

# **Capital Market: Structure and Emerging Trends**

## **Part-4**

### **Topic: Merchant Banking**

#### **Merchant Banking: Meaning**

A merchant bank may be defined as an institution or an organisation which provides a number of services including management of securities issues, portfolio services, underwriting of capital issues, insurance, credit syndication, financial advices, project counselling etc. There is a distinction between a commercial bank and a merchant bank. The merchant banks mainly offer financial services for a fee, while commercial banks accept deposits and grant loans. The merchant banks do not act as repositories for savings of the individuals.

Thus, Merchant banking can be defined as a skill-oriented professional service provided by merchant banks to their clients, concerning their financial needs, for adequate consideration, in the form of fee.

#### **Services offered by Merchant Banks**

Merchant Banks offers a range of financial and consultancy services, to the customers, which are related to:

- Marketing and underwriting of the new issue.
- Merger and acquisition related services.
- Advisory services, for raising funds.
- Management of customer security.
- Project promotion and project finance.
- Investment banking
- Portfolio Services
- Insurance Services.

Merchant banking helps in reinforcing the economic development of the country, by acting as a source of funds and information to the business entities.

## Merchant Banker

Any person, indulged in issue management business by making arrangements with respect to trade and subscription of securities or by playing the role of manager/consultant or by providing advisory services, is known as a merchant banker. The activities carried out by merchant bankers are:

- Private placement of securities.
- Managing public issue of securities
- Satellite dealership of government securities
- Management of international offerings like Depository Receipts, bonds, etc.
- Syndication of rupee term loans
- Stock broking
- International financial advisory services.

In India, the functions of the merchant bankers are governed by the Securities and Exchange Board of India (SEBI) Regulations, 1992.

## Functions of Merchant Banking Organization

1. **Portfolio Management:** Merchant banks provide advisory services to the institutional investors, on account of investment decisions. They trade in securities, on behalf of the clients, with the aim of providing them with portfolio management services.
2. **Raising funds for clients:** Merchant banking organisation assist the clients in raising funds from the domestic and international market, by issuing securities like shares, debentures, etc., which can be deployed for starting a new project or business or expansion activities.
3. **Promotional Activities:** One of the most important activities of merchant banking is the promotion of business enterprise, during its initial stage, right from conceiving the idea to obtaining government approval. There is some organisations, which even provide financial and technical assistance to the business enterprise.
4. **Loan Syndication:** Loan Syndication means service provided by the merchant bankers, in raising credit from banks and financial institutions, to finance the project cost or working capital of the client's project, also termed as project finance service.
5. **Leasing Services:** Merchant Banking organisations renders leasing services to their customers. There are some banks which maintain venture capital funds to help entrepreneurs.

6. **Other Specialised Services:** In addition to the basic activities involving marketing of securities, merchant banks also provide corporate advisory services on issues like mergers and amalgamations, tax matters, recruitment of executives and cost and management audit, etc. Many merchant bankers have also started making of bought out deals of shares and debentures. The activities of the merchant bankers are increasing with the change in the money market.

Hence, Merchant Banking helps in coordinating the operations of intermediaries, with respect to the issue of shares like registrar, advertising agency, bankers, underwriters, brokers, printers and so on. Further, it ensures compliance with the rules and regulations, of the capital market.

## **Merchant Banking under SEBI Regulations**

SEBI, in exercise of the powers conferred under section 30 of the SEBI Act, 1992 has made the different regulations for almost all aspects of capital market. For regulating the activities of merchant bankers, the Board has enacted SEBI (Merchant Bankers) Regulations, 1992.

### **1. Classification of Merchant Bankers**

The SEBI has classified merchant bankers under four categories for the purpose of registration. Category-I can act as issue manager, advisor, consultant, underwriter and portfolio manager.

Category-II can act as advisor, consultant, underwriter and portfolio manager.

Category-III can act as underwriter, advisor and consultant only.

