CHAPTER 1

INTRODUCTION AND DESIGN OF THE STUDY

INTRODUCTION

"Go forth and multiply", says the Bible. The financial services sector in particular has taken this Biblical exhortation to heart and proliferated like amoebae. These are exciting times for business. The government has been making waves with its bold moves - bold for India, that is - to deregulate the economy. All are trying to speak the language of business.¹

Banking in the world at large, has gone through considerable changes in terms of what ever major aspects one looks at; composition of assets, mobilisation of resources, pricing of products, management philosophy of key players, customer-banker relationship, regulatory framework etc. Not only the group of bankers and customers have had to take note of these changes but even other agencies like the regulatory authorities, financial analysts, monetary authorities have found it difficult to reckon with the fast changes taking place. One feature worthy of note has been the increasing importance of merchant banking as a constituent of the totality of international financial system.

¹ Banking in India has grown up from a deposit and lend industry into a catalytic agency for promotion of economic development. Several innovations

in the field of banking have spurred banks to diversify and to undertake activities hitherto unknown. One such area is merchant banking.  

Due to the introduction of liberalisation measures the protection is removed and the competition has set in. Competition not only among the borrowers but also among bankers to choose and keep a good entrepreneur in their clientele who would efficiently, run his business and also provide business to bankers. Those shrewd borrowers started calculation of their cost of funds. Hence the bankers are forced to lend at a lower rate and also provide many other services including non-fund based business so as to spread their cost of funds and to maximise their profits.

At this juncture a metamorphosis has taken place in the economy and public also started searching for a better market for their funds/savings in a profitable manner despite the risks involved. This made the public to switch over to investment in companies through various financial instruments such as shares and debentures and even fixed deposits in view of higher profitability/income. It is this change that gave rise to the capital market.

SIGNIFICANCE OF THE STUDY

Merchant bankers serve as a vital link between investors and industrial entrepreneurs. On the one hand the merchant bankers are retained by companies to assist them in raising funds from the primary market through

issue management, underwriting etc. On the other hand, they play a historical role in developing and promoting equity cult by ensuring interests of the investor vis-à-vis the promoters objectives.

Merchant bankers are financial intermediaries. They act as intermediaries in the process of transfer of capital from those who own it to those who deploy it. But they do this with a difference.

Recognising the need for least interference in the financial sector, the Government of India has abolished the office of the Controller of Capital Issues and given freedom to companies in the matter of pricing of their public issues. Consequently, there is a flood of new and right issues in the market and investors are bewildered how to take investment decision. Their main cause of concern is how to ensure safety, liquidity and a fair return on the investment. Towards this end the Securities and Exchange Board of India Act, 1992 has been enacted and the SEBI has been vested with independent status and powers for ensuring healthy growth of capital market and protecting the interest of investors. The latest attempt of the SEBI is to regulate the business of Merchant Bankers who play an important role in capital management.

In India, merchant banking was initially confined to the management of public issues of the corporate sector. But today, the scope has widened considerably and has gone beyond issue management. Many banks' merchant
banking divisions are now engaged in providing a wide spectrum of financial and related services to their clientele.

Merchant banking today is a protective and promoting force to entrepreneurs, corporate sector and investors. The role can enlarge both in the domestic and international market. In a transitional economy as in India when more and more industries come up, the corporate structure and capital requirement will broaden. This places the corporate sector to depend on an external agency to determine how best it may raise the required capital in the required quantum and in a suitable form. At this juncture corporate sector had the only alternative to avail of the capital market services for meeting their long term financial requirements through capital issues of equity and debentures. With the growing demand for funds, commercial banks, share brokers and financial consultancy firms had to enter the field of merchant banking. With the result, all the commercial banks in the public sector as well as private sector in India have opened their merchant banking windows and are competing with each other.

The primary capital market grew astonishingly in the last decade. Further investors are also becoming cautious and discerning. Under such circumstances the merchant bankers have to be in constant touch with the economic environment and provide inputs on the direction the markets are moving and develop newer and better marketing strategies, covering specific
investor groups. They have to provide value-addition to the issuer at all steps in the resource raising process right from structuring the issue to selling it.

