CHAPTER – I

INTRODUCTION

The economic development of a country depends largely on the growth of financial system. The system is meant to mobilise capital resources from diverse sources and channelise the same to multifarious productive areas. In this process, financial institutions play the role of intermediaries. These intermediaries include both banking and non-banking institutions rendering yeomen services. The former concentrate on fund based activities while the latter concentrate on fee based activities, though some of the latter units undertake even the fund based activities. The amendment to the Banking Regulation Act in 1984 opened the floodgates to the banks to undertake ‘non-banking services’.1 As a result, banks promoted their own subsidiaries to undertake housing finance, lease financing, merchant banking, etc. Among these various intermediaries, merchant banks have a crucial and typical role to play in the financial system.

“Merchant banks are issue houses rendering such services to industrial projects or corporate units as floatation of new ventures and new companies, preparation, planning and execution of new projects, consultancy and advice in technical, financial, managerial and organisational fields. A number of other functions such as
restructuring, revaluation of assets, mergers, takeovers, acquisitions, etc., are also undertaken by them."

The need for institutions like Merchant Banks (MBs) was recognised by the Banking Commission set up in 1972. In its report the Commission opined that, "there is a *prima facie* case for the creation of institutions to offer services like the preparation of projects and giving advice on management and financial problems." The Commission recommended initially four merchant banking institutions to be set up by commercial banks and specialised financial institutions.

The MBs are the most crucial links between companies raising the funds and the public who invest their savings. An MB's reputation goes a long way in making an issue a successful one. MBs as financial intermediaries, ensure the flow of community savings into productive avenues and the commercialisation of budding entrepreneurs' ideas and innovations.

Besides Initial Public Offers (IPO), the MBs have to assure adequacy of funds for corporates' expansion, diversification, replacement, renovations, etc., by successfully managing Further Offers (FOs) and Rights Issues (RIs) of both equity and debenture instruments. The very concept of minimum subscription stipulated in the Indian Companies Act makes the role of the MBs inevitable. The MBs as issue or lead managers instill investors' confidence in the issues floated and assure corporates of minimum subscription, the absence of which
will lead to jettisoning of ideas and innovations of entrepreneurs. Further, social responsibility on the part of MBs expects them to weed out entrepreneurs floating new issues with unviable projects and perforce the young technocrats with viable ideas through better issue management.

The corporates’ capital structure, capital budgeting and profitability aspects are decided by MBs working. MBs efficiency in issue management affects issuers’ floatation costs and cost of capital. Higher floatation cost leads to higher cost of capital. The higher cost of capital may vitiate even the very profitable proposals.

The investment culture in any economy to a great extent depends on the activities of MBs. The dubious and unscrupulous MBs in connivance with unscrupulous promoters with malafide intention kill the equity culture. This leads to diversion of funds from equity markets to bank deposits, thus jeopardising the objectives of disintermediation.

The investors too depend on the MBs in making investment decisions. The issue manager appeals attractively to the investors. The good and highly rated MBs can heighten investors’ confidence and make them to invest in the issue. The MBs are considered to be ‘oasis in a desert’ for such investors who lack sufficient information from the companies and are unable to take their independent decisions.
The growth of sick units in corporate sector poses a threat to the development of Indian economy in the emerging world of liberalisation and globalization. The MBs, with their rich experience and knowledge, have to frame action plans to overcome the mismanagement aspects and strengthen the units to withstand environmental threats.

The free flow of international funds is the most expected factor for which the MBs can create and develop a healthy investment environment and foreign friendly projects.

In the wake of reforms and innovations introduced in India in 1991-92, the capital market is getting deepened in which MBs have a dynamic role to play, requiring myriad skills, expertise, technology, etc. All of these will lead to the ‘financial engineering’, i.e., a drive for development and implementation of creative solutions for the problems.

The multi-dimensional role of MBs could boost the issuers' morale, investors' faith and enthusiasm of policy makers. The important services which MBs perform can be studied from the point of investors, corporates, economy, etc.