Category-IV can act as consultant or advisor to the issue of capital.

### **2. Capital Adequacy Norms**

For registration of merchant bankers of various categories, SEBI has prescribed capital adequacy norms. Minimum 'net worth' of category I was fixed at Rs. 1.00 crore which was further raised to Rs. 5.00 crore by an amendment in the regulations in 1995. For category II, the minimum net worth was fixed as Rs. 50.00 lakhs, while for category III, this amount was Rs. 20.00 lakhs. Category IV was not required to have any capital or net worth.

### **3. Restriction on Appointment of Lead Managers**

The regulations state that the number of lead merchant bankers (issue manager to the issue) may not exceed in the case of any issue of –

<b>Size of the issue</b>	<b>No. of lead managers</b>
Less than Rs. 50 crore	Two
Rs. 50 crore but less than Rs. 100 crore	Three
Rs. Rs. 100 crore but less than Rs. 200 crore	Four
Rs. 200 crore but less than Rs. 400 crore	Five
Above Rs. 400 crore	Five or more as may be agreed by the board.

#### **4. Responsibilities of Lead Managers**

The Regulations state that no lead manager shall agree to manage or be associated with any issue unless his responsibilities relating to issue mainly those of disclosures, allotment and refund are clearly defined, allocated and determined and a statement specifying such responsibilities is furnished to the Board at least one month before the opening of the issue for subscription: Provided that where there are more than one lead merchant bankers to the issue, the responsibilities of each of such lead merchant banker shall clearly be demarcated and a statement specifying such responsibilities shall be furnished to the Board at least one month before opening of the issue for subscription.

#### **5. Underwriting Obligations**

In respect of every issue to be managed, the lead merchant banker holding a certificate under category I shall accept a minimum underwriting obligation of five percent of the total underwriting commitment or rupees twenty five lakhs, whichever is less:

Provided that, if the lead merchant banker is unable to accept the minimum underwriting obligation, that lead merchant banker shall make arrangement for having the issue underwritten to that extent by a merchant banker associated with the issue, shall keep the Board informed of such arrangement.

### **Merchant Banking vs. Investment Banking**

The **key difference between Merchant Bank and Investment Bank** lies in the fact that a merchant bank is a bank that provides services like brokerage to business houses, fundraising and also acts as a financial advisory to its clients and fulfils the capital requirements in the form of share ownership.

An Investment bank is a banking company that helps a company in raising funds by acting as an intermediary between the client and investing public. Merchant banks engage in international finance, whereas investment banks focus on underwriting and issuance of securities.

### **Comparison between Merchant Bank and Investment Bank**

<b>Basis of Comparison</b>	<b>Merchant Bank</b>	<b>Investment Bank</b>
Purpose	Merchant banks exist primarily to provide business loans, facilitate international finance, and serve the various trading companies with underwriting roles.	Investment banking exists to create capital for commercial and government entities.
Funding	The services of merchant banks are availed for commissions and interests. As such, they tend to be more expensive to come by comparatively.	Those of the investment banking is however accessible via fees and funding on a case by case basis. They hence tend to be comparatively cheaper to come by.
Clientele	Merchant banks mainly deal with high net worth individuals and medium-sized corporate entities.	Investment banks, however, deal with huge corporations as they have higher financial muscle power than the merchant banks.
Services Provided	A merchant bank facilitates the exchange of goods and services mainly by offering advisory services to the companies that deal with those trade. It also underwrites debts, processes payments and facilitates access to credit.	Investment banks however aid companies in expanding their services mainly by scaling new heights. They arrange for extra capital and help companies in widening their scope of operations.
Sheer Size	As we have already hinted, the merchant banks are smaller in size and financial muscle power. These two are mainly due to the fact that they handle fewer clients.	Conversely, investment banks are larger in scope and financial muscle power due to their handling of many clients and the use of huge amounts of money.