Merchant banking outfits provide a one point service centre for a whole gamut of activities including underwriting and syndication of loans. With their large net work base, merchant banks are now able to underwrite large portions of the capital issues, ensuring that the issue requirements of project funding are met adequately.

THE NEED FOR MERCHANT BANKING SERVICES

- The rules and regulations, guidelines and press-release instructions brought out by the government from time to time will involve the problem of providing technical and financial advice to the needy. Merchant bankers, with their skills, updated information and knowledge, provide this service to the corporate units.

- The need for developing industries like fertilizers, petrochemicals and electronics which are highly sophisticated and complex in nature will require specialised services.

- Now the lending policies of organised credit institutions changed from security to credit worthiness of the business, corporate enterprises will require the services of a financial intermediary in respect of project appraisal, financial management, etc.

- The need for merchant banking institutions is felt in the wake of huge public savings lying idle. Merchant banks can play a highly significant
role in mobilising funds of savers to investible channels assuring better returns on investments.

The medium industries which did not have the benefit of the services of established industrial houses will continue to feel the need for such services.

Corporate sector both in the public and private would be able to raise the required amount of funds annually from the capital market for the benefit of merchant bankers.

When the Indian enterprises are investing in joint ventures abroad, there may be certain problems which have not been faced by Indian industries.

Merchant bankers advise the investors of the incentives available in the form of tax reliefs, other statutory relaxation, good return on investment and capital appreciation in such investment to motivate them to invest their savings in securities of the corporate sector.

The merchant bankers help industry and trade to raise funds and the investors to invest their surplus in sound and healthy concerns with confidence, safety and higher yields.

Merchant banking activity has accepted a professional character nowadays. Some of the industrial giants have set up their own merchant banks to exploit the potential market. India needs the expertise of modern merchant banking.
OBJECTIVES OF THE STUDY

The following are the objectives of the present study.

i. To trace the origin and development of merchant banking in India.

ii. To review the services rendered by select merchant banking institutions with special reference to issue management, underwriting and project appraisal.

iii. To evaluate the role of SEBI in exercising control in the stipulated spheres of merchant banking in India.

iv. To make performance evaluation of the merchant banking operations of the select merchant banks in Tamil Nadu.

v. To analyse the problems confronted by the select merchant bankers in the public sector in general and in the above mentioned areas in particular.

vi. To summarise the findings and suggest remedial measures based on such findings.

REVIEW OF LITERATURE

A study was carried out by the ENS Economic Bureau Bombay to analyse only the issue management activities undertaken by merchant bankers both in the private and public sector in the country.

ENS Economic Bureau, "Merchant bankers reap good harvest", The Indian Express, June 7 1993.
It was found in the study that the year 1992-93 was a bonanza year in the area of issue management with a record of 527 public issues aggregating Rs.6,059.63 crores as against 196 public issues for Rs.1,711.36 crores in 1991-92.

It was also found that among the bankers in the public sector, SBI Capital Markets Limited maintained its top rank both in number of issues and the funds handled. This was followed by PNB Capital Market Services, Bank of Baroda and Ind Bank Merchant Banking Services Limited. Among the foreign banks as many as six were involved. Grindlays Bank ranked first with 11 Issues. Among the private merchant banker, CRB Capital Markets tops the list followed by IM Financial, Subash Dalal etc. It was concluded in this study that the number of merchant bankers is growing. Due to the bombing of capital issues, merchant banker, would now be concerned more with the quality than quantity.

A study made by S.Lalitha observed that a consortium of brokers and merchant bankers should take the role of market makers. This is because share brokers, generally being partnership firms, do not have the financial clout which is necessary for market making activity.

A minimum of ten scrips have been proposed by the SEBI for the market makers. Brokers have contested this move on the ground that the

market maker should be left to decide which scrips he wants to pick up. Also, there should be no minimum or maximum number of scrips in which a broker is allowed to make a market, they have contended.

It has been pointed out that the merchant bankers, particularly those who are engaged in the field of portfolio management should be inducted into the system after providing adequate safeguards for protecting the funds of investors.

C.R.L. Narasimhan has pointed out that the Securities and Exchange Board of India has been given regulatory powers over the issuers of capital which it was clamouring for, to regulate the capital market. The latest ordinance enables it to impose monetary penalties on the erring intermediaries and prosecute companies directly without referring to any government agency. Such prosecution can now be launched for a variety of violations including violation of the listing agreements with stock exchanges.

