THEORY

Years	May		Nov	
	RTP	Paper	RTP	Paper
2015	-	-	Yes	Yes
2016	Yes	Yes	Yes	Yes
2017	Yes	Yes	Yes	Yes
2018 (Old)	Yes	Yes	Yes	Yes
2018 (New)	Yes	Yes	Yes	Yes

Question 1 **Nov 2015 - RTP**

(a) Nostro, Vostro and Loro Accounts
(b) Characteristics of Financial Leasing
(c) Marking to Market
(d) Relevant assumptions of CAPM
(e) Exchange Traded Funds

Solution

(a) In interbank transactions, foreign exchange is transferred from one account to another account and from one centre to another centre. Therefore, the banks maintain three types of current accounts in order to facilitate quick transfer of funds in different currencies. These accounts are Nostro, Vostro and Loro accounts meaning "our", "your" and "their". A bank's foreign currency account maintained by the bank in a foreign country and in the home currency of that country is known as Nostro Account or "our account with you". For example, An Indian bank's Swiss franc account with a bank in Switzerland. Vostro account is the local currency account maintained by a foreign bank/branch. It is also called "your account with us". For example, Indian rupee account maintained by a bank in Switzerland with a bank in India. The Loro account is an account wherein a bank remits funds in foreign currency to another bank for credit to an account of a third bank.

(b) Salient features of Financial Lease

(i) It is an intermediate term to long-term arrangement.
(ii) During the primary lease period, the lease cannot be cancelled.
(iii) The lease is more or less fully amortized during the primary lease period.
(iv) The costs of maintenance, taxes, insurance etc., are to be incurred by the lessee unless the contract provides otherwise.
(v) The lessee is required to take the risk of obsolescence.
(vi) The lessor is only the Financier and is not interested in the asset.

(c) It implies the process of recording the investments in traded securities (shares, debt-instruments, etc.) at a value, which reflects the market value of securities onthe reporting date. In the context of derivatives trading, the futures contracts are marked to market on periodic (or daily) basis. Marking to market essentially means that at the end of a trading session, all outstanding contracts are repriced at the settlement price of that session. Unlike the forward contracts, the future contracts are repriced every day. Any loss or profit resulting from repricing would be debited or credited to the margin account of the broker. It, therefore, provides an opportunity to calculate the extent of liability on the basis of repricing. Thus, the futures contracts provide better risk management measure as compared to forward contracts.

Suppose on 1st day we take a long position, say at a price of Rs.100 to be matured on 7th day. Now on 2nd day if the price goes up to Rs.105, the contract will be repriced at Rs.105 at the end of the trading session and profit of Rs.5 will be credited to the account of the buyer. This profit of Rs.5 may be drawn and thus cash flow also increases. This marking to market will result in three things – one, you will get a cash profit of Rs.5; second, the existing contract at a price of Rs.100 would stand cancelled; and third you will receive a new futures contract at Rs.105. In essence, the marking to market feature implies that the value of the futures contract is set to zero at the end of each trading day.

(d) Relevant Assumptions of CAPM

(i) The investor's objective is to maximize the utility of terminal wealth;
(ii) Investors make choices on the basis of risk and return;
(iii) Investors have identical time horizon;
(iv) Investors have homogeneous expectations of risk and return;
(v) Information is freely and simultaneously available to investors;
(vi) There is risk-free asset, and investor can borrow and lend unlimited amounts at the risk-free rate;

There are no taxes, transaction costs, restrictions on short rates or other market imperfections;

Total asset quantity is fixed, and all assets are marketable and divisible.

(e) Exchange Traded Funds (ETFs) were introduced in US in 1993 and came to India around 2002. ETF is a hybrid product that combines the features of an index mutual fund and stock and hence, is also called index shares. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.

ETF can be bought and sold like any other stock on stock exchange. In other words, they can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day. NAV of an ETF is the value of the underlying component of the benchmark index held by the ETF plus all accrued dividends less accrued management fees.

There is no paper work involved for investing in an ETF. These can be bought like any other stock by just placing an order with a broker.

Some other important features of ETF are as follows:

1. It gives an investor the benefit of investing in a commodity without physically purchasing the commodity like gold, silver, sugar etc.
2. It is launched by an asset management company or other entity.
3. The investor does not need to physically store the commodity or bear the costs of upkeep which is part of the administrative costs of the fund.
4. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

Rahul Malkan

Question 2 **Nov 2015 - Paper**

Write short notes on any **four** of the following:
(a) Assumptions of Modigliani & Miller Hypothesis.
(b) Define the following Greeks with respect to options:
   (i) Delta
   (ii) Gamma
   (iii) Vega
   (iv) Rho
(c) Money Market Mutual Funds
(d) Instruments of international finance
(e) Forfaiting Vs Export factoring

Solution

(a) The Modigliani & Miller hypothesis is based on the following assumptions:

(i) The firm operates in perfect capital markets in which all investors are rational and information is freely available to all.
(ii) There are no taxes. Alternatively, there are no differences in the tax rates applicable to capital gains and dividends.
(iii) The firm has a fixed investment policy.
(iv) There are no floatation or transaction costs.
(v) Risk of uncertainty does not exist. Investors are able to forecast future prices and dividends with certainty, and
(vi) one discount rate is appropriate for all securities and all time periods. Thus, r = k = Kt for all t.

(b) (i) *Delta:* It is the degree to which an option price will move given a small change in the underlying stock price. For example, an option with a delta of 0.5 will move half a rupee for every full rupee movement in the underlying stock.
The delta is often called the hedge ratio i.e. if you have a portfolio short 'n' options (e.g. you have written n calls) then n multiplied by the delta gives you the number of shares (i.e. units of the underlying) you would need to create a riskless position –

i.e. a portfolio which would be worth the same whether the stock price rose by a very small amount or fell by a very small amount.

(ii) *Gamma:* It measures how fast the delta changes for small changes in the underlying stock price i.e. the delta of the delta. If you are hedging a portfolio using the delta-hedge technique described under "Delta", then you will want to keep gamma as small as possible, the smaller it is the less often you will have to adjust the hedge to maintain a delta neutral position. If gamma is too large, a small change in stock price could wreck your hedge. Adjusting gamma, however, can be tricky and is generally done using options.

(iii) *Vega:* Sensitivity of option value to change in volatility. Vega indicates an absolute change in option value for a one percentage change in volatility.

(iv) *Rho:* The change in option price given a one percentage point change in the risk-free interest rate. It is sensitivity of option value to change in interest rate. Rho indicates the absolute change in option value for a one percent change in the interest rate.

(c) An important part of financial market is Money market. It is a market for short-term money. It plays a crucial role in maintaining the equilibrium between the short-term demand and supply of money. Such schemes invest in safe highly liquid instruments included in commercial papers certificates of deposits and government securities.
Accordingly, the Money Market Mutual Fund (MMMF) schemes generally provide high returns and highest safety to the ordinary investors. MMMF schemes are active players of the money market. They channelize the idle short funds, particularly of corporate world, to those who require such funds. This process helps those who have idle funds to earn some income without taking any risk and with surety that whenever they will need their funds, they will get (generally in maximum three hours of time) the same. Short-term/emergency requirements of various firms are met by such Mutual Funds. Participation of such Mutual Funds provides a boost to money market and help in controlling the volatility.

(d) The various financial instruments dealt with in the international market are briefly described below:

1. **Euro Bonds:** A *Eurobond* is an international bond that is denominated in a currency not native to the country where it is issued. Also called external bond e.g. A Yen floated in Germany; a yen bond issued in France.
2. **Foreign Bonds:** These are debt instruments denominated in a currency which is foreign to the borrower and is denominated in a currency that is native to the country where it is issued. A British firm placing $ denominated bonds in USA is said to be selling foreign bonds.
3. **Fully Hedged Bonds:** In foreign bonds, the risk of currency fluctuations exists. Fully hedged bonds eliminate that risk by selling in forward markets the entire stream of interest and principal payments.
4. **Floating Rate Notes:** These are debt instruments issued upto 7 years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than fixed rate debt instruments; however, they suffer from inherent interest rate volatility risk.
5. **Euro Commercial Papers:** Euro Commercial Papers (ECPs) are short-term money market instruments. They are for maturities for less than a year. They are usually designated in US dollars.

(e) Major differences between Forfaiting and Factoring are as follows:

Factoring	**Forfaiting**
This may be with recourse or without recourse to the supplier.	This is without recourse to the exporter. The risks are borne by the forfeiter.
It usually involves trade receivables of short maturities.	It usually deals in trade receivables of medium and long term maturities.
It does not involve dealing in negotiable instruments.	It involves dealing in negotiable instrument like bill of exchange and promissory note.
The seller (client) bears the cost of factoring.	The overseas buyer bears the cost of forfaiting
Usually it involves purchase of all book debts or all classes of book debts.	Forfaiting is generally transaction or project based. Its structuring and costing is case to case basis.
Factoring tends to be a 'case of' sell of debt obligation to the factor, with no secondary market.	There exists a secondary market in forfeiting. This adds depth and liquidity to forfaiting.

Question 3 **May 2016 - RTP**

Write a short note on
(a) Factors that affect Bond's Duration
(b) Process of Portfolio Management
(c) Benefits of International Portfolio Investment
(d) Benefits of Debit Card
(e) Factors affecting the selection of Mutual Funds

Solution

(a) Following are some of factors that affect bond's duration:

(1) Time to maturity: Consider two bonds that each cost ` 1,000 and yield 7%. A bond that matures in one year would more quickly repay its true cost than a bond that matures in 10 years. As a result, the shorter-maturity bond would have a lower duration and less price risk. The longer the maturity, the higher the duration.

(2) Coupon rate: Coupon payment is a key factor in calculation of duration of bonds. If two identical bonds pay different coupons, the bond with the higher coupon will pay back its original cost quicker than the lower-yielding bond. The higher the coupon, the lower is the duration.

