need for life insurance cover if they have no dependants to worry about. Of course, the decline of the extended family in many parts of the world also creates greater demand for products that provide financial

support in retirement, including pensions, care insurance and equity release products.

Culture

Understanding consumer needs is central to any marketing activity, and those needs will often be heavily influenced by cultural factors. Culture is a complex idea, and is difficult to define. As a general rule, it can be thought of as a term that defines 'how we do things here' – it relates to how people behave, what they believe, what they value, their customs and traditions, and what is considered acceptable and unacceptable. Any type of marketing must recognize the significance of culture, and financial services are no exception. In principle, the biggest challenge that culture presents is in relation to international markets, where an ability to understand the prevailing culture and adjust and adapt to it are essential. However, an understanding of culture and cultural changes is also relevant in domestic markets. The nature of marketing communications, the use of colour and particular symbols can all touch on cultural sensitivities. Some countries may have a relatively homogeneous culture, while others can be very diverse. In the US, for example, marketers must be sensitive to the different heritage and cultures of the Hispanic, African and white communities. In the UK there is also considerable diversity, with significant proportions of the population being of south Asian or Caribbean heritage. Different cultural backgrounds may be reflected in different response to marketing communications, different decision-making processes and different product preferences. One of the strongest elements of culture is religion, and this provides a very clear example of the way in which culture can affect marketing. Paying or receiving interest (*riba*) is against the teaching of Islam, and is thus *haram* (unlawful). Islam forbids all forms of economic activity that are morally or socially injurious. *Riba* is harmful because it is seen as wealth generated purely by the ownership of money rather than by genuine economic activity. The prohibition of interest in Islamic law (*Shari'ah*) presents a major challenge for traditional banks, whose business revolves around interest margins, but equally presents a major opportunity for the growing number of specialist Islamic banks. Further detail about Islamic financial services is provided in Chapter 10.

Other social influences

A range of other issues relating to social structures and social values may also be important for financial services providers, including changing patterns of work, changing social structures and changing values. These factors may affect the ways in which people may wish to access financial services – for example, people who are working longer hours may place greater importance on being able to access their bank accounts through ATMs, telephone banking and Internet banking. Social influences may also affect the types of financial services demanded. Thus, for example, with an increasing value being placed on education, prospective parents may seek financial services that allow them to save for their children's education. With more people travelling internationally, demand for internationally recognized debit and credit cards will continue to increase. Where consumers are concerned about environmental or ethical issues, there may be a demand for financial services that

are provided in a way that is consistent with these values. This trend has been touched on in reference to the earlier discussion on Islamic finance, but its impact may be broader still if consumers seek to invest in stocks or mutual funds which have a 'green' (environmentally friendly) dimension.

4.3.4 The technological environment

Technology essentially refers to our level of knowledge about 'how things are done'. That is to say, understanding this aspect of the marketing environment is much more than simply being familiar with the latest hi-tech innovations. Technology affects not only the type of products available, but also the ways in which people organize their lives and the ways in which goods and services can be marketed. In the financial services sector, the single most important aspect of technology has been ICT – information and communications technology. ICT has had a dramatic impact on the delivery of financial services, the types of financial services that can be offered and the ways in which those services are marketed.

Financial services may now be delivered via ATMs, by telephone and via the Internet (by either PC or Wap phone). ATMs were first introduced in the US in the 1970s, and at that stage their main function was to dispense cash. As technology developed and consumer acceptance of ATMs increased, machines were developed with a much wider range of functions which allow individuals to undertake an extensive range of banking activities. Customers of many banks, including ABN-AMRO, Standard Chartered and HSBC, can undertake most standard banking transactions 24 hours per day, including withdrawal, deposit, balance updates, balance transfers, and bill payment and passbook updates. The ICICI Bank in India is one of a growing number of banks with an even wider range of services offered via their ATMs, including top-ups to pre-paid mobile phones, charity donations, calling cards, mutual fund transactions and even donations for blessings at selected temples. The development of ATMs has certainly provided much greater flexibility for consumers in terms of their access to bank services; it has also served as an additional marketing tool, as banks use the ATM transaction to promote other services.

The telephone has a long history of use in the purchase and management of financial services, supporting interpersonal interactions and paper-based transactions (for example, customers telephoning to obtain an insurance quotation). Phone banking was probably the next major initiative in service delivery, with the first systems appearing in the mid-1980s. Most financial services providers now offer or are developing phone banking systems using a mixture of automated voice recognition outside of reasonable working hours, and personal contact during reasonable working hours. In the UK, First Direct was launched in 1989 as the country's first purely phone bank, and rapidly became one of its most successful. In another innovation, First Direct launched text-messaging banking and is currently the UK's largest provider of this service.

A growing number of financial services are now available on-line. The development of the worldwide web provided a major impetus for the development of computer-based banking. Until this point in time, and with a few notable exceptions, computer-based banking was largely restricted to corporate markets. In the mid-1990s the early adopters launched their Internet-banking services in the

US, Europe, Japan, Australia and New Zealand. Regions such as South East Asia, South Asia, the Middle East and South America rapidly followed. Yet, for retail customers, Internet banking has not replaced the traditional branch – it has become essentially an alternative, complementary channel of distribution, and the number of purely Internet banks remains limited. The Internet has also proved effective for dealing in a range of other financial services, including simple insurance, loans, mortgages, share trading and mutual fund trading. However, research on customer attitudes does tend to suggest that more retail customers feel comfortable when using the Internet for relatively simple products and many are much less comfortable with the idea of using it for more complex products (Black *et al*., 2001).

Clearly, these technology-enabled distribution channels offer many benefits to certain customer segments. They also offer significant cost benefits to organizations, with the cost of Internet-based transactions being estimated at 10 per cent of the cost of phone transactions and 1 per cent of the cost of in-branch transactions. However, Internet-based distribution may also pose a marketing problem if fewer customers visit the branch and there is, therefore, less of an opportunity actively to sell to those customers. A growing challenge for many banks concerns the management of large branch networks at a time when more and more of their customers are looking to alternative forms of delivery.

The impact of ICT developments is probably most visible in relation to external developments in delivery channels. However, the internal marketing implications of ICT are considerable. Rapid developments in processing power (based on both hardware and software improvements) allow financial services organizations to collect and process huge volumes of customer information. Marketing databases can be developed based on the information provided by customers in, say, an application for a credit card or a mortgage. These data can then be used to understand existing customers more thoroughly, and also to identify the types of consumers most likely to buy certain products. The nature and importance of customer relationship management and the significance of effective use of customer information is discussed in greater detail in Part III of this book.

4.4 The market environment

The market environment focuses on the immediate features of the market in which the firm operates. Understanding this aspect of environment is of particular importance, as the market environment will have a very immediate impact on an organization's activity. There are many different approaches that might be used to understand what is happening in the market environment. One of the most widely employed is the idea of analysing the five forces that determine market/industry profitability – an approach that was developed in the 1980s by Michael Porter. This is shown in Figure 4.3.

An effective marketing strategy will need understanding of how these forces work together and what they mean for the organization. If a particular market environment is favourable or attractive, then an organization should find it easier to compete effectively. A market is considered favourable or attractive if the forces

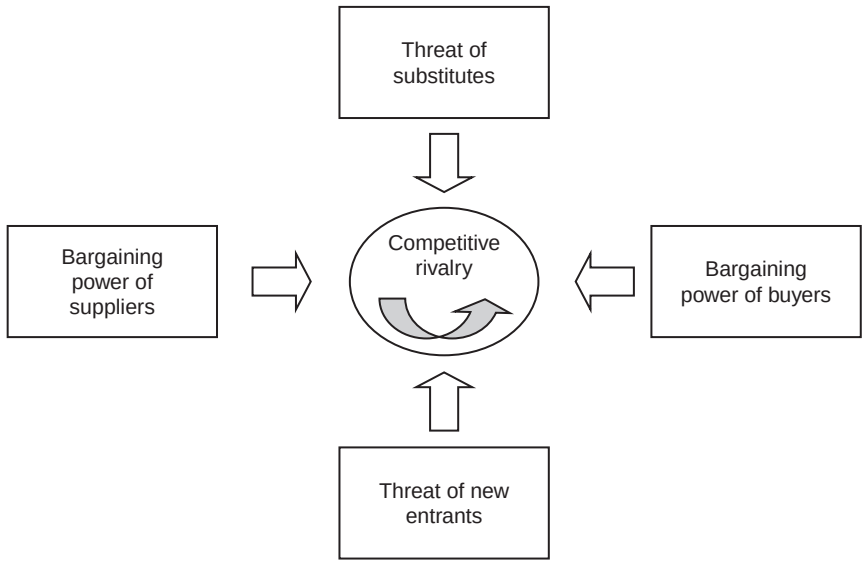

Figure 4.3 Five-force analysis (source: Porter, 1980).

working against an organization are relatively weak. Where the forces are strong they impose constraints upon what an organization can do, and marketing strategies will need to consider how best to neutralize and respond to the problems that the organization faces. Thus, for example, customers may be in a strong position (high bargaining power) because it is relatively easy to switch between different providers. In this situation, a bank may consider focusing attention on marketing strategies that build a strong relationship with customers (perhaps via cross-selling a range of products), making them more likely to remain with the bank. If successful, this strategy will make the market more attractive and thus enhance the bank's competitive position.

Porter argues that market or industry attractiveness and profitability depends (as economic theory would suggest) on the structure of the industry, and specifically on five key features:

1. *The bargaining power of suppliers*. Powerful suppliers can force up the prices paid by an organization for its inputs, and thus reduce profitability. Suppliers in financial services include the suppliers of essential business goods and services (computing equipment, training, etc.), and to the extent that these suppliers are in a strong position they can affect the prices paid for relevant goods and thus affect costs. It could also be argued that, in some instances, the term 'suppliers' could also include customers. Customers making deposits with financial institutions are effectively acting as suppliers of certain essential raw materials, and again, if these suppliers are in a relatively strong position they can impact on the cost of providing certain related financial services.
2. *The bargaining power of consumers*. Powerful consumers can insist on lower prices and/or more favourable terms, which may impact negatively on profitability.

Clearly, the bargaining power of buyers in financial services varies considerably. In personal markets it seems that the bargaining power of individual consumers is relatively weak, although consumer pressure groups may partly counterbalance this – particularly through their evaluations of the performance of financial institutions. In corporate markets the situation may be rather different, with relatively large businesses being in a rather more powerful position.

3. *Threat of entry*. A profitable industry will generally attract new entrants; if it appears relatively attractive for new organizations to enter a market, profitability will tend to be eroded. While there are certainly barriers to entry to the financial marketplace, not least of which are the many regulatory requirements, the financial sector does attract a variety of new entrants. In some cases, these are new entrants from other sectors of the domestic economy. A growing number of retailers offer consumer credit and store cards to fund consumer purchases. In the US, General Motors offers credit cards, while in the UK, supermarkets such as Tesco and Sainsbury offer a wide range of financial services alongside their traditional grocery products. Richard Branson's Virgin Group, originally in the music business, now offers a range of financial services ranging from credit cards to personal pensions. In many cases these new entrants may still rely on traditional financial services providers, which are then offered to consumers using the new entrant's own brand. Even though they may depend upon existing suppliers of financial services, they still constitute a significant new source of competition. The threat of new entry is not restricted to firms in other sectors of the economy; there is increasingly a very real threat from new entrants from overseas, as is discussed in greater detail in Chapter 6.
4. *Competition from substitutes*. The existence of products which are close substitutes enhances customer choice and provides an alternative way of meeting a particular need. Thus, in markets where there are close substitutes, the buying power of consumers is effectively enhanced because they have a much greater degree of choice. The extent to which there are real substitutes for financial services is perhaps limited, although in certain sections of the market, such as investment services, gold, jewellery, antiques and other collectibles may be regarded as substitutes for investments in mutual funds, equities and other forms of saving. It is interesting to note the extent to which increasing numbers of people view investment in property as a substitute for traditional investment in pensions as a vehicle to provide income and capital in old age. This, in part, has fuelled a rapid increase in what is termed the 'buy-to-let' market.
5. *Rivalry between firms*. Clearly, the greater the degree of competition, the more likely it is that the industry will be less profitable and therefore less attractive. While there are few close substitutes for financial services (as indicated above), there is considerable competition within the industry. Most countries have seen some degree of consolidation in their financial services sector and, while this has reduced the number of competitors, the remaining players are often strengthened, resulting in increased competition. Moreover, as financial markets have liberalized and the barriers between institutional types have been reduced, competition has also increased. Insurers no longer compete just with other insurers – they also compete with banks, savings institutions and investment companies. The development of bancassurance (a term used to describe a system in which banks broaden their product offerings to include a more extensive range of insurance,

savings and investment products which would have traditionally been offered by more specialized companies) in many financial sectors worldwide is just one example of this type of development. Equally, in the banking sector, current accounts and housing finance may be offered by companies that traditionally specialized in insurance. In Malaysia, for example, the insurer AIA now offers housing finance in direct competition with traditional suppliers. In the UK, the insurer Prudential launched the on-line bank Egg, which offers a range of traditional banking products with very competitive terms and conditions.

These five forces determine the attractiveness of the industry through their impact on either costs incurred or prices received, or both. The development of an effective marketing strategy will depend upon a thorough examination of the market in order to enable the organization to identify strategic approaches to counterbalance the effects of these five forces.

4.5 The internal environment

Clearly, the internal environment is the area in which the firm can exercise greatest control. Understanding the internal environment requires analysis of an organization's resources and capabilities in order to understand how these might be used to create a competitive edge in the delivery of financial services to the organization's target market.

4.5.1 Resources

The term *resources* is used to describe any inputs which are used by an organization in order to produce its outputs. Resources are normally categorized as either tangible or intangible. Tangible resources include the following:

1. Human resources, including issues such as the number and type of staff, and their particular skills and qualities (attributes such as flexibility, adaptability, commitment, etc., may be of particular significance in many organizations). The UK bank First Direct might point to its staff – their customer orientation, expertise and skill – as being a key tangible resource.
2. Financial resources, including a variety of factors such as cash holdings, levels of debt and equity, access to funds for future development, and relationships with key financial stakeholders (for example, bankers and shareholders). Leading international banks such as HSBC and Citibank may see their financial strength as a significant resource.
3. Physical/operational resources, encompassing premises, equipment, internal systems (e.g. IT systems) and operating procedures. CapitalOne, the credit card company, might point to its systems for rapid development and product customization as being a key resource for the company. For a domestic bank the branch network may be a key resource, particularly when competing against new international entrants.

Intangible resources typically do not have any physical form, and some may not have any obvious monetary value, but for many organizations they can be one of the key resources that help to create competitive advantage. Examples of intangible resources might include specialist knowledge or experience, brand names and brand equity, and the internal culture within an organization. American Express might cite the strength of its brand as a significant intangible resource; investment companies might focus on the skills and knowledge of their fund managers in delivering superior returns to customers. Corporate culture, which is typically defined as the prevailing value system within an organization, is widely recognized as an important intangible resource. This value system may be one that has arisen through time, or it may be one that is actively created and managed by senior staff. A corporate culture associated with rapid innovation and risk-taking will have different marketing implications to a culture orientated towards high quality and an exclusive image, and this in turn will differ from an organization with a low-risk culture looking to follow the market with a standard product.

Some commentators also make a distinction between internal resources, which actually belong within the organization, and external resources, which are outside the organization but still under its control (such as formal or informal networks, personal contacts, locations, surroundings, etc.). Some financial services providers might look to their relationships with networks of financial advisers as an important external resource.

4.5.2 Competences/capabilities

The words 'competence' and 'capability' are often used interchangeably, although some would suggest that they have slightly different meanings. For our purposes, we will use the two words interchangeably. They refer to certain skills or attributes that are necessary in order to be able to operate within a particular industry. Competences or capabilities would be present amongst most organizations in an industry – without those competences, the organization would not be able to operate. Operating in the banking industry requires competences in relation to deposit-taking, lending, service provision, financial management, treasury, etc. Equally, insurers require competences in relation to premium collection and management, underwriting, customer service and claims management. Key to an analysis of competences is the ability to identify those in which an organization is noticeably more effective than its competitors. These core competencies or distinctive capabilities provide a basis for delivering superior customer value, and thus creating competitive advantage. A core competence will typically arise from a combination of resources and competences which are of value in relation to a particular market. In the US, Wachovia Bank's competence in credit, derived from both people and systems, has enabled it to report much lower write-off rates compared to the industry average, resulting in a significant positive impact on return on equity (Coyne *et al*., 1997).

The distinguishing features of core competences are that they are only possessed by the successful organizations in an industry, they are important in fulfilling customer needs and they are difficult to copy. Core competences provide an organization with a genuine competitive edge in the marketplace. When properly exploited, core competences are the basis for delivering superior customer value (Prahalad and Hamel, 1990).

4.5.3 Auditing the internal environment

Analysis of the internal environment requires a careful evaluation or audit of the organization's resources and capabilities. This is more than just assessing the quantity or a resource or capability – it is also about assessing quality. A good audit might consider the following:

- Specificity – are the resources/capabilities unique to a particular type of industry or are they generic? Resources/capabilities that are unique and important to a specific industry are often more likely to provide bases for developing a core competence.
- Substitutability – can this resource/capability be replaced with another? Substitutability may allow for greater flexibility in the process of delivering value for customers.
- Mobility – could this resource/capability be easily transferred to a competitor? (For example, staff may be an important resource, but are potentially quite mobile.) Where resources are mobile, there is a need to think careful about how to protect them and retain their value within an organization.
- Contribution – what is the importance of a particular resource/capability in terms of adding value to the overall offer? Resources/capabilities with a key role to play in value added may require more protection and investment than resources that are not strategically significant.

An internal analysis may also focus on internal structures (for example, how does marketing relate to other activities?), recruitment and reward systems for staff, the effectiveness of internal communication and the degree of centralization. Although these may not be directly related to marketing, they can have important implications for what marketing does. Thus, for example, a bank that rewards a group of staff based on the number of credit cards it sells or the number of new accounts it opens may create an incentive for those staff to deal with every customer as quickly as possible and pressure them into buying. This may yield short-term benefits, but the danger is that in the longer term the customers recruited in this way will be less satisfied and perhaps less profitable.

4.6 Evaluating developments in the marketing environment

The kind of analysis described in the previous sections will generate a large amount of data. The process of SWOT (Strengths, Weaknesses, Opportunities, Threats) analysis is one of the simplest techniques for summarizing information about the marketing environment and guiding the direction of strategy. The information collected in the environmental analysis can be classified as either external (i.e. it relates to the outside environment) or internal (i.e. it relates to the organization itself). External information may present the organization with an opportunity, or it may create a threat. Equally, internal information may describe either a strength or a weakness. Any evidence produced by the environmental analysis will therefore belong to one of these groups:

- *Strength*. Any particular resource or competence that will help the organization to achieve its objectives is classified as a strength. This may relate to experience in specific types of markets – for example, HSBC may point to its accumulated knowledge of Asian markets. Specific skills or abilities may also constitute a strength, as will resources such as a strong brand image, or an extensive branch or ATM network.
- *Weakness*. A weakness describes any aspect of the organization that may hinder the achievement of specific objectives. Weaknesses are often the opposite of strengths, so, for example, a small branch network, poor internal information systems or an unfavourable brand image may all constitute weaknesses.
- *Opportunity*. Any feature of the external environment that is advantageous to the organization, given its objectives, is classed as an opportunity. Credit card issuers may see the growing demand for foreign travel as an opportunity to increase the sale of credit cards. Insurers looking at the Chinese market might see the current low take-up of life insurance as an opportunity.
- *Threat*. A threat is any environmental development that will create problems for an organization in achieving its specific objectives. Opportunities for one organization may be a threat for others. The efforts of the EU to create a single market in financial services might be classed as a threat by some providers because of its potential to increase competition.

Once information has been classified in this way, it can be presented as a matrix of strengths, weaknesses, opportunities and threats. For SWOT analysis to be of value it is important to ensure that strengths and weaknesses are internal factors specific to the organization, and that opportunities and threats are factors which are present in the external environment and are independent of the organization. A common mistake in SWOT analysis is to confuse opportunities and threats with strategies and tactics. For example, the ability to contact customers via direct mail is not an opportunity, it is a marketing tactic. The relevant opportunity would be the existence of a segment in the market that would respond favourably to promotion via direct mail.

Given the volume of information, a SWOT analysis should concentrate only on the most important strengths, weaknesses, opportunities and threats. Whether something is important depends upon how likely it is to happen and how significant its effect would be. Thus, for example, a provider of housing finance may consider a major economic downturn to be something that would have a big impact on new and existing business, but if the likelihood of this happening is low, then this factor should not be seen as a serious threat. In the example in Figure 4.4, the information in each cell is ranked to account for these factors.

Having formulated this matrix, it then becomes feasible to make use of SWOT analysis in guiding strategy formulation. The two major strategic options are:

1. *Matching*, which entails finding (where possible) a match between the strengths of the organization and the opportunities presented by the market. Strengths that do not match any available opportunity are of limited use, while opportunities that do not have any matching strengths are of little immediate value from a strategic perspective. Thus, for example, the bank in Figure 4.4 may consider a strategy of using its captive account base to pursue a strategy of cross-selling

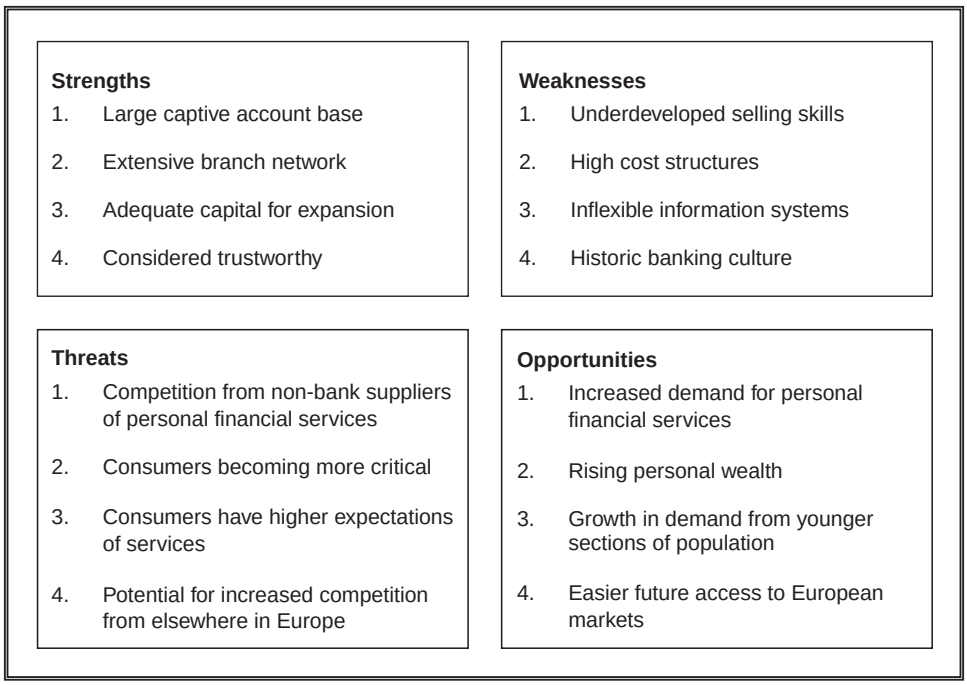

Figure 4.4 SWOT Analysis for a UK clearing bank in relation to the market for personal financial services (adapted from Ennew, 1993).

other financial products through direct mail campaigns that emphasize the bank's trustworthy image.

2. *Conversion*, which requires the development of strategies that will convert weaknesses into strengths in order to take advantage of some particular opportunity, or converting threats into opportunities which can then be matched by existing strengths.

Case study 4.1 shows how the Czech insurer Kooperativa was able to build on key strengths, relating to staff skills, expertise and willingness to learn, to exploit the opportunities created by liberalization and the low penetration of insurance products.

Case study 4.1 Kooperativa Insurance Company Ltd

Kooperativa pojistovna a.s. (Kooperativa Insurance Company Ltd.) is one of the largest and fastest-growing insurance companies in post-Communist Eastern Europe. In just 15 years it has grown from scratch to become the Czech Republic's second largest insurance company, with a record-breaking US$1.1bn of written premiums in 2005.

Case study 4.1 Kooperativa Insurance Company Ltd—cont'd

The following factors have been of significance in enabling Kooperativa to achieve its success:

- the formation of a group of competent and well-skilled staff from the insurance business who were willing to take the risks associated with leaving the former monopolist company to set up the new venture
- support from shareholders, chief of which was Wiener Staedtische Allgemeinge Versicherung
- a favourable backdrop whereby the Czech insurance market was open to new kinds of insurance
- the extensive use of reinsurance to hedge risk
- a willingness to gain know-how from foreign shareholders and reinsurers.

Kooperativa strengthened its position as second in the market, and by the end of 2005 its market share had increased to 22.9 per cent; non-life insurance accounted for 28.9 per cent of the market. Life assurance written premiums had grown by 25 per cent to a total of CZK 6 billion. It has more than two million clients – indeed, Kooperativa insures every fifth Czech citizen. The financial results are also positive; for example, in 2004 Kooperativa achieved a gross profit of CZK 765 million (US$30m) and in 2005 it was CZK 1300 million (US$52m) – a year on year increase in profit before tax of 11.9 per cent and 70 per cent respectively.

Today, Kooperativa offers a complete insurance service for all kinds of clients – business as well as individuals. Its product range comprises general insurance and life assurance, including insurance for liability risks. From the beginning, Kooperativa positioned itself in the market with an individual approach to the client – a new phenomenon in the Czech insurance market. For the country's budding new entrepreneurs, it has helped to identify the risks that most endanger their economic prospects in both their personal and business affairs. It offers modern contracts drafted in order to inconvenience them as little as possible. Being simple and quick to complete, they save time and provide a wide range of insurance coverage according to customers' wishes, needs and financial possibilities – from its very start the company has always provided insurance to fit closely both their product and service needs.

Another reason for Kooperativa's success is the quality of its claims adjustment. This includes the ability to report losses by telephone, the use of up-to-date methods of communication, and technologies such as digitalization and the Internet.

In 2004, the company acquired four smaller insurance businesses and established the development of a strategic co-operation with the Ceska Sporitelna Financial Group (one of the biggest Czech banks). These events represented the company's response to changes in its business environment – including: the Czech Republic's entry into the European Union, new competition, and the continuing adaptation of the Czech market to the up-to-date insurance trends found in more commercially advanced countries. This has enabled Kooperativa to respond to the

Continued

Case study 4.1 Kooperativa Insurance Company Ltd—cont'd

challenges posed by bancassurance and other financial new product developments in an effort to provide for all clients' financial needs at a single sales point.

Kooperativa's trade representatives are gradually becoming true financial advisers, able both to satisfy all clients' insurance needs and to act as brokers for other financial services – whether obtaining a credit card or a mortgage, or executing contracts on building savings or supplementary annuity insurance. They are also able to broker consumer loans for clients, or to assist them in opening a bank account.

Recently, the company has reaffirmed that the core of its corporate strategy for the next few years will be based upon:

- developing Kooperativa as a large, modern insurance company transacting all types of life assurance and non-life insurance based on the needs of the clients
- continuously improving the quality and comprehensiveness of the services offered, to transact business swiftly, and to take a flexible and personal approach to the clients
- guaranteeing the clients a considerable level of security based on high registered capital and a high-quality reinsurance programme.

Kooperativa endeavours to be not only an insurer but also a reliable partner, providing advice and support under all circumstances.

Again, a key strategic objective of the company is to strengthen its position in the domestic insurance market and increase its market share.

Source: Vladimir Chludil, Kooperativa.

SWOT analysis is probably one of the most widely used tools in marketing and strategic planning, and is simply a method of structuring information of both a qualitative and a quantitative nature. Its advantages arise from the fact that it is easy to use, does not require formal training and therefore is accessible to all levels of management across a broad field. This simple technique provides a method of organizing information and identifying possible problems and future strategic directions.

4.7 Summary and conclusions

The environment within which organizations operate is becoming increasingly complex and turbulent and, as a consequence, increasingly uncertain. Understanding the nature of this environment and its implications for the organizations is a key element in any marketing strategy. The environment must be analysed at a number of different levels, from broad, macro-factors to market-specific and finally organization-specific factors. However, although these elements of the environment constrain the

activities of the organization, it is increasingly important to recognize that the organization itself, through its marketing activities, can influence the environment to produce conditions which are more favourable to the success of its strategies.

Review questions

1. Why is it important to understand the external environment? What role does marketing play?
2. Choose a financial services provider. What are the opportunities and threats that the macro-environment creates?
3. Choose a market that you know well (e.g. current accounts, mutual funds, credit cards, housing finance) and analyse the five forces. What are the opportunities and threats?
4. Prepare a SWOT analysis in relation to an organisation in the market that you analysed in Question 3. What are the market-level opportunities and threats and macro-level opportunities and threats that you think may be relevant? Include them in the analysis.
5. In what ways do factors in the physical environment, such as climate-related issues, impact upon financial services?

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5

Strategic development and marketing planning

Learning objectives

By the end of this chapter you will be able to:

- explain the importance of planning marketing activities
- understand the value of taking a strategic approach to marketing
- outline stages in the process of planning marketing
- understand some of the tools and techniques that are used in developing marketing strategies.

5.1 Introduction

Planning is an essential element of marketing. Planning will help to ensure that an organization's marketing activities are consistent with its objectives, with the capabilities of the organization and with the needs of the marketplace. Planning provides a systematic analysis of what marketing activities are being undertaken, why and how. Effective planning must establish targets, identify how and when those targets are to be achieved, and establish who will take responsibility for the relevant marketing tasks. By stating objectives, procedures, processes and personnel requirements prior to undertaking marketing activities, the plan also provides a framework for the monitoring and control of marketing.

Planning has always been an important activity, and in the current environment it is particularly important. Chapter 4 discussed some of the changes that have occurred in the marketing environment. Change is increasingly common, it happens quickly and it can often be complex. For example, the European Union's Financial Services Action Plan, when launched in 1998, proposed a series of policy initiatives

to establish a single market in wholesale financial services, to make retail markets open and to strengthen the rules on prudential supervision. In so doing, it heralded a period of significant change for the financial services sector. Planning encourages the organization to think about the future and to adopt a strategic focus, which means that the organization should be much better placed to respond to a rapidly changing environment.

The sort of changes described in the previous chapter have created significant competitive threats for established financial services organizations. At the same time, many of these changes have also created new opportunities. Faced with this environment, it would be unwise to adopt an unplanned approach to marketing. It would be equally unwise to rely on a simple tactical approach, supplying the same products to the same markets. When faced with a complex, changing and uncertain environment, it becomes increasingly important for organizations to adopt a strategic approach to their markets. Such an approach will encourage careful consideration of products offered and markets served, and should provide an organization with the means to allocate its resources effectively and efficiently in the pursuit of specified objectives.

This chapter deals with both strategy and planning in relation to marketing. It will begin by defining strategic marketing, and will then examine the structure of a marketing plan and briefly review stages in the planning process. The later sections will examine strategy development and explore the different tools that can be used to guide strategic thinking. The focus throughout will be on the strategic aspects of marketing planning, including strategies for growth, sources of competitive advantage and methods for planning the product portfolio.

5.2 Strategic marketing

It is generally thought that organizations in the financial services sector have been slow to adopt a strategic approach to their marketing activities. For a long time, the marketing of financial services was largely concerned with how best to advertise and sell an existing set of products in a given market; indeed, many people think that this is what marketing is all about. However, there is more to marketing. A strategic approach to marketing in the financial services sector needs to concern itself with understanding consumers and deciding how best to respond to their needs. It must also focus attention on the competition and try to identify how to outperform key competitors.

The adoption and implementation of a strategic approach to marketing should impact positively on organizational performance. An understanding of customer and competitors will enable an organization to deliver superior customer value to the market. In turn, superior customer value will facilitate both customer acquisition and customer retention. Successfully growing new business and keeping existing customers will have a positive impact on organizational performance, and particularly on profit and cash flow. However, for life and pensions business there is the added consideration of the need for capital to support the new business strain that accompanies growth. This serves to strengthen further the need for effective long-term

marketing planning. The concept of the service–profit chain which is discussed in more detail in Part III of this book, stresses the importance of retention in improving performance on the grounds that it costs less to retain a customer than it does to acquire one. More generally, Doyle (2000) argues that investment in strategic marketing in order to increase revenues is a far more effective way of improving shareholder value than trying to reduce costs. The degree to which costs can be reduced is limited and, while cost control will be important, the best opportunities for enhancing financial performance arise from growing the volume and/or the value of sales. Strategic marketing is essential to revenue growth because it focuses the organization on customers, competitors and the challenges of a constantly changing marketplace. Central to Doyle's view is the argument that marketing expenditure should be viewed as an investment (rather than an annual cost) and its impact monitored over a longer time period. Investment in activities such as brand-building, establishing new distribution networks or moving into new markets are all long-term activities. Their initial impact on sales may actually be quite limited; their longer-term impact could be quite considerable.

Thus, a strategic approach to marketing has at its heart organizational performance and the idea that performance can be enhanced if the organization is market orientated , if it understands the changing market environment and can respond in ways which result in the delivery of a level of value to customers that is superior to that offered by competitors. In that sense, we can think about strategic marketing as being a broad, generic approach to marketing. The specific form that strategic marketing takes will vary across organizations and markets, and will be represented by the organization's marketing strategy.

Within any financial services provider, strategies develop at several levels. A corporate strategy is concerned with the overall development of the business and will include specific strategies for different areas (e.g. an IT strategy, a human resource strategy, a marketing strategy). The marketing strategy focuses specifically on the organization's activities in relation to its markets.

Like any strategy, marketing strategy is concerned with being both efficient and effective. Efficiency is about doing a particular activity well. An efficient phone banking operation will be one that is highly cost-effective and reliable. In contrast, effectiveness is concerned with doing the right thing. Thus, an effective phone banking operation is one that offers the right services to the target consumers – the services that consumers need and want. To be effective, a financial services provider must have the right sort of services and be offering them to the right market. This in turn means that an understanding of the environment is essential, because it is only by understanding the market, and how it might change, that an organization can be confident that it is doing the right thing. When the Indian banking sector liberalized in the mid-1990s, the success of one of the early entrants, HDFC Bank, was largely due to its awareness of changing customer expectations and the identification of a significant group of mid-market customers who were prepared to pay for better service (Saxena, 2006).

A good marketing strategy will:

- identify specific objectives that the organization wishes to achieve
- commit resources (money, time, people) to help achieve these objectives
- involve a thorough evaluation of the marketing environment

- aim to match environmental opportunities and organizational capabilities
- focus on the delivery of superior value.

Delivering superior value to customers lies at the heart of strategic marketing and the development of a competitive marketing strategy. The notion of 'superior value' highlights the importance of outperforming the competition. Indeed, when talking more broadly about competitive strategy, Porter (2002) notes that:

> Competitive strategy is about being different. It means deliberately choosing a different set of activities to deliver a unique mix of value.

Clearly, delivering superior value starts with the organization itself and the activities in which it is able to excel. What is delivered must then be superior to the competition and relevant to customers. Superior value may arise from reducing costs to the customer or from increasing benefits, and those benefits may be functional or emotional. The emotional benefits associated with leading brands (e.g. reduced risk, increased confidence) may be a particularly important element of value in some areas of financial services.

5.3 Developing a strategic marketing plan

A marketing strategy is essentially a statement of how an organization plans to compete for business in its particular market, and most marketing strategies will be presented in the form of an overall marketing plan. Philip Kotler (1994) defined strategic planning as:

> the managerial process of developing and maintaining a viable fit between the organization's objectives and resources and its changing market opportunities. The aim of strategic planning is to shape and reshape the company's business and products so that they combine to produce satisfactory profits and growth.

Every organization has its own approach to preparing marketing plans, and there is no single correct approach. However, a good plan does have a number of important features. It should:

- have a logical structure
- contain explicit marketing objectives which link to corporate objectives
- analyse the environment (both internal and external) and the current position of the organization
- based on this analysis, identify which combinations of products and markets the organization will serve and how it will compete (segmentation, targeting and positioning)
- contain specific decisions relating to key marketing variables such as product, price, promotion and place (the marketing mix)
- conclude with an outline of the appropriate methods for implementing the identified strategy, including issues relating to budget, accountability and evaluation.

Although the plan needs to provide clear guidelines as to how marketing activities are to be managed, it should have some flexibility to allow the organization to adapt and respond to unexpected changes.

As we have said, there is no single format for a plan, but one possible approach is outlined in Figure 5.1. This presents the key elements of a marketing plan and also highlights the importance of feedback, which may lead to adjustments to the plan once it has been put into operation.

5.3.1 Company mission and objectives

The mission statement essentially requires that the organization defines the area of business in which it operates, and defines it in way that will give focus and direction. In effect, the purpose of the mission statement is to outline the goals of the organization and identify, in broad terms, the ways in which the organization will achieve those goals. For example, the mission of the Indian based Bank of Baroda is:

> To be a top ranking National Bank of international standard committed to augmenting stakeholders' value through concern, care and competence.

The nature of the corporate mission depends on a variety of factors. Corporate history will often influence the markets and customer groups served – for example, Credit Agricole's rural and mutual tradition influences the way in which it approaches its market. Although it is in no way restricted to serving the agricultural community,

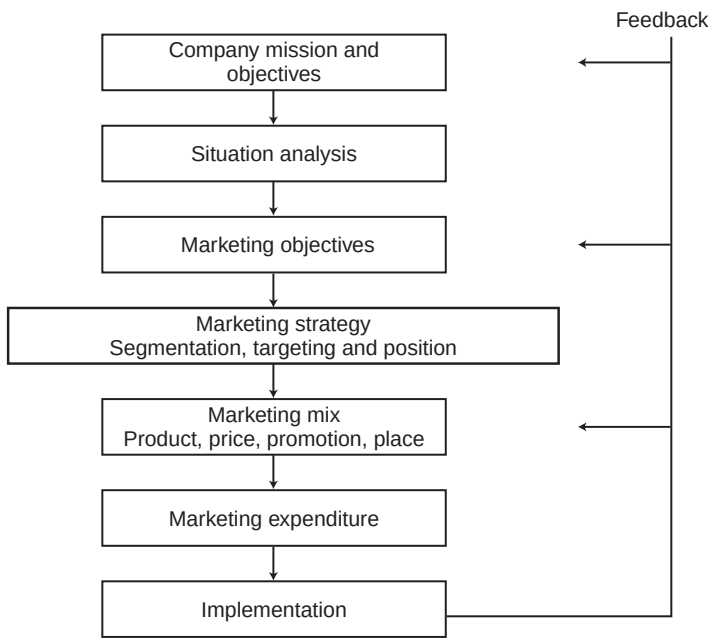

Figure 5.1 An illustrative strategic marketing plan.

Credit Agricole's heritage means that the bank places particular importance on involvement in the local community, being close to the customer, and the bank prides itself on having the largest high-street branch network. Similarly, culture in its broadest sense will also be an important influence – perhaps most notably with Islamic banks, as is apparent in the mission statement of Malaysian-based Bank Islam:

> To seek to operate as a commercial bank functioning on the basis of Islamic principles, providing banking facilities and services to Muslims and the whole population of this country, with viability and capability to sustain itself and grow in the process.

Typically, a corporate mission will be defined in terms of the types of customers (e.g. Muslims and the whole population), the needs being satisfied (banking facilities) and the technology used (Islamic principles). This way of defining the mission is helpful from a marketing perspective, because it forces managers to think about customers and their needs. Indeed, ideally the mission statement would avoid mentioning a product. For example, an insurance company should perhaps think of its mission as being 'meeting consumer needs for risk reduction and financial security', rather than simply 'insurance'. By focusing specifically on needs and not on the product, the mission statement can help to guide the future development of the organization. It can also help the organization avoid 'marketing myopia' – a problem that arises when organizations focus too much attention on their products and not enough on their customers' needs.

5.3.2 Situation analysis

In many senses, marketing strategies and marketing plans are concerned with obtaining a 'fit' or 'match' between an organization and its environment. To be effective, an organization needs to be able to use its resources and capabilities in an environment in which they will have most value. Consequently, any marketing plan will require a thorough analysis of both the external and the internal environment. This analysis will help the organization to meet customers' needs more effectively than the competition, and to make the most of its available resources. Details on the process of analysing the marketing environment were discussed in Chapter 4. The results of a PEST analysis, a five-force analysis and SWOT analysis all provide essential input to a good marketing plan.

Marketing research and market intelligence provide much of the information used in an analysis of the marketing environment. This information may be gathered by a variety of formal and informal means, ranging from a customer survey through commercial databases, informal contacts and consultancy reports to, increasingly, material on the Internet.

It must be appreciated that the SWOT analysis plays a key role in producing guidance at both the strategic and tactical levels. A well-founded, intelligently approached SWOT analysis ensures that opportunities are not overlooked and choices are made that play to the company's strengths. The quality of the SWOT analysis is a function of the quality of the Situation Review. Superficial, casually conducted Situation Reviews result in anodyne, somewhat pointless, SWOTs. A degree of detail is required that is commensurate to the market or product area in question.

It is important to grasp the point that when we refer to a strength, we should seek to identify aspects of the organization's assets, capabilities and competencies that represent *a relative competitive strength*. It is not sufficient simply to identify those aspects of the company's operation that it considers it is good at. The search for competitive advantage calls for the matching of external opportunities with a company's relative strengths. Similarly, the identification of weaknesses should search for areas of *relative competitive weakness.* Such features render the company particularly vulnerable to external threats, and need to be addressed with far more vigour than those areas in which the company performs no worse than the rest of the industry.

Therefore, SWOTs will often benefit from the degree of focus that can often only be achieved at the product group level. In the case of a life insurance company, this might involve separate plans for protection, pension and investment product groups. Each plan will have to be consistent with the bigger picture, and it is the job of senior marketing management to ensure that effective co-ordination occurs.

5.3.3 Marketing objectives

Once the nature of the marketing environment has been fully analysed and a suitable SWOT conducted, it is then possible to specify appropriate marketing objectives. These marketing objectives are not ends in themselves; they are intermediate outcomes which will lead to the organization achieving its corporate objectives. Thus, when specifying marketing objectives, it is essential to ensure that they are derived from and will contribute to corporate objectives. For example, if corporate objectives emphasize expansion, then marketing objectives may be specified in terms of growing market share or sales volume or sales value.

Marketing objectives should be clear, measurable, realistic and time-limited. A particular problem in specifying objectives is the potential confusion between intended goals and the means by which those goals should be attained. The former represent objectives, whereas the latter concerns processes. Sometimes, what are specified as objectives in a marketing planning document are in fact simply a representation of planned activities. Some examples of marketing objectives may serve to illustrate the point:

- *Example 1: To achieve a 12.5 per cent increase in volume sales of new personal pensions during the budget year*. This example represents a sound objective, as it specifies a measurable outcome (i.e. 12.5 per cent growth in sales), qualifies that it concerns personal pension sales volumes and specifies a timescale for achievement.
- *Example 2: To increase pension sales by year end*. This example is still an objective, albeit one that is poorly drafted. It gives no target level for the increase to be achieved, nor does it qualify whether it concerns case volumes or premium value. Finally, it does not specify whether it concerns all sources of pension growth, or whether it relates to growth from new sales as opposed to securing growth from existing pension customers.
- *Example 3*: *To promote personal pensions through the branch network*. This is simply not an objective – at least not at the level of a marketing plan. Instead, it represents but one of a range of actions that, in combination, should achieve a given objective.
- *Example 4*: *To re-price the personal pension product to improve competitive rating*. This is an example of a *process* element; not of a valid objective.

To qualify as a valid marketing objective, the following minimum conditions must be satisfied:

1. The desired outcome must be specified – for example, growth in sales, growth in market share, level of consumer awareness, level of customer satisfaction
2. The outcome must be sufficiently well-qualified to eliminate ambiguity and facilitate precise measurement – for example, growth in number of policies sold to new customers, growth in market share by new business premiums
3. A specific quantum of outcome must be proposed – for example, a 7.5 per cent growth in new business sales volumes
4. The timescale for achievement of outcome must be specified – for example, by the end of the second quarter.

Without well-defined objectives, it is impossible to evaluate outcomes properly.

5.3.4 Marketing strategy

Once the environment has been analysed and the objectives set, the market plan must move on to consider the choice of marketing strategy. Of course, the overall corporate strategy will affect the choice of marketing strategy, but the marketing strategy focuses specifically on the choice of markets and how the organization plans to compete and create value in those markets.

The main component of a marketing strategy is often described as the STP (Segmentation, Targeting and Positioning) process:

1. *Segmentation* involves identifying the different groups (segments) of consumers that exist in the market, and understanding their wants and needs
2. *Targeting* involves evaluating the attractiveness of different segments, choosing which ones to target with the organization's products and services
3. *Positioning* involves identifying the organization's competitive advantage, the way in which it can create value for customers, and how this offer should be presented to customers.

Case study 5.1 Parish National Bank (PNB), New Orleans – segmentation, targeting and positioning in strategic marketing

The financial services sector in the US has experienced a period of deregulation, technological innovation and changing patterns of competition. The Financial Modernization Act of 1999 repealed many of the restrictions that had previously restricted competition in US banking. Barriers to operating across sectors were lifted, and at the same time restrictions on interstate and international banking were disappearing. Regulatory changes, combined with changing market conditions, resulted in increased competition and a trend towards greater consolidation. Small local and regional banks were increasingly becoming 'endangered species'.

Case study 5.1 Parish National Bank (PNB), New Orleans – segmentation, targeting and positioning in strategic marketing—cont'd

Parish National Bank (PNB) is a small commercial bank operating in four parishes of New Orleans. Faced with this changing environment, the bank needed to develop an appropriate response. Some smaller banks had responded by aggressively looking to grow in consumer markets and thus position themselves as acquisition targets; others sought to identify particular niches where they could continue to compete effectively. PNB choose the latter course of action. Among the different market segments available, the bank identified local small businesses and small business employees as an attractive market segment. To deliver value to customers in this segment, PNB positioned itself as 'high tech and high touch', and aimed to provide customers with good banking relationships, innovative services and appropriate use of web-based technologies to support delivery.

Source: Henson and Wilson (2002).

The process of segmentation, targeting and positioning is discussed in more detail in Chapter 8. Case study 5.1 outlines the efforts of a small US bank to build a successful marketing strategy through careful segmentation, targeting and positioning.

5.3.5 Market-specific strategy

A market-specific strategy outlines specific decisions about how to market particular products and services to particular groups of consumers. This stage will include an indication of the necessary level of marketing expenditure, as well as details on the product itself and how it will be promoted, priced and distributed (the marketing mix). These decisions must be guided by the choice of market position. Thus, for example, if an organization has chosen to position itself as serving wealthy consumers with a high-value, personalized product, then the market-specific strategy will need to look for an appropriate (relatively high) price, decide on which product features to customize, and choose ways of promoting and distributing the product that will appeal to the chosen consumer groups. These decisions are discussed in more detail in Part II of this book.

5.3.6 Implementation

Implementation is concerned with how the marketing plan is put into practice. It must consider budgets, accountability and evaluation. Timescales should be identified, and some consideration may also be given to contingency planning. However well thought-out the marketing plan may be, the market is always changing and, consequently, certain planned activities may turn out to be inappropriate

or ineffective. It is important to be aware of these and be in a position to respond – i.e. to modify the strategy as new information becomes available.

Effective financial control is essential for the credibility of a marketing plan – indeed, it is vital for the credibility of a marketing function as a whole. Budgets need to be produced on an accurate and defensible basis. They require a sufficient level of detail to facilitate effective control and the pursuit of efficiency gains. Lack of attention to detail can be a particular problem. For example, it may be relatively easy to identify the total cost of a direct-mail campaign, but if cost per individual contacted and cost per sale are ignored, resources may be badly allocated. For example, one direct-marketing team in the banking sector established a total budget for a campaign which resulted in them planning to spend more in terms of cost per sale than the total margin of the product being promoted.

The plan should make it clear where responsibility and accountability lie for the different activities within the plan. Ownership should be clarified and unambiguous and sole ownership for a particular task should always be sought. It is common to encounter a plethora of shared accountabilities, which results in an unclear sense of ownership. Indeed, well-defined accountability is a necessary prerequisite of an appropriate appraisal system and performance review.

One increasingly important dimension of implementation is internal marketing. Internal marketing deals with the way in which an organization manages the relationship between itself and its employees at all levels. It plays an important role in creating and maintaining a market-orientated corporate culture. The process of internal marketing is seen as particularly important in the financial services sector, not least because of the importance of people in the marketing process. Internal marketing helps to ensure that staff understand the product itself and believe in what the organization is trying to do. If an organization's own employees are not market orientated, if they do not support the overall corporate and marketing strategies, then the chances of successful plan implementation are minimal.

5.4 Tools for strategy development

Later chapters will consider many elements of the marketing plan in more detail. The remainder of this chapter will introduce some of the techniques that organizations can use in order to help develop marketing strategies within the context of the development of the marketing plan. These tools help managers to think about what may be the best strategy to pursue. They can provide useful insights and recommendations. However, good marketing managers will use these tools carefully – they will not provide definite answers and they will not tell you exactly what your organization should do. What they can do is to help you think about the marketing challenges being faced and about how the organization might respond to these challenges.

We begin by looking at options for growth, and then consider tools that might be used when choosing the product portfolio (the mix of products and services to be

offered to different target markets). Thereafter, the discussion will examine the issue of competitive advantage.

5.4.1 Growth strategies

An organization that is looking at how best to grow and expand can think about this problem by considering whether to look at new products or new markets. The available choices are represented in Ansoff's Product/Market matrix. This suggests four possible options, which are outlined in Figure 5.2 – market penetration, market development, product development and diversification.

Market penetration

Market penetration means trying to sell more of the existing product in the existing market. To do this, an organization may try to persuade existing users to use more, or non-users to use, or to attract consumers from competitors. There are many examples of marketing tactics that would support a market penetration strategy. Promotional offers such as 'Air Miles' are designed to encourage existing customers to make greater use of their credit cards. In Malaysia, Public Bank's offer of a free mobile phone to new and existing customers for its ACE account (subject to a minimum balance) is another attempt at market penetration by encouraging new purchases from existing and new customers. Usually, a market penetration strategy is more appropriate when the market still has room to expand. In a mature market (where most of the likely buyers have already bought the product), market penetration is more difficult because the organization will need to attract customers directly from competitors, and this is often more difficult than trying to attract new customers to the market. In the UK, the market for current accounts is largely saturated. One or two of the newer entrants, such as the Internet bank, Smile, have tried to follow a market penetration strategy by encouraging customers of other banks to switch their accounts, but most providers appear to be focusing their efforts on retaining customers and exploiting opportunities to cross-sell.

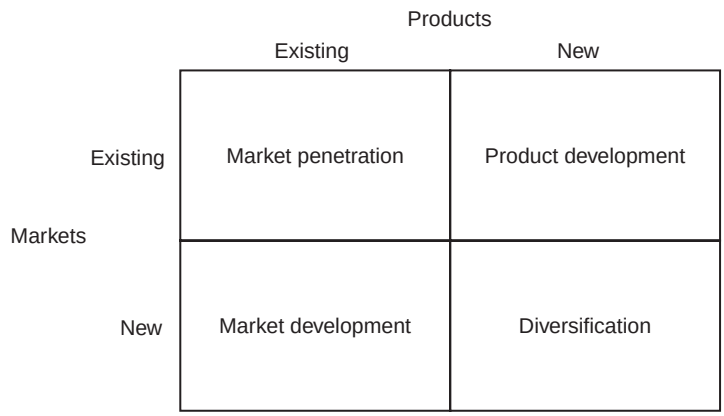

Figure 5.2 Ansoff's Product/Market matrix.

Market development

Market development involves the organization trying to identify new markets for its existing products. Most commonly, this strategy is associated with expansion into new markets geographically. For example, when American International Group (AIG) became the first foreign insurer to obtain a licence to operate in China, it was engaging in market development via geographical expansion. In the US, Morgan Stanley was originally established as an investment bank. The Glass-Steagall Act prevented an expansion into other domestic markets, and so Morgan Stanley grew primarily by overseas expansion. However, deregulation has mean that movement into new market segments is also an important approach to market development. For example, following its conversion from building society to bank, the UK-based Alliance and Leicester pursued a market development strategy by expanding its banking services into corporate markets.

Product development

Growth through product development means developing related products and modifying existing products to appeal to current markets. The diversity of new mortgage products that have become available in the UK market provides an example of modifying existing products to make them more attractive to current markets. The history of American Express is dominated by a series of examples of product development. Initially, the company focused on money orders, travellers' cheques and foreign exchange. In 1958, American Express issued its first charge card. Subsequently the company also launched credit cards, targeting both new customers and existing charge-card customers. A strategy of this nature relies on good service design, packaging and promotion, and often on company reputation to attract consumers to the new product. Case study 5.2 demonstrates the use of product development as a strategy by HBF Health Fund Inc. in Australia.

Case study 5.2 HBF Health Fund Inc.

The Hospital Benefits Fund of Western Australia Inc. was incorporated in 1941 to provide private health insurance services to the people of Western Australia. Since then, HBF (as it has become known) has grown to be the largest private health insurance organization in Western Australia, with a 65 per cent share of the private health insurance market. Incorporated as a mutual organization, HBF has nearly a million members – which is almost half the total population of the state of Western Australia. The HBF brand is instantly recognized by over 99 per cent of the population, and the organization is renowned for its service to members, high ethical standards and sound financial management.

In the late 1980s and early 1990s the emerging global economy, where competitive advantages lie in ever-increasing scale, presented HBF with the challenge of continuing to service the needs of its members whilst competing with national (and even international) competitors with, in some cases, operations many times the size of its own.

Case study 5.2 HBF Health Fund Inc.—cont'd

Without a member-base or any brand awareness in other parts of Australia, it was soon realized that attempting to replicate the scale-based strategies of the major competitors by expanding HBF's operations nationally would expose the organization to an unacceptably high level of risk whilst simultaneously diverting attention away from servicing the needs of its members, all of whom lived in WA. Rather, a decision was taken to expand the organization's operations to cover complementary services for members, focusing on the key strategic advantages available to HBF, particularly the relationship it had with its members.

The first products identified were domestic general insurance products for home, contents and motor vehicle. However, the general insurance market in WA was already mature and dominated by a small number of well-established players. Also, with a history deeply rooted in private health insurance, the HBF brand had become synonymous with this in WA. Stretching the brand to cover domestic insurance products was therefore a significant challenge.

The approach taken by HBF was to differentiate its general insurance products from those already in the market by emphasizing the attributes that had developed around the HBF brand as a provider of private health insurance. HBF focused on its organizational strengths of service to members, mutuality and high ethical standards. Whilst the established players in the domestic insurance market clearly held a competitive advantage in the 'manufacture' of general insurance products, they were unable to match the depth of the relationship HBF had with its members.

Although growth in the general insurance portfolio was slow initially, HBF members who purchased domestic insurance products from the organization soon discovered that the qualities attributed to the health insurance service were also present in the general insurance service.

Despite slow growth initially, HBF was able to persevere with its product development initiative because, as a mutual organization, it is accountable to its members (customers) and not the capital market. Where the traditional capital markets would have demanded a financial return from the investment in a new line of business, HBF was able to take into account the strategic value being generated, represented by a growing acceptance of the new line of business by members.

By 2005, HBF's general insurance business had gained a 12 per cent share of the market in Western Australia. It is generating annual returns on capital of approximately 25 per cent and is growing policy numbers by 15 per cent per annum. The investment in the general insurance business has produced an average annual return of over 20 per cent after tax.

HBF followed a similar strategy with the launch of a Retirement and Investment Advisory business in 2003. After only two years of operation, HBF Financial Services reached an operating break-even. It is projected to generate positive cash flows by the end of 2006.

Continued

Case study 5.2 HBF Health Fund Inc.—cont'd

As in the launch of general insurance 15 years ago, HBF emphasized the organization's strengths, applying them in an industry that had experienced a series of scandals arising from inappropriate behaviour by existing players. Despite a complete lack of scale in the financial advisory industry, HBF has been successful in capturing a segment of the market that is seeking the trust and security offered by a reputable organization.

Source: Paul Italiano, HBF.

Diversification

Diversification tends to be a more risky strategy, as it involves an organization moving into new products and new markets. Pure diversification may be relatively unusual in financial services, but the development of bancassurance represents a form of diversification as established banks move into the provision of insurance-related products. Similarly, the decisions by traditional banks to offer Islamic banking products can also be seen as a form of diversification.

5.4.2 Selecting the product portfolio

Part of any marketing strategy involves consideration of how to manage a range of different products. This requires decisions about which products need to be developed, which products need to be maintained and which products should be dropped. Details of product strategy are discussed in greater depth in Chapter 10, but at a strategic level there are tools available to help marketing managers to evaluate the existing range of products and make decisions about what should happen with each product. Two common approaches which are used to determine product portfolios are the matrix-based approaches of the Boston Consulting Group (BCG) and the General Electric (GE) Business Screen, and the concept of a product lifecycle.

Matrix-based approaches

Both the BCG and the GE matrices require a classification of products/business units according to the attractiveness of a particular market and the strengths of the company in that market. The BCG matrix bases its classification scheme purely on market share and market growth, while the GE matrix relies on multivariate measures of market attractiveness and business strengths. In both cases, the appropriate strategy is determined by the position of a product in the matrix.

A simple example of the BCG matrix is presented in Figure 5.3; the division on the horizontal axis is usually based on a market share identical to that of the firm's nearest competitor, while the precise location of the division on the vertical axis will depend on the rate of growth in the market – with 10 per cent usually seen as a reasonable

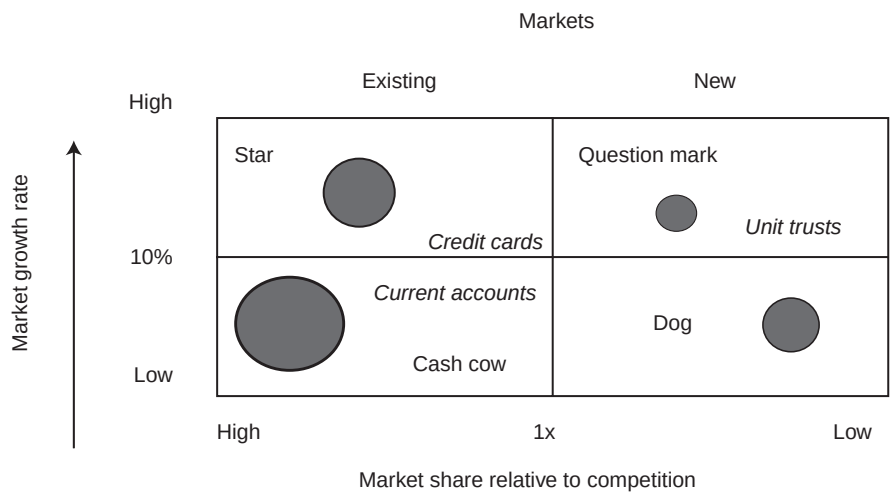

Figure 5.3 The BCG matrix.

cut-off point. Products are positioned in the matrix as circles with a diameter proportional to their sales revenue. The BCG matrix relies on the assumption that a larger market share results in lower costs and thus higher margins.

The appropriate strategy for a particular product will depend upon its position within the matrix. The question mark (or problem child) has a small market share in a high-growth industry. The basic product is popular, but customer support for the specific company versions is limited. If future market growth is anticipated and the products are viable, then the organization should consider increasing marketing expenditure on this product. Otherwise, the possibility of withdrawing the product should be considered.

The star has a high market share in a high-growth industry. By implication, the star has the potential to generate significant earnings currently and in the future. At this stage it may still require substantial marketing expenditures to maintain this position, but can be regarded as a good investment for the future. By contrast, the cash cow has a high market share but in a slower-growing market. The traditional bank current account probably falls into this category. Product development costs for the cash cow are typically low and the marketing campaign is well established, so the cash cow will usually make a reasonable contribution to overall profitability.

Finally, the dog represents a product with a low market share in a low-growth market. As with the cash cow, the product will typically be well established, but it is losing consumer support and may have cost disadvantages. The usual strategy would be to consider withdrawing this product unless cash flow position is strong, in which case the recommended strategy would be to cut back expenditure and maximize net contribution.

The BCG matrix is potentially useful, but its recommendations must be interpreted with care. In particular, it is important to recognize that it focuses only on one aspect

of the organization (market share) and one aspect of the market (sales growth). The GE matrix works on similar principles, but concentrates more generally on trying to measure the attractiveness of the market (rather than just measuring market growth) and competitive strength (rather than just market share). This means that the GE matrix gives a broader picture of the strengths and weaknesses of the product portfolio, although it is often more difficult to construct.

Best (2005) suggests using the GE matrix to guide the choice of offensive versus defensive strategies, as shown in Figure 5.4. Comparing market attractiveness and competitive strength results in a series of recommendations about the most appropriate way for the organization to compete in its market. These strategic options are classified as either offensive or defensive.

Offensive strategies include: invest to grow, improve position, and new market entry. These are very similar to Ansoff's growth strategies. *Invest to grow* involves marketing expenditure to grow market share or even to grow the overall market. It is essentially equivalent to a market penetration strategy. *Improve position* involves investing resources to enhance the value offered to consumers relative to the value offered by competitors. Such an approach is analogous to a product development strategy. *New market entry*, as the description suggests, is effectively equivalent to market development and diversification strategies.

Defensive strategies are classified as: protect position, optimize position, monetize, and harvest/divest. A strategy of *protect position* is appropriate where an organization has a currently strong position in an attractive market, and the aim is to discourage new entrants and limit the expansion potential of other competitors. In a market where growth is slowing down, *optimize position* involves focusing attention on maximizing the return on marketing investment. Typically, such an approach would involve trying to focus attention on the profitable customers and controlling marketing expenditure. Trying to persuade less profitable customers to make more use of low-cost channels (such as the phone and Internet) and less use of high-cost channels (such as the branch) is one example of an optimizing strategy.

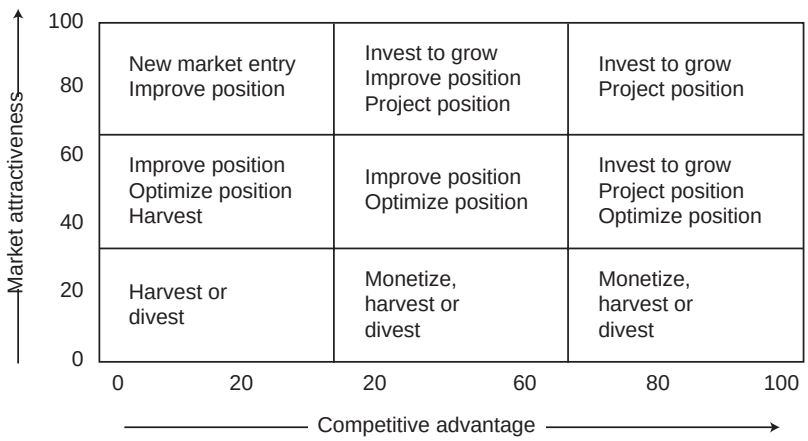

Figure 5.4 Offensive and defensive strategies (adapted from Best, 2005).

Monetize is a more aggressive version of optimize, and focuses on maximizing cash flow without actually preparing to exit from the market. Finally, a *harvest/divest* strategy goes a stage further and involves maximizing cash flow from a product prior to exiting the market. If there is no opportunity to maximize cash flow, then an early market exit would be preferred.

The product lifecycle

The product lifecycle (PLC) is widely used as a tool for market planning, in that it can be employed to guide an organization both in the determination of the appropriate balance of products and in the development of a suitable strategy for the marketing of those products. Its usefulness has been regularly challenged, and clearly there is a risk that the PLC could oversimplify the evolution of a product. While recognizing these limitations, it remains a potentially helpful way of thinking about the strategic management of products.

The product lifecycle, as shown in Figure 5.5, suggests that a given product or service will pass through four basic stages: introduction, growth, maturity and, eventually, decline. The role of marketing is generally considered to be one of prolonging the growth and maturity phases, often using strategies of product modification or product improvement, which are frequently regarded as less risky than developing completely new products.

Assessing the existing product range according to lifecycle position can give some indication of the balance of the existing product portfolio. Furthermore, according to stage in the lifecycle, the organization can obtain some guidance as to the appropriate marketing strategy.

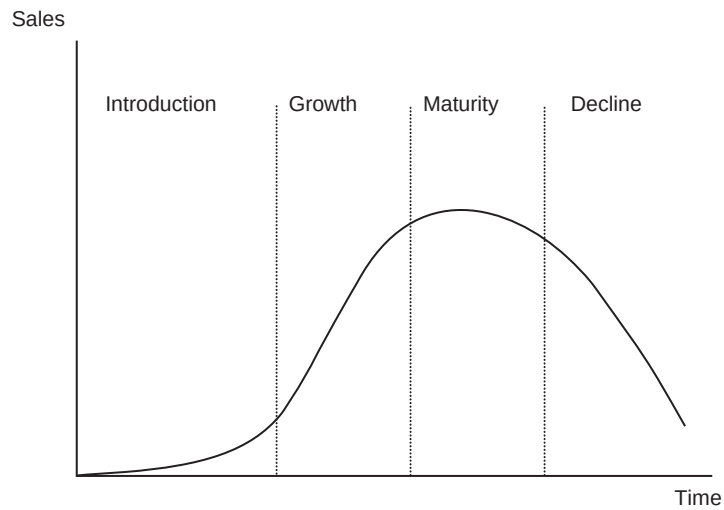

Figure 5.5 The product lifecycle.

Detailed stages of the lifecycle are as follows:

1. *Introduction*. A period of slow growth and possibly negative profit, as efforts are being made to obtain widespread acceptance for the service. Cash flows are typically negative and the priority is to raise awareness and appreciation of the product, with the result that the marketing mix will place a high degree of emphasis on promotion. Mobile banking is one example of a service in the introductory stages of its lifecycle.
2. *Growth*. Sales volumes increase steadily, and the product begins to make a significant contribution to profitability. Increases in sales can be maintained by improvements in features, targeting more segments, or increased price competitiveness. It is at this stage that the new service will begin to attract significant competition. Growth services currently include telephone banking, and the more sophisticated types of ATM. Unit trusts and other related types of investment product have probably also reached the growth stage of the product lifecycle.
3. *Maturity*. Sales growth is relatively slow, and the marketing campaign and product are well established. Competition is probably at its most intense at this stage, and it may be necessary to consider modification to the service and the addition of new features to prevent future decline. Many bank current accounts are products that can be seen as having reached maturity, and in many cases are being modified in attempts to prolong their lifecycle.
4. *Decline*. Sales begin to drop away noticeably, leaving management with the option of withdrawing the product entirely – or at least withdrawing marketing support. In the financial services sector product withdrawal may be difficult, as some products (such as life insurance) cannot simply be withdrawn because some customers will still be paying premiums. Endowment policies (life insurance based savings) are probably now in the decline phase of a lifecycle.

The use of the product lifecycle in marketing planning can provide some guidelines for the allocation of resources among service products, enabling the organization to attach high priority to growth products and medium priority to mature products, and to consider possible withdrawal of declining products. However, as with the BCG matrix, the recommendations should be interpreted with care and not simply followed without question. In particular, it is important to recognize that lifecycles will differ very dramatically across product types – they may be very short or very long. Some products may appear never to reach the decline phase, while others may never get past the introduction stage. The lifecycle for a product class (e.g. bank accounts) will typically be much longer than the lifecycle for a specific brand. Moreover, the marketing recommendations must be interpreted with care to avoid the potential for the lifecycle to become a self-fulfilling prophecy – for example, if a product looks as though it has reached maturity and possibly started to decline, the reduction of marketing support will tend to ensure that the predicted actually occurs. Finally, it is essential not to think only of a product's position in the lifecycle. As Hooley (1995) has shown, strategy and performance may be driven as much by market position (specifically, market share) as by lifecycle stage.

5.4.3 Competitive advantage

Identifying the organization's competitive advantage is an essential part of any marketing strategy. Michael Porter suggests that to compete effectively, an organization must focus either on low costs or on differentiation. A low-cost strategy relies on a relatively standardized product, and the organization offers value through low costs and thus low prices. The differentiation-based approach means that the organization offers a product that is distinctive and offers value to the customers because of the range of features it possesses. For differentiation to be successful, the higher price received by the organization must outweigh the costs of supplying the differentiated product. At the same time, the customer must feel that it is worth paying extra for the distinctive image of the product and the additional features offered.

Using these two routes to competitive advantage and considering the nature of the target market, Porter identifies three broad strategic options:

1. *Cost leadership*. A cost leadership strategy involves trying to be the lowest-cost producer, usually by concentrating on providing relatively standardized products. Low costs allow the organization to attract customers by offering lower prices. Such a strategy typically requires up-to-date and highly efficient service delivery systems. It can be argued that cost leadership was a traditional strategy in many areas of financial services. However, many organizations are finding it increasingly difficult to gain a significant cost advantage over their competitors, and are instead tending to focus more attention on differentiation.
2. *Differentiation leadership*. A differentiation-based strategy means trying to offer something that is seen as unique and distinct. A perceived uniqueness and the associated customer loyalty protect the firm from its competitors, the threat of entry and substitute products. HSBC, Citibank and American Express may all attempt to claim a perceived uniqueness based on their global presence and experience. However, research in the financial services sector suggests that this goal may be difficult to attain for many providers. Devlin and Ennew (1997) have highlighted the difficulties that UK providers of financial services experience in trying to create a clear competitive advantage based on either price or differentiation in a mass market, and also the greater opportunities associated with either focus or niche-based strategies.
3. *Focus/nicheing*. This strategy uses either costs or differentiation, but concentrates on specific segments of the market – market niches. The aim is to identify parts of the market with distinctive needs which are not adequately supplied by larger organizations. Differentiation focus is the most common form of focus strategy, and implies producing highly customized products for very specific consumer groups. For example, in Malaysia, Scotia Bank pursues a focus strategy in relation to a range of products. One such product is its housing loan. Like most other providers, Scotia Bank offers discount rates, but what makes it special is the way in which the bank tries to build relationships with its customers and tailor products to their particular circumstances. Profits arise not from housing loans as such, but from the other products that Scotia Bank can sell to these customers. Another example of a differentiation-based focus strategy is the UK's Ecology Building Society, which specializes in lending that supports sustainable housing, sustainable communities and sustainable enterprises.

Porter's analysis stresses the importance of avoiding a situation where the organization is 'stuck in the middle' – i.e. trying to be all things to all consumers. The firm trying to perform well on costs *and* on differentiation is likely to lose out to firms concentrating on one strategy *or* the other. However, this concept of 'stuck in the middle' has been criticized for its ambiguity, and in any consideration of Porter's framework it is essential to be aware of the importance of value. Value is a based on the relationship between the costs to the consumer and the benefits. Superior value can be created by either adding benefits or reducing costs. Porter's cost- and differentiation-based approaches to building competitive advantage can most sensibly be thought of as approaches to delivering value that concentrate on either reducing costs relative to a given range of benefits (cost leadership) or improving benefits relative to a given cost (differentiation).

5.5 Summary and conclusions

The market for financial services has become increasingly competitive in recent years. Regulatory changes (current and future), developments in information technology, globalization, and fluctuations in economic performance have resulted in an increasingly competitive market environment. In such an environment, success requires a planned and strategic approach to marketing. Developing a plan to guide marketing is of considerable value, because it encourages careful thought and analysis.

The organization must have a clear mission and objectives, it must understand its operating environment and it must be clear about the products and markets it serves. In making choices about products and markets, it is essential that the organization tries to develop a match between its own particular strengths and the needs of the different segments of the market.

There are many different tools available to help an organization develop its marketing plan and its marketing strategy. These tools provide a way of analysing information about the organization and what it is doing. They also provide recommendations about strategic choices which, when combined with the marketing manager's knowledge and understanding of the environment, can be a useful aid for strategy development.

Review questions

1. Why is it important to plan marketing activity?
2. What is your organization's corporate mission, and how might this help guide the future development of marketing activity?
3. What are the essential elements of a marketing plan?
4. What are the differences between market development and product development? Find examples of both from the financial services sector.
5. What is the difference between cost leadership and differentiation leadership? Using Michael Porter's generic strategies, how can organizations try to create a competitive advantage? Identify examples of organizations that you think are using these approaches.

6

Internationalization strategies for financial services

Learning objectives

By the end of this chapter you will be able to:

- identify key drivers of internationalization in the financial services sector
- understand the factors influencing the choice of internationalization strategy
- identify the marketing implications associated with internationalization.

6.1 Introduction

Internationalization is a broad term. It goes beyond the basic notions of trade and exporting to encompass all aspects of business activity that extend beyond national borders. Exporting is often thought of as simply the first stage in this process, which can extend to the establishment of a fully-fledged business presence in an overseas market. Most discussions of service marketing, including those relating to financial services, tend to focus on marketing in a domestic context. Equally, most textbooks on international strategy and marketing tend to focus predominantly on the activities and issues associated with companies providing physical goods. Yet services account for an increasingly large share of world trade, and there is a long tradition of international activity within the financial services sector. World Trade Organization figures suggest, that in 2003, services accounted for some 20 per cent

of world trade by value, having grown some 13 per cent on the previous year (World Trade Organization, 2004). The US-based Citibank has been operating in France since 1906, Argentina since 1914 and Brazil since 1915. The UK bank, Barclays, formed its international division in 1925 through the merger of the Colonial Bank, the Anglo-Egyptian Bank and the National Bank of South Africa. In the insurance sector, Prudential established its first overseas agencies for the sale of general insurance products in the 1920s and for the sale of life products in the 1930s. Yet, despite this long tradition of international activity, most discussions of financial services marketing pay relatively little attention to the activities of firms in overseas markets.

The purpose of this chapter is to provide an overview of the issues relating to the internationalization of financial services, and their marketing implications. The next section explores the relationship between the characteristics of financial services for the process of internationalization. Thereafter, a brief review of the drivers of internationalization in financial services is presented. The chapter then proceeds to outline internationalization strategies and their relevance to financial services. Finally, there is a brief discussion of the marketing challenges associated with international environments.

6.2 Internationalization and the characteristics of financial services

The distinctive characteristics of financial services and their marketing implications were discussed in Chapter 3. These characteristics also have implications for internationalization. The intangibility of financial services means that actually there is nothing physical to move from producer to consumer. In principle this intangibility may make it relatively easy to export some financial services, particularly in corporate markets. For example, if the investment bank UBS handles an equity trade in New York for a client in Japan, it is effectively exporting its services – nothing physical is being transported, but a service is provided remotely. In retail markets, exporting is often more difficult: consumer reactions to intangibility often make it difficult to supply financial services without a physical presence in the domestic market. Inseparability implies a need to focus particular attention on how to manage interactions with customers in different locations, while heterogeneity reminds us of the additional challenges associated with providing a consistent service across different countries. Of course, concerns about fiduciary responsibility mean that financial services providers also face the challenge of operating in potentially diverse regulatory environments if and when they internationalize.

In terms of service classifications, financial services are typically heavily information-based services, and in principle are easily digitized. It is this feature that makes export relatively straightforward in theory. However, the complexity of many financial services suggests that significant interpersonal interaction is often required in their delivery. This has important implications. First, there is often strong pressure for a financial services organization to have a physical presence in the market in which it is delivering its services. Many buyers (particularly those in retail markets)

feel the need to be able to access their service provider and are reassured by a physical presence (even if they may deal with a provider remotely), and regulators commonly require such a presence. Thus, in comparison with suppliers of manufactured goods, financial services providers will often be less reliant on exports and much more likely to internationalize by establishing overseas operations. This in turn raises important issues in relation to the nature and management of service delivery.