**Important Services Rendered by MBs to:**

**(A) Economy:**

* Conversion of savings into corporate investments,
* Cultivation of equity culture,
Construction of sound capital market,
Co-ordination and co-operation among various participants,
Carrying the tempo of liberalisation, globalization, and privatisation,
Creation of healthy investment environment to attract foreign funds,
Assistance in foreign collaborations, mergers, amalgamation, etc.

(B) Investors:
Provision of genuine investment opportunities,
Providing optimum disclosures about the issues,
Educating the investors,
Vetting of offer documents or prospectus,
Regulations of allotment procedure, grievances, etc.
Providing post issue care,
Adopting rational pricing policies of issues, etc.

(C) Corporates:
Conversion of project ideas into industrial ventures,
Guidance in tapping different sources,
Select and co-ordinate various participants in capital market,
Perform efficiently the issue related activities,
Advise in corporate decisions like capital mix, restructuring, mergers and amalgamations,
Maintain high integrity, secrecy of corporate data, and
Assist in expansion, diversification, etc.
Need for the Study:

The MBs in India comprise the multifarious institutions, which include financial institutions at central and state levels, foreign and private MBs and subsidiaries of public sector banks, etc. The nationalised commercial banks with their independent merchant bank subsidiaries structure occupy a key position. These subsidiaries are being blessed by competitive networking of their parent institutions who are the forerunners of merchant banking activities in India.

Since bank subsidiaries carry the onus of social responsibility, they have to assume a unique role in the economic progress of India. They have to aim at service rather than profits. Their strategies should aim at purifying the contaminated capital market operations. Further, the inclusion of pure advisory services into their functional spectrum has a special significance, for, it is the value based professionalised advice given by them to the investors, corporates and to the government. They have to nourish and nurture the equity cult by boosting the investors' confidence and channelising their savings towards corporate securities. Their sound fundamentals are an added advantage in the process of salvaging the ideas of technocrats who suffer from scant public support and confidence.

As such the merchant bank subsidiaries of public sector banks are expected to be viable both operationally and financially. These MBs should be intact in their functioning. Any inefficiency on their part
would be a great handicap in developing viable and reliable financial markets.

Though there has been a substantial expansion in their size, coverage and operations with considerable government encouragement particularly in the post-liberalisation era, an in-depth study of their functioning is conspicuous by its absence. Certain inconsistencies and imperfections in their performances have marred the smooth progress of capital market recently. The growing number of ‘vanishing companies’ in India is a mirror to the functioning of the MBs and is a real cause for worry.

There has been a criticism against the MBs that they make a hay when the sky is clear by functioning merely as pre-issue houses, without bothering much for the post-issue happenings of the corporates. The public sector banks’ subsidiaries as MBs instead of marshalling their operations right to the needs of the corporate world, have become frustrated promoters.

At present, there are about thousand MBs on the SEBI’s register, but a very few of them are functioning actively. The most anticipated equity culture is vanishing and on the other hand debt and private placement markets are swinging.

Among the MB subsidiaries a few are running with quite appealing and successful anecdotes. The merchant banking subsidiaries of nationalised commercial banks, too have an admixture of stories all
the way. But, recently their functional spectrum has undergone a metamorphosis with the segregation of activities into fee based and fund based ones. Hence, some have closed down and some are on the verge of merger with their parent institutions. As an exception, a few are earning enormous amount of profits.

In the light of all these changes, the present study assumes a special significance.

Scope of the Study:

The study has selected the four MB subsidiaries of public sector banks for evaluating how far these subsidiaries have been effective in their working individually and comparatively. The units selected are the State Bank of India Capital Markets Limited (SBICAP), the Indbank Merchant Banking Services Limited (IBMBS), Bank of India Finance Limited (BOIFIN) and Bank of Baroda Capital Markets Limited (BOB Caps).

The reasons for selecting these four units are quite obvious. First of all, these are the subsidiaries of public sector banks promoted with specific objective of undertaking merchant banking and other related financial services. Of these units, the SBICAP stands apart. The SBICAP has been regarded as a market leader in issue management activities, selection of underwriters, loan syndication, leasing activities, etc. The other subsidiaries are vying with each other for market share. The other reasons for selecting these units are:
the units have identical objectives as prescribed by SEBI,

- the units have similar organisational structure, i.e., they are subsidiaries of public sector banks, and

- the units continue to function in the merchant banking field.

