UNIT 11 OTHER SOURCES OF SHORT TERM FINANCE

Objectives

The objectives of this Unit are:

- To discuss the sources of short term finance, other than bank credit and trade credit, to meet the working capital needs, and
- To highlight the framework of rules and regulations prescribed by the authorities regarding these non-bank sources of finance.

Structure

11.1 INTRODUCTION

Trade credit and commercial bank credit have been two important sources of funds for financing working capital needs of companies in India, apart from the long term source like equity shares. However, more stringent credit policies followed by banks, tightening financial discipline imposed by them, and their higher cost, led the companies to go in for new and innovative sources of finance. As the new equities market has remained in a subdued condition and investor interest in the equities has almost vanished during recent years, corporates have raised larger resources through debt instruments, some of them being for as short a period as 18 months. The situation has turned bouyant for corporates during 2002 and after for any type of finance.

Raising short term and medium term debt by inviting and accepting deposits from the investing public has become an established practice with a large number of companies both in the private and public sectors. This is the outcome of the process of dis-intermediation that is taking place in Indian economy. Similarly, issuance of Commercial Paper by high net-worth Corporates enables them to raise short-term funds directly from the investors at cheaper rates as compared to bank credit. In practice, however, commercial banks have been the major investors in Commercial Paper in India, implying thereby that bank credit flows to the corporate sector through the route of CPs. Inter-Corporate loans and investments enable the cash rich corporations to lend their surplus resources to those who need them for their working capital purpose. Factoring of receivables is a relatively recent innovation which enables the corporates to convert their receivables into liquidity within a short period of time. In this unit we shall discuss the salient features of various sources of non-bank finance and the regulatory framework evolved in respect of them.

11.2 PUBLIC DEPOSITS

Public deposits are unsecured deposits accepted by companies for specific periods and at specific rates of interest. These deposits have acquired prominence as a source of finance for the companies, as it is more convenient and cheaper to mobilise short term finance through such deposits. Public deposits provide a fine example of dis-intermediation, as the borrower directly accepts the deposits from the lenders, of course with the help of brokers.

In India, acceptance of deposits from the public is regulated by sections 58A and 58B of the Companies Act 1956, and the Companies (Acceptance of Deposits) Rules, 1975. The above sections were inserted in the Companies Act in 1974 with the objective to safeguard the interests of the depositors. The regulatory framework in this regard is contained in the Companies Act and the Rules. Their important provisions are stated below:

Sections 58A (1) empowers the Central Government, in consultation with the Reserve Bank of India , to prescribe the limits up to which, the manner in which and the conditions subject to which deposits may be invited or accepted by a company either from the public or from its members. Such deposits are to be invited in accordance with the rules made under this section and after insertion of an advertisement issued by the company.

Section 58 (2) (c) which was inserted with effect from March 1, 1997 prohibits a company which is in default in the repayment of any deposit or part thereof or any interest thereupon, from accepting any further deposit.

Categories of Deposits and Statutory limits

Rule 3 lays down that the period for which such deposits may be accepted by a company should not be less than 3 months and not more than 36 months from the date of acceptance or renewal of deposit. Companies are not permitted to accept deposits repayable on demand or on notice. Deposits accepted by companies are divided into the following two categories and separate limits have been prescribed for each of them:

i) ***Deposits received from specified sources:***

Deposits against unsecured debentures

Deposits from shareholders

Deposits guaranteed by directors

The maximum limit upto which such deposits are allowed is 10% of the aggregate paid up share capital and free reserves.

ii) ***Deposit received from the general public:***

This category of deposits may be accepted to the extent of 25% of the aggregate paid up capital and free reserves of the company.

For government companies, there is only one single limit of 35% of paid up capital and free reserves for all such deposits.

Companies are, however, permitted to accept or renew deposit from depositors falling in category (i) above for periods below 6 months but not less than 3 months for the purpose of meeting any short term requirements of funds provided such deposits do not exceed 10% of the aggregate of paid up share capital and free reserves of the company.

Maintenance of Liquid Assets

Every company accepting public deposit is required to deposit or invest before 30th April of each year, an amount which shall not be less than 15% of the amount of its deposits which will mature during the next financial year ending 31st March in any one or more of the following:

a) in a current or other deposit account with any scheduled bank, free from charge or lien,

b) in unencumbered securities of the central or state governments,

c) in unencumbered securities in which Trust funds may be invested under the Indian Trust Act, 1882; or

d) in unencumbered bonds issued by Housing Development Finance Corporation Ltd.

The securities referred to in clauses (b) or (c) shall be reckoned at their market value. The amount deposited or invested as aforesaid shall not be utilised for any other purpose than the repayment of deposits maturing during the year.