One of the major challenges that organizations face when operating internationally relates to cultural differences, and the greater the difference in cultures, the greater the challenges. Cultural differences impact on financial services internationalization in two ways. First, there are issues related to familiarity and use of financial products. In many Islamic countries, the prohibition on interest means that credit-card holders will seek to pay off accounts at the end of each month rather than accumulating interest charges. Variable-rate mortgages are widespread in the UK, whereas many countries in continental Europe have a longstanding tradition of fixed-rate mortgages. Secondly, culture can impact significantly on interactions where the two parties have different heritages. Cultural differences can affect the development of long-term relationships, where the creation of trust plays a central role – for example, the rather direct negotiating styles of the British and Americans may appear quite threatening and even rude in Japan, thus inhibiting the development of mutual trust. In addition, cultural differences are often a source of misunderstanding in communications, with all sorts of negative consequences for service provision. For example, Egg, the UK-based Internet bank, invested £280m expanding in France but withdrew after 2 years; a poorly thought through and culturally insensitive advertising campaign was one of a number of factors that contributed to the failure of this venture. In contrast, UK banks relying on offshore outsourcing to deliver customer service to domestic customers from bases in India have invested considerably in ensuring that local staff are familiar with key aspects of British culture.

Given the significance of cultural differences, it is perhaps not too surprising to observe that many examples of the internationalization process in financial services started with moves into environments that are in some respects culturally similar. It is no accident, for example, that many Spanish banks have tended to concentrate their international activity in South America, or that many UK financial services providers initially established overseas operations in countries which were then colonies and in which there were substantial anglophile market segments. 'Cultural proximity' is a useful piece of shorthand to describe this phenomenon.

Although the nature of financial services presents important challenges to the internationalization process, it is apparent that there are clear attractions to international operations and these are encouraging many financial services to expand beyond their domestic market. The next section explores the conditions that influence financial services providers to operate globally.

6.3 The drivers of internationalization

When considering the drivers to internationalization, it is useful to distinguish between firm-specific and macro-environmental factors. Firm-specific factors are those factors that create incentives for individual firms to move into international markets.

Macro-environmental factors are those features of the overall environment that create conditions which favour internationalization for all firms. Naturally, the two are related and interdependent.

6.4 Firm-specific drivers of internationalization

At the level of the individual firm, the motives for expanding beyond the domestic market by a given provider may be divided into 'push' and 'pull' factors. Push factors are essentially domestic market conditions that will tend to encourage a firm to look outside its national markets, while pull factors are features of non-domestic markets that encourage a firm to consider expanding operations overseas.

Push factors focus essentially on conditions in the domestic market that may in some way inhibit a firm from achieving its strategic goals. The simplest example of a push factor might be slow growth, high costs or high levels of competition in the domestic market. Cost considerations, for example, have been a major driver of the decision of many financial services providers to establish call-centres in countries such as India. Another push factor might well be domestic regulation. For example, in the US the Glass-Steagall Act of 1933 which, until its repeal in 1999, prevented banks from engaging in both commercial and investment banking has been identified as one factor that encouraged US banks to expand overseas where they could engage in activities which were not permitted domestically. In Spain, domestic competition and pressures on profit margins were identified as one reason why a number of banks looked to expand into international markets.

More commonly, overseas expansion is thought to be influenced by pull factors which make overseas markets attractive as places to do business. Probably the commonest pull factor is the size and growth of markets in other countries. The liberalization of the economies of India and China has contributed to rapid growth in both countries, and this, combined with their size, has made these markets highly attractive and has encouraged a large number of financial services providers to seek to establish a presence in these countries. ING, for example, has acquired a 20 per cent stake in Vysya Bank in India, while Chase Capital has taken a 15 per cent stake in HDFC Bank. Banks currently operating in China include Citibank, HSBC, Standard Chartered, BNP Paribas, Dresdener Bank and the Industrial Bank of Korea. Both markets are also attractive to insurers because of the combination of growing incomes and the relatively low levels of expenditure on insurance products. Cardone-Riportella and Cazorla-Papis (2001) note that the low level of competition, the low level of banking services and increasing deregulation in many Latin-American countries has made them attractive target markets for Spanish banks looking to move overseas. International markets may also be attractive because they provide an opportunity to leverage a particular competitive strength or because they provide a means of adding value to the company's service. For example, many financial services providers moved overseas to follow their international customers and thus be in a position to offer an integrated service to those customers.

While the factors that affect individual firms and create incentives for expansion overseas are clearly important and need to be fully understood, there are also broader, macro-level factors which mean that some industries or some sectors may be more suited to globalization than others. These factors are discussed in the next section.

6.5 Macro level drivers of internationalization

At the macro-level, there is a series of developments in the business environment which make internationalization an increasingly attractive activity. The different forms that such internationalization can take are discussed in greater detail in the next section, where specific distinctions are drawn between global, international and transnational strategies.

Yip (1992) originally identified five drivers of globalization, namely market, cost, technology, government and competition. Lovelock and Yip (1996) subsequently explored the applicability of these factors in the service sector. The rest of this section explores the drivers for globalization in financial services, based on Yip's framework.

Market drivers

This category refers to those features of the marketplace that encourage globalization. The following are of particular significance are:

1. *Common customer needs*. In markets where customer needs are essentially the same across the world, globalization is thought to be an attractive strategy because a business can offer a relatively standardized product across a series of markets. In the global securities business the needs and expectation of investment houses are generally very similar across countries, and consequently the securities houses that serve those customers are increasingly operating in a global market.
2. *Global customers*. If customers themselves operate globally, then again there is an incentive for the companies that supply them to operate on a similar scale. One of the important drivers in the internationalization of banking has been the internationalization of the businesses that those banks serve. Equally, in the personal market, a company such as American Express needs to operate globally because the customers it serves are effectively global, not just in terms of where they live but also in the extent to which they travel.
3. *Global distribution channels*. If channels of distribution are themselves global, then it is much easier for companies that sell through those channels to operate globally. Although we tend to think of financial services as being characterized by relatively short distribution channels, it is important to remember that financial services are typically information-intensive and that developments in electronic distribution systems have, in some senses, created global distribution systems. Networks such as Cirrus, for example, which allow customers to withdraw funds

from ATMs worldwide, provide a means by which banks can make some aspects of their service available to customers globally.

4. *Transferable marketing*. If marketing campaigns developed in one country are easily transferred to other countries, then global operations are much easier to implement. Marketing activities which are specific to a particular environment and not easily transferred increase the costs associated with operating overseas. Indeed, many companies operating or looking to operate globally pay particular attention to ensuring that their campaigns are designed to be transferable. The HSBC brand-building exercise which demonstrates an understanding of cultural differences worldwide, supported by the claim to be 'The World's Local Bank', is a case in point. Although the bank aims to localize its services to individual countries, it gains significant economies from a globally transferable marketing campaign and a global brand.

Cost drivers

Cost drivers are concerned with the extent to which expansion globally can enable a firm to reduce its costs. Most commonly, cost drivers are associated with economies of scale – the cost savings that are associated with expanding the scale of operations. Such cost savings are often thought to be relatively unimportant in the service sector, including financial services. However, cost savings may arise in other ways, most obviously through access to lower-cost resources. In financial services the developments in IT have facilitated the separation of front- and back-office processing, and consequently one form of expansion overseas has been in the form of outsourcing business processes to lower-cost countries. This has more recently been augmented by the outsourcing of certain front-office functions, including outbound telemarketing and customer service. In the UK, a range of financial services providers (including Lloyds TSB, Barclays, Zurich Financial Services, Prudential and Capital One) have all outsourced a range of activities to India to benefit from lower costs in that market.

Technology drivers

Technology drivers are in many respects closely related to cost drivers – at least in a financial services context. Developments in information and communications technology have supported internationalization by facilitating global distribution and supporting outsourcing for a range of business processes.

Government drivers

Government drivers to globalization refer to any aspects of government or public policy that make it easy (or difficult) for foreign firms to operate in a domestic market. Most commonly, government drivers are the presence or absence of restrictions on market entry, or the presence of regulatory systems which restrict what foreign entrants may do. Case study 6.1 outlines the consequences of China's entry into the World Trade Organization for potential entrants to the banking and insurance sectors.

Case study 6.1 China and the WTO

The World Trade Organization produced the following statement in response to the conclusions of negotiations on China's accession.

Banking

Upon accession, foreign financial institutions will be permitted to provide services in China without client restrictions for foreign currency business. For local currency business, within two years of accession, foreign financial institutions will be permitted to provide services to Chinese enterprises. Within five years of accession, foreign financial institutions will be permitted to provide services to all Chinese clients.

Insurance

Foreign non-life insurers will be permitted to establish as a branch or as a joint venture with 51 per cent foreign ownership. Within two years of China's accession, foreign non-life insurers will be permitted to establish as a wholly-owned subsidiary. Upon accession, foreign life insurers will be permitted 50 per cent foreign ownership in a joint venture with the partner of their choice. For large-scale commercial risks, reinsurance and international marine, aviation and transport insurance and reinsurance, upon accession, joint ventures with foreign equity of no more than 50 per cent will be permitted; within three years of China's accession, foreign equity share shall be increased to 51 per cent; within five years of China's accession, wholly foreign-owned subsidiaries will be permitted.

Source: WTO (2001).

Competition drivers

Competition drivers relate to a range of factors associated with the nature and level of competition in different markets. A move into an international market might be prompted by the entry of a competitor into the home market. Equally, the entry of a competitor into a new market might create an incentive for a company to follow suit in order to maintain some degree of competitive parity.

6.5.1 The extent of internationalization in the financial services sector

Clearly, there are many examples of financial services providers operating internationally and in many sectors of the industry, the macro-environment favours international operations. In particular, financial services targeted towards large corporates lend themselves to international operations because of the similarity in customer needs and the fact that many customers themselves are global. In contrast, personal financial advice is more suited to domestic provision because needs do vary, distribution is essentially personal and regulations are very different.

Retail banking is predominantly domestic, but there is a growing number of banks (e.g. HSBC, Citibank, Standard Chartered) offering their services in a range of markets worldwide; some of the target market may be expatriate staff, but the rest will be domestic nationals and the service provided is usually broadly similar to that offered in other countries. Many insurers are following a similar strategy and establishing networks of operations worldwide. Case study 6.2 outlines the experience of the European Union (EU) in trying to encourage greater international activity in financial services among member countries.

Case study 6.2 Internationalizing financial services in the European Union

In 1985 the European Commission published a White Paper, 'Completing the Internal Market', which proposed a series of measures to create a single internal market among the countries of the then European Community. This was codified in the Single Europe Act of 1986, the first major amendment to the Treaty of Rome (which had initially established the European Union in 1957). This Act required that the measures outlined in the 1985 White Paper should be implemented by the end of 1992, and included provision for mutual recognition of national product standards and a range of other measures to eliminate barriers to trade within the Union. The Single European Market formally came into being in 1993, underpinned by the 'four freedoms' – free movement of goods, services, labour and capital.

In the case of financial services, the single European market aimed to eliminate restrictions on cross-border activity, thus encouraging greater competition, greater efficiency, lower prices and better service for customers. Given the high level of regulation in financial services and considerable differences in industry tradition, the single market relied on the principle of mutual recognition – if a financial services provider was licensed to operate in its home market, then it was effectively free to provide services to consumers throughout the European Union.

Although formal legal restrictions on cross-border activity in financial services have been largely removed as a consequence of the Single European Act, progress towards a genuine single market in retail financial services has been slow. Genuine cross-border trade in financial services failed to grow substantially, and most providers serving non-domestic markets did so by establishing a physical rather than an export presence, with that physical presence typically being via mergers and acquisition rather than greenfield developments. In principal, there is no reason why many retail financial services need to be provided locally; in practice, most are. Take the case of a mortgage; while it is technically possible for a resident of Germany to obtain a mortgage for a house in Germany from a Spanish bank, in practice many customers are nervous of non-domestic providers with no physical presence in the market. Equally, banks may be concerned about lending into a different legal environment where it may prove costly to recover the security (i.e. the house) in the event of default. Differences in tax treatment and consumer protection legislation between countries may also

Case study 6.2 Internationalizing financial services in the European Union—cont'd

serve as a disincentive to the purchase of savings and investment products across borders. In business markets, progress has been rather faster and the degree of integration is much greater, although considerable effort has been required to address areas such as capital adequacy requirements and accounting standards.

Recognizing some of the particular difficulties with financial services, the European Commission developed a Financial Services Action Plan (FSAP) in 1998 which focused on eliminating barriers to cross-border trade. The Action Plan concentrated on developing a genuine single market for wholesale financial services, creating open and secure retail markets, ensuring the continued stability of EU financial markets and eliminating tax obstacles to financial market integration. Considerable progress was made in relation to the wholesale markets; progress with retail markets was slow and the scale of cross-border activity remained low.

Subsequently, in December 2005, the Commission published a White Paper, 'Financial Services Policy 2005–2010', to outline its policies for the rest of the decade. The White Paper focused its attention on ensuring that existing policy changes were implemented and consolidated, improving regulation, enhancing supervisory convergence, increasing competition between service providers and expanding the EU's influence in global financial services.

Source: European Commission (2006), The Internal Market, available at http://europa.eu.int/comm/internal_market/index_en.htm (accessed 4 March 2006).

As well as there being variety in the extent to which financial services providers operate globally, there are variations in the approaches that they adopt. The next section explores in some detail the different ways in which organizations may choose to operate in non-domestic markets.

6.6 Globalization strategies

Thus far, the words internationalization and globalization have, to some extent, been used interchangeably. However, researchers in international business would distinguish between the two and see them as potentially quite different approaches to operating outside of domestic borders. In particular, Ghoshal and Bartlett (1998) suggested that the right approach to internationalization would depend on the extent to which there were:

- pressures to integrate activities across markets – i.e. pressures to exploit economies of scale and offer a relatively standardized product which leverages around particular assets or competences

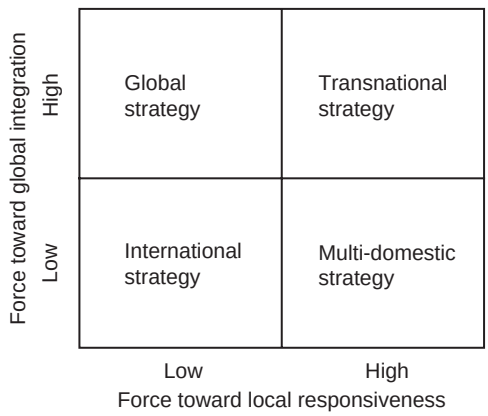

Figure 6.1 Different forms of internationalization (adapted from Ghoshal and Bartlett, 1998).

- pressures to be locally responsive, adjusting and adapting a service offer to local (country-specific or regional) needs.

This led to the identification of four basic options for internationalization, as outlined in Figure 6.1.

6.6.1 International strategies

An international strategy is, in many senses, a weak or unstable position. Such a strategy involves doing broadly the same thing in a series of different markets, but without any attempt to integrate to get costs down or to tailor the service to the specific market. While pressures for integration or responsiveness may not be strong, firms following an international strategy will always be vulnerable to competitors who are able to integrate and outperform them in terms of costs or competitors who are able to customize and outperform them in terms of benefits offered to the consumer. Historically, this is probably the strategy that many financial services organizations operated in the early stages of internationalization. HSBC, for example, traditionally operated across a range of markets, offering relatively standard banking services but under a different brand and name in each country. In the UK, HSBC traded as the Midland Bank, in Australia as the Hong Kong Bank of Australia, in the Middle East as the British Bank of the Middle East and in the USA as the Marine Midland Bank. In 1998, the bank announced a move to create a unified brand for all its operations worldwide in order to be able to integrate marketing activities, improve marketing effectiveness and increase shareholder value. In effect, HSBC was moving away from an international strategy and towards a global strategy by more fully integrating its marketing activities worldwide.

6.6.2 Global strategies

A global strategy essentially focuses on integrating business activities across markets in order to ensure greater efficiency in operations; differences between markets tend to be discounted and the pressure to be locally responsive is considered to be weak. Rather than focusing on possible differences in customer needs, a global strategy focuses on similarities and sees different international markets as being essentially homogenous. Typically, such a strategy is associated with manufacturers of highly standardized physical goods and emphasizes economies of scale in production and marketing. Matsushita is the example cited by Ghoshal and Bartlett (1998), with 90 per cent of its production concentrated in highly efficient plants in Japan and yet 40 per cent of its revenue coming from sales overseas.

In many senses, it is difficult for any financial services provider to be truly global because regulatory regimes vary across countries and limit the extent of true standardization. However, in retail markets, banks such as HSBC and Citibank are arguably following something close to a global strategy, with recognized global brands and strong presence worldwide. The same may be said of American Express, Visa and Mastercard. In corporate markets, Bank of Tokyo Mitsubishi, with its diversified global network and ability to provide a full range of services to customers worldwide, is probably also following something close to a global strategy.

6.6.3 Multi-domestic strategies

A multi-domestic strategy arises when the pressures for integration are low and the pressures for local responsiveness are high. Such a strategy is characterized by operations across multiple markets, but with a high degree of decentralization to ensure that services are tailored to the needs of those local markets. Any pressures on costs which might encourage integration are outweighed by the importance of local responsiveness; if a head office exists, its control is relatively weak and the organization is perhaps best thought of as a federation of semi-autonomous companies. Multi-domestic strategies are probably most closely associated with manufacturers of products that are in some way culturally sensitive (such as food and personal care) and where adaptation is essential. Multi-domestic strategies are relatively unusual, but in the financial services sector such an approach would apply to relatively information-intensive and people-focused services such as financial advice, where local responsiveness is essential. For example, De Vere and Partners – one of the largest chains of independent financial advisers – operates in 30 different countries worldwide. Differences in regulation and differences among consumers mean that scope for integration is limited, and that advice must be tailored to customer and country context.

6.6.4 Transnational strategies

According to Ghoshal and Bartlett, transnational strategies are a relatively recent phenomenon and have emerged in markets where there are significant pressures to

keep costs low through global integration, and also a need for a high degree of local responsiveness. This approach requires a high degree of global co-ordination and careful management of operations to fully exploit opportunities for increased efficiency, while retaining the flexibility to tailor the service to a given market. In principle, a transnational strategy creates a strong competitive position, being more locally responsive than a global strategy and of a lower cost than a multi-domestic strategy. There are probably relatively few examples of genuinely transnational strategies in services, not least because of the difficulty of delivering both integration and responsiveness. In the service sector more generally, MacDonald's is sometimes cited as an example of a service-based company moving towards a transnational strategy. It uses supply-chain management systems and global branding to ensure a high degree of integration whilst, within this framework, adjusting the products offered in each country to accommodate the tastes and expectations of domestic consumers. In financial services, given that IT enables a greater degree of remote delivery and facilitates the separation of front- and back-office activities, there may be the potential for some of the providers who are moving towards global strategies to become increasingly transnational.

6.7 Strategy selection and implementation

From the discussion of different strategic approaches to international markets in the previous section, it is apparent that the choice of strategy is likely to depend on the type of service and the nature of the business environment. For example, services that require a high degree of interpersonal interaction (what Lovelock and Yip (1996) would describe as people-processing services) will probably be most suited to a multi-domestic strategy, particularly if cultural or regulatory differences between markets are significant. In contrast, services that have limited requirements for interpersonal interaction (information- or possession-processing services) will be more suited to global or transnational strategies. The choice between the two will then be driven by the extent to which customer needs differ, and the ability of the organization to deliver a differentiated service.

In addition to thinking about the right strategic approach to adopt for international operations, there are three other important decisions that require consideration: which markets to enter, how to enter those markets, and how to market services within those markets.

6.7.1 Which markets to enter

In very simple terms, the choice of markets to enter is based on identifying those that offer the best long-term returns. Superficially this may sound like a straightforward decision; in reality, it is potentially very complex. The factors discussed in Chapter 5 as being the basis for an evaluation of target market attractiveness domestically will all be relevant to the choice of target market internationally. Cultural proximity is frequently a major factor in determining international developments, at least during the early stages of a strategy for overseas expansion.

However, broader macro-influences must also be considered and factored into the market selection decision. Factors such as size of population, levels of income and rate of growth will have important implications for the attractiveness of a market. One of the reasons why both India and China are attractive to many financial services organizations is that they are large markets and, although income levels are relatively low, economic growth rates are high, suggesting considerable long-term potential. Economic variables are imperative in determining the attractiveness of a market, but it is equally important to consider the feasibility of operating in a particular market. Infrastructure is one important consideration, encompassing the quality and capacity of communications networks, access to essential supporting services (e.g. market research) and the ability to access suitable premises. Given the importance of people in a service business the availability of appropriate quality staff must be considered, and this may be of particular significance in cases where there is a significant cultural difference between home and target market (a high psychic distance). In financial services, understanding the nature of domestic market regulation and its implications for the conduct of business is essential. Finally, of course, it is important to remember that some international markets may be strategically significant and that, irrespective of the other factors, firms need to have a presence in those markets. For banks operating internationally, a presence in the key markets of London, Tokyo and New York will probably be essential quite simply because customers and competitors expect to see them there.

6.7.2 Method of market entry

Methods of market entry are normally divided into three categories: export, contractual and investment. In very simple terms we can think about these forms of market entry as being distinctive in terms of cost and control, with exporting at one extreme seen as offering low cost but low control, and investment being high cost but high control. The choice of entry mode can then be thought of in terms of the extent to which the firm needs to control the marketing and delivery of its products and services to customers, and the extent to which it wishes to control costs. Exporting is often presented as being the first stage in internationalization, because it involves a relatively low resource commitment. As firms build up experience they are thought to move on to more complex and high commitment method of market entry, such as a contractual arrangement or direct investment in overseas markets. In practice, of course, the choices are rarely that straightforward, and the nature of financial services does tend to constrain the choice of mode of market entry. A helpful overview that highlights some of the complexities associated with internationalization and methods of market entry is provided by Whitelock (2002).

The methods of market entry are described below:

1. *Export*. Exporting involves supplying goods from the home country to customers located in international markets. Provider and customer essentially remain at arm's length. Different regulatory systems and customer preferences for a physical presence make this form of market entry difficult for providers of financial services, although deregulation within the European Union has sought to encourage increased trade in financial services through a system of mutual recognition.

Moreover, it has been suggested that high levels of information intensity in some financial services, combined with the ability to digitize, have increased the potential for service exports (McLaughlin and Fitzsimmons, 1996). Certainly the global securities business, which relies heavily on digitized information relies on growing volumes of export-style activities with, for example, an investment house in New York dealing with a securities house in Hong Kong who will then provide a service remotely, based around information.

2. *Contractual*: A contractual entry mode involves some form of partnership arrangement with a domestic provider which typically does not involve any shared ownership. Contractual entry modes are rather more costly than exporting, but also provide rather more control. The most immediately recognizable forms of contractual entry are franchising and licensing. Both these arrangements grant an overseas firm the right to use some of the knowledge and expertise associated with the firm wishing to internationalize, and, because they draw on local managerial expertise, can be of particular value when there is a need to be sensitive to and adapt to local culture. Licensing arrangements are common in the physical goods sector – a variety of different types of soft drinks and food stuffs available worldwide are manufactured 'under licence', i.e. using licensed recipes, manufacturing processes etc. Franchising extends the licensing concept to cover not just the product but also a broader business format. Service businesses such as Hertz, Hilton Hotels and MacDonald's rely heavily on franchising as a method of market entry, but it is relatively less popular in the financial services sector for internationalization, although it is used in domestic markets for activities such as financial advice and broking.
3. *Investment*: Investment-based entry describes any type of operation in which a control is established over physical assets in an international market. It is the highest-cost mode of entry and requires considerable commitment, but it also offers the highest level of control over the conduct of business. Investment-based entry may involve wholly new developments (sometimes referred to as greenfield developments) or some form of joint venture, strategic alliance or merger/acquisition. Greenfield developments are costly, but allow the organization to do exactly what it wants. Citibank's entry to the Japanese market in the 1980s was managed as a wholly new development. Joint ventures and strategic alliances are less flexible, because they entail working with local partners, but they do ensure access to organizations with local knowledge (which can be very important in some markets). In many countries, government regulations require that foreign entrants operate in a joint venture (see Case study 6.1 regarding China), so new market entrants may simply not have a choice. Mergers and acquisitions can be attractive as routes to market, because they provide speedy access to an existing customer base and save the new entrant the difficulty of building up the business from nothing. The acquisition of the British-based Abbey plc by the Spanish Banco Santander is a good example of such an approach. However, there are clear challenges associated with integrating the staff and systems of two or more businesses, and this can make mergers and acquisitions difficult to manage. In general, investment entry modes have been widely used in financial services; there are numerous examples of joint ventures where required by regulations and market conditions, but many of the larger international financial services organizations have reached their position through

a series of mergers and acquisitions. For example, Deutsche Bank became a global bank through the acquisition of Banca d'America e d'Italia in 1986 (Italy), Morgan Grenfell in 1989 (UK), Bankers Trust in 1999 (USA), Scudder Investments in 2002 (USA), Rued Blass & Cie in 2003 (Switzerland) and United Financial Group in 2006 (Russia).

The choice of method of market entry is subject to a variety of influences, including the nature of the service, the internal resources and capabilities of the firm, the regulatory environment and the host-country environment. This means that it can be difficult to generalize about the best mode of market entry for any given service, but investment modes do appear to be the preferred route to market for most financial services providers – reflecting, perhaps, the importance of a physical presence in the market, regulatory considerations, the value of local knowledge and the need for control over the service itself and the way in which it is delivered.

6.7.3 How to market in international markets

Once a method of market entry has been selected and implemented, the issue of marketing needs to be addressed. Discussions of international marketing have traditionally revolved around the debate between standardization and customization – should an organization operate with the same marketing strategies and tactics across all markets, or should strategy and tactics be tailored to the local market? In basic terms, this can be thought of as directly analogous to the choice between a global strategy (low levels of local responsiveness) and a multi-domestic strategy (high levels of local responsiveness). Although this debate has attracted much attention in academic literature and international marketing textbooks, most academics and practitioners would recognize that some degree of customization is unavoidable and that sensible approaches to international markets will involve standardizing where possible (the brand, advertising messages, logos, use of colour, methods of distribution) and being prepared to customize where necessary (product features, creative presentations, use of language, price). The leading global financial services providers such as Standard Chartered Bank, American Express, HSBC and Citibank all provide examples of how this is done. Some marketing activities are adapted to the specific context, but there remains considerable standardization in terms of the marketing communications, thus ensuring that the brand is recognizable worldwide.

6.8 Summary and conclusions

This chapter has introduced some of the major issues relating to internationalization in the financial services sector. Although it is commonly assumed that financial services are very much domestic markets because of regulatory frameworks and consumer expectations regarding a physical presence, many aspects of the industry are highly international. A variety of factors may encourage internationalization. At a micro-level, we can distinguish those factors which 'push' an organization

overseas and those which 'pull'. At a macro-level, variations in the environment can make international operations more or less attractive.

A series of broad strategic approaches to international activity can be identified based on the degree to which there is pressure for integration to exploit economies of scale and the degree to which there is a need for local responsiveness. As well as establishing a broad strategic approach to operating internationally, organizations must also give careful consideration to the choice of markets in which to operate, the method of market entry, and the right approach to marketing its services once established.

Review questions

1. Why are banks more international than financial advisers? Why are corporate financial services more international than retail financial services?
2. What are the benefits to HSBC of the development of a global brand?
3. Compare and contrast exporting and investment modes of market entry for financial services. Why have investment modes of entry been more widespread?

7

Understanding the financial services consumer

Learning objectives

By the end of this chapter you will be able to:

- understand the factors that influence consumer decision-making in financial services
- recognize the ways in which financial services providers can influence the buying process
- recognize the differences between final consumers and business consumers in relation to financial services.

7.1 Introduction

Understanding consumers is central to effective marketing, and yet our understanding of how consumers buy financial services is rather limited. For many personal consumers, financial services are not seen as particularly interesting or exciting purchases; they are seen as complicated, and often it is difficult for consumers to identify differences between a bank account from, say, HSBC and one from Standard Chartered, or between an insurance policy from Aetna and one from AIA. Consumers find it difficult to evaluate their purchase in advance, and consequently experience high levels of perceived risk. Furthermore, as explained in Chapter 3, financial services are often seen as uninteresting and consumption is contingent – that is, the services in themselves do not generate a current consumption benefit; indeed, they can serve to reduce current consumption pleasure. In some cases

financial services may create consumption opportunities in the future; in other cases they may never result in tangible consumption for the individual who made the purchase (e.g. life insurance). Many consumers regard them as 'distress purchases' – things that they have to buy but don't want to – and often have little incentive to learn more about such products. Thus, many personal consumers are often rather uninterested and relatively passive consumers.

The same may not be true of business customers, many of whom will have detailed knowledge of financial services and their companies' financial needs. Their purchases of financial services will be seen as important factors contributing to the performance of the business, and consequently they are likely to be much more active and better informed during the buying process. Of course this is something of a generalization, care must be taken not to stereotype consumers too much. However, the comparison helps to show that trying to understand financial services buying behaviour can be very complicated.

This chapter, which is substantially based on Ennew and McKechnie (1992), aims to provide an explanation of how consumers make decisions when buying financial services. The main focus will be on personal consumers, but, where appropriate, the experiences of personal consumers will be contrasted with the experiences of business customers. The chapter begins with a discussion of consumer decision-making based on established information-processing models of consumer choice.

7.2 Consumer choice and financial services

It is important to bear in mind that the term 'customer' is multifaceted, whereby a number of roles combine together to result ultimately in consumption. For example, there is the role of *initiating* the desire to satisfy a given need; this may be followed-up by the role of the *influencer* and lead on to the *decider*, *purchaser* and *user*. In the consumer domain all five roles are frequently performed by the same person, especially with regard to what are termed routine purchases. However, in the B2B domain they are very often carried out by separate individuals or, possibly, groups of individuals. We call this a decision-making unit (dmu), and it has significant implications for the organization of marketing activities. It calls for detailed knowledge of the dmu at the level of the individual business entity, and this is a major challenge when marketing financial services to corporate clients.

There are many different frameworks for understanding consumer behaviour. Indeed, there is a growing interest in researching consumers from interpretivist perspectives to understand the meaning, nature and significance of consumption of certain types of goods and services to individuals. However, the majority of research on financial services consumers has relied on traditional cognitive-based approaches to understanding consumer behaviour. These approaches to understanding consumers are based on the notion that consumer choice is the result of some form of systematic processing and evaluation of information. The consumer is seen as a problem-solver who moves sequentially through a series of stages in a decision-making process prior to making a purchase. One of the best examples of

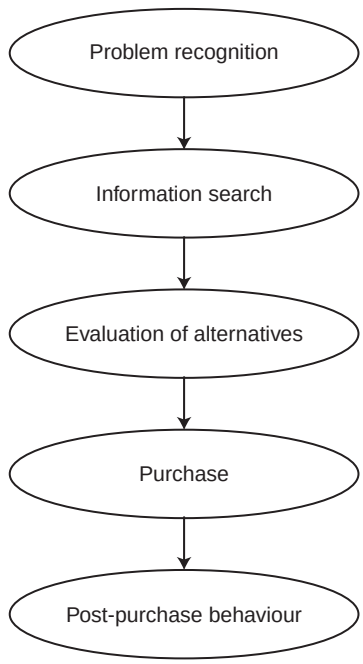

Figure 7.1 The Engel–Kollat–Blackwell model.

this approach for final consumers is probably the Engel–Kollat–Blackwell model (Engel *et al*., 1991), which is outlined in very simplified form in Figure 7.1.

In essence, the decision process begins when the buyer recognizes a 'problem' (that is, a difference between a desired and an actual state) and is motivated to act. Need recognition may be stimulated by either external factors (e.g. advertising, promotion, awareness of the consumption of others) or internal factors (e.g. hunger, thirst, need for security). To solve the problem, the buyer engages in a search for relevant information (either from memory or external sources, or from both). Based on that information, the consumer evaluates the alternative options that are available and makes a purchase decision based on which option best meets the initial need. Finally, once the purchase has been made, there will be further evaluation and responses including, typically, evaluations of satisfaction, willingness to recommend and willingness to repurchase.

Treating consumer choice as a problem-solving process may have a certain intuitive appeal, but it also has a number of weaknesses. In particular, such an approach assumes a high degree of rationality in purchase decisions; it assumes that decision-making is very logical and linear, and it assumes a degree of consistency in behaviour. It is important to recognize these limitations and to be aware that consumer choice in financial services is potentially a very complex process. However, the simple framework outlined in Figure 7.1 is helpful as a way of structuring the discussion of consumer choice in financial services. In particular, it is useful as means of understanding some of the different ways in which marketing can and does influence the choice process. It should be appreciated that not all five steps in the

Engel–Kollat–Blackwell process need necessarily apply sequentially to all purchase occasions. In some cases, and for frequently purchased and simple products, consumers might proceed directly from problem recognition to purchase because they are familiar with the means of satisfying a given need. Given that financial services are complex and infrequently purchased, it might be reasonable to expect that the choice process may be more thorough and considered, although, in practice, anecdotal evidence suggests that some consumers may actually make quite impulsive purchases, not least because of a lack of interest in the product.

7.2.1 Problem recognition

This is concerned with understanding the needs and wants of consumers and the extent to which they are motivated to satisfy those needs and wants. Needs and wants for personal customers will vary according to personal circumstances, whereas the needs of business customers will depend upon the stage of development and the situation of the business. For personal customers there is a range of 'needs' that may be satisfied through the purchase of financial services, including the need to make payments (e.g. cheques), the need to defer payments (loans, mortgages, credit cards, etc.), the need for protection (house insurance, health insurance, life insurance, etc.), the need to accumulate wealth (managed funds, stocks, life insurance based savings, etc.) and the need for information and advice (tax/financial planning, etc.). For many personal consumers, 'needs' of this nature are intrinsically uninteresting; there is often also a preference to ignore certain 'needs' which may be associated with unpleasant events such as burglary, illness or death. Because financial services are often products which consumers would prefer not to think about, there is a danger that they will not recognize a need for a financial service. The relatively low take-up of products such as critical illness insurance (which pays out on the diagnosis of a life-threatening condition) may in part be due to consumers' reluctance to consider the possibility that this will happen to them. Equally, the complexity of many financial services and the lack of transparency in marketing may mean that customers are unable to recognize the ways in which those services might meet their needs.

As a consequence of the lack of intrinsic appeal and the complexity of the range of financial services available, it is often argued that consumers do not actively recognize that they have 'needs' for various financial products; rather, they remain essentially passive participants in a decision process until the point of sale (Knights *et al*., 1994). At this point, the marketing process then starts to focus on the identification and activation (some would even suggest creation) of those needs. This raises a number of issues. Clearly, marketing is much more difficult in those instances in which customers are largely uninterested and unaware of the benefits of the product. It becomes impractical to rely to any degree on consumer 'pull', and instead many organizations will place considerable emphasis on 'sales push' – i.e. actively pushing products to consumers and persuading them of the benefits of purchase. This comparatively greater reliance on sales push is reflected in the widespread use of personal selling, particularly for the more complex products. A reliance on sales push does create potential problems – a situation in which customers have limited knowledge and interest combined with an industry which

has to rely heavily on active selling creates considerable potential for mis-selling (i.e. selling products that are clearly inappropriate for the person concerned).

The difficulties that consumers experience in relation to problem recognition are often compounded by a lack of transparency in marketing. A common source of complaint in many parts of the world is that key aspects of product design and pricing are not clearly displayed and explained. *Transparency* is the word applied to this form of openness.

In recent years there have been great strides forward in a range of countries as regulators seek to make products more transparent. However, it is particularly difficult to achieve the desired degree of transparency in an area which is often characterized by variable and uncertain outcomes, product complexity and relatively poorly informed consumers. Chapter 12 explains the complexity that applies to financial services, and the range of different pricing concepts with which consumers need to be familiar in order to make well-judged choices.

In addition to whatever written rules apply to standards of transparency, it is important that marketing managers embrace the spirit of transparency. This will be in the long-term interests of providers, as such an approach will result in much better-managed consumer expectations and enable customers to recognize their needs and identify suitable products more clearly.

For corporate customers the range of basic needs is likely to be similar, although many of the products used to satisfy those needs may be more complex, particularly when the customer represents a large business organization. In addition, business customers, particularly those from larger organizations, will have a much better understanding and awareness of their own needs, suggesting that marketing may need to be less concerned with helping consumers to understand what their needs are and more concerned with deciding how best to meet those needs.

7.2.2 Information search

Information search describes the process by which consumers gather relevant information either from their own memories of from external sources – whether marketing communications, from other consumers or from independent third parties. To the extent that the nature of financial service induces consumer passivity, the degree of information search is likely to be limited. Even when consumers are willing to be more active in the purchase process, information-gathering presents problems. A significant element of information-gathering typically relates to search qualities, but intangibility and inseparability mean that financial services are low in search qualities while high in experience and credence qualities (Zeithaml, 1981). Unless consumers can draw on their own prior experience of the product (and this is likely to be rare, since most financial services are long term, continuous or both) there will be a tendency to rely heavily on the experience of others in the form of word-of-mouth recommendations, and on the credibility of the organization as a whole.

Even allowing for the difficulties that consumers face in gathering information, there are further problems in relation to the validity and accessibility of information. First, many financial services are long term in nature; consequently, even when consumers gain vicarious experience from word-of-mouth recommendations, that experience may be at best very partial since the full benefits of a product (a 10-year

savings plan for example) may not have been realized. Secondly, since many products are effectively customized to individuals (reflecting health status, age, martial status, etc.), drawing on the experience of others can be misleading if personal circumstances differ. Thirdly, the complexity of many financial services means that many consumers may collect information but not actually interpret it, or may interpret it incorrectly. The difficulties associated with information search may be compounded by lack of transparency, as discussed above. In the UK, the financial services sector has been criticized for lack of transparency in the representation of so-called guaranteed equity bonds (GEB). Caine (2005) observes that over 200 bonds of this type were launched in 2005. Caine is particularly critical of the way in which the guarantee of the return of the initial investment does not always make clear the opportunity cost of loss of interest that investors should consider. She also argues that insufficient profile is given to the fact that explicit reference to the respective role and contribution of dividends as well as pure share price growth is absent.

While information search is clearly problematic, it is important to recognize that there has been a notable increase in consumer understanding and knowledge of financial services and considerable expansion in the various sources of independent information. Most daily papers have sections devoted to personal finance, and there is a growing number of specialist magazines to provide information and advice to customers – including *Smart Investor* (Australia), *Outlook Money* (India), *Investors' Chronicle* (UK) and *Money* (US). In addition, organizations such as *Which*? in the UK and the Consumers' Union in the US provide regular advice and product comparisons. In addition, most leading web portals provide a growing amount of financial information. For example, in the UK, Motley Fool (www.fool.com) provides advice about investment and other financial services, Money Expert (www.moneyexpert.com) provides product comparisons, and uSwitch (www.uswitch.com) provides product comparisons and advice on switching. Thus, personal consumers are generally thought to be better informed now than was the case in the past. However, the simple availability of information does not necessarily mean that it can always be used to good effect.

It is probably easier for corporate customers, who have more experience of using financial services and are better able to evaluate competitor offerings. In addition, the key decision-makers are likely to have more specialist knowledge, and so information search should be more straightforward, even if the original needs are rather more complex.

7.2.3 Evaluation of alternatives

If there are difficulties for consumers with respect to the gathering of information, these difficulties are magnified when the consumer attempts to evaluate alternative services. Like many services, financial services are processes rather than physical objects; the predominance of experience qualities makes pre-purchase evaluation difficult and, where credence qualities are significant, post-purchase evaluation may also be problematic. Typically, alternatives are evaluated in relation to dimensions specified in the initial problem-recognition stage; if consumers are in some senses inert or inactive in relation to problem recognition, then the criteria being used for evaluation are likely to be poorly defined. However, even accepting that consumers can make evaluations, the process of so doing will be complicated by a number of features of financial services. There is a variety of different products that may satisfy

a particular need; for example, the consumer who wishes to accumulate wealth may consider a range of products – national savings certificates, guaranteed equity bonds, unit trusts and simple equity investments. The risk–return characteristics of these services vary considerably, as do the prices, and there is rarely any easy way to make direct comparisons across different service types. These problems have been exacerbated by the lack of transparency in the pricing and promotion of many financial services (Diacon and Ennew, 1996). Although recent regulatory changes regarding commission disclosure have partly remedied this situation, comparisons across service types remains difficult.

The presence of credence qualities in many financial services also makes evaluation complex. Products that need a significant element of advice, or which require 'managing' over the course of their life, may be difficult to evaluate even after purchase. In particular, the performance of many long-term investment products is determined partly by the skill of the relevant fund managers, but partly by economic factors which are beyond the control of the supplier. Thus, consumers expose themselves to certain risks (both actual and perceived) in purchasing these products, but will subsequently experience difficulty in determining whether poor performance was due to company-specific factors or external contingencies. A consequence of this situation is a tendency for customers to evaluate service providers (rather than the services themselves) and to rely heavily on trust and confidence as attributes of those providers. Indeed, trust is a concept that lies at the heart of the relationship between a financial services supplier and its customers. The fund of trust that a financial services brand can instil in the public represents a major asset, as observed by HSBC's Group CEO Stephen Green (in Ennew and Sekhon, 2003):

> If customers have faith in the HSBC brand, they will give us a trusted role in their lives and help us build our business.

Those involved in marketing financial services must place priority on engendering the trust of consumers, and avoiding policies and practices that serve to undermine trust.

7.2.4 Purchase

Purchase is normally expected to follow logically as the result of the evaluation of alternatives, unless any unexpected problems materialize. However, earlier discussions have suggested that, for many financial services customers, needs are only created or activated at the point of purchase. Accordingly, the actual process of purchase will often be the result of an active selling effort by a supplier. Customer interaction with sales staff is then likely to be of particular significance in the purchase process. Even with developments in relation to the Internet and in ATMs and telephone sales, the significance of face-to-face interaction is likely to continue in the medium term. However, while sympathetic, unpressured selling may be highly effective, the complexity and riskiness of financial services, combined with their common status as 'avoidance' products, means that many customers may be vulnerable to 'hard' or 'over' selling. There can be little doubt that this has been the case in the past in some parts of the market (Ennew and Sekhon, 2003), and that it has resulted in a significant loss of consumer confidence in those parts of the industry where confidence is so important.

Furthermore, the purchase process is influenced by the inseparability of production and consumption in financial services. The frontline service employees play an important 'boundary spanning role' in the production of services, as do the consumers themselves in their capacity as 'partial employees' (Bowen and Schneider, 1988). Therefore, an important influence on the purchase process will be the interaction between buyer and supplier. Since services depend upon input from both service employees and consumers for their production, the quality of the service output very much depends on the nature of the personal interactions of these parties.

Fiduciary responsibility is often highlighted as an important characteristic which distinguishes financial services from other services and goods; one dimension of fiduciary responsibility is that suppliers need to exercise discretion with respect to the sale of certain products. For example, it would be inappropriate for a bank to lend money to a business that has few prospects for survival and success. However, until a consumer has signalled the intent to purchase it may not be possible to identify whether or not it is appropriate to provide that product to that customer. Thus, the consumer effectively faces the added problem that even if a conscious decision to purchase has been taken, the financial institution concerned may be unwilling to provide the product.

7.2.5 Post-purchase behaviour

The post-purchase evaluation of financial services is difficult, for the reasons mentioned earlier. Indeed, it is often suggested that evaluation may place rather more emphasis on functional aspects of the service (how things are done) than on technical aspects (what is done) because the latter are more difficult to evaluate (Zeithaml, 1981). The difficulties of post-purchase evaluation would tend to suggest that the risk of cognitive dissonance among consumers is high, and that this may subsequently reduce brand loyalty. Evidence for this is ambiguous; for continuous products such as bank accounts, a high level of cognitive dissonance might be reflected in high levels of switching. In practice, the number of consumers changing bank, although increasing (Burton, 1994; Ennew and Binks, 1996b), is still low. This may reflect a low level of dissonance; alternatively, given switching costs, consumers may be willing to tolerate high levels of dissonance before being motivated to act. In the case of savings and investment products the levels of switching are higher, and the relatively low proportion of retained customers may reflect the high level of dissonance experienced.

However, where a high degree of trust is established between buyer and seller, there can be considerable benefits for both parties. The establishment of trust can bring about a degree of inertia in buyer–seller relationships. Since an irreversible amount of time and effort is required by an individual in order to acquire the necessary experience and information on which to assess an institution's reliability, it is usually the case that, once satisfied, a consumer is more likely to remain with that institution than to incur the costs of searching for and vetting alternative suppliers. This does create a potential problem for marketing, in that organizations may fall into the trap of assuming that, once acquired, customers will remain with the organization, resulting in insufficient attention to customer retention and an overemphasis on customer acquisition.

The Engel–Kollat–Blackwell model assumes a highly rational approach to decision-making whereby individuals seek to optimize their well-defined preferences, and mitigate the associated risks through the acquisition of knowledge. Such a rational approach is more likely to be a feature of the B2B environment, where purchasing takes place in order to satisfy the financial goals of a company. However, this model of economic rationality may not hold true to such an extent in the consumer domain. Factors such as relative financial illiteracy and the often-observed low level of interest in and engagement with financial services products can result in consumer behaviour that seems far less economically rational. Behavioural finance and economic finance are fields of knowledge that seek to explain why it is that human beings individually and collectively approach decision-making in what seems to be an irrational and illogical manner. This gathering body of knowledge is based upon combining relevant concepts from the disciplines of psychology and economics. Readers interested in learning more about this field are referred to the work of people such as Daniel Kahneman at Princeton University.

7.2.6 Summary

From the discussion above, it should be clear that there are good conceptual reasons for expecting consumers to encounter difficulties with respect to the choice of financial services. The severity of these problems will vary across market segments. For example, the problem of complexity may be rather less important for a corporate buyer evaluating different leasing companies than for an individual evaluating pension providers. Furthermore, corporate buyers may well be expected to express needs more actively and accurately than personal customers. Nevertheless, within the personal market there are clearly some subgroups of customers who are more actively aware of their needs than are others. Allowing for this variation in the degree and type of difficulties consumers may experience, there is a number of themes that seem to be of particular relevance to the choice process. These include the importance of trust and confidence in the supplier, the concern about customer passivity, the relative importance of functional aspects of the service product, and the importance of interaction and contact with people.

7.3 Consumer buying behaviour in financial services

The previous section has highlighted some of the difficulties that customers encounter in the purchase of financial services. In this section we examine briefly some of the existing empirical research relating to buying behaviour, and consider the extent to which it corroborates the issues discussed in the previous section. The results of a variety of studies of buying behaviour for both personal and corporate financial services are summarized in Tables 7.1 and 7.2. Most of the work to date has emphasized specific aspects of buying behaviour, such as factors affecting the choice of bank, usage of financial services and customer loyalty, rather than attempting to

Table 7.1 Personal financial services buying behaviour

Author(s)	Field of study	Geographic area	Key finding(s)
Laroche *et al*. (1986)	Factors influencing choice of bank	Canada	Importance of location convenience, speed of service, competence and friendliness of bank personnel
Jain *et al*. (1987)	Customer loyalty in retail banking	USA	Customer loyalty is a useful construct; bank non-loyal segment swayed by economic rationale, whereas greater emphasis placed on human aspects of banking by bank loyal segment
Joy *et al*. (1991)	Link between ethnicity and use of financial services	Canada	Ethnicity should be considered as a construct having strong potential impact on consumption
Leonard and Spencer (1991)	Importance of bank image as a competitive strategy for increasing customer traffic flow	USA	Preference for banks amongst students as providers of financial services; greater confidence in large to medium-sized banks; importance of courtesy of personnel, competitive deposit rates, loan availability
Lewis (1991)	International comparison of bank customers' expectations and perceptions of service quality	UK/USA	Very high expectations of service quality and high perceptions of service received, yet gaps did exist
Ennew (1992)	Consumer attitudes to independent advice	UK	More importance may be attached to image and reputation of an independent financial adviser than their status
Chan (1993)	Banking services for young intellectuals	Hong Kong	Financial sophistication of youth market
Boyd *et al*. (1994)	Consumer choice criteria in financial institution selection	USA	Reputation and interest rates (loans/savings) more important than friendliness of employees, modern facilities, drive-in service
Harrison (1994)	Segmentation of market for retail financial services	UK	Distinct segments identified based on financial maturity (based on likely range of product holdings) and perceived knowledge of financial services
Burton (1996)	Ethnicity and financial behaviour	UK	Evidence of considerable variety in the take-up of pensions according to ethnic origin; suggests that financial services providers have not yet accommodated the needs/expectations of distinct ethnic groups

Goode *et al*. (1996)	Satisfaction with ATMs	UK	Levels satisfaction and overall usage of services influenced by customer expectations and by perceived risk
Kennington *et al*. (1996)	Study of banking habits and bank choice in a transitional economy	Poland	Consumers in a transitional economy select banks using the same criteria as consumers in other countries, although pricing concerns do appear to be particularly significant
Levesque and McDougall (1996)	Determinants of satisfaction in retail banking	Canada	Satisfaction influenced by service quality, service features, service problems and service quality; these variables also affect intentions to switch bank
Veloutsou *et al*. (2004)	Determinants of bank loyalty	Greece	Examines role of satisfaction, perceived quality and image as drivers of bank brand loyalty
Verma *et al*. (2004)	Understanding customer choices in E-Financial Services	US	Suggests customer swilling to pay more for an online service that gives offline value and online benefit
Pont and McQuilken (2005)	Customer satisfaction and loyalty across two divergent bank segments	Australia	Investigated retirees and university students; no significant difference in satisfaction levels between segments, but a significant difference on three behavioural intentions dimensions – loyalty, pay more and customer relations

Table 7.2 Corporate financial services buying behaviour

Author(s)	Field of study	Geographic area	Key finding(s)
Turnbull (1982a)	Purchase of international financial services by large/medium-sized UK companies with European subsidiaries	UK	Greater effort required to understand the nature of customer needs and bank/customer relationships through detailed application of the Interaction theory
Turnbull (1982b)	Role of branch bank manager in bank services marketing	UK	Lack of customer orientation amongst bank branch managers
Turnbull (1982c)	Use of foreign banks by UK companies	UK	High concentration of decision-making and extent of split banking; crucial importance of development and maintenance of a company-bank relationship
Turnbull (1983)	Relationship between banks' corporate customers and their sources of financial services	UK	Small/medium-sized companies do not always consider major UK banks as an appropriate source for all financial services
Turnbull and Gibbs (1989)	Relationship between large companies and its lead and closest substitute bank	South Africa	Predominant bank selection criteria: importance of quality of service, quality of staff and price of services; split banking common
Chan and Ma (1990)	Corporate customer buying behaviour for banking services.	Hong Kong	Great importance attached to banks understanding their clients' attitudes in order to serve them better
File and Prince (1991)	Purchase dynamics of SME market and financial services	USA	Existence of three distinctive sociographic segments adopting innovations in bank services: return seekers, relevance seekers and relationship seekers
Edwards and Turnbull (1994)	Current and future use of foreign banks by UK middle corporate market	UK	Very conservative approach to domestic banking, with foreign banks used as secondary banks
Zineldin (1995)	Bank–company interactions	Sweden	Smaller companies tend to have stable relationships with a single bank, but larger organizations operate with a variety of banking relationships; there is evidence of low levels of satisfaction among smaller companies

Ennew and Binks (1996a)	Impact of service quality on customer retention	UK	Both product characteristics and service quality affect potential for small businesses to switch bank
Ennew and Binks (1996b)	Customer involvement in banking relationships	UK	Greater degrees of customer involvement in a banking relationship result in improved service quality
Turnbull and Moustakatos (1995)	Empirical research using a sample of investment banks and their large corporate customers.	UK	Suggests likely polarization in industry structures. Major players will be full service investment banks with a worldwide capability accompanied by specialist niche players on a geographical or product basis
Mols *et al*. (1997)	European corporate customers' choice of domestic cash management banks	Europe	Differentiation between the service offering as perceived by managers towards individual and business customers; evidence of superior service experience of individual rather than business customers
Athanassopoulos and Labroukos (1999)	The nature relationships between corporate companies and financial institutions	Greece	Evidence that profitable firms resist cross-selling; need for relationship marketing to expand scope; product-bundling not sufficient to ensure lasting relationships
Lam and Burton (2005)	Bank selection and share of the wallet among SMEs: apparent differences between HK and Australia	HK/Australia	Firms in both countries view a bank's willingness to accommodate their banking and credit needs as being important. Hong Kong firms appear to give this factor higher priority, while Australian firms appear to place higher emphasis on long-term relationships.

examine the buying process as a whole. This largely reflects the difficulties associated with testing decision-process models in their entirety.

Empirical studies relating to the personal market highlight the importance of factors such as confidence, trust and customer loyalty. Some of the common choice criteria in bank selection include dependability and size of the institution, location, convenience and ease of transactions, professionalism of bank personnel, and availability of loans. It would appear, therefore, that the personal consumer is more interested in the functional quality dimension of financial services (i.e. how the service is delivered) than in the technical quality dimension (i.e. what is actually received as the outcome of the production process) (see Grönroos, 1984). This is hardly surprising, given the difficulties consumers have in evaluating services.

In contrast, work relating to corporate customers places much greater emphasis on the importance of interaction and understanding. This is consistent with the notion that issues such as passivity, complexity and problems of comparison are perhaps less important to corporate decision-makers, but that the intangibility and the lack of search qualities means that personal relationships, trust, confidence and reliability continue to be important influences within the purchase process.

7.4 Industry responses

The first part of this chapter highlighted some of the problems which confront consumers when choosing financial services. These difficulties are due partly to the generic characteristics of services, partly to the unique features of financial services and partly to the practices employed within the industry itself. Given the existence of these problems, effective marketing must concern itself with reducing or minimizing the difficulties that consumers face in the purchase process. In order to examine the current evidence on industry responses, this section considers the nature of strategies and tactics employed in relation to selected characteristics of financial services – intangibility, inseparability/perishability, heterogeneity, fiduciary responsibility and the long-term nature and uncertainty of many of the products. However, it should be noted that many of these responses can address more than one service characteristic.

7.4.1 Intangibility

Intangibility is probably the dominant characteristic of any service, and there is a variety of strategies that can be used to mitigate its effects. The simplest approach is to find some means of tangibilizing the service. The provision of some physical evidence (whether essential or peripheral) is probably the most common approach to dealing with intangibility (Shostack, 1982). Examples of peripheral physical evidence might include wallets with insurance policies, cheque-book covers, and even promotional free gifts. Essential physical evidence is typically associated with branch networks or head offices, with the appearance and layout being used to give a tangible representation of the organization. Often, physical evidence of this nature is supported by the use of a tangible image or name. Thus, for example, the

'Leeds Permanent' and the 'Northern Rock' are both organizational names that try to link to an image of stability and security. Equally, a tangible image or association such as the Black Horse (Lloyds) or Direct Line's red telephone on wheels can serve a similar purpose. Using physical evidence or imagery to tangibilize a financial service is a key element of most marketing strategies. Nevertheless, there are pitfalls associated with this approach, particularly with respect to the development of a tangible image. The image developed necessarily creates expectations in the consumers' mind and if the organization cannot match those expectations then customer satisfaction may decrease.

Tangibilizing a service addresses the problem of lack of physical form, but is less effective in relation to product complexity and lack of consumer interest (a form of mental intangibility). Two key strategies are important in this respect. First, to address the complexity issue there is a need to focus on reducing perceived risk through building trust and confidence; if consumers cannot fully understand the nature of the service, then they must be able to trust a supplier and feel confident that their finances are being safely managed. Attempts to build such trust and confidence often rely on the longevity of the organizations. For example, The Royal Bank of Scotland claims in its literature that:

> You can also be sure that your money is in safe hands. We have been around for more than 260 years, which gives us a wealth of banking experience.

Similarly, MAA claims in its advertising that it is:

> a tried and trusted insurance company with over 30 years' experience in protecting the savings of Malaysian families and investors.

Equally important is the use of third-party endorsements to indicate quality and reliability. Thus Arab Malaysian Unit Trusts Bhd emphasizes endorsements from Standard and Poor's Micropal for several of its funds, while China Construction Bank draws attention to its status as 'Bank of the Year' in The Banker Awards.

The lack of consumer interest in many financial services and the fact that consumption is essentially contingent can often be addressed by focusing on the benefits gained from the purchase of the product. Thus, promotional material for personal loans tends to emphasize the purchases which can be made as a result of the loan (whether cars, hi-fi equipment, holidays or houses). Similarly, marketing for life insurance and other related protection products will emphasize the benefit of security for the policyholder's dependents. Because financial services are generally products that consumers would prefer to avoid and because they have no obvious value in themselves, marketing must put extra effort into emphasizing the benefits that these services provide.

7.4.2 Inseparability/perishability

The fact that they are typically produced and consumed simultaneously means that financial services are perishable and, most significantly for this discussion, that customers have considerable difficulties with respect to pre-purchase evaluation. Although an *ex ante* evaluation of a particular product may be difficult, consumers

can evaluate the organization and can draw on the experience of others. Accordingly, a common theme in the marketing of financial services is to emphasize the performance and quality of the organization and its people in order that there will be a halo effect from organization to product. Such approaches are often reinforced by active attempts to secure word-of-mouth recommendations. American Express, for example, actively encourages existing customers to recommend new customers, and rewards those customers who do introduce new members.

Furthermore, given the importance of the interaction between customers and employees and the potential role of employees in inspiring trust and confidence, many organizations are increasingly looking at human resource policies, training and internal marketing as means of building more effective relationships with customers in order to encourage retention and re-purchase. These relationships are seen as being of considerable significance in reducing the levels of both perceived risk pre-purchase and dissonance post-purchase. First Direct, for example, when recruiting staff for the launch of its telephone banking service, placed much greater emphasis on the interpersonal skills of customer contact staff than it did on their detailed knowledge of banking practice.

7.4.3 Heterogeneity

A logical consequence of inseparability and the important role played by people is that the quality of service delivery has the potential to be highly variable. Clearly, the potential for such variability will hinder the process of evaluation by consumers. Mechanization of service delivery through ATMs, automated phone-based systems and Internet-based systems, for example, or even through the use of expert systems, has the potential to reduce quality variability, although this option may not be available for all services. Where delivery cannot be mechanized, then financial institutions must emphasize internal marketing and training to ensure higher levels of consistency in service delivery.

7.4.4 Fiduciary responsibility

The concept of fiduciary responsibility concerns itself with the implicit and explicit responsibilities of financial institutions with respect to the products they sell. The impact of fiduciary responsibility is arguably at its greatest at the purchase stage, when a consumer may find that, despite an active marketing campaign which has stimulated a decision to purchase, the institution indicates that it is unable to provide the product. For example, a common complaint from both personal customers and smaller businesses is that banks will actively promote the fact that they offer a variety of loans, but will then turn down applications from some customers. Similar issues arise in relation to insurance, where many companies are increasingly looking to sell only to good risks. In part this may simply reflect the overall importance of profit and an unwillingness to supply loans or insurance when the risk is too high (Knights *et al.*, 1994). However, we should perhaps note that such decisions may also reflect an element of fiduciary responsibility in the sense that financial services suppliers are obliged to recognize that many of their 'raw materials' are actually funds

provided by other customers. An extension of the idea of responsibility in relation to the management of funds is evidenced in the case of the Co-operative Bank. The bank's positioning and promotional campaign revolves around its ethical stance and its commitment to the responsible sourcing and distribution of funds.

The selling process itself is also an area of concern because of the substantial information asymmetries which exist between supplier and customer. To address these problems is difficult. The simplest route is perhaps to emphasize honesty and prudence as themes in promotional campaigns. Consider, for example, the HSBC campaign which claims:

> We believe that the way forward is to offer a range of financial services honestly, simply and with integrity. That is how we have accumulated 23 million customers in 81 countries and territories.

Furthermore, there are difficulties for financial service organizations in that fiduciary responsibility means that they may be promoting products to those individuals who are unlikely to be able to purchase because they are considered to be poor risk. While clearly this is something that many suppliers seek to avoid, in practice the identification of exactly who is an appropriate customer is difficult and, even with sophisticated marketing information systems, this process will be less than perfect.

Finally, with respect to fiduciary responsibility, there is the issue of the purchase (sales) process itself. Given the information asymmetries that exist between supplier and customer, many customers are vulnerable to high-pressure selling and bad advice. Indeed, this is probably the issue that has done most to undermine the image of the financial services sector in recent years. Nevertheless, there are ways in which these issues can be tackled both internally and externally. One approach which a number of organizations have adopted is to reconsider their reward systems with a view to eliminating or at least reducing the reliance on commission-based selling. In a number of cases the nature of the reward structure (e.g. 'our salesmen aren't paid just on commission') is used as a component of advertising in order to reassure consumers of the high standards of the supplying organization.

7.4.5 The long-term nature and uncertainty of products

Many financial services are either consumed continuously (current accounts, credit cards) and therefore require a long-term relationship, or only yield benefits in the longer term, and the precise nature of these benefits may be uncertain. As indicated earlier, these features of financial services will tend to increase the perceived risk associated with the purchase and decrease consumers' ability to evaluate the service both *ex ante* and *ex post*. To address this problem, there is again a tendency to rely heavily on marketing activities that emphasize the longevity of the supplier, trust, confidence and reliability. A good illustration of this approach is the TV advertising used by Clerical Medical, which emphasizes the origins of the company during the early part of the nineteenth century and its success at serving particular customer groups since that time. More recently, Royal Insurance has used a campaign that focuses on the relationship between a particular financial adviser and a client; the advert depicts the two individuals growing older together and seeks to highlight the

company's ability to provide a continuous relationship that meets the individual's changing financial needs.

7.5 Summary and conclusions

Although there has been a variety of empirical research examining customer choice, understanding of the buying process for financial services is still limited. However, what is apparent both conceptually and from existing empirical evidence is that certain characteristics of financial services present a number of problems for consumers when they make choices. Financial services are low in search qualities and high in experience and credence qualities. Information is difficult to collect and interpret, and there is a tendency to rely heavily on the experience of others rather than on supplier-provided information. Evaluation is even more complex, partly because of the lack of search qualities but also because of the complexity of many of the products and the reluctance of many suppliers to facilitate comparisons across products. Consumer needs often do not become apparent until the actual point of sale, and the problems of information search and evaluation mean that buyers are always likely to be vulnerable to the 'hard' sell. Having bought a particular financial service, a customer may still find evaluation difficult, and many buyers experience high levels of cognitive dissonance post-purchase.

There is a variety of strategies and tactics that marketers can use to address these problematic aspects of consumer choice; they include tangibilizing the service, emphasizing particular dimensions of image, and investing in staff training and internal marketing. However, there are also many aspects of the marketing of financial services that have tended to reinforce some of the problems experienced by consumers. In particular, pricing and product benefits are often not clearly presented, and the historic reliance on commission-based selling has resulted in a number of well-publicized and damaging cases of over-selling of certain products. Some of these problems are being rectified by a combination of company-specific actions and industry-wide regulation. However, from a marketing perspective it is crucial that financial services organizations recognize that they operate in a high-contact business where the nature of buyer–seller interactions and the establishment of long-term relationships based on confidence and trust have real implications for the successful retention of customers and recruitment of prospects.

Review questions

1. What are the main differences in buyer behaviour between retail and business consumers, regarding financial services?
2. How might consumers collect information to help them choose between financial services? How can marketing help this process?
3. Why is it important to tangibilize a financial service?
4. How can financial services organizations build trust and confidence?

8

Segmentation targeting and positioning

Learning objectives

By the end of this chapter you will be able to:

- explain the different approaches to segmenting a market
- understand the issues involved in selecting a target market
- understand the role of positioning in communicating the value proposition.

8.1 Introduction

The process of segmentation, targeting and positioning is central to effective strategic marketing. Segmentation is concerned with the process of identifying different groups of customers who are similar in ways that are relevant to marketing. In order to segment a market, it is important to understand who customers are, why they behave in particular ways and how they may be grouped together. Targeting decisions can then be made based on the range of identified segments. In order to choose the most appropriate target markets, it is necessary to understand what different segments want and the extent to which the organization can supply those wants. Finally, having identified target markets, the organization must then consider how to position itself in those markets. Positioning refers to the way in which an organization tries to communicate its value proposition to its target market in order to convince customers that it has a distinct offer. In effect, positioning is about the way in which the organization tries to build and communicate its competitive advantage.

This chapter will review segmentation, targeting and positioning. It will begin by explaining the benefits of market segmentation and targeting for both providers

and customers. The requirements for successful segmentation will be examined in general terms, and approaches to segmenting final consumer and corporate markets will then be explored in more detail. The chapter continues with a discussion of different approaches to market targeting, and the final sections will explain the key elements of positioning and repositioning.

8.2 The benefits of segmentation and targeting

Segmentation is essentially a process whereby a provider of goods or services chooses to group prospective customers together on the basis of a set of common characteristics that have significant implications for its marketing activity. Common characteristics that might be used to segment a market include variables such as age, income, personality and lifestyle. On the basis of those common characteristics, segments are expected to respond differently to marketing activities – they may want different features, be more or less price-sensitive, respond to particular types of marketing communications, or use different channels. Targeting is then concerned with the identification of an appropriate set of segments which the organization will seek to serve. Implicit in any decision to undertake segmentation and targeting is the realization that no single organization is capable of being all things to all men. It is inevitable that certain products will have particular appeal to certain kinds of individuals. At one extreme, each individual customer could be presented as a segment of one because each individual has different needs. In such a case, the marketing mix is bespoke to match the characteristics and needs of a single person or organization. This practice is perhaps more common than might at first be imagined. In retail markets, financial advisers provide a service encounter that is unique to the individual client – as do private bankers. In corporate markets, a customized approach is essential when dealing with large corporate clients. At the other extreme, the whole population could be treated as if it were a single homogenous segment. Traditionally, banks have treated the personal banking market as homogenous and provided a single standard current account to all customers. Increasingly, however, there is recognition that customers do have differing banking needs and that there is the potential to develop specific products for specific segments. Thus, for example, Barclays now offers over ten different current accounts in the UK market, targeted to a variety of segments – including children, students, people with very high incomes and people with very low incomes.

Segmentation and targeting is a means by which a number of important benefits are secured for both providers and consumers of products and services. In summary, the benefits of segmentation and targeting are as follows:

1. *It facilitates efficient resource utilization*. Indiscriminate use of the marketing mix is a wasteful use of precious resources. By identifying and targeting discrete segments of consumers (retail or corporate), a company is able to limit the scope of individual components of the mix and thus reduce costs. To take a simple example, an advertising programme involving the use of the press media will be less expensive if it involves the use of magazines that are read by a discrete target segment of consumers rather than the entire population. Similarly, products designed to meet the particular needs of a given segment will not need features

they do not require. Thus, segmentation results in greater resource efficiency, which benefits consumers through better value, shareholders through reduced waste and lower costs, and the environment through resource efficiency.

2. *It allows effective targeting of new customers*. The logical next step from segmenting a market is the selection of segments to target for marketing activities. Nowadays, it is unusual for a company to have a completely indiscriminate approach to targeting new customers. As the costs of customer acquisition have increased and companies become increasingly focused upon customer profitability, they have to be selective in respect of which kinds of people or organization they want to be their customers. It must be appreciated that different customers display different characteristics and behaviours that impact upon customer value. For example, in the UK, SAGA targets people aged over 50 for its range of leisure and financial services. SAGA is able to price its motor insurance premiums very keenly, as the over-50s represent a low-risk group in terms of propensity to incur motor claims. Thus, SAGA can be very price-competitive and deliver superior value to this group of consumers in a way that would not be possible if the company was trying to serve a mass market.
3. *It facilitates competitive advantage*. The more specific an organization's approach to segmenting the market, the easier it is to establish and maintain competitive advantage. This arises by virtue of the fact that competitive advantage is a relative concept that involves differentiating an organization from its rivals in the eyes of its customers. Self-evidently, the more indiscriminate the approach to targeting, the wider the array of competitors against whom an organization will have to seek to differentiate itself. In the case of SAGA, it is required to maintain a competitive advantage over those other organizations that also seek to target the over-50s – such as RIAS. This presents SAGA with a smaller set of key rivals than if it were to target the entire adult population. In turn, this makes it easier to achieve and maintain differentiation.
4. *It directs the marketing mix*. Best practice dictates that each target segment chosen by an organization should be subject to a specific and relevant marketing campaign. In this way, marketing is managed to achieve the best fit with each target segment. Consider the case of the NFU Mutual Insurance Company. Originally aimed at providing for the insurance needs of Britain's farmers, it has repositioned itself to address the insurance and investment needs of the following segments:

   - farmers
   - people who live in rural communities
   - people who live in non-metropolitan towns and have an affinity for the countryside.

The mix for the farming segment includes insurance products that are specific to farmers, such as crop and livestock insurance. In terms of promotion, it advertises extensively in the farming press. As far as rural dwellers are concerned, it uses radio and television selectively to target those who live in predominantly rural parts of the country. Its product range is geared towards rural dwellers with a special interest in country pursuits such as horse-riding.

Some financial service providers are affinity-based, and this allows for particularly close targeting of the marketing mix. The Police Mutual Assurance Society (PMAS), based in Lichfield, Staffordshire, has a mix that makes full use of its affinity

relationship with the UK's police service. For example, it makes use of locally-based police officers as part of its distribution processes. So-called 'Authorized Officers' act as a conduit for communication between serving police officers and civilian staff, and PMAS. Authorized Officers have introducer status, and this enables PMAS to enjoy exceptionally low new business acquisition costs. PMAS's low-cost provision is further enhanced by the way in which it arranges for deduction of premiums through the police payroll system. The promotional element of the mix makes full use of specialist forms of communication, such as police magazines and publications. The Bournemouth-based Teachers Provident Society enjoys a similar affinity relationship with Britain's largest teaching union, as does Maif with respect to teachers in France. Their marketing mixes take advantage of the close relationships they enjoy with their respective affinity groups in order to achieve a bespoke approach.

5. *It enhances customer satisfaction*. Segmentation and targeting is an effective means of enhancing customer satisfaction through the ways in which the mix should achieve a close match with customer needs and wants. Clearly, the more precisely a product and its features reflect the characteristics of a given group of individuals, the greater the degree of satisfaction they should experience from its consumption. The corollary to this is that the absence of well-managed segmentation results in a generalized approach to the market. This results in customers feeling that a number of product features are irrelevant to them, and that communications messages are ill-judged and lacking real relevance to their personal circumstances and preferences. As a consequence, such consumers will always be vulnerable to competitors with a more focused approach to segmentation that enables them to deliver greater customer satisfaction.

Alongside these benefits, there are also costs associated with segmentation. Identifying, measuring and maintaining a system of segmented markets is a cost in itself. Additionally, costs are incurred through the development of different products and different marketing campaigns for these different segments. Any exercise in market segmentation must be aware of these costs, and look to implement market segmentation only where the benefits outweigh the costs.

8.3 Successful segmentation

There is no best way to segment a market. On the contrary, as will become clear in subsequent sections, there is a variety of approaches that can be used with varying degrees of complexity and sophistication. Ultimately, a commercial judgement must be made to ensure the best fit between the incremental costs that segmentation entails and the incremental value that can be realized. For an organization to get an approach to segmentation that is 'right' for it depends on a good understanding of the market, the right skills and knowledge, and careful evaluation of the different options. In terms of skills and knowledge, the following areas are of particular importance:

1. *A sense of touch for the market*. Managers seeking to segment a market have to display a sound understanding of the marketplace in which they operate.

This understanding should be based upon the ability to integrate all relevant sources of knowledge to form a cohesive, whole picture of the market. Not only does this involve hard, objective facts such as market values, number of customers, frequency of purchase, competitors and their respective market share, but it also involves more subjective and qualitative-based inputs. Such inputs include an understanding of consumer choice and an awareness of the strategies of competitors. A sense of touch for the market provides the marketing manager with the capacity to identify opportunities for differentiation and competitive advantage.

2. *Analytical skills and resources*. Access to appropriate data and the ability to manipulate and interpret it is vital. The more varied the data about a market, the greater the number of options for segmentation. Markets vary considerably with regard not only to the variety of data sources that are available but also in respect to recency, frequency, consistency and accuracy of data. The ability to source and analyse relevant data is a competence that is not always in evidence. Therefore, there has to be a commitment to developing this competence if it is not already present.
3. *Commercial judgement*. A wide range of 'common characteristics' can be used in market segmentation. These vary from basic demographic criteria, such as age and gender, through to subtle and complex criteria based upon personality traits. It must be appreciated that choice of target segments is a crucial part of marketing strategy and a key facilitator of competitive advantage. A fine judgement has to be made regarding the impact that a chosen approach to segmentation is likely to have on the commercial outcome. This entails careful consideration of costs and benefits for any given method of segmentation.
4. *Creative insight*. To be successful, segmentation calls for a combination of elements of marketing as both art and science. Science is required in terms of the gathering of factual information, its analysis, and the use of various modelling and simulation processes. Ultimately, a judgement has to be made regarding which approach is most likely to facilitate effective differentiation and competitive advantage. This requires a high degree of creative insight if a segment is to be identified that can be successfully penetrated. It also requires creative intuition regarding how to translate the company's aspirations to penetrate a given segment into a concrete marketing mix that appeals to the segment. It is understood that the Co-operative Bank chose the ethical consumer segment more on the basis of creative insight than conventional factual analysis.

Thus, good segmentation combines elements of science and art, elements of the quantifiably objective and qualitatively judgemental.

In terms of evaluating different options for segmentation, there are several factors that require consideration. Organization-specific criteria relating to fit with current activity and ability to serve will clearly be important. Equally, it is helpful to evaluate proposed methods of segmentation in terms of their performance in a number of key areas. One common approach is to focus attention on the following criteria:

1. *Measurability*. This is concerned with the extent to which the preferences, size and purchasing power of different segments can be measured. Certain segmentation

variables are difficult to measure, making segment size and purchasing power difficult to identify. An investment company may identify small investors who are risk averse as an attractive market segment, but may find it difficult to find out exactly how many people fall into this category because of the difficulties of measuring risk aversion. In contrast, the segment of women aged over 60 will be much easier to measure.

2. *Profitability*. This is the degree to which segments are large and/or profitable enough. A segment should be the largest possible homogenous group worth going after with a tailored marketing programme. Medical students are one very distinctive and homogenous segment of the market, but it would probably not be viable for a bank to develop a distinct current account just for this particular group.
3. *Accessibility*. This refers to the degree to which the segments can be effectively reached and served. A bank that wishes to target individuals in social class AB will usually be able to gather enough information about the television programmes that such individuals watch and the newspapers that they read, and this should make such a segment relatively accessible. In contrast, a bank that has identified the existence of a segment of internationally orientated companies that it wishes to target with a range of export financing products may find it more difficult to identify which firms are in that segment and communicate with them.
4. *Relevance*. This is the degree to which the common characteristics used to group customers are relevant to customer decisions. A segmentation system which groups individuals in terms of lifestyle and establishes that the type of credit card carried (standard, gold, platinum) depends on an individual's aspirations and self-concept uses a personality-based characteristic to explain preference. This type of characteristic is likely to be a more relevant predictor of consumer decisions on which card to carry than, say, a characteristic such as age or income.

From the discussions so far, it is clear that there is a variety of approaches used to segment markets. What they all have in common is the search for a set of common characteristics – i.e. characteristics that all customers in a group share and which are in some way associated with the way in which those consumers respond to marketing activities. A very simple example of a common characteristic would be age or income; a more complex example might be personality. The next sections explore the common characteristics that are used in segmenting customer and business markets.

8.4 Approaches to segmenting consumer markets

Earlier in this chapter, segmentation was described as grouping consumers around a common characteristic that is of relevance to marketing. The choice of *common characteristics* is crucial in determining a successful outcome when segmenting a marketplace, since this effectively defines target markets and thus impacts on what the organization will be expected to deliver to that market. The types of common characteristics than can be used to segment consumer markets can be divided

into two broad categories, which give rise to customer- orientated segmentation and product-based segmentation.

8.4.1 Customer characteristics: customer-orientated segmentation

This category comprises characteristics that define who the customers are, where they live, the kind of people they are, the kind of lifestyle they lead and the views they hold. Thus, it is entirely consumer-centric as an approach to segmentation. In specific terms, the sort of characteristics used in segmentation can be broken down as follows.