**Review of Literature:**

A review of literature on merchant bank subsidiaries reveals that, there are only a few studies concerning the bank subsidiaries and plethora of studies have been conducted on merchant banking in general. A few of the studies done so far are dealt with the aspects of public sector banks’ subsidiaries which do not have any direct bearing on the functioning of sample subsidiaries. In the following pages an attempt has been made to summarise some of the important studies made on the merchant banking services in India.

**Somwanshi, S.A. (1986) :**

The study entitled, ‘Merchant Banking : Turning Challenges into Opportunities’ concludes that the merchant banking in India is still in its infancy stage and suggests that, in order to enhance the financial advisory services to corporates, the MBs have to diversify their activities, develop human resource, publicise message of Merchant Banking, etc.

The study primarily dealt with the historical perspective and growth of merchant banking in India. The Indian MBs are the popular forms of organisations providing merchant banking services in both the pre and post-issue period of issues of the corporate securities. The study concludes that MBs of SBI and BOB are working satisfactorily and the commercial banks have a big role to play in future.

Thrikha, Kapila (1989) : 6

The present study is an attempt at critical evaluation of PIM of MBs. The study provides some insights into the PIM activity and concludes that the management of PIs should not be an end in itself but a means to an end. The MBs should be made responsible for the failure of the issues. Further, the MBs should blacklist the companies failing to comply with the prospectus promises. Such measures would ensure the faith of investing public in MBs, concludes the study.


The present study focuses on the services rendered by the modern MBs. The need to diversify the activities towards promotional, corporate counselling, factoring, etc., have been highlighted in the wake of changing industrial scenario and economic liberalisation. The researcher points out that in the sphere of capital formation, the merchant banking has to assume a pivotal role in the interest of the
development of the economy which calls for a role of liaison among the government and corporates and investing public.

* Lall Nigam, B.M. (1991) :8

The study opines that MB is non-fund based specialised service and its role in the development of entrepreneurship was examined under the fast changing infrastructure field, capital issue management, project counselling, project financing, capital restructuring, equipment leasing, etc. The study concludes that the MBs in India have failed to face the challenges and seize the opportunity of serving those companies which experienced greater difficulties. The high cost structure, big client phobia, lack of professional approach, etc., are considered to be some of the reasons for their failure.


The study thoroughly analyses the conceptual framework of merchant banks and their activity profile. The study correlates the growth of MBs with the investment habits, changing preferences for the newer securities, etc. and concludes that MBs need to diversify their activities for minimising the cost of floatation and adoption of modern technology.

* Shekhawat, G.S. (1991) :10

The study is an attempt at diagnosing the functions performed by MBs in India and opines that merchant banking is an innovative step in
the Indian banking sector. The study opines that the venture capital, portfolio management, etc., are the prospective areas and calls upon MBs to venture into such areas.

* Kamalaksha, (1992) :\(^ {11} \)

The present study is an attempt at evaluating the organisational and functional performance of SBICAP in key areas as issue management, leasing and hire-purchase, foreign funds management, OTCEI, venture capital, bought out deals, advisory services, etc. Using five years' statistical data, the study concludes that the SBICAP is expected to play a more crucial role in the dynamic capital markets of India.

* Suneja, H.R. (1994) :\(^ {12} \)

The study deals with merchant banking in India and abroad. Accepting MBs as 'neither merchants nor bankers', the study provides historical background in support of the statement. Further, it covers SEBI's regulations on disclosure norms, investors' protection, authorised services of MBs, etc. The study opines that MBs have played a significant role in funding the public and private sector companies.

* Sankar, D. and Sushil Khanna (1994) \(^ {13} \) :

The study examines the economic and financial implications of the SEBI's regulations 1992 and concludes that some of the
implications of the guidelines are in conflict with the avowed objectives of the current economic policy. Further, the guidelines may be self-defeating in that they may result in less rather than more information for the investing public about the typical qualities of new issues.