Rates of Interest and Brokerage

The Rules prescribe the maximum rate of interest payable on such deposits. At present companies are allowed to pay interest not exceeding 15% per annum at rates which shall not be shorter than monthly rests.

Companies are permitted to pay brokerage to any broker at the rate of 1% of the deposits for a period of upto 1 year, 1½ % for a period more than 1 year but upto 2 years and 2% for a period exceeding 2 years. Such payment shall be on one time basis.

Advertisement

Every company intending to invite or accept deposits from the public must issue an advertisement for that purpose in a leading English newspaper and in one vernacular newspaper circulating in the state in which the registered office of the company is situated.

The advertisement must be issued on the authority and in the name of the Board of Directors of the company. The advertisement must contain the conditions subject to which deposits shall be accepted by the company and the date on which the Board of Directors has approved the text of the advertisement. In addition, the advertisement must contain the following information, namely:

a) Name of the company,

b) The date of incorporation of the company,

c) The business carried on by the company and its subsidiaries with the details of branches of units, if any,

d) Brief particulars of the management of the company

e) Names, addresses and occupations of the directors,

f) Profits of the company, before and after making provision for tax, for the three financial years immediately preceding the date of advertisement,

g) Dividends declared by the company in respect of the said years.

h) A summarised financial position of the company as in the two audited balance sheets immediately preceding the date of advertisement in the prescribed form,

i) The amount which the company can raise by way of deposits under these rules and the aggregate of deposits actually held on the last day of the immediately preceding financial year.

j) A statement to the effect that on the day of the advertisement, the company has no overdue deposits, other than the unclaimed deposits, or a statement showing the amount of such overdue deposits, as the case may be, and

k) A declaration as prescribed under the Rules.

The advertisement shall be valid until the expiry of six months from the date of closure of the financial year in which it is issued or until the date on which the balance sheet is laid before the company at its general meeting, or where Annual General Meeting for any year has not been held, the latest day on which that meeting should have been held as per the Companies Act, whichever is earlier. A fresh advertisement is required to be made in each succeeding financial year.

Before issuing an advertisement, a copy of such advertisement shall have to be delivered to the Registrar for registration. Such advertisement should be signed by the majority of the Directors of the company or their duly authorised agents.

The above provision regarding mandatory publication of an advertisement is necessary in case the company invites public deposits. But if the company intends to accept deposits without inviting the same, it is not required to issue an advertisement but a statement in lieu of such advertisement shall have to be delivered to the Registrar for registration, before accepting deposits. The contents of the statement and its validity period shall be the same as in the case of an advertisement.

Procedure for Accepting Deposits

Every company intending to accept public deposits is required to supply to the investors forms, which shall be accompanied by a statement by the company containing all the particulars specified for advertisements. The application must also contain a declaration by the depositor stating that the amount is not being deposited out of the funds acquired by him by borrowing or accepting deposits from any other person.

On accepting a deposit or renewing an existing deposit, every company shall furnish to the depositor or his agent a receipt for the amount received by the company within a period of eight weeks from the date of receipt of money or realisation of cheques. The receipt must be signed by an officer of the company duly authorised by it. The company shall not have the right to alter to the disadvantage of the depositor, the terms and conditions of the deposit after it is accepted.

Register of Deposits

Every company accepting deposits is required to keep as its registered office one or more registers in which the following particulars about each depositor are to be entered:

a) Name and address of the depositors,

b) Date and amount of each deposit

c) Duration of the deposit and the date on which each deposit is repayable

d) Rate of interest

e) Date or dates on which payment of interest will be made.

f) Any other particulars relating to the deposit.

These registers shall be preserved by the company in good order for a period of not less than eight years from the end of the financial year in which the latest entry is made in the Register.

Repayment of Deposits

Deposits are accepted by companies for specified period say 12 months, 18 months, 24 months, etc. Companies prescribe different rates of interest for deposits for different periods. Other terms and conditions are also prescribed by the companies and interest is paid at the stipulated rate at the time of maturity of the deposit.

But, if a depositor desires repayment of the deposit, before the period stipulated in the Receipt, companies are permitted to do so, but interest is to be paid at a lower rate. Rules prescribe that if a company makes repayment of a deposit after the expiry of a period of six months from the date of such deposit, but before the expiry of the period for which such deposit was accepted by the company, the rate of interest payable by the company shall be determined by reducing one percent from the rate which the company would have paid had the deposit been accepted for the period for which the deposit had run.