1. Demographic:
   - age
   - gender
   - family relationships
   - ethnic group
   - religious affiliations
   - life stage
   - educational attainment
2. Socio-economic:
   - income
   - financial assets
   - social class
   - occupational status
3. Geographic:
   - country of domicile
   - region or locality
   - metropolitan
   - urban v. rural
4. Psychographic:
   - attitudes
   - lifestyle choices
   - beliefs
   - motives
   - personality type.

One increasingly common approach to consumer-orientated segmentation is based around geo-demographics – a combination of demographics, socio-economic and geographical information. The underlying principle of geo-demographics is the belief that households within a particular neighbourhood exhibit similar purchasing behaviour, and have similar attitudes, expectations and needs. Neighbourhoods can therefore be classified according to the characteristics of the individuals who live there and can then be grouped together, even though they are widely separated. Geo-demographics is thus able to target customers in particular areas who exhibit similar behaviour patterns.

A number of commercial systems for this type of segmentation are available. In the UK, leading products include MOSAIC (Experian) and ACORN (CACI), both of

Table 8.1 Distribution of UK households by financial ACORN and financial mosaic classification

Financial mosaic	%	Acorn	%
Adventurous spenders	14.5	Wealthy investors	28.7
Burdened borrowers	6.6	Prospering families	11.3
Capital accumulators	6.3	Traditional money	13.4
Discerning investors	5.1	Young urbanites	12.9
Equity-holding elders	4.2	Middle-aged comfort	11.7
Farm-owners and traders	6.5	Contented pensioners	5.1
Good paying realists	19.5	Settling down	4.1
Hardened cash payers	18.7	Moderate living	6.7
Indebted strugglers	4.7	Meagre means	2.1
Just about surviving	13.9	Inner city existence	2.2
		Impoverished pensioners	1.4
		Unclassified	0.4

Source: WARC (2003) and Financial Acorn – http://www.caci.co.uk/pdfs/facornprofiler1.pdf (accessed 21st March 2005).

whom offer generalized classification and financial services-specific classifications. The latter are shown in Table 8.1. These systems are typically constructed on the basis of census data, which are then updated by each organization on a regular basis and may also be supplemented with additional information such as consumer surveys. Classification occurs at the postcode level. Thus, users are able to categorize individual postcodes (usually groups of around fifteen households) into one of the segments shown below (or into sub-segments) and then profile those segments on a range of consumer and purchase characteristics.

Elsewhere in the world, Experian provides generic geo-demographic systems in a range of countries including the US, Australia, Hong Kong, Japan and Spain. Experian also offers a similar system (SUPERMAP) in China, and a worldwide product, Global MOSAIC. Acxicom provides geo-demographics in Japan with its Chomonicx system, and SIG offers its CAMEO system in Mexico.

It must be appreciated that choice of characteristic to use in segmentation is a contextual matter dependent upon the considerations given at the start of this section. Trade-offs often have to be made, especially with regard to practical issues concerning implementation. Demographic variables are usually the most simple to use, as they readily lend themselves to requirements of accessibility and measurability, although they are often weak in relation to relevance as demographics alone rarely explain why an individual makes a particular purchase. From the point of view of promotional aspects of the mix, media typically provide data on readership, listenership and viewership that is based upon demographic variables.

Life stage is an approach to segmentation that is of particular relevance in the context of financial services. This is because of the long-term nature of many of the products encountered and the duration over which utility is experienced. The basic principle upon which the life-stage approach is based is that people progress through varying stages in their lives, each of which is associated with different product needs. Figure 8.1 shows schematically a set of typical life stages and the associated product needs that are indicated.

Looking at Figure 8.1, the role performed by the current account as a gateway product can be fully appreciated. It also demonstrates the ways in which financial

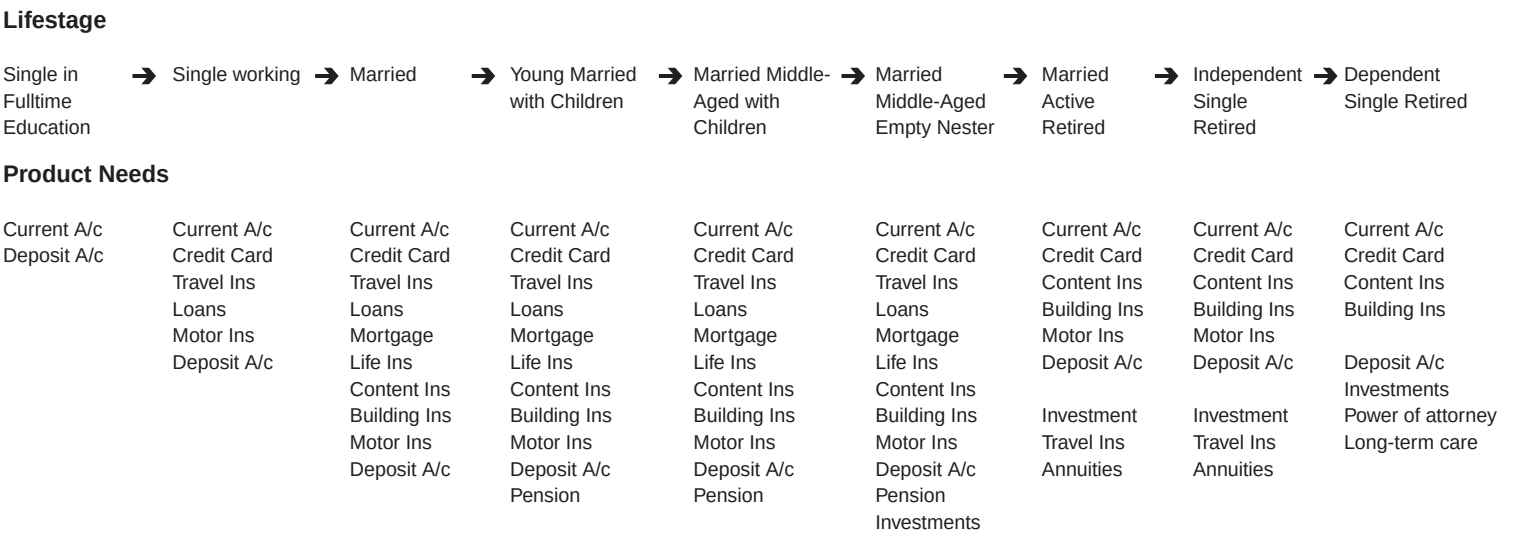

Figure 8.1 Typical life stages and associated financial-product needs.

complexity develops as individuals progress from adolescence through to being middle-aged with children. It is interesting to note how the balance between assets and liabilities alters at different life stages. By the time an individual has graduated, he or she can be expected to be in debt to the order of £12 000 in the UK. This indebtedness continues to grow as credit card and unsecured loan debts accumulate. A major step increase in indebtedness occurs when the individual takes out a mortgage to fund home-purchase. Gradually net indebtedness reduces until a point – typically at an age of between 50 and 60 – where the individual becomes a net asset holder. This is precisely why the over-50s are the primary target for investment product marketing activity. Alternative forms of life stage can be designed to reflect different lifestyles, such as people who remain single, those who marry but have no children, those who get divorced and so on.

Psychographic variables may offer the greatest potential for differentiation and creativity in executional terms. However, there are particular challenges in terms of determining: measurability, profitability and accessibility. Since the early 1990s, the Co-operative Bank has targeted that segment of the population which has a particular preference for socially responsible banking practices. Thus the bank has set out to position itself as '*the ethical bank*'. It is an interesting example of a bank using what is essentially a psychographic variable as the basis of its segmentation strategy.

8.4.2 Customer needs and behaviours: product-orientated segmentation

This approach comprises variables that define the nature of the utility that consumers seek to gain from the consumption of a product or service. It also incorporates the nature of the consumer's interaction with the product. Thus it is more of a product-centred approach to segmentation than its customer-orientated counterpart. In specific terms, it can be broken down as follows.

Core financial needs	Banking
Savings	
Investing	
Home ownership	
Retirement planning	
Life assurance	
Health insurance	
Possessions insurance	
Product/service usage	Frequency of purchase
Frequency of service usage	
Quantum of purchase	
Means of accessing service	
Means of purchase	
Timing of purchase	
Timing of accessing service	
Product attributes	Pricing
Value	
Ownership status of provider	
Feature simplicity/complexity	

In practice many financial service providers use multivariable approaches to segmentation, which draw upon characteristics that are both customer- and product-orientated. For example, an investment company might choose to target a segment defined in the following terms:

> Women in the age group 35 to 60 who want to invest for retirement and favour an ethical approach to investment.

In such a case, due attention must be paid to matters concerning measurability and so on, to ensure that the segment is executionally and commercially viable.

8.5 Approaches to segmenting business-to-business markets

The benefits that accrue from segmentation apply equally within the context of business-to-business marketing. Indeed, the costs of acquiring a new customer in the organizational business arena are usually considerably greater than in the consumer arena, and so too are the income flows. This makes effective targeting of marketing resources all the more important. As discussed elsewhere, managing B2B and B2C relationships involves points both of comparison and difference. As with the consumer domain, there are various approaches to segmenting the organizational domain; the following characteristics are those most widely used.

Business demographics	
Industrial sector	Financial services: banks, general insurance, building societies etc.
Retailing: food, clothing etc.	
Professional services: management consultancies, accountants, legal practices	
Engineering	
Information technology	
Organization size	Turnover
Assets	
Funds under management	
Number of employees	
Fee income	
Organizational structure	Centralized
Branch-based	
Ownership	Proprietary
Mutual	
Core quoted company	
Subsidiary company	
Business geography	
International	Head office domicile
countries represented	
Single country	National centralized
Regions	

Continued

Business geography—cont'd	
Metropolitan Town	
Local/regional Town	Metropolitan
Business processes	
Purchasing Devolved	Centralized
Decision-making By negotiation Individual/committee-based	By tender
Choice criteria Degree of customization Service intensity Product/service range Performance criteria Image and positioning R&D and innovation	Lowest cost
Business performance Business growth rate Return on capital Market sector growth rate High margin/low margin	
Markets served Commercial markets Consumer markets High net-worth individuals Mainstream mass market Lower social-economic groups Niche markets	
Product specialisms	

As with consumer market segmentation, multivariable segmentation is often encountered in the B2B domain. For example, a general insurance company might choose to target a business segment defined in the following terms:

> businesses in the hotel, catering and leisure sectors with a turnover of less than £25m per annum serving high net-worth individuals and with a particular need for liability insurance.

8.6 Targeting strategies

In addition to choosing the basis upon which to segment a market, choices must be made regarding which segments to target. This is not necessarily a sequential process. Indeed, choice of segmentation criteria and choice of targets (i.e. the targeting strategy) is an interactive and interdependent set of processes which may well

require a high degree of iteration before a final strategic position is arrived at. Segments must be evaluated in terms of their attractiveness to the organization, their profit potential, and the organization's ability to deliver the required service. This information can then be taken into consideration when deciding which segments to target. The basic array of targeting strategies is as follows:

- *Undifferentiated* – serves an entire marketplace with a single marketing mix which does not distinguish between sub-segments of the market
- *Differentiated* – an aggregate marketplace, such as banking, is organized into a number of segments, each of which is targeted with a tailored marketing mix
- *Focused* – a choice is made to target a small subset of the segments of a multi-segment marketplace with a single marketing mix that best suits the needs of that segment
- *Customized* – each individual that comprises the target market is the subject of a marketing mix that is tailored in some way to the individual's specific needs.

8.6.1 Undifferentiated targeting

It should not be assumed that an undifferentiated strategy is necessarily an inherently inferior form. An analysis of customer characteristics may simply reveal the absence of a compelling variable upon which segmentation could be based. Equally, it may be the case that the cost of segmenting the market and producing a set of bespoke marketing mixes is not commercially justifiable.

In the recent past, life insurance companies operating in the UK and using an essentially commission-only sales-force adopted a largely undifferentiated strategy. This was sometimes referred to as 'playing the numbers game', whereby the low cost of new customer acquisition and the heavy up-front charges meant that almost any new customer thus acquired was likely to contribute to embedded value profits. A range of developments, such as the regulation-induced increase in new customer acquisition costs, lower product margins and the pressure to improve persistency rates, have all served to make the life insurance industry more discriminating in its approach to gaining new customers, and thus there has been a growing tendency to move away from an undifferentiated approach. Admittedly, the attempts to introduce segmentation have sometimes been somewhat elementary, often based simply upon a minimum income threshold. Most of the life insurance companies that operated an undifferentiated approach are no longer open to new customers.

8.6.2 Differentiated targeting

This arises when a company has been able to identify a commercially valid basis upon which an aggregate market can be broken down into segments. The fast-moving consumer goods sector has probably been the best exemplar of differentiated marketing. Differentiated segmentation is gaining in popularity within the financial services sector. There is a sense in which its development has been held back by a relative lack of suitable marketing orientation within the sector; however, the major clearing banks, such as Barclays, Lloyds TSB and HSBC, are showing a

growing usage of differentiated marketing. Typical generic segments that are encountered among mainstream clearing banks include:

Business banking marketplace segments	Business start-ups
Sole traders and partnership	
Small businesses (typically with 5–50 staff)	
Medium business (typically 50–250 staff)	
Large business (typically 250–1000 staff)	
Large Corporate Market (more than 1000 staff)	
Retail banking marketplace segments	Student banking
Ordinary current account customers	
High net-worth customers (e.g. earning more than £50 000 pa)	
Private banking customers (e.g. have investable assets in excess of £500 000)	

The illustrative banking segments shown above reveal a fairly basic approach to segmentation. In the case of B2B banking, segmentation is typically based on business demographics. As far as B2C banking is concerned, it is typically based upon demographic or socio-economic characteristics. To a large extent, this comes down to the practicalities of the typical large clearing bank which, in the UK, might have over 50 000 staff of whom more than 10 000 are based in some 2000 or more branches. Segmentation has to reflect the practicalities of gaining the engagement of a huge and diverse workforce in implementing a segmentation strategy.

8.6.3 Focused segmentation

This approach to segmentation is encountered in circumstances where a company breaks a market down into a set of segments but chooses to target a small subset of available segments or, in some cases, only a single segment. A focused approach may take a number of different forms:

1. *Single segment concentration*. In this approach, the organization concentrates only on a single segment in the market and supplies products tailored specifically to the needs of those customer groups. This approach is often described as niche marketing. It is potentially highly profitable, because the organization focuses all its efforts on a particular segment of the market where it has a strong differential advantage. At the same time there are risks associated with this approach, because if the segment were to disappear or a new competitor enter the market, the organization could be vulnerable to a significant loss of business. The general insurer Hiscox focuses on high net-worth clients, whereas the Ecclesiastical Insurance Company focuses upon providing general insurance to churches and allied organizations. Endsleigh Insurance has carved out a niche for itself by focusing on the student segment.
2. *Selective specialization*. Selective specialization is another type of niche marketing. However, rather than concentrating only on one segment the organization chooses to operate in several (possibly unrelated) segments. This approach to targeting is less focused than single segment specialization, but probably less risky.
3. *Product specialization*. Most markets can be seen as comprising a number of different customer groups and a number of different but related products. The organization

that concentrates on supplying a particular product type to a range of customer groups is pursuing a product specialization strategy. This approach to market targeting may be particularly appropriate to organizations with particular strengths or knowledge in relation to a given technology or product. Thus, Al Baraka Islamic Bank in Bahrain, Bank Islam in Malaysia and the Islamic Bank of Britain can be seen to be pursuing a product specialization strategy by offering Islamic financial services (a particular product type) to a range of different customer groups (segments) which range from retail customers needing very simple banking products through to businesses requiring very complex financing arrangements.

4. *Market specialization*. This approach is the opposite to product specialization. Rather than concentrating on a particular product, the organization chooses to specialize in meeting the needs of a particular customer group. This strategy may be most suitable where knowledge of the customer group's particular needs is a particularly important basis for establishing a competitive advantage. Private banks pursue this type of approach in relation to high net-worth individuals – they seek to provide a range of different financial products to meet the needs of the high net-worth customers.

8.6.4 Customized targeting

This approach represents the ultimate manifestation of the segmentation concept, based as it is upon a separate, tailored marking mix for each customer. Some markets lend themselves more naturally to a customized approach, especially those that are in service sectors involving a high degree of human interface. In the financial services sector, customized targeting is most in evidence as part of a hybrid strategy in which a distinct set of services (such as investment banking) is offered to a particular segment (such as large corporations) and then the service is customized to individuals within that segment.

8.7 Positioning products and organizations

Positioning represents a logical step that follows the processes of segmentation and targeting. Having selected the criteria upon which to segment a market and made the choice of which segments to target, the company must then decide how best to present itself, either corporately or as a specific product brand, to the individuals that comprise the target segments. Positioning is a piece of marketing jargon that concerns the issue of perception. At the core of positioning lies a brand's or company's competitive advantage in terms of how it differentiates itself from the competition and how it delivers value to its customers. Thus, positioning is about how a company or brand wants itself to be perceived in the minds of the individuals who comprise its target segments. The choice of position is based upon the agreed form of differentiation. The objective of positioning is to generate and maintain a clear value proposition to customers, thus creating a distinctive place in the market for

the brand or organization. When successful, positioning results in a brand or company being seen as distinctive from its competitors.

To be commercially advantageous, positioning should be based upon product and service characteristics that:

- are relevant to the target segment
- achieve differentiation from the competition
- can be communicated clearly to the market
- can be sustained.

Positioning is a truly strategic concept that requires a considerable investment over a prolonged period of time. It is the primary manifestation of competitive advantage, and represents a considerable source of brand and corporate value. To be successful, it requires alignment between how an organization (or brand) wants itself to be perceived and how it is actually perceived by consumers.

The brand characteristics upon which positioning may be built can relate to demonstrable product and service attributes or image-related factors. McDonald's has historically based its positioning on features concerning fun, food and family, which is perceived appropriately through the entirety of the consumer's engagement with the brand. The company employs the tag-line '*mmmm, I'm loving it*', which conveys the sense of enjoyment. Burger King, on the other hand, has a positioning that is based on more explicit reference to product quality communicated in a more serious manner than McDonald's. L'Oréal is an example of a brand whose position is based more on image than specific product features. Its hair- and skincare products use the tag-line '*Because I'm worth it*' to convey the notion of products that are about self-indulgence, and they are priced accordingly. Designer-label luxury goods are positioned very much on the basis of an image of exclusivity rather than the tangible features of the products themselves.

Positioning is less well-developed as a concept in the field of financial services than in the field of consumer goods. Given the earlier assertion that it takes time to establish a successful position in the mind of the consumer, it is perhaps rather early days to give a definitive view on financial services positioning. What we can say is that financial services positioning operates to an overwhelming extent at the corporate level as opposed to that of the individual product or brand. In this context, organizations have relied on positioning with respect to product/service attributes or image-related factors in much the same ways as is observed in the tangible goods domain. Morgan Stanley's position is based on product/service attributes and emphasizes '*excellence in financial advice and market execution*'. Similarly, the Standard Bank of South Africa aims to be '*Simpler. Faster. Better*'. Examples of approaches that are more image-based include HSBC, which positions itself as '*the world's local bank*' to create the image of a bank that delivers value on the basis of both local knowledge and global strength. Similarly, in Japan, where banks have traditionally placed most emphasis on serving corporate clients, Shinsei Bank emphasizes its orientation towards satisfying retail customers and building strong relationships.

The Co-operative Bank is an example of an organization that positions itself on the basis of an image-related attribute. When it conducted a review of its competitive position in the early 1990s, it anticipated that its future position would be based upon product or service attributes. Such attributes could have included factors like

the number of branch outlets, range of services, quality of service delivery, charges, interest rates, investment returns and so on. This is a fairly predictable approach to branch-based financial services, and it would have been difficult for the Co-operative Bank to differentiate itself from its larger rivals on such a basis. A spark of intuition and judgement resulted in its choice of '*the ethical bank*' as the basis for its position.

Case study 8.1 shows how Co-operative Bank's allied financial services business CIS has reflected an ethical stance in its approach to investment fund management.

Case study 8.1 Ethical investment policies and the ethically-orientated investor segment – the Co-operative Insurance Society Limited (CIS)

Headquartered in Manchester, England, CIS is the only Co-operative insurer in the UK and is one of the largest providers of personal financial services in the country. A particular point of interest is that the Co-op has developed a strong affinity with that section of the population that displays a strong ethical orientation towards a range of issues. Indeed, the Co-operative Bank has clearly positioned itself as *the ethical bank*. What is interesting is the way in which the Co-op Bank and CIS have adapted their marketing mixes in ways that are consistent with their approach to segmentation and positioning. Here, we consider how the needs of the ethically-orientated segment have been reflected in CIS's approach to investment management.

As a member of the Co-operative movement, CIS shares this ethical underpinning which, when applied to investment, has always been construed as requiring the optimization of financial returns for customers. Recognizing the increasing sophistication of the market, in 1989 CIS introduced a range of unit trusts (mutual funds) to which was added, in 1990, a fund that screens companies on environmental, health and safety criteria. These positive criteria are supplemented by negative criteria relating to animal testing, armaments, oppressive regimes, tobacco and nuclear power. Like other CIS products, units in this fund, now known as the CIS Sustainable Leaders Trust, are sold through the Society's direct sales-force in people's homes. The availability of this product has extended the interest in social investment within the Society's customer base, and the Trust has always been amongst the largest funds of its kind, although it represents less than 1 per cent of CIS's overall assets. The managers of the fund have been able to demonstrate that the adoption of an ethical approach to a fund's structure is financially as well as ethically sound. Indeed, the following data, supplied by S&P Micropal, show how well the Trust has performed compared with industry acknowledged benchmarks

£1000 invested on 31 December 2002 was, on 31 December 2005, worth:

- £1664 if 'invested' in the FTSE All-Share Index
- £1672 on the basis of the Average UK All Companies Fund
- £1733 if used to purchase units in the Trust (assuming the income was reinvested).

Continued

Case study 8.1 Ethical investment policies and the ethically-orientated investor segment – the Co-operative Insurance Society Limited (CIS)—cont'd

There is a continuing market for screened investments, although the potentially greater financial risk must be made clear to customers. Nevertheless, the trend has been towards using enhanced analysis required to integrate social, ethical and environmental (SEE) considerations with the investment mainstream. In 1999 CIS launched a programme known as 'Responsible Shareholding', applying to all equity funds and based on engaging with companies on matters of concern. These matters were identified through a customer consultation exercise, from which an ethical engagement policy was developed which provides the basis for approaching companies. In part, this represents a reaffirmation of the Co-operative movement's democratic roots, but it also acknowledges the fact that SEE issues are increasingly important in establishing a company's social responsibility and future sustainability. This does not relate only to a company's community activities, but also to the way in which it develops its workforce, for instance, and above all how it governs itself in the relationships between management, board, shareholders and other stakeholders. Analysis of corporate governance is an important part of Responsible Shareholding, and CIS undertakes to vote on every motion put to investee company AGMs (whenever possible), supplemented if necessary by attendance to raise questions from the floor. Reporting is seen as an essential component of corporate responsibility, and detailed analysis takes place of disclosure on matters such as executive remuneration and SEE issues, in order to determine how the Society's votes will be exercised. Along with some other UK investors, CIS has been recognized in the press as one of the foremost UK institutions practising Socially Responsible Investment (SRI). It is becoming increasingly accepted that such activities contribute to investment sustainability – UNEP's Asset Management Working Group concluded in 2004 that environmental, social and corporate governance issues affect long-term shareholder value, sometimes profoundly. If this is proved, it will demonstrate that an active response by companies to SEE and governance concerns voiced by customers does enhance the financial returns that they receive.

Source: Robert Taylor, CIS Investment Management (personal communication).

A variant on product/service positioning is positioning that is based upon serving the needs of the distinct target segment – i.e. a focused positioning strategy. By means of such a strategy, the organization is trying to create the perception that it has a unique understanding of the needs of the individuals that compromise its target segment. The implication is that the overall value reposition will be seen to be superior to that of competitors in the eyes of customers. Police Mutual Assurance

and Teachers Assurance position themselves as specializing in the needs of employees of the police service and education sector respectively.

Although positioning in the field of financial services is overwhelmingly at the corporate rather than product-brand level, there is a growing incidence of portfolios of organizational brands that reside within an overall corporate structure. Smile.co.uk is positioned as a youthful, approachable high-tech brand within the Co-operative Financial Services umbrella organization that includes the *ethical* Co-operative Bank. HBOS retains the clearly distinctive positioning of organizational brands such as the Bank of Scotland and Halifax. Similarly, Lloyds TSB continues to support the distinctive positioning of the Scottish Widows and Cheltenham and Gloucester brands within its overall brand architecture.

8.7.1 Perceptual mapping

It is important to have some understanding of the type of processes that are used to determine a company's or product's position. One commonly used approach is perceptual mapping, which relies primarily on information about consumer perceptions of both the organization and its competitors. This information may be based upon either quantitative research-based data or more subjective judgements. It is important to remember that it is not simply a product that is being positioned but, rather, the complete product or corporate offer, including product and service features, image, quality and pricing. Perceptual mapping requires that an organization first identifies the main feature of a product category available to consumers. The next step is to establish the relative importance of those features to consumers, and the relative performance of competing offers. Market research is used to arrive at the relative importance of features and competitive ratings. Qualitative research methods, such as the use of focus groups and individual depth interviewing, are useful means of seeking original and insightful new positions.

Through the research and evaluation process, the organization typically tries to identify two major dimensions of itself or its product that could form the basis of competitive advantage. This is partly a matter of judgement, but may also be supported by more detailed statistical analysis of consumer perception. Figure 8.2 presents a hypothetical perceptual map that might apply to the investment fund management sector. It assumes that the chosen discriminators upon which Company A wishes to base its position are *reputation for investment performance* and *concern for the investors' interests*.

Company A has a competitive advantage arising from its position as a company that is seen to deliver competitively superior investment performance and cares about its customers. Its nearest rival is Company F, and it needs to maintain a close watch on F to ensure that Company A continues to maintain a relatively superior position. Company D is clearly competitively disadvantaged on the basis of its investment performance and perceived concern for investors' interests. Company E displays relatively high levels of concern for its investors' interests, but fails to deliver with regard to investment performance. Company B delivers very good investment performance, but comes across as having an uncaring approach to investor interests. Finally, Company C is pretty much stuck in the middle, being just average or both constructs of performance.

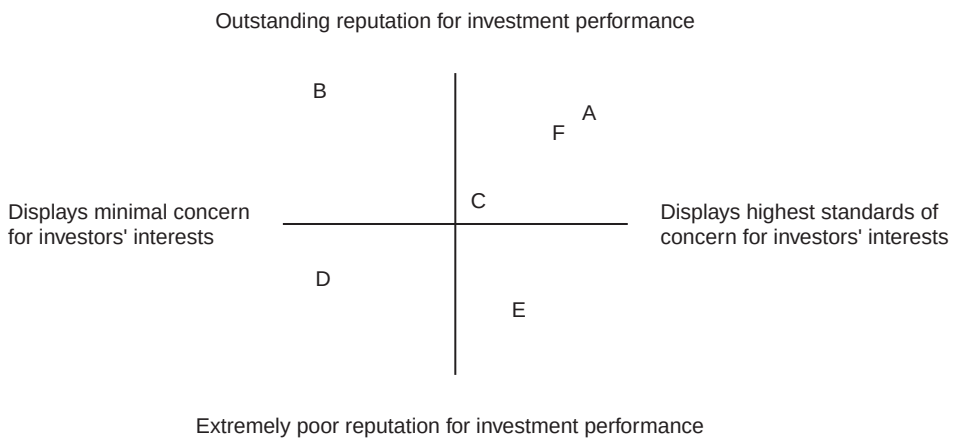

Figure 8.2 Perceptual map for investment fund management companies.

Whatever position is decided upon, it must satisfy some basic tests of its likely effectiveness. Jobber (2004) identifies a set of four such tests, namely:

1. *Clarity* – is the basis of the position clear and straightforward to grasp?
2. *Credibility* – can the position be justified and validated by the evidence available?
3. *Consistency* – is the essence of the position communicated consistent over time in all elements of the marketing mix?
4. *Competitiveness* – does the position result in benefits to the customer that are demonstrably superior to those provided by its competitors?

The crucial test is whether the company (or brand) is perceived to be distinctive. Positioning presents particular challenges to the financial services industry, owing to the intangibility of its products, the absence of patent protection and the ease with which products and services can be copied by competitors. Arguably, positioning is still in its infancy in many areas of financial services around the world. There often seems to be little that discriminates between the mainstream banks and insurance companies, certainly as far as the perceptions of consumers are concerned. In time we can expect to see more distinctiveness, but it will require a degree of sustained consistency that has so often been absent in the past.

8.8 Repositioning

An important aspect of positioning is that it is contextual and impacted upon by forces within the marketplace. By its very nature, it requires customers to draw comparisons between the array of competing offers to which they are exposed. As with any aspect of marketing strategy, positioning needs to be reviewed on an appropriate basis to ensure that it delivers the required differentiation. Over time, market forces may exert pressures that threaten the relevance and value of

the position. Consumer preferences and priorities alter, competitors are continually creating change, and new ways of satisfying needs arise from the forces of innovation. Thus, companies must be very vigilant in protecting their competitive advantage.

However, a given position can sometimes be threatened or, indeed, lose credibility and competitive relevance. Examples of problems with longstanding successful positions abound in the consumer goods and retailing areas. In the 1980s, the Guinness brand's position, based as it was on connotations of health-giving properties within a context of traditional beer drinking, was becoming increasingly irrelevant. At about the same time, Toyota came to realize that, no matter how hard it tried, it just could not establish and maintain the Corolla brand's position in the executive car market. The Tesco of the 1980s also found itself a hostage to positioning based upon a product range with limited consumer appeal and a somewhat outmoded estate of outlets.

Guinness, Toyota and Tesco have all had to engage in major repositioning activities which have resulted in new positions that have achieved differentiation and renewed competitive advantages. In the case of Guinness, the brand has been repositioned with new product variants and a somewhat quirky modern style of advertising, initially featuring the cult actor Rutger Hauer. Toyota undertook a far more radical approach to repositioning itself in the executive car market with the Lexus brand. In addition to a new brand, a whole new range of vehicles has emerged and is distributed and serviced through distinctive dealerships. Tesco also embarked upon a vigorous repositioning exercise, beginning in the late 1980s, and this has seen it grow to become Britain's most profitable retailer, accounting for some 15 per cent of all retail spending.

Jobber has identified four basic repositioning strategies, which are outlined in Figure 8.3.

The approach illustrated in Figure 8.3 is helpful in enabling managers to conceptualize the nature of repositioning that they could consider should there be concerns regarding the robustness of their current position. In common with similar such 2×2 matrices, a degree of caution should be exercised because a degree of ambiguity can often be encountered when seeking to apply them in practice. The important learning point is not to get unduly hung up on precise categorization, but rather to use the model to think though the extent to which repositioning should involve the

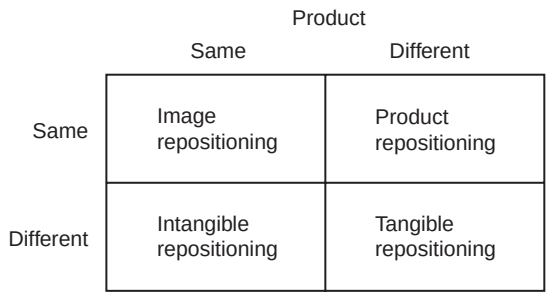

Figure 8.3 Repositioning strategies.

consideration of product/service development, new market development, or a combination of the two. It might also lead to the conclusion that the answer lies in creating new perceptions about the product among existing markets – i.e. image repositioning.

An interesting example of repositioning in the banking sector is afforded by the experience of Mitsubishi UFJ Securities (MUFJ). In October 2005, Mitsubishi Tokyo Financial Group (MTFG) merged with UFJ Holdings to create MUFG, the world's largest bank, with total assets in excess of US$600bn. Historically, the Japanese banking market has been dominated by the needs of the business sector – indeed, according to Standard & Poor's, retail banking represents just about 30 per cent of total Japanese banking profits. This compares with 50 per cent for Barclays and 70 per cent for Bank of America. The proportion of MUFG's business profits that is accounted for by retail banking is of the order of 15 per cent, and the bank's management intends to grow the proportion to 35 per cent during the course of the next few years.

In order to realize this goal, the company has embarked upon a strategy to reposition itself as a consumer-orientated retail banking brand capable of competing on equal terms with banks such as HSBC and Citigroup. This has required changes to the marketing mix, comprising elements such as a wider product range, new branch layouts, new pricing structures, more responsive systems (including 24-hour ATM access) and, crucially, the creation of a new culture. Reorienting staff to relate more appropriately to retail customers has required the company to set up an internal retail academy. Training courses lasting from a single day to over 3 months are evidence of the seriousness that the company attaches to the *people* element of the marketing mix. Independent commentators have made the point that there will also be a requirement to increase staffing levels to deal effectively with the retail market sector. It is to be hoped that the anticipated higher margins will be sufficient to offset the inevitable costs associated with the bank's repositioning strategy.

8.9 Summary and conclusions

Segmentation, targeting and positioning are at the heart of the development of any marketing strategy. To compete effectively, an organization must first identify different groups of consumers or business customers within the market place. These groups need to be different from each other, but customers within each group must be relatively similar in terms of their needs and wants – i.e. the common characteristic.

Few organizations have the resources to serve every segment within the market, and therefore companies must select a series of market segments to target. These target markets must be chosen according to the nature of customers' wants and the organization's ability to supply those needs. The decision must also take levels of competition into account.

Once target markets have been identified, the organization must pay careful attention to how it wishes to present itself. This means that the organization must have a clear idea of its source of competitive advantage, and be able to communicate it effectively to target consumers.

Review questions

1. What are the criteria for effective segmentation?
2. What variables do you think are most suitable for segmenting the market for credit cards?
3. What are the advantages of a differentiated approach to market targeting?
4. When will focused market targeting be most appropriate?
5. What factors should be taken into account when trying to develop a competitive position?

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Part II

Customer acquisition

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9

Customer acquisition strategies and the marketing mix

Learning objectives

By the end of this chapter you will be able to:

- understand the relationship between marketing strategy and the marketing mix
- appreciate the differences and relationship between annual marketing planning and the strategic marketing plan
- explain the nature of the marketing mix as it applies to financial services
- understand the challenges associated with developing a financial services marketing mix.

9.1 Introduction

Discussions of marketing have traditionally focused attention on how to attract new customers – a process typically described as customer acquisition. Increasingly it is recognized that the retention of existing customers may be every bit as important as the acquisition of new ones. The elements of marketing used for acquisition and retention are in many respects very similar, but the ways in which they are used can be quite different. In Part II of this text we focus upon aspects of marketing management which are particularly concerned with the acquisition of new customers. Specifically, we focus on the well-established concept of the marketing mix which is introduced in this chapter and subsequently explored in more detail.

The marketing mix is a term used to describe the marketing tools that a manager controls. Managers must make decisions about these different tools in order to create a clear competitive position in the market for the organization's products and services that is consistent with the nature of the overall marketing strategy. The tools that make up the marketing mix are often referred to as the '4-Ps' – product, price, promotion and place – although in services marketing this is often extended to 7-Ps by adding people, process and physical evidence. It is through the marketing mix that strategy takes practical effect. In other words, the marketing mix is the practical expression of the marketing strategy. Consumers have little or no knowledge of, or interest in, strategy. What concerns them is the utility they experience from the contact they have with the marketing mix.

It is important to recognize that decisions about the marketing mix have both strategic and tactical dimensions. The strategic dimension of the marketing mix is primarily concerned with decisions about the relative importance of the different elements of the marketing mix. For example, promotion, and particularly television advertising, may play an important role in the marketing mix for many retail financial services, but be almost irrelevant for specialized corporate financial services. Equally, a mass-market financial service such as a standard bank account or mortgage will need a distribution system that makes it easily available to a large proportion of the population, whereas a highly specialized product can rely on a far more selective system of distribution. In contrast, the tactical dimension of the marketing mix is concerned with specific decisions about the individual marketing tools. Thus, for example, once a decision has been taken about the general approach to pricing (e.g. premium pricing), a specific decision is required regarding the actual price to be set.

The purpose of this chapter is to provide an overview of the marketing mix for financial services, paying particular attention to the way in which the marketing mix may be used for customer acquisition. The traditional 4-Ps are discussed more fully in the following chapters. The chapter begins with a brief discussion of short-term, annual marketing planning, to set a context for discussion of the mix elements. This is followed by a discussion of the strategic issues relating to the marketing mix, and the subsequent section provides an overview of the individual mix elements and their relevance in a financial services context. The chapter moves on to explore the challenges associated with using the marketing mix for customer acquisition in financial services.

9.2 Short-term marketing planning

In Chapter 5 we considered strategic marketing planning and recognized that its primary role is to set direction over the medium to long term – typically 3–5 years. It is upon the platform of the strategic marketing plan that major policy decisions are made, such as selecting which segments are to be served and establishing how the organization will differentiate itself in delivering value to customers and thus achieve competitive advantage. To complement the strategic marketing plan, best practice dictates that an organization should have an *'annual marketing plan'*. If the strategic marketing plan is about the setting of long-term direction and the determination of competitive advantage, the annual marketing plan is about achieving a joined-up and co-ordinated approach to achieving short-term marketing objectives.

In the way that there is no universally agreed process and template for strategic marketing planning, there is no such model for the annual marketing plan. However, it is important that there is consistency between a given organization's strategic and annual marketing plans. Moreover, it is important that organizations that comprise a number of individual strategic business units (SBUs) or business lines adopt a common approach to marketing planning. For example, a broad-based financial services provider such as HSBC might choose, say, to produce an annual marketing plan for its range of mortgage and property finance products. This may be quite separate from, for example, its pension product range. Whilst both of these product groups will be guided by the overall corporate positioning statement of being '*The World's Local Bank*', they each nonetheless operate in quite distinct marketplaces. Therefore, each will have quite different requirements in respect of the market-specific objectives that they specify, the elements that need to be considered when analysing the marketing environment, and the characteristics of the segments that they identify and target. For example, the competitor set that applies to pensions products will vary greatly to that of the mortgage area. This is an important point, as there are real dangers of conducting a marketing plan at too aggregate a level. There are no straightforward solutions to this difficulty other than to say that all organizations must approach the issue in a way that best suits their particular circumstances, such as product range, scope and organizational structure.

The conduct of the annual marketing plan comprises two components, namely: the process and the written plan itself. It must be borne in mind that there should not be a strict one-size-fits-all approach to the annual marketing plan; rather, it should be tailored to suit the particular characteristics of any given organization. However, the model shown in Figure 9.1 represents a sound core structure for the ultimate output of the planning process.

The plan should make it clear where responsibility and accountability lies for marketing objectives and the successful completion of marketing-mix activities.

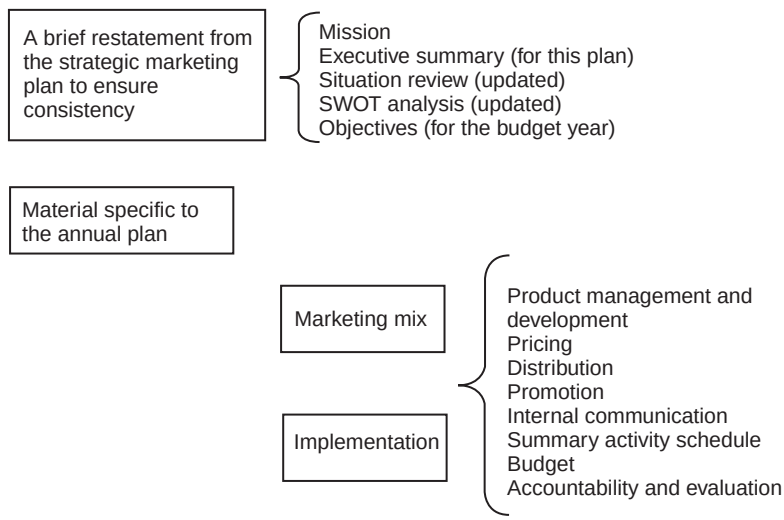

Figure 9.1 The annual marketing plan.

Ownership should be made clear and unambiguous, and sole ownership for delivery should always be sought. It is common to encounter a plethora of shared accountabilities, which results in an unclear sense of ownership. Indeed, well-defined accountability is a necessary prerequisite for an appropriate appraisal system and performance review. This section of the plan can also be used to summarize the array of key performance indicators (KPIs) that arise from the marketing-mix activities.

In the discussion of strategic marketing planning in Chapter 5, explicit reference was made to *internal communication*. The lack of sufficient emphasis upon this issue is a major contributory factor to the failure of marketing plans to achieve their objectives. It is very rare for a marketing objective in the field of financial services to be accomplished without the involvement of people in other functions. In the case of an insurance company there may be a sales-force to consider; a building society must take care to inform branch staff. In all types of financial services companies it is vital that administration staff are made fully aware of marketing activities that will impact upon their work. Similarly, IT and business systems colleagues need to know how plans for new products or new product features should be factored into their own functional plans.

A central component of any annual marketing plan will be decisions about the marketing mix and details about how key marketing variables will be managed and controlled. The remainder of this chapter will explore in more detail the concept of the mix as it applies in financial services.

9.3 The role of the financial services marketing mix

It is vital to grasp the point that the marketing mix is what determines the customer experience. Thus, it is the role of the mix to deliver customer satisfaction and result in a stream of margin that delivers shareholder value. Purchase decisions are made by consumers on the basis of the overall service offer and how well this meets their needs. A service offer can simply be decomposed into the elements of product, price, promotion and place (and even people, process and physical evidence), and these form the basis of the traditional marketing mix. Marketing managers make decisions about these variables in order to implement a marketing strategy – in particular, they use these variables to create a clear market position and demonstrate how their product meets consumer needs in the target market. This process is shown in Figure 9.2.

The remaining chapters in Part II address in detail those aspects of the mix that have historically been prominent in acquiring new customers. It must be borne in mind that the same elements of the mix also have a part to play in the retention of customers, and the range of the mix in this context will form the focus for Part III of this book.

Each chosen target customer segment should be the subject of a tailored marketing mix. Unless the organization has chosen to follow an undifferentiated strategy, the mix must be adjusted to suit the particular characteristics of each individual segment.

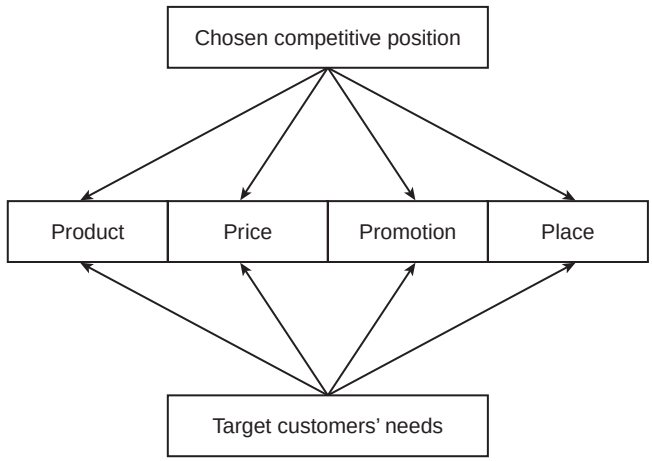

Figure 9.2 Customer needs and the marketing mix.

In addition to segmentation, the strategy will identify the basis of the company's competitive advantage. The chosen form of competitive advantage provides a reference point for the marketing mixes designed for each target segment. Thus, there must be consistency in the design of segment-specific mixes to ensure that the core competitive advantage is in evidence across the range of mixes employed. All elements of the marketing mix must be designed, presented and delivered in ways that are mutually reinforcing and faithfully reflect the company's chosen basis for differentiation.

In practice, there is a range of different marketing tools that marketing managers can use. Thus, when we use the term 'the 4Ps' it is important to remember that each 'P' encompasses a range of different marketing tools. Some examples of these are as follows:

- Product – includes range of products offered, features, brand, quality, packaging, warranties, terms and conditions
- Price – includes listed price, discounts, payment periods, credit terms
- Promotion – includes advertising, personal selling, sales promotion, publicity, public relations
- Place – includes channels of distribution, location, access (opening hours), staffing.

In managing the marketing mix, it is important to remember that each decision about a particular tool will send a message to consumers. A high price, for example, may be interpreted as indicating high quality. A limited number of outlets for a product or service may imply that it is exclusive, as might advertising in expensive magazines with limited circulation. Thus, if the marketing mix is to be used to create the organization's desired competitive position there are two key requirements;

1. *Consistency with position*. The decisions about each mix element must be consistent with the position that has been chosen. Thus, for example, when Maybank

decided to promote a youthful lifestyle image in Malaysia, it supported that decision with a major promotional event that included a live band, promotional offers for mobile phones and a competition with a VW Beetle as the major prize. These were all activities that were seen as being consistent with a youthful image. If the same event had included a performance by a string quartet, and a Volvo as the competition prize, many consumers would have found this inconsistent with the image being portrayed and the promotional event would have been much less successful.

2. *Synergy from mix elements*. As well as ensuring that an element of the mix is consistent with the chosen position, it is also important to ensure that all the mix elements are consistent with each other. This is important because each element of the mix presents customers with a very clear message about the organization and its products and services. There are very real synergies generated when each element of the mix conveys the same message to consumers. Equally, if elements of the mix send different messages, then consumers may be confused. For example, the American Express Platinum charge card is associated with high-income consumers and symbolizes prestige and success. It is the fact that it is exclusive that makes it attractive. A press campaign in mass-market media will be inconsistent with the product and the image it projects. There will be no opportunity for synergy, and the image of the card may be damaged because the real target market will not recognize the appropriateness of the card for them.

Thus, an effective marketing mix must aim for consistency and synergy – consistency with strategic position, and synergy from the individual elements. Individual elements of the mix should not be viewed in isolation; constant cross-referencing is essential to ensure consistency with other elements in the mix.

9.4 The financial services marketing mix: key issues

In Chapter 3, the distinguishing features of financial services were identified and their marketing implications discussed. The main differences between financial services and physical goods were listed as:

- intangibility – financial services have no physical form and are often complex and difficult to understand
- inseparability – financial services are produced and consumed simultaneously, they cannot be stored, and there needs to be significant interaction between customer and supplier
- heterogeneity – the quality of financial services is highly variable because of differences between consumers and a heavy dependence on people to provide the service
- perishability – financial services cannot be inventoried; they have to be produced on demand.

To address intangibility, marketing activities might consider:

- making the service more tangible by providing consumers with some physical evidence (or at least a tangible image)
- building trust and confidence through the people that help deliver the service.

To address inseparability, marketing activities might consider:

- training to ensure that staff are friendly and responsive
- developing processes for service delivery that are customer orientated.

To address heterogeneity, marketing activities might consider:

- standardizing service delivery processes
- managing and training staff to encourage a high and consistent level of quality.

To address perishability, marketing activities might consider:

- automating services features via processes for remote access
- managing demand through careful use of staff rosters or by using special price mechanisms.

Thus, the provision of physical evidence, staff management (people) and the systems for delivering service (process) are all likely to be important elements of marketing decision-making for financial services. As a consequence, Booms and Bitner (1981) proposed that people, processes, and physical evidence should be added to the original 4-Ps framework to create what is termed the extended marketing mix (7-Ps). The remainder of this book will be structured around the traditional marketing mix, but a brief description of the elements of the extended marketing mix is provided below. The decision on whether to adopt the 4-Ps or 7-Ps approach can only be determined in the light of the specific circumstances of an individual company or product group. There is little point in being slavish to the 7-Ps model at the tactical level if the 4-Ps version is perfectly fit-for-purpose. What matters is that the marketing-mix decisions outlined in the plan serve to identify a range of actions under suitable headings that will result in the achievement of the desired outcomes – the objectives.

9.4.1 People

The 'people' factor in the marketing mix emphasizes the important role played by individuals in the provision of financial services. Consumers will frequently find the precise details of a financial service difficult to understand, they often do not see anything tangible for their expenditure, and the benefits from many financial services may only become clear at some time in the future. Furthermore, the provision of information and purchase of a financial service depends on the interaction between the consumer and representatives of the organization. These features of financial services mean that the purchase decision may be heavily influenced by the way in

which consumers perceive the staff that they deal with and how they interact. The people who provide a service affect the way in which customers see the product, how it is promoted and how it is delivered.

In particular, the people component of services marketing is most commonly associated with personal selling which relates to both the promotion and distribution (place) elements of the marketing mix. It is also relevant to the product element of the mix, because it can have a significant impact on the quality of service.

9.4.2 Process

Process is concerned with the way in which the service is delivered, including business policies for service provision, procedures, the degree of mechanization etc. There are several reasons why process is important. First, the heterogeneity of services raises the issues of quality management and control. Secondly, inseparability suggests that the process of providing the service may be highly visible to the consumer and will need to be flexible enough to accommodate potential demand variations. Thirdly, the intangibility of services means that the process by which the service is provided will often be an important influence on the consumers' assessment of service quality. Accordingly, the main concern with process is typically in the context of distribution, but it also has relevance to pricing decisions.

In developing distribution systems for financial services, the intangible nature of the product means that there is nothing physical to supply to the consumer; the consumer is paying only for a bundle of benefits and the delivery process will need to emphasize these benefits. Furthermore, the variability of service quality leads to pressure for automation in service delivery wherever possible. For some services (such as money transmission) this is relatively easy, whereas for others (such as financial advice) this is more complex, although recent developments in expert systems are assisting with the automation of some of the more complex services.

Although process is important in relation to distribution, it is also relevant to price through its impact on the monitoring and measurement of production costs. Careful attention to the process of delivering a service can be of value in understanding the nature of costs and thus developing a sensible approach to pricing.

9.4.3 Physical evidence

Physical evidence refers to anything tangible which is associated with a given service – it may be the buildings that an organization occupies, the appearance of staff, or the cheque-book holders or wallets that are provided for documents. The need for physical evidence within the marketing mix arises directly from the typically intangible nature of the service. It is generally recognized that physical evidence can be subdivided into two components:

1. Peripheral evidence, which can be possessed by the consumer but has little independent value (e.g. a document wallet)
2. Essential evidence, which cannot be possessed by the consumer but has independent values (e.g. a bank branch).

The provision of physical evidence is likely to be most obvious in the product and place components of the marketing mix, but it is also relevant to promotion. In the product element of the marketing mix, brand-building is important in the process of tangibilizing a service. Building an image and a brand is seen as increasingly important in the financial services sector, because the brand is a way of reducing risk and emphasizing quality. Increasingly, brands are accompanied by a variety of forms of peripheral evidence (cheque books, plastic cards, document wallets, etc.) to reinforce the brand's message.

The need for physical evidence is also significant in the context of promotion. The particular problem facing suppliers of financial services is that they have no physical product to present to consumers. Thus, from a marketing perspective, promotion must try to develop a message and a form of presentation which makes a service seem more tangible. It is also interesting that the more successful forms of sales promotion have tended to be those offering tangible items as free gifts (calculators, watches, etc.) and competitions rather than simple price promotions.

9.5 Customer acquisition and the financial services marketing mix

Thus far, this chapter has given an overview of the key elements associated with the marketing mix for financial services. This section focuses on the challenges which might confront organizations when trying to manage these elements with a view to the acquisition of new customers. Case study 9.1 provides an example of how HDFC Bank in India has effectively integrated its marketing strategy and marketing mix to promote customer acquisition.

Case study 9.1 Customer acquisition at HDFC Bank

Until the 1990s, the banking sector in India was dominated by two main groups – the public-sector banks and the international banks. The former dealt with the mass market, although the quality of products and services provided was generally considered to be poor. The latter focused on the more wealthy segments and were typically very selective in terms of accepting new customers. Liberalization during the 1990s paved the way for the influx of new private-sector banks, the first of which was HDFC, launched in 1995. The bank's research had identified a significant middle-class market, which expected a high quality of service and was willing to pay for it. These customers were not prepared to tolerate poor service and long queues in the public-sector banks, but equally were less trusting of the international banks and less attractive to those banks because they were outside the very high-income brackets.

As a new entrant, HDFC needed to develop its marketing mix in order to target these customers and persuade them to switch to HDFC. The basic value proposition that underpinned HDFC's approach was that of '*international levels of service at a reasonable price*'. Specific marketing mix decisions were as follows.

Continued

Case study 9.1 Customer acquisition at HDFC Bank—cont'd

Product

To meet the needs of the chosen mid-market segment, HDFC offered a comprehensive range of banking services, comparable to the product range of international banks. This was supported by the targeting of specific products to sub-segments based on differences in needs, expectations and behaviours. Staff were recognized as being of considerable importance, particularly those on the frontline, and the bank paid particular attention to recruiting staff with good customer service skills.

Price

HDFC offered its initial bank account with the requirement for a minimum balance of Rs 5000 – significantly below the typical international bank requirement of Rs 10 000, and so significantly cheaper, but still higher than the public-sector requirement of Rs 500. This ensured that HDFC had the margin to support the delivery of superior service, while remaining significantly cheaper than the international banks.

Promotions

HDFC supports its product and service offer with the usual range of above and below the line marketing promotion, with direct mail, e-mail and SMS becoming increasingly important. A significant recent innovation has been the use of sophisticated analytical techniques to test and evaluate campaigns. This has enabled HDFC to gain a better understanding of how customers respond to marketing promotions and use this information to develop more effective campaigns in the future. In addition, this analysis has enabled HDFC to target its communications more effectively, thus reducing marketing spend and the costs of acquisition.

Place

HDFC focused attention on the 10 largest cities in India, which account for close to 40 per cent of the population, and concentrated on gaining maximum market share in those areas before expanding to other cities. The decision to operate with a central processing unit allowed the bank to keep the cost of establishing a branch network relatively low, and thus supported more extensive coverage (around 500 branches in around over 200 towns and cities). Alongside its branch network, HDFC also delivered its services via ATMs, phones, the Internet and mobiles to ensure that it met the diverse set of needs of its mid-market customers.

The success of HDFC is evidenced in growth rates of 30 per cent per annum and a string of awards from AsiaMoney, Forbes Global, Euromoney and many others.

Sources: Saxena (2000); Interview with Ajay Kelkar (available at http://www.exchange4media.com/Brandspeak/brandspeak.asp?brand_id=811; HDFC Bank (www.HDFCBank.com).

However, not all financial services providers have been so successful in managing the mix for consumer acquisition. Historically, the financial services sector has received considerable criticism for tending to focus on new customer acquisition to the detriment of existing customers. Indeed, the cynical practice of offering unsustainably attractive benefits to consumers at the time of acquisition, which are subsequently reduced, remains a feature of certain parts of the industry. It is undoubtedly true that companies have the right to use promotional pricing as part of its new customer acquisition activities. Promotional pricing is prevalent in virtually every category of consumer goods and service marketing, so why should financial services be exempt? Promotional pricing does indeed have a perfectly legitimate role to play in financial services. However, it has to be used with care, given the complexity of the products, the timescale over which they operate, and limited consumer understanding. With the one-off purchase of, say, a television or a holiday, consumers understand clearly the net price they have to pay and are in a position to make a well-informed choice. When 'buying' a deposit account from a bank or a building society, consumers may well be in possession of the facts regarding the short-term price promotion but not in a position to judge the long-term competitiveness of the interest rate. In the field of mortgages, an attempt has been made to factor-in the effect of special introductory offers through the introduction of the Annual Equivalent Rate (AER). The key point to grasp is that care must be taken with the use of new-customer price promotions to ensure the appropriate management of expectations.

In addition to concerns about the way in which marketing mix variables are used, we must also recognize that the specific features of the financial services sector may create additional challenges. Chapter 2 devoted considerable attention to the array of products that comprise the domain of retail financial services. In Chapter 10, we present key models and concepts concerning the successful management of products. Meanwhile, it is important to appreciate that the relationship between *product* and *process* is particularly close in the case of financial services. When a person 'buys', say, a current account; that person is seeking to secure access to a range of service benefits on a continuing basis. The availability of Internet banking facilities may be perceived as a *product* feature or a *process* associated with the consuming of the product. However, in the context of customer acquisition – the focus of this part of the book – we should consider *process* in terms of how an individual first becomes a current-account customer of a given provider. It must be borne in mind that the processes associated with customer acquisition comprise things that the organization chooses to require, and certain things that are imposed by external agents such as the regulator. To continue with the example of a current account, many countries have strict rules regarding money laundering. This results in the need to provide original forms of documentary evidence as proof of identify and address. It adds a degree of complexity to the new customer acquisition process and may cause frustration for the customer; however, it cannot be avoided, and this must be explained and managed.

A further aspect of the mix that may be challenging in a financial services context is *place*. In the conventional consumer goods context, *place* is pretty straightforward; it concerns the means by which the consumer gains access to buying the product – i.e. the channel of distribution. This meaning of the term also applies in

the case of financial services. For example, IFAs represent the primary means of distribution by which a consumer gains access to the products of Skandia, the Swedish-owned life insurer. However, having become a customer of Skandia, ongoing service contact is likely to be directly with the company via the telephone, for example. Thus *place* is a rather ambiguous concept, since it can refer both to the channel of distribution that a consumer uses to become a customer and to the means by which a customer engages in service interventions with the provider company.

Owing to the economics of new customer acquisition, it is becoming increasingly important for companies to market themselves on the basis that there will be an ongoing customer relationship in which a number of products will be bought by the customer over a prolonged timescale. In other words, the profit is in the lifetime value of a new customer, and not necessarily in the profitability of the first product purchased. Customer profitability is determined to a large extent by a surprisingly small group of variables that apply fairly consistently to most forms of financial services products. Consider the case of, say, a loan that is secured on the value of a consumer's home. This type of loan is sometimes referred to as a second mortgage because, in law, the lender can only gain access to the property's security value once any first mortgage debt has been discharged. The profitability of a new second-mortgage customer is a function of:

- the amount of money loaned
- the term of years over which repayment of the loan takes place
- the likelihood of the customer defaulting on the loan
- the interest margin
- the purchase of other products from the lending company.

Relatively small changes, either positive or adverse, in one or more of these variables can exert significant impact on profitability, especially if all five variables are affected. This model works equally for first mortgages and unsecured loans.

In the life insurance sector, the profitability of a new customer is a function of:

- the value of the sum assured
- the term that the policy remains in force
- the likelihood of a claim being made
- policy margins
- the purchase of other products from the insurance company.

Again, the cumulative impact of positive or adverse variances with respect to these key variables has a compounding effect upon customer profitability. These variables should be factored into the plans that are designed to achieve a targeted level of new customer acquisition. The logic of this thinking indicates a balanced scorecard approach to new customer target-setting. To target crudely on the basis of maximizing new customers or products sold in a given budget year is to play a pure numbers game that invites considerable long-term commercial risks. Case study 9.2 gives some examples to illustrate this point.

Case study 9.2 Centralized mortgage lending – a salutary story

The latter part of the 1980s in the UK witnessed the rapid birth, and almost equally rapid nadir, of what were termed centralized mortgage lenders. Names such as The Mortgage Corporation, National Homeloans and Mortgage Express came from a standing start to take of the order of 25 per cent of new mortgage business by 1990. Their success was based upon a combination of opportune timing and the unresponsive nature of traditional sources of mortgages, most notably the building societies.

In terms of good timing, the centralized lenders were able to take advantage of a period of time during which the cost of funds on the wholesale money market was cheaper than retail-sourced funds. Building society mortgages were largely funded by retail-sourced funds – indeed, there were strict limits on the percentage of their mortgage funds that could be sourced on the wholesale money market. Being centralized lenders, they had no branch infrastructure costs to carry and were able to administer new mortgage applications efficiently from one central administration centre. This gave them additional cost advantages which, together with lower funding costs, gave them a clear pricing advantage over their traditional rivals.

Three other factors worked together with their pricing advantage to give the centralized lenders a tremendously strong competitive edge. First, they were able to process new mortgage applications very fast (often within 24 hours, compared with the 4–6 weeks that was typical for building societies at the time). Speed is of the essence for the typical homebuyer as, once a desirable new home has been found, there can often be a race to cement a deal with the seller of the property. Secondly, the centralized lenders appreciated the importance of intermediaries, such as estate agents, mortgage brokers and insurance company sales agents, in placing new mortgage business. In the late 1980s, in the order of 60 per cent of new mortgages were placed with lenders via intermediaries. This resulted in a very low cost of new business acquisition compared with the branch costs of the traditional lenders. Recognizing the role of intermediaries, the centralized lenders focused their own new customer acquisition activities upon them. Thus, high volumes of new business were generated at low cost, and in a short period of time the newcomers were challenging the supremacy of a well-established incumbent industry. Thirdly, the centralized lenders brought product as well as service innovation to the mortgage business. They were able to use their treasury skills to provide new forms of interest rate management, such as fixed rate and 'cap-and-collar' loans.

They began to use securitization as a means of putting their loan books off balance sheet and thereby enhancing the return-on-capital to their shareholders. They introduced so-called deferred rate mortgages, most notably the 3:2:1 scheme, whereby the interest rate payable in the first year of the mortgage was a full 3 per cent less than the standard variable rate (SVR), reducing to a 2 per cent discount in the second year and 1 per cent in the third year. The '6 per cent' deferred interest arrived at in this way was to be added to the outstanding loan at the end of Year 3, and the new, higher amount would be repaid at the prevailing SVR from Year 4 onwards.

Continued

Case study 9.2 Centralized mortgage lending – a salutary story—cont'd

The meteoric rise of the centralized lenders was also assisted by three factors external to their control. First, the house-purchase market in the UK experienced a sustained boom from 1985 onwards. Secondly, interest rates were falling steadily towards the end of that decade. Thirdly, in 1999 the Thatcher government gave advance warning that it was going to remove a tax-break known as 'multiple MIRAS'. This had the effect of lighting the blue touch paper on a firework – the housing marketing rocketed property values to stratospheric levels.

Just as propitious timing had brought about the dramatic growth of centralized lending, so too did a set of negative economic factors result in its almost equally dramatic demise. During the course of 1990 interest rates began to rise – indeed, in little over a year the base rate doubled from 7.5 per cent to 15 per cent. Unsurprisingly, the housing market went from boom to bust within just a few short months. The centralized lenders' price-edge evaporated, causing already declining sales to fall even faster. The rapid rise in interest rates caused hardship for borrowers, and mortgage payment defaults began to grow. At the same time, falling property prices rapidly eroded the margins of security of the lenders. To make matters even worse, many borrowers on deferred-rate mortgage schemes were among the defaulters. This meant that the interest outstanding grew rapidly and added to the losses that would be incurred as security margins disappeared. It should be borne in mind that the centralized lenders' 'asset' base of mortgages was accumulated when property prices were at or near their historical peak, and that loan-to-value ratios were typically 90 per cent. In other words, the lenders had a margin of security of just 10 per cent, while between 1990 and 1992 the average property value fell by the order of 30 per cent. The outcome was that the new lenders withdrew from the market by ceasing to accept new business in order to limit further potential losses for their shareholders. All operational focus was upon damage limitation by acting quickly to gain access to whatever security remained in the valuations of properties in default. Repossessions rose sharply, and so did the financial losses of the centralized lenders.

Inevitably, it was the more 'successful' companies which had built the largest books of business that suffered most, and the majority of the high-profile lenders went out of business. Some of the smaller ones managed to survive, and have carried on at the margins of the mainstream business.

So what is to be learned from this case study? First, it is probable that undue emphasis was laid upon the key performance indicators of volume and value of new customer business. Insufficient emphasis was placed upon the quality of the new loan books. Secondly, greater caution should have been exercised in assessing the drivers behind the growth of this new market sector. This should have included the use of scenario planning to stress test the probable impact of adverse environmental factors.

Thirdly, more detailed analysis of the drivers of the behaviour of intermediaries and their working practices should have occurred. This would have revealed the impact of inappropriate remuneration systems and the poor-quality customers with whom many of the intermediaries dealt. Fourthly, there should have been greater investment in default mitigation resources and processes, and a greater degree of caution built into provisions made for bad debts. Finally, the business model should have taken a more holistic approach to the assessment of new customer value, as described earlier in this chapter.

Elements of this case study are in evidence in other marketplace settings, such as the personal pension boom of the latter 1980s and early 1990s, and the dot-com boom of the mid-1990s. All rapidly expanding new market phenomena should be subject to a greater degree of scrutiny. Particular attention should be focused upon developing a thorough understanding of:

- the underlying drivers that are fuelling the growth
- the motives and behaviours of customers
- the motives and behaviours of intermediaries and other distributors
- the customer value model.

9.6 Summary and conclusions

The effectiveness of any marketing strategy depends on the development of an effective marketing mix. The marketing mix consists of all the marketing tools that can be used to communicate an organization's service offer to its target markets. To be effective, the elements of the marketing mix must be consistent with the organization's chosen position and with each other. In financial services, the marketing mix must recognize and respond to the distinctive features of service products. In particular, when managing the elements of product, price, promotion and place, marketers in the financial services sector need to pay particular attention to the people delivering the service, the process by which the service is delivered and the physical evidence which represents the service.

Review questions

1. Why is consistency important in the development of an effective marketing mix?
2. What makes the marketing mix for financial services different from the marketing mix for physical goods?
3. What are the major challenges for financial services providers when developing a marketing mix for customer acquisition?
4. Which practices on the part of a financial services provider undermine consumer trust, and which practices and activities can enhance trust?

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10

Product policies

Learning objectives

By the end of this chapter you will be able to:

- explain the nature of financial services products
- explain the operation of key Islamic financial services
- outline the issues influencing product policy
- provide an overview of issues relating to the management of existing products
- develop an understanding of the implications of the product lifecycle concept for the marketing mix
- outline the issues associated with the development of new products.

10.1 Introduction

By definition, the product is fundamental to any marketing activity, since it is by consuming the product that a customer experiences enjoyment and utility. Clearly, a product which does not offer what consumers want at a price they are prepared to pay will never succeed. Decisions about the products that an organization offers are both strategic and tactical. The strategic issues associated with the management of the product portfolio were introduced in Chapter 5, and discussed further in relation to segmentation, targeting and positioning in Chapter 8. Alongside these strategic-level decisions about the product, there are also important tactical issues which must be considered. These relate to the development, presentation and management of products which are offered to the marketplace. Thus the product element of the marketing mix deals with issues such as developing an appropriate product range and product line, as well as considering decisions relating to the attributes and features of individual products. In this context, the issue of branding is becoming increasingly important for individual products as well as for the organization as a whole. The product element of the marketing mix also deals with issues relating to new product development. Extending product ranges and product lines, either

by new product development or through the modification of existing products, is increasingly important for organizations that wish to remain competitive in a rapidly changing market environment.

This chapter begins by providing an overview of financial services products and how they present particular challenges for marketing. It introduces the main types of Islamic financial services which have recently become more widely available. The next section examines the factors that will influence decisions about the development of the product element of the marketing mix. Here we revisit the product lifecycle concept and consider its uses and limitations in further detail. Subsequent sections deal specifically with aspects of the product range strategy and the process of new product development in the financial services sector.

10.2 The concept of the service product

In the tangible goods domain the notion of what constitutes a product is pretty straightforward, as it comprises palpable physical characteristics. However, the situation is less straightforward when it comes to financial services because product comprises both utility features and service features. The former concerns the primary need for which the product was bought – for example, a personal pension to provide an income in retirement. Amongst the utility features associated with a pension may be a choice of investment funds, the ability to switch between funds, and an option for income drawdown. Services features are somewhat analogous to the process element of the extended marketing mix of the 7-Ps. In the case of a personal pension, it could include ability to access a fund's value and make additional contributions on-line, or perhaps access to information and assistance via a 24/7 call-centre. Sometimes the boundary between the two types of feature can appear to be somewhat blurred.

An additional dimension to appreciate is the role played by service features where third-party intermediaries form part of the distribution processes of a product provider. In these cases, real competitive advantage can be achieved by providing intermediaries with a range of helpful and responsive service features such as the ability to input new cases on-line and the provision of connectivity between the IT systems of the provider and the intermediary.

Thus, when we refer to terms such as product, product management and product development in the context of financial services, we must ensure that both utility and service features are given due consideration.

Products are only purchased because they provide these benefits to the consumer. Therefore, in order to understand products and how they should be managed, it is important to understand what those benefits are and how they are provided. Understanding the nature of the service product requires an understanding of both the needs of customers and the organization's ability to meet those needs.

10.2.1 What customers want

The majority of organizations offer a range of products to a variety of customer groups in order to meet a variety of customer needs. In financial services, the prime customer groups are personal, institutional and corporate. In personal markets, financial institutions will often separate high net-worth individuals (HNWI) from

other customer groups. In the corporate markets, banks will typically separate large corporates from small and medium-sized enterprises. These customer groups have a wide variety of financial needs. The diversity of customer needs outlined in Chapter 2 can be classified under six main headings:

1. The need to move money and make payments (e.g. current accounts, ATMs debit cards)
2. The need to earn a return on money (e.g. savings accounts, unit trusts, bonds)
3. The need to defer payment or advance consumption (e.g. loans, credit cards, mortgages)
4. The need to manage risk (e.g. life insurance, general insurance)
5. The need for information (e.g. share price information services, product information)
6. The need for advice or expertise (e.g. tax planning, investment planning, advice on IPOs, advice on mergers and acquisitions).

Box 10.1 outlines the key features of a common but often misunderstood financial product, namely bonds, which are used to satisfy buyer needs to earn a return on money and issuer needs to advance consumption.

Box 10.1 What is a bond?

A bond, very simply, is a loan that the bondholder makes to the bond issuer. Governments, corporations and sometimes municipalities issue bonds when they need capital. If you buy a government bond you are lending the government money, and the same with a company. Just like any other loan, a bond pays interest periodically at a given rate; this is known as a coupon, and it repays the principal at a stated time. The risk to the bondholder is that the bond issuer may default in the interest payments or the actual repayment of the loan.

Bond characteristics

A bond can be traded in the secondary open market after it is issued, and its market price is dependent on a range of variables, including interest rates, supply and demand and maturity – although, in theory, a bond's price is supposed to equal the present value of all future cashflows, including the final redemption.

Bonds are normally issued with face (nominal or par) value of £100, which can be simply understood as the amount returned to the investor upon redemption. A bond's price is normally quoted in pence or cents, depending on which country and currency the bond is issued in. For example, if a bond is quoted at 99p, the price is £99 for every £100 of the face value of the bond. If that same bond is quoted at 101p, the price is £101 for every £100 of the face value. In the first instance, the quoted or market price of the bond is said to be at a 'discount' to (i.e. lower than) the nominal price (of £100), and money can be made (a 'capital gain') on redemption. In the second instance, the bond is said to be trading at a 'premium' (where the quoted price is higher than the nominal price). In this case, money would be lost (a 'capital loss') on redemption. If the bond is at its face value of £100 (meaning the quoted price is 100p), it is then described as trading at 'par'.

Continued

Box 10.1 What is a bond?—cont'd

Another important character of a bond is its yield. At the most basic level, this can be understood to be the return an investor can expect from such an instrument. The 'nominal yield' is the amount of income the bond generates per year as a percentage of its nominal value. Thus the nominal yield (calculated by dividing annual income by nominal value) on a £100 bond which pays 5 per cent interest a year is $(5/100) \times 100 = 5$ per cent. This yield can normally be found in the description of the security – for example, 'Treasury 4.25% 2016', where the nominal yield in 4.25 per cent. Whereas this yield might be useful for someone who buys a bond at issue or 'at par', it cannot be used when a bond is bought at a premium or discount to nominal value. Here, it is appropriate to use the 'current yield', which is calculated by dividing the annual income by the current market price of the bond. If the above-£100 bond which pays 5 per cent coupon is trading at £95, then the yield is $(5/95) \times 100 = 5.26$ per cent. The limitation of the current yield is that it only provides a snapshot based on the market price today, and takes no account of a capital loss or gain made if the bond is held until maturity. The widely used 'gross redemption yield' solves this problem and provides a standard with which individuals can compare many varying bonds of different coupons and maturities, and discover whether they are at a discount or premium. The aim of the redemption yield is to show the total return of the bond while taking into account the interest/coupon that will be paid (before tax), the number of years left until the bond matures, and the capital loss or gain involved if the bond is bought at the current market price and held it until it is redeemed. An important thing to note when using gross redemption yield (or yield to maturity, as it is otherwise known) is that the return is calculated based on the assumption that the investor reinvests the coupons received at the same yield as that at time of purchase of the bond.

The bond price always moves in the opposite direction to its yield, so that if interest rates rise, bond prices will fall and yields rise – and *vice versa*. This relationship between interest rates and price is not a perfect linear relationship, but a slightly curved one. An imaginary line is then drawn at a tangent to this curve and the resulting estimate of change in price for a given change in yield is known as 'modified duration'. The idea behind duration is pretty simple – for example, if a bond has a duration of 3 years, then the price of that bond will rise by 3 per cent for each 1 per cent fall in interest rates or decline by 3 per cent for each 1 per cent increase in interest rates. Such a bond is less risky than one that has a 10-year duration. That bond is going to decline in value by 10 per cent for every 1 per cent rise in interest rates.

There is also another relationship specific to bonds, that between the yield and time left till maturity, arising from the fact that changes in interest rates affect all bonds differently. The longer a bond has until redemption, the greater the risk that interest and inflation rates will fluctuate or rise higher, prompting the investor to expect a higher yield for taking on the extra risk. A line that plots the yields of bonds at a given point in time with differing maturities is known as a 'yield curve'. This curve generally rises from lower yields on shorter-term bonds to higher yields on longer term bonds. The shape of the yield curve is closely scrutinized because it helps to give an idea of future interest rate change and

Box 10.1 What is a bond?—cont'd

economic activity. There are three main types of yield curve shapes: normal, inverted and flat (or humped). A normal yield curve (Figure 10.1) is one in which longer-term bonds have a higher yield compared to shorter-term bonds due to the risks associated with time.

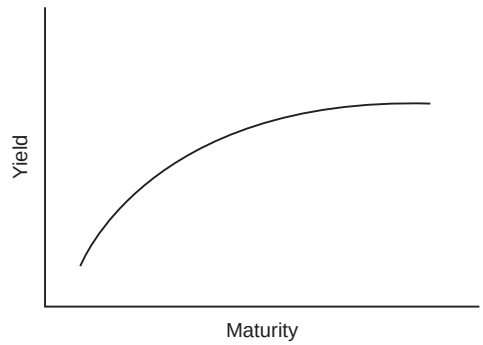

Figure 10.1 The yield curve
Source: Investopedia.com.

An inverted-yield curve is one in which the shorter-term yields are higher than the longer-term yields, which can be a sign of impending recession. This has recently been the case with the US yield curve, where the 2-year Treasury bond is yielding more than the 10-year Treasury bond. A flat (or humped) yield curve is one in which the shorter- and longer-term yields are very close to each other, which is also a predictor of an economic transition. The slope of the yield curve is also seen as important: the greater the slope, the greater the gap between short- and long-term rates.

Credit quality and rating

When evaluating a fixed-income security the credit quality is an important consideration, as the bond may not reach maturity for a number of years and during which time an investor needs to be secure in the knowledge that the bond issuer will pay interest payments on schedule and return the nominal value on redeeming said bond. There are many different types of bonds issued by various differing entities, and a credit rating provides a standard way of evaluating the credit-worthiness and financial soundness of issuers. There are rating agencies (such as Standard & Poor's, Moody's and Fitch) that assign ratings to many bonds when they are issued and monitor developments during the bonds' lifetime, measuring the willingness and ability of the issuer to make interest and principal payments when due. The highest rating (i.e. the bond least likely to default on payment, also known as 'default risk') is AAA for S&P and Aaa for Moody's. It then proceeds down the rating scale – AA+, AA, AA–, A+, A, A–, BBB+, BBB, BBB–, BB+, BB, BB– and so on. Any rating equal to or above BBB- is known as 'investment grade', and represents those entities with low probability of default. Ratings equal to or lower than BB+ are known as 'high-yield bonds' or 'junk bonds'.