(b) Portfolio management is a process and broadly it involves following five phases and each phase is an integral part of the whole process and the success of portfolio management depends upon the efficiency in carrying out each of these phases.

(1) Security Analysis: Security analysis constitutes the initial phase of the portfolio formation process and consists in examining the risk-return characteristics of individual securities and also the correlation among them. A simple strategy in securities investment is to buy underpriced securities and sell overpriced securities. But the basic problem is how to identify underpriced and overpriced securities and this is what security analysis is all about. There are two alternative approaches to analyse any security viz. fundamental analysis and technical analysis. They are based on different premises and follow different techniques.

(2) Portfolio Analysis: Once the securities for investment have been identified, the next step is to combine these to form a suitable portfolio. Each such portfolio has its own specific risk and return characteristics which are not just the aggregates of the characteristics of the individual securities constituting it. The return and risk of each portfolio can be computed mathematically based on the risk-return profiles for the constituent securities and the pair-wise correlations among them.

(3) Portfolio Selection: The goal of a rational investor is to identify the Efficient Portfolios out of the whole set of Feasible Portfolios mentioned above and then to zero in on the Optimal Portfolio suiting his risk appetite. An Efficient Portfolio has the highest return among all Feasible Portfolios having identical Risk and has the lowest Risk among all Feasible Portfolios having identical Return.

(4) Portfolio Revision: Once an optimal portfolio has been constructed, it becomes necessary for the investor to constantly monitor the portfolio to ensure that it does not lose it optimality. In light of various developments in the market, the investor now has to revise his portfolio. This revision leads to addition (purchase) of some new securities and deletion (sale) of some of the existing securities from the portfolio. The nature of securities and their proportion in the portfolio changes as a result of the revision.

(5) Portfolio Evaluation: This process is concerned with assessing the performance of the portfolio over a selected period of time in terms of return and risk and it involves quantitative measurement of actual return realized and the risk borne by the portfolio over the period of investment. Various types of alternative measures of performance evaluation have been developed for use by investors and portfolio managers.

(c) Benefits of International Portfolio Investment are as follows:

(a) ***Reduce Risk:*** International investment aids to diversify risk as the gains from diversification within a country are therefore very much limited, because macro economic factors of different countries vary widely and do not follow the same phases of business cycles, different countries have securities of different industries in their market portfolio leading to correlation of expected returns from investment in different countries being lower than in a single country.

(b) ***Raise Return through better Risk – Return Trade off*:** International Investment aids to raise the return with a given risk and/or aids to lower the risk with a given rate of return. This is possible due to profitable investment opportunities being available in an enlarged situation and at the same time inter country dissimilarities reduce the quantum of risk.

(d) Benefits of Debit cards are as follows:

1) Obtaining a debit card is often easier than obtaining a credit card.
2) Using a debit card instead of writing cheques saves one from showing identification or giving his personal information at the time of the transaction.
3) Using a debit card frees him from carrying cash or a cheque book.
4) Using a debit card means he no longer has to stock up on traveller's cheques or cash when he travels
5) Debit cards may be more readily accepted by merchants than cheques, in other states or countries wherever the card brand is accepted.
6) The debit card is a quick, "pay now" product, giving one no grace period.
7) Using a debit card may mean one has less protection than with a credit card purchase for items which are never delivered, are defective, or misrepresented. But, as with credit cards, one may dispute unauthorized charges or other mistakes within 60 days. One should contact the card issuer if a problem cannot be resolved with the merchant.
8) Returning goods or canceling services purchased with a debit card is treated as if the purchase were made with cash or a cheque.

(e) Factors affects the selection of Mutual Funds is as follows:

(1) *Past Performance* – The Net Asset Value is the yardstick for evaluating a Mutual Fund. The higher the NAV, the better it is. Performance is based on the growth of NAV during the referral period after taking into consideration Dividend paid.
Growth = $(NAV_1 – NAV_0) + D_1 / NAV_0$.

(2) *Timing* – The timing when the mutual fund is raising money from the market is vital. In a bullish market, investment in mutual fund falls significantly in value whereas in a bearish market, it is the other way round where it registers growth. The turns in the market need to be observed.
(3) *Size of Fund* – Managing a small sized fund and managing a large sized fund is not the same as it is not dependent on the product of numbers. Purchase through large sized fund may by itself push prices up while sale may push prices down, as large funds get squeezed both ways. So it is better to remain with medium sized funds.
(4) *Age of Fund* – Longevity of the fund in business needs to be determined and its performance in rising, falling and steady markets have to be checked. Pedigree does not always matter as also success strategies in foreign markets.
(5) *Largest Holding* – It is important to note where the largest holdings in mutual fund have been invested.
(6) *Fund Manager* – One should have an idea of the person handling the fund management. A person of repute gives confidence to the investors.
(7) *Expense Ratio* – SEBI has laid down the upper ceiling for Expense Ratio. A lower Expense Ratio will give a higher return which is better for an investor.
(8) *PE Ratio* – The ratio indicates the weighted average PE Ratio of the stocks that constitute the fund portfolio with weights being given to the market value of holdings. It helps to identify the risk levels in which the mutual fund operates.
(9) *Portfolio Turnover* – The fund manager decides as to when he should enter or quit the market. A very low portfolio turnover indicates that he is neither entering nor quitting the market very frequently. A high ratio, on the other hand, may suggest that too frequent moves have lead the fund manager to miss out on the next big wave of investments. A simple average of the portfolio turnover ratio of peer group updated by mutual fund tracking agencies may serve as a benchmark. The ratio is lower of annual purchase plus annual sale to average value of the portfolio.

Question 4 **May 2016 - Paper**

Write short notes on any **four** of the following:

(a) Distinguish between Investment Bank and Commercial Bank.
(b) Horizontal merger and Vertical merger.
(c) Distinguish between Money market and Capital market.
(d) Operations in foreign exchange market are exposed to number of risks.
(e) Interface of financial policy and strategic management.

Solution

(a) The fundamental differences between an investment bank and a commercial bank can be outlined as follows:

Investment Banks	Commercial Banks
Investment Banks help their clients in raising capital by acting as an intermediary between the buyers and the sellers of securities (stocks or bonds)	Commercial Banks are engaged in the business of accepting deposits from customers and lending money to individuals and corporate
Investment Banks do not take deposits from customers	Commercial banks can legally take deposits from customers.
The Investment Banks do not own the securities and only act as an intermediary for smooth transaction of buying and selling securities.	Commercial Banks own the loans granted to their customers.
Investment Banks earn underwriting commission	Commercial banks earn interest on loans granted to their customers.

(b) (i) Horizontal Merger: The two companies which have merged are in the same industry, normally the market share of the new consolidated company would be larger and it is possible that it may move closer to being a monopoly or a near monopoly to avoid competition.
(ii) Vertical Merger: This merger happens when two companies that have 'buyer-seller' relationship (or potential buyer-seller relationship) come together.

(c) The capital market deals in financial assets. Financial assets comprises of shares, debentures, mutual funds etc. The capital market is also known as stock market.
Stock market and money market are two basic components of Indian financial system. Capital market deals with long and medium term instruments of financing while money market deals with short term instruments.
Some of the points of distinction between capital market and money market are as follows:

Money Market	**Capital Market**
There is no classification between primary market and secondary market	There is a classification between primary market and secondary market.
It deals for funds of short-term requirement (less than a year).	It deals with funds of long-term requirement (more than 1 year).
Money market instruments include interbank call money, notice money upto 14 days, short-term deposits upto three months, commercial paper, 91 days treasury bills.	Capital Market instruments are shares and debt instruments.
Money market participants are banks, financial institution, RBI and Government.	Capital Market participants include retail investors, institutional investors like Mutual Funds, Financial Institutions, corporate and banks.
Supplies funds for working capital requirement.	Supplies funds for fixed capital requirements.
Each single instrument is of a large amount.	Each single instrument is of a small amount.
Risk involved in money market is less due to smaller term of maturity. In short term the risk of default is less.	Risk is higher
Transactions take place over phone calls. Hence there is no formal place for transactions.	Transactions are at a formal place viz. the stock exchange.
The basic role of money market is liquidity adjustment.	The basic role of capital market includes putting capital to work, preferably to long term, secure and productive employment.
Closely and directly linked with the Central Bank of India	The Capital market feels the influence of the Central Bank but only indirectly and through the money market

(d) A firm dealing with foreign exchange may be exposed to foreign currency exposures. The exposure is the result of possession of assets and liabilities and transactions denominated in foreign currency. When exchange rate fluctuates, assets, liabilities, revenues, expenses that have been expressed in foreign currency will result in either foreign exchange gain or loss. A firm dealing with foreign exchange may be exposed to the following types of risks:

(i) **Transaction Exposure:** A firm may have some contractually fixed payments and receipts in foreign currency, such as, import payables, export receivables, interest payable on foreign currency loans etc. All such items are to be settled in a foreign currency. Unexpected fluctuation in exchange rate will have favourable or adverse impact on its cash flows. Such exposures are termed as transactions exposures.

(ii) **Translation Exposure:** The translation exposure is also called accounting exposure or balance sheet exposure. It is basically the exposure on the assets and liabilities shown in the balance sheet and which are not going to be liquidated in the near future. It refers to the probability of loss that the firm may have to face because of decrease in value of assets due to devaluation of a foreign currency despite the fact that there was no foreign exchange transaction during the year.

(iii) **Economic Exposure:** Economic exposure measures the probability that fluctuations in foreign exchange rate will affect the value of the firm. The intrinsic value of a firm is calculated by discounting the expected future cash flows with appropriate discounting rate. The risk involved in economic exposure requires measurement of the effect of fluctuations in exchange rate on different future cash flows.

(e) Interface of Financial Policy and Strategic Management: Financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The need for fund mobilization to support the expansion activity of firm is utmost important for any business.

Policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital.

Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all.

Question 5 **Nov 2016 - RTP**

Write a short note on
(a) Project Appraisal in inflationary conditions
(b) Bought Out Deals (BODs)
(c) Financial Engineering
(d) Call Money in Context of Money Market
(e) Nostro, Vostro and Lora Account

Rahul Malkan

Solution

(a) Under conditions of inflation, the project cost estimates that are relevant for a future date will suffer escalation. Inflationary conditions will tend to initiate the measurement of future cash flows. Either of the following two approaches may be used while appraising projects under such conditions:

(i) Adjust each year's cash flows to an inflation index, recognising selling price increases and cost increases annually; or

(ii) Adjust the 'Acceptance Rate' (cut-off) suitably retaining cash flow projections at current price levels.

An example of approach (ii) above can be as follows:

Normal Acceptance Rate : 15.0%

Expected Annual Inflation : 5.0%
Adjusted Discount Rate : 15.0 x 1.05 or 15.75%
It must be noted that measurement of inflation has no standard approach nor is easy. This makes the job of appraisal a difficult one under such conditions.

(b) It is a new method of offering equity shares, debentures etc., to the public. In this method, instead of dealing directly with the public, a company offers the shares/debentures through a sponsor. The sponsor may be a commercial bank, merchant banker, an institution or an individual. It is a type of wholesale of equities by a company. A company allots shares to a sponsor at an agreed price between the company and sponsor. The sponsor then passes the consideration money to the company and in turn gets the shares duly transferred to him. After a specified period as agreed between the company and sponsor, the shares are issued to the public by the sponsor with a premium. After the public offering, the sponsor gets the shares listed in one or more stock exchanges. The holding cost of such shares by the sponsor may be reimbursed by the company or the sponsor may get the profit by issue of shares to the public at premium.

Thus, it enables the company to raise the funds easily and immediately. As per SEBI guidelines, no listed company can go for BOD. A privately held company or an unlisted company can only go for BOD. A small or medium size company which needs money urgently chooses to BOD. It is a low cost method of raising funds. The cost of public issue is around 8% in India. But this method lacks transparency. There will be scope for misuse also. Besides this, it is expensive like the public issue method. One of the most serious short coming of this method is that the securities are sold to the investing public usually at a premium. The margin thus between the amount received by the company and the price paid by the public does not become additional funds of the company, but it is pocketed by the issuing houses or the existing shareholders.

(c) "Financial Engineering" involves the design, development and implementation of innovative financial instruments and processes and the formulation of creative solutions and problems in finance. Financial engineering lies in innovation and creativity to promote market efficiency. In involves construction of innovative asset-liability structures using a combination of basic instruments so as to obtain hybrid instruments which may either provide a risk-return configuration otherwise unviable or result in gain by heading efficiently, possibly by creating an arbitrage opportunity. It is of great help in corporate finance, investment management, trading activities and risk management.
Over the years, Financial managers have been coping up with the challenges of changing situations. Different new techniques of financial analysis and new financial instruments have been developed. The process that seeks to adopt existing financial instruments and develop new ones so as to enable financial market participants to cope more effectively with changing conditions is known as financial engineering.
In recent years, the rapidity with which corporate finance and investment finance have changed in practice has given birth to new area of study known as financial engineering. It involves use of complex mathematical modelling and high speed computer solutions. Financial engineering includes all this. It also involves any moral twist to an existing idea and is not limited to corporate finance. It has been practiced by commercial banks in offering new and tailor made products to different types of customers. Financial engineering has been used in schemes of merger and acquisitions.
The term financial engineering is often used to refer to risk management

(d) The Call Money is a part of the money market where, day to day surplus funds, mostly of banks, are traded. Moreover, the call money market is most liquid of all short-term money market segments.

The maturity period of call loans vary from 1 to 14 days. The money that is lent for one day in call money market is also known as 'overnight money'. The interest paid on call loans are known as the call rates. The call rate is expected to freely reflect the day-to-day lack of funds. These rates vary from day-to-day and within the day, often from hour-to-hour. High rates indicate the tightness of liquidity in the financial system while low rates indicate an easy liquidity position in the market.

In India, call money is lent mainly to even out the short-term mismatches of assets and liabilities and to meet CRR requirement of banks. The short-term mismatches arise due to variation in maturities i.e. the deposits mobilized are deployed by the bank at a longer maturity to earn more returns and duration of withdrawal of deposits by customers vary. Thus, the banks borrow from call money markets to meet short-term maturity mismatches.

Moreover, the banks borrow from call money market to meet the cash Reserve Ratio (CRR) requirements that they should maintain with RBI every fortnight and is computed as a percentage of Net Demand and Time Liabilities (NDTL).

(e) In interbank transactions, foreign exchange is transferred from one account to another account and from one centre to another centre. Therefore, the banks maintain three types of current accounts in order to facilitate quick transfer of funds in different currencies. These accounts are Nostro, Vostro and Loro accounts meaning "our", "your" and "their". A bank's foreign currency account maintained by the bank in a foreign country and in the home currency of that country is known as Nostro Account or "our account with you". For example, An Indian bank's Swiss franc account with a bank in Switzerland. Vostro account is the local currency account maintained by a foreign bank/branch. It is also called "your account with us". For example, Indian rupee account maintained by a bank in Switzerland with a bank in India. The Loro account is an account wherein a bank remits funds in foreign currency to another bank for credit to an account of a third bank.

Question 6 **Nov 2016 - Paper**

Write short notes on any **four** of the following:

(a) What is cross border leasing? State its advantages.
(b) What are the rigidities in the Indian money market?
(c) What is exchange traded fund ? What are its advantages ?
(d) What are the problems for mergers and acquisitions in India ?
(e) What makes an organization sustainable ? State the specific steps.

Solution

(a) Cross-border leasing is a leasing agreement where lessor and lessee are situated in different countries. This raises significant additional issues relating to tax avoidance and tax shelters. It has been widely used in some European countries, to arbitrage the difference in the tax laws of different countries.

Cross-border leasing have been in practice as a means of financing infrastructure development in emerging nations. Cross-border leasing may have significant applications in financing infrastructure development in emerging nations - such as rail and air transport equipment, telephone and telecommunications, equipment, and assets incorporated into power generation and distribution systems and other projects that have predictable revenue streams.

A major advantage of cross-border leasing is to reduce the overall cost of financing through utilization by the lessor of tax depreciation allowances to reduce its taxable income. The tax savings are passed through to the lessee as a lower cost of finance. The basic prerequisites are relatively high tax rates in the lessor's country, liberal depreciation rules and either very flexible or very formalistic rules governing tax ownership.

Other important advantages of cross border leasing include the following:

- The lessor is often able to utilize nonrecourse debt to finance a substantial portion of the equipment cost. The debt is secured by among other things, a mortgage on the equipment and by an assignment of the right to receive payments under the lease.
- Also, depending on the structure, in some countries the lessor can utilize very favourable "leveraged lease" financial accounting treatment for the overall transaction.
- In some countries, it is easier for a lessor to repossess the leased equipment following a lessee default because the lessor is an owner and not a mere secured lender.
- Leasing provides the lessee with 100% financing.

(b) Notwithstanding the deregulation process initiated by the Reserve Bank of India and several innovations, the money market is not free from certain rigidities which are hampering the growth of the market. The most important rigidities in the Indian money market are:

(i) Markets not integrated,
(ii) High volatility,
(iii) Interest rates not properly aligned,
(iv) Players restricted,
(v) Supply based-sources influence uses,
(vi) Not many instruments,
(vii) Players do not alternate between borrowing and lending,
(viii) Reserve requirements,
(ix) Lack of transparency,
(x) Inefficient Payment Systems,
(xi) Seasonal shortage of funds
(xii) Commercial transactions are mainly in cash, and
(xiii) Heavy Stamp duty limiting use of exchange bills

(c) Exchange Traded Funds (ETFs) were introduced in US in 1993 and came to India around 2002. ETF is a hybrid product that combines the features of an index mutual fund and stock and hence, is also called index shares. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.

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2. It is launched by an asset management company or other entity.
3. The investor does not need to physically store the commodity or bear the costs of upkeep which is part of the administrative costs of the fund.

4. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed ended fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

(d) Problems for mergers and acquisitions in India

- Indian corporates are largely promoter-controlled and managed.
- In some cases, the need for prior negotiations and concurrence of financial institutions and banks is an added rider, besides SEBI's rules and regulations.
- The reluctance of financial institutions and banks to fund acquisitions directly.
- The BIFR route, although tedious, is preferred for obtaining financial concessions.
- Lack of Exit Policy for restructuring/downsizing.
- Absence of efficient capital market system makes the Market capitalisation not fair in some cases.
- Valuation is still evolving in India.

(e) The concept of sustainable growth can be helpful for planning healthy corporate growth. This concept forces managers to consider the financial consequences of sales increases and to set sales growth goals that are consistent with the operating and financial policies of the firm. Often, a conflict can arise if growth objectives are not consistent with the value of the organization's sustainable growth. Question concerning right distribution of resources may take a difficult shape if we take into consideration the rightness not for the current stakeholders but for the future stakeholders also.

Sustainable growth is important to enterprise long-term development. Too fast or too slow growth will go against enterprise growth and development, so financial should play important role in enterprise development, adopt suitable financial policy initiative to make sure enterprise growth speed close to sustainable growth ratio and have sustainable healthy development.

Sustainable growth models assume that the business wants to:

1. maintain a target capital structure without issuing new equity;
2. maintain a target dividend payment ratio; and
3. increase sales as rapidly as market conditions allow.

Since the asset to beginning of period equity ratio is constant and the firm's only source of new equity is retained earnings, sales and assets cannot grow any faster than the retained earnings plus the additional debt that the retained earnings can support. The sustainable growth rate is consistent with the observed evidence that most corporations are reluctant to issue new equity. If, however, the firm is willing to issue additional equity, there is in principle no financial constraint on its growth rate.