This study attempts to ascertain the risk perception of MBs in India with accounting variables. The study is based on a survey of 102 registered MBs and 20 sample companies’ shares across the industry selected from BSE sensitive index. Assuming that the shares are purchased and held for a well diversified portfolio, the study concludes that the risk perception of the MBs was associated with seven accounting variables, calculated on the BSE directory.


The present study covers the major aspects of MBs’ working and their performance with regard to the innovative products, corporate financial services, project finance, etc., The study opines that Indian MBs should work cautiously against foreign competition by adopting themselves to new service areas such as placement of commercial papers, loan syndication, capital structuring, portfolio management, bill discounting, broking, venture capital management, OTC sponsorship, leverage and buyouts, designing, rehabilitation packages for sick units,
etc. A proper coverage of these areas is a sure bet for MBs' survival and growth in the new century.

* Khuntia, Natabar (1995):*16

The study suggests that merchant banking methodology, i.e., an expert evaluating the prospects of a project before financing should be adopted to the rural lending also to make it more productive. The study expects MBs to establish special divisions, namely, 'Rural Credit Departments' to spread their activities in and across the rural areas.

* Desai Vasant (1995):*17

The study evaluates the system of merchant banking in India in the light of emerging trends. The functions performed by MBs have been studied in detail and factors responsible for the growth of merchant banking in India have been thoroughly analysed along with the organisational aspects.

* Mishra, D. (1996):*18

The study is related to the participation of MBs in PIM under the SEBI's regulations. The study covers a wide range of services offered by the MBs with a detailed coverage of pre and post-issue management of corporate securities. The code of conduct and regulations of SEBI, which are to be followed by the MBs have been highlighted in the study.
* Batra, G.S. (1996) : 19

The main focus of G.S.Batra's study is on the institutional framework and merchant banking services rendered by the development banks, viz., ICICI, IDBI, IFCI, SIDC, etc. The regulatory framework under SEBI, classifications of functions on the basis of net worth, etc., have been highlighted. Recent changes in the capital market operations with reference to CRISIL, ICRA, SHCIL, DFIH, STC, etc., have been discussed. The study focuses on the challenges ahead in the light of increasing economic interdependence among nations and cross border flow of capital.


In their study entitled, 'Towards Merchant Banking', the authors cover the historical perspective of merchant banking in India. The study notes the relevance of MBs' services in the light of recommendations of Banking Commission (1972). The growth attained by MBs during the short tenure is highly appreciated and opines that the establishment of MBs by commercial banks is a positive development and a right step in the growth of equity culture in India.


The study covered the history and growth of merchant banking in India and the rest of the world. The PIM activities of leading MBs have been evaluated in terms of number and size of the issues managed.
The study suggests that the profit can never be the only criterion of success in future and the corporate counselling, mergers and amalgamations, cash management, etc., are the few areas for which demand is increasing and expects the MBs to exploit this situation.

The Government of India appointed a number of committees to examine various issues related to stock exchanges and merchant bankers. Some of these committees' work has been provided here:


The working group under the Chairmanship of Sri Abid Hussain recommended that Merchant Bankers should be made responsible and accountable for the lapses of defaulting companies to protect the interest of investors and a statement regarding the viability of the project issued by MBs should be included in the prospectus. The above recommendations are highly appreciated in India, as they would make the MBs cautious while floating issues of new companies.

* Committee on Financial Reforms (1991) :23

A high powered committee constituted under the Chairmanship of Sri Narasimhan on financial reforms submitted its report in December 1991. The committee focused on strengthening the financial sector. The alternatives suggested are enlargement of the lines of operation, autonomy to banks, etc. The government, in the opinion of the committee, should harness the process of liberalisation of capital
market by removing restrictions on premia. The committee felt the need for a separate agency to supervise the mutual funds, merchant banks, leasing companies, etc.