Types of bonds

There is a broad range of types of bonds, which can be described in the following categories:

- Bonds issued by governments or sovereign entities, which go by various titles – UK, Gilts; USA, Treasuries; Germany, Bunds; Japan, JGBs; France, OATs.

Continued

Box 10.1 What is a bond?—cont'd

These securities are thought to pose the least risk to investors, as governments are generally thought of as trustworthy issuers who will provide interest payments annually and return the nominal value at redemption. There are, however, many more bonds issued from smaller emerging market countries, some of which are far riskier, including Columbia and Ukraine. There is also a class of 'quasi' government bonds issued by non-governmental organizations such as the World Bank and the European Investment Bank, which are often compared to sovereign debt for their similar characteristics.

- Index-linked bonds. A number of governments also issue index-linked bonds, which are linked to the rate of inflation. In the US, these are known as TIPS (Treasury Inflation Protected Securities); in Europe they are known as Linkers.
- Local government bonds. These have virtually disappeared in the UK, but are more common elsewhere – especially in the US and Canada.
- Floating rate notes. These are bonds that can be issued by governments or companies without a fixed coupon – i.e. the interest payments are not a fixed amount but usually quoted as some percentage over the rate of LIBOR (London Interbank Offer Rate).
- Corporate bonds. These are bonds issued by corporations to finance their spending or investment, and currently account for more than 50 per cent of the UK fixed interest market. It is here in particular that the credit rating of the issuer becomes important. They are divided into two main rating categories – investment grade and high-yield bonds – with the rating for each bond depending on the financial conditions, management, economic and debt characteristics of the company. High-yield bonds represent higher default risk, and were established to provide bonds for more speculative and higher-risk companies. They often trade at either a substantial discount or higher coupon, to reflect the additional risk being taken by the investor.
- Securitized bonds or asset-backed securities. In this area, cash flows from various types of loans and payments (mortgages or credit-card payments, for example, and also recording revenues like the famous 'Bowie' bond) are bundled together and resold to investors as securities.

Bonds, although not traded or listed on a Regulated Investment Exchange, which is the common place for equities, are dealt through dealers who are regulated by the FSA. The fixed interest market is much larger than the equity markets in most countries; in the UK it is approximately 4.5 times larger. Bonds form a key part of professional portfolio construction, providing income, diversification, protection against economic slowdown when other investments can be affected, and (for index-linked bonds) protection against inflation. The asset class, unlike many equity markets, is still growing with increased popularity from companies of all sizes.

Source: Justin Urquhart-Stewart, Marketing Director, Seven Investment Management.

Organizations in the financial services sector concentrate on the development of products and services which meet these particular needs. However, to be successful it is not enough just to have products that meet these very basic needs. Organizations must also seek to understand customers' wants and preferences, and identify ways in which they can make the product particularly attractive and convince the customer to purchase. In order to understand how organizations can make their products attractive to customers, we must understand the nature of the product itself.

10.2.2 What organizations can provide

Organizations provide products to meet customer needs. One common way of thinking about products is to see them as a series of layers surrounding the central core:

1. *The core*. The core product represents the basic need that is being provided – in the case of a bank current account, the core product is money transmission. At the core-product level, all organizations in the market are basically the same – all current accounts offer money transmission, all credit cards offer the opportunity to delay payment, and all unit trusts provide an investment opportunity.
2. *The tangible product*. The next layer of the product is usually described as the tangible product, and at this level the organization will make the product identifiable by adding certain features, facilities, brand name, etc. The products of different organizations will be slightly differentiated although, from the consumers' perspective, all the features offered in this layer are what they would expect as a minimum before purchasing. This suggests that it would be difficult really to differentiate products at this level.
3. *The augmented product*. The third layer, which is described as the augmented product, is usually used to refer to those features which organizations add to make their products distinct from the competition, such as the special customer service offered to holders of platinum credit cards. It is at this level that an organization hopes to gain a competitive edge by offering attractive features that competing products do not offer. Of course, as explained in Chapter 3, this is difficult because of the ease with which the features of financial services can be copied.
4. *The potential product*. The final layer of the product is described as the potential product. This refers to features that are either very new or not yet available, but which can potentially be added to a product to make it very distinct.

An illustration of these different layers is shown in Figure 10.2. In Figure 10.2, the financial service being illustrated is a unit trust. The core element of a unit trust is that it provides customers with a way of investing existing wealth and generating a return in the future. The tangible elements would include an association with a specific supplier (branding), a choice of investment realization method (income v. capital growth), projected returns, accessibility, etc. The augmented element would then incorporate additional features which go beyond those that would be expected by the consumer. In the case of a unit trust, this might include the option to invest only in environmentally responsible companies. Finally, the potential product might include a facility that allows consumers to buy and sell over the Internet.

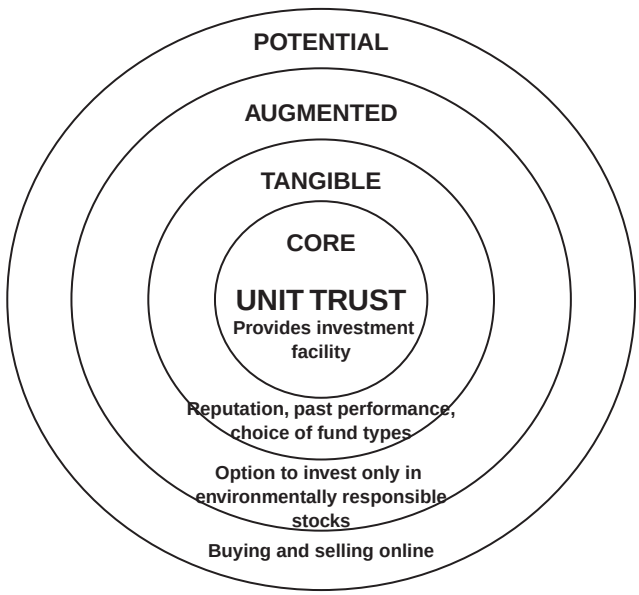

Figure 10.2 The service product.

Based on this way of thinking about products, marketing managers must:

- understand the core benefit that their product offers, and the needs of customers
- identify the tangible elements that consumers would expect the product to offer
- identify augmented product features that would provide the basis for differentiating the product
- monitor developments that could provide the basis for potential future features.

In performing these tasks, it is important to be aware of the distinctive features of services (discussed in Chapter 3). In particular, there is a clear need to create some tangible representation of the product for consumers, and also to address the issues that arise in relation to the variability in quality.

10.3 Islamic financial instruments

In Chapter 2, the range of conventional financial services was discussed in some detail. Such products are widely available across many different markets worldwide, and have been so for some time. In addition, over the past 30 years a new range of financial services has emerged that is structured around Islamic principles. Islamic financial services in themselves are not new, but their widespread development owes much to the pioneering work of the Central Bank of Malaysia, Bank Negara (Hume, 2004). The core product for an Islamic financial service is the same

as the core product for a conventional financial service. Murabaha and a mortgage will both fulfil the consumer's need to purchase an asset and pay for it in the future, but operate in rather different ways. In particular, since paying or receiving interest is against the teaching of Islam and is thus *haram* (unlawful), financial institutions use alternative, non-interest based approaches to providing Islamic financial services (see, for example, Mills, 1999). The following are examples of some of the main approaches to the provision of Islamic financial services:

1. *Murabaha*. This is an alternative to conventional loans, and is sometimes referred to as cost plus financing. Under *Murabaha*, the bank purchases the goods which the customer requires from a third party. The bank then sells the goods to the customer for a pre-agreed (higher) price with deferred payments. Customers wishing to deposit money with a bank may make deposits into a Murabaha fund, and then will share in the returns from such transactions. In Malaysia, Bay Bithamin Ajil (BBA) is the most common form of Murabaha, with payments being made in instalments sometime after the delivery of the specified goods. Arab Malaysian Bank's al-taslif Visa card is a product based on BBA financing, while Bank Muamalat offers both house purchase and fixed asset purchase on BBA principles. In the UK, the Islamic Bank of Britain provides unsecured personal lending based on Murabaha, while Al Baraka Islamic Bank in Bahrain provides financing for commercial clients to purchase finished goods, raw materials, machines or equipment on the same basis.
2. *Musharakah*. This is a form of equity funding (partnership finance) in which both a business and a bank invest in a particular venture. The profits are be shared between both parties, and both parties bear any losses. This is probably the purest form of Islamic financing, with return being uncertain and both parties sharing the profit and the loss. Jordan Islamic Bank offers Musharakah-based financing to commercial clients, as does Emirates Islamic Bank.
3. *Mudarabah*. This is a contract between provider of capital and an entrepreneur. The provider (referred to as the *rabb al-mal*, or the sleeping partner) entrusts money to the entrepreneur (referred to as the *mudarib*, or the working partner) in connection with an agreed project. When the project is complete, the *mudarib* returns the principal and a pre-agreed share of the profit to the *rabb al-mal*. Any losses are borne by the *rabb al-mal*. The operation of Mudarabah with the bank as the provider of capital is a basis for making loans. Where the depositor is the provider of capital and the bank is the entrepreneur, then Mudarabah serves as a basis for taking deposits – as, for example, with Arab Malaysian Finance's GIA Quantum deposit service or Affin Bank's Tiny Tycoon Savings account.
4. *Al-Ijara*. This is a form of leasing finance. The bank will purchase the asset required by the customer and then lease the asset to that customer at a pre-arranged rate, with the asset to be used productively and in ways that do not conflict with Shari'ah law. Emirates Islamic Bank is one of many banks that provides leasing for equipment, vehicles, etc. on the principles of Al-Ijara.
5. *Qard Hasan*. This is a beneficial (interest-free) loan in which the borrower is obliged to repay the principal to the lender, but any additional payment is entirely optional. Qard Hasan loans are offered by most Islamic banks, although are often restricted to particularly needy customers. Qard Hasan loans are usually funded through some bank capital, and also through *zakat* donations.

6. *Amanah and Al Wadi'ah*. These approaches are both concerned with guaranteeing and securing a sum of money. In practical terms, products based around Amanah (in trust) and Al Wadi'ah (safe-keeping) are similar. They all guarantee the return of the principal (whether an individual takes a loan or makes a deposit), but there is no additional payment. Affin Bank bases its current account on Al Wadi'ah, while HSBC bases its Mastercard on Amanah.
7. *Al Kafalah*. These are effectively documentary credits, but with a non-interest-based commission. Most commercial banks will offer these letters of credit for a variety of business activities.
8. *Takaful*. This is a form of Islamic insurance based on the Koranic principle of *Ta'awon*, or mutual assistance. It provides mutual protection of assets and property, and offers joint risk-sharing in the event of a loss by one of its members. In Takaful, the equivalent of insurance premiums (donations) are divided between two funds. A small part of the donation is paid to the mutual fund, and this fund is used to make payouts should the insured event happen. The larger part of the donation is paid into an investment fund, and the surpluses from the investment fund are subsequently equitably distributed between the participants and the insurer according to the principles of al-mudarabah. The size of individual donations is dependent upon both risk factors (such as health and lifestyle) and the desired compensation (amount payable on death).

It should be clear that these financial instruments can meet the same set of financial needs as conventional products. What makes these financial instruments distinct is the avoidance of interest payment and a reliance on an approach which is much closer to equity-based finance, such that both parties effectively share the risk element. For many Muslim customers this approach to providing financial services is very attractive, because it is consistent with religious beliefs. Increasingly, products provided on Islamic principles are also proving attractive to non-Muslim customers. In Malaysia, for example, it is estimated that as much as 70 per cent of Islamic finance is actually supplied to non-Muslims (Hume, 2004). At the same time, some customers are concerned about the apparent risk associated with many Islamic financial services. While these risks are very small in practice, their existence does mean that the marketing of Islamic financial services must emphasize safety and security and try to reduce consumers' perceptions of risk – particularly if the bank or insurance company wishes to extend its target market beyond Muslim customers.

10.4 Influences on product management

Financial services organizations will look to develop services that meet some or all of the financial needs of some or all customer groups. Some organizations will concentrate on serving a subset of customers (described in Chapter 8 as market specialization). Some organizations will focus on a subset of needs (described in Chapter 8 as product specialization). A small number of organizations – typically the major banks – will attempt to serve the majority of customer groups and meet the majority of customer needs.

Table 10.1 Product lines at Southern Bank Berhad

Savings	Investment	Current account	Home loans	Credit cards
Regular Savings Account Teen-in-Charge Maxplus Savings Maxplus Two-in-One	Regular FD Golden Time Deposit Maxplus Fixed Deposit	Regular Current Account	SUMO 1 Home Sweet Home	Gold Mastercard Mastercard Classic Eco Gold Mastercard Eco Mastercard Classic Espre Gold Mastercard Espre Mastercard Classic Jordan Gold Mastercard Honda Gold Mastercard Gold Visa Visa Classic

To meet the selected needs of selected customers requires a range of differing products. A simple example of the product range that might be offered to personal customers is presented in Table 10.1, for the Southern Bank Berhad in Malaysia.

The *width of the range* refers to the number of different broad product types or lines (savings, investment, credit card). Each type or line will consist of a number of related products, and the number of such products determines the *length of the line*. In the case of Southern Bank Berhad, the credit card line consists of ten different variants, while the savings line consists of only four different individual products.

A key aspect of product management is to make decisions about the development of this range to ensure that the organization maintains and improves its competitive position. As explained in the introduction to this chapter, this involves both strategic and tactical decisions and covers a broad range of activities. For the purpose of this discussion, product management will be discussed under two broad headings:

1. *Management of existing product lines*. This includes product design (features, quality, brand, points of differentiation, etc.), product modification (checking product performance and making adjustments to product design where necessary) and product line management (addition of new variants of existing products).
2. *Product range management*. This focuses on the overall choices regarding the range of products to offer. Of particular importance in this area are the introduction of new products and the removal of older, poorer-performing products.

While each of these aspects of product management will be considered separately later in this chapter, it should be recognized that they are necessarily interdependent; product attribute decisions have implications for the product range, and decisions relating to the product range will also have implications for aspects of the new product development process, managing products over their lifecycle, and product elimination.

Chapter 5 introduced the concept of the product lifecycle (PLC). The PLC has many detractors, whose issues with the concept are threefold. First, there are those who argue that the progress of a product through the stages from growth to decline and extinction has more to do with poor quality marketing of the product than with any immutable law concerning its natural life. This flawed marketing approach is often in evidence in companies that have direct sales-force distribution. A new product is launched and, if successful, the product manager responsible is promoted and the product loses its champion. Additionally, with perhaps an annual rate of sales-force turnover of 40 per cent, within a couple of years most of those present at the initial product launch have left the company. Meanwhile, another new product has been launched to a largely new sales-force, and the previous 'new product' loses a major part of its distribution capability. Unsurprisingly, the previous 'new product' goes into rapid decline.

The second group of critics is often to be found in the packaged goods domain. These people simply see no reason why, so long as there is a need for the product and it is properly marketed, it should not achieve growth on an indefinite basis. Mars has always been of the view that the PLC does not apply to its brands. Having been launched in the UK in the early 1930s, the Mars Bar continues to flourish as a brand over 70 years later. Mars ensures that successive generations of brand managers conform to what might be termed a policy of 'brand husbandry' to ensure that the legacy of the brand is maintained to ensure its continuing success.

The third issue cited by detractors from the PLC concept is that, with an established product, it is very difficult to determine at precisely what stage in the lifecycle the product has reached. For example, if a product's sales level is at roughly the halfway point in the growth phase, how can you tell whether it is about to enter its maturity phase or has several years of continued growth ahead of it?

While noting these criticisms, the PLC has its uses, when handled with due caution, as a conceptual device to determine how to structure and make adjustments to the marketing mix in support of a product. For example, the pre-launch mix will place a great deal of emphasis upon gaining distribution and staff training. During the launch phase, there will be heavy use of the promotional elements of the mix to achieve awareness and encourage a desire to find out more about the product. In the tangible goods field, this is a phase when there may be a lot of money spent on sampling and special price promotions to encourage trial purchase. As growth continues, there may come a time when additional features could be introduced to the product to refresh it and revitalize interest by distributors and consumers. A prolonged period of flat sales may indicate the need to reposition the product, possibly in conjunction with product performance improvements.

Like any aspect of marketing, the product management process will be influenced by a range of external factors; in particular, it will be important for organizations regularly to monitor customers, competitors and the external and internal environments to identify new ways of meeting consumer needs. Equally, of course, product management must be based on a clear understanding of the organization's strengths and weaknesses. Each factor is considered here in turn.

1. *Customers*. Consumer needs, wants and expectations are a major influence on product management. In personal markets, factors such as customers' tastes and preferences, lifestyles, patterns of demographic change and income levels will be of particular importance. For corporate customers, marketing managers must focus on the objectives and strategies of customers and on understanding the

environment in which customers' businesses operate in order to identify likely financial needs. Understanding consumers, particularly retail consumers, can be very difficult. Financial services are often complex and seen as uninteresting, and are therefore difficult to research. One important factor to take into consideration is the idea of trying to understand consumers' changing lifestyles and the implications that these will have for customer financial needs. For example, an awareness of the increasing time pressure on many consumers and the increased desire for flexibility should lead banks consistently to look for ways of delivering service in a more flexible and convenient fashion (24-hour ATMs, WAP phones, Internet, etc.).

2. *Competitors*. The regular monitoring of competitors is an important source of information for product managers, for several reasons. First, changes in a competitor's product range and product features will indicate a possible change in the pattern of competition. Secondly, because it is relatively easy to copy financial services, monitoring what competitors are doing can be an important source of new product ideas.
3. *External environment*. The importance of the external environment and its influence on marketing strategy was discussed at length in Chapter 4. Marketing managers must be aware of general trends in the environment so that they can identify new threats and opportunities. For example, China's accession to the WTO created a major opportunity for non-domestic financial services providers to access a market with one of the highest savings rates in the world. Similarly, the development of WAP technology provided an opportunity for the development of a new method of distribution. In contrast, the progress of the EU policy to create a single European market in financial services might be regarded as a significant threat by many domestic providers.
4. *Internal factors*. As explained in Chapter 5, understanding internal factors is important because it defines what is possible. To make good product decisions, managers must have a clear understanding of the resources available to the organization and its particular strengths and weaknesses in order to understand how best to respond to a particular opportunity or threat. Thus, for example, Prudential's strengths and track record in life insurance and investment management give the company a strength that it has been able to match to emerging market opportunities in countries such as Vietnam, Thailand, Indonesia and the Philippines.

This analysis of self, customers, competitors and the external environment is a continual process. Marketing managers must keep abreast of these factors and consider how best to respond to key changes. It is not operationally or financially feasible for an organization to react to every change in the marketing environment; at the same time, no organization can afford to miss key opportunities that may be presented by legislative, social or economic change.

10.5 Managing existing product lines

The management of existing product lines covers two broad areas: the first deals with decisions about the features to attach to a particular product; the second deals

with product line management and, in particular, issues relating to product modification and line length modification.

10.5.1 Product attributes

One of the most basic sets of decisions relates to the choice of product attributes (features, brand name, quality, etc.). These attributes are used to create a tangible or augmented product, as described earlier in this chapter. Thus, the generic service product (life insurance, for example) has to be developed into some tangible or augmented form (General China's GC Living Assurance Plan, for example) through the addition of various features such as cover for total and permanent disability, premium waivers in the event of disability and so on.

The features that are offered as part of a particular service product are one means of differentiating the service. Thus, for example, the main distinction between NatWest Current and NatWest Current Plus is that the former pays no interest on cash balances but has a slightly cheaper overdraft rate and therefore is suited to consumers who hold small amounts of surplus cash and overdraw regularly. By contrast, the Current Plus account pays interest but charges a higher overdraft rate, and therefore is more suited to those customers who have larger cash balances and do not overdraw.

However, the actual range of distinct features which can be attached to a particular financial service is limited and may not provide a long-term basis for differentiation, since such features are easily copied. Offering interest payments on chequeing accounts will be an extra attraction for customers, but is one that can easily be copied by competitors. It therefore becomes very difficult to differentiate in terms of product attributes. Thus, any attempt to differentiate a product at the expected or augmented level must look beyond simple product features and consider instead issues such as quality, branding and organizational image.

Quality is regarded as an increasingly important product feature, and refers to the ability of a product to perform its intended task. As explained in Chapter 15, quality in the service sector in general, and in financial services in particular, can be a rather more complex concept. Some researchers (Grönroos, 1984) suggest that customers should assess service quality based on both technical and functional quality:

- technical (or outcome) quality is concerned with how the product performs (e.g. does a capital growth investment trust provide an acceptable rate of capital growth?)
- functional or (process) quality is concerned with the way in which the service is delivered, and might include factors such as the way staff behave towards customers, and the speed of response to questions.

Often, the way the service is delivered (process) can be every bit as important as the technical quality of the product itself.

Branding is well developed in the marketing of products, and is now increasingly important in financial services. Branding has particular value because it provides a means of creating a clear identity in a competitive marketplace. It is important to recognize that branding is more that just creating a memorable name. Effective branding

aims to create a relationship between the product and the customer; when that relationship exists, the brand provides a means of communicating information about quality, differentiating the product from the competition and encouraging customer loyalty. For many financial services providers, it is the perceived strength of their brand that provides a justification for the move into bancassurance. Thus, the strength of the Banco Santander brand in Spain provides a basis for customers to choose insurance-related products from the bank as opposed to dealing with a specialist insurance provider.

In the financial services sector, it is arguably the customer's image of the organization that is the most important type of branding available. Most financial products are identified primarily by the supplier's name, and where individual product brands are created (such as Citibank EZ Checking and Citibank Everything Counts), these are typically a combination of both company name and product name. The company name is seen as being of particular importance in branding because of relatively high levels of recognition in the marketplace and the potential to exploit the overall corporate reputation. Despite the undoubted importance of brand in financial services, research in the UK suggests that financial services brands are relatively weak, lack relevance to customers and fail to build a strong emotional bond with target markets (Devlin and Azhar, 2004). This research highlights the importance of thinking carefully about the best way to connect with customers and differentiate a brand from the competition. Making a connection with customers relies on emotional appeal as well as appeal based on the functional values of products, and most financial services organizations have not adequately developed such appeal (Dall'Olmo Riley and de Chernatony, 2000; O'Lauglin *et al.*, 2004). Traditionally, financial services organizations have relied very heavily on functional values such as size and longevity. While these are clearly important in building trust and confidence, they are probably not enough to create a real connection with consumers. Indeed, Devlin and Azhar (2004) suggest that the relative success of non-traditional entrants into financial services is that their brands are much better developed, much more clearly differentiated and much more able to connect with customers. For example, the Virgin group has seen significant success in the financial services sector, building on its brand image of unconventional customer champion.

10.5.2 Product modification/product development

Once a product is established, there are two broad areas that require attention: product modification and product development. Product modification is concerned with changing the attributes of a product to make it more attractive to the marketplace. Product development involves creating a new variant of an existing product, and is typically associated with either product-line stretching or product proliferation.

Product modification in financial services aims to improve the performance of an existing product. This may mean making the service easier to use (fixed annual repayments on existing mortgages, for example), improving the quality of the service (personal account managers for corporate clients) or improving the delivery system (redesigning an on-line banking site to make it more useable). With increases in competition and with high consumer expectations, product modification is important for organizations seeking to maintain and expand the customer base.

Obviously, if a product is at the mature or decline stage in its lifecycle then additional expenditure on that product may be risky. At the same time, trying to develop completely new products is also risky, so an approach that concentrates on modifying existing products can be very attractive.

Product-line stretching or product proliferation involves adding new services to an existing service line, and has traditionally accounted for much of the new product development activity in financial institutions. One widespread example of this form of activity is the development of premium bank accounts providing customers with a range of additional services. For example, in addition to its Regular Savings Account, HDFC Bank in India offers a Payroll Account, a Classic Salary Account, a Regular Salary Account and a Premium Salary Account, each of which offers a slightly different set of features and attributes. The rationale for stretching a product line is to further differentiate existing products in order to appeal to more specific segments of the market. Since line stretching is a form of new product development in a market with which the organization is familiar, the risks tend to be relatively low.

There are dangers with line stretching. In particular, it is possible to identify a large number of segments among the consumers of financial services and develop variants of existing products to meet the needs of these segments. However, if these segments are not large enough or distinct enough to be viable, then the effect of line stretching may be to increase costs but not increase revenue. The organization will have too many different variants of a product, the product line will be long and difficult to manage, and this can cause confusion amongst consumers who almost face too much choice. Accordingly, product line management must be aware of the need to consider withdrawing existing products as well as introducing new ones. This is a particular problem in many areas of financial services owing to the extended lives of many products (see, for example, Harness and Marr, 200). For example, a company might launch a new mortgage product (let's call it the maxi-mortgage) and then, some time later, launch another new mortgage (the mega-mortgage). Unlike the tangible goods marketplace, the company cannot simply cease manufacture, run down stocks and remove the maxi-mortgage from its product range. Instead, it has to maintain the product for those customers who have already bought it and may well wish to continue using it for, say, the next 25 years. Such a product is known as a *legacy product*, and the world's established financial services companies are frequently burdened with the costs of running a plethora of legacy systems. This is why new entrants to financial services can often be highly cost-effective compared with their established rivals: they don't have to carry the legacy system cost burden. The implication of this is that new product development and launch needs to be based upon significant new products that can be expected to have a prolonged life for the provider. It is also important to design products and contracts in such a way as to facilitate migration of current products to newer variants in order to mitigate the legacy cost problem.

10.6 New product development

Developing new products is an important aspect of product management because it ensures that the range is up to date, innovative, and meets changing consumer needs. The term New Product Development (NPD) covers a range of types of

innovation; some new products are genuinely new, but others are actually developments of existing product. It should be borne in mind that innovation can be in areas concerning service features as well as utility features. In this section we will consider two specific types of new product development:

1. *Major innovations*, which are products that are new to the organization and new to the market. As such, while they offer great potential in terms of returns they are also more risky since they will typically require a much higher level of investment and the use of different and new technologies. They may also involve the organization moving into areas in which it is comparatively inexperienced. Such major innovations are rare in financial services. Critical illness insurance, launched in the 1980s, was one such product, as were equity release and the launch of the Virgin One offset account in the 1990s, both having spawned a range of variants. Box 10.2 outlines some of the key features of one of these innovations, namely equity release.

Box 10.2 Equity release as a financial planning option for the elderly

Equity release is a sector of the UK financial environment that is growing rapidly. For many years it has been common for homeowners to extend their mortgage commitments in order to release equity from their property. Historically, the funds released in this way were typically used to fund home improvements such as building extensions or loft conversions. More recently, household equity has been released to fund a much wider array of purposes, including the purchase of second homes, cars and even aspects of current consumption. However, the focus here is on older homeowners who do not intend to draw down equity with intent to repay during their lifetime, but instead trade off the value of their housing asset which would otherwise have been inherited through their estate. This affords them the ability to enjoy the spending power locked in their home in the shorter term.

Market drivers

In common with many European countries, in the UK there are increasing concerns about the adequacy of retirement income provision. Two distinct types of generic customer have emerged: the 'needy', who have a specific and urgent need for funds not available from elsewhere for property maintenance, medical care or other pressing requirements; and 'lifestyle' customers, who wish to use releases to improve or maintain their standard of living.

The new generation of retirees are increasingly seeing their home as an investment that they have worked many years to acquire, and feel it is their right to draw on its value as an asset rather than pass it on as an inheritance. These factors combine to create a favourable environment for the development of equity release.

Market development

The total amount released has grown from £33m in 1995 to £1.5bn in 2005, and is forecast to grow to £5bn by 2010 (Northern Rock Plc forecast, December 2005).

Continued

Box 10.2 Equity release as a financial planning option for the elderly—cont'd

There are two main product types that dominate the market as methods of releasing equity:

1. Lifetime mortgages – interest is allowed to roll-up during the term of the loan and the total accumulated debt is repaid when the borrower dies, moves into long-term care or sells the property. The transfer of risk and the long-term nature of the fixed rate funding mean that interest rates are slightly higher than for conventional fixed-rate mortgages. For example, in December 2005 a fixed-for-life rate for a typical lifetime mortgage had an interest rate of 5.89 per cent, compared with 5.19 per cent for a 15-year fixed rate for conventional house purchase purposes.
2. Reversions – the reversion provider purchases either all or a share of the property, so technically the transaction is not a mortgage but a sale. The seller enjoys the same right of continuing occupation as with a mortgage, but does not pay rent. Consequently, the purchase price paid by the provider is discounted from the market value; the discounted value is actuarially calculated to reflect the life expectancy of the seller.

Lifetime mortgage selling standards have been regulated by the Financial Services Authority since October 2004. Similar regulation will apply to reversions from 2006/2007. When both types of product are regulated, reversions are expected to represent 10–15 per cent of the market – significantly more than recently.

Competition

The structure of the market for lifetime mortgages reflects its lack of maturity, with three dominant lenders, Mortgage Express, Northern Rock and Norwich Union, each holding approximately 25 per cent market share, the remainder being split between a number of other lenders. A greater degree of competition is anticipated as some of the major mortgage brands enter the market. There is also an increasing amount of innovation in product development taking place, with Northern Rock being particularly active.

The reversion market is far more fragmented, with business spread across a number of smaller providers. The absence of any major brands seems to have inhibited this market; however, the entry of Norwich Union into this sector in 2005 is likely to give it new stimulus.

Similar equity release products to those outlined above have been available in the USA for a number of years (known as 'reverse mortgages'), and during 2004/2005 Australia, New Zealand and Sweden also saw the emergence of similar products.

Source: Bob Wright, Assistant Director, Northern Rock Plc.

It is interesting to note that governments have often been the source of major new product developments for the industry. For example, in the UK the Thatcher government of the 1980s was largely responsible for the huge growth of the personal pension market. Similarly, that same government also devised the Personal Equity Plan (PEP) and the Tax Exempt Savings Account (Tessa). Not to be outdone, the government of Tony Blair has thus far introduced the Stakeholder Pension, the Individual Savings Account (ISA) and the Child Trust Fund. The so-called Sandler suite of stakeholder products represents a major initiative on the part of the Blair government to provide a set of easy-to-understand products that represent good value for money for unsophisticated consumers.

Britain is not alone in this, as governments around the world play a major role in product development. The Polish government has introduced the IKE personal pension account. The IKE is one of the forms of the Polish government's third level of pensions, and can be in a form of a life insurance policy or different kinds of bank investments or investment funds. There are tax allowances – for example, no capital gains tax is payable when consumers receive their accumulated fund on retirement, but if they want to withdraw money beforehand then they pay the tax. The Ghanaian government has brought out a students' savings account, while in Libya the government has been responsible for the introduction of new tax-advantaged loans for home purchase.

As well as being responsible for the introduction of new products, governments also influence product policy in other ways. For example, the stakeholder products mentioned above place price caps on the charges that may be levied on the products that comprise the range. Similarly, regulations have had a major impact, notably at the service feature level, by introducing rules such as hard disclosure of charges and commissions, and rules regarding fact-finding.

Arguably, it is in the area of service features that innovation has had the most noticeable effect upon the customer experience. For example, innovation in telephone and Internet banking, ATMs and call-centres have probably affected customers more profoundly and directly than utility feature innovation in recent years.

2. *New service lines.* These are products that are new to the organization but not new to the market. Sometimes they are referred to as 'me too' products, and this aspect of product development has been more in evidence than wholly original product development during the past. Since there are competing products already established in the market the potential returns may be lower, but at the same time the organization is moving into an area with which it is considerably more familiar, in terms of either the technology or the markets. It is probably one of the most common forms of NPD in the financial services sector, particularly so as regulatory changes have reduced some of the restrictions on what organizations can do. For example, a number of competitors have copied the offset account that was originally devised by Virgin. Indeed, it is impossible to recollect a single new product that has not been taken up by any number of rival companies. The same goes for product features and fund variants. No sooner was the first ethical fund launched in the late 1980s than a range of analogues gradually entered the market.

The factors that influence the success of new-product development programmes in financial services have attracted considerable research interest. Athanassopoulos

and Johne (2004) highlight the importance of customer involvement at an early stage, and the significance of communications with key or lead customers. The importance of leadership, teamwork and empowerment were highlighted in a study of consumer banking in the UK by Johne and Harborne (2003). In the case of Thailand, Rajatanavin and Speece (2004) have highlighted the important role played by sales staff as a conduit for customer information, and also the importance of cross-functional teamwork.

Whether considering genuine innovations or the addition of new service lines, there are many benefits from operating a structured process to consider which developments are most suitable. The basic components of a new-product development process are outlined in Figure 10.3.

1. *New-product development strategy*. A clear strategy is important to ensure that all those involved understand the importance of NPD and what the organization wishes to achieve. For example, it is essential that all those involved should understand whether the process of NPD is to be orientated towards taking advantage of new market segments, seen as crucial to the continued competitiveness of the organization, required to maintain profitability, or designed to reduce excess capacity or even out fluctuating demands. The ideas that should be considered are likely to vary according to the purpose of the NPD programme.
2. *Idea generation*. Ideas may be generated from both inside and outside an organization. Ideas may be generated internally from specialize NPD teams, from employee feedback or suggestions. Externally, ideas may be generated based on customer feedback, market research, specialist new product development agencies or by copying competitors. One common failing in idea generation is a tendency to

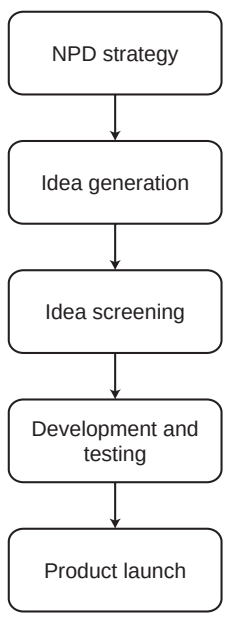

Figure 10.3 The new-product development process.

focus on what is possible rather than what the market wants – this has been particularly apparent with new technology-based products, where too much attention has been paid to what the technology can do and not enough to what consumers want.

3. *Idea screening*. The variety of ideas produced at the idea-generation stage must be screened to check that they are suitable. This usually means deciding, in advance, a set of criteria to be used when ideas are evaluated. The sort of criteria used can vary, but questions asked are likely to include the following:
   - Does the idea fit with the organization's strategy?
   - Does the idea fit with the organization's capabilities?
   - Does the idea appeal to the right market segments?
   - Is the idea viable in terms of cost and profit?

   Often the screening process passes through several stages; initially all ideas are screened, using simple criteria to eliminate any obviously unattractive suggestions. The remaining ideas are then screened much more thoroughly, involving a more detailed examination of their operational and financial viability, and often some product-specific market research.
4. *Development and testing*. Ideas that have survived the screening process are then worked up into specific service concepts – that is to say, the basic idea for the new product must be translated into a specific set of features and attributes which the product will display. At this stage it is common to test this newly defined product and to identify consumer and market reactions in order to make any necessary modifications to the product before it is launched. The problem with test-marketing in the financial service sector is that it gives competitors advance warning of an organization's latest ideas and thus offers competitors the opportunity to imitate. As a consequence, test-marketing of financial services is comparatively unusual. Many organizations argue that the actual costs of developing new products are often low, but the losses from giving advance warning to competitors may be quite high.
5. *Product launch*. The product launch is the final stage and the true test of any newly developed product; it is the point at which the organization makes a full-scale business commitment to the product. At this stage, the major decisions are essentially of an operational nature – decisions regarding the timing of the launch, the geographical location of the launch and the specific marketing tactics to be used in support of that launch.

Effective new product development is clearly important to the maintenance of a competitive position. Consequently, the process of developing new products has been extensively researched and a number of important practices that contribute to success have been identified:

1. Maintain regular contacts with the external environment to identify changes in market characteristics and customer requirement
2. Encourage a corporate culture which is receptive to innovative ideas
3. Operate a flexible approach to management to stimulate and encourage the NPD process
4. Identify key individuals with specific responsibility for the NPD process

5. Encourage a supportive environment
6. Ensure support and commitment from head office/senior managers
7. Ensure effective communications both internally and externally
8. Choose a product that fits well with the company
9. Develop strengths in selling
11. Offer product quality
12. Use market knowledge and customer understanding.

These practices cannot guarantee success, but it is clear that an open, supportive and flexible approach to NPD, supported by good marketing at product launch, can contribute significantly to the success of NPD activities.

10.7 Summary and conclusions

The key to successful product management is the development and maintenance of an appropriate product range. This requires that a financial service be developed with a set of features which correspond to consumer requirements, and that this range is constantly monitored so that existing services can be modified and new services can be developed. The process of new product development in the financial services sector has tended to concentrate on the redesign of existing products within an organization's portfolio, and the development of products which are new to the organization though not necessarily new to the sector. The perennial problem that faces the provider of financial service products is the ease with which such products may be copied and the consequent importance of ensuring rapid market penetration in the desired segment when new products are launched.

Review questions

1. Choose a product with which you are familiar. What are the different layers in that product? Choose what you think is the main point of differentiation between this product and other competing products.
2. Why is line stretching an important part of product management? What are the risks associated with this approach to product management?
3. What are the key stages in the NPD process? Why is it useful to have an organized process for developing new products?
4. What are the main types of Islamic financial services? What do you see as the main challenges when marketing financial services?

11

Promotion

Learning objectives

By the end of this chapter you will be able to:

- explain the basic principles of communication for marketing
- examine the process of planning a promotional campaign
- provide an overview of the strengths and weaknesses of different approaches to promotion for financial services.

11.1 Introduction

The term 'promotion' refers to the range of methods used by an organization to communicate with actual and potential customers (e.g. advertising, publicity/public relations, personal selling and sales promotion) in order to evoke an attitudinal position and an appropriate behavioural response. In service businesses in particular, internal communication and promotion is also important in helping to build a market orientation. Thus, promotion (or marketing communications) increasingly focuses attention on employees as well as customers. Marketing communications play a key role in the process of building a brand and giving value to that brand, both by creating awareness and also by building favourable images/associations in the minds of customers. Building a clear brand image or brand association in the minds of consumers (and employees) depends on a high degree of co-ordination across promotional activities. The message presented by TV advertising needs to be consistent with what press advertising says, with what sponsorship implies and with the message communicated by sales staff. As with the marketing mix overall, if marketing communications are consistent and integrated, the impact of the overall campaign will be that much greater (synergy). Indeed, the concept of integration has attracted so much attention in recent years that

practitioners increasingly refer to 'integrated marketing communications' (IMC) rather than just 'marketing communications'.

Promoting financial services is very similar to promoting physical products in many respects. However, financial services organizations do face some significant challenges. As explained in Chapter 3, they have no physical product to present to consumers, and consequently a major requirement of promotion is to develop a message and a form of presentation which allows the organization to present a product that is essentially intangible in a tangible form. Furthermore, financial services can be difficult to differentiate, and this can make it difficult for an organization to develop a clear message about the superiority of its own products. Finally, consumers tend to be relatively uninterested in financial services, and this suggests that there may be a greater need to attract attention; thus, developing creative approaches to communication may be particularly important for financial services organizations.

This chapter addresses the issues surrounding the development of an effective promotional strategy in financial services. The following sections provide an overview of the communications process in financial services and examine the development of promotion campaigns. The relative merits of different forms of promotion are then discussed, followed by a summary and conclusions.

11.2 Principles of communication

From a marketing perspective, the term 'communications' refers quite simply to the way in which organizations are able to send messages to target markets. The communications process is most commonly thought to be concerned with telling consumers about the features, benefits and availability of a particular product and attempting to persuade them to make a purchase. Increasingly, however, it is being recognized that communication has a rather broader role to play. In addition to stimulating consumer interest in a product, the communications process is also concerned with the way in which an organization projects itself and the image and identity it seeks to create with various interest groups and stakeholders.

The communications process is outlined in Figure 11.1. The main components of this process are:

1. *Source* (or sender). The source is whoever sends the message. Usually this is the organization or its representatives. However, if publicity or public relations is the chosen form of communication, then the source may be presented as a quasi-independent body giving 'objective' support to the particular product or service.
2. *Coded message*. The idea that the organization wishes to convey through the communications process must then be coded, either verbally or in symbols, in a form that is understandable to the target audience. For example, Phillips Securities wishes to emphasize the safety aspect of their Asset Savings Plan, and to do so they rely on the words '*As Safe As Possible*' (virtually the same letters as the product name) and the image of a man with three inflatable life belts.
3. *Medium*. The medium describes the particular channel through which the message is transmitted, and may be either personal (sales staff) or non-personal

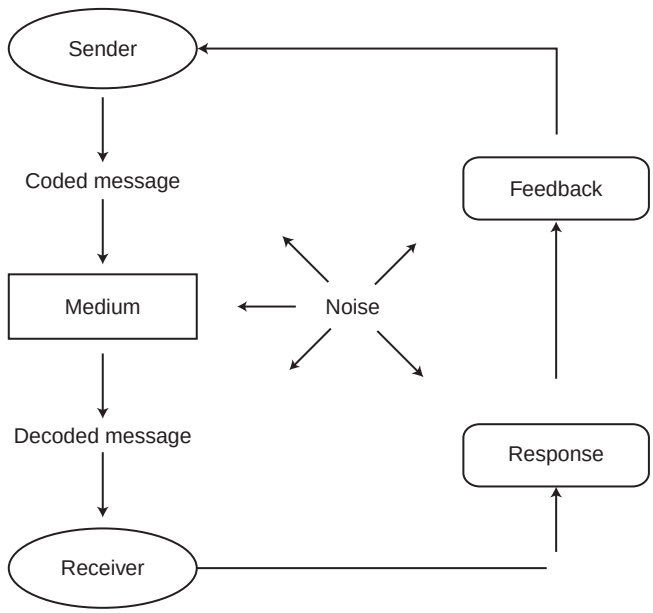

Figure 11.1 The communications process.

(advertising, publicity or sales promotion). The selection of an appropriate medium is crucial to ensure that the message reaches the target audience. Financial services targeted to a mass market will often rely on media such as TV, radio and general newspapers, whereas those services targeted at niche markets are likely to focus on more specialist media (e.g. *Investors' Chronicle*, *Mortgage Magazine*).

4. *Decoded message*. As the message is transmitted, the receiver interprets and assigns some meanings to the words and symbols that comprise that message. The sender hopes to encode the message in a way that results in the consumer interpreting the message in the way that was intended. This can be a particularly difficult task, since it relies on the sender being able to understand how consumers are likely to see the world.
5. *Receiver*. The receiver represents the target audience for the communications process. This may be a specific market segment, or the general public as a whole, or even the company's employees.
6. *Response*. Response describes the way in which the receiver reacts to the message, based on his or her interpretation of it. Typically, this refers to the sort of attitudes which the target audience forms in relation to the product.
7. *Feedback*. Some of the receiver's responses will feed back to the sender. Feedback may be in the form of enquiries or purchase if the message has been successful, but could equally be in the form of complaints if the message has been a failure or has been offensive.
8. *Noise*. Noise refers to any unplanned interference with the communications process which distorts the message. The presence of noise in any communications process is unavoidable. There will be few messages that are not distorted in some

way; the target audience may receive only part of the message being communicated, may interpret it in accordance with their own preconceptions and may recall only parts of the message. Effective communications will aim to minimize distortions by keeping messages brief, distinctive, relevant to the target audience and unambiguous.

Communication is essential in any marketing strategy to ensure that consumers are aware of what the organization offers (features, benefits, etc.) and how that offer is positioned in the marketplace. However, any form of communication can be misinterpreted or distorted. Thus, an effective communications strategy requires careful thought and planning to ensure that the organization has a clear and coherent message to present. This message must be clear, simple, honest and believable. Finally, of course, it is important that any promotional activity does not promise something that the organization cannot deliver. Apart from any legal implications that this might have from the point of view of advertising standards, etc., promising what cannot be supplied will lead to consumer dissatisfaction with the purchase and the potential loss of future consumers.

Although it is usual to think of communications as being concerned with particular products or services, a growing number of financial services organizations rely on communication and promotional activities to build a positive image and reputation for the organization itself. In effect, financial services organizations are placing greater emphasis on corporate branding, and marketing communications are becoming an important tool for building the corporate brand.

11.3 Planning a promotional campaign

The previous section highlighted the importance of a well-managed and planned promotional campaign to ensure that the communications process is effective. Careful planning is also important to ensure that the different methods of marketing communications are sending consistent messages, and that marketing communications are consistent with other elements of the marketing mix. The simplest way to think about the planning of a promotional campaign is to think of it as a series of stages, as shown in Figure 11.2 and described below.

11.3.1 Objectives

Defining objectives is important so that all involved in a promotional campaign know what they are trying to achieve. Often objectives are specified in terms of an increase in sales, but other objectives may concern themselves with raising awareness, creating a particular image, evening out patterns of demand, etc. In general, there are two broad types of objective that may underpin any promotional campaign:

1. Influence demand. Promotions may be directed explicitly towards influencing the level of demand for a service or range of services. Normally, this would imply

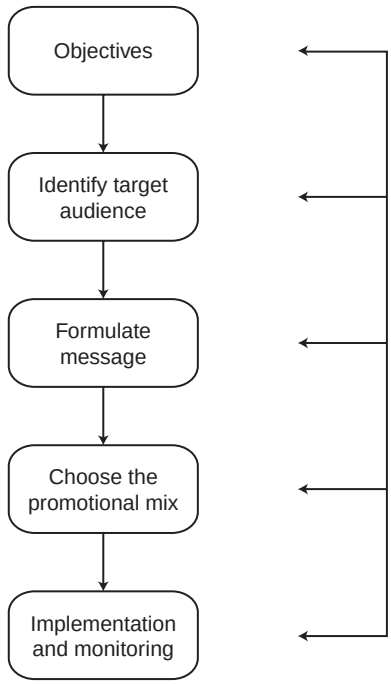

Figure 11.2 Planning a promotional campaign.

increasing the level of demand through attracting new customers away from competitors, increasing usage by existing customers, and encouraging non-users of the product to use.

2. Corporate image. Many promotional campaigns are directed towards creating and maintaining a particular corporate image. Such campaigns are particularly noticeable in the financial services sector because the characteristics of financial services (as discussed in Chapter 3) mean that organizations must pay particular attention to their brand and reputation.

As far as possible, objectives should be quantified. The guidelines given in Chapter 5 regarding the criteria for a suitably robust marketing objective are equally relevant for promotional objectives. This may simply mean specifying a target for increased sales volume or value. Alternatively, in the case of image-based objectives, targets may be set based on levels of awareness of the organization or on attitudes towards the organization.

11.3.2 Target audience

The next stage in promotional planning requires the identification of which groups are to be the target of the promotional activity – that is, which groups are to receive

the message. At one level, this may simply involve defining the target market for a specific service or specifying 'the general public' (if the promotion is concerned with corporate image). However, it is also important to recognize that there will be differences between consumers in terms of their knowledge and awareness of an organization's image and range of services. In particular, researchers have suggested that consumers pass through four different stages when considering a purchase. This is known as the AIDA model, because consumers are expected to moved from Awareness to Interest, to Desire and finally to Action. Defining the target audience should consider which stage in the AIDA sequence consumers have reached. A promotional message and medium which is concerned with creating awareness of (or interest in) a product is likely to differ from one that is trying to create a desire to purchase or stimulate an actual purchase.

11.3.3 Formulate message

Having identified the target audience, the next stage is to establish what form the message will take. Any message can be divided into two key components – the message content and the message form. The message content relates to the basic ideas and information that the sender wishes to convey to the receiver. It should make clear why the product is different, what benefits it offers and why the consumer should buy this product rather than one of the available alternatives. Once the basic content of the message has been established, the next stage is to consider the form this message should take. It is at this point that the creative input from outside organizations such as advertising agencies becomes important. This process involves finding the most appropriate combination of verbal, audio and visual signals that will present the content of the message in a form which is most suitable for the target audience. This means that great care must be taken with the process of encoding, to avoid possible misunderstandings. At the same time, the information must be presented in a form that will attract attention and maintain sufficient interest in an advertisement or a leaflet to enable the potential consumer to absorb the information being conveyed. Sometimes this may involve using humorous sketches or indirect comparisons with competitors, or it may simply focus on the product or the organization itself. For example, in the UK, Sainsbury's Bank uses a character, 'Little Bill', to promote its car insurance, playing on the fact that 'Bill' might refer to both a person and also the cost of the car insurance (see Figure 11.3). Financial services organizations often make heavy use of their staff in the creative element of advertising to emphasize the personal touch. Thus, for example, Halifax Bank uses a staff member, Howard Brown, to promote a range of financial services.

Accuracy and honesty in the design and presentation of a message is essential in any form of advertising, and arguably particularly so in financial services because consumers find the products complex and difficult to understand. Most countries have policies in place to protect consumers from the potentially detrimental effects of misleading advertising. Nevertheless, the accuracy and honesty of advertising continues to be a cause for concern. For example, a recent study of financial services advertising in the UK by business and financial advisers, Grant Thornton,

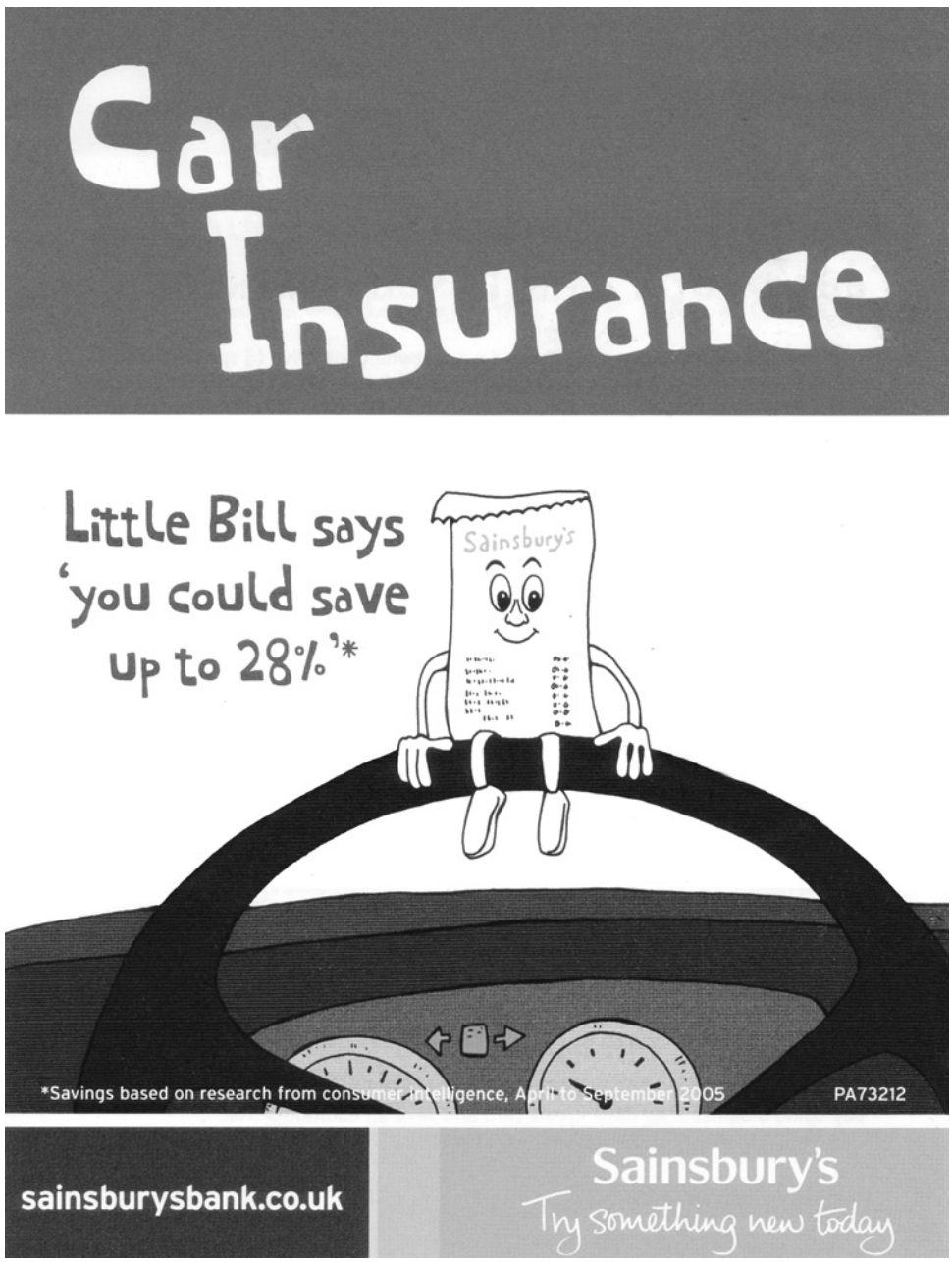

Figure 11.3 Sainsbury's 'Little Bill' promotion.

suggested that over three-quarters of financial services adverts were misleading and do not conform to guidelines laid down by the Financial Services Authority (Grant Thornton, 2006). Particular problem areas were misleading price comparisons, headline rates for products which in practice were not available to customers, excessive use of jargon, claims that could not be justified, and a failure to include warnings about risk.

11.3.4 Budget

A budget must be established for the promotional exercise as a whole, and, at a later stage, for the individual components of the promotional mix. There are no hard and fast rules for determining the size of the promotional budget and, even within the same broad market, organizations will vary enormously in terms of promotional expenditure. There are a number of different approaches to the formulation of promotional budgets, including:

1. *The affordable method*. This simply suggests that the organization's expenditure on promotion is determined according to what the overall corporate budget indicates is available. The organization basically spends what it thinks it can afford.
2. *Sales revenue method*. This approach sets the promotional budget as some percentage of sales revenue. By implication, this means that sales 'lead' promotion rather than promotion 'leading' sales – which is what might be desired. That is to say, the size of the promotional budget will be dependent on past sales rather than desired future sales.
3. *The incremental method*. The budget is set as an increment on the previous year's expenditure. This is widely used, particularly by smaller firms. However, it offers no real link between the market and promotional expenditure, and does not allow promotional or marketing objectives to guide the level of expenditure.
4. *The competitive parity approach*. This approach focuses on the importance of promotion as a competitive tool, and entails setting budgets to match those of competitors.
5. *The objective/task method*. This is probably the most logical approach to the establishment of promotional budgets, but perhaps also the most difficult to implement because of the complexity of many of the calculations. As a consequence, it is not used widely. It relies on specific quantified objectives, and then requires that a precise cost is calculated based on the activities required to achieve these objectives. The budget is then based on these costs, so that marketing managers have a precise budget which should allow them to achieve their stated objectives.

A growing number of researchers argue that the marketing budget in general and a promotional budget in particular should be seen not as an annual cost but rather as an investment (see for example, Doyle, 2000). This approach argues that many marketing activities, and particularly advertising, have a cumulative effect and pay a key role in building the brand. If the effects of promotional expenditure have an impact over a number of years, then it would be misleading to focus on costs on an annual basis.

11.3.5 Choosing the promotional mix

Having determined the appropriate level of promotional expenditure, this must be allocated between the various promotional tools available to the organization – namely, advertising, publicity, sales promotions and personal selling. This mix will vary across organizations, products and markets. While it is difficult to generalize, retail markets will often make more use of mass-communication methods such as advertising, sales promotion and public relations/publicity, while personal selling will be more important to corporate customers. In financial services, as explained in Chapter 12, personal selling is relatively widespread in retail markets for more complex financial services. However, mass forms of communication remain popular for the less complex products, such as credit cards, current accounts and savings accounts.

There is a high degree of substitutability between promotional tools, so organizations must consider the strengths and weaknesses of different methods of communication and choose the combination that is most appropriate to the particular product and market. The individual components of the promotional mix will be examined in more detail in the next section.

11.3.6 Implementation and monitoring

As with any plan, the final stage concerns the process of implementation and monitoring. Implementation concerns itself with the allocation of tasks and the specification of timescale. Monitoring focuses on the regular evaluation of the progress of the promotional campaign and the identification of any areas where changes may be necessary. The problem that faces many organizations is the difficulty of measuring the effectiveness of promotional activities. There is a number of approaches that might be used to assess the effectiveness of promotional campaigns:

1. *Pre-testing*. Pre-testing involves demonstrating the promotional campaign to selected consumers. Based on their response, the organization attempts to predict the likely effectiveness of a campaign and eliminate weak spots. However, pre-testing does not guarantee effectiveness, and many successful advertisements have failed pre-tests.
2. Ex post *commercial market research*. Commercial market research once a campaign has started is widely used to determine levels of recall and comprehension. Recall and comprehension surveys can indicate whether the basic message has been conveyed to the target audience, but are less suitable for assessing how effective a campaign has been in terms of encouraging purchase. Simply because people say that they have recalled an advertisement or are aware of or interested in a product does not mean they intend to buy it.
3. *Statistical analysis*. Statistical analysis is often used to assess the impact of advertising on the level of sales. Basically, this involves a comparison of sales before the campaign with sales after the campaign. The findings of such studies can often show a change in sales after the campaign, but it is difficult to demonstrate that the campaign actually caused the change to occur.

Thus, evaluating campaigns can be difficult and, ideally, organizations would use several different sources of information and undertake detailed research with consumers. In practice, the costs of different types of research often lead to a reliance on general, commercial studies and an acceptance of some loss of detail and relevance in the evaluation.

11.4 Forms of promotion

As the previous section has indicated, there is a range of different promotional tools available to suppliers of financial services. This section discusses some of the more important methods of promotion in greater detail, and highlights their strengths and weaknesses. In blending together the different promotional tools, it is essential to focus on the issue of integration – namely, ensuring that the message contained in each form of promotion is consistent and integrated with other promotional messages. HSBC Bank provides a good example of this approach. The colour combination of red, white and black is consistent across all communication channels, as is the use of the strap line '*The World's Local Bank*'. The 'Cultural Collisions' series of TV adverts draws attention to HSBC's worldwide strength and local knowledge – a message that is replicated in print media, posters, point-of-sale material, air-bridge advertising and, of course, on the HSBC website.

11.4.1 Advertising

Advertising is a form of mass communication which is paid for and involves the non-personal presentation of goods/ideas. As such, it covers television, radio, Internet and press advertising, along with other approaches such as direct-mail and direct-response advertising. Advertising is usually classified as being of two types:

1. *Above-the-line advertising* refers to all forms of advertising where a fee is payable to an advertising agency, and includes press, TV, radio, Internet, cinema and poster advertising. The major advantage of above-the-line advertising is that it enables an organization to reach a large and diverse audience at a low cost per person. A further strength is that the sponsor (i.e. the organization) retains a good degree of control over the message content, its presentation and timing. A potential disadvantage is that advertising messages are highly standardized, and as such advertising can be an inflexible promotional tool. It may also be wasteful, because it reaches a large number of individuals who are not potential consumers.
2. *Below-the-line advertising* describes forms of advertising for which no commission fee is payable to an advertising agency, and includes direct-mail and direct-response advertising, exhibitions and point-of-sale material. In comparison with the types of media advertising described above, these methods tend to be much more focused; they reach a smaller number of people at a higher cost per person, but this is often counterbalanced by the higher degree of accuracy associated with such methods. Case study 11.1 explains how ING Direct used direct mail to target new products to its existing customer base.

Case study 11.1 A direct-mail campaign at ING Direct

Since bursting onto the scene in 2003, ING Direct has used its high-interest, hassle-free savings product to win the hearts and wallets of UK consumers. Demand has remained strong, and the company has become the world's leading direct savings bank in a short space of time. However, a proportion of ING Direct's customer base was flagged as 'do not mail'. This was preventing the company from giving their customers the opportunity to hear about (and take advantage of) promotions and offers that might potentially be of interest. ING Direct is not alone in encountering problems with the 'opt-out' option. Many financial services companies believe that customers fail fully to understand the implications of ticking the box marked 'do not wish to receive further marketing communications'.

At present, ING Direct offers only one product to the UK marketplace. Although the company's customers are exceptionally loyal, with 98 per cent happy to recommend ING Direct (TNS surveyed 1934 customers in September 2004), any future product launches could be hindered by the number of opted-out customers. The aim of this test campaign was therefore clear-cut: to open the door (and the letterboxes) to the potential of cross-selling across ING Direct's existing customer base. To re-engage with these customers, the company needed to communicate directly and present a simple yet compelling reason for them to re-think their decision not to receive marketing communications.

'After talking to our Royal Mail Key Account Manager, we discovered that a financial services company in a similar situation had used a mailing to achieve the success we were looking for,' explains Sarah Barnes, Direct Marketing Manager at ING Direct. 'So direct marketing, with its ability to reach and influence named individuals while minimizing cost, was the logical medium for us.'

The campaign objectives were as follows:

- to invite customers to opt back in to receiving marketing material
- to explain how they are currently missing out on future product and service news, as well as other offers and promotions that could be of interest
- to target a random 10 000 customers from the ING Direct database
- to encourage the target audience to complete and return a postal response or call the ING Direct call-centre
- to measure the campaign against three key criteria – response rate (%), cost per customer, and number of complaints received.

The company chose to mail a straightforward A4 folded letter, with a perforated reply slip, in a C5 branded envelope that promised 'no catches with ING Direct'. The letter outlined the key benefits that customers would enjoy once they had decided to opt back in. These focused on being kept up-to-date with future ING Direct products, services and promotions. To illustrate the point, the letter spelled out that the customer may have already missed out on the chance

Continued

Case study 11.1 A direct-mail campaign at ING Direct—cont'd

to celebrate the company's first birthday on board the Orient Express. The letter also reassured customers that there were no hidden catches – ING Direct never passes personal information to other companies, so customers would never receive unwanted communications from elsewhere.

'Royal Mail worked very hard to help us with the campaign', says Sarah Barnes. 'As well as suggesting the mailing in the first place, they advised us on including a Business Response envelope to ensure maximum response, something we had not initially intended. We decided to use Mailsort 2, and are delighted with the results. The power of Royal Mail is clearly demonstrated by the fact that every single response was received by post – there was no telephone response whatsoever.'

ING Direct mailed 10 000 letters at a cost of some £9000. The campaign achieved an excellent response rate, which means that the company can now communicate its offers and promotions and cross-sell future products and services with more of their customers.

Source: Leonora Corden, Head of Market Development, Royal Mail.

Advertising is one of the most widely used promotional tools in retail financial services because of its ability to reach large numbers of customers cost-effectively. However, the features of financial services do present some difficulties when developing advertising. As mentioned earlier, financial services are intangible, so there is little to show in an advert. Furthermore, customers often require large amounts of information in order to make purchase decisions, but many forms of above-the-line advertising are not very effective at making this information available. Press advertising can provide more information than TV, radio, cinema and poster advertising, but the quantity of information is still limited. The Internet can provide rather more information to consumers once they have clicked on a particular advert.

However, to date, Internet advertising has not proved to be very effective for financial services. In particular, although many organizations have invested in banner advertising, consumer click-through rates have been disappointing, suggesting that this may not be a very effective advertising medium. In contrast, the organization's own website may offer much greater potential for communicating with customers. However, websites provide a very passive form of communication, since they rely on the customer choosing to visit the site rather than allowing the organization actively to communicate with its customers.

Because customers will often need a lot of information in order to make a decision, above-the-line advertising is often thought to be more suited to the process of raising awareness and generating interest, while other promotional tools are used to encourage desire and action (remember the AIDA model discussed in the previous section). For example, many unit trust companies will operate campaigns to raise customer awareness of their fund performance and encourage interest. These adverts provide minimal information – rather, their aim is to encourage a sufficient level of interest that the consumers will think about approaching the

company for a prospectus, or alternatively will respond positively if a prospectus is mailed to them.

Above-the-line advertising can also be particularly effective in building organizational reputation and image, because this type of communication does not require detailed information but rather focuses on a broad general message. An example of this latter type of advertising would be Great Eastern's '*Great Trust Great Confidence*' campaign, which involved minimal information – just a logo and a message. Equally, HSBC's campaign which illustrates the bank's local knowledge is run worldwide and plays a major role in building the HSBC brand.

The particular advantage of both direct-mail and direct-response advertising is that they can potentially provide customers with a lot of the detail necessary to make a final purchase decision. Indeed, direct mail which is accurately targeted to the right customer group can be very effective at generating new business, as well as cross-selling to existing customers. Accordingly, these methods of advertising are likely to be more effective in encouraging the final stage in the AIDA model – namely, the purchase (action). In addition, direct mail has the advantage that it is invisible to competitors. However, the ability to use direct mail effectively does depend on the organization having a good, accurate and up-to-date customer database, and this can present a problem for many financial services organizations.

Advertising of financial services is carefully regulated in many countries because of its potential to mislead. The combination of product complexity and limited consumer interest means that some forms of creative presentation can give the wrong impression. Interest rates are a particular area of concern, because many consumers do not fully understand different forms of presentation (such as APR and AER) and their relationship with headline rates (Buch *et al*., 2002). The presentation of investment performance is another area of concern. Many advertisements rely heavily on figures about past performance to demonstrate the quality of their products, and then accompany such adverts with a disclaimer in small print to indicate that past performance is no guide to what will happen in the future. In addition, the actual formats used to present investment performance figures may result in the same real performance being interpreted differently according to style of presentation, as is shown in Box 11.1.

Box 11.1 Consumer reactions to the presentation of past performance information

Existing research suggests that past performance of market-based financial services (e.g. equity-based funds, bond funds, etc.) is of little use to investors as it does not serve to predict future performance, but it remains widely used by providers and customers alike. Financial services regulators have long been concerned about the ways in which companies selling market-based financial services can present information on past performance selectively in order to create a more favourable (and perhaps unrealistic) view among customers of the quality of the products they offer. Past performance is often presented in a graphical format.

Continued

Box 11.1 Consumer reactions to the presentation of past performance information—cont'd

This piece of research used actual past performance charts in a controlled experiment to assess the impact on customers of different forms of presentations and the use of data over different timescales. The experiment used a choice of fixed interest v. equity investment fund, with past performance presented as an annual percentage yield either on investment or on the changing absolute value of the fund. The results suggested that timescale had no effect on investor preferences, but presentation format did. In particular, when performance was charted using annual percentage yields, respondents were less likely to choose an equity-based fund. Of those respondents who had selected a FTSE-based tracker fund when shown information based on fund values, around half changed their choice when shown the same information using annual percentage yield figures. Furthermore, the use of annual percentage yield figures as a measure of past performance was also found to increase risk perceptions.

Source: Diacon (2006).

Thus, advertising can take many forms, and the type of advertising used by a financial services organization will be influenced by the stated objectives and the nature of the target audience. Whatever type of advertising is used, particular attention must be paid to trying to make the service more tangible, reducing customers' perceived risk, being transparent, and trying to build trust and confidence.

11.4.2 Personal selling

Personal selling is discussed in more detail in Chapter 13. Personal selling has a dual role to play in the marketing of financial services. It is a channel of distribution and also a method of communication. Personal selling is probably most common in corporate markets, but is also widely used in personal markets in relation to some of the more complex financial services.

One of the major benefits of personal selling as a form of communication is that it allows immediate feedback from the consumer to the organization (or its representative). Other forms of communication are basically one-way, but personal selling is two-way. The customer can raise queries with the salesperson, and those queries or concerns can be dealt with immediately. This means that the information communicated can be very accurately tailored to the needs of particular individuals. Furthermore, because personal selling allows queries and responses, it is often thought to be very effective towards the end of the AIDA process – in encouraging action (purchase).

Thus, although personal selling can be a valuable and effective form of promotion, it is also very expensive. It therefore tends to be used more heavily for relatively

high-value products and when customers are close to making a purchase. As well as being expensive, it is also a form of promotion that can be difficult to manage.

11.4.3 Publicity/public relations

Publicity is normally defined as being any form of non-paid, non-personal communication and, like advertising, it involves dealing with a mass audience. For this discussion, we broaden the concept of publicity to include an additional element, namely public relations. Public relations is paid for, whereas publicity is assumed to be 'free'. However, it is included under this heading because it is concerned more generally with building and maintaining an understanding between the organization and the general public.

Publicity offers a number of benefits to the organization. It has no major time costs, it provides access to a large audience, and the message is considered to have a high degree of credibility. The information is seen as coming from an independent or quasi-independent source rather than from the organization itself. However, it is also one of the more difficult forms of promotion to implement and control, since the final presentation and timing of information about the organization will usually be edited by the media, such as television, newspapers and online news providers.

Traditionally, publicity and public relations were seen as being centred on producing regular, informative press releases and building up good contacts with journalists. As a consequence, their importance has often been underestimated. However, with increasing pressure on advertising space and costs, the importance of publicity seems likely to increase. Two areas merit particular attention – the creation of a corporate image, and sponsorship.

Corporate image

The importance of corporate image and organizational branding has been mentioned earlier in this chapter. The development of a suitable corporate image is an aspect of public relations which is of particular importance to financial services organizations, because the reputation or image of the company has a major impact on consumer choice. Indeed, corporate image is often seen as one of the most important forms of branding that is available to a financial services organization. Each December, the magazine *PR Week* publishes a report on corporate reputation based upon the extent and nature of public relations coverage that businesses receive in the UK. Similar reports are to be found in many other parts of the world; however, it is unusual for financial services companies to feature in the upper echelons of such surveys. In the Australian 2005 report, the top three places went to Toyota, Microsoft and Sony respectively. Writing in the *Wall Street Journal* Online on 6 December 2005, Ronald Alsop reported that the top five companies, based upon public perception of their reputations, were Johnson & Johnson, Coca Cola, Google, UPS and 3M.

The factors that contribute to the creation of a favourable image are many and varied. A clear corporate identity is important, to make the organization instantly recognizable. An organization's corporate identity can be represented by a variety

of visual symbols associated with promotional material, the branch network, and staff appearance. Other forms of communication can be used to help create an image and personality. Internal marketing can be used to encourage staff to commit to the corporate identity and believe in the image that the organization wishes to create.

Sponsorship

One increasingly important aspect of public relations and the creation of a desirable corporate image has been the growth in sponsorship. The extent to which this method of communication is used varies considerably across organizations, but with increased competition for advertising slots on television and rising media costs in general, sponsorship is seen as an important and effective way of projecting the image of the organization.

Particular features of the usefulness of sponsorship include the ability of the sponsoring brand to be associated with the characteristics of the sponsored activity (the so-called presenter effect), and the facility to be used for corporate hospitality. The latter feature is why sponsorship is often favoured by financial services companies involved in B2B marketing. Financial services organizations are involved in sponsorship of a variety of events, including sports events (e.g. football), entertainment (e.g. music concerts) and cultural events (e.g. art exhibitions). This type of sponsorship can be very effective at getting the organizations noticed by retail customers. For corporate customers, the sponsorship of local business seminars is also a widely used technique. The advantage of sponsorship, apart from its cost-effectiveness, tends to be that it is viewed less cynically by the consumer than are more traditional forms of advertising.

11.4.4 Sales promotions

Sales promotions in financial services are usually described as being demand–pull methods of promotion. Demand–pull promotions are specifically concerned with providing consumers with a direct incentive to try and buy a product. The use of sales promotions as part of a marketing campaign has increased considerably in recent years, as is evidenced by the rapid growth in the volume of business conducted by specialist sales promotion agencies.

There is a variety of techniques available, although the most popular are probably as follows:

1. *Benefits tied to product use*. This is one of the most popular forms of promotion used in financial services and in many other sectors. If the consumer uses/buys a particular product or service, he or she receives a free or discounted gift. Barclays has offered new personal pension customers the equivalent of three months' free contributions as a promotional tool to encourage new customer acquisition. The promotion was supported by in-branch promotional material and reinforced by branch staff in their interactions with customers. Loyalty schemes, which provide rewards such as Air Miles based on the level of spend on a credit or charge card, are widely used in financial services, and are another example of promotion

based on product-use benefits. These schemes are discussed in more detail in Part III of this book.

2. *Reduced price*. This constitutes the most direct method of sales promotion, in that it simply involves offering the product to the consumer at a reduced price. It is similar to couponing (see below), but is available to anyone rather than being restricted to those consumers with a coupon. For example, Citibank offered a 1-year fee waiver as a promotional device when they launched their Citibank Blue Credit Card.
3. *Competitions*. Competitions are a popular and easy-to-manage form of promotion. Consumers of the product are offered the opportunity to enter a competition to win attractive prizes. Citibank's *'99 Wishes'* campaign was a competition which allowed card-holders to send their top 9 wishes from a list of 99, and if their list matched the popular list for that day then the customer's number-1 wish was fulfilled. As only Citibank customers were able to enter, this can be seen as the kind of competition that would encourage new customers to Citibank as well as generating publicity. Similarly, Standard Chartered offered prize-draw entry to anyone who signed up for the Standard Chartered Motorists' Club Visa.
4. *Couponing*. Money-off coupons are probably the technique that is most commonly associated with sales promotions. It is less common in financial services, although a number of companies will offer particular discounts through direct mailing to certain target customers, and this can have a similar effect in that it should encourage purchase. A related concept is that of the introductory offer, and a growing number of financial services providers are offering either initial discounts on credit products or introductory interest premia on savings products.

Sales promotions can be very effective towards the final stage of the AIDA process, as they are designed to encourage the consumer actually to make the purchase.

11.5 Summary and conclusions

Promotional strategy deals with all aspects of communication between an organization and its customers, its employees and other interested parties. Four main promotional tools are available to an organization – advertising, publicity, sales promotion and personal selling. The balance between these tools will vary according to the nature of the overall marketing strategy, the characteristics of the product, the resources of the organization and the nature of the target market. Whatever promotional mix is chosen, the effectiveness of the communications process depends on the development of a clear and unambiguous message that is presented to the right target audience, at the right time and through the most appropriate medium.

Promotion has always been important in financial services, but if anything its importance is increasing. The market for financial services is going through a period of rapid change, and levels of competition are increasing. Deregulation, increased consumer sophistication and technological developments have encouraged a rapid growth in marketing, and particularly in promotional activity. Financial services institutions now spend significant amounts on communicating a variety of product

and brand messages to a range of target audiences. With promotion attracting a significant level of marketing expenditure, it is important that promotional activity is careful planned and implemented and that it is consistent with the rest of the organization's marketing activities.

Review questions

1. Think of an advertising campaign that an organization has used. What were the different stages in the communications process? Explain these, using this campaign as an example.
2. What do you understand by the term AIDA? How can this framework be used to help choose the best method of promotion for a particular financial service?
3. What are the differences between above- and below-the-line advertising? Which do you think would be most effective for the marketing of a unit trust?
4. What are the strengths and weaknesses of the four main promotional tools?

12

Pricing

Learning objectives

By the end of this chapter you will be able to:

- explain the role of pricing in the financial services marketing mix
- understand the complexities associated with pricing in financial services
- understand the different approaches and methods of setting price.

12.1 Introduction

Of all of the component elements of the marketing mix, pricing is often the most problematic for marketing executives to manage. Unlike all other constituent parts of the mix, pricing is concerned with the determination of revenue and plays a crucial role in the derivation of product margins and profit. In many financial services organizations, price is the one element of the mix that is not under the control of the marketing function. Indeed, it is commonplace for the marketing team to have little influence in the setting of prices, but for them to be passive recipients of prices set in other parts of the organization. In the case of an insurance company, prices are often prescribed by one of the actuarial functions. In banks, prices are often set by the finance or treasury division, whilst in building societies it is often the prerogative of the finance team. Thus, pricing is often the source of much internal organizational politicking and must therefore be handled with care to ensure that all relevant parties participate in the process in a suitably joined-up fashion.

This chapter provides an overview of pricing in relation to financial services. It begins with a brief discussion of the role and characteristics of pricing and then moves on to explore in more detail some of the challenges associated with pricing in financial services. Subsequent sections consider approaches to price-setting, the issues associated with price discrimination, the process of price determination and the nature of overall pricing strategy.

12.2 The role and characteristics of price

Price has been defined as the value of a good or service for both the buyer and seller in a market exchange. For our purposes price is expressed as a monetary value, and as such is the metric by which the financial performance of an organization is evaluated. Thus price is a measure of value for both buyers and sellers, or, rather, customers and providers. From the customers' point of view, price performs a number of functions:

1. It is used as a yardstick to compare competing options
2. It is the means by which value is assessed
3. It may be used as an indicator of product or service quality
4. It represents the cost of the good or service
5. It can influence the frequency of purchase or quantum of an individual purchase.