Question 7 **May 2017 – RTP**

Write a short note on

(a) Lintner's Model of actual dividend behaviour
(b) Necessary conditions to introduce 'Commodity Derivative'
(c) 'Starting point and end point of an organisation is money'
(d) Benefits of Real Estate Investment Trusts (REITs)
(e) Chop Shop Method of Valuation

Solution

(a) The classic study of the actual dividend behavior was done by John Lintner in 1956. The study was conducted in two stages. First, he conducted a series of interviews with businessmen to form a view of how they went about their dividends decisions. He then formed a model on the basis of those interviews which could be tested on a larger data.

(b) His formula is

$D_1 = D_0 + [(EPS \times \text{Target Payout}) - D_0] \times Af$

Where

D_1= Dividend in year 1

D_0= Dividend in year 0

EPS = Earning Per Share

AF= Adjustment Factor.

Lintner model has two parameters:

(1) The target pay-out ratio and

(2) The spread at which current dividends adjust to the target.

From the interviews he conducted, it emerged that investment needs were not a major consideration in the determination of dividend policy, rather the decision to change the dividend was usually a response to a significant change in earnings which had disturbed the existing relationship between earnings and dividends. Lintner concluded that

(1) Companies tend to set long run target dividends-to-earning ratios according to the amount of positive net present value (NPV) project that are available.

(2) Earning increases are not always sustainable. As a result, dividend policy is not changed until managers can see that new earnings level are sustainable.

The following attributes are considered crucial for qualifying for the derivatives trade:

(1) a commodity should be durable and it should be possible to store it;

(2) units must be homogeneous;

(3) the commodity must be subject to frequent price fluctuations with wide amplitude; supply and demand must be large;

(4) supply must flow naturally to market and there must be breakdowns in an existing pattern of forward contracting.

The first attribute, durability and storability, has received considerable attention in commodity finance, since one of the economic functions often attributed to commodity derivatives markets is the temporal allocation of stocks.

Since commodity derivatives contracts are standardized contracts, the second attribute, requires the underlying product to be homogeneous, so that the underlying commodity as defined in the commodity derivatives contract corresponds with the commodity traded in the cash market. This allows for actual delivery in the commodity derivatives market.

The third attribute, a fluctuating price, is of great importance, since firms will feel little incentive to insure themselves against price risk if price changes are small. A broad cash market is important because a large supply of the commodity will make it difficult to establish dominance in the market place and a broad cash market will tend to provide for a continuous and orderly meeting of supply and demand forces.

The last crucial attribute, breakdowns in an existing pattern of forward trading, indicates that cash market risk will have to be present for a commodity derivatives market to come into existence. Should all parties decide to eliminate each and every price fluctuation by using cash forward contracts for example, a commodity derivatives market would be of little interest.

(c) No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and / or preference shares for mobilizing ownership capital.

Along with the mobilization of funds, policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio. However this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization under study.

Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions. A planner has to frame policies for regulating investments in fixed assets and for restraining of current assets. Investment proposals mooted by different business units may be addition of a new product, increasing the level of operation of an existing product and cost reduction and efficient utilization of resources through a new approach and closer monitoring of the different critical activities.

Now, given these three types of proposals a planner should evaluate each one of them by making within group comparison in the light of capital budgeting exercise.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the firm.

It may be noted from the above discussions that financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies related to external awareness about the firm, specially the awareness of the investors about the firm, in respect of its internal performance. There is always a process of evaluation active in the minds of the current and future stake holders of the company. As a result, preference and patronage for the company depends significantly on the financial policy framework. And hence attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself.

(d) Reits typically offer the following benefits:

- For the Investors: REITs as an investment class provide the common man an opportunity to invest in fixed income securities which also provide long term capital appreciation and a natural inflation hedge. It also opens to small investors an arena (i.e. rent generating real estate assets) which was hitherto the monopoly of large investors.
- For the Industry: Reits assist in streamlining the real estate sector by creating a new and transparent source of raising finance in the real estate sector. Further, Reits can provide developers with institutional capital to sell their assets and use funds to repay banks and/or utilize the funds for more development.

(e) This approach attempts to identify multi-industry companies that are undervalued and would have more value if separated from each other. In other words as per this approach an attempt is made to buy assets below their replacement value. This approach involves following three steps:

Step 1: Identify the firm's various business segments and calculate the average capitalization ratios for firms in those industries.

Step 2: Calculate a "theoretical" market value based upon each of the average capitalization ratios.

Step 3: Average the "theoretical" market values to determine the "chop-shop" value of the firm.

Question 8 **May 2017 - Paper**

Write short notes on any FOUR of the following:

(a) What makes an organization financially sustainable?
(b) Distinguish between Cash and Derivative Market.
(c) Briefly explain the main strategies for exposure management .
(d) What is simulation analysis and how it is beneficial?
(e) What is commercial meaning of synergy and how it used as a tool when deciding Merger and Acquisitions?

Solution

(a) To be financially sustainable, an organization must:

- have more than one source of income;
- have more than one way of generating income;
- do strategic, action and financial planning regularly;
- have adequate financial systems;
- have a good public image;
- be clear about its values (value clarity); and
- have financial autonomy.

(b) The basic differences between Cash and the Derivative market are enumerated below: -

(a) In cash market tangible assets are traded whereas in derivative market contracts based on tangible or intangibles assets like index or rates are traded.
(b) In cash market, we can purchase even one share whereas in Futures and Options minimum lots are fixed.
(c) Cash market is more risky than Futures and Options segment because in "Futures and Options" risk is limited.
(d) Cash assets may be meant for consumption or investment. Derivative contracts are for hedging, arbitrage or speculation.
(e) The value of derivative contract is always based on and linked to the underlying security. However, this linkage may not be on point-to-point basis.
(f) In the cash market, a customer must open securities trading account with a securities depository whereas to trade futures a customer must open a future trading account with a derivative broker.
(g) Buying securities in cash market involves putting up all the money upfront whereas buying futures simply involves putting up the margin money.
(h) With the purchase of shares of the company in cash market, the holder becomes part owner of the company. While in future it does not happen.

(c) Four separate strategy options are feasible for exposure management. They are:

(a) Low Risk: Low Reward- This option involves automatic hedging of exposures in the forward market as soon as they arise, irrespective of the attractiveness or otherwise of the forward rate.

(b) Low Risk: Reasonable Reward- This strategy requires selective hedging of exposures whenever forward rates are attractive but keeping exposures open whenever they are not.

(c) High Risk: Low Reward- Perhaps the worst strategy is to leave all exposures unhedged.

(d) High Risk: High Reward- This strategy involves active trading in the currency market through continuous cancellations and re -bookings of

(e) forward contracts. With exchange controls relaxed in India in recent times, a few of the larger companies are adopting this strategy.

(d) Simulation is the exact replica of the actual situation. To simulate an actual situation, a model shall be prepared. The simulation Analysis is a technique, in which infinite calculations are made to obtain the possible outcomes and probabilities for any given action.

Monte Carlo simulation ties together sensitivities and probability distributions. The method came out of the work of first nuclear bomb and was so named because it was based on mathematics of Casino gambling. Fundamental appeal of this analysis is that it provides decision makers with a probability distribution of NPVs rather than a single point estimates of the expected NPV.

This analysis starts with carrying out a simulation exercise to model the investment project. It involves identifying the key factors affecting the project and their inter relationships. It involves modeling of cash flows to reveal the key factors in fluencing both cash receipt and payments and their inter relationship.

This analysis specifies a range for a probability distribution of potential outcomes for each of model's assumptions.

1. Modelling the project: The model shows the relationship of NPV with parameters and exogenous variables. (Parameters are input variables specified by decision maker and held constant over all simulation runs. Exogenous variables are input variables, which are stochastic in nature and outside the control of the decisio n maker).
2. Specify values of parameters and probability distributions of exogenous variables.
3. Select a value at random from probability distribution of each of the exogenous variables.
4. Determine NPV corresponding to the randomly generated value of exogenous variables and pre-specified parameter variables.
5. Repeat steps (3) & (4) a large number of times to get a large number of simulated NPVs.
6. Plot probability distribution of NPVs and compute a mean and Standard Deviation of returns to gauge the project's level of risk.

Advantages of Simulation Analysis:

(1) We can predict all type of bad market situation beforehand.

(2)Handle problems characterized by

(a) numerous exogenous variables following any kind of distribution.
(b) Complex inter-relationships among parameters, exogenous variables and endogenous variables. Such problems defy capabilities of analytical methods.
(c) Compels decision maker to explicitly consider the inter -dependencies and uncertainties featuring the project.

(e) Synergy may be defined as

follows: V (AB) > V (A) + V (B)

In other words the combined value of two firms or companies shall be more than their individual value. Synergy is the increase in performance of the combined firm over what the two firms are already expected or required to accomplish as independent firms. This may be result of complimentary services economics of scale or both.

A good example of complimentary activities can be that one company may have a good networking of branches and the other company may have efficient production system. Thus the merged companies will be more efficient than individual companies.

On similar lines, economics of large scale is also one of the reasons for synergy benefits. The main reason is that, the large scale production results in lower average cost of production e.g. reduction in overhead costs on account of sharing of central services such as accounting and finances, office executives, top level management, legal, sales promotion and advertisement etc.

These economics can be "real" arising out of reduction in factor input per unit of output, or pecuniary economics are realized from paying lower prices for factor inputs for bulk transactions.

Question 9 **Nov 2017 - RTP**

Write a short note on

(a) Project appraisal under inflationary conditions
(b) Salient features of Operating Lease
(c) Radical approach in Dividend Policies
(d) Synergy in the context of Mergers and Acquisitions
(e) Main functions of an investment bank

Solution

(a) Under conditions of inflation, the project cost estimates that are relevant for a future date will suffer escalation. Inflationary conditions will tend to initiate the measurement of future cash flows. Either of the following two approaches may be used while appraising projects under such conditions:

(i) Adjust each year's cash flows to an inflation index, recognising selling price increases and cost increases annually; or

(ii) Adjust the 'Acceptance Rate' (cut-off) suitably retaining cash flow projections at current price levels.