He also pointed out that capital market intermediaries could, before the ordinance, be penalised by having their licenses suspended and so on. Now an alternative mode of prescribing fines has been introduced. Intermediaries are now directly answerable to the SEBI for a number of violations. Brokers can now be penalised by SEBI for not issuing contract notes on shares and for charging excess brokerage.

Mutual funds too can be fined up to Rs.10 lakhs for not obtaining a certificate of registration and Rs.5 lakhs for not filing the listing application. The ordinance also gives SEBI additional power to supervise its own take-over code announced earlier.

Mr. Anand Desai has made an attempt to analyse that with the abolition of the Office of the Controller of Capital Issues, it has become imperative that the issue of securities be priced optimally - one that gives the maximum benefit of the premium to the issues and at the same time is attractive and offers reasonable scope for capital appreciation to the investor. The responsibility of optimally pricing the issue of securities is with the merchant bankers. In addition the Securities and Exchange Board of India has laid down guidelines for disclosure in order to enable the investor to take decisions. The merchant banker has thus to ensure that adequate disclosures are made in the offer documents issued by the company.

He also pointed out that there have been cases of bought out deals where the merchant banker buys out the entire issue of securities himself and later offloads it in the market. This goes a long way in reducing the costs incurred by a corporate in marketing issues.

He concluded that in the era of free pricing, the role of the merchant banker has changed tremendously as he has to keep abreast of the changes in

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the capital market scenario, national as well as international. The rules of the game are constantly changing and "survival of the fittest" will be the dictum.

A study made by the Financial Express Bureau,\textsuperscript{7} New Delhi highlighted the role played by SEBI with regard to merchant bankers.

The regulations are exhaustive in nature setting out the conditions for grant of registration, obligations and responsibilities of merchant bankers, procedure for inspection of merchant bankers by SEBI and code of conduct for merchant bankers.

Under the regulations, the merchant bankers are required to fulfil certain capital adequacy requirements. The regulations further stipulate that all issues should be managed by at least one merchant banker functioning as a lead manager. It also provides for a procedure for inspection of merchant bankers by SEBI.

SEBI is empowered to suspend registration of a merchant banker in case they furnish wrong or false information, fails to resolve the complaints of investors, indulges in price rigging, fails to maintain capital adequacy requirements, etc. This can be done only after holding an enquiry and giving sufficient opportunity to the merchant banker of being heard.

\textsuperscript{7} The Financial Express Bureau, "Merchant banker, brought under SEBI, made accountable". The Financial Express, Jan 2, 1993.
Mr. Vishal Bakshi has made an attempt to highlight the issue that discontent is brewing among the private merchant bankers over the influence used by nationalised banks in securing business for their merchant banking subsidiaries.

He also pointed that the modus operandi adopted by banks is simple, companies enjoying credit facilities and loans from the banks and persuaded to appoint the merchant banking subsidiaries of these banks as merchant bankers for their public or rights issues. The same tactics are adopted to lure new companies who may not be existing clients of the banks. This places the private merchant bankers at a disadvantage.

Chabungbam Jadunanda Singh and Bibhuti Bhusan Pradhan conducted a survey through a questionnaire mailed to 102 registered merchant bankers of India to assess the riskiness of 20 sample companies shares across the industry selected from 30 companies of Bombay Stock Exchange sensitive index group on a nine point scale for measuring risks and familiarity on their own assumption that the shares were being purchased now and was to be held for a well diversified portfolio, 27 respondents complied to the request. The risk perception of the merchant bankers was associated with seven accounting variables i.e., dividend pay out, current ratio, asset size, asset growth, financial

Vishal Bakshi., "Discontent among merchant banks", The Indian Express, Jan 27 1993
leverage, earning variability and earning coverability for 20 sample companies to ascertain their relationship for a significant analysis.

A study conducted by Sankar De and Sushil Khanna has pointed out that the economic and financial implications of some of the regulations introduced by the Securities and Exchange Board of India, through the guidelines it has periodically issued, in execution of its responsibilities. The regulators in question apply to investment or merchant banking services required for corporate issues of long-term securities in India.

Their study is concerned with determining whether the changes being effected by the regulations are consistent with the twin goals of capital market development and investor protection.

