

## **CHAPTER I**

### **INTRODUCTION**

This chapter provides the background to the research proposition and describes the statement of problem.

## **1.1 BACKGROUND**

The growth and expansion of public sector banks can be categorised in to three phases i.e pre-nationalisation, post-nationalisation and post- liberalisation period. In the pre-nationalisation period banks were controlled and managed by private owners and profit making was the sole objective of the private banks. As a result, common men suffered in many respects in order to avail the banking services. In 1969, the Government of India nationalised 14 major commercial banks and another 6 commercial banks during 1980 with the objective of making banking services available to a larger section of the society. The primary goal of the nationalized banks is to render services while profit earning remains secondary. After nationalization, efforts were made to open new branches in rural parts of the country. Hence we see that more than 56 per cent of bank offices are located in villages and 20 percent are in semi-urban areas. The mass banking concept was developed during post nationalisation period. The profitability of banks was affected by the high cost of branch expansion, extension of higher percentage of credit portfolio to generally low yielding assets, growth of non-performing assets, increasing cost of personnel and administration etc.

The philosophy of liberalisation, globalisation and privatization was intensified in 1991. Tremendous changes occurred after liberalisation in the banking industry. The entry of private banks and foreign bank branches posed a stiff competition to the public sector banks. Over the years, other financial institutions have emerged in the finance sector. A number of new saving instruments were introduced and earning a good yield as compared to those offered by the commercial banks for similar instruments. The fluctuating interest rate

provided by these banks created adverse impact on the saving mobilisation in commercial banks.

The public sector banks with new challenges diversified their products and services. The banking industry began to move from its core area of traditional services to modern services. They are now diverting from banking business to non-banking business areas. Public sector banks are also facing competition from private finance companies, co-operative credit societies and capital market.

## **1.2 FINANCIAL SERVICES IN PUBLIC SECTOR BANKS**

The pre-nationalisation era of banking industry consisted of financial services and products which were largely traditional in nature such as accepting deposits, lending loans, overdraft, cash credit, bills discounting etc. Accepting deposits and lending credit was the core service of banking industry. In the post-nationalisation period banks played an vital role in extending banking services in rural areas, mobilising and channelising resources, providing finance to weaker sections of the community. During this period there was a gradual shift from urban to rural banking, from class banking to mass banking and traditional to modern banking.

The implementation of Narasimham Committee Report from 1992-93 brought about a tremendous transformation in banking industry. Public sector banks diversified their services from traditional to non-traditional services<sup>1</sup>. It includes merchant banking services, factoring, mutual funds, hire purchase and

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<sup>1</sup> A.K. Kanthale, Diversification of Banking business to meet the challenges-problems and prospects of departure from traditional banking, The banker, June, 1989

leasing, housing finance, credit cards etc. and also emerging services like internet banking, insurance were introduced in banking industry. These services are more of non-banking nature than banking services. These services are classified into fee-based and fund-based services. Fee based services includes issue management, portfolio management, co-operative counselling, loan-base syndication, arranging foreign collaboration, mergers and acquisition etc. and fund based services include equipment leasing, hire-purchase, bills discounting, loans syndication, venture capital, housing finance, factoring etc. In the post liberalisation period the importance of fee –based services rendered by public sector banks has increased more than fund-based services.

### **1.3 FACTORING AND MUTUAL FUND SERVICES OF PUBLIC SECTOR BANKS**

Public sector banks provides various services which are of non-banking nature and important services includes factoring and mutual funds. These services are provided by public sector banks by establishing separate subsidiaries.

The term factor has its origin in the Latin word Facere meaning to make or do, i.e to get things done. During the 15th and 16th centuries, factors were appointed by manufacturers in England, France and Spain to arrange for the sale and distribution of their goods. During the 19th and 20th centuries the manufacturers retained their distribution function, but transferred the financing, credit and collection function to these factors.<sup>2</sup>A factor is an agent who finances through the purchase of account receivables. Factoring is the type of financial

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<sup>2</sup> K.Nirmala, Factoring services in India , Journal of the Indian Institute of Bankers vol.68,No1,Jan.1997

services rendered by specialised agents to help manufacturing and trading organisation in management of their receivables. It involves outright purchase of receivables of the firm by factoring agent.