An example of approach (ii) above can be as follows:

Normal Acceptance Rate	:	15.0%
Expected Annual Inflation	:	5.0%
Adjusted Discount Rate	:	15.0 x 1.05 or 15.75%

It must be noted that measurement of inflation has no standard approach nor is easy. This makes the job of appraisal a difficult one under such conditions.

(b)

(i) The lease term is significantly less than the economic life of the equipment.
(ii) It can be cancelled by the lessee prior to its expiration date.
(iii) The lease rental is generally not sufficient to fully amortize the cost of the asset.
(iv) The cost of maintenance, taxes, insurance are the responsibility of the lessor.
(v) The lessee is protected against the risk of obsolescence.
(vi) The lessor has the option to recover the cost of the asset from another party on cancellation of the lease by leasing out the asset.

(c)

This approach takes into consideration the tax aspects on dividend i.e. the corporate tax and the personal tax. Also it considers the fact that tax on dividend and capital gains are taxed as different rate. The approach is based on one premise that if tax on dividend is higher than tax on capital gains, the share of the company will be attractive if the company is offering capital gain. Similarly, if tax on dividend is less than the tax on capital gains, i.e. company offering dividend rather than capital gains, will be priced better.

(d) Synergy May be defined as follows:

V (AB) > V(A) + V (B).

In other words the combined value of two firms or companies shall be more than their individual value. This may be result of complimentary services economics of scale or both.

A good example of complimentary activities can a company may have a good networking of branches and other company may have efficient production system. Thus the merged companies will be more efficient than individual companies.

On Similar lines, economics of large scale is also one of the reason for synergy benefits. The main reason is that, the large scale production results in lower average cost of production e.g. reduction in overhead costs on account of sharing of central services such as accounting and finances, Office executives, top level management, legal, sales promotion and advertisement etc.

These economics can be "real" arising out of reduction in factor input per unit of output, whereas pecuniary economics are realized from paying lower prices for factor inputs to bulk transactions.

(e) The following are, briefly, a summary of investment banking functions:

- Underwriting: The underwriting function within corporate finance involves shepherding the process of raising capital for a company. In the investment banking world, capital can be raised by selling either stocks or bonds to the investors.
- Managing an IPO (Initial Public Offering): This includes hiring managers to the issue, due diligence and marketing the issue.
- Issue of debt: When a company requires capital, it sometimes chooses to issue public debt instead of equity.
- Follow-on hiring of stock: A company that is already publicly traded will sometimes sell stock to the public again. This type of offering is called a follow-on offering, or a secondary offering.
- Mergers and Acquisitions: Acting as intermediary between Acquirer and target company.
- Sales and Trading: This includes calling high networth individuals and institutions to suggest trading ideas (on a caveat emptor basis), taking orders and facilitating the buying and selling of stock, bonds or other securities such as currencies.
- Research Analysis: Research analysts study stocks and bonds and make recommendations on whether to buy, sell, or hold those securities.
- Private Placement: A private placement differs little from a public offering aside from the fact that a private placement involves a firm selling stock or equity to private investors rather than to public investors.
- Financial Restructuring: When a company cannot pay its cash obligations - it goes bankrupt. In this situation, a company can, of course, choose to simply shut down operations and walk away or, it can also restructure and remain in business.

Question 10 **Nov 2017 - Paper**

Write short notes on any FOUR of the following:

(a) Various processes of strategic decision making
(b) Financial restructuring
(c) Chop Shop method of valuation
(d) What are P-notes? Why it is preferable route for foreigners to invest in India?
(e) Differentiate between 'Off-share funds" and 'Asset Management Mutual Funds'.

Solution

(a) Capital investment is the springboard for wealth creation. In a world of economic uncertainty, the investors want to maximize their wealth by selecting optimum investment and financial opportunities that will give them maximum expected returns at minimum risk. Since management is ultimately responsible to the investors, the objective of corporate financial management should implement investment and financing decisions which should satisfy the shareholders by placing them all in an equal, optimum financial position. The satisfaction of the interests of the shareholders should be perceived as a means to an end, namely maximization of shareholders' wealth. Since capital is the limiting factor, the problem that the management will face is the strategic allocation of limited funds between alternative uses in such a manner, that the companies have the ability to sustain or increase investor returns through a continual search for investment opportunities that generate funds for their business and are more favourable for the investors. Therefore, all businesses need to have the following three fundamental essential elements:

- A clear and realistic strategy,
- The financial resources, controls and systems to see it through and
- The right management team and processes to make it happen.

(b) Financial restructuring, is carried out internally in the firm with the consent of its various stakeholders. Financial restructuring is a suitable mode of restructuring of corporate firms that have incurred accumulated sizable losses for / over a number of years. As a sequel, the share capital of such firms, in many cases, gets substantially eroded / lost; in fact, in some cases, accumulated losses over the years may be more than share capital, causing negative net worth. Given such a dismal state of financial affairs, a vast majority of such firms are likely to have a dubious potential for liquidation. Can some of these Firms be revived? Financial restructuring is one such a measure for the revival of only those firms that hold promise/prospects for better financial performance in the years to come. To achieve the desired objective, 'such firms warrant / merit a restart with a fresh balance sheet, which does not contain past accumulated losses and fictitious assets and shows share capital at its real/true worth.

(c) This approach attempts to identify multi-industry companies that are undervalued and would have more value if separated from each other. In other words as per this approach an attempt is made to buy assets below their replacement value. This approach involves following three steps:
Step 1: Identify the firm's various business segments and calculate the average capitalization ratios for firms in those industries.
Step 2: Calculate a "theoretical" market value based upon each of the average capitalization ratios.
Step 3: Average the "theoretical" market values to determine the "chop-shop" value of the firm.

(d) International access to the Indian Capital Markets is limited to FIIs registered with SEBI. The other investors, interested in investing in India can open their account with any registered FII and the FII gets itself registered with SEBI as its sub-account. There are some investors who do not want to disclose their identity or who do not want to get themselves registered with SEBI.
The foreign investors prefer P-Notes route for the following reasons:

(i) Some investors do not want to reveal their identities. P-Notes serve this purpose.
(ii) They can invest in Indian Shares without any formalities like registration with SEBI, submitting various reports etc.
(iii) Saving in cost of investing as no office is to be maintained.
(iv) No currency conversion.

FII are not allowed to issue P-Notes to Indian nationals, person of Indian origin or overseas corporate bodies.

(e)

Off-Shore Funds	Mutual Funds
Raising of Money internationally and investing money domestically (in India).	Raising of Money domestically as well as investing money domestically (in India).
Number of Investors is very few.	Number of Investors is very large.
Per Capita investment is very high as investors are HNIs.	Per Capita investment is very low as investors as meant for retail/ small investors.
Investment Agreement is basis of management of the fund.	Offer Document is the basis of management of the fund.

Question 11 **May 2018 - RTP**

Write short notes on:

a) Interface of Financial Policy and Strategic Management
b) Social Cost Benefit Analysis in relation to evaluation of an industrial project
c) Green Shoe Option
d) Debt/Asset Securitization
e) Forfaiting versus Export Factoring

Solution

(a) Interface of Financial Policy and Strategic Management: Financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The need for fund mobilization to support the expansion activity of firm is utmost important for any business.

Policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital.

Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all.

(b) Social Cost Benefit Analysis in relation to evaluation of an industrial project: This refers to the moral responsibility of both PSU and private sector enterprises to undertake socially desirable projects – that is, the social contribution aspect needs to be kept in view.

Industrial capital investment projects are normally subjected to rigorous f easibility analysis and cost benefit study from the point of view of the investors. Such projects, especially large ones often have a ripple effect on other sections of society, local environment, use of scarce national resources etc. Conventional cost -benefit analysis ignores or does not take into account or ignores the societal effect of such projects. Social Cost Benefit (SCB) is recommended and resorted to in such cases to bring under the scanner the social costs and benefits.

SCB sometimes changes the very outlook of a project as it brings elements of study which are unconventional yet very relevant. In a study of a famous transportation project in the UK from a normal commercial angle, the project was to run an annual deficit of more than 2 million pounds. The evaluation was adjusted for a realistic fare structure which the users placed on the services provided which changed the picture completely and the project got justified. Large public sector/service projects especially in under-developed countries which would get rejected on simple commercial considerations will find justification if the social costs and benefits are considered.

SCB is also important for private corporations who have a moral responsibility to undertake socially desirable projects, use scarce natural resources in the best interests of society, generate employment and revenues to the national exchequer.

Indicators of the social contribution include

(i) Employment potential criterion;
(ii) Capital output ratio – that is the output per unit of capital;
(iii) Value added per unit of capital;
(iv) Foreign exchange benefit ratio.

(c) Green Shoe Option: It is an option that allows the underwriting of an IPO to sell additional shares if the demand is high. It can be understood as an option that allows the underwriter for a new issue to buy and resell additional shares upto a certain pre - determined quantity.

Looking to the exceptional interest of investors in terms of over -subscription of the issue, certain provisions are made to issue additional shares or bonds to underwriters for distribution. The issuer authorises for additional shares or bonds. In common parlance, it is the retention of over-subscription to a certain extent. It is a special feature of euro-issues. In euro-issues the international practices are followed.

In the Indian context, green shoe option has a limited connotation. SEBI guidelines governing public issues contain appropriate provisions for accepting over - subscriptions, subject to a ceiling, say, 15 per cent of the offer made to public. In certain situations, the green-shoe option can even be more than 15 per cent.