The rules also provide that if a company permits a depositor to renew the deposit, before the expiry of the period for which such deposit was accepted by the company, for availing of benefit of higher rate of interest, the company shall pay interest to such depositor at higher rate, if

a) such deposit is renewed for a period longer than the unexpired period of the deposit, and

b) the rate of interest as stipulated at the time of acceptance or renewal of a deposit is reduced by one percent for the expired period of the deposit and is paid or adjusted or recovered.

The Rules also stipulate that if the period for which the deposit had run contains any part of a year, then if such part is less than six months, it shall be excluded and if part is six months or more, it shall be reckoned as one year.

Return of Deposits

Every company accepting deposits is required to file with the Registrar every year before 30^{th} June, a return in the prescribed form and giving information as on 31^{st} March of the year. It should be duly certified by the auditor of the company. A copy of the same shall also be filed with the Reserve Bank of India.

Penalties

Sub-section 9 and 10 of section 58 A, which were inserted with effect from 1^{st} September 1989, provide a machinery for repayment of deposits on maturity and also prescribes penalties for defaulting companies. According to sub-section (9), if a company fails to repay any deposit or part thereof in accordance with the terms and conditions of such deposit, the Company Law Board may, if it is satisfied, direct the company to make repayment of such deposit forthwith or within such time or subject to such conditions as may be specified in its order. The Company Law Board may issue such order on its own or on the application of the depositor and shall give a reasonable opportunity of being heard to the company and to other concerned persons.

Sub-section 10 prescribes penalty for non-compliance with the above order of the Board. Whoever fails to comply with its order shall be punishable with imprisonment which may extend to 3 years and shall also be liable to a fine of not less than Rs. 50 for every day during which such non-compliance continues.

The above rule shall not apply to those categories of amounts which may be specified in consultation with Reserve Bank of India.

Section 58 A (6) stipulates penalties for accepting deposits in excess of the specified limits. Where a company accepts deposits in excess of the limits prescribed or in contravention of the manner or condition prescribed, the company shall be punishable:

a) Where such contravention relates to the acceptance of any deposit, with fine which shall not be less than an amount equal to the amount of the deposit accepted,

b) Where such contravention relates to the invitation of any deposit, with fine which may extend to Rs. 1 lakh, but not less than Rs. 5000.

Every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to 5 years and shall also be liable to fine.

Deduction of Tax At Source

According to section 194 A of the Income Tax Act, 1961, the companies accepting public deposits are required to deduct income tax at source at the prescribed rates if the aggregate interest paid or credited during a financial year exceeds Rs. 5000. This limit has been recently (May 2000) raised from Rs. 2500 to Rs. 5000.

Public Deposits with Companies in India

Public Deposits constitute an important source of working capital for corporates in India. According to the data published by the Reserve Bank of India, the total amount of Public deposits with the companies as at the end of March 1997 was Rs. 357, 153 crores, out of which 62.7% was held by the Non-finance companies and the rest by finance companies and other Non-banking Companies.

Companies attract deposits because of higher rates of interest vis-à-vis the banks. One year coupon rate of leading manufacturing companies at present ranges from 11% to 15% . Moreover, most of the companies provide incentive ranging from 0.25 to 1% to the depositors. For the guidance of the depositors the fixed deposits of the companies are rated also by the Credit Rating agencies and the credit ratings are published by the companies to solicit deposits. The rate of interest varies with the credit rating assigned to it. Higher credit rating carries lower rate of interest and vice-versa.

Public deposits with the companies are unsecured deposits and do not carry the cover of deposit insurance while bank deposits are insured by Deposit Insurance and Credit Guarantee Corporation of India to the extent of Rs. 1 lakh in each account. Many companies default in the repayment of the deposits along with interest. In many cases, the District Consumers Disputes Redressal Fora have penalised the companies for not paying their depositors' money. The Fora have held the companies guilty for deficiency of service and maintained that a depositor was a consumer within the meaning of the Consumer Protection Act., 1986 Nevertheless, reputed companies do attract deposits from the public, because of their sound financial position and reputation.

Activity 11.1

1) Fill in the blanks:

   a) A company which ………………………………………………….. is prohibited from accepting any further deposit.

   b) The maximum period for which a company may accept deposit is ………….months.

c) The advertisement for deposit must give the profits of the company and dividends declared during…………………………………financial years immediately preceding the date of advertisement.

2) Can a company repay a deposit before the period stipulated in the Receipt? Will the depositor suffer in such a case?

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3) What penalty is imposed on the company if it accepts deposit in excess of the prescribed limits?