Factoring is defined as a continuing legal relationship between a financial institution (the factor) and a business concern(the client) selling goods or providing services to trade customers(the customers) on open account basis. The factor purchases the clients book debts(account receivables)either with or without recourse to the client and in relation there to controls the credit extended to customers and administers the sales ledger

The study group appointed by international institute for unification of private law (UNIDROIT)<sup>3</sup> has defined 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

According to dictionary of finance, factoring is the buying of trade debts of a manufacturer assuming the task of debt collection and accepting the credit risks.

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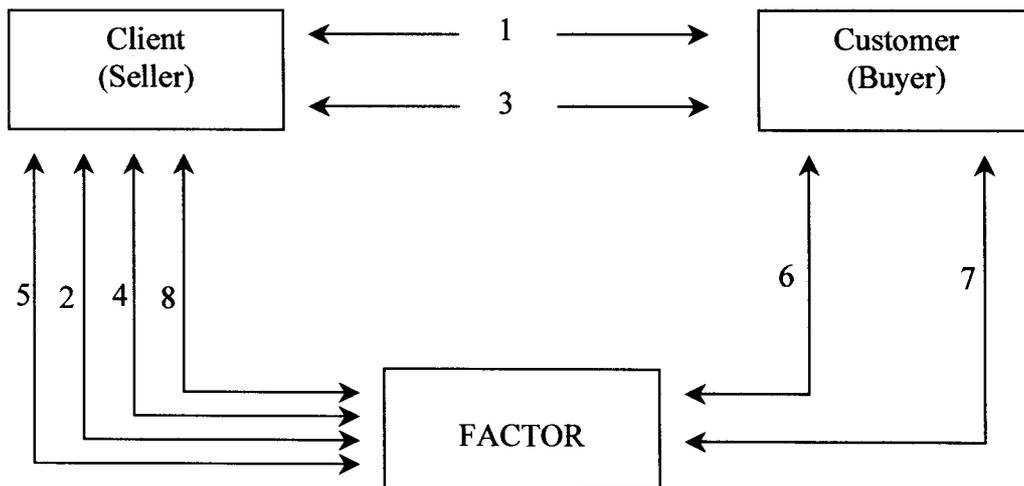
<sup>3</sup> Report of the International Institute for Unification of the private law (UNIDROIT) as quoted by Prof A.K .Sengupta and Dr .S. V .Kavalekar, in factoring services, skylark publication. New Delhi.

Thus provides the manufacturer with working capital. A firm engaging in factoring is called a factor.<sup>4</sup>

Factoring can broadly be defined as an agreement in which receivables arising out of sale of goods/services are sold by a firm(client) to the factor(a financial intermediary) as a result of which the title to the goods/services represented by the said receivables passes on to the factor.<sup>5</sup>

According to Khoh, Factoring is an asset based means of financing in which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods,<sup>6</sup>

The process of factoring can be explained as follows<sup>7</sup>



<sup>4</sup> A dictionary of finance, oxford university press,1993,p.104

<sup>5</sup> M .Y Khan, Financial services, Tata Mc-Graw Hill publishing company ltd , 2002 ,p.no 62

<sup>6</sup> E. Gordon and K. Natarajan :Discounting, factoring and forfaiting, Financial markets and services, Himalaya Publishing house, Delhi pp 309-310

<sup>7</sup> K. Nirmala, Factoring Services in India, The Journal of the Indian Institute of Bankers, Vol. 68, No. 1, Jan-March, 1997.