Examples:

IDBI had come–up earlier with their Flexi bonds (Series 4 and 5). This is a debt - instrument. Each of the series was initially floated for Rs.750 crores. SEBI had permitted IDBI to retain an excess of an equal amount of Rs.750 crores.

ICICI had launched their first tranche of safety bonds through unsecured redeemable debentures of Rs.200 crores, with a green shoe option for an identical amount.

More recently, Infosys Technologies has exercised the green shoe option to purchase upto 7,82,000 additional ADSs representing 3,91,000 equity shares. This offer initially involved 5.22 million depository shares, representing 2.61 million domestic equity shares.

(d) Debt/Asset Securitization: Debt Securitisation is a method of recycling of funds. This method is mostly used by finance companies to raise funds against financial assets such as loan receivables, mortgage backed receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors, etc. and thus beneficial to such financial intermediaries to support their lending volumes. Thus, assets generating steady cash flows are packaged together and against this assets pool market securities can be issued. Investors are usually cash-rich institutional investors like mutual funds and insurance companies.

The process can be classified in the following three functions:

1. **The origination function** – A borrower seeks a loan from finance company, bank, housing company or a financial institution. On the basis of credit worthiness repayment schedule is structured over the life of the loan.

2. **The pooling function** – Many similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special Purpose Vehicle), which acts as a trustee for the investo r. Once the assets are transferred they are held in the organizers portfolios.
3. **The securitization function** – It is the SPV's job to structure and issue the securities on the basis of asset pool. The securities carry coupon and an expected maturity, which can be asset base or mortgage based. These are generally sold to investors through merchant bankers. The investors interested in this type of securities are generally institutional investors like mutual fund, insurance companies etc. The originator usually keeps the spread available (i.e. difference) between yield from secured asset and interest paid to investors.

   Generally, the process of securitization is without recourse i.e. the investor bears the credit risk of default and the issuer is under an obligation to pay to investors only if the cash flows are received by issuer from the collateral.

(1) Forfaiting versus Export Factoring

(i) A forfaiter discounts the entire value of the note/bill. In a factoring arrangement the extent of financing available is 75-80%.
(ii) The forfaiter's decision to provide financing depends upon the financing standing of the availing bank. On the other hand in a factoring deal the export factor bases his credit decision on the credit standards of the exporter.
(iii) Forfaiting is a pure financial agreement while factoring includes ledger administration as well as collection.
(iv) Factoring is a short-term financial deal. Forfaiting spreads over 3-5 years.

Question 12 **May 2018 - Paper**

Write short notes on any **four** of the following:

(a) Interface of Financial Policy and Strategic Management.
(b) Nostro, Vostro and Loro Accounts.
(c) Distinguish between Credit Card and Debit Card.
(d) Instruments of International finance.
(e) Straddles and Strangles.

Solution

(a) Interface of Financial Policy and Strategic Management: Financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth.

- Sources of finance and capital structure are the most important dimensions of a strategic plan. The need for fund mobilization to support the expansion activity of firm is utmost important for any business.
- Policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital.
- Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all.

(b) In interbank transactions, foreign exchange is transferred from one account to another account and from one centre to another centre. Therefore, the banks maintain three types of current accounts in order to facilitate quick transfer of funds in different currencies. These accounts are Nostro, Vostro and Loro accounts meaning "our", "your" and "their". A bank's foreign currency account maintained by the bank in a

Rahul Malkan

(c) foreign country and in the home currency of that country is known as Nostro Account
(d) or "our account with you". For example, An Indian bank's Swiss franc account with a bank in Switzerland. Vostro account is the local currency account maintained by a foreign bank/branch. It is also called "your account with us". For example, Indian rupee account maintained by a bank in Switzerland with a bank in India. The Loro account is an account wherein a bank remits funds in foreign currency to another bank for credit to an account of a third bank.

(e) Difference between Credit Card and Debit Card

It's the difference between "debit" and "credit." Debit means "subtract." When one uses a debit card, one is subtracting his money from his own bank account. Debit cards allow him spend only what is in his bank account. It is a quick transaction between the merchant and his personal bank account.

Credit is money made available by a bank or other financial institution, like a loan. The amount the issuer allows one to use is determined by his credit history, income, debts, and ability to pay. One may use the credit with the understanding that he will repay the amount, plus interest if he does not pay in full each month. He will receive a monthly statement detailing his charges and payment requirements.

The basic difference between the two is the fact that a credit card takes the form of a personal loan from the issuing bank to the consumer, while a debit card is more like a cheque, money is directly deducted from a person's bank account to pay for transaction.

(f) The various financial instruments dealt with in the international market are briefly described below:

1. **Euro Bonds:** A Eurobond is an international bond that is denominated in a currency not native to the country where it is issued. Also called external bond e.g. A Yen floated in Germany; a yen bond issued in France.
2. **Foreign Bonds:** These are debt instruments denominated in a currency which is foreign to the borrower and is denominated in a currency that is native to the country where it is issued. A British firm placing $ denominated bonds in USA is said to be selling foreign bonds.
3. **Fully Hedged Bonds:** In foreign bonds, the risk of currency fluctuations exists. Fully hedged bonds eliminate that risk by selling in forward markets the entire stream of interest and principal payments.
4. **Floating Rate Notes:** These are debt instruments issued upto 7 years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They providecheaper money than fixed rate debt instruments; however, they suffer from inherent interest rate volatility risk.
5. **Euro Commercial Papers:** Euro Commercial Papers (ECPs) are short-term money market instruments. They are for maturities for less than a year. They are usually designated in US dollars.

(g) Straddles

An options strategy with which the investor holds a position in both a call and put with the same strike price and expiration date. Straddles are a good strategy to pursue if an investor believes that a stock's price will move significantly, but is unsure as to which direction. The stock price must move significantly if the investor is to make a profit.
However, should only a small movement in price occur in either direction, the investor will experience a loss. As a result, a straddle is extremely risky to perform. Additionally, on stocks that are expected to jump, the market tends to price options at a higher premium, which ultimately reduces the expected payoff should the stock move significantly.

This is a good strategy if speculators think there will be a large price movement in the near future but is unsure of which way that price movement will be. It has one common strike price.

Strangles

The strategy involves buying an out-of-the-money call and an out-of-the-money put option. A strangle is generally less expensive than a straddle as the contracts are purchased out of the money. Strangle is an unlimited profit, limited risk strategy that is taken when the options trader thinks that the underlying stock will experience significant volatility in the near term. It has two different strike prices.

Question 13 **May 2018 (New) - RTP**

DISTINGUISH between:

a) Banking and Non-Banking financial institutions
b) Primary participants and secondary participants in securitization
c) Islamic Finance and Conventional Finance

Solution

a) Distinction between Banking and Non-Banking financial institutions

Basis for comparison	Banking Institutions	Non-Banking Institutions
Meaning	Bank is a financial intermediary which provides banking services to general people. And it requires a bank license for that.	Non-banking institutions are basically company form of organization that provides banking services to people without holding a banking license.
Transaction Services	Banks provide transaction services like providing overdraft facility, issue of cheque books, travelers cheque, demand draft, transfer of funds, etc.	The non-banking institutions do not provide any transaction services.
Money supply	Bank deposits constitute a major part of the national money supply.	The money supply of the nonbanking institutions is small.
Credit creation	Banks create credit.	Non-banking institutions do not create credit.
Compliance	Banks are required to comply with some of the legal requirements like Cash Reserve Ratio (CRR), Statutory Liquidity Ratio and Capital Adequacy Ratio (CAR).	Non-banking institutions are not required to comply with these legal requirements.
Demand Deposit	They are not accepted.	They are accepted.
Payment and settlement system	Contains an integral part of the system.	Not a part of the system.

b) Distinction between Primary Participants and Secondary Participants in securitization

Primary Participants: Primary Participants are main parties to this process. The primary participants in the process of securitization are as follows:

(i) **Originator**: It is the initiator of deal or can be termed as securitizer. It is an entity which sells the assets lying in its books and receives the funds generated through the sale of such assets.

(ii) **Special Purpose Vehicle**: Also, called SPV is created for the purpose of executing the deal. Since issuer originator transfers all rights in assets to SPV, it holds the legal title of these assets. It is created especially for the purpose of securitization only and normally could be in form of a company, a firm, a society or a trust.

(iii) **The Investors**: Investors are the buyers of securitized papers which may be an individual, an institutional investor such as mutual funds, provident funds, insurance companies, mutual funds, Financial Institutions etc.

Secondary Participants

Besides, the primary participants, other parties involved into the securitization process are as follows:

(i) **Obligors**: Actually they are the main source of the whole securitization process. They are the parties who owe money to the firm and are assets in the Balance Sheet of Originator.

(ii) **Rating Agency**: Since the securitization is based on the pools of assets rather than the originators, the assets have to be assessed in terms of its credit quality and credit support available and that is where the credit rating agencies come.

(iii) **Receiving and Paying Agent (RPA)**: Also, called Servicer or Administrator, it collects the payment due from obligor(s) and passes it to SPV. It also follow up with defaulting borrower and if required initiate appropriate legal action against them.

(iv) **Agent or Trustee:** Trustees are appointed to oversee that all parties to the deal perform in the true spirit of terms of agreement. Normally, it takes care of interest of investors who acquires the securities.

(v) **Credit Enhancer:** Since investors in securitized instruments are directly exposed to performance of the underlying and sometime may have limited or no recourse to the originator, they seek additional comfort in the form of credit enhancement. In other words, they require credit rating of issued securities which also empowers marketability of the securities.

Originator itself or a third party say a bank may provide an additional comfort called Credit Enhancer. While originator provides his comfort in the form of over collateralization or cash collateral, the third party provides it in form of letter of credit or surety bonds.