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11.3 COMMERCIAL PAPER

Commercial paper (C.P) is another source of raising short term funds by highly rated corporate borrowers for working capital purposes. A commercial paper at the same time provides an opportunity to cash rich investors to park their short term funds. The Reserve Bank of India permitted companies to issue Commercial paper in 1989 and issued guidelines entitled "Non banking Companies (Acceptance of Deposits through Commercial Paper) Directions 1989," to regulate the issuance of C.Ps. The guidelines have been significantly relaxed and modified from time to time. The salient features of these guidelines (as amended to date) are as follows:

Eligibility to Issue CPs

Companies (except the banking companies) which fulfil the following requirements are permitted to issue CPs in the money market:

i) The minimum tangible net worth of the company is Rs. 4 crore as per the latest audited balance sheet.

ii) The company has fund-based working capital limits of not less than Rs. 4 crore.

iii) The shares of the company are listed at one or more stock exchanges. Closely held companies whose shares are not listed on any stock exchange are also permitted to issue CPs provided all other conditions are fulfilled.

iv) The company has obtained minimum credit rating from a Credit rating agency i.e. CP2 from Credit Rating Information Services of India Ltd., A2 from Investment Information & Credit Rating Agency or PR2 from Credit Analysis and Research.

Terms of Commercial Paper

The Commercial paper may be issued by the companies on the following terms and conditions:

a) The minimum period of maturity should be 15 days (It was reduced from 30 days effective May 25, 1998) and the maximum period less than one year.

b) The minimum amount for which a CP is to be issued to a single investor in the primary market should be Rs. 25 lakh and thereafter in multiple of Rs. 5 lakh.

c) CPs are to be issued in the form of usance promissory notes which are freely transferable by endorsement and delivery.

d) CPs are to be issued at a discount to face value. The rate of discount is freely determined by the issuing company and the investors.

e) The issuing company shall bear the dealers fee, rating agencies fee, and other charges. Stamp duty shall also be applicable on CPs.

f) CPs may be issued to any person, corporate body incorporated in India, or even unincorporated bodies. CPs may be issued to Non-resident Indians only on non-repatriation basis and such CPs shall not be transferable.

g) The issue of CP will not be underwritten or co-accepted by any individual or institution.

h) There will be no grace period for payment. The holder of the CP shall present the instrument for payment to the issuing company.

Ceiling on the amount of issue of Commercial Paper

The amount for which the companies issue Commercial Paper is to be carved out of the fund based working capital limit enjoyed by the company with its banker. The maximum amount that can be raised through issue of commercial paper is equal to 100 percent of the fund based working capital limit. The latter is reduced pro-tanto on the issuance of CP by the company. Effective October 19, 1996 the amount of CP is permitted to be adjusted out of the loans or cash credit or both as per the arrangement between the issuer of the CP and the concerned bank.

Standby facility withdrawn

As stated above, the amount of CP is carved out of the borrower's working capital limit. Till October 1994 commercial banks were permitted to provide standby facility to the issuers of CPs. It ensured the borrowers to draw on their cash credit limit in case there was no roll-over of CP. Thus the repayment of the CP was ensured automatically.

In October 1994 Reserve bank of India prohibited the banks to grant such stand-by-facility. Accordingly, banks reduce the cash credit limit when CP is issued. If subsequently, the issuer requires a higher cash credit limit, he shall have to approach the bank for a fresh assessment of his requirement for the enhancement of credit limit. Banks do not automatically restore the limit and consider the sanction of higher limit afresh. In November 1997, Reserve Bank of India permitted the banks to decide the manner in which restoration of working capital limit is to be done on repayment of the CP if the corporate requests for restoration of such limit.

Procedure for Issuing Commercial Paper

1) The company which intends to issue CP should submit an application in the prescribed form to its bankers or leader of the consortium of banks, together with a certificate from an approved credit rating agency. The rating should not be more than 2 months old.

2) The banker will scrutinize the proposal and if it finds the proposal satisfying all eligibility criteria and conditions, shall take the proposal on record.

3) Thereafter, the company will make arrangement for privately placing the issue within a period of 2 weeks.

4) Within 3 days of the completion of the issue, the company shall advice the Reserve Bank through its bankers the amount actually raised through CP.

5) The investors shall pay the discounted value of the CP through a cheque to the account of the issuing company with the banker.

6) Thereafter, the fund-based working capital limit of the company will be reduced correspondingly.

Commercial Paper in India

The Vagul Committee suggested the introduction of commercial paper in India to enable the high worth corporates to raise short term funds cheaper as compared to bank credit. On the other hand, the investors in CPs were expected to earn a better return because of the absence of intermediaries between them and the borrowers. As the issuer bears the cost of issuing the CPs, his total cost is higher by 1% point or so over the discount rate on the CPs issued by him.