As far as providers are concerned, price is important for the following reasons:

1. It is a crucial determinant of margin and profit
2. It influences the level of demand for its products and services
3. It plays a key role in affecting relative competitive position
4. It can be adjusted quickly, under certain conditions, to enable the provider to achieve short-term volume or margin priorities
5. It can be varied at different stages in the product lifecycle in conjunction with other elements of the marketing mix.

In the conventional tangible-goods marketing texts, it is customary to observe that price can be changed quickly in response to events in the marketplace or opportunistic situations. However, for some products the changing of price can be extremely time-consuming and costly. For example, in the life assurance arena the implementation of a price change can be a complex matter requiring major resource inputs from actuarial and systems departments. Depending upon the prevailing systems architecture, a price change can require as much resource as and involve a lead-time comparable to that of the launch of a new product. However, there are other products that are highly flexible and responsive to urgent deadlines, such as certain interest-rate driven products.

12.3 The challenges of pricing financial services

For the marketers of packaged goods, pricing is a relatively straightforward matter whereby the cost to the customer is simply the price he or she pays. It is similarly straightforward as far as the customer is concerned. The emergence of profit is similarly simple to grasp; it is the purchase price minus all direct and indirect costs. However, pricing is far more complex for financial services; indeed, the terminology

associated with pricing is itself a complex and diverse issue. For example, consider the following products and the ways in which price is expressed:

Product	Terms associated with price
Whole-of-life assurance policy	Premium
Bid : offer spread	
Initial charge	
Annual management charge	
Policy fee	
Early surrender penalty	
Market value adjustment	
Cost of advice	
Reduction in yield	
Mortgage	Arrangement fee
Interest rate	
Average equivalent rate (AER)	
Early redemption penalty	
Unsecured loan	Interest rate
Annual percentage rate (apr)	
Current account	Overdraft rate
Charges – overdraft arrangement fee	
Charges – unauthorized overdraft fee	
Charges – additional statements	
Charges – cheque representation fee	
Personal pension	Contribution
Initial charges	
Bid : offer spread	
Charges	
Policy fee	
Annual management charge	
Cost of advice	
Reduction in yield	
Credit Card	Annual fee
Annual percentage rate (APR)	
Average equivalent rate (AER)	
Late payment charge	
Interest charge	
General insurance	Premium
Excess charge	

From this set of examples, it can readily be appreciated that customers are faced with the need to develop a familiarity with a wide range of terms used for expressing price. Additionally, the overall cost to the customer is often arrived at through the accumulation of several differently expressed charges. In the case of a number of products, there is the added confusion that arises from the fact that the notional amount of money paid into certain products represents an investment by the customer from which certain charges will be deducted. Thus, the *contributions* paid into a pension, the *premiums* paid into an endowment savings plan and the *investment* made in a mutual fund all represent sums of money that are being invested on

behalf of the customer. They do not strictly represent *price*, where price means the sacrifice made by the customer. In these cases, *price* is represented by the various charges that are deducted by the product provider. However, in the case of general insurance products such as home contents and motor insurance, the premium does actually represent the price to the customer. In such cases there is no investment content incorporated into the premiums, and thus no return of funds at the expiry of the contract period. Indeed, there may well be additional charges levied on the customer, such as the payment of an *excess charge* should a claim arise.

Term assurance is similar to general insurance in that there is no investment content incorporated into the premiums paid by the customer. Thus the premium is used in its entirety to provide for the costs of providing the given level of life protection cover.

The difficulties which consumers face in fully appreciating the price they pay for certain financial services products are compounded further by a combination of complexity and the accumulation of charges. We have already observed how complexity arises from the range of terminology that applies to financial services pricing, and from the added confusion surrounding the treatment of the sums of money that the consumer invests in one form or another. A further issue that must be appreciated is the way in which charges accumulate during the period of the life of the product. Consider the case of a personal pension, shown in Box 12.1.

Attempts are made to present the cumulative impact of charges during the lifetime of an investment policy. One method is called the *reduction in yield* (RIY). RIY operates by showing the impact of charges in terms of how it reduces average

Box 12.1 Personal pension – indicative cumulative effect of charges

Let us assume that a consumer undertakes to contribute £300 per month to a personal pension (PP) and does so during a 30-year period. Let us also assume that the PP comprises the following charging structure:

Initial charge	5 per cent is deducted from each contribution made
Policy fee	A fee of £2 per month is deducted
Annual management charge	An AMC of 1 per cent of the consumer's fund value is deducted per annum

Thus, during the course of the 30-year term the consumer will have incurred the following charges:

Initial charges (£300 × 5 per cent × 12 × 30)	£5400
Policy fees (£2 × 12 × 30)	£720
AMC (assumes average annual growth of 7.5 per cent)	£32 730
Total costs	*£38 850*

Thus, during the course of the 30 years that the personal pension has been in force, the consumer will have paid £38 850 in total charges.

annual returns on the consumer's investment. For example, if the cumulative impact of charges on a personal pension have a RIY of 2.8 per cent, it means that instead of a consumer receiving annual growth of, say, 7.5 per cent from his or her contributions, the consumer receives an actual return of 4.7 per cent. Looked at another way, the effect of the 2.8 per cent RIY is to reduce the return on investment by 37 per cent ($2.8 \div 7.5 \times 100$).

The complexity and confusion already discussed contributes to a relative lack of transparency regarding costs and pricing. Llewellyn and Drake (1995) suggested that, when considering the pricing of financial services, it might be helpful to distinguish between two main forms of pricing, namely explicit or overt pricing and implicit or covert pricing.

12.3.1 Explicit or overt pricing

This approach makes the price paid for the service very clear. Consumers are presented with clear and precise figures about what they will pay for this service. When a bank charges for an ATM withdrawal or a credit card company charges an annual fee, this is an example of explicit pricing. This approach has the advantage of being very clear to both consumer and to supplier. The supplier is likely to be better able to predict likely revenue, and the consumer is much more obviously aware of what the service costs. Furthermore, an explicit price allows the organization to signal costs of different services and use price as a way of influencing consumer behaviour. For example, if branch-based transactions were priced relatively high (because of their high costs) and ATM transactions were priced relatively low (because of their lower costs), the organization could use pricing to try to encourage consumers to move from branch-based transactions in favour of ATMs. However, to operate a good and efficient system of overt pricing does require a thorough understanding of the cost base and principles of cost allocation. As explained earlier, this can be a difficult area for financial services organizations.

12.3.2 Implicit or covert pricing

This is a system of pricing in which the actual price to the consumer is unclear and appears not to be paid by consumers. The bank that offers free banking but pays no interest on credit balances is pursuing an implicit pricing policy. Consumers may not be aware of it, but they are effectively paying a price based on the size of any outstanding credit balances. Similarly, an organization providing a regular savings product may not explicitly charge for its services, but will take a share of the initial payments in order to cover costs and contribute to profit.

Implicit pricing has the advantage of being very simple for both the organization and the customer, and it is relatively low cost to administer because it does not necessarily require the same sort of detailed understanding of costs. However, there are significant disadvantages to this approach. First, both the price paid by the customer and the revenue paid by the bank will vary according to the interest rate or the amount that consumers wish to save/invest. Secondly, there is no incentive for consumers to move to lower-cost services because all services offered appear to be free

of charge. Thirdly, implicit pricing creates potential for cross-subsidization. Thus, for example, the customer with significant positive credit balances will pay a much higher price for a given service than will the customer with a minimal credit balance. In effect, the customer with a large credit balance subsidizes the service provided to the customer with a small credit balance.

12.4 Methods for determining price

A number of elements of economic theory are helpful in enabling us to understand how price levels are arrived at. The demand curve is useful as an aid to understanding the relationship between price and demand. As we see in Figure 12.1, in simple terms, the lower the price of the given product the greater the level of demand for that product.

In Figure 12.1, as price increases from £P1 to £P2, demand falls from Q1 volume to Q2 volume. From the supply side, the higher the price, the greater will be the volume of output that manufacturers and product providers are willing to supply. However, this is an oversimplification, since it assumes economic rationality on the part of consumers and an ability clearly to identify best value. It also implies that high price is a proxy for high margin from the supplier's point of view. Indeed, the basic economic theory of price implies the characteristics associated with perfect competition. Fundamental to the notion of perfect competition is consumer sovereignty, whereby the consumer is both highly knowledgeable about all aspects of the product in question and has full and unhindered access to all forms of information regarding the entire universe of suppliers. In practice such conditions seldom apply in the field of financial services, and the term *information asymmetry* is commonly used to describe the balance between consumer and provider knowledge.

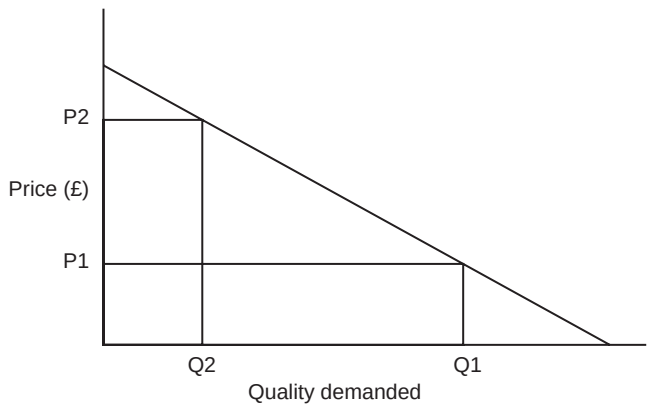

Figure 12.1 The demand curve.

Nevertheless, under certain circumstances there is little doubt that demand is stimulated by price reductions, and that price increases can be used to lessen demand. For example, in September 2005 Fidelity announced that it would be increasing the charges that apply to new investments in its Special Situations fund as part of a process of reducing the overall scale of the fund.

Shapiro and Jackson (1978) propose three core approaches to the determination of price:

1. Cost-based
2. Competitive
3. Market-orientated.

12.4.1 The cost-based approach

In simple terms, the cost-based approach to pricing operates by identifying the costs associated with a given product and then adding on a profit margin to arrive at a price. In practice, there are two main variants of the cost-based approach to pricing: full-cost pricing and marginal-cost pricing. Whereas full-cost pricing takes account of all components of cost (overhead as well as direct or variable costs), marginal-cost pricing relates just to the direct costs associated with the manufacture of the good or service. Two examples will help to illustrate these alternative approaches.

Example: Full-cost pricing

Fixed overhead costs	£100 000
Variable (direct) costs per unit	£25
Forecast sales	5000 units
Profit margin mark-up	20%
Total costs	£100 000 + (5000 × £25) = £225 000
Full cost per unit	£225 000 ÷ 5000 = £45
Mark-up (20%)	£9
Price	£54

The advantage of full-cost pricing is that it should ensure that profit is achieved and that all costs have been covered. However, it suffers from the potentially major disadvantage that it can result in an uncompetitively high price. Such a situation can arise from two perspectives. First, the adoption of a cautious approach to forecast sales will limit the extent to which fixed costs can be attributed to units of output. In the above example, if we had forecast sales volume of 20 000 units instead of 5000 we would have arrived at a materially different set of costs and price, as can be seen below:

Fixed overhead costs	£100 000
Variable (direct) costs per unit	£25
Forecast sales	20 000 units
Profit margin mark-up	20%
Total costs	£100 000 + (20 000 × £25) = £600 000
Full cost per unit	£30

Mark-up (20%)	£6
Price	£36

The difference in the two examples is explained by the reduction in overhead cost per unit from £20 to £5. Had the provider been more bullish about sales, it would have opted for a higher sales forecast and thus set a price some 36 per cent lower than the price based upon the cautious forecast of 5000 units. The second weakness is that we do not know the price level that applies to the nearest competitor. If we assume a competing product is priced at £45, it seems reasonable to assume that a £54 price tag will be unattractive. If such a scenario were to result in actual sales of 3000 units instead of the 5000 forecast, the price would have to be reviewed again as follows:

Fixed overhead costs	£100 000
Variable (direct) costs per unit	£25
Forecast sales	3000 units
Profit margin mark-up	20%
Total costs	£100 000 + (3000 × £25) = £175 000
Full cost per unit	£58.33
Mark-up (20%)	£11.67
Price	£70

Thus, this example shows the creation of a self-fulfilling prophecy whereby price is based upon conservative forecasts that do not fully reflect what the competition is charging. It results in a price that is uncompetitive, sales are below expectation, and this in turn results in a further price increase and commensurately lower sales.

Example: Marginal cost pricing

The marginal cost-based price is arrived at by adding a profit margin onto the direct, variable costs of manufacture. Taking the earlier example:

Direct cost per unit	£25
Mark-up (20%)	£5
Price	£30

Marginal costing results in a much lower price than the full-cost approach because no account is taken of overhead cost attribution. It is sometimes used in highly competitive situations on the basis that so long as the price at least covers direct costs, it is making a contribution to the fixed-cost overhead. However, in practice it means that the price is set at an unrealistically low level and other products will, in effect, be subsidizing the direct cost-based product. It is an economic fact of life that overhead has to be paid for somehow, and there has to be a compelling commercial reason to use marginal cost as a basis for pricing decisions.

Branch-based organizations often have difficulty in arriving at an accurate apportionment of fixed costs to individual products. Banks typically have very wide, diverse product ranges, and identifying how much of branch costs should be allocated to individual products is fraught with difficulties. Nevertheless, some arbitrary cost allocation bases can be used to ensure that an appropriate contribution be made to overhead costs.

12.4.2 The competitive approach

Rather than set price on the basis of cost, with the disadvantages that have been identified, price can also be based upon competitors' price levels. Two variants are commonly encountered: going-rate pricing and competitive bidding.

Going-rate pricing implies that there is little heterogeneity between competing products, and that providers are in effect price-takers rather than price-setters. The idea of going-rate pricing seems at odds with strategies based upon product and service differentiation. Indeed, it suggests a largely commoditized marketplace with little scope for premium pricing. However, it is undoubtedly true that what we might term benchmark pricing applies in many commercial areas. There has to be a very good reason for a price premium being charged in the real estate market, for example, where a 1.5 per cent fee is a common benchmark. Sometimes governments and regulators can establish going-rate pricing, such as the 1.5 per cent charge cap on the Child Trust Fund and stakeholder pension in the UK.

The second basic approach to competition-based pricing is competitive tendering. In this case, prospective suppliers are invited to submit their most competitive bid to the prospective customer. Such an approach to pricing is rarely encountered in the domestic marketplace, and is more a feature of the business-to-business environment.

As can be readily appreciated, such a method is fraught with the twin dangers of bidding too high a price and failing to get the business or bidding too low, and damaging margins. Success in an area that involves competitive tendering requires great expertise in understanding both your own organization's cost base and the cost bases of your competitors. It can be remarkably difficult to achieve differentiation and premium pricing in marketplaces that are characterized by competitive tendering. Once successful with a bid, the service or product provider can render themselves vulnerable to the customer, who can assume a great degree of power.

12.4.3 The market-orientated approach

The limitations associated with cost- and competition-based pricing have resulted in the development of marketing-orientated pricing. Marketing-orientated pricing sets out to reflect a broad range of variables in the determination of price. Significantly, it recognizes that price has a strong strategic dimension in being closely implicated in issues such as positioning and competitive advantage. David Jobber (2004) identifies an array of ten components of a marketing-orientated approach to pricing as follows:

1. Marketing strategy
2. Price–quality relationships
3. Product line pricing
4. Negotiating margins
5. Political factors
6. Costs
7. Effect on distributors and retailers
8. Competition
9. Explicability
10. Value to customer.

Marketing strategy

Pricing presents valuable opportunities for a company to craft extremely subtle approaches to the implementation of its marketing strategy. This is in part made possible by the multi-variable nature of financial services pricing. Consider the example of level term assurance (LTA). This is one of the simplest types of life assurance, and its price (premium) varies from customer to customer depending upon the following customer attributes:

- amount of sum-assured
- duration of term
- age
- gender
- smoker/non-smoker
- health status
- occupation
- leisure pursuits.

The maximum number of permutations, and hence individual prices, that arise from the above variables will run into thousands. An insurer has to make choices regarding where it wants to position itself with regard to its competitors for those thousands of individual prices. Amongst the choices to be made are which competitors to benchmark against. This is far from straightforward, as different groups of competitors are to be found in different parts of the market for LTA. The answer lies in adopting a pricing policy that is designed to complement the marketing strategy with regard to target segments, and positioning. Let us consider two hypothetical providers of LTA and the ways in which they can use pricing that are consistent with their respective strategies.

Example: Hallmark Insurance

Hallmark Insurance is an insurance company that is based in the eastern seaboard of the USA. It specializes in providing LTA on high sums assured for terms of up to ten years. A particular field of expertise is the use of Hallmark's LTA as a loan protection policy for SME company directors who are taking out high-value loans for purposes such as corporate buy-outs and acquisitions. As such, they target corporate financiers and investment banks to promote their products and services. Hallmark has designed a pricing strategy to enable it to be competitive in the following areas:

- sums assured from $1m to $20m
- terms of 5 to 10 years' duration
- individuals aged 35–55.

Figure 12.2 shows where Hallmark has set its pricing in terms of quartile ranking on the key variables indicated above. By the term 'quartile' we mean 25 per cent – thus the first quartile means the top 25 per cent of companies ranked on the basis of price competitiveness.

Sums Assured – 5–10 years, Age Range 35–55 years

	$1m–5m	$5m–10m	$10m–15m	$15m–20m
Q1			Hallmark	Hallmark
Q2		Hallmark		
Q3	Hallmark			
Q4				
No of Competitors	200	50	25	10

Figure 12.2 Hallmark's LTA price positioning in preferred sectors.

It can be seen that Hallmark has set its stall out to be highly competitive, the more so as its sums assured increase. Note how the number of competitors falls as sums assured increase, thus making positioning all the more important.

Example: Everyman Insurance – a subsidiary of Everyman Bank

Everyman Insurance is based in Melbourne in Australia, and is the bancassurance arm of one of Australia's leading high-street banks. An important part of its strategy is that it seeks to support the bank's small-business operation, which has the goal of trebling the size of its loan book during the next five years. The small-business banking operation enjoys close relationships with its customers, who show a high degree of loyalty to the bank. Part of the Everyman Bank strategy is that its small-business owners go on to become owners and directors of much bigger businesses in due course.

Everyman Insurance has designed a primary strategy to enable it to be competitive as part of an overall Everyman loan and insurance package to its small-business customers. Thus it seeks to be especially competitive in the following areas:

- sums assured from $50 000 Au to $250 000 Au
- terms of 5 to 10 years' duration
- individuals aged 30–40 years.

Figure 12.3 shows where Everyman Insurance has positioned its prices in quartile ranking terms according to its preferred business profile.

Figure 12.3 shows Everyman Insurance structuring its price positioning to become increasingly competitive as the sums assured increase to its optimum position. At these levels of sums assured, the number of competitors remains almost static. Everyman's price positioning in non-target areas of sums assured, term and age are typically pitched at the mid-point of the third quartile. This enables them to achieve good margins on business they do not seek to chase.

These two hypothetical examples should give a clear indication of how pricing can be organized to fit the overall marketing strategy. In a study of the UK term assurance market conducted on a private basis by one of the authors in the late 1990s, it was noteworthy how random price-positioning appeared to be. Of some

	$25–50,000	$50–100,000	$100–200,000	$200–250,000	$250–400,000
Q1			Everyman	Everyman	
Q2		Everyman			Everyman
Q3	Everyman				
Q4					
No of Competitors	75	75	75	75	70

Figure 12.3 Everyman Insurance's LTA price positioning in preferred sectors.

20 insurance companies studied, only 1 demonstrated the kind of logical coherent approach illustrated in Figures 12.2 and 12.3. Thus, pricing should be used in a thoughtful and commercially astute manner in a way that is consistent with the company's approach to market segmentation.

Price–quality relationships

Consumers form a judgement about the relationship between price and quality. It is understood that a high-quality, personalized service will incur higher costs to the provider than will an undifferentiated basic form of commoditized service.

Product line pricing

Product line pricing refers to the need for integrity between all of the products that comprise an overall product range. Thus an investment management company will be expected to charge more for a personalized portfolio management service than it does for managing a packaged portfolio of investments.

Negotiating margins

Negotiating margins apply in circumstances where customers expect to be able to haggle over prices. Thus, an extra margin is included in the basic list price to allow for negotiation. The inclusion of negotiating margins is a particular feature of B2B marketing, where sellers are faced with professional buyers. Such buyers are skilled at conducting negotiations and usually have personal objectives to achieve, which include successful negotiation of procurement activities.

Costs

Clearly, costs have to be taken into account when setting price if the company is to avoid making a loss. Financial services present particular problems in respect of the allocation of variable as well as overhead costs to individual products. This problem is further exacerbated in circumstances where the marketing team is on the periphery of the pricing process. In such circumstances, marketing staff can miss out on the opportunity to develop a keener sense of commercial judgement. Organizations that view pricing as a responsibility of the marketing team can be expected to benefit from marketing executives who have a solid grasp of costs and of how profit emerges.

Effect on distributors and retailers

Distribution channels can have a profound effect upon pricing, since they require a level of remuneration that motivates them to work in a vigorous and committed manner on behalf of the product provider. This argument applies to both direct and indirect distribution channels. Some forms of distribution become too costly for product providers to be able to satisfy the remuneration needs of the distributors and their own profit requirements. It is common for, say, banks and insurance companies to decide not to market certain products, such as stakeholder pensions, insurance ISAs and the Child Trust Fund, because their cost bases do not leave enough margin for their distributors to earn what they consider to be an appropriate level of remuneration.

A common dilemma for product providers is that distributors seek to maximize their remuneration from their distribution activities, yet want to be able to offer a competitive price to their end customers. We see this in the grocery domain, where supermarkets seek to negotiate good margins for distributing products yet want to offer consumers the lowest possible prices. This has tipped the balance of power very much in favour of the supermarkets and resulted in a weak position for producers. Thus brokers might also expect to receive high levels of commission for distributing, say, motor insurance, but want to offer low premiums to their customers. This particular dynamic has been a major catalyst for the development of remote, IT-based distribution methods in a number of areas such as motor insurance.

It is fair to say that the ability to make sound judgement calls in respect of setting a price that optimizes distribution margin and customer attraction is a crucial marketing competence. The preferred approach is to argue that lower customer prices will result in such a high volume of demand that distributors will ultimately earn more cash, albeit at a lower margin per unit, than they would from selling a lower volume at a higher margin. Such an approach assumes elements of a perfect market and price-elasticity-of-demand that are not necessarily in evidence universally in the financial services sector.

Competition

In some respects, the pricing of financial services has been less influenced by competition than have many other product categories. Until comparatively recently, life, pension and investment products were priced more to secure distributor support than to ensure competitive value for money. Importantly, the complexity and lack of transparency of financial services pricing act as inhibitors to highly competitive pricing. Fortunately, a combination of regulatory, legislative, technological and competitive development are acting to achieve a significant increase in the role played by competition in the pricing of financial services.

Competition exerts its most powerful effect in circumstances characterized by product simplicity, consumer knowledge and confidence, low perceived risk from buying largely on the basis of lowest cost option, limited product differentiation, simplicity of purchase process, ease of switching, and a wide number of competing providers. Thus, it can be appreciated that motor insurance is influenced by competition to a far greater degree than is the provision of banking services to small companies or critical illness insurance.

Explicability

By explicability, we mean the ability to explain and justify why a product is significantly more (or indeed less) expensive than competing offerings. Products that are materially cheaper than the norm may attract consumer suspicion in product areas that are typified by relative consumer ignorance and the risks associated with making a poor choice. A corollary to this is that, under conditions of consumer ignorance and perceived riskiness, a price higher than the norm may be seen to imply quality and instil consumer confidence. This is somewhat akin to the so-called 'Giffen effect', from the eponymous Victorian economist Sir Robert Giffen. According to the Giffen effect, under certain circumstances demand increases as prices rise. This may in part explain the attractiveness of certain exclusive or designer-label goods.

Explicability is more difficult to achieve the closer market conditions approximate to perfect competition. The implication for marketers is that those seeking to achieve a premium price position must invest in an appropriate level of product/service differentiation that can justify the price premium. It is interesting to note that a number of high-street banks, such as Barclays and Lloyds TSB, have attempted to market higher net-worth current account banking services at a premium price in recent years. The impression conveyed is that neither has been particularly successful, as consumers fail to place sufficient value on the premium price they are charged.

Value to customer

The ultimate test of a price must be the extent to which customers feel they are receiving fair value and will maintain a mutuality advantageous relationship with the provider. As discussed earlier, customer value (from the provider's perspective) is a function of a remarkably discrete set of variables such as, in the case of a loan:

- value of sum borrowed
- duration of loan
- incidence of default
- cross-sale/purchase of other products.
- interest margin

Thus, the retention of customers based upon their perceptions of the value-for-money they enjoy is assuming ever greater importance in companies' marketing strategies.

12.5 Price differentiation and discrimination

In many marketplaces there are rules and regulations concerning price discrimination. Discrimination refers to a product or service being offered to a buyer at a lower price than applies to other buyers. Implicit in price discrimination is the notion that the buyer presented with the higher price is being treated unfairly. Resale price maintenance was once a common feature of the consumer goods marketplace in the UK. However, such a rigid approach to pricing has become increasingly out of step

with the contemporary competitive environment. In practice, there is a growing recognition that the charging of differential pricing is a legitimate, and indeed desirable, feature of a consumer-orientated marketplace. As a component of the marketing mix, price can be adjusted to suit a range of buying situations. Such variations in price may be a reflection of genuine lower costs that apply to differing buying scenarios. In the consumer goods domain, for example, buying soft drinks in bulk quantities involves genuine cost savings to the distribution channel that can be reflected in a lower cost per unit to the end consumer. Similarly, bulk discounts are a defensible aspect of the pricing structure that applies to the distribution channels associated with the soft drinks market. A retailer committing to buy a million cases of Pepsi Cola should expect to receive a better price than one buying just a dozen cases at periodic intervals.

Equally, it seems perfectly reasonable for a railway company to stimulate higher levels of off-peak usage of its trains by charging a lower price than applies during the rush-hour period. In this way differential pricing serves the interests of not only the supplier and customer but also the wider community, by using resources in a more efficient manner. In turn, this makes a contribution to the goal of sustainability – an issue that is assuming ever growing importance in a wide variety of contexts.

Thus, deliberately disadvantaging one group of customers through price discrimination represents a highly undesirable practice. Price differentiation, on the other hand, has a number of positive features that serve the interests of a wide range of stakeholders. Differential pricing can be based upon a number of factors, reflecting both genuine commercial considerations on the part of providers and also customer characteristics, including:

- lower costs associated with bulk purchase
- costs that vary according to different factors, such as geographical variation in labour costs and rents
- costs that vary according to buyer characteristics – for example, people with a poor credit history indicate a greater propensity to default on loans and therefore may pay a higher rate of interest
- utilization of off-peak capacity
- demographic factors – age, employment status, gender.

Arguably, price differentiation is particularly well-advanced in the field of financial services. The most graphic example is life assurance, where prices vary according to age, sex, occupation and health status. Price differentiation in this case is based upon genuine cost-related factors, concerning mortality, that vary with age and so on.

Differential costs associated with different types of customer have acted as the basis for what are termed *preferred lives* insurance companies. This is a form of niche marketing where the company targets a specific segment based upon clearly defined cost advantages that are in evidence. For example, SAGA Financial Services offers relatively low premiums on motor insurance because it only sells to the over 50s – an age cohort that has relatively low claims experience. By excluding younger drivers from its book of business, SAGA is reducing the costs associated with their higher incidence of claims.

The preferred lives approach can be applied in a number of situations where clear customer characteristics have a direct and material bearing upon customer value.

In health insurance, for example, a company might choose to target just those individuals who have favourable health status. It should be borne in mind that there some marked differences around the world with regard to the acceptability of preferred lives insurance. For some people and political organizations preferred lives insurance is seen as an oxymoron, in that insurance should be about the use of pooling in order to best serve the overall public good. This philosophical principle underpins the approach of the French health mutuals, whose premiums do not discriminate on the basis of age. In South Africa there is hostility to the concept, because consumers do not like to divulge the kind of information that would be needed to adopt a preferred lives approach on a mass-market basis. Preferred lives insurance is at its most advanced in the US insurance market.

12.6 Price determination

Some form of process is required for an organization to arrive at the finally agreed selling price. Earlier in this chapter we considered the three main bases upon which price can be developed – namely cost-based, competitive and market-orientated.

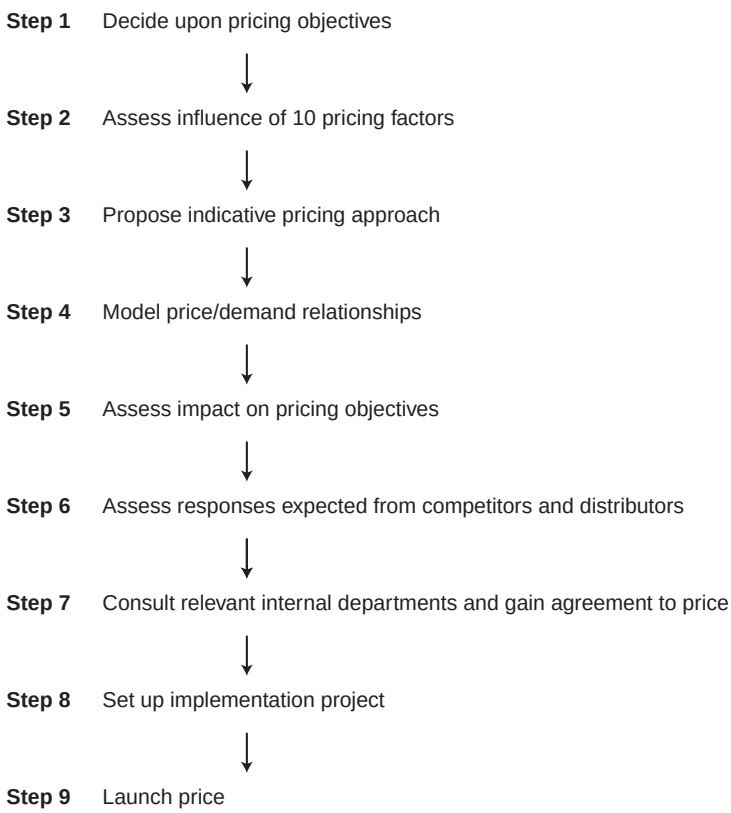

Figure 12.4 Price determination process.

However, whichever basis is used, a number of steps need to be considered when setting price. The nature of these steps will vary according to whether the cost-based, competitive or market-orientated approach is used. Here we will consider a process that might be applied when setting price in accordance with the marketing approach; Figure 12.4 indicates the steps involved, and these are discussed below.

12.6.1 Step 1: Decide upon pricing objectives

At the outset, there needs to be clarity regarding the financial and non-financial objectives that are being sought. Typical financial objectives might include:

- sales value
- margin
- profit
- return-on-capital.

Non-financial objectives may comprise one or more of the following:

- sales volume
- market share
- market position
- customer value.

12.6.2 Step 2: Assess influence of 10 pricing factors

Having formed a view on the desired pricing objectives, it is important that an assessment be carried out of how the following 10 factors might be expected to exert an influence on the final price:

1. Marketing strategy
2. Price–quality relationships
3. Product line pricing
4. Negotiating margins
5. Political factors
6. Costs
7. Effect on distributors
8. Competition
9. Explicability
10. Value to customer.

12.6.3 Step 3: Propose indicative pricing approach

Armed with a clear set of price objectives and an assessment of relevant influences, an indicative price can be proposed. This stage in the process can be relatively complex

in the case of insurance-related business, where there is a huge array of individual premiums to be calculated. In such a case, it is recommended that a number of specific headline premiums be proposed that are indicative of key market positioning. For other sectors of financial services – mortgages, for example – it can be far more straightforward, as it may simply be a case of proposing a single rate of interest.

This is also the stage where factors such as special promotional pricing are considered. For example, it is commonplace for companies seeking new depositors to offer a bonus rate of interest for, say, the first 6 months.

Other aspects of price that might also be addressed at this stage are:

- status requirements – for example, no claims bonuses on motor insurance, income, occupation, previous financial history, track record
- volume-related factors – for example, lower rates of interest charged for high-value loans
- allied charges – for example, penalty fees on overdue payments, unauthorized overdraft charges
- customer contributions – for example, the level of excess payments on general insurance contracts, and early settlement penalties on, say, fixed-rate mortgage loans.

12.6.4 Step 4: Model price/demand relationships

It is advisable to model how price elasticity of demand might operate, given the proposed price. This can be used to make various trade-offs, such as whether a lower price could result in significantly enhanced results in terms of market share or sales volumes. Such outcomes will need to be judged in the light of their impact upon the break-even point and emergence of profit. For a life assurance policy, this could have a material impact upon new business strain and hence capital requirements.

12.6.5 Step 5: Assess impact on pricing objectives

The modelling carried out in step 4 is a key input to assessing the likely impact of the indicative price on the achievement of the desired pricing objectives. An unfavourable outlook may result in the need to make changes to the pricing objectives or indicative pricing approach. It is advisable to ensure that relevant parties are aligned at this stage, before committing further resources to the overall process.

12.6.6 Step 6: Assess responses expected from competitors and distributors

To some extent, certain aspects of this stage will have already been incorporated into steps 3, 4 and 5. However, this is the point at which a more explicit assessment needs to be made. Scenario planning may be a useful approach to adopt as a means of considering the range of distributor and competitor options.

12.6.7 Step 7: Consult relevant internal departments and gain agreement

It is expected that an appropriate level of consultation and collaboration will already have taken place. Many companies have formal pricing and credit committees whose endorsement is required before the price can be finally agreed.

12.6.8 Step 8: Set up implementation project

There is a wide range of complexity when setting prices in financial services, and in some cases extensive project management will be required. It is especially important that pricing events involving a significant amount of IT resources are planned well in advance – probably well before step 1 of this process. Systems resources are usually key elements on the critical path, and the availability of relevant personnel has to be scheduled at an early stage if target launch dates are to be met. Staff from other functions may have an equally significant role to play – pricing actuaries, for example – and so the expectation of their availability has to be suitably planned for. Due regard must be paid to gaining the timely involvement of appropriate administration staff. It is by no means uncommon for them to be treated as somewhat of an afterthought in such activities; such oversights must be avoided. Other requirements that need to be factored into the implementation plan include price lists, documentation and rate books, computerized illustration systems, trade communication, customer communication and staff training.

Finally, price changes on existing products need to take account of cut-off dates regarding pipeline business.

12.7 Pricing strategy and promotional pricing

It is axiomatic of all components of the marketing mix that they interact in a complementary and consistent manner to support the chosen product or corporate position. Thus, a premium-quality service can be expected to yield distinctive value-added features to its customers, and should be promoted in a manner that is in keeping with its high-quality market position and attract a price that reflects its superior characteristics. Pricing must therefore be consistent with a product or corporate position, as well as achieving its financial objectives. Indeed, the two are closely inter-related. In this way, strategies in respect of the use of price must align with the wider marketing strategy. However, any such adjustments must be made by paying due regard to overall product positioning and not be used superficially in response to possible tactical pressures. At the very outset of a new product's life it can be helpful to consider the options shown in Figure 12.5 with regard to pricing strategies.

Consideration of the four options presented in Figure 12.5 needs to pay due regard to product characteristics, such as the degree and value of any competitive advantages it enjoys, as well as market characteristics, such as the likely timescale over which demand may be expected to materialize. It also depends upon the expectations of the company with regard to return-on-investment.

		Promotion	
		High	Low
Price	High	Rapid skimming	Slow skimming
	Low	Rapid penetration	Slow penetration

Figure 12.5 New product: pricing strategies.

An aspect of pricing strategy that is often a source of contention concerns the relationship between prices charged to new, as opposed to existing, customers. In effect, this is a further variant of the price differentiation discussed earlier in this chapter. This practice is especially common in the field of savings, loans and credit, and poses real dilemmas. Take the case of savings deposit accounts. It is commonplace for deposit-takers to offer higher rates of interest to new depositors than those that apply to existing depositors.

Arguably, the premium rates frequently offered to new depositors are unsustainably high and imply a degree of cross-subsidy on the part of current depositors (sometimes referred to as the 'book'), or that, in due course, the rate offered to the new depositors will be reduced to a substantially lower rate of interest. In effect, the advantageous price offered to new customers is an example of promotional pricing and is a variant of the rapid penetration strategy shown in Figure 12.5. A similar approach can often be observed when new credit-card customers are offered, say, a zero rate of interest for the first 6 months. In the mortgage market, it is commonplace for new mortgage borrowers to be offered lower repayment interest rates for a period of time.

In the early part of this decade, the Nationwide Building Society adopted what it considered to be the highly ethical stance of having no differential pricing between new and existing borrowers and depositors (see Case study 12.1). As a result, its deposit products tend not to appear in any of the best-deal tables promoted in the consumer financial press. This has had a detrimental impact upon Nationwide's market share. However, when presented as a weighted rate to savers over a longer timeframe – say 3–5 years – Nationwide compares favourably with its peers. Thus the company has adopted what it considers to be a responsible and morally correct pricing strategy, and hopes that consumers will recognize this and take a long-term view of interest rates.

Case study 12.1 Nationwide Building Society's pricing philosophy

Far from being a building society purely focused on mortgages and savings, Nationwide competes effectively across all aspects of the financial services market, including current accounts, credit cards and personal loans.

Nationwide's approach to its customers is based firmly on the fundamental beliefs it holds as a mutual organization. It delivers best value to its membership by providing financial services products with competitive interest rates

Case study 12.1 Nationwide Building Society's pricing philosophy—cont'd

and lower fees and charges, and this is all underpinned by a policy of fairness, honesty and transparency. It has also successfully campaigned on the issues of greater transparency for credit cards, personal loans and cash-machine charges, as well as calling on the Treasury to review stamp duty.

Nationwide's approach to mortgage pricing is based on the belief that existing borrowers should not have to pay higher interest rates to subsidize the lower rates offered to new customers – as is common amongst many of its competitors. This fair and transparent approach means that new and existing customers have access to the same great-value products, which are generally at market-leading rates. They also have the reassurance of knowing that any fees and charges are kept to a minimum and, where they are necessary, these are competitive, fair, and disclosed upfront.

Savings rates offered by Nationwide are subject to a similar philosophy, and are underpinned by the same brand beliefs of honesty, transparency and fairness. The Society is committed to offering competitive savings rates that represent long-term value. Nationwide, unlike many of its competitors in the savings arena, does not offer 'flash-in-the-pan' introductory bonuses or place unreasonably restrictive caveats on its products. All of Nationwide's customers have access to a wide choice of fixed- and variable-rate savings products, and these are available across a choice of branch, postal and Internet channels. All are simple to understand and use.

Nationwide has recently launched several products across the savings and insurance fields aimed at the 'silver generation'; these demonstrate its commitment to delivering good value and are designed to meet the needs of the older age group.

It has also begun campaigning on the issue of children's savings, and in December 2005 issued its Children's Savings report. The report carries with it an action plan which Nationwide believes will help to change attitudes to saving and the way people manage their finances. It calls upon the government to do more to encourage people to save, and to promote the benefits of starting from a young age.

Investment products are also offered through its wholly-owned subsidiary, Nationwide Investment Group. The products have no initial charges and a low annual management charge – both of which set them apart in the marketplace. NIG aims to offer customers competitive annual management charges across the range of products, and strives to ensure that its pricing is both fair and unique in the marketplace.

Some might think that having a policy of not offering introductory bonuses or overly-inflated headline rates would stop Nationwide from appearing at the top of many best-buy tables. While it is acknowledged that many other players manipulate their accounts and rates to ensure that they appear in best-buy tables on a regular basis, this doesn't show the bigger picture to the consumer. Will the once attractive rate simply slide away to obscurity and be managed down? How will the customer service and experience stack up? Recently, the compilers of

Continued

Case study 12.1 Nationwide Building Society's pricing philosophy—cont'd

these tables have started applying a different (and some might say fairer) approach, and in doing so seem to be making some progress towards quietly illustrating that taking a snapshot of just one feature of a product isn't always a good guide to the longer term. Hopefully, in the future more tables will start to reflect products that offer a good, consistent rate over a period of time – and when that happens, Nationwide will appear even more frequently.

Source: Stuart Bernau, Commercial & Communications Director, Nationwide Building Society.

In practice, many consumers choose not to take a long-term view and are attracted by headline rates offered to them as new customers. Once the promotional pricing period is over, buyer inertia sets in and the customer reverts to a lower rate (having become part of 'the book'). Alternatively, some consumers become serial new customer deal-chasers (sometimes referred to pejoratively as 'rate tarts'). These customers take advantage of special offers on credit cards and deposit accounts, in particular, to gain maximum advantage.

It is interesting to observe the ways in which financial services companies are emulating the promotional pricing approaches encountered in the packaged-goods and high-street retail domains. In December 2005, HSBC used heavyweight promotional displays to communicate a range of price-based promotions with the banner headline: '*Up to Half Price Sale and other Great Offers*'. The body copy of the promotional leaflet presented the special price promotions as a 'sale' that started on 28 December 2005 and ended on 31 January 2006. It included a special promotion on mortgages that offered:

> Up to 50 per cent off, We've reduced our six-month fixed rate mortgage by a massive 50 per cent – down from 5.30 per cent to 2.69 per cent for borrowings up to £100 000. Taking up this offer is quick and easy, but hurry – it's only available while stocks last.

In a somewhat similar vein, Scottish Widows had an in-store promotion in Lloyds TSB branches promoting:

> Save 50 per cent on initial charges for lump sum ISA Investments. From 1 February 2006 to 30 April 2006, Scottish Widows is offering a 50 per cent discount on the initial charge for lump sum ISA investments.

Not to be outdone, Sainsbury's had an in-store display showing a special promotion on loans with the headline of:

> Loan sale. Best ever instore rate. 6.1 per cent APR (typical). Ends 31 March. There's never been a better time to borrow money. That's because the

> Sainsbury's bank loan sale is on now, offering you our best ever instore rate at just 6.1 per cent APR typical. But hurry, this offer ends 31 March.

And so we see the financial services sector endeavouring to mimic the promotional approaches more typical of the mainstream consumer goods and retail markets. Senior management of banks have often commented that they consider themselves to be in the retail market and have recruited staff from the traditional retail sector. Perhaps the above examples are evidence of those new recruits seeking to transfer their skills from one domain to another. The extent to which such approaches work in the financial services sector remains to be seen.

12.8 Summary and conclusions

This chapter has highlighted the importance of pricing in the marketing process. Pricing is the only element of the marketing mix that contributes to revenue rather than cost, so its importance must not be underestimated. For any organization, the pricing decision is influenced by a range of internal and external factors. Financial services organizations do face some additional challenges when dealing with pricing decisions because of the greater complexity of costing, the need to deal with risk, the problems of variability, and the difficulties that consumers have in understanding price.

Review questions

1. What role does pricing pay in the marketing mix?
2. What are the particular difficulties that marketing managers face when trying to set prices for financial services?
3. Explain the difference between implicit and explicit pricing. What are the advantages of explicit pricing?
4. Which type of pricing strategy do you consider most appropriate for banking services?
5. To what extent do you believe that the price promotion techniques of the fast-moving consumer goods and retail sector transfer to the world of the high-street bank and supermarket?

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13

Distribution channels: routes-to-market

Learning objectives

By then end of this chapter you will be able to:

- understand the distinctive nature of distribution in financial services
- explain the different forms of distribution used by financial services providers
- evaluate the strengths and weaknesses of different distribution channels.

13.1 Introduction

In any marketing mix, the place component (distribution) is concerned with making sure that a product reaches the target market at a convenient time and place. In relation to physical goods, distribution decisions are concerned with both channel management and logistics. Channel management refers to all those activities involved in managing relationships between the producer and the various organizations that distribute the product (e.g. wholesalers and retailers). Logistics is concerned with the physical movement of products from the place where they were made to the place where they will be purchased. Within the consumer goods domain, retailing represents the dominant channel through which goods are purchased. This channel may operate on a direct basis by which products are shipped direct from manufacturer to consumer. Supermarkets represent the best example of the direct distribution channel for consumer goods. Alternatively, goods can be moved from site of manufacture to the site of purchase on an indirect basis. Indirect distribution channels may involve some combination of agents, brokers and wholesalers interposed between producer and retailer. The logistical

dimensions of tangible-goods distribution is often referred to as supply chain management. Success in the field of tangible-goods distribution requires expertise in both the strategy and management of sales channels, and in supply chain management.

Of course, with financial services there is no physical product, so the logistics element of distribution is of little relevance. Instead, distribution in financial services marketing is concerned with how the service is delivered to the consumer, making sure that it is available in a location and at a time that is convenient for the customer. In Chapters 3 and 8 we saw the ways in which financial services products differ from tangible goods, and those differences have important implications when developing channel strategies and deciding upon routes-to-market. For example, by virtue of their intangibility, financial services do not involve the logistical aspects of supply chain management. Similarly, the characteristic of perishability obviates the need for warehousing and inventory management and control. Other important features of financial services, such as duration of consumption, uncertainty of outcome, contingent consumption, lack of transparency, consumer financial illiteracy and fiduciary responsibility, all have important implications for the distribution of financial services.

This chapter provides an overview of the nature and management of distribution for financial services. The chapter begins by exploring the distinguishing features of distribution, then moves on to examine in detail the different channels that may be used to deliver financial services to the target market and discusses their advantages and disadvantages.

13.2 Distribution: distinguishing features

As far as financial services are concerned, distribution fulfils the following roles:

1. The provision of appropriate advice and guidance regarding the suitability of specific products
2. The provision of choice and a range of product solutions to customer needs
3. The means for purchasing a product
4. The means for establishing a client relationship
5. Product sales functions
6. The provision of information concerning relevant aspects of financial services
7. Access to the administration systems and processes required for the ongoing usage (consumption) of the product or service
8. The means for managing a customer relationship over time
9. The cross-selling of additional products to existing customers.

During the course of this current chapter we will largely focus upon the ways in which distribution addresses roles 1–6 listed above. In Part III, we will devote specific attention to items 7, 8 and 9.

As a component of the marketing mix, distribution has a number of distinctive features that distinguish it from the other elements of the mix; these are discussed below.

13.2.1 Cost

The costs associated with distribution may well dwarf the combined costs of all of the other components of the mix. For example, the real-estate costs of a branch-based retail bank could well be in excess of a billion pounds sterling. Similarly, the staffing costs associated with a substantial branch network will run into several hundred million pounds. For a life assurance company, the costs associated with developing and maintaining a direct sales-force of scale will incur an annual operating cost well in excess of a hundred million pounds.

The use of the Internet may appear to offer dramatic cost savings to a potential new entrant to the banking or insurance sector. However, these savings may well be nullified by the heavy costs associated with marketing communications and promotion aimed at generating awareness and demand, and establishing trust and credibility. Clearly, the costs associated with channel strategy have major implications for pricing and profitability.

13.2.2 Timescale

The development of certain channels can take a considerable period of time to come to fruition. Obvious examples of this are the timescales associated with the creation of a branch infrastructure or of a direct sales-force of scale. Similarly, once entered into, the timescales associated with certain third-party distribution arrangements can place limitations on strategic options over a protracted period of time.

13.2.3 New business strain and capital requirements

The costs associated with the distribution and set-up of a range of investment-related products can impose significant pressure upon capital. Take the case of personal pensions. A new personal pension policy may well not achieve its break-even point until the policy has been in force for many years. Until break-even point is achieved, each policy sold will represent a deficit in cash flow terms to the product provider. This deficit is referred to as *new business strain*, and an appropriate amount of capital is required to finance the strain until a surplus begins to be generated.

Thus, product features and the costs associated with certain channels of distribution will have major implications for capital. This, in turn, will influence the structure of the product range, the source of product supply and the method of distribution. For example, in 1999 Barclays took the decision to cease being the sole supplier of its life assurance and pensions products and entered into an agreement with Legal and General for the manufacture of such products. Whilst Barclays would of course forego the underwriting profits arising from these products in the long term, the change would reduce the need for capital to fund the associated new business strain. Thus, Barclays could enhance its internal return-on-capital or divert the capital thereby saved into other potentially more attractive aspects of its business – such as, say, business banking.

13.2.4 Contractual arrangements

The involvement of third parties in the distribution of an organization's products may require a commitment to a contract term lasting a number of years. Whilst this can facilitate a degree of certainty and assist in long-term planning, it does involve a degree of inflexibility during the term of the contract.

13.2.5 Loss of control

Product providers who distribute their products through third parties, such as insurance brokers, finance brokers and appointed representatives, risk being unable to exert the required degree of control regarding consistency amongst all distribution channel members. This may result in damage to the product provider's reputation should a material degree of customer dissatisfaction arise. Additionally, it may add to costs if sub-standard documentation occurs, and can weaken the quality of an overall book of business if a broker introduces relatively poor-value customers to the provider.

As an aside, the UK pensions mis-selling scandal saw product providers having to accept full responsibility for compensation in cases where policies had been mis-sold through sales agents directly in their employ. However, consumers who had been mis-sold by IFAs had to seek redress from the IFAs concerned. In such cases, product providers could not be deemed to be in a position to have controlled the selling practices of IFAs.

13.2.6 Interdependencies with other mix elements

The choice of which routes-to-market to employ has potentially far-reaching implications for all other elements of the marketing mix. These implications arise in the form of capability, resources and costs and, amongst other factors, timing and responsiveness.

For example, a general insurance company planning to adopt a purely Internet-based method of distribution might, at least in theory, have the opportunity for a highly competitive pricing structure. However, such a strategy means that the organization restricts its potential market solely to individuals that have ready access to the Internet and are willing to transact their insurance requirements in this way. It also results in the need to have well-developed skills and competencies with regard to the use of the promotional mix. Esure is a good example of a new general insurance brand that has adopted this approach to the distribution of its products. The company is having to invest heavily in a range of high-profile forms of marketing communications in order to create awareness and stimulate purchase. This has included a major television campaign featuring movie director Michael Winner, together with poster advertising in places such as the London Underground system and press advertising.

The case of telesales as a channel of distribution places heavy demands upon the *people* and *process* elements of the mix. It may also be co-ordinated with a major investment in the use of direct mail as a means of both stimulating inbound enquiries for quotations as well as fulfilling post-quotation requirements. This calls

for significant expertise in the use of direct mail and, possibly, direct-response advertising in the press.

13.2.7 Product interface

There is an extremely close relationship between product characteristics and route-to-market. It is in the very nature of certain products that they lend themselves to certain types of channel or, indeed, rule out other options. Pensions are a classic case of the need for a channel strategy that involves face-to-face interaction between customer and seller/adviser (not necessarily product provider). For a number of reasons, consumers appear, for the most part, to be unwilling to buy a personal pension on a remote basis via the Internet, direct response or, indeed, telesales. Issues concerning trust, uncertainty of outcome, timescale for delivery of outcome, and consumer financial illiteracy mean that the consumer feels a strong need to be advised by a suitably qualified individual in a face-to-face setting. This seems to be an obvious example of risk-reducing behaviour on the part of consumers. As yet, no pension product producer has built a book of business of any scale by relying solely on remote channels of distribution. On the other hand, motor insurance distributed via remote channels has been an enormous success. Again, this is very much a function of factors such as the greater degree of familiarity that consumers have with motor insurance and the low level of perceived risk that they associate with this type of product.

13.3 Distribution methods and models

13.3.1 Direct versus indirect distribution

Having discussed the role and characteristics of distribution, it is appropriate to crystallize the array of options available in the twenty-first century environment. It is customary to make reference to the basic paradigm of direct versus indirect channels of distribution in texts of this nature – indeed, these alternative modes of distribution have already been referred to. The concept of direct/indirect distribution is pretty straightforward and unambiguous within the context of tangible-goods markets. However, it is somewhat less straightforward as a means of addressing the major approaches for the distribution of financial services. Indeed, the use of the term *direct* in the context of financial services is liable to give rise to confusion, owing to the ambiguity with which it is used.

In purist terms, direct distribution concerns the provision of a good or service from manufacturer/provider to customer in the absence of an intermediary that is under separate ownership, management and control. Therefore, it is channel ownership rather than the structure of the distribution channel that determines whether distribution is direct or indirect. In the case of a direct route-to-market, all of the steps involved in acquiring a customer and selling a product are owned by the product provider. Indirect distribution, on the other hand, involves the use of agents of one form or another that are owned by a third-party organization. As can be imagined, direct distribution facilitates a far greater degree of control over the customer experience than does indirect distribution. However, that degree of control may be

bought at the price of a lower level of sales than might occur if some form of indirect distribution is employed. A range of factors must be considered when addressing the issue of direct versus indirect distribution, and these are summarized below.

Direct distribution

The advantages and disadvantages of direct distribution are as follows.

Potential advantages:

- Control of brand values
- Control of customer experience
- Control of corporate reputation
- The maintenance of competitive advantage from unique products and features
- Control of regulatory obligations
- Freedom of action
- Strategic flexibility
- Clarity and consistency of internal communication.

Potential disadvantages:

- Direct distribution limits distribution coverage
- It restricts sales volumes
- It limits market share
- Requires considerable amount of capital.

Indirect distribution

In many ways the potential advantages and disadvantages of indirect distribution are the obverse of those given above. However, it is helpful to see them presented as a discrete list.

Potential advantages:

- The provider can focus on core competencies, of which distribution may not be one
- The ability to focus on product quality and costs
- The avoidance of set-up costs associated with new forms of distribution
- Allows for rapid penetration of markets, nationally and internationally
- Access to higher sales volumes may result in lower aggregate costs that could feed into enhanced price competitiveness
- The added cachet of having products distributed by high-profile intermediaries with strong brand reputations
- Flexibility to experiment with new sales channels within limited cost parameters
- It may limit access to marketplace by competitors
- It can enable provider and major distributors to test a working partnership that could ultimately result in a merger
- Can reduce need for capital.

Potential disadvantages:

- Lengthy and variable communication arrangements can slow down reactions to tactical events

Table 13.1 UK sources of general insurance premiums, 2003

	Personal lines	Commercial lines	Marine & aviation	Total
National brokers	10	54	88	31
Chain brokers and telebrokers	5	5	–	5
Other independent intermediaries	16	24	4	19
Direct	32	7	6	21
Company staff	3	1	–	2
Company agents	5	5	2	5
Other	28	3	–	16

Source: ABI Statistical Bulletin.

- Loss of control over brand values, customer experience and reputation
- Regulatory risks
- Long-term distribution contracts can limit strategic options
- Indirect distribution can result in undue reliance on dominant distributors.

Elements of direct and indirect distribution models are to be encountered in most areas of financial services. However, some areas display a greater tendency towards one than others. For example, retail banking remains overwhelmingly direct. Life Assurance has become increasingly indirect in the UK – indeed, in the 12 months to 31 December 2003 some 66 per cent of new individual life and pensions business was accounted for by IFAs. If we add to this the business introduced by tied agents, the proportion is of the order of 80 per cent. It is important to note that certain product categories within an aggregate financial services sector display a marked bias towards either direct or indirect distribution. Table 13.1 shows the ways in which this bias is displayed in the general insurance sector.

13.3.2 Whether products are bought or sold

Before presenting an overview of currently available distribution methods, it is important to grasp the thorny issue of whether financial products are bought or sold. This issue is of fundamental significance to the marketing of financial services, and was initially discussed in Chapter 7.

Although the needs expressed for the range of financial services are easily understood and readily appreciated, the motivation on the part of consumers to engage in proactive product search and buying behaviour is more muted. We can all grasp the benefits of enhanced income in retirement from buying a pension, or the security a family gains when the breadwinner buys a critical illness insurance policy. However, the level of expressed demand and proactive purchasing behaviour is of a relatively low order. A range of factors is implicated in this reluctance, not least of which is affordability. Additionally, there is the opportunity cost to current consumption of other more pleasure-inducing goods and services. Undoubtedly there are circumstances in which the consumer does actively seek to buy; this is most

apparent with mortgages and motor insurance. In the latter example, there can be simply a legal obligation for motor vehicle owners to ensure they have at least third-party insurance cover.

Whilst it is certainly the case that some products are predominantly *bought* whilst others fall more generally into the category of being *sold*, it is far from a product-specific issue. Rather, it is a complex and multi-faceted matter which involves the interplay of product, customer and situational considerations. An individual might proactively *buy* into, say, a mutual fund on one occasion; equally, he or she might well decide to make an unplanned purchase on another occasion as a result of proactive sales activity on the part of a product provider or intermediary.

A financial services sector based purely upon products distributed to proactive buyers would be of a materially smaller scale than one that engages in proactive selling. It is in the interests of all parties (consumers, providers, intermediaries, regulators and governments) that proactive sales activity is fully appropriate to the customer's circumstances. In other words, great care must be taken to ensure that the rights of all parties are respected. It is similarly important that all parties are aware of their responsibilities, and act in ways that are commensurate with those responsibilities.

Although the role played by intermediaries is notable within the context of life and general insurance, indirect channels play an important role in other areas, including:

- mortgages
- credit cards
- secured loans
- unsecured loans
- health insurance
- creditor protection insurance
- hire purchase
- share dealing.

13.4 Distribution channels

There is a diversity of channels used in the distribution of financial services. These include the following:

- Specialist financial services branch outlets, such as banks, building society branch offices, credit union offices
- Non-financial services retailers, such as supermarkets, electrical goods, motor dealers, clothes shops, department stores
- Quasi-financial services outlets, such as post offices, real estate agents
- Face-to-face sales channels, such as financial advisers, direct sales-forces, credit brokers, insurance agents
- Bancassurance
- Telephone selling via both outbound and inbound call-centres

- The Internet
- Direct mail
- Direct-response advertising, including newspapers and magazines, commercial radio and television
- Affinity groups, such as employers, trades unions, football clubs, universities.

The above methods of distribution are described below.

13.4.1 Specialist financial services branch outlets

The branch outlet has until recently been the dominant means of gaining access to the mainstream products associated with banking and mortgages. In this context, the branch has performed the dual roles of acting as a retail outlet in which buying and selling activities could take place as well as providing a range of processing functions to facilitate the ongoing administration of products. The importance of the branch network in retail banking is evidenced by the fact that there are very few banks worldwide which operate without a branch network. For example, HDFC Bank in India draws attention to the rapid development of its branch network as a key factor behind its successful market-penetration strategy. However, with the development of bancassurance, bank branches have become orientated more towards being product sales outlets and less involved in administrative functions. This transition from the branch as essentially a customer services outlet to being a customer sales outlet has not been without its difficulties. For established branch networks, the culture of the branch has had to undergo a major transformation as staff have had to adapt to a new sales-orientated role – a process which many traditional bank staff find challenging (Sturdy and Morgan, 1993).

The branch itself is a complex environment. It is an area where consumers make routine transactions, staff may try to make sales and a range of back office tasks have to be accomplished. Traditional branch designs placed very heavy emphasis on back-office processing, and the traditional bank branch provided a relatively unwelcoming environment. Recent developments in branch design have placed much greater emphasis on ensuring a customer-friendly environment and increasing the amount of space available for customers. Thus, banks rely on open-plan layouts and decoration which is themed according to the bank's corporate identity. For example, Standard Chartered's new 'Financial Spas' dedicate the majority of floor space to customers, the branch is softly lit and it has reading materials, comfortable seats, computer terminals and television screens.

Many banks have also introduced 'zoning'. This means that the floor area is divided up so that there are distinct areas for particular types of banking transaction. Thus, for example, a bank may decided to have a separate 'self-service' area for basic money transmission, balance enquiries, etc., often relying only on ATMS. A different area of the branch will then be dedicated to standard products such as account opening, credit-card applications and basic loans. Finally, a third area may be set aside for customers looking for more complex products requiring detailed discussions with a member of the branch staff.

Many banks are also looking to expand the range of services available via the branch in order to make more efficient use of their network. Again, a prime example is

Standard Chartered's Financial Spa, which is presented as a one-stop financial management centre or 'financial supermarket'.

The advantages and disadvantages associated with specialist financial services branch outlets as a means of acquiring customers are summarized below:

Advantages associated with specialist financial branch outlets as a means of new customer acquisition are that they:

- represent physical evidence of intangible services
- provide reassurance and represent solidity of the provider
- give confidence to customers that they can gain access to services features and help
- achieve reinforced awareness of brand
- provide access to face-to-face service and advice
- allow complex transactions to be easily conducted
- facilitate easy deposit and withdrawal of cash and cheques
- are particularly effective as a means of selling complicated products
- are highly effective as a means of achieving so called 'cross-selling', i.e. selling additional products to existing customers.

Disadvantages associated with branch outlets are that:

- rural and poor communities are often poorly served
- limited opening hours restrict access to services
- branch geography is based on historical usage patterns
- they have high costs
- pressure on staff to achieve cross-sale targets can cause customer dissatisfaction.

13.4.2 Non-financial services retailers (NFSRs)

A wide range of retail outlets has some involvement in the distribution of financial services as an adjunct to their core business. Some of these outlets are involved in the direct distribution of their own manufactured products, whereas others act as agents for third-party product providers. Additionally, some retailers are hybrids in that they distribute their own products (direct) as well as products manufactured by other providers on an agency basis. A characteristic of most forms of NFSRs is that financial services are not their core business. Table 13.2 provides some examples of typical NFSRs' variants.

In the UK, supermarkets such as Tesco and Sainsbury have established their own banking subsidiaries and have acted as catalysts for greater competition in the market for current and deposit accounts. Other forms of retailer have provided various forms of finance, such as hire purchase, for many years – indeed, for many it represents a significant source of margin. However, being a non-core part of the mainstream business places certain limitations on the scope of financial services that can be distributed in this way. For example, services tend to be a single product provided by a single provider, such as car finance distributed via an automobile dealership. In this case, motor vehicle finance is viewed by the consumer as a credible adjunct to the dealer's own business of automobile sales. The resonance between a car dealership and automobile finance is reasonably viewed as being salient,

Table 13.2 Typical NFSRs' variants

Retail outlet	Typical financial services distributed
Supermarkets	Current banking accounts, general insurance: motor, health, holiday, unsecured loans, credit cards
Motor dealers	Car loans, creditor protection insurance
Home improvement companies	Finance, creditor protection insurance
Electrical goods retailers	Hire purchase, extended warranties, creditor protection insurance
Department stores and clothes-retailing chains	Own-label credit cards
Furniture outlets	Hire purchase, creditor protection insurance

or representing a good fit. However, the relationship between a car dealership and other forms of financial services may not be viewed as having the same degree of saliency. For example, if the car dealership was considering selling, say, mutual funds, consumers might be expected to be somewhat resistant because the product (mutual funds) is not readily associated with the provider (car dealer).

The issue of brand saliency plays a role in the case of supermarkets. They have made material progress in distributing relatively straightforward products, such as motor and holiday insurance, but have yet to register a significant breakthrough as a vehicle for distributing products such as pensions and investments. It is interesting to speculate on why major retailer branches have stretched into simple financial services products but not, as yet, into the more challenging areas of financial services. The answer to this issue may have less to do with brand saliency than with the issue of whether products are bought or sold. Arguably, brands such as Virgin, Tesco and Sainsbury can stretch successfully into product areas characterized by the *bought* mode of acquisition, but do not yet have the capability to operate effectively in the *sold* mode.

There is evidence from research by Devlin (2003) that consumers are willing to place their trust in brands that are primarily not financial services-orientated as a source of financial products. This suggests that, at least in the UK, non-traditional financial services brands could leverage their brand associations into the financial services arena. However, the extent to which brand saliency or selling capability lies at the heart of the current limitations on the penetration of major retailing and consumer brands into complex financial services product areas is as yet unclear.

Advantages of NFSRs as a means of new customer acquisition are that:

- well-respected consumer brands can create high levels of trust and imply value and dependability
- the physical branch presence facilitates low-cost promotional displays
- the branch facilitates access to help and assistance
- face-to-face help can be provided at relatively low marginal cost
- in their role as intermediaries, they can provide access to high volumes of new customers
- they are well-suited to the distribution of complementary products (e.g. car finance via car dealers
- they can be a relatively low cost means of distribution.

Disadvantages of NFSRs are that:

- they may not be seen as credible providers of financial advice
- they may not be seen as credible providers of complex products such as pensions, mortgages and investment funds
- loss of control over quality of business is introduced
- there is loss of control over the quality of the customer experience
- there are the potentially high costs of commission paid to introducers
- over-dependence on high-volume producing agents can make a supplier vulnerable.

13.4.3 Quasi-financial services outlets (QFSOs)

This term refers to channels that, whilst not being traditional financial services outlets, have a strong affinity with them. The best examples of QFSOs are post offices and real-estate agents. Throughout the world, post offices are often the channel through which state social security payments are made, and this positions them as having a money transmission role. As well as making cash payments of state benefits, post offices are typically used for providing access to state-owned savings institutions such as National Savings & Investments in the UK. Thus, they may well be limited in their ability to distribute products supplied by the private sector. However, in an era of deregulation of financial markets worldwide, this may become less of a hurdle in the future. Japan is considering privatizing its postal system, and this could well create new opportunities for the private sector to gain access to the post-office channel.

We consider real-estate agents as QFSOs rather than NFSRs because of the complex nature of real-estate finance. The financing of a real-estate purchase involves, potentially, the interplay of a range of complex financial products, including: mortgages, endowment insurance schemes, life protection policies, pensions and critical illness insurance. Thus, the real-estate channel has the potential to be a highly profitable method of customer acquisition, given the bundle of products that can be packaged together. Indeed, this was an important part of the rationale of major banks and insurance companies acquiring real-estate chains in the late 1980s and early 1990s. Many of those acquisitions foundered as the new owners failed properly to value the chains they acquired and recognize the competencies needed to run businesses that were outside their previous experience. Unfortunately, it also coincided with a dramatic recession in the UK housing market.

Advantages of QFSOs as a means of new customer acquisition are that:

- a highly localized branch network of post offices provides ready access to all consumers
- post offices are seen as trustworthy and secure
- post offices handle cash sums and have the systems capability for a range of money transmission options
- post offices often have extended opening hours compared with banks
- post offices can play a vital role in facilitating financial inclusion
- real-estate agents can provide access to high-value sales opportunities
- branch outlets are conducive to face-to-face advice and assistance.

Disadvantages of QRSOs are that:

- although well-suited to simple products, QFSOs may be less suited to the distribution of complex products where advice may be required
- there is often a lack of privacy which consumers find inhibits the nature of their transactions
- there is often limited space for effective point-of-sale promotion
- queues are often a feature of post offices, and this inhibits their usefulness as distribution outlets
- real-estate agents often suffer from a poor reputational image which may undermine consumer trust
- real-estate firms are often led by strong local characters with a highly independent approach
- there is the potential for loss of control re. compliance with regulations and customer experience.

13.4.4 Face-to-face sales channels

Direct sales-forces have been the backbone of the life assurance industry throughout the world for decades. However, their role, culture and style of working have changed radically as more and more markets are adopting strict standards of regulation. For example, during the 1980s it was estimated that in excess of 200 000 people in the UK were registered with the then regulator of life assurance direct sales-forces (LAUTRO; the Life Assurance and Unit Trust Regulatory Organization). By the turn of the last millennium, this number had reduced dramatically to fewer than 20 000.

Historically, a key driver of the direct sales-force model was the notion that life assurance, investment and pension products had, fundamentally, to be sold rather than be bought. Although there is undoubtedly a given level of business that is *bought*, the adherents to the *sold* model argue that it is in the nature of life, pension and investment products that a significant element of demand is latent rather then expressed. The primary role of the direct sales-force is to turn latent demand into real new business through its capability to prospect for new customers. Thus, the capacity of a direct sales-force to work as a powerful means of prospecting has been seen as key to its success. Often referred to as 'a numbers game', the traditional prospecting direct sales-force was underpinned by a funnel model shown in Figure 13.1.

It has not been uncommon for the ratio of suspects to prospects to customers to be of the order of 100 : 10 : 1 – i.e. it takes 100 suspects to produce 10 prospects leading to just 1 customer. Hence, direct selling has sometimes been seen as essentially a numbers game. The more skilful the individual salesman, the narrower the angle of the sales funnel. Until the rigours of financial regulation and control began to take effect, the direct sales-force was driven to increase its headcount year-on-year since, so the theory went, the bigger the sales-force, the greater the sales volumes. Unsurprisingly, direct sales-forces can often display extremely high staff turnover rates. Indeed, in the UK in the late 1980s it was often in excess of 40 per cent per annum. Thus, a company with a direct sales-force of 3000 advisers would have to

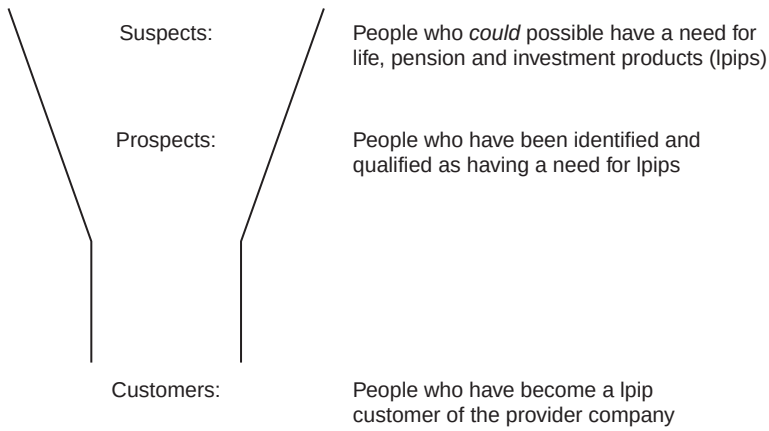

Figure 13.1 The prospecting funnel.

recruit 1200 new salesmen per annum (assuming a 40 per cent turnover rate) just to stand still. As can be imagined, the recruitment of 100 new salesmen each and every month is a challenging task. For this reason, sales managers would spend a disproportionate amount of time sourcing new recruits relative to the time spent training and developing their existing salesmen and women.

Such a model is clearly highly inefficient, and has resulted in unsustainably high distribution costs. It is a model which is predicated by the notion that life, pension and investment products are fundamentally sold rather than bought, and results in the costs associated with overall prospecting activities being borne by the customer who actually buys. Thus, in the example of the prospecting funnel given earlier, the costs associated with the 99 people who do not buy are loaded onto the single person who does. This had resulted in distribution-related costs that have been criticized for delivering poor customer value.

The means by which direct sales-forces are remunerated has been the subject of much controversy and debate. In essence there are two basic approaches, namely commission, or salary plus bonus. However, a number of variations based upon these two basic approaches are to be found. In the commission-based approach, the salesperson receives payment purely on the basis of sales made. Thus, an individual who works diligently but fails to make a sale will receive no income. This may well seem to benefit the provider company, since it results in the avoidance of certain overhead costs associated with the sales-force. Critics of this method of remuneration argue that it places undue pressure upon the salesperson to make a sale, which in turn results in coercive sales practices to the detriment of the consumer interest (Diacon and Ennew, 1996).

Adherents of the salary-based model argue that this method of remuneration is more consistent with present-day employment philosophies by recognizing the professionalism of the salesperson. Importantly, it is argued that a salaried approach reduces the pressure on the salesperson to make a sale, and that this in turn results

in better quality of business and greater levels of customer satisfaction. However, the costs associated with time spent prospecting still have to be paid for, and these costs are loaded onto the customer who buys in much the same way as in the commission-based approach. Arguably, the costs are even higher in the salaried model than in the commission-based model since it results in a higher level of fixed cost to the provider.

The discussion regarding remuneration so far assumes that the advisory function provided by the salesperson is available free of charge to prospective customers. A contrary point of view is that financial advice should be seen to be a professional service in much the same way as the advice given by a lawyer or an accountant. Accordingly, the argument runs that prospective customers should be offered the opportunity to pay a fee for advice, whether or not they subsequently make a purchase. Ultimately, it is presumed that the distribution costs loaded into product charges will fall as actual purchasers are relieved of the cost burden associated with prospecting activities. This may well sound good in theory, but in practice the vast majority of domestic consumers and business customers are, as yet, unwilling to pay up-front fees for advice. This seems odd, given that consumers seem increasingly willing to pay arrangement fees (frequently of the order of £600) for a wide range of mortgages. Clearly this is a complex matter concerning human attitudes, perceptions and behaviours.

In 2005, changes to the sales polarization rules in the UK resulted in IFAs having to offer their customers the opportunity to choose to pay either an up-front fee for advice or receive 'free advice' on the understanding that it will be paid for in the commission that the product provider pays to the IFA.

There are instances where salespeople are paid purely on the basis of a flat-rate salary with no sales-value or volume-related bonus. The advantages claimed for this approach are that it frees the salesperson from any pressure to sell and results in good-quality sales and high levels of customer satisfaction. However, the prevailing corporate orthodoxy maintains that some degree of incentive is necessary to encourage high performance, and thus remuneration based upon sales results remains the norm.

Since the early 1990s there has been a sharp reduction in the proportion of direct salespeople who are remunerated purely by commission, and a commensurate increase in the proportion who are salary-based. This has forced the companies concerned to become far more professional in their approach and achieve significant improvements in the productivity levels that are achieved by the sales-force. This latter point is of great importance, as the average number of sales of the typical direct sales-force in the early 1990s was in the order of one sale per person per week. In practice, a small cadre of highly productive salespeople were achieving well in excess of one sale per week, and a disproportionately large group of individuals were woefully unproductive – the so-called 'tail' of the sales-force.

It is worth commenting a little upon the cultural differences that apply to commission and salaried direct sales-forces, since they have far-reaching implications. Commission-based sales organizations revere high-performing individuals and have been accused of almost encouraging the cult of the sales prima donna. Such organizations position the role of the salesperson as a self-employed business person who enjoys considerable freedom to act. In extreme cases, salespeople enjoy the freedom to organize their work very much as an independent contractor.

The value of what are termed 'renewal commissions' can be commuted to achieve a capital value that high-performing advisers can realize in much the same way as small entrepreneurs can sell their business and realize a capital gain. Notwithstanding the rigours of regulation, self-employed commission-based sales advisers set their own target regarding sales performance at a level that satisfies their personal lifestyle aspirations. They are often disdainful of their sales managers, who they consider to be their inferiors in the highly-charged field of life assurance sales.

The culture of the salary-based direct sales-force represents a far more controlled business environment. As an employee, the individual salesperson is expected to conform to the values, style and processes of the employer company in much the same way as other employee, such as those working in administration or IT. A more traditional approach to the managerial hierarchy is in evidence, whereby top-performing advisers are not encouraged to feel that they have a direct line to the Chief Executive. Importantly, strict standards are laid down for the achievement of input-orientated performance, such as the number of appointments carried out per day or per week.

It is appropriate to make some additional comments regarding independent financial advisers. This form of face-to-face distribution has become the dominant form of distribution for a number of products in the UK. In principle, the IFA is viewed as the agent of the consumer. This contrasts with Appointed and Company Representatives (ACRs), who are deemed to be the agents of the provider company. As a result, IFAs are viewed as having a particular duty of care to provide the best-possible outcome for the client's needs from the full spectrum of product providers in the marketplace. Box study 13.1 provides an overview of the IFA sector in the UK.

Box 13.1 IFAs in the UK

IFAs are organized in a number of ways, from large national sales-forces down to one-man bands. According to information supplied by Matrix-Data Ltd, the IFA domain was structured as follows as at mid-2004:

IFA type	Total no. of firms
Nationals	109
Big IFAs	235
Regionals	560
Small IFAs	11 207
Total	12 111

The trade association representing IFAs is AIFA, and it estimates that in the order of 25 000–30 000 individual financial advisers are employed by the 12 111 firms shown above. New rules regarding the provision of financial advice were introduced in June 2005, related to a regulatory initiative termed *de-polarization*. The practical effect has been to replace the clear demarcation between fully independent and tied advice with the addition of multi-tied agents

Box 13.1 IFAs in the UK—cont'd

(referred to earlier in this chapter). The early indications are that IFAs are, by and large, choosing to remain fully independent. However, under the new rules IFAs have to allow the customer the opportunity to pay a fee for advice as an alternative to product-loaded commissions. A firm choosing not to offer the advice fee option will no longer be able to call itself an IFA; instead, it is deemed to be a 'Whole of Market Financial Adviser' (WMFA) It seems likely that these developments will serve to create an even greater degree of consumer confusion, given the following array of types of adviser.