(vi) **Structurer:** It brings together the originator, investors, credit enhancers and other parties to the deal of securitization. Normally, these are investment bankers also called arranger of the deal. It ensures that deal meets all legal, regulatory, accounting and tax laws requirements.

c) Distinction between Islamic Finance and Conventional Finance

How Islamic Finance is different from Conventional Finance

Major differences between Islamic finance and other form of finance (Conventional Finance) are as follows:

Basis	**Islamic Finance**	**Conventional Finance**
Promotion	Islamic Finance promotes just, fair and balanced society. Hence, interest is prohibited.	Based on commercial objectives and interest must be paid irrespective of outcome of business.

Ethical framework	Structured on ethical and moral framework of Sharia. Verses from the holy Quran and tradition from As-Sunnah are two divine guidance.	No such framework.
Speculation	The financial transactions should be free from the element of uncertainty (Gharar) and gambling (Maisir)	No such restrictions.
Unlawful Goods and Services	Islamic Finance must not be involved in any transactions not involve trade not allowed as per Islamic principles such as alcohol, armaments, pork and other socially detrimental products.	There are no such restrictions.

Question 14 **May 2018 (New) - RTP**

a) DESCRIBE Value at Risk and its application.

b) EXPLAIN the concept of Bootstrapping and describe the various methods of bootstrapping used by start ups.

c) DESCRIBE the guidelines for SME listing and its benefits.

Solution

a) VAR is a measure of risk of investment. Given the normal market condition in a set of period, say, one day it estimates how much an investment might lose. This investment can be a portfolio, capital investment or foreign exchange etc., VAR answers two basic questions -

(i) What is worst case scenario?

(ii) What will be loss?

It was first applied in 1922 in New York Stock Exchange, entered the financial world in 1990s and become world's most widely used measure of financial risk.

Features of VAR

Following are main features of VAR

(i) *Components of Calculations:* VAR calculation is based on following three components :

(a) Time Period

(b) Confidence Level – Generally 95% and 99%

(c) Loss in percentage or in amount

(ii) *Statistical Method:* It is a type of statistical tool based on Standard Deviation.

(iii) *Time Horizon:* VAR can be applied for different time horizons say one day, one week, one month and so on.

(iv) *Probability:* Assuming the values are normally attributed, probability of maximum loss can be predicted.

(v) *Control Risk:* Risk can be controlled by selling limits for maximum loss.

(vi) *Z Score:* Z Score indicates how many standard Deviations is away from Mean value of a population. When it is multiplied with Standard Deviation it provides VAR.

Application of VAR

VAR can be applied

(i) to measure the maximum possible loss on any portfolio or a trading position.

(ii) as a benchmark for performance measurement of any operation or trading.

(iii) to fix limits for individuals dealing in front office of a treasury department.

(iv) to enable the management to decide the trading strategies.

(v) as a tool for Asset and Liability Management especially in banks.

b) An individual is said to be boot strapping when he or she attempts to found and build a company from personal finances or from the operating revenues of the new company.
A common mistake made by most founders is that they make unnecessary expenses towards marketing, offices and equipment they cannot really afford. So, it is true that more money at the inception of a business leads to complacency and wasteful expenditure. On the other hand, investment by startups from their own savings leads to cautious approach. It curbs wasteful expenditures and enable the promoter to be on their toes all the time.

Methods: Here are some of the methods in which a startup firm can bootstrap:

(i) **Trade Credit:** When a person is starting his business, suppliers are reluctant to give trade credit. They will insist on payment of their goods supplied either by cash or by credit card. However, a way out in this situation is to prepare a well-crafted financial plan. The next step is to pay a visit to the supplier's office. If the business organization is small, the owner can be directly contacted. On the other hand, if it is a big firm, the Chief Financial Officer can be contacted and convinced about the financial plan.

(ii) **Factoring:** This is a financing method where accounts receivable of a business organization is sold to a commercial finance company to raise capital. The factor then got hold of the accounts receivable of a business organization and assumes the task of collecting the receivables as well as doing what would've been the paperwork. Factoring can be performed on a non-notification basis. It means customers may not be told that their accounts have been sold.

(iii) **Leasing:** Another popular method of bootstrapping is to take the equipment on lease rather than purchasing it. It will reduce the capital cost and also help lessee (person who take the asset on lease) to claim tax exemption. So, it is better to a take a photocopy machine, an automobile or a van on lease to avoid paying out lump sum money which is not at all feasible for a startup organization.

c) Guidelines for SME Listing

(i) *Capital:* The post issue face value capital should not exceed Rs.Twenty-five crores.

(ii) *Trading lot size*

- ❖ The minimum application and trading lot size shall not be less than Rs.1,00,000/-.
- ❖ The minimum depth shall be Rs.1,00,000/- and at any point of time it shall not be less than Rs.1,00,000/-.
- ❖ The investors holding with less than Rs.1,00,000/- shall be allowed to offer their holding to the Market Maker in one lot.
- ❖ However in functionality the market lot will be subject to revival after a stipulated time.

(iii) *Participants:* The existing Members of the Exchange shall be eligible to participate in SME Platform.

(iv) *Underwriting:* The issues shall be 100% underwritten and Merchant Bankers shall underwrite 15% in their own account.

Benefits of Listing in SME

(i) *Easy access to Capital:* BSE SME provides an avenue to raise capital through equity infusion for growth oriented SME's.

(ii) *Enhanced Visibility and Prestige:* The SME's benefit by greater credibility and enhanced financial status leading to demand in the company's shares and higher valuation of the company.

(iii) *Encourages Growth of SMEs:* Equity financing provides growth opportunities like expansion, mergers and acquisitions thus being a cost effective and tax efficient mode.

(iv) *Ensures Tax Benefits:* In case of listed securities Short Term Gains Tax is 15% and there is absolutely no Long Term Capital Gains Tax.

(v) *Enables Liquidity for Shareholders*: Equity financing enables liquidity for shareholders provides growth opportunities like expansion, mergers and acquisitions, thus being a cost effective and tax efficient mode.

(vi) *Equity financing through Venture Capital*: Provides an incentive for Venture Capital Funds by creating an Exit Route and thus reducing their lock in period.

(vii) *Efficient Risk Distribution*: Capital Markets ensure that the capital flows to its best uses and those riskier activities with higher payoffs are funded.

(viii) Employee Incentives: Employee Stock Options ensures stronger employee commitment, participation and recruitment incentive.

Question 15 **May 2018 (New) – Paper**

Write a short note on Real Estate Regulatory Authority (RERA).

Solution

India has a vast population with needs regarding food, house and jobs on an ever-increase mode. The housing among these fields is one of the major ones. Thousands of people have grown to be rich and as many of them have made loss in real estate business. It is the one of the leading revenue generators for the government. Even though it has such strong presence in the country, it never had a regulating body. Due to the failure of the government to observe this, many people have become the victims of some scheming people doing the real estate business. The buyers who come from a middle-class background have time and again fallen prey to such petty real estate developers. There was a growing need to bring a transparent government body which can check the developers.

Finally, the government delivered by making an authority known as RERA which stands for Real Estate Regulatory Authority. It was passed in March 2016 by the parliament. This promises to bring a justice to the buyer through making strict policies that have to be fulfilled by the developers to sell their projects. The major problem that real estate in India is facing is that of the delayed possession given to the home seeker by the rich and the cunning builders. Thus, RERA will help people by bringing in a high level of transparency and discipline that these builders must have to follow.

The laws under RERA are still in the early days of development but one thing is for sure that there will be a huge relief for the buyers regarding developer -specific risk. The mechanism of RERA will be made such that it provides a common ground for both the buyers as well as the developers. Transparency is the key point regarding the rules under RERA as the government wants that every aspect of information that the general public should know should be made available on an informational portal.

The regulatory risk will also be laid upon the developer as he will have to pay compensation if any mishap happens while giving the possession of a unit. All the builders will have to register themselves under RERA which will see a low risk in the property business.

Question 16 **May 2018 (New) – Paper**

Explain the interface of Financial Policy and Strategic Management

Solution

The interface of strategic management and financial policy will be clearly understood if we appreciate the fact that the starting point of an organization is money and the end point of that organization is also money. No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both i.e. internally and externally mobilized financial base.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The need for fund mobilization to support the expansion activity of firm is very vital for any organization. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and / or preference shares for mobilizing ownership capital and debenture to raise borrowed capital.

Policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio.

However this ratio in its ideal form varies from industry to industry. Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions. A planner has to frame policies for regulating investments in fixed assets and for restraining of current assets. Investment proposals mooted by different business units may be divided into three groups. One type of proposal will be for addition of a new product, increasing the level of operation of an existing product and cost reduction and efficient utilization of resources through a new approach and or closer monitoring of the different critical activities. Dividend policy is another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the organization.

It may be noted from the above discussions that financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. As a result preference and patronage for the company depends significantly on the financial policy framework. Hence, attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself.

Question 17 **May 2018 (New) – Paper**

Discuss what you understand about Embedded Derivatives.

Solution

A derivative is defined as a contract that has all the following characteristics:

- Its value changes in response to a specified underlying, e.g. an exchange rate, interest rate or share price;
- It requires little or no initial net investment;
- It is settled at a future date;
- The most common derivatives are currency forwards, futures, options, interest rate swaps etc.

An embedded derivative is a derivative instrument that is embedded in another contract - the host contract. The host contract might be a debt or equity instrument, a lease, an insurance contract or a sale or purchase contract.

Derivatives require to be marked-to-market through the income statement, other than qualifying hedging instruments. This requirement on embedded derivatives are designed to ensure that mark-to-market through the income statement cannot be avoided by including - embedding - a derivative in another contract or financial instrument that is not marked-to market through the income statement.

An embedded derivative can arise from deliberate financial engineering and intentional shifting of certain risks between parties. Many embedded derivatives, however, arise inadvertently through market practices and common contracting arrangeme nts. Even purchase and sale contracts that qualify for executory contract treatment may contain embedded derivatives. An embedded derivative causes modification to a contract's cash flow, based on changes in a specified variable.