Commercial paper is being issued by corporates in India for about a decade now. During this period the quantum of outstanding CPs has gradually increased. Till May 1997 the outstanding amount of CPs remained below the level of Rs. 1000 crore and the rate of discount ranged above 11%. But since May 1997 the outstanding amount has gradually increased and the discount rate remained much below 10%. During the year 1998, Rs. 5249 crore were raised during the first fortnight of January 1998 and again in the second fortnight of August 1998 when discount rate ranged between 8.5 and 11%. Since May 1998, the level of outstanding CPs has gradually risen and has touched the mark of Rs. 11153 crore in December 1998. Discount rate touched the low range of 8.5 to 9% during this period. By the end of July 31, 2003, the outstanding CPs stood at Rs.7,557 crore and the typical effective rates of discount varied between 4.99% to 8.25%. Thus the corporates find the CP route far cheaper than normal bank credit.

Banks continue to be the major investors in CPs as they find CPs of top-rated companies very attractive, because of the excess liquidity situation they are presently placed in. As on February 28, 1999, the outstanding investment by scheduled commercial banks in CP amounted to Rs. 5367 crore with an effective discount rate in the range of 10.2% to 13%. Outstanding investments in CPs steadily increased to Rs. 7658 crore as on September 30.1999 due to easy liquidity.

The Reserve Bank of India has issued revised draft guidelines on July 6,2000 for the issuance of commercial paper. The important changes proposed were:

i) Corporates are permitted to issue CP upto 50% of their working capital (fund-based) under the automatic route, i.e. without prior clearance from the banks.

ii) CPs can be issued for wide range of maturities from 15 days to 1 year and can be in denominations of Rs. 5 lakh or multiple there of.

iii) Financial Institutions may also issue CPs.

iv) Foreign instutional investors may invest in CPs. Within 30% limit set for their investments in debt instruments

v) Credit rating again will decide the period of validity of the issue.

11.4 INTER-CORPORATE LOANS

Short term finance for working capital requirements of a company may be raised through accepting inter-corporate loans or deposits. Some companies, which may have surplus idle cash due to seasonal nature of their operations or otherwise would like to lend such resources for such period when they are not needed by them. On the other hand, some other companies face financial stringency and need cash resources to meet their immediate liquidity needs. The former lend their surplus resources to the latter through brokers, who charge for their services. Inter-corporate loans facilitate such lending and borrowings for short periods of time. The rate of interest and other terms and conditions of such loans are determined by negotiations between the lending and borrowing companies. The prevailing market conditions do exert their influence on the determination of interest rates.

Statutory Provisions Prior to January 1999

The Inter-corporate loans were, till recently, governed by the provisions of section 370 of the Companies Act, 1956 and the Rules framed thereunder. This section provided that no company shall (a) make any loan to or (b) give any guarantee or provide any security in connection with a loan given to any body corporate unless such loan or guarantee has been previously authorised by a special resolution of the lending company. But such special resolution was not required in case of loans made to other bodies corporate not under the same management as the lending company where the aggregate of such loans did not exceed thirty percent of the aggregate of the subscribed capital of the lending company and its free reserves.'

Further the aggregate of the loans made by the lending company to all other bodies corporate shall not, except with the prior approval of the Central Government, exceed.

a) Thirty percent of the aggregate of the subscribed capital of the lending company and its free reserves, where all such other bodies are not under the same management as the lending company.

b) Thirty percent of the aggregate of the subscribed capital of the lending company and its free reserves, where all such corporates are under the same management as the lending company.

Section 372 of the Companies Act laid down the limits for investment by a company in the shares of another body corporate. Rules framed thereunder laid down that the Board of Directors of a company shall be entitled to invest in the shares of any other body corporate upto thirty percent of the subscribed equity share capital or the aggregate of the paid up equity and preference share capital of such other body corporate whichever is less. Permission of the Central Government was also required in case the investment made by the Board of Directors in all other bodies corporate exceed thirty percent of the aggregate of the subscribed capital and reserves of the investing company.

Present Statutory Provisions

After the promulgation of Companies (Amendment) Ordinance 1999 in January 1999 the provisions of sections 370 and 372 were made ineffective and instead a new section 372A was inserted to govern both inter-corporate loans and investments. According to the new section 372 A, a company shall, directly or indirectly.

a) make any loan to any other body corporate,

b) give any guarantee, or provide security in connection with a loan made by any other person to any body corporate, and

c) acquire, by way of subscription, purchase or otherwise, the securities of any other body corporate upto 60% of its paid up capital and free reserves or 100% of the free reserves, whichever is more.