1. IFAs:
   - must give the most suitable advice from all the products in the marketplace
   - must offer the customer the option to pay a fee for advice instead of a product-loaded commission.
2. WMFAs:
   - must give the most suitable advice from all the products in the marketplace
   - advice is funded purely by product-loaded commission.
3. Multi-tied agents:
   - must give the most suitable advice from the products provided by their panel of supplier companies
   - advice costs are funded by commission.
4. Company representatives:
   - are contracted directly to a single supplier company, as either a salaried employee or a self-employed adviser
   - must give the most suitable advice from the product range of their supplier company
   - advice costs are levied on the customer in the form of a product-loaded commission.
5. Appointed representatives:
   - work on behalf of a third-party intermediary distributor and not directly for the product provider
   - may be remunerated by a commission or salary
   - must give the most suitable advice from the product range of the supplier company
   - advice costs are levied on the customer in form of product-loaded commission.

13.4.5 Bancassurance

As the name implies, this is a form of distribution that has its origins in France. In simple terms, it concerns the provision of life, pension and investment products by a banking organization. Indeed, in many parts of continental Europe bancassurance has become the dominant distribution channel for products of this nature – in countries such as France and Spain, bancassurance may account for 60–80 per cent of insurance sales. Bancassurance expanded rapidly in the UK between 1986 and 1992,

in the immediate post-deregulation period. At that time, many industry pundits were predicting that bancassurance might capture of the order of 40 per cent of the market by the second half of the 1990s. In the event, bancassurance peaked at about 15 per cent of the UK life assurance market and has remained at about that level. Bancassurance has also become an important channel for distribution in Latin America, Singapore (where it may account for as much as 24 per cent of new life insurance sales), Australia, Malaysia, India and China. Bancassurance emerged in India at the end of the 1990s, when the life insurance sector was privatized. New insurance entrants into both India and China are using bancassurance models to compete against established insurance companies with their own extensive branch networks. Both countries are expected to display significant growth in bancassurance-based distribution over the next 10 years, partly because of the impact of foreign entrants to the domestic market and partly through the growing use of this channel by domestic insurers.

The real power of the bancassurance model derives from its ability to:

- achieve low customer acquisition costs
- maximize cross-selling opportunities
- utilize relevant customer data.

Bancassurance comprises elements of both the *bought* and *sold* aspects of customer acquisition addressed earlier. We might term these the *passive* and *active* models of bancassurance.

The passive model of bancassurance is as follows

- Step 1: A current-account customer decides to solve a financial problem by visiting the bank branch. Most typically, this will concern the need for a mortgage or loan of some kind.
- Step 2: The customer's primary need (e.g. for a mortgage) is resolved by the relevant member of the branch's staff.
- Step 3: In the example of a mortgage, some form of loan-related insurance will be required to provide security to the bank in the event of the death of the borrower before the loan is repaid. Depending upon the prevailing regulatory rules, the loan-protection may need to be transacted by a properly authorized financial adviser.
- Step 4: The financial adviser conducts a fact-find and completes the purchase of the insurance policy. In this way, the bank has gained a customer for its insurance business.

It can be readily appreciated that this passive model operates reactively to instigation by the client. Two notable consequences arise from this model. First, the mix of life, pension and investment products displays a marked bias in favour of loan-protection insurance policies. Secondly, it fails to engage that proportion of the total current account customer base which does not proactively use the branch to engage in suitable problem-solving behaviour.

These consequences were overlooked by the bullish commentators of the early 1990s, and hence their projections were completely unrealistic. Indeed, the over-reliance of bancassurance on the residential mortgage market was a critical

weakness in the product sales mix, and explains why its market share fell as the housing market experienced a sharp period of decline between 1991 and 1995.

The limitations of the passive model of bancassurance gives rise to the *active* model. In this model, the bancassurer recognizes the need to achieve the dual goals of optimizing sales opportunities presented by the current-account customer base as a whole and achieving a well-balanced product sales mix.

The bancassurance model can only begin to achieve its full potential when it adopts the active model. However, this requires a different approach to the passive model, as the organization seeks to make the transition from a customer-pull method of distribution (the *bought* approach) more towards a supplier-push method (the *sold* approach). In the mid-1990s, Barclays recognized the need to adopt a more active approach to its bancassurance business. This change of approach required a well-coordinated programme of change management involving a range of initiatives such as:

- strengthening the systems, procedures and resources needed to ensure high standards of compliance with advice-related regulations
- adjusting the remuneration system to lessen reliance of advisers on the passive model
- improving the competitiveness of the product range to ensure good value for customers and give confidence to advisers
- strengthening the effectiveness of in-branch promotional activities of non-loan related products
- communicating proactively with potential customers who do not tend to visit branches
- strengthening sales management supervision to raise the work rate of the sales-force
- increasing the training given to sales advisers and the managers to build upon their skill base
- achieving higher levels of communication between the branch staff and their management and the bancassurance organization
- making better use of data held on existing bancassurance customers.

A key issue to grasp when adopting the active model of bancassurance is the relationship between the insurance and branch banking operations. Although a wide range of organizational structures is encountered, there is usually some form of structural boundary that separates the two entities of insurance and branch banking. A typical model is one in which cashiers and other branch-based customer service staff perform the role of introducer of prospective customers to the sales advisers of the bancassurance operation. Therefore, it is of paramount importance that excellent working relationships are fostered between the two. Indeed, it is the norm that branch staff have a balanced scorecard of objectives to achieve, and the bancassurance advisers should work closely with them to achieve the valuable synergies that exist. This requires a high degree of mutual understanding and respect. Organizations that fail to recognize the importance of managing the introducer–adviser interface are unlikely to succeed in achieving their aspirations for bancassurance.

When it operates effectively, bancassurance can be a highly successful means of acquiring new customers for the life, pension and investments organization of a

banking institution. A typical bancassurance adviser can be expected to achieve sales productivity levels greatly in excess of the prospecting sales-forces of the stand-alone life assurance company.

Advantages of bancassurance as a means for new customer acquisition are that it:

- provides access to high volumes of good quality potential customers
- has high levels of adviser sales productivity
- has potentially lower acquisition costs than prospecting sales-forces
- is backed by the reputation of the core bank brand
- permits face-to-face advice in the branch, the home or office
- can use current account data and transactions as triggers for sales opportunities
- has potential for developing a bundled pricing approach involving bank and life, pension and investment products
- has ongoing administration synergies.

Disadvantages of bancassurance are that:

- a poor banking reputation can limit customers' willingness to buy its life, pension and investment products
- a bank brand may not convey sufficient saliency regarding certain products – i.e. may lack a degree of credibility
- overzealous telephone prospecting harms the core banking relationships
- overzealous prospecting in branch harms the core banking relationship
- face-to-face advice can be expensive for low-margin products
- the passive model fails to achieve the expected success.

13.4.6 Telephone-based distribution

The telephone has become a powerful means for the achievement of a range of purposes in the field of retail financial services. At its simplest, it can act as a cost-effective means of prospecting for potential new customers by seeking to secure sales leads. At its most complex, it can provide a fully-functional banking service. In between these two extremes sits the use of the telephone as a highly successful means of product distribution, especially for general insurance products.

During this current section we will focus primarily upon the role of the telephone as a channel of distribution in the context of new business acquisition. The role played by the telephone in managing ongoing customer relationships will be addressed in Part III of this text.

It was during the 1980s that the telephone began to assume major significance as a distribution channel in financial services; prior to that it had been employed typically as a promotional tool associated with canvassing for leads for sales people. However, as the 1980s progressed, advances in telecommunications capability and data processing facilitated a far more integrated approach to the use of the telephone as a distribution channel. Throughout the world, these advances have seen the development of a teleworking industry on an enormous scale. By 1998 the European Commission guesstimated that somewhere in the region of 1.1 million to 4 million people were employed in teleworking in the EU. The top European countries identified for teleworking were Denmark (9.7 per cent of the workforce) and the

Netherlands (9.1 per cent). Since that time telemarketing has become far more global, with major telephone call-centres established in India and other parts of Asia. Indeed, Indian-based telephone call-centres have formed the core of the fast-evolving offshore outsourcing of financial services.

Two terms that are commonly encountered in the context of telemarketing are *outbound* and *inbound*. By *outbound*, we mean that the call centre proactively seeks to make contact with people by initiating the telephone contact. This could take a variety of forms, such as cold calling from telephone lists or in response to an initial contact prompted by, say, a direct mail shot. Inbound calls, as the name implies, relate to when the call-centre responds reactively to a call initiated by the consumer. The consumer may well be calling in response to some forms of stimulus from the provider company, such as a television or magazine advertisement.

The economics of *outbound* calling have presented major difficulties. This arises from practical problems such as low daytime response rates and the relatively high incidence of engaged lines. Again, technology has helped, with the advent of the predictive dialler that automatically dials a list of numbers and presents a call to an agent only when the phone has been answered by the consumer. Even so, *outbound* calling tends to be more limited than *inbound* calling.

As a distribution channel, the telephone has been especially successful with relatively simple products such as motor insurance using the *inbound* approach. Originating in 1985, Direct Line has grown to become a major player in the direct insurance market. Direct Line has evolved its strategy in response to the growth of Internet usage, and began to distribute its products on-line in 1999.

Telephone-based distribution permits real-time person-to-person interaction without the need for expensive branch networks or direct sales-forces. However, there are limitations on the nature of business that consumers are willing to transact on this remote basis, and it remains firmly based upon relatively simple, low-risk transactions. However, there is growing use of this form of distribution for a range of investment products and services on a purely outbound basis, such as broking services and investing in wine, commodities, and the other non-mainstream asset classes. Case study 13.1 shows how telephone-based distribution channels have been used to good effect by a new entrant to the financial services sector, Kwik-Fit Insurance Services.

Case study 13.1 Kwik-Fit insurance services

Since opening its first Kwik-Fit Centre in Edinburgh back in 1971, the company has grown to become one of the world's largest independent automotive repair specialists and has established its credentials as a leading brand in the field of motoring. During 1994, Kwik-Fit came to the realization that technology in terms of advanced telephony and database management techniques provided an opportunity to address both of the strategic imperatives of defending the customer franchise and creating cross-selling possibilities. Thus, the idea of Kwik-Fit Financial Services (KFFS) was born. KFFS signalled a major form of

Continued

Case study 13.1 Kwik-Fit insurance services—cont'd

diversification for Kwik-Fit. Motor insurance was the obvious first product for KFFS, and so it set up a panel of motor insurance providers and commenced its telemarketing operations in 1995.

To begin with, KFFS created an inbound model using significant above-the-line advertising and promotion to create consumer demand-pull. It did not take KFFS long to realize that this model presented logistical and commercial challenges. First, it is difficult to plan the resources needed to handle demand-pull telemarketing when using in-house facilities, and KFFS did not wish to outsource these functions. Secondly, the cost per sale did not make economic sense. Kwik-Fit responded quickly to this experience and created a wholly new model. This involved the creation of four separate groupings of telephone call agents, namely Research, Sales, Customer Service and Claims.

The research team role contacts customers who have used a Kwik-Fit Service Centre during the previous two days. Following an assessment of satisfaction, customers are asked whether they would like to receive a quotation for motor insurance, and a positive response to this line of questioning results in a lead. The motor insurance lead and relevant customer data are transferred electronically to the sales team, which makes outbound sales calls.

This new model has proved to be a great success solving the problems of resourcing and cost encountered in the earlier phase. Initially, the research team contacted some 5000 customers each day; more recently, the company has adopted a more precisely targeted approach by only telephoning those customers to whom it believes it can offer a competitive deal. By using this research encounter to obtain leads, Kwik-Fit has driven down the cost of customer acquisition dramatically. At the same time, it can manage sales call resourcing much more efficiently through the adoption of an outbound approach. This business model is an example of a service organization leveraging a real source of competitive advantage to achieve what in Ansoff's terms is a strategy of product development. An unexpected spin-off from this research–lead–outbound call process was a material level of inbound requests for quotations as a consequence of word-of-mouth advocacy by 'delighted' customers.

So successful has this new business acquisition model become that the company has ceased all forms of demand-pull advertising and promotion. Its sole form of publicity is advertising in Yellow Pages. As at the end of 2005, some 75 per cent of KFFS' new customers were sourced from the Kwik-Fit Service Centres, an additional 15 per cent originated via the directories, and the remaining 10 per cent via the Internet.

The third call agent grouping concerns customer service, and has the role of dealing with inbound customer service requirements such as a change of address or including an additional driver on the policy. Customer service call agents also have objectives – to generate leads to cross-sell other products which have now been added to the KFFS portfolio, including breakdown insurance, home contents and buildings insurance. In addition to general insurance products, the company also sells life assurance as an Appointed Representative

Case study 13.1 Kwik-Fit insurance services—cont'd

of Legal & General. A further broadening of the product range concerns an arrangement the company has developed with Scottish Power to sell gas and electricity on its behalf. Again, calls are monitored frequently to ensure the quality of the call-agent–customer dialogue. The fourth team is responsible for the initial handling of claims in response to inbound customer contact. However, the actual claims management process is handed-off to the individual insurance companies.

KFFS has faced ever more intense competition from a widening variety of sources, including supermarkets and on-line brands such as Esure and the HBOS subsidiary Sheilas' Wheels. It might be imagined that Direct Line poses the single most important threat. However, Direct Line does not have KFFS' competitive advantage of low-cost acquisition via the nationwide Kwik-Fit Service Centre network. Direct Line would appear to be pursuing a somewhat selective customer recruitment policy, given that it underwrites its own policies. KFFS, on the other hand has an altogether more inclusive approach based upon its strategy of acting as an intermediary to a range of underwriting companies.

Now in its eleventh year of operation, it is estimated that KFFS has built an in-force book of more than 500 000 policies, and for the last financial year it posted an operating profit of £6.8m. Its operation has grown to comprise some 800 employees, and it is considering further product range extensions. The company is believed to have the largest insurance outbound telephone marketing operation based in the UK. Moreover, KFFS has been rated as one of the UK's best 100 companies to work for some four years in a row.

Source: Martin Oliver, Chief Executive, Kwik-Fit Financial Services.

Advantages of telephone-based distribution channels as a means for new customer acquisition are that it:

- avoids the high cost of a branch infrastructure
- is very flexible and can offer 24/7 access
- allows real time person-to-person interaction
- lends itself to third-party administration (TPA) and outsourcing as a means of further reducing costs
- complements direct-mail and other forms of direct-response promotions
- makes good use of existing customer relationship and databases as part of a cross-selling strategy.

Disadvantages of telephone-based distribution channels are that:

- it is not as effective as face-to-face for certain products and services
- automated call-handling systems can cause customer dissatisfaction
- unsolicited outbound sales calls can cause customer dissatisfaction and weaken a customer's relationship with the brand.

13.4.7 Internet-based distribution

The rapid development of the Internet from the mid-1990s onwards has had far-reaching implications for financial services. In common with telephone-based developments, the Internet has resulted in new sales as well as administration solutions to customer needs. However, a great deal of hype surrounded the development of the Internet around the time of the millennium. In the way that the potential of bancassurance was over-inflated during the early 1990s, so too was the near-term impact of the Internet some 10 years later. Indeed, some of the more extreme forecasters were predicting that the Internet (clicks) would make branches (bricks) redundant within a 5-year period. Both sets of prognoses were flawed because they were based upon an inadequate appreciation of how consumers and organizations interact. With regard to the Internet, there was a failure to appreciate the subtle range of variations in distribution preferences that arise from the interplay of customer need, product and segment. The comparisons between the Internet and the development of telephony are marked. Both offer lower-cost alternatives to traditional branch-based or direct sales-force-based methods of distribution. However, neither are as yet viable alternatives to those situations in which customers require real-time face-to-face or branch-based service. Small businesses rely upon the branch to transact much of their cash- and cheque-based business. There are real concerns regarding security and fraud. Additionally, complex products such as mortgages and pensions have yet to become mainstream products sold over the Internet.

The Internet has brought consumer benefits in the form of greater access to financial services with the introduction of Internet banking, Internet trading and greater choice of 24/7 services. It has also resulted in the introduction of products that offer better value for money in areas such as loans and deposit-taking. However, this has been complementary rather than a substitute for more traditional forms of financial services distribution and administration.

The Internet has obvious advantages in countries that are characterized by a geographically dispersed population and where branch networks are patchy. There is a growing body of evidence that consumers are using the Internet in growing numbers as a means of conducting information-gathering, and are then buying either face-to-face or via the telephone. Such behaviour emphasizes the importance to the marketer of attractive, interesting and easy to navigate websites. There is also growing evidence of the competitive superiority of a combined 'bricks and clicks' approach to distribution, as opposed to a pure 'clicks' approach, for general financial services providers such as banks and building societies. A purely clicks-based approach is achieving success at the margins and within specific narrow product categories (the Internet bank Egg, for example, and the general insurer Esure). It can be expected that the relative importance of a clicks-based approach to product purchase will grow over time as a consequence of greater consumer confidence in transacting business in this way.

At the strategic level, the Internet would appear to have presented two basic options to providers. First, it has been used by some simply as another means of accessing their products and services, in much the same way as the telephone was adopted as a complementary means of distribution. Citibank, the Industrial and Commercial Bank of China and the ICICI Bank in India are all good examples of this

approach. Secondly, it has been used to allow financial services suppliers to set up completely new organizations with a discrete brand identity that is purely Internet-based. The Co-operative bank did this when it set up Smile.com, as did Abbey with its Cahoot Internet bank. Whichever strategy is pursued, there can no doubt that the Internet is able to achieve dramatic cost savings, especially with regard to routine administration functions such as making payments and funds transfers.

An issue that has to be confronted concerns the capabilities required and the costs associated with generating customer demand for a pure Internet-based brand. As already established, financial services are not routine purchases in the vast majority of cases, but are infrequent, high-involvement purchases. The implication of this is that a provider has to ensure its brand has a consistently high level of awareness and attraction to coincide with the infrequent purchases of a sufficient number of people. This indicates a substantial and sustained investment in above-the-line advertising and complementary promotion through, say, direct mail. Some new entrants with a purely Internet-based approach have discovered that the heavy costs of achieving and maintaining brand awareness have cancelled out the lower administrative costs the Internet offers.

A final point of note is that a material element of cost-saving that accrues from the use of the Internet arises from the transfer of work (sometimes the complete purchase) from the provider's administration staff and onto the customer. The complete purchasing scenario applies to motor and home contents insurance, for example. It indicates the importance of clarity, ease of use and the clear flagging of how to get help if problems arise at any stage during the purchasing process. By no means do all websites conform to a best practice model, and it is not uncommon for an Internet purchase to take far longer to complete than one transacted via the telephone. Marketers must ensure that all new Internet-based services are subject to extensive piloting to ensure that what looks good in theory works in practice for the benefit of the customer.

Advantages of the Internet as a channel for new customer acquisition are that it:

- provides customer access anywhere, anytime
- enables providers to gain universal distribution
- complements other channels
- permits cost-effective proactive communication with existing customers
- has low administration costs
- can be a low-cost purchase channel
- encourages diversity and choice through easy entry by new providers
- allows consumers to transact business in a completely impersonal and remote manner
- results in lower prices
- can allow new products and services to be piloted at low cost, and thus encourages innovation
- allows providers to react quickly to changes in the marketplace
- enables customer research to be conducted easily and cheaply
- can enable providers to bespoke customer services and move towards more finely-tuned segmentation
- can facilitate development of close relationships through customized communication
- lessens demands placed on branch networks and face-to-face sellers and advisers.

Disadvantages of the Internet are that:

- it disenfranchises people who do not have access to the Internet, and thus exacerbates financial exclusion
- concerns regarding security and fraud inhibit consumer purchasing via the Internet
- difficult-to-use sites cause consumer dissatisfaction
- it is not well-suited to complex products and customer encounters requiring person-to-person conversational interaction
- it requires a well-known existing brand or high-cost marketing communication programme for new customer acquisition and product purchase.

13.4.8 Direct mail

In contrast with the recency of the development of the Internet, direct mail is one of the longest-established forms of distribution. According to its UK trade association, the Direct Marketing Association (DMA), it is growing at an annual rate of 9 per cent and accounts for some £13.6bn of marketing budgets. Thus it has not suffered any decline in the face of the rapid growth of telemarketing and the Internet.

Clearly, direct mail performs a number of roles, from simple awareness-raising and information-giving through sales-lead generation and onto the actual closing of a sale. The use of direct mail by the financial services sector has grown on a worldwide basis. In certain respects, this medium has a particularly important role to play within the context of financial services. For example, product complexity coupled with regulatory requirements lends itself to the need for hard-copy communication in many cases.

Advances in the use of databases and the technology associated with direct mail have facilitated a high degree of personalization. In conjunction with these developments, companies are able to use direct-response mail with respect to both their existing customers and prospective customers with a greater degree of accuracy and efficiency than ever before.

Direct mail is a highly controllable means of distribution that lends itself to rigorous analysis of key performance indicators (KPIs) such as cost per individual mailer, conversion-to-sale rate and cost per sale. Although direct mail is frequently referred to somewhat pejoratively as junk mail, with high wastage rates, it can nonetheless be a highly cost-effective means of obtaining sales. Indeed, a number of organizations use it as the primary method for new business acquisition. The successful use of direct mail hinges upon quite a small array of KPIs, namely:

- Accuracy of lists used
- Creative appeal and impact of the individual mailing piece
- Speed and follow-up to responses
- Quality of response follow-up.

There is a rapid rate of decay, from the time at which the recipient of the mailshot posts her or his response, in the recipient's motivation to engage in any subsequent follow-up activity on the part of the originator of the mailshot. This is especially important where a two-stage mailing process is being used, whereby the first

mailshot is aimed at stimulating an enquiry and the follow-up mailshot seeks to complete the actual purchase. This rapid decay rate also applies where the initial direct-mail communication is intended to generate a sales lead which is to be followed-up on a person-to-person basis by either a direct salesperson or a telephone sales agent. As a rule of thumb, direct-mail responses should be followed up by the product-provider within 48 hours of the receipt of the response. It is essential that the user of direct mail has the necessary resources, infrastructure, systems and processes to ensure rapid follow-up to prospective customer response. The longer the delay in the follow-up contact, the lower the ultimate sales conversion rate and the greater the cost per sale.

Advantages of direct mail as a channel of new customer acquisition are that it:

- can communicate a great deal of detail
- can communicate detailed regulatory warnings and requirements
- can be retained for future reference
- is a means of providing physical evidence of an intangible product
- allows volumes to be controlled to match resources for follow-up
- allows messages to be highly personalized
- lends itself to a multi-segment marketing strategy
- allows costs and efficiency to be finely monitored
- can complement other channels, such as telesales, direct sales
- can take advantage of opportunities presented by the behavioural cues of existing customers
- permits low-cost entry into a market
- allows for experimentation at low cost.

Disadvantages of direct mail are that:

- it is a common source of consumer irritation and dissatisfaction
- it can place heavy demands upon the literacy skills of recipients
- regulatory requirements can result in a large amount of copy and information that diverts prospects from core sales messages
- low response rates can make it uneconomic
- there is no opportunity to discuss problems and concerns
- it often suffers from a poor image, which can undermine trust in a brand.

13.4.9 Other distribution channels

Direct-response advertising using methods other than direct mail include direct-response radio, television, press, magazine and poster advertising. These forms of direct response are less controllable and less easily targeted than direct mail, but offer their own discrete creative advantages. For example, direct-response television advertising using daytime schedules has become commonplace for organizations targeting the retired sector of society. Equity release schemes and simple forms of life insurance plans are of particular note in this regard. Direct-response press advertising is used extensively by organizations marketing secured loans (sometimes called second mortgages). The preferred media are those aimed at the mass-market, such as *The Sun*, *The Star* and *The Daily Mirror* in the UK. At the other end

of the societal continuum we see investment products such as investment trusts, mutual funds (unit trusts and OEICS) and bonds distributed on a direct-response basis using titles such as *The Daily Telegraph* and the *The Sunday Times.*

A final form of distribution is the use of affinity groups such as trades unions and sports clubs. These often provide a means of access to people, using methods such as telesales, direct mail and direct sales. As such, they are not so much a distribution channel as a means of generating sales leads; therefore, they should be more correctly viewed as forming part of the promotional mix.

13.4.10 Multi-channel distribution

During the course of this chapter we have sought to provide a pragmatic insight into the real world of financial services distribution. Although the major methods of distribution have been discussed as individual channels, it is important to appreciate that, to an increasing extent, companies are simultaneously employing a range of channels. Thus, multi-channel distribution strategies are now the norm for most mainstream, mass-market financial services organizations. For the typical clearing bank, such a multi-channel approach will comprise:

- the branch network
- a direct sales-force
- direct mail
- the Internet
- telemarketing
- direct-response advertising.

A typical mass-market life assurance company will employ a multi-channel distribution strategy comprising:

- direct channels – direct sales-force, telemarketing, direct mail, direct-response advertising and Internet sales
- indirect channels – IFAs and tied agents.

13.5 Summary and conclusions

This chapter has argued that distribution channels play a central role in the marketing of financial services because they provide the opportunity for a purchase or sale to be made. Financial services organizations often employ a multi-channel strategy, using a number of different distribution channels to reach different target markets. These channels may be the organization's own direct channels or they may involve the use of intermediaries (indirect distribution). The range of possible distribution channels available is determined partly by technology and partly by regulation. Cost, customer and competitor influences will determine which channels are actually chosen.

Of the different distribution channels available, the branch network is still the most important for traditional current and savings accounts, while personal selling is probably the most common method of distribution for pensions and investments. However, new electronic-based channels are developing rapidly, and are likely to increase in importance over the next 5 years. Already, ATMs, telephone and web-based distribution systems are well established. Web-based distribution is expected to experience the greatest growth, with the most important developments being concerned first with the method of access, and secondly with what can be done via the web. In terms of method of access, it is anticipated that there will be a much greater variety of ways of accessing the web, with interactive digital TV being one of the most significant. In addition, as bandwidths increase and infrastructure improves, there will be the potential for customers to engage in face-to-face interactions with sales staff via the Internet. Such a development will have major implications for the distribution of financial services, because it will mean that traditional face-to-face selling falls in cost and becomes much more convenient to customers. Furthermore, for many customers, the prospect of dealing with someone face-to-face may reduce some of the resistance to using on-line distribution.

Review questions

1. What is the difference between direct and indirect distribution? Provide one example of each form of distribution channel for a financial services organization.
2. Which channels of distribution does your organization use? Which are direct and which are indirect? Which is the dominant channel, and why?
3. What are the factors that influence the choice of distribution channels for a bank and for a life insurance company?
4. What are the advantages and disadvantages of distributing financial services through a branch network?
5. What are the advantages and disadvantages of distributing financial services using the worldwide web? Why might some customers be unwilling to use the worldwide web to manage their financial affairs?

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Part III

Customer Development

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14

Customer relationship management strategies

Learning objectives

By the end of this chapter you will be able to:

- understand the growing importance of relationship marketing and customer retention in financial services
- understand the interactions between customer acquisition, customer retention and marketing activities
- understand the nature and significance of the concept of customer lifetime value
- be aware of contextual influences on the management of customer relationships.

14.1 Introduction

Until comparatively recently, there has been a presumption that marketing is principally concerned with the processes surrounding the creation of customers for a commercial organization. Thus, decisions concerning the use of the marketing mix were largely geared to this end. In part, this perhaps explains why marketing and sales are often viewed as being one and the same thing. It is undoubtedly true that customer acquisition has historically been the dominant purpose of marketing in the field of financial services. However, from the late 1980s onwards marketing skills and resources have been used increasingly in the context of the existing customer base – that is to say, organizations have increasingly focused attention on

marketing their services to their existing customers, encouraging them either to purchase more of the same product or to purchase different products from the organization's product range. This process is described in a number of different ways. Some will simply use the generic term 'relationship marketing'; others will refer to customer retention or customer base marketing. Increasingly, the term CRM – customer relationship marketing (or management as some prefer to call it) is used to describe this form of marketing. Whatever term is used, the important thing to remember is that we are dealing with that branch of marketing which concerns the contribution of marketing inputs once the customer acquisition phase has ended. During the course of the third and final part of this book we will focus upon marketing as it concerns the retention, management and development of existing customers. Thus, this section completes the triangle of strategy and planning, customer acquisition and customer management that forms the basis of this book.

This chapter provides an overview of some of the key issues associated with the management of customer relationships. Subsequent chapters will deal with issues relating to service quality, value, customer satisfaction, service recovery and the management of the marketing mix for customer retention. The chapter begins by exploring the factors that have encouraged a greater focus on the management of relationships with existing customers. The subsequent sections consider issues relating to the acquisition and retention of customers who will be both loyal and profitable. Thereafter, the concept of the relationship chain is introduced and the issues surrounding the management of customers at different relationship stages are introduced. The penultimate section deals with the specific issues that arise when managing customer relationships through an intermediary, and when managing relationships in an international context. Finally, the chapter discusses issues relating to customer lifetime value and customer data. Throughout this chapter, the terms CRM, relationship marketing and customer base marketing will be treated as broadly equivalent and used interchangeably.

14.2 Drivers of change

It is often suggested that the nature of financial services means that providers have always had relationships with their customers and that marketing is inherently relational (Stewart, 1998). While there is much truth in this view, it is also the case that financial services providers have traditionally not managed these relationships well in a mass-market context. This is clearly changing. A range of environmental factors has contributed to the growing concern about customer retention and development of customer-base (or relationship) marketing in financial services, including:

- rising costs of customer acquisition
- increasing focus upon customer value
- competition
- consumerist pressures
- regulation and legislation
- technological innovation
- development of relationship marketing in other sectors.

It is instructive to have some appreciation of how the above factors have influenced the growth of relationship marketing in financial services.

1. *Rising costs of customer acquisition*. As the penetration rate of the marketplace or market segment rises (i.e. the proportion of the total market that is already purchasing a product or service), the marginal costs of acquiring the custom of as yet unpenetrated customers increases. Since the 1980s the penetration rates in most product categories in developed economies have steadily grown, and this has added to marginal acquisition costs. At the same time, the value of customers at the margins of a segment can be expected to be of lesser value than those already served. Rising costs of customer acquisition have affected some areas more than others, especially with regard to regulation-induced cost increases.
2. *Increasing focus on customer value*. The economics of marginal customer acquisition referred to above have acted as a catalyst for an increased focus upon customer profitability as opposed to product profitability. That is not to say that the management of product margin is not important; clearly, such an assertion would be foolish. Both measures of value have a role to play in determining commercial performance. However, it is in the nature of financial services products, notably the characteristics associated with longevity and timescale, that individual product margins are of lesser significance than long-term individual customer value. It makes more sense to appraise the value of a business by reference to its aggregate customer worth, rather than simply the sum total of its in-force product margins.
3. *Competition*. The retail financial services sector is a dynamic and diverse arena with relatively few barriers to new entrants. Innovation in fields such as third-party administration (TPA), web-based distribution, call-centre functionality, and access to capital enable new entrants to participate in what are already highly penetrated market sectors. Additionally, the previous factors make it relatively easy for existing financial services organizations to diversify into new areas, as has happened with, for example, insurance companies setting up banks (Standard Life's Standard Life Bank, and Prudential's creation of Egg). The continual development of the competitive environment in market sectors that are already highly penetrated means that one company's newly acquired customer is increasingly likely to be the lapsed customer of a rival organization. Under such circumstances, the retention of existing valuable customers becomes even more important.
4. *Consumerist pressures*. Organizations representing the consumer interest, such as *Which?* and the National Consumer Council in the UK, the Consumers Union in the US and the Consumers Federation of Australia, have long campaigned to improve the ways in which the financial services industry serves the interests of consumers. Their campaigns have addressed a range of issues, including product charges, the use made of orphan funds, mortgage endowments, and overarching matters of how boards of directors are accountable for serving customer interests. Indeed, *Which?* claims to have received in the order of a million hits on its website, set up to put pressure on the industry to resolve consumer concerns regarding the selling of mortgage endowments. As a result, companies have become more sensitive to accusations that they attract new customers with attractive propositions, only to be subjected to detriment once they have become customers. This has provided further impetus to the need to develop more effective and sophisticated marketing policies and practices with regard to existing customers.

5. *Regulation and legislation*. The range of regulatory and legislative developments that have occurred since the mid-1980s has had far-reaching implications for the industry. That they have added to operating costs cannot be denied, and a new industry based upon compliance has *de facto* emerged. There is an aspiration that, in the long run, such costs will be compensated for by the avoidance of costly mis-selling compensation and more persistent (and hence profitable) product sales. Meanwhile, the costs of new customer acquisition have been impacted upon by the costs associated with sales adviser training, competence and supervision, along with an enormous array of other provisions included in the rule books of regulators around the world.

In addition to their impact upon costs, developments in this area have also impacted upon pricing and charging policies and mechanisms. This issue is becoming increasingly important, especially in areas such as life assurance and pensions. Until comparatively recently, the prevalence of high, up-front product charges meant that regular premium/contribution-based products could be profitable to the provider after they had been in force for quite short periods of time. The imposition of cancellation charges and penalties of one form or another meant that high initial costs associated with sales remuneration, underwriting and policy issue could be met and still yield a profit. Pricing policies of this type are becoming increasingly unacceptable and subject to government and regulatory scrutiny. Indeed, it has been estimated that the typical stakeholder pension with its maximum charge of 1.5 per cent of the fund's value takes at least eight to nine years before starting to achieve break-even for the provider. Under such circumstances, it is even more important that care is taken to recruit customers who have a high propensity to remain loyal to their provider.

6. *Technological innovation*. Innovations in telecommunications, database management and the worldwide web have had a dramatic impact upon customer management. The careful and detailed capture of appropriate data during the customer acquisition process provides an organization with the ability to manage the relationship to far greater effect than was hitherto possible. It is fair to say that technological innovation has been a major facilitator of customer base marketing.
7. *Development of relationship marketing in other commercial sectors*. Arguably, the B2B sector pioneered the concept and practice of relationship marketing because of the importance of forging genuine buyer–seller partnerships. The information asymmetry that is said to characterize retail financial services is far less in evidence in the B2B context. This is because buyers are often professional procurement executives and are considerably more empowered than the typical financial services domestic consumer. Indeed, the B2B business areas of major banks have themselves long practised effective relationship marketing processes in the handling of major corporate-client relationships.

CRM, which is essentially technology-enabled relationship marketing, has increasingly become a vital element of the marketing approach of many consumer goods markets and the retail sector. The rapid expansion of customer affinity schemes by supermarkets such as Tesco's Clubcard perhaps provide the best example of this

form of marketing in practice. The extensive use of relationship marketing across the B2B, fast moving consumer goods (fmcg) and retail sectors has added further impetus to its adoption by financial services organizations.

As a consequence of these pressures, financial services providers across the world are now focusing much more actively on the development and management of relationships with their customers. In B2B markets, much of this continues to be conducted at a personal level. Increasingly, in B2C markets, technology (in the form of CRM systems) is supporting the creation of more personalized relationships with customers. Case study 14.1 provides an example of the relationship marketing approach adopted by Rabobank in the Netherlands.

Case study 14.1 Rabobank – building on domestic and business banking relationships in the Dutch market

Rabobank is an AAA rated co-operative bank with 5 million retail customers and a very strong local presence evidenced by approximately 1500 branches. In 1995 Rabobank was the first to introduce Internet banking, and today holds the largest number of Internet bank accounts in Europe. The Dutch banking market has learned that customers are usually unwilling to change from a trusted brand to a new bank, and this places certain limitations on the strategic choices that are available to banking institutions. In practice, this means that a large number of financial institutions opt for a customer penetration strategy, thus devoting resources to their existing customer base. A combination of this strategy of penetration, and what Treacy and Wiersema (1996) call customer intimacy, has proven to be a very successful aspect of the strategy of Rabobank, one of the top three banks in the Netherlands.

Rabobank has concentrated on being physically close to customers through both the Internet and a physical branch network. Cross-selling of mortgage and savings products to current-account customers has allowed Rabobank to become a market leader in retail banking. Similarly, the removal of restrictions on bancassurance in 1990 provided further opportunity for Rabobank to expand the range of services offered to its established customers.

Rabobank's success is not limited to personal markets. Management built on the bank's traditional strengths in agricultural markets and expanded into the non-agricultural small and medium-sized enterprise market. Rabobank now has 21 per cent of the small business market in the Netherlands, and is making solid progress with cross-selling and up-selling to their existing customers. To support the range of services offered to medium and larger companies, Rabobank has built an international network of branch offices, strategic alliances and acquisitions to ensure that the bank can offer a comprehensive service to customers operating internationally.

Source: Suzanne Tesselaar, TCI Communications, The Netherlands.

14.3 Customer persistency – acquiring the right customers

A feature of a great many businesses is that they simultaneously both acquire new customers for their organizations whilst losing a number of existing customers. Such a process of acquisition and attrition can result in a business working incredibly hard to stand still as far as its numbers of customers are concerned. This has been referred to as the *bucket theory of marketing*, a term attributed to James L, Schorr, a former Executive Vice President of Holiday Inn.

It is axiomatic of any organization that it seeks to achieve growth in the number of new customers it acquires and a reduction in the number of customer defections, and thereby to achieve net growth in the total customer base. Unfortunately, the prevalence of the bucket theory can make it a slow and expensive process. Indeed, it is by no means uncommon for a company to appear to be standing still as the number of new customers acquired merely matches the number of those lost.

Faced with this problem, there is an understandable response whereby a company devises a detailed, and costly, customer retention programme. However, such programmes can be misplaced if they result in the retention of relatively poor-value (and possibly negative-value) customers in the process. Some customers have a greater propensity to maintain a relationship with a product provider than others. From the provider's point of view, it is desirable to try to identify customer characteristics that are associated with a high likelihood of lapsing. The need to do this applies to organizational as well as domestic customers, because differential lapse rates apply to customers in both the B2B and B2C domains.

Identifying those characteristics of a customer that are associated with a relatively high propensity to lapse – or to persist, for that matter – is an important marketing activity. It requires the determination of which aspects of customers themselves, as well as of the marketing mix, are causally related to relative persistency. This is by no means an easy and quick procedure to accomplish. Rather, it calls for thoughtful and detailed analysis of possible causal factors over a protracted period of time. Thus, it could take years rather than weeks or months to yield truly valuable insights. In the long run it can have a profoundly beneficial impact upon the bottom line by increasing average customer value and reducing wasteful marketing and administration spend. A decision to conduct a customer persistency measurement programme requires the capture of data that would play a part in influencing persistency. Such data have to be captured during the customer acquisition process and be supported by the development of appropriate systems for analysis and reporting. The characteristics associated with persistency, both causal and correlated variables, differ according to marketplace, customer segment, purchasing situation and so on; there is no one-size-fits-all solution. However, likely candidates for consideration as possible persistency factors are as follows.

1. Customer characteristics:
   - age
   - income level
   - occupation
   - previous history in consuming a given product type

2. Acquisition process characteristics:
   - strength of real need by customer
   - whether product was bought or sold (degree of customer proactivity in acquisition process)
   - distribution channel used
   - individual, distributor or salesperson
   - date of acquisition
3. Other marketing mix characteristics:
   - usage of a sales promotion
   - source of sales leads
   - special price offers
   - product feature variants.

The above list is purely indicative of possible factors; each company must resolve to determine what is appropriate given its particular circumstances. Ultimately, such analysis should inform marketing planning and result in focusing customer acquisition activities upon relatively persistent customers. Thus, the key to effective customer retention is the acquisition of customers who can be presumed to be persistent in the first place.

14.4 Retaining the right customers

The reasons why customers cease their relationships with product providers are of four basic types, namely:

1. *Customer self-induced* – the original need no long exists. For example, a mortgage loan has been repaid early and therefore the loan protection policy is no longer required. Another example could be that the customer wants immediate access to cash, and so surrenders an insurance endowment policy.
2. *Customer environment-induced* – for example, the customer has become unemployed and is unable to maintain the premium/contribution, interest payments.
3. *Provider self-induced* – for example, poor service (service failure) has caused a level of dissatisfaction that leads the customer to sever the relationship. Alternatively, pricing changes may have caused the customer to seek a different supplier.
4. *Provider environment-induced* – for example, an increase in prevailing base interest rates may result in some customers lapsing; a fall in stock markets may cause customers to cash in equity-based investments. It might also be the case that an appealing competitor offer has induced a desire to switch provider.

The implications of the above are that providers must identify those factors on which they can exert some influence whilst developing contingency plans for those outside of their control. Ideally, customer self-induced defections are best mitigated by careful selection of customers during the initial acquisition process. Where they do arise, it is probably best to deal with their request to 'leave' as efficiently, swiftly and at as little cost as possible.

Provider self-induced customer lapsing is a particular cause for concern from a marketing perspective, since it is associated with a failure to deliver the right service experience. Research to date has suggested that switching/exit is a process rather than a response to specific individual events (Stewart, 1998). Triggers for exit are usually charges, facilities, information and service encounters, and usually there is an accumulation of negative experience prior to exit. The fact that exit appears to be a cumulative process would suggest that opportunities do exist for relationships to be rebuilt (and the ability to respond effectively to complaints is often one very important part of such a process, as will be discussed in Chapter 15), although the extent to which financial services providers have been able to capitalize on these is more debatable. One major challenge associated with customers who are lost through provider self-induced lapsing is the potential for negative word of mouth.

Customer environment-induced cases also need to be managed with care. Difficulties associated with the loss of a job may be insurmountable, and should be dealt with in a suitably sensitive yet efficient manner. However, unemployment tends to be a temporary matter, and measures such as contributions holidays or policy loans may enable the customer to maintain the product until he or she is in employment again. Careful analysis of key customer variables, such as income level, occupation, duration of customer relationship, and other products held, is essential in enabling a sound judgement to be made. It makes no sense to allow a customer–product relationship to lapse automatically when a request is received from a customer. Administrative staff must be trained to appreciate the important role they can play in retaining valid customer–product relationships. This calls for the development of suitable management information systems to match product lapse cues with relevant customer data. Such cues might include a missed monthly payment or, say, a request for a valuation or early surrender value, as well as written requests to cancel.

In addition to the availability of appropriate management information, a range of suitable options needs to be easily available to enable the customer to maintain the relationship with the provider, such as those already mentioned. It is important that a company has a clear strategy in respect of customer retention and a set of policies that give guidance to the relevant administration staff. Where customer administration is outsourced to a third-party administrator (TPA) partner, it is important that due regard be paid to issues concerning customer retention. In such situations, care must be taken to ensure that the staff of the TPA have the necessary mandates to engage in purposeful customer retention activities.

The development of effective customer retention practices raises the need for the careful identification of the reasons that induced the prospective lapse. Vital information can be accessed to enable the most appropriate course of action to be followed. Such an approach can be especially useful when employed in conjunction with inbound telephone-based lapse enquiries. It is rather more difficult, and potentially more costly, when used in conjunction with lapse-related enquiries that arrive via the postal system. Internet-based customer-contact processes offer a potentially powerful means of defending against customer defections. Routines can be devised that are able to determine the cause of the prospective lapse with a high degree of reliability. Having identified the underlying cause, customers can be presented

with a range of options aimed at helping to solve their problem without recourse to actual product lapsing. This can be a highly cost-effective means of retaining customers by helping them through what might be a temporary period of difficulty.

Customer defections brought about through the actions of competitors present particular challenges for financial services companies. This is likely to be encountered more in some areas than others. For example, credit cards have become a fiercely competitive arena where customer acquisition is commonly based upon transferring a consumer's outstanding balance to the new provider at a highly attractive rate.

In writing about customer retention, Payne (2000), drawing on the work of Reichheld and Sasser (1990), demonstrates graphically just how sensitive profit is to relatively small shifts in customer retention levels, as can be seen in Figure 14.1. Box 14.1 draws attention to research findings which have examined the diversity of financial and non-financial benefits of relationship marketing and customer retention.

The argument that it is much cheaper to retain existing customers than to attract new ones (sometimes referred to as the *economics of customer retention*) is a powerful driver of increased interest in the management of customer relationships. However, it is important to note that this does not imply that all retained customers are profitable, or that all customers should be retained. As explained later in this chapter, the lifetime value of customers varies. In research outside of financial services, Reinartz and Kumar (2002) identified a class of customers who they described as

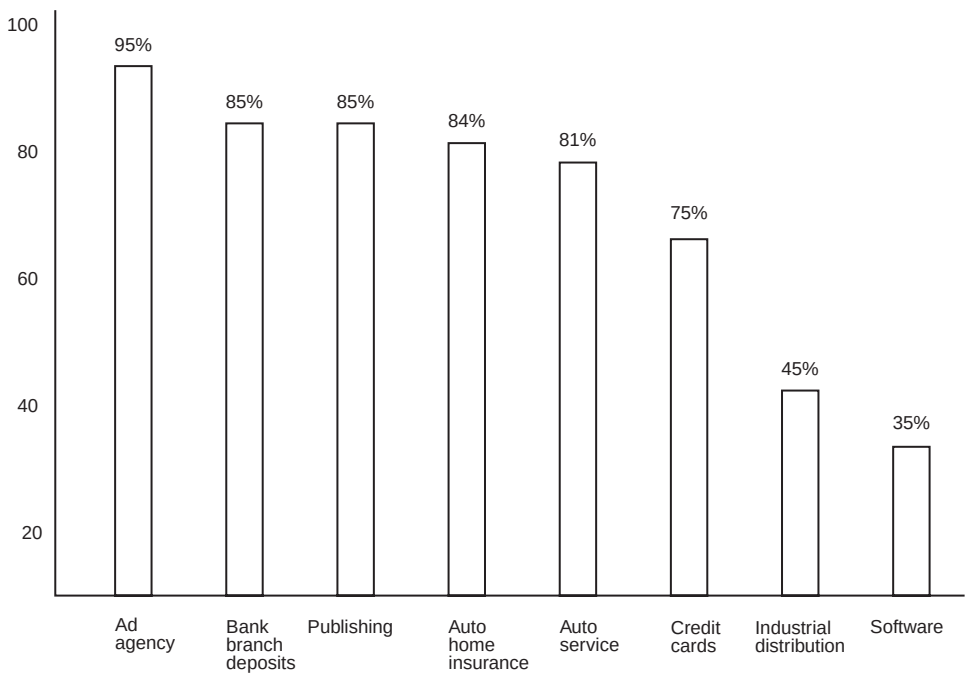

Figure 14.1 NPV profit impact of a 5 per cent points increase in customer retention (based on Reichheld, 1994).

Box 14.1 Relationships and customer retention – research findings

Empirical evidence on the economic benefits of customer retention in financial services is limited. However, measuring the direct financial benefits of loyalty is challenging and, as a consequence, much of the published work focuses attention on addressing the factors that contribute to relationship quality, to loyalty/retention and to satisfaction. Selected findings include:

Crosby and Stephens (1987)	Positive impact of relationships on customer satisfaction and retention
Storbacka (1994)	Positive impact of loyalty on profitability
Council on Financial Competition (1995)	Increasing retention by 5 per cent adds 3 years to the average customer lifetime and account usage increases with length of relationship (in Murphy, 1997)
Ennew and Binks (1996)	Nature of the customer's relationship and service quality have a positive impact on loyalty; distinguish between customers who are genuinely loyal and those who are only partly loyal (considered switching but did not)
Zeithaml *et al.* (1996)	Highlight the importance of service quality as a determinant of intention to remain loyal
Paulin *et al.* (1997)	Positive relationship between perceived strength of a relationship and customers' willingness to continue to purchase, willingness to recommend and judgements about quality and satisfaction
Ennew and Binks (1999)	Customer involvement in the banking relationship has a positive impact on satisfaction and retention
Sharma and Patterson (2001)	Trust and satisfaction have a positive impact on commitment to a relationship (satisfaction is particularly significant); high switching costs will induce commitment even if satisfaction is low

'barnacles' – customers who were retained/loyal but unprofitable because they were relatively costly to serve and did not generate significant revenues. Thus the challenge for marketers is not customer retention across the board, but rather the retention of profitable customers.

14.5 Customer retention strategies

Zeithaml and Bitner (2003) have built upon the framework proposed by Berry and Parasuraman (1991) to develop a useful model for the development of a customer retention strategy. Zeithaml and Bitner's model posits that excellent service quality and value must provide the basis for an effective retention strategy. They proceed to

identify a sequence of four bonds (financial, social, customization and structural) which, when operationalized by means of the marketing mix, should result in a high probability of retaining valuable customers. These are summarized as follows.

14.5.1 Level 1: Financial bonds – volume and frequency rewards, bundling and cross-selling, stable pricing

At Level 1, the intention is to tie the customer in to the provider through the provision of a range of financial incentives. In this way, the provider is reflecting its perceived worth of the customer relationship by increasing the economic value that the customer gains. A straightforward example of this is to be found in the frequent-flyer programmes operated by airlines such as Singapore Airlines. In the financial services area, companies such as Fidelity offer discounts on initial charges to existing customers when they make subsequent purchases of a mutual fund. General insurance companies will offer discounts to customers who have, say, a home contents policy when they buy a buildings insurance policy too. Credit-card companies frequently offer special deals on a range of other services, such as air travel, hotel accommodation and car hire. Mastercard provides air miles to its customers as a means of encouraging retention. Stable pricing refers to a provider shielding its customers from general price increases as a means of lessening the impact of customer defections.

Financial bonds are relatively easy to implement and straightforward to communicate. For these reasons they are easily copied by competitors, and therefore have limitations as a means of achieving long-term differentiation.

14.5.2 Level 2: Social bonds – continuous relationships, personal relationships, social bonds among customers

The types of actions proposed in Level 2 represent an attempt by the provider to recognize the individuality of the customer. It is based upon interactions that build upon the financial incentives provided by Level 1 to create a sense of affiliation with the provider. A classic example of this is to be found in the life assurance sector, where advisers endeavour to meet clients on a fairly regular basis to review their circumstances and needs. Well-established financial advisers frequently report that in the order of two-thirds of their new product sales in a given year are derived from existing customers. In addition, a further one-fifth of their sales arise from referrals that they receive from their existing customers. Thus, sales to wholly new customers account for less than one-fifth of the total new product sales of advisers who have invested in developing successful long-term customer relationships.

The development of social bonds is a particular feature of the B2B area of financial services. A range of forms of hospitality is frequently encountered, including the use of sponsorship of sporting and cultural events. Such sponsorship activity can be a highly effective means of building bonds not only between the provider and its client, but also amongst the actual client community itself. It is much more difficult for a competitor to replicate the social bonds that a rival provider may have formed with its customers.

14.5.3 Level 3: Customization bonds – customer intimacy, mass customization, anticipation/innovation

Level 3 strategies involve the two-way flow of information between provider and customer, with the aim of creating a marketing mix that is tailored to the particular needs of the customer. Although elements of this process of customizing are in evidence in Levels 1 and 2, in Level 3 the boundaries are pushed out as detailed knowledge of individual customer requirements are translated into customer-specific mix components such as product and service features. Zeithaml and Bitner cite the example of the Zurich Group seeking to build relationships with its customers through the provision of solutions that are customized to the needs of individual customers.

Historically, the costs associated with the development of Level 3 strategies meant that they were a particular feature of the B2B environment. However, advances in customer database technology have allowed the concept of mass customization (i.e. marketing to a segment of one) to become a cost-effective reality within the B2C arena. The Internet has been instrumental in further advancing customization bonds, by acting as a highly efficient means of communicating with customers.

14.5.4 Level 4: Structural bonds – shared processes and equipment, joint investments, integrated information systems

The creation of structural bonds between provider and customer represents the greatest challenge to competitive activity and, in conjunction with activities carried out under Levels 1, 2 and 3, can achieve long-term differentiation and competitive advantage. Examples of this can be seen in the way that IT suppliers integrate their systems with a range of financial services companies. Level 4 strategies afford the potential for significant synergies to occur as each partner contributes its expertise to create unrivalled value. From a customer perspective, there is the risk that such an integrated relationship may in the long term be detrimental. Safeguards should therefore be considered to ensure that customers can mitigate any potential long-term disadvantage. Ultimately, a commercial judgement must be made about the costs, risk and benefits of forming structural bonds with a supplier. Indeed, this type of risk can work both ways, in that a powerful customer may be able to exert a high degree of power over the product-service provider in contract negotiations over the long term.

14.6 The customer relationship chain

So far in this chapter, emphasis has been placed upon the inter-relationships between getting and keeping customers. It has been established that getting the right customers in the first place is instrumental in keeping them. Thus, it is helpful to conceptualize the process associated with customer acquisition and management as forming component elements of an overarching process that we call the *customer relationship chain*, shown diagrammatically in Figure 14.2 and explained below.

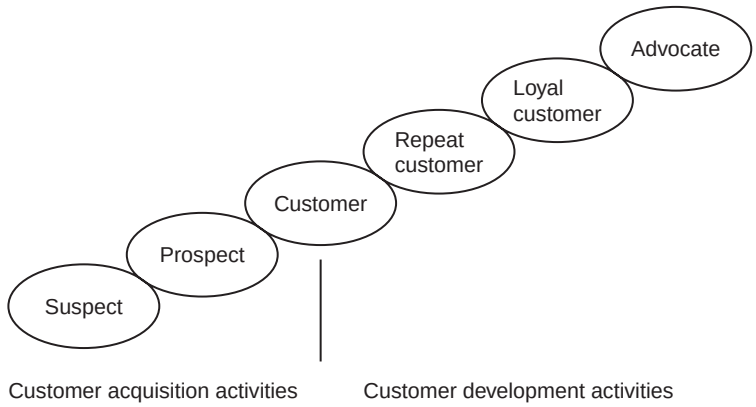

Figure 14.2 The customer relationship chain.

The customer relationship chain is applicable in both the B2C and B2B domains. Indeed, in the latter case the financial consequences of the loss of a valuable customer will be far more significant than in the former.

14.6.1 Suspect

A suspect is an individual who has been identified as being a member of one of the company's target market segments. The company will use its marketing mix to try to attract a suspect's attention and interest in order to engage them in some form of dialogue.

14.6.2 Prospect

Once a dialogue has been established, the suspect becomes a prospect. There is a wide range of behaviours associated with this link in the chain. For example, a television advertisement aimed at suspects could invite contact via a freephone telephone number to find out more about the provider company or a given product. Alternatively, a mailshot aimed at suspects could invite a response to request a personal financial review.

14.6.3 Customer

Becoming a customer is the obvious outcome of effective prospecting activity. It may be that the prospect has agreed to buy, say, an insurance policy, or, as can also be the case, has registered to become a customer without having actually made a product purchase. This frequently happens in the case of stock-broking firms.

However, the Singapore-based insurance company NTUC has recently introduced a marketing model where it sets out to enrol prospects as customers prior to any product purchase taking place, as Case study 14.2 explains.

Case study 14.2 NTUC Singapore

NTUC Income has set out its business strategy for the future, in a document called 'Insurance Company of the Future'. It is now building the technology to support this strategy. This case study sets out the NTUC experience so far regarding the following areas that support the business strategy:

- Website
- Register the customer first
- Educate the customer
- Simple products
- Pull strategy.

NTUC Income's website was voted the best website in the *Asia Insurance Review* Awards 2005. The website (www.income.coop) has 15 million hits each month. It is easy to use, provides information on NTUC products and practices, and is available in three languages.

The customer-centric strategy is to register a customer first and to sell products later. This was successfully implemented 10 years ago with a travel insurance product. NTUC registers customers first and obtains their particulars. When the customers travel, they call the hotline and activate their travel insurance. They enjoy a lower premium (15 per cent discount) and the convenience of immediate, hassle-free cover.

NTUC handles about 120 000 transactions each year, with a premium income of US$6 million from an active base of about 500 000 customers. It holds an estimated market share of 25 per cent. Lower distribution costs and expense ratios allow NTUC to offer a price advantage of 5.5 per cent. The success of this travel insurance product gave NTUC confidence that the 'register the customer first' strategy could work well for other products. The key elements of this strategy are:

- Register the potential customer first
- Obtain the contact information, e.g. name, date of birth, gender, contact number, e-mail address
- Send brief materials to educate the customer
- Introduce the customer to the website
- Invite the customer to attend educational talks on insurance products
- Leave the customer to contact the call-centre later.

NTUC places particular emphasis on educating the customer about the range of insurance products available in the market. Information is provided

Case study 14.2 NTUC Singapore—cont'd

via the website, e-mail broadcasts, educational talks, and video and voice on digital media.

During the past year, NTUC has held an educational talk each week on products such as medical insurance and investment-linked funds. Typically, about 150 people have attended each talk. Potential customers who attend a talk and decide to purchase within 14 days of it are offered special incentives. About 30 per cent of the customers take up the incentive.

Although it is often said that 'insurance has to be sold', NTUC believes that people are willing to 'buy insurance' if they are offered simple products that they can understand, and enjoy a price advantage. Encouraging potential customers to approach NTUC to buy insurance increases the productivity of sales agents, and supports lower commission rates and thus lower prices for customers.

In essence, ICT and particularly web-based technology, has enabled NTUC to build close relationships with customers without initially actively pushing products to them. By educating customers about financial needs and products, they are encouraged to approach NTUC as they identify a need. This helps to keep costs down, relieves sales pressure on consumers and ultimately results in more satisfied customers and enhanced business performance.

Source: Tan Kin Lian, Chief Executive, NTUC Income.

14.6.4 Repeat customer

A common mistake is the belief that, having bought a product, the customer becomes part of what is sometimes termed the 'warm customer base'. As such, this renders the customer well-disposed towards that provider company. The evidence indicates that an individual who has bought a financial services product has a high probability of buying a further product within 18 months of the initial purchase. If the initial product provider has not secured that subsequent purchase, the relationship weakens and a stronger affiliation is likely to be struck up with the provider of the subsequent purchase. In such a situation, the customer will, in all probability, cease to be a *warm customer*. Indeed, there is evidence to suggest that such customers become no more responsive to the marketing efforts of the initial provider company than completely new suspects.

There have been many cases of financial services companies adopting a complacent attitude towards customers who have a single product with them. Effective marketing should be geared towards ensuring that the new customer buys a second product from them rather than from an alternative provider, otherwise there is a strong likelihood of the chain being broken. A hallmark of effective customer marketing at *the customer* link in the chain is that the provider is proactively trying to secure that subsequent purchase.

14.6.5 Loyal customer

A loyal customer is one that has two or more products with a given provider and, when the need arises, takes the initiative to invite the current provider to offer a solution to that need. Customers may well contact other potential providers too, and may not necessarily buy from the current provider. However, they will have experienced a sufficiently high level of satisfaction and confidence in the current provider to give them the first chance of securing the additional business. Customer-initiated proactive behaviour is what defines the loyal customer.

14.6.6 Advocate

Advocates are customers who express such a high level of trust in their provider that they recommend it to any member of their personal reference group should such a third party raise the fact that they have an appropriate need. Thus, friends, family members, workplace colleagues and social contacts represent opportunities for advocacy to take place. Personal recommendations are considered to represent a particularly important aspect of consumer choice in the field of financial services. Just consider the potential power offered by having, say, 10 per cent of your customers become advocates. A company with a customer base of 2 000 000 people could have 200 000 people recommending that company to their respective reference group contacts.

14.7 Lifetime customer value

The notion of lifetime customer value is central to the concept of retaining and developing customer relationships. It moves the thinking about profitability beyond mere one-off product margins, important though they are, and on to a much broader appreciation of customer value. It is entirely possible that attempts to maximize short-term product margins may not result in optimal long-term profitability. For example, high-quality customers may be deterred from buying an investment fund with a relatively expensive charging structure if they are not convinced of the incremental value that the premium price delivers. Instead, they may choose a less expensive alternative that results in a highly persistent provider relationship. Therefore, it is axiomatic that strategies based upon the existing customer base are firmly grounded in a robust model of lifetime customer value.

In simple terms, lifetime customer value involves making a set of assumptions regarding the following variables:

Revenue variables	Number of products bought
	Value of products bought
	Duration of individual product persistency
Cost variables	Costs of providing customer services
	Other costs (e.g. claims or bad debts)
Referral variables	Number of new customers introduced
	Value of referral business

Knowledge about the likely revenue, cost and referral variables that apply to the array of consumer and organizational customer types will have already been reflected in a company's segmentation strategy. This can be further fine-tuned through the careful analysis of the performance of customer groups over time. The resultant data can be used to inform the development of a lifetime customer value model. An illustrative example of what this might look like is given in Case study 14.3.

A similar approach can be applied to the consumer marketing domain. It is simply a case of identifying the relevant revenue, cost and referral variable data and computing the sum. For both final consumers and business consumers, the development of a suitable model of lifetime customer value is essential for the development of effective customer management strategies.

Case study 14.3 Motim manufacturing revenue scenario

Motim Manufacturing has a relationship with Beta Broking, a general insurance broker that began when Motim sourced a public liability policy via Beta. A year later, Motim decided to source its Director's liability cover from Beta. The following year its all-risks buildings and plant policy came up for renewal, and Beta secured the business in competition with the incumbent provider. This was followed by the provision of motor insurance to its fleet of 15 vehicles. The value of premium income secured by Beta with Motim during a 15-year period was as follows.

Revenue variables (assuming no annual policy increase for illustrative purposes)

	Annual premium (£)	Term	Total premium (£)
Public liability policy	2200	15	33 000
Directors' liability	4750	14	66 500
Buildings and plant	12 250	13	159 250
Motor vehicle cover	7500	12	90 000

The total 'lifetime premium income' was therefore £348 750, and the value of commission income generated at 20 per cent of annual premium was £69 750.

Referral variables

Number of new clients introduced by Motim (one per year)	15
Value of referred business (assuming same profile and product mix as Motim itself)	£2 158 000
Commission earned from referrals	£431 600

Thus, the lifetime value to Beta Broking of its relationship with Motim Manufacturing amounted to commission earnings of some £501 350 over the 15-year period.

This illustration gives some idea of the real value of making that initial sale of a £2200 public liability policy that generated just £440 in commission. It also underlines graphically just how valuable it is to follow through the customer relationship chain to achieve customer advocacy. Indeed, in this example the real value is derived from referrals; during the 15-year period of the example, 88 per cent of the lifetime value accruing to the Motim relationship is accounted for by the resultant referrals.

14.8 Relationship marketing in specific contexts

Arguably, the provision of financial services in B2B contexts has always been characterized by a focus on long-term relationships. In mass B2C markets, the focus on building customer relationships and encouraging customer retention has been more recent. Discussions thus far have highlighted the importance of the careful management of customer relationships from acquisition through to long-term retention, highlighting the importance of understanding and focusing attention on those customers who are likely to be profitable. While these principles have general relevance, their application can vary according to context. This section focuses attention on two specific contexts, namely marketing via intermediaries and marketing internationally.

14.8.1 Relationship marketing and the role of intermediaries

Particular challenges are presented in using relationship marketing or CRM approaches where there is the involvement of third-party intermediaries. Typical examples might include high-street general insurance brokers, independent financial advisers (IFAs) or appointed representatives (ARs).

There are inherent conflicts of interest, with the accompanying potential for mistrust. Much of this surrounds the thorny question of 'who owns the customer?' This often depends upon whether any given request by a customer is likely to result in additional sales revenue/commission or lead to the incurring of some administrative task, and the accompanying costs. The incentive structure (additional sales means revenue, administration implies costs) means there is a risk that intermediaries will display a preference to think that they 'own' the customer when a new sale is in the offing, or a potential policy lapse that could result in commission claw-back. By contrast, such intermediaries may defer customer ownership in favour of the core product provider where a non-income related task is indicated.

It is important to grasp that companies that distribute via brokers may have spent decades building and maintaining a culture in which the intermediary is viewed as *the* primary customer. Indeed, it may seem that the needs of the broker take precedence over those of the end customer. Therefore, there is a strong cultural dimension to the development of a relationship or CRM-based approach, whereby the intermediary sales branches of provider companies have to learn to view brokers and their relationship to customers in a new light, with the needs of the end-consumer taking precedence over those of the broker. This may seem straightforward enough, but for some companies and their broker sales support staff it can represent a radically different way of thinking and behaving.

It could be argued that the provider needs to consider a form of relationship marketing or CRM that treats intermediaries and the ultimate consumer as separate customer groups, each being the subject of a CRM programme geared to their respective needs. However, such an approach calls for protocols that achieve a balance between the interests of all three parties. Formal customer–supplier agreements are sometimes used for this purpose. Such arrangements stipulate the respective rights and responsibilities of product provider and intermediary in respect of the array of interactions that could occur with the customer. It can involve the construction of quite sophisticated models for handling all possible forms of customer

contact. Perhaps somewhat paradoxically, it is often the case that smaller broking firms like to be involved more intimately in customer contact than do their much larger rivals. The latter can display a tendency to adopt a somewhat more remote and aloof posture regarding customer contact. Those experienced in the intermediary market will often comment that larger broker firms gear their activities primarily towards income-generating activities, to the detriment of pure customer service.

The situation is seldom different with regard to group business such as occupational pension schemes. There is considerable anecdotal evidence to suggest that large firms specializing in the employee benefits market see their role as being one primarily geared towards selling the scheme to the employer. Therefore, there is frequently an expectation that the job of signing up the individual scheme members falls to the staff of the product provider. Indeed, there are situations in which the intermediary simply 'sells' a shell scheme to an employer and expects employee participation to be managed entirely by the product provider.

In the UK the industry has made some progress in developing common systems trading architecture, but as yet it remains somewhat basic and limited in functionality. Examples of progress to date include a common approach to commission messaging, and a common commission statement has been developed. It is perhaps revealing that the needs of the intermediary appear to have taken priority over those of the consumer. Without a fully developed common trading platform, the potential to develop a truly joined-up approach to CRM programmes that seek to integrate customer–broker–product provider activities will be constrained. A number of attempts have been made to develop open architecture-based systems aimed at enabling intermediaries to link up with provider databases on an individual company basis. Providers that have invested in such technology are beginning to realize material commercial benefits. The corollary is that those who have yet to make such investments are exposing themselves to risks to their future new business prospects. Indeed, this might even present risks to their current business as IFAs migrate to those providers that are more technologically advanced. Such an outcome would present the laggards with further competitive disadvantages. It is understood that Friends Provident is one of the most advanced organizations in this endeavour. However, the general lack of a suitable common trading platform for the whole industry acts as a brake on this development.

In the absence of the desired common platform, intermediaries tend to design their own individual set of protocols that they seek to apply to all of the providers with which they do business. Equally, product providers endeavour to apply their own set of policies and procedures to all of the intermediaries with which they trade. As might be imagined, a degree of negotiation takes place as intermediary and product provider seek to best serve their respective interests.

To conclude, the management of CRM programmes is much more straightforward in those instances in which there is no intermediary involvement in the business acquisition and ongoing customer management processes. Where intermediaries are involved, a customer management model is required that:

- positions the end customer as the ultimate beneficiary of the product/service provided and clearly establishes the primacy of their interests
- has a robust set of protocols that establishes the respective rights and responsibilities of the provider and intermediary; a suitable level of security must be

guaranteed such that there are no compromises either to the data protection rules that apply in any given country or from commercial sensitivities between intermediaries
- clearly identifies the array of possible events in the life of the customer relationship, and specifies the respective roles of provider and intermediary in handling those events
- has a CRM programme geared specifically to address the interests of the intermediary sector, in addition to the CRM programme designed for the end-consumer.

14.8.2 Relationship marketing: some international perspectives

In Chapter 6 we considered some of the ways in which operating across national boundaries impacts upon marketing strategy and planning. Operating internationally can give rise to a range of new opportunities and threats, and will require the development and maintenance of a new set of competences. Similarly, each country will present its own unique set of opportunities and threats to be matched with the appropriate set of strengths and weaknesses. Clearly, this adds a material degree of complexity to strategy development and use of the marketing mix. Doole (1998) has identified three particular features that are associated with the strategies of organizations that have competed successfully in international markets:

1. A clear, competitive focus based upon in-depth knowledge of each respective market, a strong competitive positioning, and a truly international marketing strategy
2. Well-managed organizations characterized by a culture of learning, innovativeness, effective monitoring and control procedures, and high levels of energy and commitment to international markets
3. An effective relationship strategy, based upon strong customer relations, the commitment to quality products and services, and a high degree of commitment to customer services across all international markets.

We observe elements of all three of these features in brands such as Singapore Airlines, Ritz Carlton Hotels and American Express. In the case of financial services, particular consideration has to be given to issues such as regulation and culture, as they can vary widely from country to country and be of profound significance, as Kaspar *et al*. (1999) observe:

> Formulations of relationship marketing based on contemporary western interpretations may fail if transplanted to overseas countries, where the cultural and economic environments differ significantly from the country for which a relationship policy was originally formulated.

These differences are less likely to be of material significance in the business-to-business domain. Again, relationship management is a particularly important feature of the B2B market. Technology and process innovation have presented new threats and opportunities to financial services organizations that operate on a global basis. Additionally, deregulation and the opening up of markets to new forms

of competition have added to the value attached to effective international CRM strategies for financial services companies involved in the B2B domain. It is instructive to consider the four relationship bonds proposed by Berry and Parasuraman (1991) and discussed by Zeithaml and Bitner (2003), presented earlier in this chapter. These have particular relevance in the B2B, context where financial, social, customization and structural bonds can be developed in a cost-effective and potentially meaningful way. There are particular opportunities for the development of customization and structural bonds, these being less easy and cost-effective to employ in the B2C context.

In both the B2B and B2C contexts, decisions regarding the development and execution of international CRM programmes have to take account of issues such as:

- Segmentation – which groups of customers are in sufficient numbers and of a value that it makes sound economic sense to make them the focus of an international CRM programme (ICRMP)?
- Cultural proximity – do the desired target segments for an ICRMP display sufficient cultural proximity to make the programme a practical proposition?
- Devolution – which aspects of an ICRMP should be determined and managed centrally, and which should be devolved to local management?
- Competition – how can an ICRMP protect valuable customers from the overtures of overseas competitors?
- Rewards – how transferable are individual rewards in influencing behaviours by members of the target segment on an international basis?
- Partnerships – how can reward-scheme supplier relationships be leveraged for mutual benefit, preferably on a global basis?
- IT – how can IT be used to increase the cost-effectiveness of an ICRMP, preferably by achieving interconnectivity between local national customer databases and central management facilities?
- Commercial – does it make strategic and financial sense?

The above set of factors is neither exhaustive nor mutually exclusive but, nonetheless, provides a firm basis for considering the development of an ICRMP. American Express has acquired significant expertise in managing customer loyalty programmes on a global scale. In many respects, this is an understandable response to the phenomenal growth of competition in the credit-card market across the globe. Case study 14.4 shows how Amex uses its international loyalty programme to reinforce the relationship it has with its higher-value customers.

Case study 14.4 The American Express international loyalty programme

American Express is one of the best-known and most respected brand names in the world. In the 1960s and 1970s it enjoyed a dominant role in the global credit-card market. However, from the 1980s onwards it has had to respond to an unprecedented growth in competition in all the territories it serves. In the face of such competition, the company has had to work hard to earn the loyalty

Continued

Case study 14.4 The American Express international loyalty programme—cont'd

of customers and build lasting relationships. American Express has fought back in recent years, and has invested heavily in new products, expanded its rewards and loyalty programmes, and strengthened its servicing capabilities to meet the needs of its customers better. As a result, in 2004 it attracted some 5 million new cards-in-force and achieved record spending of more than $416 billion – a wide lead over its competitors in terms of average spending per card.

In sharp contrast to many of its rivals, American Express has generated most of its growth organically, rather than by mergers and acquisitions. Through this approach, the company has grown its card-in-force base to 65.4 million.

American Express first introduced a customer loyalty programme in its home US market in 1991. During the course of the next few years the model proved its worth and was rolled out to many other markets around the world. By 2006, the international Membership Rewards Programme (MRP) had expanded such that it is now operating in 50 separate countries and encompassing some 13 million card holders. In outline, the scheme is as follows.

- Relatively high-value customers are invited to become members of the programme. Value is based upon characteristics such as annual credit drawn down and number of American Express products held by the customer.
- Successful applicants pay an annual membership fee which varies from country to country, roughly in a range from $15 to $50.
- Once enrolled in the programme, the member earns points on the basis of the monetary value of each transaction registered on their card.
- The points accumulate in the member's personal 'bank account', and they can be redeemed for a wide range of goods and services via the Internet or telephone call-centres located locally.

The local American Express management is responsible for promoting the programme to card holders in their respective countries, for negotiating local partnership arrangements with providers of goods and services listed in their member catalogue and for organizing the fulfilment service.

Overall business management of the programme takes place in London to ensure that it is achieving its goals and that the brand is being managed in a consistent fashion. The central function is also responsible for driving new reward innovations that keep the programme evolving, negotiating supplier relationships with major strategic partners such as major airlines and international hotel groups, and ensuring that the common systems platform and infrastructure provide the necessary functionality and access to the programmes being operated across the territories that comprise the MRP.

Partnerships

Some 1300 partners in total provide the goods and services that MRP members enjoy in exchange for the points they have accumulated. They include brands such

Case study 14.4 The American Express international loyalty programme—cont'd

as Canon, Panasonic, Dunhill, Montblanc and Antler, as well as companies such as Hertz, Eurostar and the De Vere Hotels group. Airlines represent particularly important partners, and American Express has partnership arrangements with almost 30 of them, including Virgin Atlantic, Cathay Pacific and Singapore Airlines.

Through becoming a partner with American Express, a company benefits in a number of ways. First, it receives the value of the goods that the member receives in exchange for his or her points from American Express. Secondly, it provides the partner with access to highly desirable customers – currently some 13 million in the markets covered by the MRP. American Express has coined the term 'double-dipping' to describe the phenomenon by which the member spends money with the partner company over and beyond the value of the points that have been redeemed. For example, a member might redeem sufficient points with, say, Air France to receive a return flight from Paris to Cairo, and might purchase a further three tickets on his own account for the remainder of the family to travel with him.

A third benefit that partners gain is access to data about the spending behaviour of the 13 million MRP members. American Express carries out an enormous amount of data interrogation to generate insights into how its card holders consume goods and services. Such analysis examines not only what is bought, but also through which merchants. Notwithstanding the limitations occasioned by the various pieces of data protection legislation, partners are able to inform their individual marketing strategies and programmes by using the behavioural insights they get from American Express.

Results

Highlights of its corporate financial performance in 2004 are as follows:

- A record net income of $3.4 billion, up 15 per cent on the previous year
- Diluted earnings per share up 17 per cent to $2.68
- Record revenues of $29.1 billion, up 13 per cent
- A return on equity of 22 per cent, compared with 20.6 per cent a year ago.

Currently, the international MRP has 2.2 million enrolees in Europe, 1 million in Latin America and 2.6 million in the Japan/Asia Pacific region. These are in addition to the 8 million-plus enrolees in North America. Recent analysis with airline partners demonstrates that the yield of MRP members to an airline is, on average, in the order of 35–60 per cent higher than that of the airline's average non-MRP customer. In 2004, the MRP received a Freddie Award for the 'Best International Affinity Credit Card Loyalty Programme'. In 2006, it was named the 'Best Credit Card Rewards Programme' by *Business Traveller Magazine* for the seventh consecutive year.

Source: Elisabeth Axel, Senior Vice President American Express.

14.9 Customer data management

It is no coincidence that the increasing importance placed upon marketing to existing customers has occurred in parallel with innovation in the area of customer database management. This is because the ability to collect, store, analyse and act upon meaningful customer data is now firmly established as a critical marketing competency. Technology has facilitated the means by which vast arrays of data can be processed to identify events in the provider–customer relationship that have meaning and implications for both parties.