- 1) Customers places order on the seller
- 2) Factor and client fixes the customers limit.
- 3) Client delivers goods and invoice with notice to pay the factor.
- 4) Client sends an invoice copy to the factor.
- 5) Factor prepays 80 percent to client.
- 6) Factor does follow up with the customer.
- 7) Customer pays to factor on maturity.
- 8) Factor pays balance amount to the client.

### **Importance of Factoring**

Factoring is a process of selling debts to financial intermediate(factor) by a client(seller).The factor pays nearly 70-80 per cent as an advance money or prepayment amount to client and balance after collection of debts from the customers. Prepayment amount is used as working capital by which it helps to reduce the quantum of working capital. The delay in collection of the receivables would result in huge requirement of working capital. The receipt of the advance money from factor will reduce the borrowing from other sources and ultimately it reduces the cost of borrowings..

In factoring, the factor undertakes the responsibility of collecting debts from customers and sales ledger is maintained by the factor itself. This helps to relieve the client from collection of debts which will save their time in debt collection process and also cost incurred in collection process will reduce . Factoring is very useful for small scale firms who finds more economical to factor than to establish its own credit department. Establishment of own credit

department will increase the cost and consumers time. Such units do not have an organizational set up and/ or expertise in the area of credit management to attend to the follow up and the recovery of dues from suppliers. Factoring is also useful for new firms as they are new in the market and the collection of debts is difficult.

Factoring is also helpful in maintaining good relation between clients(seller) and customers(buyers). Good relationship with the customers will help to build goodwill and reputation in the market. Factoring also helps in the expansion of business through receipt of payment amount and relieves the client from debt collection process. It will help to reduce the current liabilities and also to improve the current ratio. Factoring works best for firms that have long delays between the making and the selling of goods and cash collection.<sup>8</sup>

The purchase of debts by factor will be off the balance sheet and it will not appear in the balance sheet. It will appear as a contingent liability if the transaction is with recourse factoring. Factoring service is helpful for the collection of export receivables. Exporters not only need protection of their interest against non-payment of debts, but also additional support in the form of adequate cover against exchange rate fluctuations, closer and continuous contacts with foreign buyers, setting up warehousing facilities etc.

Factoring works best for firms that have long delays between the making and the selling of goods and collection. Service industries such as advertising and publishing are prime targets for factoring. Also start-up companies and emerging

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<sup>8</sup> G. Kendall Hubbard, Factors image: Under exposed, ABA Banking Journal, Nov, 1987

business with low turnover are ideal areas for factoring services. As these business do not have or are be able to afford sophisticated credit and collection systems.

### **Types of Factoring**

Factoring can be classified in to various types and they are as under ;

#### **1) *Full factoring or Non-Recourse factoring***

It includes of receivable and maintainence of sales ledger, credit control, credit protection i.e insurance cover for customer default and finance. Basic feature of this type of factoring is that risk of default is borne by factor.

#### **2) *Resource factoring***

It does not cover the credit risk of debts, but entitles the factor to recover advance paid to the client if the customer fails to pay the invoice amount on the due date. In recourse factoring the factor does not bear the non payment from customer.

#### **3) *Advance factoring***

Under this arrangement, the factor provides advance at an agreed rate of interest to the client on uncollected and non-due receivables

#### **4) *Undisclosed factoring***

Under this type of factoring customer is not notified about the arrangement between the client and the factor

### **5) *Invoice Discounting***

In this arrangement, the only facility provided by the factor is finance. In this method the client is a reputed company who would like to deal with its customers directly.

### **6) *Disclosed factoring***

Here the factor informs the relationship between himself and client to the customer.

### **7) *Export factoring***

In this type of factoring, services are provided to exporting companies and the factor collects amount due from the importers in other country.

## ***MUTUAL FUND***

Mutual funds are the fastest growing segment of the financial service industry<sup>9</sup>. It has emerged as a main vehicle of investment and important source of returns for small investors on their investments. The volatility in the capital market and reduction of interest rates on deposits diverted a large number of small investors towards mutual funds.