The loan, investment, guarantee or security can be given to any company irrespective of whether it is subsidiary company or otherwise. If the aggregate of all such loans and investments exceed the above limit the company would have to secure the permission of shareholders through a special resolution which should specify the particulars of the company in which investment is to be made or loan, security or guarantee is proposed to be given. It should also specify the purpose of the investment, loan, security or guarantee and the specific sources of funding. The resolution should be passed at the meeting of the Board with the consent of all directors present at the meeting and the prior approval of the public financial institutions where any term loan is subsisting, is obtained. But no prior approval of the public financial institution is necessary , if there is no default in payment of loan instalment or repayment of interest thereon as per the terms and conditions of the loan.

The above provisions of Section 372 A will not apply to any loan made by a Holding company to its wholly owned subsidiary or any guarantee given by the former in respect of loan made to the latter or acquisition of securities of the subsidiary by the holding company. Section 372 A Shall not apply to any loan, guarantee or investment made by a banking company, an insurance company or a housing finance company or a company whose principal business is the acquisition of shares, stocks, debentures etc or which has the object of financing industrial enterprises or of providing infra structural facilities.

The loan to any body corporate shall be made at a rate of interest not lower than the Bank rate. A company which has defaulted in complying with the provisions of the section 58A of the Companies Act, 1956 shall not be permitted to make inter-corporate loans and investment till such default continues.

Companies making inter- corporate loans/ investment are required to keep a Register showing the prescribed details of such loans/investments/guarantees. Such Register shall be open for inspection and extracts may be taken therefrom. The provision of the new section are not applicable to loans made by banking, insurance/housing finance/investment company and a private company, unless it is subsidiary of a public company.

If a default is made in complying with the provisions of section 372A, the company and every officer of the company who is in default shall be punishable with improvement upto 2 years or with fine upto Rs. 50,000/-.

Activity 11.2

1) Fill in the blanks:

    a) The minimum period of maturity of CP. should be ………………..days

    b) The CP must have………………………. Rating from Credit Rating Information Services Ltd.

    c) The loans by a company to another company shall carry a rate of interest which is not less than ....

2) Explain what do you understand by Standby facility?

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3) Provision of Section 372 A are not applicable to certain companies. Specify them.

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11.5 BONDS AND DEBENTURES

Bonds and debentures are another form of raising debt for augmenting funds for long term purposes as well as for working capital. It has gained popularity during recent years because of the depressed conditions in the new equities market and the permission given to the banks to invest their funds in such bonds and debentures. These debentures may be fully convertible, partly convertible, or non-convertible into equity shares.

The salient points of the Guidelines issued by Securities and Exchange Board of India (SEBI) in this regard are as follows:

1) Issue of fully convertible debentures having a conversion period more than 36 months will not be permissible unless conversion is made optional with "put" and "call" options.

2) Compulsory credit rating is required, if conversion of fully convertible debentures is made after 18 months.

3) Premium amount on conversion, and time of conversion in stages, if any, shall be predetermined and stated in the prospectus. The rate of interest shall be freely determined by the issuer.

4) Companies issuing debentures with maturity upto 18 months are not required to appoint Debentures Trustees or to create Debentures Redemption Reserves. In other cases the names of debentures trustee must be stated in the prospectus. The trust deed must be executed within 6 months of the closure of the issue.

5) Any conversion in part or whole of the debentures will be optional at the hands of the debenture holders, if the conversion takes places at or after 18 months from the date of allotment but before 36 months.

6) In case of Non-Convertible Debentures and Partly convertible debentures, credit rating is compulsory if maturity exceeds 18 months.

7) Premium amount at the time of conversion of Partly convertible debentures shall be pre-determined and stated in the Prospectus. It must also state the redemption amount, period of maturity, yield on redemption for Non-convertible/ Partly Convertible Debentures.

8) The discount on the non-convertible portion of the Partly convertible debentures, in case they are traded and procedure for their purchase on spot trading basis, must be disclosed in the propectus.

9) In case, the non-convertible portions of partly Convertible Debentures or Non-Convertible Debentures are to be rolled over without change in the interest rate, a compulsory option should be given to those debenture holders who want to withdraw and encash their debentures. Positive consent of the debenture holders must be obtained for all-over.

10) Before the rollover, fresh credit rating shall be obtained within a period of six months prior to the due date of redemption and must be communicated to the debenture holders before the rollover. Fresh Trust Deed must be made in case of rollover.

11) The letter of information regarding rollover shall be vetted by SEBI.

12) The disclosure relating to raising of debenture will contain amongst other things

a) The existing and future equity and long term debt ratio,

b) Servicing behaviour of existing debentures,

c) Payment of interest due on due dates on term loans and debentures

d) Certificate from a financial institution or bankers about their no objection for a second or pari passu charge being created in favour of the trustees to the proposed debenture issue.