During the course of the past 10–15 years a new industry has evolved, comprising software and hardware companies, information-based organizations, telecommunications suppliers and a range of consultancies aimed at transforming customer information into a highly commercially valuable resource. It is interesting to contrast the relatively sketchy and incomplete data which often typify new customer acquisition with the richness of data that can typify an organization's existing customers. Thus, existing customers present far more potential for accurate and appropriate data capture and analysis than do prospective customers. The data on consumers that are available when prospecting for new customers is pretty much common to all companies that are competing to acquire their custom. However, information regarding actual customers and their behaviour as customers is unique to the given provider. It is in the uniqueness of this information that a company possesses the means for differentiation and competitive advantage.

Storbacka and Lehtinen (2001) conceptualize the collection and organization of customer data as the creation of 'customer relationship memory'. To quote from the authors themselves, 'This customer relationship memory differs from ordinary databases in that it is the memory of a specific customer relationship'. This emphasizes the uniqueness that can be attributed to customer base marketing and the role played by technology in making it cost-effective to market to a segment of one. Data can be used to create knowledge about a customer that results in unique value being created for that customer; it provides the basis for a long and mutually beneficial relationship. Knowledge implies more than simply the awareness of a fact or piece of data. Rather, it implies an understanding and insightful awareness of the circumstances regarding a given subject – in this case, a customer. The notion of a 'customer memory' referred to by Storbacka and Lehtinen indicates the need for an organization to create customer knowledge through the analysis of appropriate inputs of data and information. The platform for the formation of customer knowledge and hence, if you like, a customer memory, is the customer database.

A basic approach to the component elements of a customer database is that it comprises four core components:

1. Customer fact file
2. Customer product file
3. Customer transaction file
4. Customer insight file.

The relationship between these four files is shown in Figure 14.3.

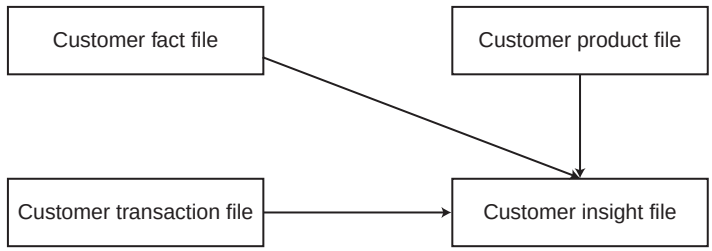

Figure 14.3 Top-level structure of the customer database.

- *The customer fact file* comprises what might be termed the customer's demographic profile, which contains data such as name, postal address, telephone number, e-mail address, gender, age, date of birth, occupation, salary, marital status, number of children, gender and ages of children.
- *The customer product file* comprises data regarding the products held with the provider, and includes information such as product name, optional features selected, value of product holding, funds selected. It also stores data on financial products held with other providers.
- *The customer transaction file* is where data are stored that provide an audit trail of the interactions that take place between the provider and customer. It might include information such as the frequency of using an ATM, the amount of cash withdrawn per transaction, whether an acknowledgement of transaction is requested, the place at which the ATM was used. It also stores written communication between the provider and customer and provides a log of all telephone-based contact, for example.
- *The customer insight file* is where data are recorded that give insights into how the customer views his or her relationship with the provider. For example, information resulting from the customer's involvement in a customer satisfaction survey is stored here. Any complaint-related feedback will also be found in this file. Importantly, it will allow provider staff a place to record their views about customer preferences and dislikes – for example, Singapore Airline's information regarding a frequent flyer's food, drink and reading material may be stored in such a file. A bank might decide to record that a given customer has a preference to deal with a particular call-centre agent when making a query. It can respond by creating a sense of familiarity that customers frequently cite as being important to them.

The customer insight file should benefit from inputs from the other three files. Thus, events in the customer's life act as a trigger for the creation of customer insights and the generation of appropriate actions on the part of the provider to add value to the relationship.

It is important that suitable systems and procedural architecture be devised to allow for the capture of data to populate the four files shown in Figure 14.3. Clearly there are cost implications to consider when developing such a framework for the management of customer information. This underlines the importance of targeting

customers with the required commercial potential as part of the customer segmentation strategy.

The crucial marketing skill is in knowing how to interpret the range of permutations of customer data to inform cost-effective interactions. Readers wishing to explore the use of data warehousing in the pursuit of customer marketing goals are referred to Ronald Swift (2001) for a more detailed discussion.

14.10 Summary and conclusions

This chapter outlines the environmental factors that have resulted in the development of customer relationship marketing. In particular, it has demonstrated how the characteristics associated with financial services have a marked resonance with the features associated with CRM. For example, the long-term nature of many financial services products makes them a natural context within which CRM programmes can succeed.

The crucial importance of carefully selecting the *right* customers in the first place is presented as a prerequisite for customer longevity and lifetime value. A range of factors has been discussed that are implicated in customer persistency. Strategies aimed at facilitating customer retention have been explored, notably Zeithaml and Bitner's model concerning the four levels of bonds.

The chapter introduces readers to the customer relationship chain. This model provides a simple yet effective basis for the ways in which the marketing mix can be used to facilitate the progression of both domestic consumers and business customers from suspect to advocate. The value of the customer relationship chain has been augmented with a demonstration of the importance of placing a value on lifetime customer value.

Consideration has been given to the implications of the use of intermediaries when adopting a CRM-based approach, and this led on to some of the particular issues that need to be addressed when considering the use of international CRM programmes. Finally, the significance attached to the role played by data has been discussed. Here, we gained an appreciation of the need for appropriate systems functionality, competence in data analysis and interrogation within any organization seeking to pursue a customer development strategy.

Review questions

1. To what extent is customer development a feature of the financial services sector in your own country?
2. What do you consider to be the relative importance of marketing's role in customer acquisition compared with customer development?
3. What are the respective merits of product profitability and customer lifetime value as measures of new business contribution?
4. In what ways might the design of a customer development marketing mix vary between the B2B and B2C marketplaces?

5. What are the customer environment-induced and provider environment-induced factors that result in customer lapsation in the market for savings deposit accounts?
6. Identify a business customer segment that you think would lend itself to an ICRMP. What practical issues need to be addressed in order to increase the likelihood of success?

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15

Service delivery and service quality

Learning objectives

By the end of this chapter you will be able to:

- explain the importance of service quality in the marketing of financial services
- understand the basic principles of the service profit chain
- understand the nature of quality in financial services
- review approaches to the management of service quality
- understand the importance of service recovery.

15.1 Introduction

The previous chapter highlighted the importance of developing and managing customer relationships and the growing concern with customer retention. One set of factors that might induce customer switching relate to poor service provision. Central to any approach to build and maintain good customer relationships is the management of service delivery to ensure quality and minimize the risks of service failure. The ability to deliver a high-quality service that meets the needs and expectations of customers is key to building a competitive advantage in the financial services sector. Because it is difficult for financial services providers to gain a sustainable competitive edge just by offering new products or new product features, attention is increasingly being focused on quality – not least because

the quality of the service that an organization provides is difficult to copy. Furthermore, research suggests that high levels of quality will lead to higher levels of customer satisfaction, and higher levels of loyalty. The economics of customer retention suggests that retained customers will be important to financial services providers for two reasons. First, retained customers are usually cheaper to serve because the company already knows something about them and their needs, and the level of marketing expenditure required to keep customers is much lower than the cost of acquiring new customers. Secondly, loyal customers can generate more revenue because they tend to be less price-sensitive, they are likely to buy additional products and services, and will engage in positive word-of-mouth. While recognizing that some aspects of this argument may be oversimplified, there are good grounds for believing that loyal customers can generate higher profits. The delivery of a high-quality service is essential to ensuring that customers maintain a productive relationship with a financial services provider, and in that sense, service quality can be expected to have a positive impact on organizational performance. Some research would also suggest that high levels of service quality can contribute to employee satisfaction as well, since staff are typically happier in their work when delivering something that is high quality as opposed to something of low quality.

This chapter provides an overview of service delivery in financial services, and highlights some of the issues associated with managing quality. The chapter begins by introducing the concept of the service profit chain as a way of thinking about the service delivery process and its impact on customers. Thereafter, the discussion focuses more specifically on quality and begins by defining service quality and highlighting its key features. The next sections discuss models of service quality, the service delivery process and the areas where problems may arise with respect to service delivery. The final section in the chapter examines the outcomes of service quality paying particular attention to the issue of service failure and service recovery.

15.2 The service profit chain

The process of delivering service, generating customer loyalty and improving profitability has been conceptualized in the service profit chain (Heskett *et al.*, 1994), which is illustrated in Figure 15.1. This model starts with internal service quality, which refers to the extent to which an organization is able to deliver quality support service to employees to enable them to service customers effectively. Included in the general concept of internal service quality are factors such as job design, working environment, reward systems, training and support systems. Internal service quality will result in higher levels of employee satisfaction, productivity and retention. Employees who are satisfied in their job and well-motivated will deliver a high-quality service to customers. This high quality is the foundation for delivering enhanced service value. Value will, in turn, lead to increased levels of customer satisfaction and retention. Given the economics of

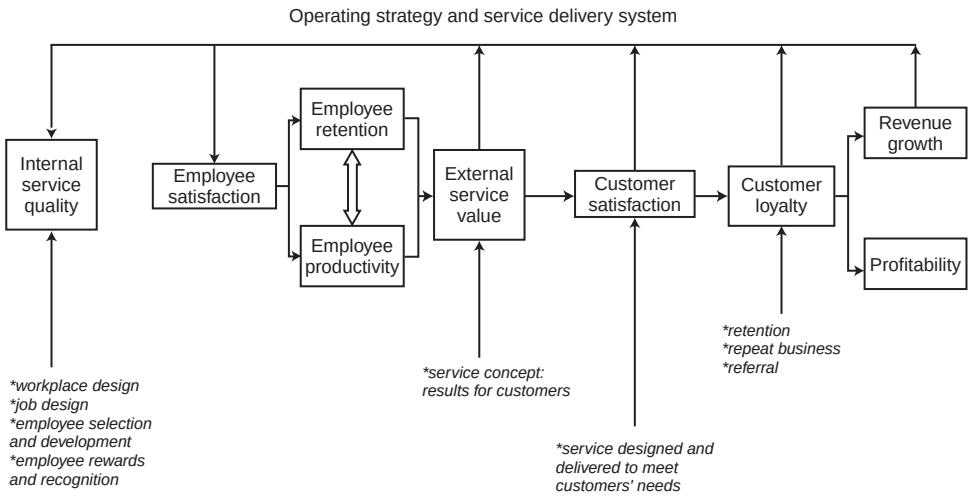


Figure 15.1 The service profit chain (*source:* Heskett *et al.* (1994).

customer retention (see, for example, Heskett *et al*., 1994), improved revenues and profit are the expected consequences. In essence, the service profit chain highlights the important links between how an organization manages itself internally, the impact of this on the experience of customers and the benefits in terms of organizational performance.

The logic of the service profit chain is very appealing, and the model has been widely adopted by consultants and managers. In particular, it has been used to guide a range of managerial interventions, most notably in relation to internal organization and management, and its usefulness has been demonstrated in a variety of settings (Case study 15.1 demonstrates the application of the service profit chain in the case of Sears). Systematic research to test this model has proved difficult because of the complexities of data collection. One of the first and most comprehensive studies using the service profit chain was undertaken in relation to retail banking in the US. Loveman (1998) used secondary, branch-level data, and found that internal reward systems, the organization's customer focus and the quality of management had a positive impact on employee satisfaction. There was rather limited evidence for a link between employee satisfaction and loyalty. Employee length of service was found to affect customer satisfaction, but the relationship between employee satisfaction and customer satisfaction was weak. Customer satisfaction had a positive impact on loyalty to the bank, and loyalty in turn was found to have an impact on financial performance. Overall, Loveman's evidence provided tentative support for the key relationships that underpin the service profit chain. More recently, however, in a retail setting, Silvestro and Cross (2000) noted that that store profitability tends to be negatively rather than positively correlated with employee satisfaction, although they did find evidence to support the customer dimension of the service profit chain.

Case study 15.1 The service profit chain at sears

The alluring logic that links employee and customer satisfaction to hard-nosed commercial outcomes is particularly well-evidenced by the experience of the American retailer Sears, Roebuck and Company; one of the world's best-known retailing brands, with its origins dating back to the nineteenth century. In 1992, the company experienced a chronic decline in performance, culminating in a loss of $3.9bn on a turnover of $52.3bn. A common and understandable response to such a situation is a radical cost-cutting exercise. Such a response may well buy an organization some time, especially as far as shareholders and stock analysts are concerned. However, cost-based retrenchment is unlikely to result in the kind of competitive advantages that can achieve a sustained turn around and in performance. That said, Sears' new Chief Executive, Arthur Martinez, who joined the company in 1992, carried out a degree of restructuring and cost-cutting. For example, over 100 stores were closed, as was its loss-making Sears catalogue. However, a number of shrewd investments were made, including the realignment of the product range and a major programme of store refurbishment. These and other actions resulted in a marked turn around in performance which saw total shareholder return for 1993 of 56 per cent.

The company was anxious to build upon this initial progress, and the CEO initiated a programme for its long-term revival. Five strategic priorities were identified, including growth in the core retailing business and greater customer focus. An overarching change management group, known as the Phoenix Team, was created, and oversaw the work of a series of task forces. The Phoenix Team became increasingly exercised by the need to devise a model for the business that linked employers, customer and shareholders. Central to the model was a set of three aspirations, namely that Sears should be:

1. For employers – a compelling place to work
2. For customers – a compelling place to shop
3. For shareholders – a compelling place to invest.

The company employed a causal pathway modelling methodology based upon staff and customer surveys linked to financial performance measures. Over time, the company came to appreciate that of the 70 questions comprising the staff survey, 10 had a particularly strong impact on employee behaviour (and consequently upon customer satisfaction). Moreover, they discovered that just two dimensions of employee satisfaction, namely attitude toward the job and toward the company, had a greater impact upon employee loyalty and behaviour toward customers than all the other dimensions put together.

During the course of something like 2 years, Sears revised its methodology and modelling to derive an approach that demonstrated causal relationships between certain key measures of employee attitudes, customer satisfaction and profitability. To have demonstrated such a link is truly impressive and inspirational. Indeed, this also had a material impact upon the Nationwide Building Society's approach to customer and staff satisfaction measurement and the ensuing actions.

Source: Rucci et al. (1998).

What the service profit chain does do is highlight the importance of value (with quality as a key component of value) and the central role of the organization's employees in delivering that value quality. What it doesn't do is provide a detailed insight into that nature of service quality and the ways in which it should be managed. This will be the focus of the rest of this chapter. The concepts of value (as the relationship between quality and costs) and satisfaction will be addressed in more detail in Chapter 16.

15.3 Defining service quality

Quality is much more difficult to define for a service than it is for a physical good. With a physical good, quality can often be measured by specifying certain physical features that the product should possess. For example, the quality of a laser printer can be specified in terms of the number of pages that will be printed each minute and the quality of the printed output. This serves as an objective standard – if the printer reaches this objective standard, then it is considered to be of a particular quality. In financial services it is much more difficult to specify objective standards, because service encounters can vary and the needs of customers can vary.

There is a range of different perspectives on quality. Garvin (1988) suggests that these can be organized under five main headings:

1. *Quality is 'innate excellence'*. This view suggests quite simply that we know excellence from repeated experience of it (either our own or others'). Although it may be one approach that many people would feel comfortable with, from a management perspective it is vague and imprecise.
2. *Quality is product attributes*. This approach assumes that quality is a precise and measurable variable, provided by specified amounts of product attribute (the fuel consumption of a car, its power, its acceleration, etc.). This approach has many attractions because of its specificity and measurability, but fails to take into consideration the needs and preferences of customers.
3. *Quality is user-based*. This approach proposes that definitions of quality are based on the perspective of the customer and the extent to which a product meets those needs.
4. *Quality is supply-based*. This approach has similarities with the product attributes-based approach in that it centres on conformance to internally developed specifications. This is largely an operations-driven approach, which focuses on productivity and cost consideration.
5. *Quality is value-based*. This approach emphasizes the trade-off between performance and price, and is often described as 'affordable excellence'.

When thinking about service quality, the most common view is that service quality is subjective – that is to say, it is based on the customers' perception of how well the service matches their needs and expectations. Service quality is what consumers perceive it to be.

15.4 Models of service quality

While recognizing that the user-based view of service quality means that quality is defined by the customer, any attempt to manage service quality requires an understanding of how customers evaluate the service they receive and which elements are most important. Because we have adopted a subjective view of service quality, the most common way to think about how consumers evaluate a service is the idea that they will have expectations about the sort of service that they will receive. They will then compare the actual service with the expected service. If the actual service meets or exceeds the expected service, then the level of quality will be seen to be relatively high. If the actual service is below what was expected, then consumers will perceive that the quality of service is poor.

While it is widely agreed that service quality will involve a comparison of expectations and actual service performance, there are different views about the aspects of service that are important. In general, there are two main ways of looking at the elements of service quality. In broad terms, attempts to define and understand service quality have developed in two distinct directions – one stream of research originated in Europe (largely Scandinavia), while the other developed in North America. The European stream of research is often described as the Nordic School, and originates in the work of Christian Grönroos (see, for example, Grönroos, 1984, 1988). This approach tends to be more qualitative, and emphasizes the overall image of the organization, the outcome of the service (technical quality) and the way in which it is delivered (functional quality). The North-American stream of research developed from the work of Parasuraman, Zeithaml and Berry (see, for example, Parasuraman *et al*., 1985, 1988); it explicitly defines service quality as the difference between perceptions and expectations, and measures quality across five main dimensions – Reliability, Assurance, Tangibles. Empathy and Responsiveness (RATER). Specifically, Parasuraman *et al*. proposed a method of measuring service quality using a measurement model called SERVQUAL. This has since been the most widely used approach to the measurement of service quality, and SERVQUAL has been applied to a variety of different services in a variety of different countries. Each of these two approaches will be discussed in more detail below.

15.4.1 The Nordic perspective on service quality

The framework developed by Grönroos is outlined in Figure 15.2. In this framework, it is proposed that customers form expectations and make evaluations of service delivery in relation to both functional and technical quality:

- *Functional quality* is concerned with the way in which the service is delivered, and will cover things such as friendliness, helpfulness, politeness, pleasantness, understanding. etc. It deals mostly with the way in which a service encounter happens. In the case of, say, a financial planner, functional quality would be concerned with the way in which the planner treats customers.
- *Technical quality* is concerned with the quality of the service outcome – that is to say, it is concerned with the extent to which the service is performed correctly

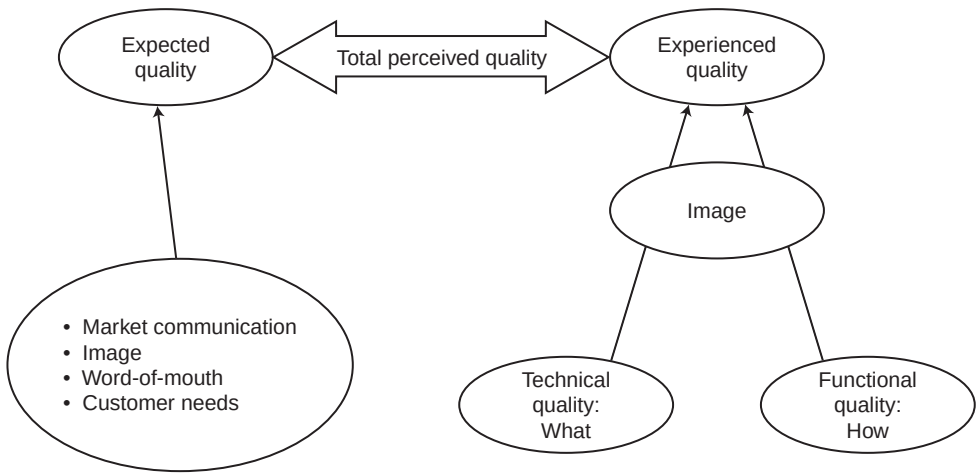


Figure 15.2 The Nordic perspective on service quality (*source:* Grönroos, 1988).

and accurately. In the case of a financial planner, technical quality would be concerned with the quality of the actual advice.

Perceptions of functional and technical quality combine to create an image for the organization, and this drives overall perceptions of quality.

Because overall service quality will be dependent on both functional and technical quality, to deliver a high-quality service will require not just good technical skills but also require good interpersonal skills. In many cases, research in financial services has suggested that functional quality may often be more important than technical quality. It has already been suggested that many personal customers find financial services complex and difficult to understand. In such situations, there will be a tendency for evaluations to be based on the quality of the interaction with the financial services provider rather than the intrinsic quality of the financial service itself.

15.4.2 The North-American perspective on service quality

The North-American perspective on service quality is based on the work of Parasuraman *et al*. (1985, 1988). They explicitly proposed that quality evaluations were based on a comparison of consumer expectations of what they *should* receive with consumer perceptions of what they *did* receive. They proposed that such comparisons would be made in five main areas:

1. *Reliability*, which is concerned with the extent to which customers can depend on the organization to perform the promised service, to do it accurately and to get it right first time.

2. *Assurance*, which is concerned with the extent to which the organization and its staff are competent, courteous, credible and trustworthy. It also considers the extent to which the consumer feels secure.
3. *Tangibles*, which includes the appearance of physical facilities such as the interior of the branch, the appearance of staff and the appearance and quality of communication materials.
4. *Empathy*, which is concerned with factors such as accessibility, good communications, understanding of customer's needs, approachability and friendliness.
5. *Responsiveness*, which is concerned with how the organization, through its staff, responds to customers. Important issues include the extent to which staff are helpful, prompt and able to solve problems.

In order to measure service quality, data should be collected about customers' expectations in each of these areas and about their perceptions of the quality that they receive. Indeed, Parasuraman *et al*. developed a questionnaire – known as SERVQUAL – specifically to collect data on these five aspects of service quality. By looking at the difference between the level of performance and the customers' expectations, an organization can identify the areas on which it should focus its attention. Consider the example in Figure 15.3. The graph plots the value of perceptions minus expectations for each of the five dimensions of service quality. Positive scores indicate that performance is above expectations, and negative scores indicate that performance is below expectations. In the case of this organization, the tangibles dimension is fine, as is empathy – both exceed customer expectations. However, performance with respect to reliability and responsiveness is clearly well below customer expectations. These findings would suggest that, in managing the

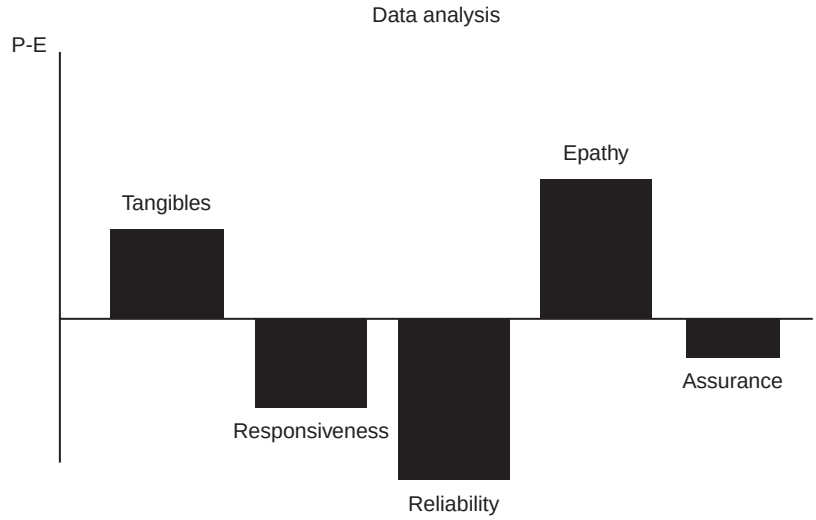


Figure 15.3 Zones of tolerance.

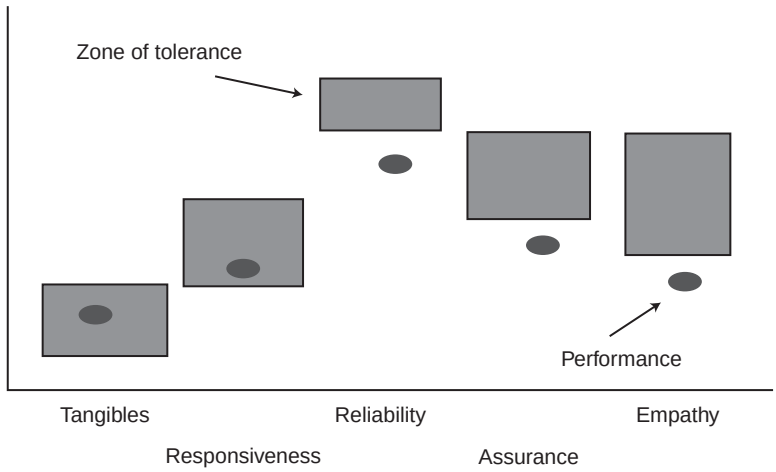
delivery of service quality, attention should be focused on reliability and responsiveness as the areas most in need of improvement.

The SERVQUAL framework has been used extensively in academic and business research, and has also attracted a significant amount of criticism (see, for example, Buttle, 1996). A particular cause for concern has been the idea that service quality is a difference score (i.e. the difference between perceptions and expectation, P – E). Implicit in this approach is the idea that when a score is negative, it indicates poor quality. However, some researchers have suggested that consumers may still perceive a high level of quality despite recording negative difference scores – for example, if expectations are very high and score at 7 while perceptions are positive but score lower at 6. In addition, difference scores do not distinguish between a situation in which P = 7 and E = 6, which indicates very positive evaluations, and one in which P = 2 and E = 1, which indicates very poor evaluations. Both would result in the same quality rating – i.e. 1. Other criticisms have been concerned with the generalizability of the SERVQUAL questions across very diverse services, and the adequacy of the coverage of the core service features. Consequently, many researchers have supplemented SERVQUAL with additional service-specific questions.

In response to criticisms, Parasuraman *et al*. continued to develop SERVQUAL. One important development related to the interpretation of expectations. The initial work on SERVQUAL treated expectations as being ideals – i.e. measures of what consumers think they should get. In recognition of the possibility that such ideal expectations could be unrealistically high, Parasuraman *et al*. (1991) proposed the concept of a 'zone of tolerance'. This approach suggested that consumers might have two types of expectations; ideal (or *should*) expectations and adequate (or *will*) expectations. In effect, it was argued that consumers would distinguish between their ideal standard of service and a realistic standard of service. Whereas the latter concerns the minimal acceptable standard that will provide a solution to their need, the former represents the level of service that they would like to experience. In Berry and Parasuraman's words: 'It is a blend of what the customer believes *can be* and *should be*' (Berry and Parasuraman, 1991).

Between the *desired* and the *adequate* levels of service is the *zone of tolerance*. This represents a range of service performance that the customer will consider satisfactory. Figure 15.4 provides an example of perceptions measured against zones of tolerance.

Consider the following example. A building society customer wishes to deposit some cash in her savings account and expects the entire service encounter, from entering the branch premises to leaving it, to take 4 minutes (the desired service level). However, the customer appreciates that a range of other variables might result in a somewhat longer service encounter. For example, there may be a number of other customers waiting to be served, one of whom may have a particularly large quantity of coins and cash to deposit. The customer may be willing to accept a total service encounter time of 12 minutes, based upon her expectations of likely factors. In this case, the difference between 12 minutes (the adequate service level) and 4 minutes (the desired service level) represents the zone of tolerance. A service encounter that is of a duration within the zone of tolerance will result in a positive assessment of service quality. However, a service encounter that is quicker will result in a highly favourable impression of the quality of service delivered while,



Performance with respect to tangible and responsiveness is within the zone of tolerance. Performance with respect to reliability, assurance and empathy is a cause for concern because all lie below the zone of tolerance.

Figure 15.4 Perceptions of service quality and zones of tolerance.

conversely, a service encounter falling below the adequate level will result in a negative assessment.

As can be imagined, the zone of tolerance is a highly flexible concept that varies not only from customer to customer and according to the nature of the given transaction, but may also vary for the same customer depending upon the circumstances surrounding a given transaction. Zones of tolerance vary across individuals because of different personal situations, differences in past experience and different service philosophies. The zone of tolerance also varies across the five key dimensions customers use in evaluating a service – reliability, assurance, tangibles, empathy and responsiveness. Reliability, or keeping the service promise, is thought to have a far narrower zone of tolerance than other aspects of a service. Zones of tolerance may also be affected by service context – for example, when faced with an emergency situation, zones of tolerance may be narrower than in a non-emergency situation. Finally, marketing activities may affect the breadth of the zone of tolerance. Marketing communications place an important role in creating expectations; over-promising in marketing communications can raise the level of 'adequate' expectations, and this reduces the size of the zone of tolerance.

The practical consequences of this model are manifold. For example, the development of customer advocacy is likely to result from customer experiences that are consistently above the upper limit of the zone of tolerance. Companies would do well to develop a firm grasp of the relative importance of zones of tolerance in respect of the more critical encounters of primary target segments. As a rule of thumb, the more crucial a given service feature, the narrower the zone of tolerance and the greater the likelihood of engendering customer negative evaluations of the

service. By knowing what the critical service encounters are, a company can take action to ensure high standards of delivery.

In addition to identifying the areas that are important to consumers when evaluating service quality, Parasuraman *et al*. (1985) also developed a model of service delivery to help managers understand how problems might arise in the service delivery process and how service delivery could be managed to ensure high levels of quality. This will be discussed further later in the chapter.

15.4.3 Integrating the Nordic and North-American perspectives

The Nordic and North-American perspectives share many similarities in the way in which they view service quality. In 2002, Brady and Cronin proposed a framework that sought to integrate the key components of the major models of service quality. Drawing particularly upon the work of Grönroos (1984), Rust and Oliver (1994) and Parasuraman *et al*. (1985), they proposed a hierarchical approach to the assessment of service experience by consumers. This is shown diagrammatically in Figure 15.5.

In Figure 15.5, it can be seen that Brady and Cronin propose that there are three primary direct determinants of perceived service quality – interaction quality, the quality of the physical environment, and the quality of the outcome of the service experience. *Interactive quality* is viewed as being a function of how employees' attitudes, behaviours and expertise are perceived to influence the quality of a service interaction. This component of the model illustrates the importance attached to the *people* element of the marketing mix, an issue that will be discussed further in

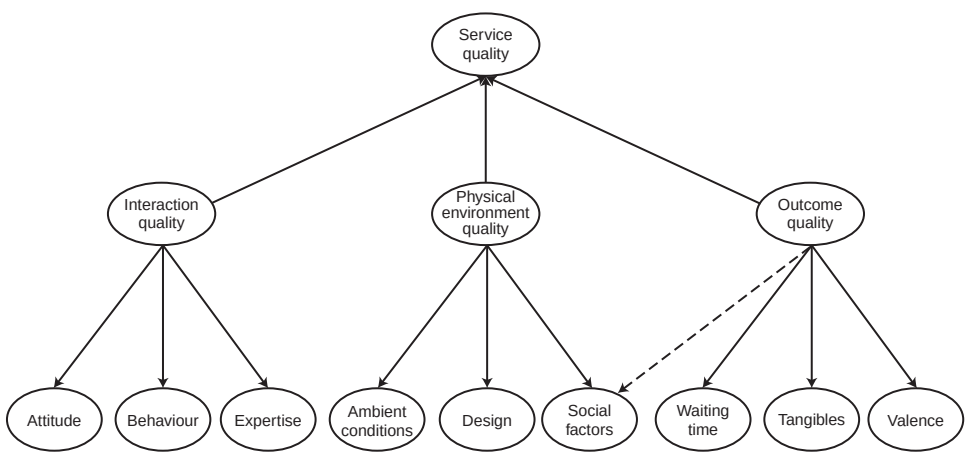


Figure 15.5 An integrated model of service quality (*source:* Brady and Cronin, 2001).

Chapter 17. The role played by the physical *environment quality* is held to be a function of the design and layout of the environment, the nature of the usage level taking place (social factors) and the atmosphere that is perceived (ambient conditions). The ambient conditions are determined by mood-setting devices such as lighting and music. It is interesting that, in Ireland, Permanent TSB bank has music playing in its branches in Dublin. It certainly achieves a form of differentiation when compared to the atmosphere of its rivals in the city.

Finally, *outcome quality* is held to be a function of waiting time, tangibles and value. Waiting time is self-evident, and the above explanation regarding zones of tolerance illustrates how these impact upon customer perception. Tangible evidence closely relates to the *physical evidence* component of the marketing mix.

Valence is a term used by Brady and Cronin to express whether the customer considers the ultimate outcome of the service experience to have been good or bad. This judgement is an overarching evaluation by the customer, irrespective of how he or she evaluates other components of the service encounter. For example, consider the case of a consumer approaching a bank for a home-improvement loan. His perceptions of the interaction quality and physical environment will be of no consequence if his loan application is refused. In other words, the appraisal of whether the core need was satisfied (valence) takes precedence over the other eight elements that influence the consumer's perception of service quality. It should be noted that the reliability, responsiveness and empathy components of the SERVQUAL model have been incorporated into the model as descriptors of the nine sub-dimensions of quality in themselves.

Brady and Cronin have subjected their model to empirical analysis, and the results provide support for its validity. They have succeeded in consolidating a range of service quality conceptualizations into 'a single, comprehensive, multidimensional framework with a strong theoretical base'. The authors recognize that the model suggests the need for further investigation, particularly with regard to the issue of valence. They also acknowledge that so far it has only been tested on a narrow range of the services domain, and may thus risk over-generalization. Nevertheless, it provides an extremely useful platform for practitioners as they seek to raise levels of perceived quality. This is important, given the role that service quality appears to play in influencing market share, relative profitability, customer loyalty, premium pricing and rates of re-purchase. Managers can use the model as a means of enabling them to identify what defines service quality, how service quality perceptions are formed, and the significance attached to the place in which the service experience occurs.

15.5 The gap model of service quality

We have already explained the idea that service quality can be based on a comparison between expectations and performance. Where there is a gap between what customers expect and what they get, this gap can be related to four other gaps in the service delivery process. In simple terms, if the delivered service does not meet

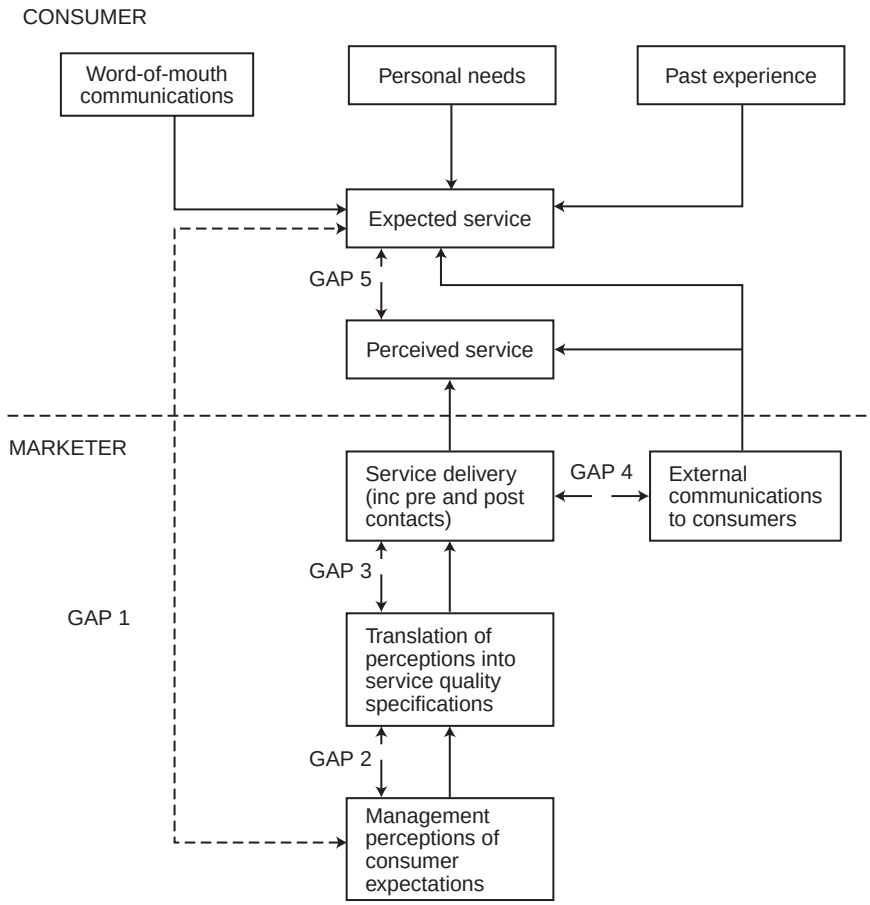


Figure 15.6 The gap model of service delivery (*source:* Parasuraman *et al.*, 1985).

customer expectations (Gap 5), this can be explained by any of four other gaps in the service delivery process:

- Misunderstanding expectations (Gap 1)
- Wrong specifications (Gap 2)
- Failure to deliver (Gap 3)
- Over-promising (Gap 4).

The service delivery process and the gaps are outlined in Figure 15.6.

Delivering a quality service requires a good understanding of what customers expect. Given their knowledge of what customers expect, managers must then set appropriate standards for the service and ensure that staff will deliver a service of

the specified standard. It is important to ensure that what is promised to customers by the organization's marketing communications is consistent which what the organization is able to deliver. Gaps in the service delivery process can arise at key points throughout this process, as Parasuraman *et al*. (1985, 1991) explain. Each of the four main gaps will be discussed in turn. If the management of the service delivery process can focus on these potential gaps and identify ways of addressing them, then the potential for the organization to be able to deliver the kind of quality that customers expect will be much greater.

15.5.1 Misunderstanding expectations (Gap 1)

This gap arises when senior management do not understand what consumers actually expect from the service. There are several reasons why this might happen. A failure to undertake market research may lead to a poor understanding of what customers actually want. Equally important as a cause of Gap 1 may be poor upward communication – frontline employees are in regular contact with customers, and probably have a good understanding of their needs and expectations. However, if management is unwilling to listen to frontline staff, then this knowledge and understanding will be wasted. Where organizations have good relationships with their customers, Gap 1 is less likely to occur because the organization will have built up a high level of knowledge about customer needs and expectations.

Clearly, then, to deal with Gap 1, attention must be paid to increasing understanding of consumers through additional market research, encouraging flows of information from frontline staff and to building stronger relationships with customers.

15.5.2 Wrong specifications (Gap 2)

The second gap (Gap 2) arises if service specifications are not consistent with the expected service. This would imply that the company specifies and designs a particular service but the features, etc., are not what customers would expect. There are several reasons why this gap may arise. Some services may be very difficult to standardize; managers may think that customer expectations are unreasonable and cannot be met. In some cases the commitment to service quality may be missing, and consequently there will be a lack of interest in setting sensible services specifications. Closing Gap 2 means ensuring that the service that is specified matches the service that consumers expect. To do this, it is essential to ensure that top management is committed to providing service quality. Once that commitment is present, it is necessary to ensure that customer service expectations are part of the design process – that they are built into service development. Key service features must be identified (what is important to the consumer), and sensible specifications identified based on consumer priorities. Thus, for example, if customers expect quick service when making a loan application, then managers must identify what 'quick' means (is it a response in 1 day, in 1 week?). If customers also expect low interest rates and

flexible repayments, then the relative importance of these should be identified and more attention paid to the feature that is most important. Where services can be standardized they should be, as this allows a single set of standards to be used rather than multiple sets.

Senior managers do play a key role with respect to Gap 2. Demonstrating a firm commitment to setting and using customer-defined performance standards can have a major impact on closing service quality Gap 2.

15.5.3 Failure to deliver (Gap 3)

Gap 3 arises when the actual service that is delivered does not match the service that was specified. Even if a sensible, customer-driven specification is in place, there is no guarantee that the service that is delivered to the customer will meet this standard. There are many reasons why Gap 3, failure to deliver, might arise. To deliver to a certain specification requires that appropriate resources (people, systems, and technology) exist and are supported. Broadly speaking, Gap 3 may arise because of problems with human resource policies, customer participation and intermediaries, because of problems with respect to managing supply and demand. If employees are not committed, willing and able to do their job well, then problems will arise with respect to the delivery of the service. If customers do not understand what they are meant to do, then there will be problems with the service that is delivered. If a service provider relies on an intermediary to distribute the service, then there may be difficulties in controlling the quality of what the intermediary does. Finally, if the organization cannot manage supply and demand, then it may be difficult to deliver that appropriate quality when levels of demand are high and staff are under pressure.

Closing Gap 3 requires that considerable attention be paid to staff. To achieve a high level of performance and ensure that high quality service is delivered requires that the organization:

- recruits the right people, with the skills and knowledge to delivery quality service
- ensures that there is a sensible reward system, so that employees received rewards (monetary and non-monetary) for delivering high-quality service.
- ensures that there is a good fit between technology and people – i.e. that people have the right technology for the job
- encourages empowerment and teamwork so that staff can adjust and adapt to differences in customer needs.

Equally importantly, the organization must make sure that customers know what they should be doing and how they should contribute to the delivery process. This requires effective communication regarding, for example, what information they need to provide, what forms they need to complete, etc.

Finally, attempting to synchronize demand and supply will be important to ensure that resources are not overstretched and quality standards can be maintained. Equally important is the need to ensure good co-operative working relationships with intermediaries to ensure that they will be motivated to deliver the standard of service that the organization expects.

15.5.4 Over-promising (Gap 4)

The fourth gap arises when the organization promises a better service than it actually delivers. This raises customer expectations, and when the delivered service then does not match those expectations, quality will be assessed as poor. A failure to deliver what was promised may arise for a number of reasons. The two most important are poor information and pressure to over-promise. Poor information flows between marketing and the rest of the organization may result in marketing having a poor understanding of what the organization will be able to do, and thus the claims that marketing makes will be inaccurate. Equally, there may be a tendency to over-promise in marketing communications, to outperform competitors and to make the organization appear in the most favourable light. Addressing Gap 4 requires that attention be paid to ensuring good, accurate communications between marketing and those involved in the service delivery process. This communication should provide clear and accurate information about what consumers can expect, and the information should then be integrated into all marketing communications to ensure that customers receive a consistent and honest message.

15.6 The outcomes of service quality

As the introduction mentioned, if an organization can deliver a high quality of service, its customers will receive better value and are more likely to be satisfied. In turn, satisfied customers are more likely to be retained and to be loyal. The nature of customer satisfaction and its measurement are discussed in more detail in Chapter 16, as is the nature of value. The remainder of this section focuses on loyalty. The central role of service quality in delivering customer loyalty and advocacy is widely acknowledged. Case study 15.2 explains how Cheshire Building Society gathers data on service quality which it then uses to gain a better understanding of exactly which aspects of their service are the most important in creating loyal customers.

Case study 15.2 Monitoring service quality at Cheshire Building Society

Through the regular gathering of member perceptions at the 'moment of truth', Cheshire Building Society has developed a systematic approach to understanding which members rate them highly, which members will remain loyal and which members are advocates of the organization. The collection of verbatim member comments also allows Cheshire to determine the drivers of loyalty and advocacy.

The key objectives of the programme are:

- to understand the members' perception of the service delivered to them corporately and locally on a monthly basis

Case study 15.2 Monitoring service quality at Cheshire Building Society—cont'd

- to track re-purchase intention and recommendation levels
- to improve service quality and uplift product purchase
- to provide process owners a monthly feed of information that flags issues and identifies practical ideas to improve service performance
- to benchmark, from a member perspective, performance against best-in-class service providers
- to recognize employees when the member perceives they have consistently delivered excellent service.

Each month 2000 survey questionnaires are mailed to members whose selection is based on a recent transaction (a telephone enquiry, new mortgage, new investment or branch visit). Additionally, a control group of members who have had no contact with the Cheshire in the last 12 months is also sampled. The surveys can also be deployed by telephone or e-mail as different member segments are added to the programme.

The detailed feedback reports provide a complete analysis of the key member experiences, identifying strengths and areas for improvement. Managers review the feedback reports each month, recognizing good performance and focusing attention and investment on correcting weaker areas. The results to date have resulted in:

- improved service delivery to members, across the channels
- development of action plans based on member feedback
- improved understanding of key drivers of what drives loyalty and advocacy
- improved benchmarked performance against best-in-class providers
- improved employee engagement satisfaction through greater recognition of service excellence.

In addition to the monthly survey, the Society utilizes other feedback mechanisms to build a comprehensive understanding of member views. These include:

- '*Have Your Say*' leaflets in branches
- website feedback forms
- member forums.

The complaint-handling process is also used to improve service delivery. Members are asked to rate the quality of the complaints process, irrespective of the outcome of the complaint, with a satisfaction rate in excess of 70 per cent being achieved during 2005.

Our members prioritize our actions and we can now act 'knowingly' rather than 'presumably'. The feedback gathered together with market research, mystery shopping and complaints data gives us an insight to how our members 'feel'. With this knowledge, Cheshire is able to develop new products and to further increase member loyalty and advocacy.

Source: Jason Gaunt, Marketing Director, Cheshire Building Society.

	Retained	Not Retained
Positive attitude	Loyal/Apostle	Mercenary
Negative attitude	Hostage	Defector/Terrorist

Figure 15.7 Attitudinal and behavioural loyalty. (*source:* Heskett *et al.*, 1995).

Loyalty is seen as a particularly significant outcome of service quality because of its impact on profit. However, loyalty is potentially a complex construct – it has both an attitudinal dimension (i.e. what the customer thinks or feels about an organization) and a behavioural dimension (i.e. what the customer does, and whether there is a repurchase). Customers may feel very positively towards an organization and thus be attitudinally loyal, but their situation may mean that no further purchases are made. Conversely, a customer may feel very negatively about an organization (be attitudinally disloyal) but continue to purchase, perhaps because of the lack of alternatives (see, for example, Dick and Basu, 1994). The different configurations of attitudinal and behavioural loyalty are outlined in Figure 15.7.

Customers classified as 'Loyal/Apostle' are those who have positive views about their experiences with the organization and continue to make purchases. 'Mercenaries' may have positive evaluations of an organization but choose not to repurchase for a variety of reasons – consumers buying mutual funds may, for example, choose to spread their business across a number of funds to spread risk, despite having very positive experiences of a given investment company. Other customers may move savings around between different providers in search of the best rates, and not because they have any negative views of the service provided by an individual organization. Customers in the 'Defector/Terrorist' category have a negative evaluation and decide not to repurchase. Such customers have clearly had very poor experience with an organization, and are thus more likely to engage in negative word-of-mouth as a result of their experiences. The final category, 'Hostage', consists of those customers who have negative attitudes to the organization but continue to repurchase because of a lack of alternatives. Such customers appear to be loyal (because they continue to purchase) but are not, and are potentially vulnerable to attractive offers from competitors. For example, many bank current-account customers are thought to fall into this category – they do not have a positive view of the service they receive, but do not switch their bank account because the process is too complex and they perceive few differences between competing banks.

To realize fully the benefits of loyalty depends on having customers who both continue to repurchase and also have positive attitudes. With such customers, there is a variety of potential financial and non-financial outcomes which provide the basis for arguments regarding the 'economics of customer retention':

1. Better knowledge of customer needs – which means that the organization is better able to meet customer needs and at a lower cost (because there is no need to gather new information).

2. Positive word-of-mouth – customers who are attitudinally loyal are likely to say positive things about the organization, and this can be an important (and cost-effective) form of marketing, particularly in financial services.
3. Spreading costs of acquisition – financial services organizations spend a lot of money (marketing expenses) to acquire customers. When a customer is behaviourally loyal, those costs can be spread out over a much longer relationship and over more transactions.
4. Less price-sensitivity – attitudinally loyal customers are thought to be less price-sensitive because they value the relationship with the organization.
5. Cross-selling – attitudinally loyal customers are more likely to purchase additional products from a particular organization.

Overall, then, creating customers who are both attitudinally and behaviourally loyal can mean reduced costs and higher revenues, and thus can have a positive effect on profitability, as argued in the service profit chain framework. Discussions in previous chapters have noted that it may be unwise to assume that all retained customers are profitable. In particular, Reinartz and Kumar (2002) have suggested that some retained customers will be 'barnacles' – retained but unprofitable. This may arise because such customers are more rather than less price-sensitive; they are aware of their potential value to the organization and demand special treatment, making them more rather than less expensive to serve. If such customers do not engage in positive word-of-mouth, then the benefits of retention to the organization may also be curtailed. While it is important to be aware that not all retained customers are profitable, this should not detract from the importance and value of customer loyalty and retention to financial services organizations.

As shown in Chapter 14, there is a developing body of research in financial services that seeks to highlight the beneficial outcomes of service quality. The evidence for service quality having an impact on financial performance is rather limited, although Storbacka (1994) and Loveman (1998) have provided evidence of positive relationships between service quality/customer satisfaction and profitability in banking. Yeung and Ennew (2001) used data from the American Consumer Satisfaction Index (ACSI) to provide evidence that customer satisfaction with financial services providers had a significant positive impact on a variety of measures of financial performance across the period 1994–1999. Other researchers have demonstrated that service quality does have a positive impact on satisfaction (Crosby and Stephens, 1987), retention (Ennew and Binks, 1996), and willingness to recommend and willingness to continue purchasing (Paulin *et al*., 1997). Thus, while there may be some debate about the precise nature of the outcomes of service quality, there is strong evidence to suggest significant benefits for organizations that focus attention on the delivery of high-quality customer service.

15.7 Service failure and recovery

Of course, we should remember that however much attention is paid to ensuring a high quality of service, there will sometimes be service failures – something will go wrong, a mistake may be made and customers may complain. For example, there may be a genuine mistake, staff may be absent (meaning that a particular customer

cannot be dealt with properly), some aspect of technology may fail, etc. A poor service or a service failure will result in customer dissatisfaction and this in turn will prompt a variety of responses, which may include complaining, negative word-of-mouth and decisions not to repurchase. If it is impossible to avoid service failures and dissatisfaction, then it becomes increasingly important for organizations to understand how to minimize their adverse effects. There is a growing body of evidence to suggest that effective service recovery can generate a range of positive customer responses, with complaint handling being seen as a key element in service recovery. Responding effectively to consumer complaints can have a significant impact on satisfaction, repurchase intentions and the spread of word-of-mouth.

In order to be able to deal with service failure, an organization must first be aware that a failure has occurred. This means making it easy for customers to complain. All too often, customers experience a service failure but for some reason – too much effort, or the expectation that nothing will be done – they may choose not to complain to the provider. They simply switch to another provider and/or engage in negative word-of-mouth. The absence of a formal complaint means that the organization has no opportunity to address the individual customer's dissatisfaction and no opportunity to learn from that customer's experience. Thus, it makes sense for an organization to make it easy for customers to complain – perhaps by providing freephone numbers and complaints hotlines, etc. Thus, for example, ICICI Bank in India promotes its 24-hour customer care hotline and promises customers 'We aim to respond to your complaint with efficiency, courtesy and fairness. You can expect a response to your complaint within 2 business days.' Similarly, African Bank Investments in South Africa stresses a commitment to responding to complaints and provides customers with a three-stage process for lodging a complaint. Such guidance and encouragement is increasingly common as organizations recognize the value of responding to and learning from service failures. In addition to making the complaint process transparent and straightforward, organizations may also consider active research to check that the service delivery has gone well; this again provides the consumer with an opportunity to complain if necessary.

If an organization is to learn from service failure, then, in addition to knowing that a failure has occurred, it is important to have a clear understanding of the type of service failure. If the failure arises in relation to the service delivery, then the appropriate focus of attention may be service operations and design. In contrast, if the failure is a consequence of employee behaviour, then the appropriate response may be to reconsider human resource management policies and practices. Service failure can take many forms. Bitner *et al*. (1990) used the critical incident technique to identify and classify three main types of service failure:

1. *Service delivery failure*. Failures in the service delivery system generally fall into three categories. First, the service may simply be unavailable – an ATM or website may not work, or a key member of staff may be unavailable to serve a particular customer. Secondly, unreasonably slow service covers any delivery experience which is unreasonably slow and includes long queues, a website that is slow to respond, and any other delay in providing service to a customer. The third category, other core service failures, is deliberately broad to encompass a range of core failures including, for example, errors in money transmission, errors in claims handling and errors in processing service applications.

2. *Failure to respond to customer needs*. Customers may have a variety of needs and requests in relation to a particular service – whether explicit or implicit. The second category of failure relates to failure to respond to these needs. Implicit needs are not formally articulated by customers, but are nevertheless important. A failure to inform customers about a change in the terms and conditions of a service would constitute a failure to respond to implicit needs. Explicit needs are generally considered to be of four types: special needs, customer preferences, customer errors, and disruptive others. A failure by a financial adviser to select a product that matches an investor's risk preferences would constitute a failure to respond to the special needs of that individual. Similarly, a failure to amend the delivery system at the customer's request, as might occur when a customer requests a different schedule of loan repayments, would be a failure to respond to customer preferences. The third type of explicit request occurs when the customer makes an error and the employee fails to respond appropriately, as could occur with a lost credit or ATM card, or a failure to make a payment on time. Finally, service failures may occur when employees are required to resolve a dispute between customers.
3. *Unprompted and unsolicited employee actions*. Service failures may also occur when employees engage in behaviours that fall outside the normal, expected service delivery system. Included in this category of service failure are behaviours such as poor employee attitudes, rudeness, ignoring customers, discriminatory behaviour, unfairness, and dishonesty.

There is a variety of recommendations about the best way to manage service recovery. For example, Bell and Zemke (1987) suggested a five-stage strategy for dealing with customer complaints:

1. *Apology*. This should preferably be a first-person apology, rather than a corporate apology, and should acknowledge that a failure has occurred.
2. *Prompt response*. Once a failure has been recognized, then a speedy response to attempt to rectify the situation, as far as is possible, is essential.
3. *Empathy*. The process of dealing with the customer's complaint should be characterized by an understanding of the customer's situation.
4. *Symbolic atonement*. The customer should be offered some form of compensation that is appropriate to the nature of the failure (e.g. refunding service charges, small gifts, discounted or free services in the future).
5. *Follow-up*. This involves monitoring customer satisfaction with the recovery process.

Bitner *et al*. (1990) suggested a similar approach, focused on four key elements:

1. Acknowledgement of the problem
2. Explanation of the reason for the failure
3. Apology where appropriate
4. Compensation, such as a free ticket, meal or drink.

In the banking sector, research by Lewis and Spyrakopoulos (2001) has highlighted the importance of ensuring that service recovery results in consumers getting what they originally expected, even if this requires exceptional treatment. Empathy and speed were also identified as important elements in the recovery process. This study

suggested that consumers' recovery expectations were generally reasonable, although customers with longstanding relationships with their bank tended to be more demanding when they experienced service failures.

Recent research on service recovery has focused attention on the role of perceived justice in understanding the effectiveness of service recovery strategies (see, for example, Tax *et al*., 1998). Perceived justice focuses on the extent to which customers perceive the process and outcomes of service recovery to be just. Where levels of perceived justice are high, consumers are more likely to be satisfied. The three dimensions of perceived justice are the fairness of the resolution procedures (procedural justice), the interpersonal communications and behaviours (interactional justice), and the outcomes (distributive justice). These are defined as follows:

- *Procedural justice* relates to factors such as the delay in processing the complaint, process control, accessibility, timing/speed and the flexibility to adapt to the customer's recovery needs.
- *Interactional justice* refers to the manner in which people are treated during the complaint-handling process, including elements such as courtesy and politeness exhibited by personnel, empathy, effort observed in resolving the situation, and the firm's willingness to provide an explanation as to why the failure occurred.
- *Distributive justice* focuses on the perceived fairness of the outcome of the service encounter. In effect, distributive justice is concerned with the level and nature of apologies and compensations.

A growing number of empirical studies have applied perceived justice to examine consumer responses to complaints. Blodgett *et al*. (1997) used retail-based scenarios to demonstrate the importance of interactional justice as an influence on subsequent consumer behaviour. In a cross-sectoral study, Tax *et al*. (1998) presented evidence for the importance of all three dimensions of perceived justice in generating positive evaluations of complaint handling.

One factor that is key to effective service recovery is ensuring that frontline staff are empowered and encouraged to deal with customer complaints and problems as they happen. They should be able to use their judgement and take the initiative in solving customer problems. Indeed, one of the things that distinguishes many of the world's best service providers is the ability of their staff to deal efficiently and effectively with service failure. Like service quality, there are good reasons for investing in service recovery. Successful service recovery can have a positive impact on customer loyalty. In addition, the process of dealing with and resolving customer complaints can provide valuable insights into the nature of the service delivery process and help the organization to identify areas that may require further attention and development.

15.8 Summary and conclusions

This chapter has focused attention on service quality as a central component of service value. It has explained that service quality is increasingly important in financial services, as it provides a source of competitive advantage. It can also contribute to

higher levels of profitability because high levels of quality can increase customer satisfaction and loyalty. These benefits mean that organizations must pay considerable attention to managing service delivery and ensuring that customers experience a high-quality service.

In services, quality is based on the customer's perception of what is delivered. In particular, the consumer's assessment of service quality is based on a comparison of the service that was expected with the actual service received. There are different ways of making this comparison; one approach suggests that consumers will consider both functional and technical dimensions of service quality. Another approach suggests that consumers will make comparisons across aspects of service, such as reliability, assurance, tangibles, empathy and responsiveness. Whichever approach is adopted, the assessment of service quality across these dimensions can help managers to identify the areas in which improvements should be made.

To determine how best to manage the delivery of service, it was suggested that we should think about quality as being a gap between customer expectations of a service and the service actually received. This gap could then be related to four problem areas (gaps) – misunderstanding customer expectations, failure to get the right service specifications, failure to deliver to specifications, and over-promising about the quality of the service. To manage the delivery of a high-quality service requires the careful management of people, processes and systems to attempt to ensure that managers understand what customers want, that they specify the right service, that staff are able to deliver to specifications, and that marketing makes accurate promises. This management process should lead to a high level of service quality, although it is probably impossible to guarantee that the organization will always get its service delivery right. Some service failures are bound to occur, and organizations must have a clear strategy for dealing with failures and solving customers' problems.

Review questions

1. Why is service quality so important in financial services?
2. What is the difference between functional and technical quality?
3. What are the differences between Gap 1, Gap 2 and Gap 3 in the gap model of service quality?
4. What are the benefits of customer retention?

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16

Customer satisfaction, customer value and treating customers fairly

Learning objectives

By the end of this chapter you will be able to:

- understand the nature of customer satisfaction and customer value
- identify the issues associated with measuring and monitoring customer satisfaction
- understand the importance of fairness in organizations' interactions with their customers.

16.1 Introduction

One of the fundamental principles of marketing is that an organization can enhance its performance by ensuring that it responds to and satisfies customer needs. This simple idea is at the heart of the service profit chain that was introduced in the previous chapter. In the long run, businesses that fail to deliver customer satisfaction go out of business. Thus, there should be no contradiction between seeking to align the interests of owners and consumers. Problems often seem to occur when attempts are made to satisfy the short-term needs of one group to the detriment of the other. For example, a company might seek to achieve above-trend profit growth by a combination of price increases with cost reductions on the input side (e.g. reducing the number of staff, using less well-trained staff). Product margins might then receive a short-term boost, but competitors and consumers will gradually figure out what is

happening and customer defection will occur. On the other hand, a company that is favouring customer preferences for higher quality at lower prices can be expected to achieve short-term growth in market share but will jeopardize the business's long-term viability if profitability is eroded in the process.

Chapter 15 introduced the concept of the service profit chain, and argued that the quality of service delivered to consumers is one of the main determinants of customer satisfaction because of its impact on value. Satisfaction is then expected to result in increased customer loyalty and improved profits and revenues.

Given that the purpose of marketing is getting and keeping customers, it is axiomatic that marketing's success must be judged in terms of how well customer needs and wants are met. It is not sufficient to rely upon levels of sales as a proxy for customer satisfaction. A business may well present a superficial appearance of continuing success based upon performance measures that are essentially financial. Although financial performance measures such as sales value and product margins are clearly important, they are merely financial reflections of consumer behaviour. A bank, for example, may be reporting healthy customer retention rates in a market where there is little competition, even though its customers actively dislike the company. However, the appearance of a competitor that is capable of providing better value for money and higher customer satisfaction could well steal significant share from the incumbent bank.

Therefore, it is vital that organizations develop the means by which they can acquire a well-founded knowledge of how they are viewed by their customers. Indeed, information about customer perceptions can yield valuable insights well in advance of the impact upon levels of sales. This chapter will explore consumer evaluations of a service with particular reference to both satisfaction and value. The chapter will begin by defining satisfaction and value and will then move on to examine specifically how organizations approach satisfaction measurement. The latter part of the chapter then examines issues relating to fairness and the way in which organizations treat their customers.

16.2 Consumer evaluations: value and satisfaction

The successful management of relationships with customers depends on ensuring that consumers have good experiences when they consume a service, that they evaluate that service experience positively and thus have a reason to maintain a relationship with a provider and make future purchases. Chapter 15 focused attention on service delivery, customer evaluations of quality, and service recovery. Consumer evaluations of the quality of service provided are clearly an important aspect of their evaluation of the overall experience of dealing with an organization. More significantly, perhaps, the evaluation of service quality is also an important determinant of value and of satisfaction, and these latter two outcomes are the focus of attention in the following discussions.

However, it is important to note that there is sometimes a degree of interchangeability, if not indeed confusion, regarding terms such as customer satisfaction, product and service quality, and value. All three terms concern the ways in which customers appraise the benefits they receive from engaging in a customer–supplier

relationship. Service quality is an evaluation of a particular service offer, judged in relation to customer expectations of the type of service that should be received (i.e. the judgement is made in relation to the consumers' expectations of 'excellence'). *Quality* is generally recognized as an antecedent to customer satisfaction. *Value* is commonly treated as an outcome of service quality, and involves a comparison of the benefits received relative to price or cost. This recognizes the possibility that something which is relatively low quality may still deliver value if the costs of consumption are equally low. *Satisfaction* is also an evaluation of a service experience, and is commonly conceptualized as a comparison of expectations and perceptions. Unlike quality, expectations are based on what customers expect that they will actually get during consumption, thus giving rise to a judgement of the extent to which consumption has provided fulfilment.

16.2.1 Customer value

Zeithaml (1988) observes that the determination of value is not a simple task, in that consumers use the term in a number of different ways about a wide range of attributes and components. She proposes that customers define value in one of four basic ways:

1. *Value is low price*. It is undoubtedly true that in some purchasing situations value is defined primarily in terms that equate to low price, or what we might call cheapness. Customers buying on the basis that value is low price focus upon the essential functional aspects of a given good or service, expect a degree of similarity across different product offers and thus focus attention primarily or even exclusively on low price. It might be argued that in motor insurance this particular approach to value is dominant.
2. *Value is everything I want from a service*. This describes a purchasing scenario in which price plays a far less significant role. Instead, customers attach importance to the extent to which a good or service most closely satisfies their wants as well as their needs. If *value as low price* concerns basic need satisfaction, *value as everything I want* is at the opposite end of the spectrum and concerns the satisfaction of desires. By their very nature, desires are far more complex and multifaceted than needs, and are far more personal and subject to customer idiosyncrasies. Private banking is an example of an aspect of financial services where this concept of value might be most relevant.
3. *Value is the quality I get for the price I pay*. This involves, in a sense, a combination of the previous two approaches to value. It involves customers making a trade-off between the range and quality of benefits they receive and the financial sacrifice they make. For example, when buying household contents insurance the customer might want to ensure they have 'new-for-old' cover, and pay accordingly for it, but be unwilling to pay for comprehensive accidental damage cover for carpets and upholstered furniture.
4. *Value is what I get for what I give*. This assesses value in a particularly quantitative and measurable way. Under such circumstances, customers assess all of the benefits they receive in detail, as well as all of the elements of sacrifice they make. The component of sacrifice comprise time and effort as well as money. For example,

> customers might decide that the additional time costs incurred in searching for the single best mortgage deal are sufficiently high that they may actually reduce the value associated with the 'best' product. Such consumers may perceive themselves to have obtained good value by obtaining acceptable product features with little or no search costs and a reasonable price.

Zeithaml (1988) suggests that, looking at these somewhat different perspectives on value, the most appropriate view of value is one which recognizes the trade-off between benefits and costs, defined broadly as follows:

> Perceived value is the consumer's overall assessment of the utility of the service based on perceptions of what is received and what is given.

Precise measurement of value is more problematic, and exactly how benefits and costs combine to produce value is unclear (is it simply the difference between benefits and costs, or is it a ratio?). However, what is clear is that value can be increased by either increasing the quality of what is offered or reducing the costs of consumption, or by a combination of the two. In both cases, it is important to recognize that benefits and costs must be thought of in their broadest sense. For example, benefits are not just functional, they are also emotional – a strong brand that inspires trust and confidence in consumers (and thus reduces risk) can be an important benefit in financial services, and may deliver higher value even in the presence of a price that is high relative to the competition. Similarly, on the cost side, we should consider not just price paid but other non-monetary costs of consumption – the increased convenience that telephone banking offers to certain market segments is effectively enhancing value by reducing the non-monetary costs of consumption.

16.2.2 Customer satisfaction

On the face of it, it might seem that customer satisfaction is a pretty straightforward concept that readily lends itself to evaluation. However, upon further consideration it can be appreciated as a complex and multifaceted concept that has attracted enormous attention from both the academic and practitioner communities, not least because it is recognized as being of great significance to the well-being of individuals, firms and the economy as a whole. In its review for The Prime Minister's Office of Public Services Reform, MORI observes that it has been estimated that some 15 000 trade and academic articles were written on the subject in the two decades up to the mid-1990s, offering a variety of different perspectives on the nature and meaning of customer satisfaction. One of the most comprehensive reviews of the nature of customer satisfaction was produced by Oliver (1997), who provided an extended discussion of definitions, theoretical frameworks, and the antecedents and consequences of customer satisfaction.

Satisfaction is generally recognized as a pleasurable outcome, 'a desirable end state of consumption or patronization' (Oliver, 1997, p 10). Precise definitions of satisfaction vary, but common themes emphasize that it is a customer's judgement of the consumption experience formed through some kind of psychological process that involves some form of comparison of what was expected with what was received.

This does not preclude the possibility that interim judgements of satisfaction can be made (i.e. part way through the consumption process), and also allows for the possibility that satisfaction judgements may be made after specific transactions or in relation to an accumulated series of transactions. For example, a customer may form a satisfaction judgement relating to a specific encounter with a financial adviser and a satisfaction judgement relating to the overall relationship with that adviser. Similarly, consumers may form satisfaction judgements about specific attributes of a service (e.g. the responsiveness of staff, the amount of information provided, branch opening hours, etc.) or about the service overall.

The term 'fulfilment' is commonly used in discussions of satisfaction. However, there is a danger in interpreting such a term too narrowly – rather than thinking of satisfaction as simply meeting basic customer requirements, there is an increasing tendency to see satisfaction as being concerned with positive, pleasurable experiences. Some commentators go a stage further and suggest that marketers should go beyond satisfaction and instead focus attention on 'delighting' customers (Berman, 2005). Satisfaction will involve a positive experience and the delivery of a service that matches (or possibly exceeds) customer expectations; delight goes a stage further, delivering beyond expectations and generating a stronger emotional response.

What is evident in most discussions of satisfaction (or even delight) is that consumer judgements are made by comparing the service that is experienced against some pre-existing standard. One of the commonest bases for comparison is that of perceptions against expectations. This is commonly referred to as the Disconfirmation Model of Satisfaction. In simple terms, when perceptions are less than expectations the result is a negative disconfirmation, resulting in a negative evaluation and a lack of satisfaction. Confirmation of expectations or a situation of positive disconfirmation (where performance exceeds expectations) will result in a positive evaluation, usually satisfaction but perhaps also delight. There are clear similarities between this perspective on customer satisfaction and the idea that service quality is derived from the gap between expectations of what should be received and perceptions of what is actually received. The key difference arises in the way in which expectations are specified. In the case of service quality, the starting point for a comparison is some notion of 'ideal' expectations (what I *should* get); in the case of customer satisfaction, the starting point is predicted expectations (what I *will* get). Expectations provide only one comparison standard, although probably the most commonly used. Other comparison standards that may be relevant in satisfaction judgements include customer needs and a sense of what is fair/reasonable (equity theory).

16.3 Managing customer expectations

From the discussion so far, it is evident that quality, value and satisfaction are all influenced by the customer's expectations and perceptions in some form or another. While perceptions are effectively a product of the service encounter and should be managed by careful management of service delivery (as discussed in Chapter 15), expectations (whether ideal or predicted) are formed in advance of experiencing the service. As Berry and Parasuraman (1991) have shown, there is a variety of factors that will affect customer expectations.

The previous experience of the customer will be of importance in determining expectations. Poor service experiences will tend to reduce expectations, while good past experiences may raise them. However, previous experience may not necessarily relate directly to the exact product or service in question, but rather relate to analogous consumption experiences. Even when experiencing a service for the first time, consumers may form expectations based on experiences elsewhere. Customers visiting a financial adviser for the first time may draw on experiences with their bank in forming expectations about the nature of the service they will receive and the nature of interactions with the adviser. It is also the case that customers have become accustomed to higher standards of quality, choice and convenience in certain areas of commerce and these create benchmarks for completely different product and service categories.

Third-party communication also impacts upon the formation of expectations. This may arise from a number of sources, including word-of-mouth information and impressions gleaned from family members, friends, acquaintances and work colleagues. It also includes the views expressed by journalists and media commentators regarding the positive and negative aspects of a product, service or company. Other forms of third-party communication might include evaluations carried out by consumer interest organizations such as *Which?*. In January 2006, for example, *Which?* achieved wide publicity for the research it carried out into home equity release products and the resultant comments on their true costs and pitfalls. This information will inevitably have impacted on the expectations of many customers considering the purchase of such products. Similarly, stockbrokers and analysts produce reports on general industry sectors and the prospects for individual companies that inform the expectations of the investment management community.

Zeithaml and Bitner (2003) draw attention to the idea of explicit and implicit service communication as having a role to play in forming expectations. *Explicit service communication* refers to the formal written and broadcast messages that a company communicates regarding the nature of product and service quality and the performance it provides. The danger here is that a company may make claims about its products or services that it does not deliver in practice. There is a well-developed research-based body of literature that demonstrates the ways in which consumers punish companies that over-promise and under-deliver.

Implicit service communication refers to the range of subtle cues that organizations put out about the nature of what they do and how they do it. Included in this are the physical conditions and state of business premises. For example, an untidy financial adviser's office with poorly produced and displayed promotional material could convey an impression of disorganization and amateurishness that may impact negatively upon customer expectations. Conversely, the elegant marble entrance halls associated with many traditional bank branches may enhance expectations relating to confidence, reliability, trustworthiness, etc.

The values and beliefs system of individual consumers will also have a bearing upon their expectations for a given company. Clearly, these influences are highly variable and subjective. A customer who attaches considerable importance to social responsibility may have particularly high expectations of this aspect of a financial service provider's behaviour. Equally, an individual with a strong belief in personal service will typically have high expectations of the nature of service provided to customers. Other individual-specific factors may also affect expectations.

Expectations may vary according to temporary personal circumstances. For example, a consumer who has lost a credit card may have particularly high expectations about speed of service because of the desire to get the card replaced. A customer experiencing financial difficulties may have high expectations regarding the flexibility of loan repayments.

A financial services provider may believe that it offers a high-quality service to its customers, and one that meets their needs at a competitive price. However, customer evaluations are the ultimate arbiter of quality, value and satisfaction. For this reason, it is vital that organizations have in place a strategy for managing customer expectations and perceptions. Ultimately, perceptions are managed through the process of delivering the service to the customer, as explained in Chapter 15. The management of expectations is equally important. The discussion of the gap model drew attention to Gap 4 – the difference between what an organization promises and what it delivers – and highlighted the importance of having a strategy to manage customer expectations. Such a strategy should comprise the following components:

1. *Objectives*. These define how the organization wants to be perceived by its various primary customer segments. This component is closely allied to the notion of positioning, addressed in Chapter 9. It should not only specify aggregate levels of perception for the customer experience as a whole, but also should break it down according to a set of key performance indicators regarding benefits and sacrifice.
2. *Delivery*. The expectations of customers should be reflected in product design and performance. Equally, they should be factored into the service encounters that customers will experience during the course of their relationship with the provider. Particular attention should be devoted to service encounters that have been described as 'moments of truth'. Importantly, staff must be aware of the required standards and of their personal role in delivering satisfaction on the one hand, or dissatisfaction on the other. Similarly, expectations regarding sacrifice need to be factored into pricing decisions, and systems and process development. In the case of motor insurance, for example, some companies levy an additional charge for taking a car on holiday to another country, whereas others do not. Ensuring that consumers are clear about exactly what they can and cannot expect from their policy, what is included and what incurs an extra charge, will help to minimize any dissatisfaction that might arise as a consequence of perceived poor value.
3. *Recovery*. As explained in Chapter 15, clear policies and procedures are required to ensure effective recovery following a failure to deliver with regard to both benefits and sacrifice. Effective service recovery can result in the creation of customer advocacy if handled well. Indeed, quality failures should be seen as valuable opportunities to demonstrate empathy and responsiveness. All too often, poor recovery policies and procedures (or indeed their complete absence) serve to make a bad situation worse.
4. *Communication*. The provider must ensure that a programme is in place to communicate the actual levels of benefit that it is delivering to its customers. It is not sufficient for a company to assume that customers have noticed that it is achieving a service standard above that which it initially promised. Similarly, customers

may need to be told when a company is holding prices steady for an additional year or giving them preferential treatment regarding the purchase of an additional product.

5. *Measurement*. Processes are necessary that facilitate the tracking of perception over time in order to identify positive or adverse trends. Ideally, the measurement process should incorporate the means to gather perception data from a range of sources, including: formal customer survey, complaints feedback, *ad hoc* customer feedback, feedback from staff, and feedback from external sources such as the media. The latter is important, given the capacity of the media to have a material impact upon corporate reputations. Expectations regarding benefit delivery and sacrifice should be established at the outset. Case study 17.2 (in Chapter 17) provides an example of a company that offers tailored solutions for measuring the experience of customers during their interactions with an organization.
6. *Feedback*. The results of customer value and satisfaction measurement should be fed back into relevant parts of the organization and, as appropriate, communicated to customers. One organization involved in business-to-business supply within the financial services sector undertook a major satisfaction survey. On the majority of key measures of service the company outperformed its three major rivals, and on aggregate it was rated number one for service quality. Unfortunately, a major opportunity was missed by the company's unwillingness to devote sufficient resources to communicating this powerful story to its customers.

16.4 The measurement of satisfaction

Most discussions of satisfaction measurement focus primarily on the measurement of customer satisfaction because of its importance as a performance metric. However, as the service profit chain shows, both employee satisfaction and customer satisfaction may be relevant as performance metrics, and both will be considered in this section.

16.4.1 Customer satisfaction

So far in this chapter we have established that customer satisfaction is a multifaceted concept and far from one-dimensional. As such, individual managers must form a view on the nature of satisfaction for their own organization with regard to factors such as the need being fulfilled, the degree and variety of competition, segment variations, and how the resultant data will be used.

As a rule, customer satisfaction is measured by the use of some form of quantitative survey. Owing to the nature of customer satisfaction and the use that is made of its data, the survey is required to be statistically reliable and robust. For example, its outputs may be used as the basis for major investment in time, money and systems resources in upgrading elements of service delivery. Managers responsible for deciding upon and implementing such investments must only do so on the basis of valid and reliable information. Thus, the sample size and structure of a customer

satisfaction survey must be of a scale and scope that engenders the necessary confidence.

The starting point for any customer satisfaction survey must be the identification of relevant, business-orientated objectives that will produce clear, unambiguous results. A useful starting point is deciding which business decisions need to be made and require knowledge regarding customer satisfaction. In common with any data capture and analysis exercise, there is no point in doing it unless it plays a role in influencing a business decision. Thus, customer satisfaction should form an integral part of senior management information flows. In this way it can influence a range of decisions by answering questions such as:

- What do we need to do to improve customer retention?
- What do we need to do to get customers to place more business with us?
- Which competitors pose the greater threat, and what do we need to do to counter those threats?
- What do we need to do to increase market share?
- What opportunities are there to reduce operating costs without harming customer satisfaction?
- What should form the basis of future competitive advantage?