In trying to market the new issue the merchant banker performs a number of different functions, including selection of advertisements, bankers, collection centres and bankers. None of them, however compares in importance with the task of securing underwriting arrangements for the issue.

The success of a rights issue is virtually costless, the difference in issue costs of a rights offering and a public offering of the same size and same certainty of issue success can be substantial. For example, for a Rs. 50 crore offering of new equity in India, the cost differential can be as much as 6.6 per

cent of the issue proceeds if the rights offering is not managed by a merchant banker, 0.6 per cent going toward merchant banking fees, 2.5 per cent towards underwriting commission, 1.5 per cent towards brokerage fees, and around 2 per cent being accounted for by the other expenses.

The guideline which has made full underwriting mandatory for a public issue. It also lays down a minimum 90 per cent subscription rule. If an issuing company does not receive 90 per cent of the issues from public subscriptions plus accepted commitments from the underwriter, within 120 days of the opening of the issue, the company is required to refund the subscribed amount.

They concluded by offering the following suggestions.

The following modification could be proposed. Continue the 90 per cent subscription rule but make it stronger and have the issuing corporations refund the subscriptions with a penalty, the amount of the penalty in each case being proportional to the extent of the shortfall from 90 per cent.

Given the provision, underwriting could be made optional for the corporations. Their choice of the level of underwriting - low, high or full as the case may be - would then signal their private information about the quality of their issues, a low level indicating a high quality.
A study conducted by the Editorial Board of Southern Economist highlighted the provisions made under the Securities and Exchange Board of India with regard to the procedure for inspection, obligations and responsibilities of underwriters and a code of conduct.

SEBI has assumed powers to cancel the registration of underwriters found indulging in deliberate manipulations, price rigging or cornering of shares. The code of conduct lays down that every underwriter should observe high standards of integrity and fairness in all dealings with clients and other underwriters.

The rules stipulate that the underwriter will enter into an agreement with each body corporate on whose behalf underwriting is being undertaken. The agreement will stipulate the period within which the underwriter shall subscribe to the issue after being asked to do so by the body corporate, the precise commission payable to the underwriter and details of arrangements for fulfilling the underwriting obligations. The rules debar an underwriter from deriving any direct or indirect benefit from underwriting the issue other than the commission of brokerage payable under the agreement.

The study focused its attention only on the underwriting activity. The other services of merchant bankers are not analysed.

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Mr. S.P. Srivatsava has pointed out that the Securities and Exchange Board of India provides investor protection and regulates the functioning of the capital and securities market.

He also pointed out the organisational set up of the SEBI. Thereby its activities have been divided into five operational departments, each of which will be headed by a senior official of the rank of Executive Director and reporting to the Chairman. The five departments are:

1. Primary market policy, intermediaries and investor grievances and guidance department.
2. The issue management and intermediaries department.
3. Secondary market, new investment products and insider trading department.
4. The secondary market exchange administration and non-member intermediaries department.
5. Institutional investment, mergers and acquisitions, research and publications and international regulations department.

SEBI has issued stringent regulations to curb the practice of insider trading. A comprehensive guideline for disclosure and investor protection was also issued by SEBI.

Another regulation towards investor protection is a regulatory framework for portfolio management services. SEBI has introduced compulsory registrations of portfolio managers.

SEBI will also take into account all matter, relating to the efficient and orderly conduct of the affairs of Mutual funds, such as, track record of a sponsor with a minimum experience of five years in the field of financial service, integrity in business transactions and financial soundness.

His main findings are that gross irregularities in allotments are being made under the employees quota. Employees of banks, financial institutions, some lead managers and even senior state and central government officials have been getting allotments under these quotas. This has happened in at least 40 companies including Tata Timken.

A study made by Mala B. Gandhi has analysed the boom period in merchant banking. The scenario in the Indian industry is witnessing drastic changes in the wake of the liberalisation norms announced since 1991. With 100% rupee convertibility now a reality; the industry is gradually poised for an interface with the world economy.

Merchant bankers entering into agreements with corporate clients are under obligation to furnish proper disclosures pertaining to any public issue.

its allotment and refund; maintenance of books of accounts, submission of half yearly reports to SEBI to ensure accountability and transparency in their operations.