13) Companies which issue debt instruments through an offer document can issue the same without submitting the prospectus or letter of offer for vetting to SEBI or obtaining an acknowledgement card from SEBI in respect of the said issue, provided the:

   a) Company's securities are already listed on any stock exchange

   b) Company has obtained atleast an 'adequately safe' credit rating for its issue of debt instrument from a credit rating agency.

   c) The debt instrument is not convertible, is not issued along with any other security or, without any warrant with an option to convert into equity shares.

14) In such cases a category I Merchant bank shall be appointed to manage the issue and to submit the offer document to SEBI. The Merchant banker acting as Lead Manager should ensure that the document for the issue of debt instrument contains the required disclosure and gives a true, correct and fair view of the state of affairs of the company. The merchant banker will also submit a due diligence certificate to SEBI.

15) The debentures of a company can be listed at a Stock Exchange, even if its equity shares are not listed.

16) The trustees to the Debenture issue shall have the power to protect the interest of debenture holders. They can appoint a nominee director on the Board of the company in consultation with institutional debenture holders.

17) The lead bank will monitor the utilisation of funds raised through debentures for working capital purposes. In case the debentures are issued for capital investment purpose, this task of monitoring will be performed by lead Institution/ Investment Institution.

18) In case of debentures for working capital, institutional debenture holders and trustees should obtain a certificate from the company's auditors regarding utilisation of funds at the end of each accounting year.

19) Company should not issue debentures for acquisition of shares or for providing loans to any company belonging to the same group. This restriction does not apply to the issue of fully convertible debentures provided conversion is allowed within a period of 18 months.

20) Companies are required to file with SEBI certificate from their bankers that the assets on which security is to be created are free from any encumbrances and necessary permission to mortgage the assets have been obtained or a No objection from the financial institutions/ banks for a second or pari passu charge has been obtained, where the assets are encumbered.

11.6 FACTORING OF RECEIVABLES

Factoring of receivables is another source of raising working capital by a business entity. Factoring is an agreement under which the receivables arising out of the sale of goods/services are sold by a firm(called the client) to the factor (a financial intermediary). The factor thereafter becomes responsible for the collection of the receivables. In case of credit sale, the purchaser promises to pay the sale proceeds after a period of time. The seller has to wait for that period for realising his claims from the buyer. His cash cycle is thus prolonged and he needs larger working capital. Factoring of receivables is a device to sell the receivables to a factor, who pays the whole or a major part of dues from the buyer immediately to the seller, thereby reducing his cash cycle and the requirements of working capital. The factor realises the amount from the buyers on the due date.

Factoring is of recent origin in India. Government of India notified factoring as a permissible activity for the banks in July 1990. They have been permitted to set up separate subsidiaries for this purpose or invest in the factoring companies jointly with other banks. Two factoring companies have been set up by banks jointly with Small Industries Development Bank of India. SBI Factors and Commercial Services Ltd. has been promoted by State Bank of India, Union, Bank of India and the Small Industries Development Bank of India. Canbank Factors Ltd. is another factoring company promoted jointly by Canara Bank, Andhra Bank and SIDBI. The Foremost Factors Ltd. is the first private sector company which has commenced its operations in 1997.

With Recourse and Without Recourse Factoring

Factoring business may be undertaken on 'with recourse' or 'without recourse' basis. Under with recourse factoring, the factor has recourse to the client if the receivable purchased turn out to be irrecoverable. In other words, the credit risk is borne by the client and not the factor. The factor is entitled to recover the amount from the client the amount paid in advance, interest for the period and any other expenses incurred by him.

In case of, without recourse factoring, the factor does not possess the above right of recourse. He has to bear the loss arising out of non-payment of dues by the buyer. The factor, therefore, charges higher commission for bearing this credit risk.

Mechanism of Factoring

1) An agreement is entered into between the seller and the factor for rendering factoring services.

2) After selling the goods to the buyer, the seller sends copy of invoice, delivery challen, instructions to make payment to the factor, to the buyer and also to the factor.

3) The factor makes payment of 80% or more of the amount of receivable to the seller.

4) The seller should also execute a deed of assignment in favour of the factor to enable him to recover amount from the buyer.

5) The seller should also obtain a letter of waiver from the banker in favour of the factor, if the bank has charge over the asset sold to the buyer.

6) The seller should give a letter of confirmation that all conditions of the sale transactions have been completed.

7) The seller should also confirm in writing that all payments receivable from the debtor are free from any encumbrances, charge, right of set off or counter claim from another person, etc.

8) The facility of factoring in India is available to all forms of business organisations in manufacturing, service and trading. Sole proprietary concerns, partnership firms and companies can avail of the services of factors, but a ceiling on the credit which they can avail of in terms of the value of the invoice to be purchased is generally fixed for each client in medium and small scale sectors. Generally the period for which receivables are factored ranges between 30 and 90 days.