The above six business questions are simply indicative of the range of issues that customer satisfaction information can inform; there are many others besides. Nevertheless, this illustrates the point that such information lies at the very core of the big issues that determines sustainable organizational success. The implications of this are clear: first, the conduct of effective customer satisfaction measurement is non-negotiable; secondly, the highest level of management must actively engage with the results of such surveys and be prepared to act upon them. Common failings are the absence of appropriate customer satisfaction measurement, or the lack of visibility of its findings and ineffective follow-through.

Therefore, the objectives for a customer satisfaction survey (CSS) must be grounded in the nature of the business decisions it will inform. The following list gives an indication of the kind of objectives that might be informed by a CSS:

- What do customers expect from the services we provide?
- To what extent are customers' expectations met by the services they receive from us?
- What level of satisfaction do our customers experience from the individual components that comprise our service?
- Which of our competitors do our customers also use for the provision of services, and what levels of satisfaction do they express for each competitor?
- How do levels of customer satisfaction with our services compare with those of our rivals?
- How do customers rate the value for money they receive from our services compared with our competitors?
- Which elements of our service do we need to improve in order to achieve higher levels of customer satisfaction?
- Which aspects of our services do customers gain little value from and consider to be of little relevance to their experience as customers?

- How does satisfaction vary by customer segment?
- How have customer expectations changed since we last surveyed their perceptions?
- How are customers' perceptions of our service quality trending over time?

The final point is interesting in that it introduces the concept of trends over time. The CSS has a major role to play in the identification of performance-related trends that have important consequences for the organization. For this reason it is important that, at the outset of a CSS programme, a view is taken regarding variables the organization wishes to track over the long term. Thus, such variables will be clearly addressed by the initial study in order to establish benchmarks. Additionally, subsequent surveys should be designed to ensure that wording is entirely consistent, to ensure that any resulting trend data can be relied upon. In a similar vein, it is important that the sample frame used over time is consistent with its predecessors.

Once an organization has some clarity regarding the purpose and objectives it requires from a CSS, it must then consider the process and methodology deemed most appropriate. A basic question concerns whether the survey should be conducted using in-house resources or be subcontracted to experienced agents such as SPSS in the USA or MORI in the UK. Using a specialist agency is usually the best option, owing to the expertise it possesses in questionnaire design, data capture, data analysis, interpretation and presentation. Furthermore, such agencies introduce a necessary degree of independence and detachment. Most such agencies also conduct staff satisfaction surveys (which really should be conducted on an independent basis), and there is a strong logic to combining both forms of survey within the same external agency. A note of caution is warranted. As with the use of all external agencies, the involvement of a specialist CSS supplier should always be subject to the development of a written brief. The writing of such a brief becomes relatively straightforward once there is clarity regarding objectives.

The in-house option may be the viable option where the customer base is relatively small. This might apply in certain parts of the B2B domain, such as where a provider of company pension schemes wishes to assess levels of satisfaction among its large corporate clients. Indeed, in such circumstances it may be desirable to measure satisfaction levels for all customers, given the higher proportion of business accounted for by each corporate client. Although the logistical and analytical aspects of such CSS activities may be of a scale that would allow the survey to be conducted on an in-house basis, the need for independence and impartiality argues in favour of outsourcing to a specialist agency. For those organizations wishing to consider the in-house option, packages are available that can be used in a wide range of circumstances, including high-volume consumer markets. For example, in the USA, AT&T has developed Business Builder as a do-it-yourself package that can be available from under $500.

Whether conducted on an in-house basis or via outsourcing, a written brief is essential. In addition to specifying objectives, it should address issues such as:

- which individual issues it requires data on, such as the specific aspects of service it wishes to investigate (the nine components of service quality proposed by Brady and Cronin (2002) might form the basis for this)

- which categorizations of the customers it wishes to use as a basis for cuts of the data, such as specific; segments; length of customer relationship; whether light, moderate or heavy users of the service; image of certain competitors, etc.
- demographic classification criteria – for example, age, gender, occupation, income, geographical location
- the format of the presentation of results
- the timescale and costs.

Once these issues have been fully resolved, the most appropriate methodology can be considered. Data can be captured in a variety of ways, most commonly by postal questionnaire, telephone interview or, in recent times, via the Internet. Face-to-face interviewing is often encountered with regard to high-value B2B situations which may involve discussions with a number of people comprising the decision-making unit (DMU) and user community. Each of these four principal methods of data capture has its respective advantages and drawbacks, and must be considered in the light of the requirements specified in the brief. For example, the telephone allows the researcher to speak directly with the customer and respond to any issues of ambiguity that might arise. However, it is best limited to calls of no longer than 10 minutes as a rule, and can present some problems regarding the use of certain rating scales. Written surveys administered by the post can permit a greater array of issues to be investigated. It can also allow certain forms of visual stimuli to be used, as well as relatively complex rating scales. However, it can result in low response rates and skewed respondent profiles. The Internet offers much of the functionality of the postal questionnaire but is low-cost and lends itself to speedy, flexible and cost-effective data analysis. User group bias may be an issue, particularly in parts of the world or among segments where usage of the Internet is patchy.

Whichever method of data capture is preferred, it is strongly recommended that an initial pilot study be carried out. The scope of the pilot study should be such that it not only tests the appropriateness of the means of data capture and the nature of the individual questions themselves, but should also test the format of results presentation. Leading on from the final point should be a simulation of the likely outputs. This will enable the organization to judge the extent to which the survey, as proposed, will inform the objectives. As a result of the pilot study, reconsideration may be made of the means of data capture wording of individual questions or, indeed, the number and nature of questions included. In this way, there is a much greater likelihood that the CSS will achieve its objectives.

A high degree of rigour is necessary when carrying out CSS activities, as it is by no means uncommon for research exercises of this nature to be subject to scope creep and redirection of emphasis in the absence of due rigour and control.

As a final point, the results of customer satisfaction surveys should not only be communicated extensively among the organization's own staff; consideration should also be given to communicating the results back to customers. This is especially important in the B2B context, which often involves face-to-face interviews with client staff. In such circumstances there is usually a strong presumption that such individuals will receive feedback on the survey in consideration of the time they have contributed to the actual survey.

A customer group that requires particular consideration in the context of financial services is that of intermediaries and brokers. In many areas of financial

services – mortgages and pensions, for example – brokers are of fundamental importance, and the satisfaction they gain from supplier relationships and service must be assessed.

16.4.2 Employee satisfaction

A complementary activity to customer satisfaction measurement is that of the assessment of staff satisfaction. In the same way that the acquisition and retention of customers is important to an organization, so too is the hiring and retention of high-quality staff. Thus, staff satisfaction surveys can yield valuable insights that can assist in the development of staff attraction and retention policies and practices. Given the importance of staff morale and motivation to the provision of good-quality service, it is important that a company possesses a solid knowledge of staff feelings and perceptions.

As with customer surveys, staff surveys should be subject to due rigour with regard to their planning and execution. This means that objectives need to be clearly articulated, data sets specified and classification categories defined. It is particularly important to incorporate questions regarding aspects of customer service into staff surveys. For example, staff should be asked what they believe to be the appropriate expectations of customers with regard to the role that they and their department perform.

A common belief surrounding the use of staff surveys is that senior management will not act upon them. Indeed, far from facilitating better staff morale and motivation, badly executed staff surveys that are poorly communicated can do more harm than good. One company made the results of a staff survey available on its intranet for a period of 1 week and then it was forgotten about. Worryingly, the perception of middle-ranking and junior staff was that senior management appeared to have treated it as a cynical exercise of 'going through the motions'.

Nationwide Building Society represents an example of extremely good practice when it comes to assessing, communicating and acting upon its staff satisfaction survey, as shown in Case study 16.1.

Case study 16.1 Satisfaction surveys at Nationwide Building Society

Nationwide Building Society has been conducting an employee opinion survey called ViewPoint since 1993. The catalyst for its introduction was the merger of Nationwide and Anglia Building Societies – two organizations with different cultures, processes and business systems. A number of years after this merger had taken place, an increasing unease and uncertainty amongst employees about its success was perceived. In addition, the UK PFS business climate was becoming increasingly competitive, with deregulation allowing banks and insurance companies to compete with building societies for mortgage and savings business, leading to further uncertainty.

Case study 16.1 Satisfaction surveys at Nationwide Building Society—cont'd

The objective was (and still is) to give employees a platform from which they can have their say about various aspects of their work, working environment and the manner in which they are led, managed and developed. In summary, where they think Nationwide is doing well and what they believe the Society could do better. Asking for opinions, however, is one thing but it is vital that in addition to listening, companies act (and are seen to be acting) on the issues raised in the survey. Failure to do so will lead to cynicism and apathy towards the surveying process.

Nationwide's ViewPoint survey is conducted annually in April by ORC International, an external consultancy. Using ORCI enables Nationwide to remain impartial and the data confidential. The survey was paper-based until 2004, when it was made available via the Society's intranet with a paper-based option retained. Time is allocated during the working day for completion.

The survey comprises three parts:

1. Employee demographics, including job type, location, age, gender, ethnicity, sexual orientation, religion, etc.
2. A variety of work-based questions (104 in all) based on a five-point Likert scale
3. A small number of open questions about working at Nationwide, with a free-form response box to allow comments to be made by employees.

In 2005, 91 per cent of employees (approx 14 000) completed the survey.

The 104 work-based questions are grouped into a number of different themes or indices, including employee satisfaction, pay and benefits, leadership and group image, training and development, and employee and customer commitment.

The results are collated by ORCI and reports are produced at Group, divisional, departmental and team levels for distribution to managers across the business. To retain anonymity and confidentiality, no reports are issued with less than six responses. The reports include peer and external benchmarking data, and a comparison to the previous year's results.

On receipt of the reports, local managers will normally organize team meetings to disseminate the results and form action plans to look into poor scoring themes or themes showing a decline in results.

At a company level, the results are made available through different media, including an intranet site and an in-house magazine.

Some of the 2005 results were as follows.

Factor	Favourable response
Employee satisfaction	77%
Employee commitment	83%
Employer of integrity	87%
Satisfaction with work–life balance	78%

Continued

Case study 16.1 Satisfaction surveys at Nationwide Building Society—cont'd

Using ORCI enables external benchmarking on a number of questions with other financial services providers and other industries. Generally, Nationwide benchmarks very favourably. When compared with other financial services organizations, out of the 41 benchmarked questions Nationwide came top – 11 question scores were the highest, 13 were second, and six were third.

The survey itself has changed very little over the last 3 years, and there are a large number of questions that have been there from the beginning. This gives the survey great power as over time trends can be established in the data that allow progress or regression to be seen. Similarly, it enables the impact of certain initiatives to be seen.

Nationwide take the results of the survey one step further than most and links the data to their customer and business performance data. This research (Project Genome) has led to the model shown in Figure 16.1.

The links between committed employees, committed customers and better business performance have been established. The data for satisfaction with pay, coaching, values and committed people all come from ViewPoint.

Through the model we can say that a 3 per cent shift in employees 'values' results in customer commitment increasing by 1 per cent, bringing in an increased net present value of £6.5 million in mortgage sales. The model allows line-of-sight from employee behaviours through customer behaviours to the bottom line. Consequently, the employee opinion survey can be used as an early warning system to future business performance.

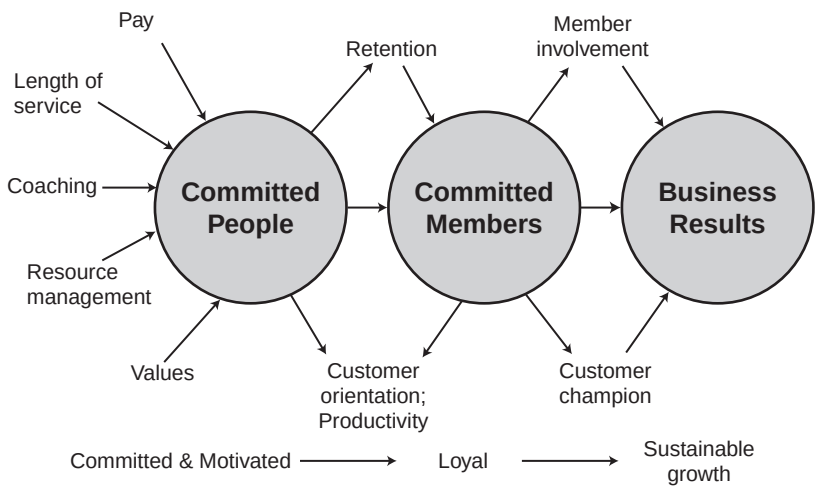

Figure 16.1 Nationwide's Genome model.

Case study 16.1 Satisfaction surveys at Nationwide Building Society—cont'd

It is valuable to exercise a degree of caution regarding employee opinion surveys as they measure employee's perceptions. These perceptions may be well-rooted or transient, and may depend on what side of the bed the employee got out of that morning. The timing of the survey is also very important, as conducting one during a redundancy period, for example, is highly likely to skew results. One other point to consider is the 'say–do' paradox. Employees will not necessarily take the course of action they say they will in the survey. A high response rate and data over time will overcome most of these potential problem areas.

To have been named as the *Sunday Times* 'Best Big Company to Work For' in 2005, voted for by employees, is a pretty good indication that Nationwide has come a long way since the unease of the early 1990s. Listening to and acting on employees' feedback has been critical to that success.

Source: Stuart Bernau, Commercial & Communications Director, Nationwide Building Society.

16.5 Treating customers fairly

Central to the concept of satisfaction is that customers feel that they have been treated fairly. Indeed, there is a close connection between the notion of fairness and trust, in that people display a willingness to trust individuals and organizations that they consider to act in ways that are fair. The corollary to this is that resentment and mistrust are the consequences of customers being exposed to what they consider to be unfair practices. Set within the context of managing ongoing customer relationships, it is imperative that organizations endeavour to build trust through being seen to act fairly. To quote from Berry and Parasuraman (1991):

> trust requires fair play. Few customers wish to build and continue a relationship with a firm they perceive to be unfair.

The concept of fairness is assuming growing significance in a range of contexts throughout the world. For example, fair-trade products have become a feature of the market for fruit and vegetables and packaged food and drink products on a global basis. In essence, fairness has to do more with adherence to the *spirit* of what is the right thing to do rather than conformance with the letter of the law. In an environment characterized by fairness, organizations must increasingly strive to avoid hiding behind punitive and unfair contractual terms. The Office of Fair Trading in the UK was established with the goal of making markets work well for consumers. It sets out to make sure that consumers have as much choice as possible

across all the different sectors of the marketplace. According to the OFT, when consumers have choice they have genuine and enduring power. To quote from its website:

> As an independent professional organization, the OFT plays a leading role in promoting and protecting consumer interests throughout the UK, while ensuring that businesses are fair and competitive. Our tools to carry out this work are the powers granted to the OFT under consumer and competition legislation.
>
> It carries out the following activities in pursuit of its goal:
>
> - enforcement of competition and consumer protection rules
> - market studies into how markets are working
> - communication to explain and improve awareness and understanding.

Fairness has also established itself firmly as part of the agenda of the Financial Services Authority (FSA). Indeed this is nothing new, as the requirement to treat customers fairly is clearly laid out in Principle 6 of its Principles for Business, which states:

> A firm must pay due regard to the interests of its customers and treat them fairly.

It began to address the issue of fairness in earnest in 2001, with the publication of *Treating Customers Fairly After the Point of Sale* and its reinforcement through a series of presentations, along with various formal dialogues and consultations with the industry. Lying behind this initiative are the FSA's concerns that rules-focused regulation and market forces have so far failed to safeguard consumers from being treated unfairly. Writing in its commentary on the FSA's TCF initiative, Kirk and Middleton (2004) point out that:

> Due to low levels of financial capability and the complexity of financial services products, customers are often unable to assess effectively where they are being treated unfairly, and cannot exercise sufficient power to penalize firms who treat their customers unfairly.

In common with the OFT, the FSA does not propose a definition of what constitutes fairness, nor does it set out to present a firm set of rules. Rather, it chooses to address the issue of fairness through its promulgation via a principles-based approach. Senior management are expected to define and interpret what fairness means within the context of their own organization. It is for senior management to decide how fairness should manifest itself in terms of strategy, culture and operations. Moreover, mere compliance with the requirements of the FSA's rulebook will not be sufficient to demonstrate that an organization is treating its customers fairly.

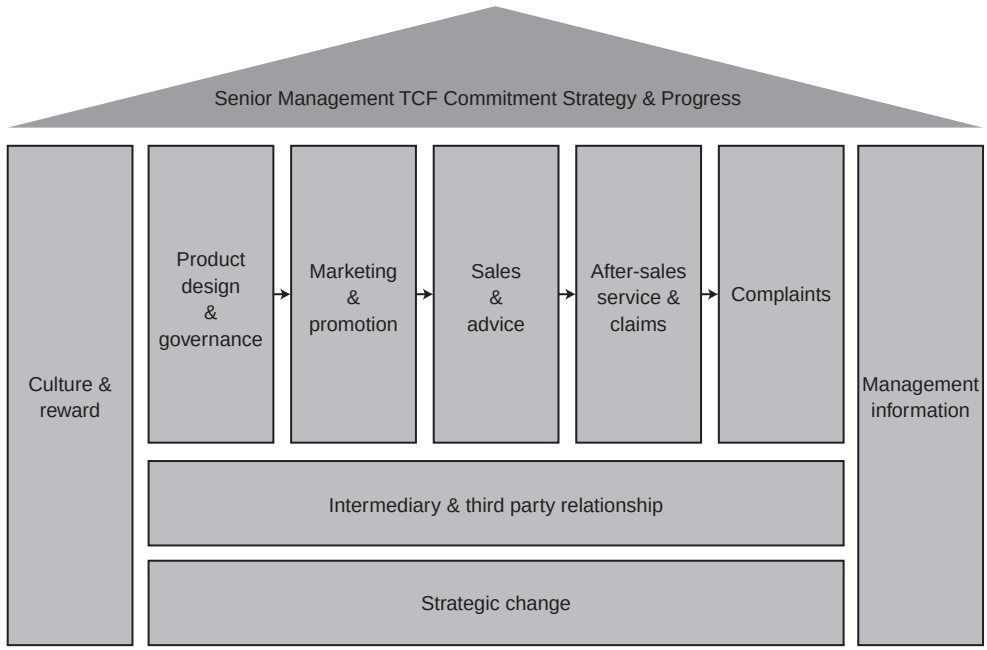

Figure 16.2 Embedding the TCF principle across an organization's activity.

The FSA has advised the organizations it authorizes that the TCF principle should be embedded in all parts of the organization and at all levels. As an aid to appreciating fully the scope and extent of TCF, the FSA has devised the conceptual scheme shown in Figure 16.2.

In practical terms, TCF should be considered in situations such as:

1. *Product design*. Many firms make use of consumer research in designing new products, but they need to ensure that this is used in the correct way.
2. *Remuneration*. There are areas where salespeople may create risks to TCF, if not appropriately managed or incentivized.
3. *Complaints management*. The quality of work to investigate and assess complaints varies widely from firm to firm.

As part of its TCF programme, the FSA has conducted consumer research which has elicited the following definitions of fairness:

- Give customers what they paid for
- Do not take advantage of customers
- Offer customers the best product you can
- Exhibit clarity in all customer dealings
- Do your best to resolve mistakes as quickly as possible
- Show flexibility, empathy and consideration in customer dealings.

Rather than viewing this as yet another imposition that will add to the burden of overhead costs, the FSA is of the opinion that the industry will ultimately benefit from embracing TCF, in the form of:

- more repeat business
- greater confidence in the industry
- fewer rules
- fewer complaints upheld by the Financial Ombudsman Service.

A recent life insurance customer experience management survey and set of discussions with 50 companies, led by Mulberry House Consulting, has shown that there is wide disparity in the progress life insurance companies are making with TCF. In most areas, respondents had recognized what needs to be achieved in their own organization and had plans in place, but the research suggested that progress was often at an early stage or limited in consistency and scope. According to the Mulberry House research, the majority of companies that had progressed with TCF implementation claimed also to be seeing business benefits (sometimes including improved retention and cross-selling), but few had formal measures in place to track progress and target process improvements.

It seems that most companies have identified the need for a more structured programme for addressing TCF but are often struggling to put this into place. The Mulberry House survey showed clearly that, as the FSA would expect, in most companies the CEO is the major sponsor of TCF. However, the internal champions are often next-level directors, which immediately separates efforts by business silo. Separation of internal structures and customer management processes typically work against the provision of a seamless and consistent customer experience. Although plans are usually in place, the Mulberry House study suggests there is much still to be achieved to ensure TCF is deployed consistently across all aspects of participating organizations.

As at the time of writing, Ernst & Young are exhorting companies to respond to the requirements of TCF most appropriately by:

- conducting a systematic review of strategy and operations
- identifying possible areas of vulnerability
- providing detailed documentation of policies and procedures supporting TCF
- having plans to build TCF into business-as-usual.

This is wise advice given that the FSA intends to incorporate an assessment of firms' effectiveness and ability to show that they treat customers fairly in their member appraisal process, called ARROW. It will issue further guidance on the subject in 2006, and continue to publish examples of good and bad practice. Again, Ernst & Young has proposed a useful battery of questions that senior management would do well to consider when determining their approach to TCF, and these are presented in Box 16.1.

Whichever country the reader resides in, it is likely that some form of TCF initiative will arise, if indeed it has not already done so. Regulators aside, it is axiomatic of good marketing strategy and execution that fairness is firmly embedded as a core principle.

Box 16.1 'From board room to boiler room'

From our experience, many firms are likely to be surprised by the wide range of interventions that may be required to ensure they can satisfy the FSA's expectations; from business strategy and high-level decision-making through to training of frontline staff and revision of remuneration and incentive systems.

Senior management should be able to answer key questions demonstrating how they meet their TCF obligations. There is no right or wrong answer to any question, and the responses should be driven from consideration of the impact TCF may have on the overall business strategy and how it operates. Without boundaries and guidance set at a strategic level, *ad hoc* decision-making at an operational level risks not treating customers fairly (or, conversely, in trying to treat customers fairly, ending up treating shareholders unfairly).

Some questions management may want to consider include:

- What does fairness mean in terms of your target customers, products and service promise, and what are the key fairness principles that will guide action within your business?
- How do you balance the objective of increasing sales and profit with the requirement to treat customers fairly?
- How do you ensure you have a full understanding of your target market, considering customers' financial needs and capability?
- What steps do you take to assess the risks to customers in a product during the product development process and throughout a product's lifecycle?
- What steps do you take to ensure marketing materials are understandable and understood, and that they provide a clear and balanced assessment of the risks, charges and penalties of the product, as well as the benefits?
- How do remuneration strategies encourage sales and marketing people to treat customers fairly?
- What steps do you take to check the customer understands and can afford the product being offered?
- How do you ensure charges are always transparent and understood?
- What steps do you take to keep customers informed about changes in the wider environment that may affect their product after the point of sale?
- What barriers do you have that may make it difficult or expensive for customers to exit or switch their products or suppliers?
- What steps have you taken to ensure your complaints handling process is easy for customers to follow and that it ensures each complaint is treated fairly?
- What is your process for ensuring you identify and tackle the root causes of complaints to prevent them re-occurring?
- What management information is available to senior management to track how fairly customers are treated, and how is this information used?

Source: Kirk and Middleton (2004).

16.6 Summary and conclusions

Central to the marketing concept is the idea that an organization can enhance its overall performance by taking a customer-orientated view of its business and focusing on the delivery of customer satisfaction. This general idea is encapsulated in the concept of the service profit chain. Satisfaction and value are both seen as being important evaluations of the service experience and as determinants of customer retention and loyalty. Satisfaction is concerned with the extent to which a service is able to deliver against customer expectations, while value is concerned with the range of benefits offered by the service relative to its associated costs. As with service quality, consumer evaluations of satisfaction and value play a major role in the development of relationships with financial services providers. Customer dissatisfaction and/or poor value are potential reasons for terminating any financial services relationship.

Careful measurement of satisfaction is an important element of any relationship marketing/CRM programme. Indeed, in some of the best examples, the measurement of customer satisfaction will be accompanied by the measurement of employee satisfaction, as the latter can serve as an important determinant of the former. While there is a variety of approaches available to measuring satisfaction, there are many benefits to be gained by the use of an external and independent agency for data collection and analysis. However, the value of such exercises is crucially dependent on the organization's willingness to use the information that is generated. Simply undertaking customer and employee satisfaction surveys without a serious commitment to act upon their results will be of little value in managing customer relationships.

In financial services in particular, the management of customer relationships is increasingly focusing attention on the concept of fairness and the need to treat customers fairly. Although such initiatives have been prompted by regulatory bodies and are probably most developed in the UK, it seems likely that the fairness agenda will increasingly become part of good relationship management across the financial services sector world-wide.

Review questions

1. Why should financial services organizations be concerned about delivering customer satisfaction?
2. What is customer satisfaction, and how does it differ from service quality and value?
3. What role do expectations play in relation to customer satisfaction? How should organizations seek to manage customer expectations?
4. What are the key steps in developing an effective consumer satisfaction survey?
5. Why is fairness so important in the marketing of financial services? In which areas of marketing is treating customers fairly of greatest significance?

17

Customer relationship management in practice

Learning objectives

By the end of this chapter you will be able to:

- appreciate how elements of the marketing mix need to be modified when used as part of a customer development strategy
- appreciate the importance of integrating the marketing mix associated with customer acquisition and development
- understand how to evaluate the contribution made by marketing to an organization
- understand marketing's wider contribution within the contexts of corporate social responsibility and sustainability.

17.1 Introduction

The appreciation of marketing's role in managing continuing customer relationships requires a quantitatively different approach to the use of the marketing mix than applies where customer acquisition is the primary purpose of marketing. It is interesting to note how much of the language used in connection with acquiring customers appears somewhat militaristic. Terms such as strategies, campaigns, targets, tactics and marketing armoury all seem to somehow resonate with a notion that marketing is concerned with a heroic battle to *win* customers. As commented upon earlier, objection-handling forms an important element of sales training and is symptomatic of an adversarial, if not confrontational, mind set. Hopefully, it has been firmly established that to see marketing just in terms of the single-minded pursuit of new customers deserves to be consigned to the history of the marketing of financial services.

By way of contrast, the discourse regarding marketing's role in customer development has attached itself to the language of social science and anthropology. Words such as relationships, communities, dialogue, intimacy and advocate are commonly encountered in the context of the use of marketing to retain and develop customers following the point of acquisition. This change of emphasis has implications for the ways in which individual components of the marketing mix are used. Importantly, it has implications for the cultural context within which marketing activities reside. The coercive customer-acquisition based model of marketing often seemed to coincide with organizational cultures that were typified as being macho, male-orientated and somewhat cynical. In such cultures, the rewards and recognition systems were overly biased in favour of new business key performance indicators, such as number of new policies (not customers) issued, value of new premiums, new loan cases proposed, and value of loans approved.

The existence of the customer funnel has meant that a numbers game based upon new customer acquisition was the dominant business model for many organizations.

Such a cultural backdrop resulted in practices that over-rewarded elements within the distribution channels, under-rewarded staff involved in serving the day-to-day needs of customers, and delivered poor value to customers. Sales organizations often wielded undue power and influence, and this rendered organizations vulnerable to a range of risks and dangers. Poor-quality business, bad debts, mis-sold products and a number of often unforeseen risks have resulted from organizations where cultures were too acquisition-based.

With the emphasis firmly placed upon the maintenance of long-term customer relationships and the engendering of advocacy, the culture and the marketing mix must interact to reinforce each other. The remainder of this chapter considers the implications of marketing's role in keeping customers in terms of the use of the individual elements of the marketing mix. Additionally, it devotes some attention to matters concerning the implementation of marketing principles and practices and how their success might be evaluated. Finally, it considers marketing's role in the discharging of an organization's corporate social responsibility and how marketing can contribute to the sustainability agenda which is assuming ever more significance.

17.2 People and culture

When the emphasis of marketing becomes orientated more toward the retention and development of customer relationships, the culture must adapt accordingly. For example, there has to be a recognition that responsibility for determining the experience of customers belongs to almost the entire organization. It is no longer appropriate for sales organizations to wield undue power. In the past this has led to abuses which have caused detriment to those involved in administering customer services. However, in the customer-orientated culture of the present and future, administration staff see themselves as shouldering major responsibility for delivering customer satisfaction. Through their interactions with customers they can provide valuable feedback to improve elements of service procedures and systems, and even product design. Those involved in the IT function must perceive that they are empowered to use their knowledge, skills and resources to improve

customer satisfaction. Similarly, people involved in, say, procurement can play a valuable role in improving the quality of bought-in products and services such that the organization operates more efficiently for the benefit of customers. Such benefits may arise because of improved functionality for customers or, possibly, by reducing costs and thereby making price reductions possible.

What is indicated is the necessity for all staff to appreciate the ways in which what they do, and how they do it, impacts upon customer perceptions. In the ideal world, all members of staff will see themselves as being, to some extent, customer-facing. Businesses that are based upon the maintenance of long-term customer relationships, as opposed to essentially the one-off sale, see the *people* element of the mix as representing a primary, if not *the* primary, determinant of customer satisfaction and advocacy. It is interesting to note evidence that the Yorkshire Building Society has identified regarding the importance of experienced staff in enhancing levels of customer satisfaction. The Society has conducted extensive research into the factors that appear to be causally and independently associated with high levels of customer satisfaction and hard-nosed commercial performance. The analysis suggests that such a causal relationship is in evidence in branches that have relatively low staff turnover and a high average length of services. Staff in such branches display relatively high levels of commitment to the organization, and this is reflected in relatively superior business results across a balanced scorecard of key performance indicators. Although not independently verified, such a finding is indicative of the importance of continuity of staff/customer interaction in the maintenance of mutually beneficial long-term relationships.

17.3 Product considerations

Of paramount importance is that a product should be fit for purpose. This means that care should be taken to ensure that the features that comprise, and functionality that applies, to a product should be clearly identified at the point of purchase and be well-evidenced for the lifetime of the product.

Owing to the particular characteristics of financial services products as outlined in Chapter 3, care has to be taken to ensure that products are presented in as transparent a way as possible. In the absence of sufficient transparency, customers may unwittingly buy a product that is suitable for their needs or personal circumstances. Regulators often lay down quite prescriptive requirements with regard to the disclosure of product features at the point-of-sale. However, responsible marketing should not depend solely on the regulator; it is up to the individual product provider to ensure that products are presented in a suitably transparent manner. It is relatively straightforward to carry out a study to establish the degree to which consumers understand the product features as presented in promotional and point-of-sale material. Such basic research could obviate costly administration queries, complaints handling and, potentially, compensation for mis-sold or misrepresented products. Leading on from transparency at the point of initial sale is the requirement to ensure that the provider is able to deliver the features and functionality that it promises. In the past, it was commonplace for new products to be launched even though the systems and administrative infrastructure to deal with a range of

customer requirements during the lifetime of the product had not been put in place. The euphemism for these unresolved processes is 'deferred features', and their prevalence was the price that had to be paid for launching new products within an unrealistically short timescale. There have been examples in which around 50 per cent of total IT development resource has been devoted to resolving deferred features. An example of such a deferred feature could be the ability to handle, say, a switch from one fund into another fund in the case of a unit-linked whole-of-life policy or a personal pension. Deferred features create a range of difficulties for an organization, and can be a major contributory factor in the lessening of respect for and credibility of a marketing department. The IT systems development staff find involvement in deferred features a source of frustration. Administration staff find themselves having to devise various manual work-arounds while they wait for the outstanding systems support to be made available. Such a scenario can typically occur in organizations that are overly orientated in favour of new business to the detriment of the long-term interest of customers. Indeed, in the long term the interest of customers aligns with the commercial interest of the company itself. Again, there are cultural implications that can be readily imagined.

Thus, product development should be organized such that what is promised at the time of initial purchase can be fully supported from the launch date of the product.

A further consideration regarding *product* is that product design should seek to provide sufficient flexibility to cope with reasonable changes in a customer's circumstances during the anticipated lifetime of the product. There are certain changes which might reasonably be expected to occur with regard to most financial services. Therefore, the ability to respond appropriately to changing circumstances is an important aspect of most financial products, certainly those with a duration of more than 12 months. The lack of sufficient product flexibility results in poor persistency and poor product profitability. It can act greatly against the customer's interests where penalty charges are applied to products that lapse in their early stages. Clearly, a judgement has to be made regarding the costs associated with proving flexibility for the duration of a long-term product. However, the failure to do so, within reason, may result in much higher costs to the organization.

17.4 Pricing and value

Care must be taken to ensure that *price* is managed in such a way as to safeguard a long-term, mutually beneficial relationship. There is little point in attracting new customers with a price that is so low as to be commercially unsustainable. Equally, the practice of acquiring customers with an attractive price tag only subsequently to introduce a substantial price rise is a cynical practice that can endanger long-term relationships. Nationwide Building Society has a policy of behaving in an even-handed fashion in respect of its pricing policy to new and existing members. In Case study 12.1 we saw how Nationwide approaches what is a significant philosophical issue regarding this somewhat controversial matter, and readers are advised to refer back to it.

A pricing policy that is geared towards customer retention and development has to address the respective merits of long-term customer value over short-term

product profitability. This emphasizes the need to model long-term customer value and evolve a pricing policy that achieves a balance between such value and the short-term profit requirements of the company. This makes it all the more important that a company's systems architecture is able to provide a holistic view of an individual customer's relationship with the company. By joining up all of the customer's product holdings, the company can identify opportunities to add value to the customer through special pricing arrangements. This is consistent with the model for retention proposed by Bittner and Zeithaml regarding what they term 'financial bonds', discussed in Chapter 14.

Such a finely-tuned, customer-based (as opposed to a policy-or account-based) system also permits effective new product pricing initiatives to take place. For example, Fidelity was promoting a reduction in the initial charge on three of its funds from 3.25 per cent to 0.5 per cent for existing customers in January 2006 who choose to transact their business on-line. By way of contrast, at the same time M&G Securities Ltd announced the introduction of what it terms the 'X' Share Class on its PEP and ISA products. The 'X' Share Class allows the customer to invest at no initial charge, but with a diminishing exit fee, during the first 5 years. M&G points out that such a pricing policy is consistent with its belief that equity investment should be for the medium to long term, and typically for a minimum of 5 years. However, the company additionally offers the choice of investing in the 'A' Share Class, whereby there is no exit fee payable but, depending upon the fund chosen, there is usually an initial charge. CRM-based marketing places heavy emphasis upon cross-selling and up-selling to existing customers, and well-designed use of pricing policies can play a key role in its success.

17.5 Advertising and promotion

A particular feature of marketing in the context of existing customer development has been the usage of promotional campaigns and programmes aimed specifically at such individuals. At a very basic level it is obviously important that consistency is achieved between what is said and presented during the acquisition process, and that which is said and presented during the lifetime of the customer lifecycle. This is, at least in part, to do with the issue of expectations, discussed in Chapter 15. Advertising and promotional devices have a major role to play in activities such as customer retention, up-selling, cross-selling and advocacy development. Much of what was presented in Chapter 11 regarding communication and promotion applies in the context of marketing to existing customers. However, once an individual becomes a customer there is a presumption that the provider company really does have in-depth, detailed knowledge about that customer, and that the customer's needs can be addressed on a highly personalized basis. To refer back to the concept of zones of tolerance (see Chapter 15), customers exhibit a relatively narrow zone of tolerance with regard to the communications they receive. They expect a high degree of relevance, customer knowledge and accuracy. Crucially, there is a presumption that their custom is valued and that the relationship is appreciated and respected.

In contrast to the acquisition of new customers, direct-response type forms of communication are significantly more important when marketing to existing customers.

Largely, this is because of the availability of detailed customer data that allows messages and propositions to be targeted on an individual basis with great precision. Therefore, competencies in direct mail, telemarketing and the Internet are especially important when using the marketing mix for existing customers. We saw in the previous section how companies such as M&G and Fidelity make extensive use of direct mail as a means of promoting special offers to existing customers.

One of the most significant developments in recent years has been that of loyalty programmes. Unlike one-off *ad hoc* mail-shots and campaigns, the loyalty programme aims to engender the achievement of long-term customer base goals through the use of the marketing mix. Such goals are typically based upon providing long-term value for money to the customer. Amongst the goals that apply to such programmes are:

- customer retention
- customer advocacy
- increased share of customer wallet
- competitive advantage.

In the context of current customers, communication has an important role to play in providing reassurance that the relationship is in the customer's best interests. This relates to the concept of cognitive dissonance. Cognitive dissonance concerns the feelings of anxiety that are frequently associated with important decisions. Well-chosen and carefully executed messages can aim to reassure customers that they are exercising sound judgement in maintaining a relationship with the provider company. This has become especially significant in the field of financial services in marketplaces that are close to (or at) saturation point. Such marketplaces result in customer acquisition strategies that blatantly seek to achieve defections from competitors. Clear evidence of this is to be seen in sectors such as the gas and electricity market and telecommunication arenas, where defection-based strategies are commonplace. The use of marketing communications programmes to reassure customers of the wisdom of declining the overtures of competitors and maintaining an existing relationship can work effectively in conjunction with the customer retention model of Bitner and Zeithaml referred to in Chapter 14. Again, the availability of a great deal of information about individual customers lends itself to highly focused, well-targeted customer communication. This may involve media such as direct mail, the Internet or call-centres. Financial services have to give careful consideration to this aspect of the use of communication, given the long-term nature of many of its products and the significance of life-time customer value in determining the profitability of individual companies.

17.6 Distribution and access

In the context of customer development, there are many linkages between *people* and *place*. Take the case of the bank branch; its role is far more significant as a distribution point for existing customers than as a means of securing new customers. Indeed, it is interesting to note the case of Barclays, whereby its process of opening

current accounts for new customers requires the customer to arrange an appointment with what it terms a *personal banker*. Cashiers are not empowered to open new accounts, unlike at NatWest, HSBC and Lloyds TSB, where counter staff are permitted to open new customer accounts.

The branch is the most visible and potent manifestation of the bank for most of its personal customers. Thus, the way in which it transacts the requirements of customers has a profound influence upon customer perceptions. Indeed, the branch is, arguably, the most powerful means a bank or building society has for increasing customer value by soliciting for product cross-sell and up-sell. In this way, branch-based distribution has a powerful selling resource that is not available to its non-branch-based, remote rivals. Of course, this capability comes at a cost, and such organizations are continually evaluating the value-added of individual branches and adjusting their portfolios of branch outlets.

The role played by branch staff is crucial in satisfying the needs of customers whilst reconciling this with the needs of the bank itself. This calls for skill and diplomacy in striking the right balance between providing services associated with a product currently held and endeavouring to introduce the possibility of the customer buying an additional product. For example, a customer may call in at her branch to pay a bill and the cashier notice that the customer maintains a significant credit balance. This might indicate an opportunity to sell, say, an investment product of some kind. Skill and sensitivity are needed to introduce this possible cross-sell opportunity, such that the customer does not feel that she is somehow being taken advantage of. To a considerable extent, the answer lies in adopting an approach that is customer-centric and will demonstrably provide value for her. It is also important to ensure that such branch staff are skilled and trained in interpersonal skills of a high order. It is fair to say that few things are as likely to cause customers irritation, dissatisfaction and defection than the perception of being coercively sold to every time they enter a branch.

The use of the branch as a means of distributing additional products to current customers relies squarely upon the *people* element of the marketing mix. Other scenarios that also facilitate the role of people are those involving direct face-to-face sales and service, such as an insurance company's direct salesforce, or the call agent in a telephone call-centre.

Direct sales-forces are of immense importance as a means of reinforcing customer relationships. Insurance agents of all forms, brokers, direct sales advisers and independent financial advisers can all be instrumental in reinforcing the relationship between product provider and customer. The expressions *hunters* and *farmers* are sometimes used in the context of direct sales-forces. *Hunters* are advisers that perform the role of acquiring new customers, whereas *farmers*, as the name implies, are responsible for looking after the servicing needs and new product requirements of existing customers. Sometimes companies have a *hunting* sales team that is distinct from a separate *farming* sales team. Such a division of responsibilities, so it is argued, permits a high degree of focus on the respective goals of acquiring, and developing customer relationships. There is much to commend such an argument; however, in practice, customers often build a positive, trusting relationship with the adviser who initially sold the product to them and resent being handed off to the *farming* adviser. For this reason, companies that experiment with the hunting/farming-focused approach tend to revert to the hybrid model whereby all advisers are

responsible for both hunting and farming. This latter approach is more in keeping with the relationship marketing philosophy in that, by having the responsibility for an ongoing customer relationship, the adviser is more likely to provide only what he or she knows can be delivered. A well trained, properly resourced, conscientious direct sales-force is a powerful vehicle for generating both shareholder value and customer benefits.

The clear separation of hunting and farming roles is more prevalent in the business-to-business environment, where the need for complex, costly and time-consuming new business pitching can make such an arrangement practically and economically viable. For example, a finance company selling leasing facilities to used-car dealers may need considerable effort to prospect for business and secure such a sale. However, the setting-up of the new processes and procedures, and their continuing review, can be even more complex and time-consuming, and call for a different skill set requiring a dedicated organizational structure. Thus, the complexity of many aspects of large-scale B2B product service provision frequently calls for a degree of specialization that makes the separation of sales and client management roles a necessity.

In Case study 17.1, we see how National Savings & Investments has successfully integrated elements of the marketing mix concerning both customer acquisition and development. A particular feature of the NS&I case is that the company has outsourced all of its administration functions to Siemens Business Services.

Case study 17.1 National Savings & Investments

Background

National Savings & Investments is the UK's third largest retail savings and investment provider, with an 8 per cent market share and accounting for some £70bn of invested assets. It has more than 26 million customers who between them generate something like 60 million transactions each year via the telephone, Internet, post office and mail. In 1999, NS&I outsourced 90 per cent of its functions (operations, processing and infrastructure development) in the UK's largest Public Private Partnership (PPP). The relationship has evolved through several stages, beyond that of client/supplier to one of co-dependent partnership.

People and processes

The outsourced call-centre and NS&I's client management teams enjoy close relationships. Most call-centre staff are recruited from back-office roles, so new staff have a working knowledge of the business which helps to smooth the process when customers are changing channels. The Training Team assesses telephony aptitudes, customer orientation, communication and attention to detail, and an interview process focuses on business awareness, cooperation and commitment. Sales and Service Delivery Managers share personal objectives to maximize effectiveness. This approach to partnership development is summarized in Figure 17.1.

Case study 17.1 National savings & investments—cont'd

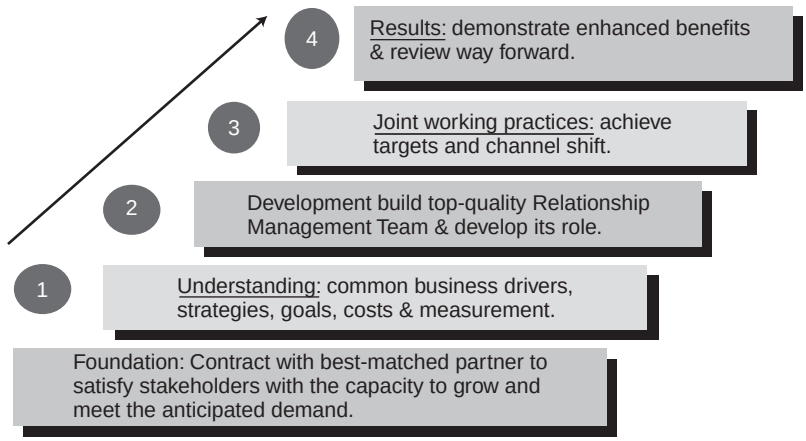

Figure 17.1 Partnership development.

The partnership's commitment to staff is evidenced by upper quartile employment terms, including Employee Bonus and Recognizing Excellence Schemes; Defined Benefit Pensions; and opportunities to influence working environment and processes. Training is co-ordinated and delivered in-house by a specialist team. Customer Service Representatives (CSRs) complete a 30-week modular programme covering 9 key call elements. Employee Opinion Survey outputs are analysed, and plans put in place to address improvements.

Distribution

The rapid expansion and development of NS&I's telephony channel has been a key business aim with achieved growth as follows:

- Capacity has increased from 160 to 285 seats (120 to 250 FTEs) in the last year
- From a standing start annual telephone sales have risen over eight-fold, from £188m in 2000/2001 to £1399m in 2004/2005
- Call volumes have increased from 811 000 to 2 993 000 over the same period, all handled by a person – not by IVR (interactive voice recognition)
- Telephone and Internet sales now make up 30 per cent of all sales but, as the overall target has also increased significantly, we still receive the same value of sales from the post office.

Customer management and research

The drive for direct sales growth to support the modernization of the business was not at the expense of the loyal existing customer base. These results were achieved by a combination of building awareness of the telephone service plus building capability by making NS&I's products available for sale by telephone

Continued

Case study 17.1 National savings & investments—cont'd

rather than just by post. Overall satisfaction levels have improved from an already high 90 per cent to 93 per cent.

Market research identified key customer segments which were developed to grow sales and move lower-cost channels to market – e.g. telephony – without alienating customers whose preferred channel of choice was postal or branch (see Table 17.1).

Research and feedback tools are used to understand and anticipate customer needs, support NS&I's strategies to exceed customer expectations, complete the channel and become best-in-class. With 51 per cent of customers matching groups High AB to C and willing to transact business by telephone or the Internet, NS&I developed its telephony mobilization initiative closely followed by the Internet. The project aims to make the customer experience one that they would wish to repeat, with further enhancements.

Building on research, NS&I will enhance its customer experience to build customer advocacy as a competitive advantage. The targets going forward are for 50 per cent of sales to be delivered by telephone and Internet. The following feedback tools are employed: *focus groups and customer panels*, *frequently asked questions*, whereby customer views are assessed for recurring themes, issues and

Table 17.1 Segmentation at NS&I

Key telephone focus	Age profile	Social group profile	Telephone propensity	Likelihood of telephone use for segment
Mature mainstream	62	A and low DE	Not a key segment for telephone but an opportunity to wean some off traditional channels	Low
Prosperous retirees	61	High AB	A key segment with a higher than average propensity to buy by phone and then transact by phone	Medium
Savvy mature	62	B	A key segment with the highest propensity to buy by phone and then transact by phone	Medium
Planners	40	B	A key segment with a high propensity to buy by phone and then transact by phone	High
Career builders	26	B	A target segment with a propensity to buy by phone and electronic means	High
Established professionals	40	C	A target segment and would be willing to buy by phone	High

Case study 17.1 National Savings & Investments—cont'd

Figure 17.2 The customer experience.

improvement areas, and *mystery shopper surveys*. Additionally, a monthly *customer telephone survey* is conducted by MORI in which recent service users are interviewed for comments on what they consider important, their experience, and how NS&I compares with other financial service providers.

The customer experience

Independent research is used to evaluate the customer experience (see Figure 17.2). Some headline facts are as follows:

- 97 per cent of our calls are answered within 20 seconds
- 99.5 per cent of sales calls and 98 per cent of all calls are answered first time
- Low staff churn (*c*. 11 per cent) ensures that call-centre staff are experienced; understand products, culture and objectives; and excel at providing customers with high-quality service
- Success in delivering brand values is measured.

Source: Jill Waters, Head Of Direct Sales, National Savings & Investments.

17.7 Processes

As an element of the financial services marketing mix for customer development, *process* plays a role in facilitating the delivery of both service and administrative routines as well as the purchasing of additional products. Although the *people* element of the mix has a role to play in providing the sales administrative functions associated with customer development, processes are closely allied. For example, the telephone call-centre and Internet have made an enormous contribution to the progress of customer development in view of their capacity to perform selling, buying and administrative roles.

The Internet has empowered customers to satisfy their needs in respect of data availability and the performance of a range of administrative functions on a 24/7 basis, at minimal cost. As such, it complements the much more costly branch-based resources of banks and building societies. However, it is important to note that it performs a complementary rather than a substitutional role, at least at this stage in the development of the market. The telephone call-centre has been particularly important as part of the marketing mix for customer development. It is a relatively low-cost means of providing a range of purchasing and administrative routines. In recent years, the offshore outsourcing of call-centres, most notably to India, has played an increasing role for companies such as Fidelity, Norwich Union and GE Capital. They offer a low-cost means of transacting inbound customer administration and buying requests. However, more controversial is their role in proactive outbound selling to the existing customer bases of a range of industries, not just financial services. The mobile phone and telecomm sector has been especially active in using offshore call-centres to make outbound sales calls, and there is evidence of growing hostility to this form of selling. It is suspected that this hostility has more to do with its intrusiveness than with the origin of the actual call itself. Nevertheless, the cost-effectiveness of the use of unsolicited outbound sales calling must be balanced against its negative impact upon overall customer satisfaction levels.

In the case of the use of the Internet and call-centre, aspects of design and process often serve to frustrate customers and reduce their satisfaction rather then heighten it. Websites can be difficult to navigate and make presumptions about the nature of enquiries that may not best reflect the needs of customer or indeed prospective customers. For example, it is commonplace for such sites to be product-based, rendering it impossible to make enquiries of a general nature. Complaints handling is often poorly dealt with, and a number that have been reviewed request purely written requests for service and resolution. The absence of appropriate telephone numbers to assist the customer or a failure to respond to calls is a frequent source of irritation.

Call-centres can result in similar frustrations, as automatic call-handling procedures (IVR) fail to deliver the required degree of service responsiveness. What is indicated is far greater use of what is termed the *customer journey*. By this term we mean that executives should thoroughly test the responsiveness, functionality and effectiveness of both Internet- and telephone-based processes at first hand. This is somewhat analogous to the practice of supermarket CEOs devoting considerable personal time to their customers' experiences as users of their stores. Such an

approach has yielded enormous benefits, not only to shoppers but also to the shareholders of those retail companies.

No matter what elements of the marketing mix are used to develop customer relationships over the long term, it is vital that effort be expended in assessing their impact. It is relatively straightforward to measure the impact of the customer acquisition process – a prospect either buys, and thus becomes a customer, or declines the invitation. Both types of individual can be invited to take part in some form of feedback aimed at informing future policies and practices. However, once a prospect has become a customer, there is a wide continuum of ways in which the customer interacts with and is exposed to the provider company. All of the customer's interactions with the marketing mix have an impact, at both the subconscious as well as the conscious level, in forming perceptions – negative and positive.

ResponseTek is a company that has evolved a methodology for capturing the experience of customers as a means of identifying business improvements. It uses the precepts of gap analysis as a means of identifying areas for improvement. The goal of engendering higher levels of advocacy also plays a key role in ResponseTek's approach. It emphasizes that the voice of today's customer is a powerful one, made all the more so by the Internet and via blogs and online chat. In ResponseTek's view, companies can choose to maintain their traditional push/pull marketing efforts and deliver what they think customers need and want. Alternatively, they can adopt ResponseTek's Customer Experience Management (CEM) framework that has been designed to enable them to listen better to their customers and act upon the insights that arise. Case study 17.2 explains ResponseTek's approach in more detail.

Case study 17.2 Customer experience management at ResponseTek

By means of CEM, a company can incorporate the voice of its customers into its business strategies and operations. The aim is the development of trust and loyalty that will lead to the ultimate goal of advocacy. According to ResponseTek, it is not sufficient simply to monitor the impact of advocacy and satisfaction of one's customers. Instead, it is necessary to take customer advocacy and satisfaction to a higher level of understanding by enabling a company to understand the root cause of customer satisfaction and advocacy. Once such root causes are identified, effective, well-focused actions can be implemented to increase satisfaction, advocacy and profitability. ResponseTek claims that its core suite is the only software platform that delivers a complete set of Customer Experience Management capabilities, comprising:

- Multi-channel experience collection
- Analysis
- Reporting
- Workflow management
- Closed-loop feedback.

Continued

Case study 17.2 Customer experience management at ResponseTek—cont'd

The CEM methodology is based upon three core elements, namely:

1. *Involve*: capture the customer's experience whenever and wherever it occurs. This means continuously gathering customer insights – whether customer, company or event-initiated – from any channel, such as the call-centre, web or in-store point of sale, when they want, and when their opinions are formed at the moment of delight or disappointment.
2. *Integrate*: integrate the customer's voice into processes and employee activities. Staff, partners and executives need to be able to make informed decisions based on real-time customer-experience information. The right information needs to be filtered to the right person at the right time, from the executive level down to frontline employees. Users should be able to communicate improvements or comments back to the customer.
3. *Improve*: continuously turn customer experience insight into actionable improvements. The ability to facilitate enterprise-wide communication and change based on customer experience information is another critical aspect in achieving the greatest customer experience management benefits. Actionable, closed-loop communication capabilities enable companies to align business strategies with customer insights, and in the process create customer advocates.

Figure 17.3 shows how ResponseTek seeks to integrate all aspects of CEM into a unified conceptual framework described as the customer-driven enterprise.

Aon Reed Stenhouse (ARS) is one of a number of financial services organizations using ResponseTek's system. ARS is the Canadian division of AON, a global provider of risk management and insurance broking services. Faced with increasing competition and limited understanding of its customers, ASR was looking for an efficient solution to improve retention, improve understanding of customers and, through that better understanding, improve the customer experience, this allowing ASR to set itself aside from the competition. ResponseTek implemented a system of ASR which provided regular monitoring of real-time customer experiences, a 'dashboard' system to provide senior management with daily summaries of the customer experience by segment and by region, and an early warning system for 'at risk' customers (potential defectors) on a daily basis.

David Cliche, marketing manager for ASR summarized the benefits of implementing CEM:

> We had to respond to the changing competitive landscape of the Insurance industry and look for alternative ways to make better informed business decisions. ResponseTek helped us to accomplish this by integrating the voice of the customer into our business processes ... We now know a lot more about

Case study 17.2 Customer experience management at ResponseTek—cont'd

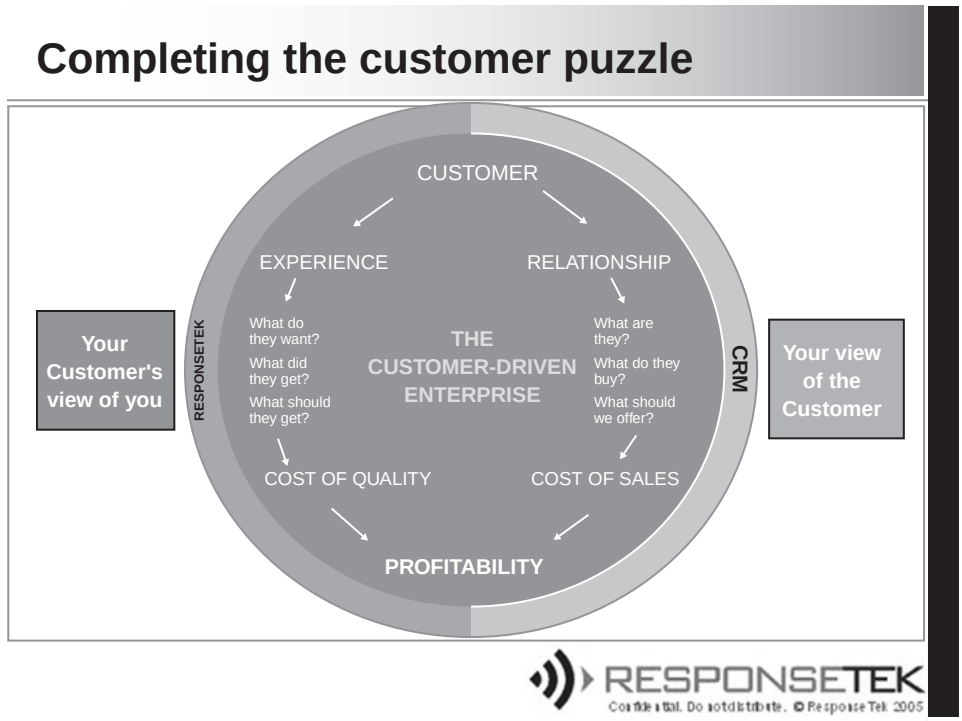

Figure 17.3 ResponseTek's customer-driven enterprise framework.

our customers than we did before. Rather than one touchpoint, we are now able to understand our interactions with customers throughout their lifecycle. Knowing what our customers want and the complementary products and services they need is invaluable information.

Source: Yalman Khan and Richard Sharp, ResponseTek.

17.8 Evaluating marketing performance

In this section we will consider issues concerning the implementation of marketing concepts and practices and how their contributions might be evaluated. By now it has been firmly established that marketing is less about the practical activities engaged in by departments bearing that name but, rather, constitutes a business philosophy or orientation. Central to this orientation is understanding the customers'

problems, needs and wants, and then providing the means by which these may be satisfied. Quite simply, marketing is about getting and keeping customers, and success in this endeavour demands that the customers' interests are given paramount significance. Thus, the truly marketing-orientated organization believes from top to bottom that delivering competitively superior customer satisfaction leads to the long-term optimization of all stakeholder interests. Arguably, the CEO of an organization should view him- or herself as the *de facto* Marketing Director or VP, as the buck stops with the CEO for the organization's customer centricity. Thus, marketing is not simply the tasks carried out by the marketing team; rather, it is the sum total of all of the organization's activities that impact upon customer experience. Any audit of marketing performance should therefore take a thorough, holistic approach by evaluating the outcomes of all functions that impact upon customer satisfaction.

In addition to assessing the degree of marketing orientation organizationally, and the impact of all departments that have an influence upon customer perceptions, there remains the need to assess the contribution of the marketing department itself. It falls to the marketing team to ensure that the activities of marketing strategy, customer acquisition and customer development are conducted in an appropriate, effective, efficient and professional manner. Marketing teams can easily become responsible for undermining credibility in marketing as a concept, as well as that of its adherents, by failing to operate to the required standard of effectiveness, efficiency and professionalism. This can arise because of the prevalence of a number of gaps that are somewhat analogous to those that occur in the SERVQUAL model. Of particular note in marketing performance analysis are the following gaps:

- Gap 1: The external role gap – the difference between the expectations of other functional management and staff regarding the role of marketing and its actual role and responsibilities.
- Gap 2: The internal role gap – the difference in expectations between marketing management and staff regarding their roles.
- Gap 3: The external delivery gap – the difference between what external management and staff expect marketing to deliver and what they perceive it to deliver.
- Gap 4: The internal delivery gap – the difference between what the marketing team set out to deliver and what they believe they actually do deliver.

It may be readily appreciated that all four of the above gaps involve a combination of what is perceived and what can be objectively evidenced. The two constructs may well not be in alignment if senior marketing management fails to devote sufficient attention to the management of perception. There are many examples of hard-working, productive marketing teams that do a great job of influencing customer perceptions of their company whilst failing to manage their department's internal perception. Too often the assessment of performance by senior marketing management is biased in favour of Gap 4, followed by Gap 2. Scant attention is devoted to addressing Gaps 1 and 3, and this oversight serves to undermine marketing's credibility. Therefore, senior marketing staff must ensure that they identify the dangers inherent in all four gaps and formulate strategies to close them.

Marketing executives need to be acutely aware of the risks that may be associated with any given activity or course of action. Indeed, it is probably fair to say that there are more risks facing the unwary in the field of financial services than in most other commercial sectors. Financial and regulatory risks present particular challenges, and failure to exercise due prudence and diligence can in extreme cases lead to the collapse of an enterprise.

Chief Executives and Marketing Directors frequently struggle to evaluate the value they gain from their marketing resources. The Canford Centre for Customer Development has set out to assess marketing's contribution to corporate goals by means of the Marketing Mentor®. Through the use of Marketing Mentor®, CEOs and Marketing Directors have the means to identify which marketing activities they should:

- maintain, as they make a valid and worthwhile contribution to corporate goals and should be continued
- improve, as they are performing at a level below that expected of them and should be the focus for an improvement programme
- initiate, as they are not currently in evidence and should be introduced to marketing's programme of activities
- delete, as they add little value to the organization's goals and should be abandoned.

Central to its methodology is the assertion that marketing performance rests upon seven core moments of truth, namely:

1. Marketing strategy
2. Customer acquisition
3. Customer development
4. Product and service management
5. Communication and perception management
6. Planning and implementation
7. People management and development.

Finally, rigour, flair and judgement will come to nought unless the individual marketing executive is able to make things happen. In spite of the commonplace mantra of 'empowerment', an array of forces acts to prevent marketing-related change taking place. Numbered among such inhibiting forces are:

- Risk aversion
- Fear of failure
- Individual and group cynicism
- Inertia and lack of corporate ambition
- Senior management control-freaking
- Blame-orientated cultures.

The above list is neither comprehensive nor are the points fully mutually exclusive; however, each captures the essence of the kind of organizational backdrop that makes it difficult to become a truly marketing-orientated organization.

17.9 Corporate social responsibility (CSR)

Alferoff *et al*. (2005) have commented that during the course of the last 20 years a range of factors have been responsible for profound changes in the operating climate for contemporary financial service organizations, including the following:

- globalization and/or regionalization
- marketization and/or public private partnerships
- the speed and transparency of communications
- the shift to a service economy
- the retreat from, or constraint of, public welfare in favour of private provision.

At the same time, there has been an increased demand from various stakeholders, including national governments, international bodies and regulators, for a greater focus on corporate ethics and social responsibility.

Governments worldwide are now looking to create greater transparency, openness and responsiveness in the business sector by introducing both 'hard' and 'soft' legislation to improve standards of corporate governance in the boardroom and social responsibility towards internal and external stakeholders. Despite these demands, made more urgent by several high-profile scandals, major problems surround the very definition of corporate social responsibility, added to which is a lack of any consensus as to whether it should be a central part of business policy and practice.

As already mentioned, CSR is assuming ever more importance on the world stage, and the American life assurer Mutual of America has been furthering its own CSR agenda for many years through the medium of the Mutual of America Foundation. In Case study 17.3 we can see how the Foundation has used the Community Partnership Award as an important element of its contribution to fulfilling its responsibilities to CSR.

Case study 17.3 Mutual of America and corporate social responsibility

Mutual of America is one of a handful of mutual life insurance companies of scale still operating in the United States. Mutual of America was originally named the National Health and Welfare Retirement Association (NHWRA), and began business on 1 October 1945 offering retirement plans and insurance coverage.

NHWRA was unique in setting up a retirement system for not-for-profit health and welfare organizations. Such groups had been generally unable to obtain coverage from insurance carriers, at the time, due to the small numbers of people employed. Furthermore, their employees were not eligible to participate in Social Security, which excluded workers in most not-for-profit organizations. Thus an obvious need existed for a new type of retirement organization.

Case study 17.3 Mutual of America and corporate social responsibility—cont'd

The Company was originally capitalized in 1945 with a loan from the Community Chest (now the United Way), and in 1984 became Mutual of America Life Insurance Company and soon was licensed to do business in all 50 states. At the end of 2005, Mutual of America's assets totalled more than US$11bn dollars.

Mutual of America is known today as a company that offers products and services of the highest quality backed by the financial strength of a first-class organization. It is a direct writing company in that it does not employ independent or commission-based producers. All of its products are marketed and serviced by its own full-time salaried professional staff. Another important indication of its approach to mutual ethics is that the company does not sell any product that incorporates a surrender penalty. Unlike many of its competitors, Mutual of America encourages its customers to be direct users of its web-based systems instead of having to gain access to such facilities via the sales agent.

The company has a long history of community-based activities and charitable giving, and in 1996 established the Community Partnership Award (CPA). Underpinning the CPA is the desire to encourage not-for-profit organizations, such as charities and community support organizations, to become more professional in their approach and enjoy a greater degree of financial security. Now in its eleventh year, the CPA is firmly established as an annual national competition for not-for-profit organizations. The CPA scheme aims to encourage greater partnership between public, private and social sector organizations devoted to the public good. Such partnerships have addressed issues such as child abuse, teenage unemployment, homelessness, the mentally ill and a range of other social and community issues. The CPA's mission:

> recognizes outstanding non-profit organizations in the United States that have shown exemplary leadership by facilitating partnerships with public, private or social sector leaders who are working together as equal partners, not as donors and recipients, to build a cohesive community that serves as a model for collaborating with others for the greater good.

An example of this is the Boys' and Girls' Club of Hartford, Connecticut. The club was experiencing difficulties in raising funds and securing suitable facilities for its recreational activities. It identified a small plot of land that adjoined a local college (Trinity College), and successfully negotiated with the college's Board of Directors for it to share the college's own sports facilities. This allowed the club to offer a wide range of facilities to neighbourhood young people, with a minimal capital investment. In addition to the provision of sporting facilities, Trinity College students acted as both sporting and academic mentors to the young people who were members of the club. In addition to the club's own sports, art and computer facilities, its young people have access to Trinity

Continued

Case study 17.3 Mutual of America and corporate social responsibility—cont'd

events and facilities: concerts and plays, playing fields, a swimming pool, library and technology rooms. From Monday through to Friday after 3 pm, and on Saturday mornings, Trinity students engage in work-study programmes, internships and volunteer activities at the club. Working alongside Boys' and Girls' Club staff, they help with homework, coach sports, teach art and computer skills, and run programmes in character development, leadership and life skills for the young people. In this way a vibrant community resource has been developed which has achieved real synergies for the various stakeholder groups involved.

The CPA has grown to the point where it receives several hundred applications each year for the competition. An independent assessment panel reduces this number to a shortlist, and these applications are subject to a more rigorous appraisal before the winners are finally chosen. An important aspect of the CPA is that considerable resources are devoted to promoting the ideas and best practices that are identified through the judging process. In this way, knowledge is shared and added to for the benefit of the wider not-for-profit sector in the United States.

Source: Thomas Gilliam, Chairman, Mutual of America Foundation.

17.10 Towards a sustainable future

In many respects, marketing and consideration of the future are inextricably linked. This relationship is in evidence in marketing's role in seeking to understand the forces that will shape the marketplace of the future. Strategic marketing planning describes the processes that formally assess environmental trends, and presents scenarios for responding to those trends in order to sustain an organization's future survival and success. Customer relationship marketing is based upon the notion of continuity and responding to the changing needs of the individual customer over an extended period of time. Thus, the term sustainability has particular resonance in the context of marketing. Its significance extends beyond marketing and strikes at the very core of the organization's future survival.

It is the authors' view that marketing can contribute to the issue of sustainability in two particular ways. First, it has a crucial role to play in ensuring the survival and future success of the organization itself through the role it plays strategically and tactically. Secondly, it can play a role in contributing to wider issues regarding social and environmental sustainability. Let's call the former *internal sustainability* and the latter *external sustainability*.

As far as internal sustainability is concerned, marketing plays a vital role in maintaining the strategic triangle referred to at various points in the book. Of particular note is the importance of marketing's role in environmental scanning. It is only by

continually refreshing one's knowledge of the forces that will shape future demand and supply that organizational survival can be safeguarded. For this reason it is vital that environmental scanning is suitably wide-ranging to provide the necessary degree of helicopter vision. This is particularly important in the case of multinational players. For example, if we consider the demographic profile of the world's major groupings, we observe that the population of North America, Europe and Japan (what we might call the old economies) amount to the order of 800 million people. The population of China is some 1.33 billion, and the combined populations of the Muslim world stretching from the Atlantic coast of Africa eastwards to the Indonesian archipelago is greater than 2 billion. Major cultural differences apply between these three basic groupings, and, clearly, multinational organizations have to be especially well-tuned to their respective drivers of change. Scenario planning is a technique that is particularly useful as a means of endeavouring to identify possible opportunities and threats in the macro-environment of the multinational organization. Such an approach can serve as a means of stimulating new insights that challenge received wisdom and the *status quo*. A world view based purely upon the conventional mindset of the G8 capitalist democracies may be woefully inadequate as a basis for shaping strategies in future.

Additionally, marketing has an obligation to discharge its responsibilities in respect of its use of the marketing mix such that it does not endanger the future prospects of the organization it seeks to serve. This involves an acute awareness of the risks associated with marketing activities on the one hand, and the need to exercise sound commercial judgement on the other. As far as the former is concerned, it calls for a thoroughgoing appreciation of regulatory and legal requirements as well as sound husbandry of corporate resources. Some years ago, an ill-conceived sales promotion for Hoover involving free transatlantic flights almost brought about the collapse of the company. The lack of effective controls concerning the use of the promotion and the qualification rules cost the company dearly – both financially and in terms of its reputation.

Sound commercial judgement is vital, and innovation in the fields of market and product development needs to be able to withstand robust challenges to its commercial probity before progressing too far.

In March 2006, analysis conducted by Cazalet Consulting (www.cazalet-consulting.com) demonstrated that hardly any net new pensions saving had taken place in the UK during the previous 4 years. The analysis pointed to the declared new business results of the industry being based almost entirely upon churning existing pension investments. Whilst the intermediaries responsible for transacting such transfers have benefited in terms of the fees and commissions they have generated, this has not served the long-term interests of providers or consumers. The analysis of single-premium pension sales reveals that it can take some 8 or 9 years simply to recoup the commission paid from the charges levied on the customer. If the life company's own initial costs are added, it can take 10–12 years for the policy to break even. Curiously, though, the commission clawback period is typically just three years. It might well be concluded that this acts as an encouragement to churn business, with all the detriment to consumers and providers that this implies. Cazalet shows that a £40 000 single-premium pension does not reach profitability until year 13. Even worse is the example they give of a £150-per-month regular premium pension. Even making no allowances for discontinuations, such a

product, using Cazalet's model of charges, does not become profitable until year 18 of its life. After allowing for discontinuances (lapses of 7.5 per cent and transfers of 2.5 per cent of in-force business each year – better than actual industry experience), the product is still loss-making in year 25.

If Cazalet's analysis is accepted, it casts a shadow over business models that are in evidence in the contemporary UK life and pensions industry. Marketing has a duty to devote its energies to products, pricing, promotional and distribution practices that best serve the long-term interests of customers and providers, such that they both enjoy the benefits of a positive-sum game.

Finally, let us turn our attention to the issue of external sustainability. Again, it should fall to marketing to appreciate the interrelationships between the organization and variables at play in the external environment beyond the micro-environment referred to in Part I. There is gathering evidence of an appreciation of how marketing can contribute to broader issues concerning the social and physical environment. The avoidance of practices that involve polluting the atmosphere and the efficient use of natural resources, for example, have a role to play in contributing to environmental sustainability. A number of companies throughout the world have become role models for the adoption of environmental policies. A particularly compelling example is the Swedish insurance company Folksam. Folksam was one of 19 insurance companies in the world to become the initial signatories of the UNEP Statement of Environmental Commitment. The Statement now has in excess of 180 signatories from the insurance industry, and the number is growing steadily. Case study 17.4 provides some interesting insights into Folksam's approach to environmental well-being and sustainability.

Case study 17.4 Folksam and sustainability

Folksam is a mutual company whose vision states: 'We work for a long-term sustainable society in which the individual feels secure'. With over four million customers, and managing over SEK 130 billion of assets on their behalf, Folksam has been one of the 10 best workplaces in the Fortune ranking of European companies.

Reducing carbon emissions

Folksam has been in the vanguard in introducing policies aimed at contributing to environmental sustainability. To ensure that Folksam's environmental objectives are made fully clear to all those concerned, parts of the business are now environmentally certified to ISO 14001. Some years ago, Folksam introduced a staff travel policy to encourage efficient car use in connection with claims inspections by ensuring that driving schedules are full and by having special 'inspection days'. The policy also prescribes the means of transport to be used on different routes. Additionally, staff are expected to avoid air and car travel between the company's main sites in Stockholm and Gotenburg, and to travel by rail whenever possible. It has calculated how much carbon dioxide emissions this saves.

Case study 17.4 Folksam and sustainability—cont'd

For the seventh successive year, in 2004 the Folksam Climate Index measured Swedish enterprises' carbon dioxide emissions and the steps they were taking to reduce them, and the results are published in the public domain.

Ridding the countryside of car wrecks

Up to 350 000 abandoned car wrecks used to litter the Swedish countryside at any time. Folksam has been working with the Keep Sweden Tidy Foundation to create greater awareness of the fact that it is an environmental offence in Sweden to abandon vehicles and leave them in a manner that may harm the environment.

Over 100 000 car wrecks have been recovered so far. Since the campaign began, the countryside has been cleared of almost one tonne of mercury, 650 tonnes of lead and 140 cubic metres of battery acid, all of which could have damaged the environment. Another 60 000 tonnes of metal has been recycled.

Folksam benefits commercially from its environmental policies and makes big savings by setting high environmental standards. In the period 2000–2004, it has saved as much as SEK 200 million on car repairs by reusing original parts and by repairing plastic parts and windscreens. The amount saved through these practices in 2004 was SEK 62 million – money which is passed on to Folksam's customers in the form of lower premiums.

A guide to environmentally conscious house renovation

Each year Folksam spends SEK 800 million on building repairs, which makes it one of Sweden's biggest buyers of building materials. As a big client, Folksam is in a position to make demands on price and on environmental performance. Another way in which it makes a difference is through an annual publication called *Byggmiljoguiden*, a comprehensive guide to building products and materials that spare the environment and safeguard the nation's health. *Bygmiloguiden* has become a unique source of information for builders, property managers, local councils, architects and home owners. There is no other collection of data that gives such a comprehensive picture of the environmental impact of building materials, and 100 000 copies of the guide had been distributed by 2005.

Making demands on contractors

Folksam has agreements with 300 building contractors and 1200 car repair shops and scrapyards. Given that it has 25 per cent of the Swedish home and car insurance market, many contractors in these industries are anxious to make agreements with the company. This enables Folksam to impose exacting environmental and quality demands on those selected. Any firm wishing to be considered as a potential contractor must complete a detailed environmental specification. There are specifications for builders, car repair shops and scrapyards. Thanks to this approach, Folksam has been the first insurance company in the world to introduce green policy conditions. These represent a promise to the customer that the company will always pay attention to environmental considerations when settling claims.

Source: Kjell Wirén, Folksam.

17.11 Summary and conclusions

Strategies to initiate, maintain and develop customer relationships must be supported by appropriate marketing practice and, particularly through the use of the marketing mix, by developing relationships with existing customers as well as acquiring new ones. Effective marketing to an existing customer base requires a thorough understanding of customer needs and expectations, and a willingness to respond to those needs. This in turn requires a market- or customer-orientated organizational culture which ensures commitment to meet customer needs at all levels of the organization. However, relationship marketing does not just imply an unconditional imperative to cross- and up-sell to an existing customer base. Requirements of corporate social responsibility and sustainability imply that marketing managers must be aware of and responsive to the broader social consequences of the products and services they provide, and the ways in which they are marketed.

More generally, successful marketing exponents display a heightened appreciation of the fact that good practice represents a combination of a number of factors, notably:

1. The rigorous application of relevant concepts and tools
2. Creative insight and flair
3. Sound commercial judgement
4. Drive and can-do attitude
5. Social responsibility.

It is to be hoped that this book has made a contribution to at least the first of the above five factors. Important as that factor is, of itself it is insufficient to ensure the successful application of marketing to the commercial needs of a financial services enterprise. The rigorous application of good marketing processes has to be complemented by creative flair that resonates with the predilections of staff, distributors and customers. Given two very similar options, as humans we will typically make a choice in favour of that which is the more interesting, attractive and appealing. Again, rigour and flair will fail to guarantee success unless the proposals and outputs of marketing executives display sound commercial judgement. There is no place for naivety in those involved in marketing, and credibility is earned by the demonstration of well-justified and well-argued cases that can convince even the most sceptical of colleagues of marketing's value. Yet, notwithstanding the commercial imperative, marketing must be conditioned by and responsive to its social context. Finally, focus must never be lost regarding the simple fact that marketing is about getting and keeping customers. Ultimately, its success can only be judged on that basis.

Review questions

1. What are the characteristics of the cultures of companies that seem to be dominated by customer acquisition? Compare and contrast these with those that seem to be advocates for a relationship-based approach to marketing.

2. What principles do you think should underpin the pricing policies of financial services companies to ensure equitable treatment of new and existing customers?
3. Discuss the role that marketing can play in furthering the goal of environmental sustainability. Do you believe that it is a legitimate use of marketing resources?
4. Identify which banks and insurance companies operating in your country you believe are the best exemplars of CRM. What in particular impresses you about their CRM policies and practices?

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