The recent decontrol measures have injected fresh momentum in the capital market with more and more companies preferring to raise finance through public issue. Currently estimated at Rs.26,000 crores in the year 1992-93 is against Rs.5,400 crores in the year 1988-89 raised by way of capital issues.

The study concluded that with the competition becoming formidable and ever-growing only those merchant banking divisions who enjoy investor confidence, corporate credibility equipped with expertise; a keen perception for growth and capital adequacy would carve a way for themselves in the fast expanding global capital market.

A study conducted by K.K. Bajaj has highlighted the current scenario of merchant banking during the period 1992-93.

There has been a host of mega issues from companies turning increasingly towards the investor, for funding their projects rather than taking term loans. About ten companies entered the market with public issues of more than Rs.100 crore each.

During the year 1992-93, the amount raised from the right issues rose sharply.

There were as many as 25 right issues of over Rs.100 crore each.

A study made by K. Shankar pointed out that merchant banking is a service function extended by financial institutions including commercial banks to clients.

In India merchant banking was initially confined to the management of public issues of the corporate sector. But today, the scope has widened considerably and has gone beyond issue management. Many banks' merchant banking decisions are now engaged in providing a wide spectrum of financial and related services to their clients. Services undertaken by merchant bankers like i) management of public issues, ii) underwriting of public issues, iii) Bankers to the issue iv) project counselling, v) term loan syndication vi) project counselling vii) investment advisory services, viii) venture capital financing, and leasing.

FRAME WORK OF ANALYSIS

Statistical techniques like correlation analysis, regression analysis, chi-square test, percentage analysis, analysis of variance under Duncan's

Multiple Range Test (DMRT) and Least Significant Differential Test (LSD), Curve of best fit and Co-efficient of variation have been adequately employed.

In addition charts, graphs and bar-diagrams have also been used to give a diagrammatic representation to the study.

SCOPE OF THE STUDY

Merchant banking activities are undertaken by banks in the public as well as in the private sector, brokers and finance companies.

In the present study merchant banking activities undertaken by banks / subsidiaries alone have been analysed from different angles.

PERIOD OF STUDY

The present Research Study takes into account eight select merchant banks covering a minimum period of six years from 1989-90 to 1994-95.

METHODOLOGY

The data pertaining to the present study were collected both from the primary and secondary sources.

The primary data were collected through mailed questionnaires prepared separately for banks and companies in the financial services market.
The required secondary data for the study were collected from various publications, periodicals, journals, dailies as well as from the annual reports and published reports of the banks.

Collection of data is effected from the offices of merchant bankers and also from the Social Science Documentation Centre, New Delhi.

**HYPOTHESES**

The following null hypotheses have been formulated and tested in the study.

1. There is no significant relation between commission and other expenses.
2. There is no significant relation between commission and total expenses.
3. There is no significant relation between other expenses and total expenses.
4. There is no significant association between cost of issue and size of issue.
5. There is no significant difference among the merchant bankers with respect to amount raised.
6. There is no significant difference among the underwriters with regard to underwritten percentage on equity shares.
7. There is no significant difference among the underwriters with regard to underwritten percentage on Non-convertible debentures.
8. There is no significant difference among the underwriters with regard to underwritten percentage on Convertible debentures.

LIMITATIONS OF THE STUDY

i. The study has taken into account only a few aspects such as issue management, underwriting and project appraisal due to scarcity of time as well as resources at the disposal of the researcher.

ii. A comparative study of the performance of the merchant bankers in other fields are outside the purview of this study.

CHAPTERISATION

The first chapter deals with the introduction as well as the methodology of the study covering objectives, scope, frame work of analysis, period of study, limitations of the study and hypotheses.

The importance of merchant banking and also a brief account of the origin, growth and working of merchant banking are dealt within the second chapter.

The third chapter portrays the merchant banking services rendered by various institutional agencies both in the public and private sector.
The fourth chapter focuses on the role and significance of SEBI in India.

The performance evaluation of services rendered by select merchant bankers in the specific area of issue management, underwriting and project appraisal has been made in the fifth chapter.

The problems faced by the merchant bankers in the specified areas of activities are highlighted in the sixth chapter.

The concluding chapter contains the summary of the findings and the suggestions offered in the light of the above for improving the working of merchant banks.