9) The factor evaluates the client on the basis of various criteria e.g. level of receivables turnover, the quality of receivables, growth in sales, etc. The factor charges a service fee and a discount. The service fee is charged in advance and depends upon the invoice value for different categories of clients. It ranges between 0.5-.2% of the invoice value.

Moreover, the factor also charges a discount on the pre-payment made to the client. It is payable in arrears and is generally linked to the bank lending rate. In case of high worth clients, the discount rate is presently one percent point lower than the rate charged under the cash credit system.

The cost of funds under, without recourse, factoring is much higher than, with recourse, factoring due to the credit risk borne by the factor. However, the service fee and discount charge depends upon the cost of funds and the operational cost.

Activity 11.3

1) Fill in the blanks:

   a) Credit Rating is compulsory if the fully convertible debentures are convertible after.................. months.

   b) The names of Debenture Trustees must be disclosed in ....

   c) In case of 'with recourse factoring', the loss arising out of non-payment of the dues by the buyer is borne by.......................

2) State the conditions under which it is not necessary for a company to issue debt instruments without submitting proposals or letter of offer to SEBI.

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   ....

3) Explain the mechanism of factoring of receivables.

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11.7 SUMMARY

In this unit, we have discussed various sources of short term funds, other than bank credit and trade credit which are used by business and industrial houses in India to finance their working capital needs. The unit covers public deposits, commercial paper, inter-corporate loans, bonds and debentures and factoring of receivables. The statutory framework, along with rules and regulations concerning these sources have been explained in detail. Relative significance of these sources has also been explained by citing relevant facts and figures. Though these sources are deemed as non-bank sources of finance, involvement of commercial banks in providing such finance is evident, specially in case of commercial paper, bonds and debentures and factoring of receivables.

11.8 KEY WORDS

Public Deposits: Public deposits are deposits of money accepted by companies in India from the public for specified period ranging between 3 months and 36 months. These deposit are accepted within the limit and subject to terms prescribed under Companies(Acceptance of Deposits) Rule , 1975.

Commercial Paper: Commercial paper is an unsecured instrument through which high net worth corporates borrow funds from any person, corporate or unincorporated body. It is issued in the form of usance promissory note; which is freely transferable by endorsement and delivery. Its minimum period of maturity should be 15 days and maximum period less then a year, It is issued at a discount to face value.

Inter-Corporate Loans : These are loans made by a company to another company, whether its own subsidiary or otherwise. These loans and investments in the securities of another company should be upto the limits specified in section 372 A of the Companies Act.

Convertible Bonds: These are bonds issued by the companies to the investors, which are convertible either fully or partly into the equity shares of the company within a specified period of time at the option of the investor.

Put and Call Options: The debt instruments like bonds and debentures are issued for a fixed period of time-i.e. they are redeemable at the expiry of a fixed period say 5 or 7 years. But sometimes the issuer includes the 'put' or/and 'call' options in the terms of issue. 'Put' option means that the investor may, if he so desires ask for the redemption of the bond after a specified period is over but before the period of maturity. If the issuer reserves this right to himself to redeem the bond after a specific minimum period but before the date of maturity, such right is called 'call' option.

Credit Rating: Credit Rating is an opinion expressed by a Credit Rating Agency about the ability of the issuer of a debt instrument to make timely payment of principal and interest thereon. It is expressed in alphabetical symbols. All types of debt instruments may be rated. Rating is given for each instrument and not for the issuer as such.

Factoring of Receivables: Factoring is an agreement under which the receivables arising out of the sale of goods/services are sold by a firm (called the client) to the factor (a financial intermediary), who becomes responsible for the collection of the receivable on the due date.

With Recourse and without Recourse Factoring : When the factor bears the loss arising out of non-payment of the dues by the buyer, it is called without recourse factoring. In case of 'With Recourse Factoring' he can recover the loss from the client (seller).

11.9 SELF ASSESSMENT QUESTIONS

1) State the two broad categories of deposits which non-banking companies can accept to meet their working capital needs.
2) State the existing guidelines regarding maintenance of liquid assets prescribed for a company accepting deposits from the public.
3) What remedy is available to the depositor, if the company fails to repay the deposit as per the terms and conditions of the deposit?
4) Describe the eligibility conditions prescribed for issuing the Commercial Paper.
5) Describe five important terms and conditions for issuing Commercial Paper.
6) Why are banks major investors in Commercial Paper?
7) Explain the provisions of newly inserted section 372 A regarding inter-corporate loans and investments.
8) Describe the guidelines issued by SEBI for the conversion of debentures into equity.