Statement of the Problem:

A perusal of available literature clearly shows that there is a great vacuum in the analysis of the functioning of merchant banking organisations in general and merchant bank subsidiaries of public sector banks in particular. The public sector banks and their subsidiaries, being government owned entities owe a lot to the economy, industry and investing public at large in India. Being the harbingers of capital market's prosperity, they are expected to develop sound equity culture by managing public issues. Further, they have to provide services like assuring minimum subscription to needy and worthwhile projects; minimising floatation costs and cost of capital, undertaking other non-fund based activities encompassing project evaluation, corporate counselling, project development, etc. The segregation of activities into fee and fund based ones by the capital market regulator, i.e., SEBI in 1997 has further heightened the importance of MBs. The future of MBs in India depends on how well they perform the fee based activities like public issue management, corporate counselling, underwriting, etc. An analysis of the functioning of merchant bank subsidiaries of public sector banks on these lines was felt necessary by the researcher. Hence, the statement of the problem:
Objectives of the Study:

The following are the important objectives of the study:

1) To review the origin and growth of merchant banking activities in India.

2) To assess the organisational profile of selected merchant banking subsidiaries of public sector banks.

3) To analyse the performance of sample units with special reference to Public Issue Management.

4) To evaluate the underwriting activities and other corporate advisory services performed by sample units.

5) To appraise the financial performance of sample units and to study the contribution of fund based and fee based activities to the financial performance of the sample units.

6) To offer suitable suggestions in the light of the findings of the study.

Based on the above objectives, the study has formulated the following hypotheses.

1) "The performance of SBICAP is better than other sample subsidiaries in public issue management."
2) "An improvement in gross spread improves the net spread."

3) "There exists a distinct relation between the sources of income and net spread among the sample subsidiaries."

4) "Financial performance of sample subsidiaries depends on Public Issue Management."

5) "The financial performance of SBICAP is better than the other sample subsidiaries."

**Research Methodology:**

To accomplish the objectives and prove and/or disprove hypotheses stated above, the study collected both primary and secondary sources of information. The necessary primary information was collected through personal interviews with the officials of MB subsidiaries selected for the study.

The relevant secondary data for the purpose of study have been collected from the following sources:

* Annual Reports of the selected sample units,
* Prime Data of Praxis Consulting and Information Services, Pvt. Ltd.,
* CMIE Reports, RBI Reports on Currency and Finance, etc.
* Statistical Reports published by Department of Company Affairs, Government of India, New Delhi,
* AMBI publications,

* Existing literature on merchant banking in India and abroad.

The study covered, for the purpose of analysing Public Issue Management, a period of 11 years from 1989-90 to 1999-2000. However, the financial performance has been analysed using the published data from the date of sample units becoming subsidiaries except in case of SBICAP for which the period selected is 1989-90 to 1999-2000.

The data, thus, collected have been properly classified, analysed and interpreted with the help of comparative activity appraisal technique. The comparative activity appraisal has been used to evaluate the PIM related activities by selecting sixteen parameters and are scaled in proportion to total merchant banking activities at national level in India. The scores, thus obtained, are used for ranking sample subsidiaries.

The financial performance analysis of sample MBs has been done with the help of ratio analysis technique. Various statistical tools like correlation, multiple correlation, multiple regression, least square fit, analysis of variance, etc., have been drafted in the study profusely to test hypotheses and achieve objectives of the study.

The detailed methodology used for achieving each objective has been dovetailed in respective chapters of the study.
Chapter Scheme:

The study has been organised into seven chapters.

Chapter one covers introduction, need for study, scope of the study, review of literature, statement of the problem, objectives, hypotheses, research methodology and chapter scheme.

Chapter two throws light on the origin and growth of merchant banking in India and the world.

Chapter three provides the glimpses of the organisational profile of the selected merchant bank subsidiaries of nationalised banks.

Chapter four aims at evaluating the performance of sample subsidiaries in public and rights issue management.

Chapter five deals with the underwriting, leasing and other activities of sample subsidiaries.

Chapter six is devoted for the study and analysis of financial health and performance of sample units.

Chapter seven enlists important findings and offers suggestions for the smooth working of merchant banking subsidiaries.
References:


11. Kamalaksha, M., *SBI Capital Ltd. – Functions and Preference*  