Mutual fund are trusts which accept savings from investors and invests the same in diversified financial instruments. It is a process of pooling large funds from small investors and return back with handful dividend or with appreciated value of units.

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<sup>9</sup>S.Ganeshan, Mutual funds the Millenium strategy, Indian Management, vol 39, No-10

According to Securities and Exchange Board of India (mutual fund) Regulations, 1996 a mutual fund means a fund established in the form of trust to raise monies 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.<sup>10</sup>

The concept of mutual fund in India was introduced in the sixties. Unit Trust of India made their entry in to mutual fund business in 1964 with Unit Scheme 64, popularly known as US 64. The domination of the UTI was over when Government opened mutual fund business to public sector banks in 1987 and further to private sector in 1993. The fund mobilized through various schemes by UTI, public sector banks and private sector mutual fund companies brought about a significant contribution in the Indian mutual fund industry..

### **Types of Mutual fund schemes**

Fund mobilized by the mutual fund from small investors is through various schemes. These schemes are classified in to open ended schemes and close ended schemes.

#### ***Open ended schemes***

These schemes do not have a fixed maturity . The investor can deal directly with mutual fund agency for investment and redemption. Liquidity is one of the

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<sup>10</sup> Amitabh Gupta :Mutual funds in India, Anmol publications Pvt. Ltd. ,p.10,2002

important feature of this scheme. Transactions are made on the basis of Net Asset Value (NAV).

### ***Close ended schemes***

These schemes have stipulated maturity period ( ranging from 2 to 15 years) The investor can invest in the scheme at the time of the initial issue and thereafter buy and sell the units on the stock exchanges where they are listed or these will be purchased by the mutual fund upon their maturity.

Mutual fund schemes are again classified on the basis of investment objectives.

#### ***1) Growth schemes***

These schemes invest a majority of their funds in equities. The aim of these schemes is to provide capital appreciation over the medium to long term.

#### ***2) Balanced schemes***

These schemes invest both in shares and fixed income securities in the proportion indicated in their offer documents. Balance schemes provide moderate risk and moderate return to the investor as the NAV of these schemes may not keep pace or fall equally when the equity market rises or falls respectively.

#### ***3) Income schemes***

These schemes invest largely in debt instrument and money market instruments like bonds, debentures , government securities, commercial papers or in the inter- bank call money market. These instruments provide a fixed interest

which is generally paid out at various intervals. Capital appreciation in these schemes is limited with negligible risk. However the return in these schemes are normally higher than bank fixed deposits.

**4) Money market schemes**

The aim of these schemes is to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer, short term instruments such as treasury bills, certificates of deposit, commercial paper and inter- bank call money. The returns on these schemes may fluctuate, depending upon the interest rates prevailing in the market.

**5) Gilt Funds**

These scheme invest their entire corpus in sovereign securities issued by the central Government and a very small portion in inter-bank call money market. All of these instruments carry the highest rating thereby giving absolute security of investment.

**1.4 REGULATORY FRAMEWORK FOR FACTORING AND MUTUAL FUND**

The regulatory framework issued by RBI and SEBI for factoring and mutual fund services are as follows:-

### **1.4.1 Factoring**

The Reserve Bank of India was accepted most of the recommendation made by the Kalyansundaram committee and following guidelines were issued<sup>11</sup>

- 1) A factor firm requires approval from R.B.I.
- 2) Bank shall not themselves undertake directly(i.e departmentally)the business of the factoring. Bank may set up separate subsidiaries or invest in factoring companies jointly with other Banks with the prior approval of department of banking operation and developments, R.B.I
- 3) A factor may undertake factoring business and such other activities which are incidental thereto.
- 4) Investment of a bank in the shares of factoring companies.  
(inclusive of its subsidiaries carrying on factoring business) shall not, in the aggregate, exceeds 10 per cent of the paid up capital and reserve of the bank.
- 5) A factor should not engage themselves in financing of other companies or concerns engaged in factoring

### **1.4.2 Mutual Fund**

Before 1993, there were three sets of mutual fund guidelines:-

- 1) guidelines pertaining to the UTI,
- 2) the guidelines issued by the RBI
- 3) ministry of finance guidelines.

In September,1991 the government of India appointed a committee under the chairmanship of Dr.S.A.Dave, then chairman of the UTI , to suggest a set of comprehensive guidelines for the Indian mutual fund industry. Based on the

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<sup>11</sup> Venugopal s , Factoring and Receivables management, Chartered secretary ,volume xxx no 4

recommendations of the Dave committee, the Securities and Exchange Board of India issued the SEBI(mutual funds) Regulations, 1993 which were applicable to all mutual funds excepting UTI. Thus , the 1993, regulations provided for the first time a formal and comprehensive regulatory framework for mutual funds and consisted of eight chapters and seven schedules. In 1996, SEBI announced the revised SEBI (mutual funds) Regulations 1996. At present , the mutual fund industry is governed by the SEBI(Mutual funds)Regulations,1996.

The regulation contains ten chapters and twelve schedules and annexures. The Act is amended in 1998 and time to time notifications has been issued by SEBI and all amendments are enacted. Mutual fund Act (1996) has been reviewed as under<sup>12</sup>

Chapter one consists of preliminary which includes short title, application and commencement. It contains the definitions of different terms defined under the Act.

Chapter two consists of registration of mutual fund. It lays down the rules and regulation for registration of mutual fund. The procedure includes registration, fee charged, eligibility criteria, certificate of registration, payment of service fees. Fees payable by mutual funds include application fees Rs25000 ,Registration fees Rs 25 lakhs, service fees Rs 250000 and filing fees for offer documents Rs 25000 and it should be paid by bank draft payable to the Securities and Exchange Board of India at Mumbai. The eligibility for certificate of registration should have a

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<sup>12</sup> Taxman, New SEBI (Disclosures and investors protection guidelines, 1999, pp

sound track record and general reputation of fairness and integrity about the business transaction.

Chapter three contains constitution and management of mutual fund and operation of trustees etc. The mutual fund shall be constituted in the form of a trust and should be registered under the provision of the Indian Registration Act,1908. This chapter contains the trust deed and its contents, disqualification from being appointment as trustee, rights and obligations of trustee. The third schedule contains the contents of the trust deed which includes the duties and responsibility of trustee, power of the trustee and regulations for trustees and asset management companies. The third schedule includes the clauses which are necessary for safeguarding the interest of the unit holders. The trustees and asset management companies shall carry out the business and invest according to objectives stated in the interest of unit holders. In real practice interest of the unit holders are not protected since investment decision depends on the trustees and asset management companies and they make decision to protect their benefits.

Chapter four includes the constitution and management of an asset management company and custodian. The appointment of an asset management company and eligibility criteria, terms and conditions to be followed and restriction on business activities of the asset management and their obligation besides in the chapter. Custodians and its appointment, agreement are also included in this chapter. The Sponsor or trustee shall appoint an asset management company and appointment can be terminated by the majority of the trustee or by seventy – five percent of unit holders of the scheme. Any change in appointment requires

prior approval of the board and the unit holders. The eligibility of asset management company contains sound track record , general reputation and fairness in transaction. Director should have adequate professional experience in financial matter. 50 percent of the director should not be in any way associated to sponsor. The asset management company has a net worth of not less than rupees 10 crores. Restriction on business activities include not to act as trustee of other company and shall not undertake any other business activities except activities in the nature of management and advisory services. The asset management company shall abide by the code of conduct as specified in the fifth schedule .

Chapter five describes the different schemes of mutual fund and their procedures. The launching scheme requires prior approval of the trustees and a copy of the document has been filed with the board. Disclosures in the offer document, advertisement as per the sixth schedule are discussed in this chapter. Listing of close ended schemes, its repurchase, refund of money and the winding of the close ended schemes are briefly described in this chapter. The investment objectives and valuation policies are mentioned in chapter six. According to it the money collected under any scheme of a mutual fund shall be invested only in transferable securities in the money market or in the capital market or in privately placed debentures or secured debts. Mutual fund shall not borrow funds except at the time of repurchase, redemption of units or payments of interest or dividend to the unit holders and that also limited to 20 percent of net asset of the scheme with maximum for six months. Mutual fund shall not be used in option trading or in short selling or carry forward transaction but mutual fund can enter in to derivatives transaction in a recognised stock exchange. The computation of net

asset value, pricing units and publishing it in newspapers at least once in a week is mandatory . Publishing net asset value and price units in news paper will assist the investor to decide about their units. The repurchase price of units shall not be lower than 93 percent of the net asset value and the sale price is not higher then 107 percent of the NAV.

General obligation relating to maintaining proper books of account and records, limitation fees and expenses on issue scheme, dispatch of warrants and proceeds, annual reports , auditors reports, publications of annual reports etc are stated in this chapter. Mutual fund companies should make half –yearly disclosures on 31<sup>st</sup> March and 30<sup>th</sup> September by publishing in news paper. This will help the mutual fund to have transperency and protect the interest of the small investors.

Inspection and Audit of mutual fund are discussed in chapter eighth. It contains the rights of the board to inspect and investigate , notice before inspection and investigation and obligations. Fees should be paid to board for purpose of inspecting books of accounts, records and documents. The procedure for action in case of default are included in chapter nine. The suspension of certificates, cancellation of registration and miscellaneous matter about power of the board to issue clarification and repeal and saving are included in chapter ten.

## **1.5 THE STATEMENT OF PROBLEM**

Finance is the life blood of business organisation. The financial institutions especially banks play a vital role in contributing capital to business enterprises. Nationalisation of banks in 1969 gave a momentum of mass banking to remote

corners of the country. The branch expansion of public sector banks has raised the horizon of employment opportunities in the economy. The industry and agriculture were considered to be as priority sectors for the growth and development of Indian economy. The Government helped immensely to implement plans and policies for the weaker sections of the community through the public sector banks .

The influence of social and economic objective in public sector banks have created an adverse impact on productivity, efficiency and profitability. The profitability of public sector banks has deteriorated and growth of non performing assets have accelerated. Political interference, branch expansion and poor efficiency of employees were some of the reasons behind the decrease in profitability.

The globalisation and liberalisation waves created a strong competitive environment in banking industry. The entry of private bank and foreign bank branches and Government encouragement to co-operative sector have put the public sector banks in economic and financial crises. The diversification of services from banking to non-banking were taken as a priority items on the agenda of public sector banks in post liberalisation period. There was a gradual shift of financial services from traditional to modern. The modern services like factoring, mutual fund, housing finance, gilt securities, credit cards were introduced by the public sector banks through establishing separate subsidiaries.

Factoring service helps industry to sell their debts to factor and reduce the flow of working capital. Factoring in public sector banks has shown a considerable growth in its factored debts, total assets, reserves and surplus and total income. At the same time ,an increase in the size of outstanding debts, non performing assets and a decrease in profitability and an increase of liquidity in Factors necessitated the need for investigation about the growth and performance of factors. The efficiency and productivity can be ranked with other organisation hence, comparativeness between two factors awareness and, problems of customers need to be investigated.

Mutual fund pools the saving from the small investors and invest in capital market which helps for industrial growth of the economy. Mutual fund of public sector banks has shown a sizable growth in their fund mobilisation, number of schemes, number of investors and income generation. But at the same time performance evaluation of mutual fund scheme, problems and awareness of investors required to study. The performance of mutual fund can be rated higher or lower if it is compared with other mutual fund. Hence, comparison was made between the mutual fund of public sector banks.

The importance of factoring and mutual fund as the financial services of banks made a researcher to evaluate and compare their size, growth and performance.