Question 18 **May 2018 (New) – Paper**

Interpret the Capital Asset Pricing Model (CAPM) and its relevant assumptions

Solution

The Capital Asset Pricing Model was developed by Sharpe, Mossin and Linter in 1960. The model explains the relationship between the expected return, non -diversifiable risk and the valuation of securities. It considers the required rate of return of a secur ity on the basis of its contribution to the total risk.

It is based on the premises that the diversifiable risk of a security is eliminated when more and more securities are added to the portfolio. However, the systematic risk cannot be diversified and is or related with that of the market portfolio.

All securities do not have same level of systematic risk. The systematic risk can be measured by beta, ß under CAPM, the expected return from a security can be expressed as:

Expected return on security = Rf + Beta (Rm – Rf)

The model shows that the expected return of a security consists of the risk -free rate of interest and the risk premium. The CAPM, when plotted on the graph paper is known as the Security Market Line (SML). A major implication of CAPM is that not only every security but all portfolios too must plot on SML.

This implies that in an efficient market, all securities are having expected returns commensurate with their riskiness, measured by ß.

Relevant Assumptions of CAPM

(i) The investor's objective is to maximize the utility of terminal wealth;
(ii) Investors make choices on the basis of risk and return;
(iii) Investors have identical time horizon;
(iv) Investors have homogeneous expectations of risk and return;
(v) Information is freely and simultaneously available to investors;
(vi) There is risk-free asset, and investor can borrow and lend unlimited amounts at the risk-free rate;
(vii) There are no taxes, transaction costs, restrictions on short rates or other market imperfections;
(viii) Total asset quantity is fixed, and all assets are marketable and divisible.

Thus, CAPM provides a conceptual framework for evaluating any investment decision, where capital is committed with a goal of producing future returns.

Question 19 **May 2018 (New) – Paper**

Explain the difference between Islamic Finance and Conventional Finance

Solution

Major differences between Islamic finance and other form of finance (Conventional Finance) are as follows:

Basis	Islamic Finance	Conventional Finance
Promotion	Islamic Finance promotes just, fair and balanced society. Hence, interest is prohibited.	Based on commercial objectives and interest must be paid irrespective of outcome of business.
Ethical framework	Structured on ethical and moral framework of Sharia. Verses from the holy Quran and tradition from As-Sunnah are two divine guidance.	No such framework.
Speculation	The financial transactions should be free from the element of uncertainty (Gharar) and gambling (Maisir)	No such restrictions.
Unlawful Goods and Services	Islamic Finance must not be involved in any transactions not involve trade not allowed as per Islamic principles such as alcohol, armaments, pork and other socially detrimental products.	There are no such restrictions.

Question 20 **May 2018 (New) – Paper**

Explain the advantages of bringing venture capital in the company.

Solution

- ❖ It injects long- term equity finance which provides a solid capital base for future growth.
- ❖ The venture capitalist is a business partner, sharing both the risks and rewards. Venture capitalists are rewarded with business success and capital gain.
- ❖ The venture capitalist is able to provide practical advice and assistance to the company based on past experience with other companies which were in similar situations.
- ❖ The venture capitalist also has a network of contacts in many areas that can add value to the company.
- ❖ The venture capitalist may be capable of providing additional rounds of funding should it be required to finance growth.
- ❖ Venture capitalists are experienced in the process of preparing a company for an initial public offering (IPO) of its shares onto the stock exchanges or overseas stock exchange such as NASDAQ.
- ❖ They can also facilitate a trade sale.

Question 21 **May 2018 (New) – Paper**

Discuss briefly the steps involved in the Securitization mechanism.

Solution

Assuming share prices are normally distributed, for level of 99%, the equivalent Z score from Normal table of Cumulative Area is 2.33.
Volatility in terms of rupees is:

2% of Rs.1 Crore = Rs.2 lakh

The maximum loss for 1 day at 99% Confidence Level is

Rs.2 lakh x 2.33 = Rs.4.66 lakh,

and expected maximum loss for 10 trading days shall be:

$\sqrt{10}$ x Rs.4.66 lakh = 14.73 lakhs or 14.74 lakhs

Question 22 **May 2018 (New) – Paper**

Explain the benefits of Securitization from the perspective of both originator as well as the investor.

Solution

The steps involved in securitization mechanism are as follows:

Creation of Pool of Assets: The process of securitization begins with creation of pool of assets by segregation of assets backed by similar type of mortgages in terms of interest rate, risk, maturity and concentration units.

Transfer to SPV: One assets have been pooled, they are transferred to Special Purpose Vehicle (SPV) especially created for this purpose.

Sale of Securitized Papers: SPV designs the instruments based on nature of interest, risk, tenure etc. based on pool of assets. These instruments can be Pass Through Security or Pay Through Certificates.

Administration of assets: The administration of assets in subcontracted back to originator which collects principal and interest from underlying assets and transfer it to SPV, which works as a conduct.

Recourse to Originator: Performance of securitized papers depends on the performance of underlying assets and unless specified in case of default they go back to originator from SPV.

Repayment of funds: SPV will repay the funds in form of interest and principal that arises from the assets pooled.

Credit Rating of Instruments: Sometime before the sale of securitized instruments credit rating can be done to assess the risk of the issuer.

OR

The benefits of securitization can be viewed from the angle of various parties involved as follows:

(A) From the angle of originator: Originator (entity which sells assets collectively to Special Purpose Vehicle) achieves the following benefits from securitization.

(i) **Off – Balance Sheet Financing:** When loan/receivables are securitized it release a portion of capital tied up in these assets resulting in off Balance Sheet financing leading to improved liquidity position which helps expanding the business of the company.

(ii) **More specialization in main business:** By transferring the assets the entity could concentrate more on core business as servicing of loan is transferred to SPV. Further, in case of non-recourse arrangement even the burden of default is shifted.

(iii) **Helps to improve financial ratios:** Especially in case of Financial Institutions and Banks, it helps to manage Capital –To-Weighted Asset Ratio effectively.

(iv) **Reduced borrowing Cost:** Since securitized papers are rated due to credit enhancement even they can also be issued at reduced rate as of debts and hence the originator earns a spread, resulting in reduced cost of borrowings.

(B) From the angle of investor: Following benefits accrues to the investors of securitized securities.

(i) **Diversification of Risk:** Purchase of securities backed by different types of assets provides the diversification of portfolio resulting in reduction of risk.

(ii) **Regulatory requirement:** Acquisition of asset backed belonging to a particular industry say micro industry helps banks to meet regulatory requirement of investment of fund in industry specific.

(iii)**Protection against default:** In case of recourse arrangement if there is any default by any third party then originator shall make good the least amount. Moreover, there can be insurance arrangement for compensation for any such default.

Question 23 **Nov 2018 – RTP**

Write a short note on:
(a) Financial Planning
(b) Role of Clearing Houses
(c) Pros and Cons of Depository Services
(d) Leading and Lagging in context of forex market
(e) Takeover by Reverse Bid

Solution

(a) Financial planning is the backbone of the business planning and corporate planning. It helps in defining the feasible area of operation for all types of activities and thereby defines the overall planning framework. Financial planning is a systematic approach whereby the financial planner helps the customer to maximize his existing financial resources by utilizing financial tools to achieve his financial goals.

There are 3 major components of Financial planning:

- Financial Resources (FR)
- Financial Tools (FT)
- Financial Goals (FG)

Financial Planning: FR + FT = FG

For an individual, financial planning is the process of meeting one's life goals through proper management of the finances. These goals may include buying a house, saving for children's education or planning for retirement. It is a process that consists of specific steps that helps in taking a big-picture look at where you financially are. Using these steps you can work out where you are now, what you may need in the future and what you must do to reach your goals.

Outcomes of the financial planning are the financial objectives, financial decision-making and financial measures for the evaluation of the corporate performance. Financial objectives are to be decided at the very outset so that rest of the decisions can be taken accordingly. The objectives need to be consistent with the corporate mission and corporate objectives. Financial decision making helps in analyzing the financial problems that are being faced by the corporate and accordingly deciding the course of action to be taken by it. The financial measures like ratio analysis, analysis of cash flow statement are used to evaluate the performance of the Company. The selection of these measures again depends upon the corporate objectives.

(b) Clearing house is an exchange-associated body charged with the function of ensuring (guaranteeing) the financial integrity of each trade. Orders are cleared by means of the clearinghouse acting as the buyer to all sellers and the seller to all buyers. Clearing houses provide a range of services related to the guarantee of contracts, clearance and settlement of trades, and management of risk for their members and associated exchanges.

Role of Clearing Houses

- It ensures adherence to the system and procedures for smooth trading.
- It minimises credit risks by being a counter party to all trades.
- It involves daily accounting of all gains or losses.
- It ensures delivery of payment for assets on the maturity dates for all outstanding contracts.

It monitors the maintenance of speculation margins.

(c) The major benefits accruing to investors and other market players are as follows:

1. Securities are held in a safe and convenient manner
2. Transfer of securities is effected immediately
3. Stamp duty for transfer is eliminated and transaction costs are reduced
4. Paper work is minimized
5. Bad deliveries, fake securities and delays in transfers are eliminated.
6. Routine changes viz. change in address of one person owning securities issued by different companies can be taken care of simultaneously for all securities with little delay.
7. Benefit accruing from issue of bonus shares, consolidation, split or merger is credited without much difficulty.
8. Payment of dividends and interest is expedited by the use of electronic clearing system.
9. Securities held in electronic form can be locked in and frozen fro m either a sale or purchase for any definite period.
10. Securities held in electronic form can also be pledged for any credit facility. Both the lender (pledge) and the investor- borrower (pledgor) are required to have a depository account. Once the pledgee confirms the request of the investor the depository takes action and the pledge is in place. By a reverse process, the pledge can be released once the pledge confirms receipt of funds.

There are however risks as well

1. Systemic failure – Input control, process control and output control being parts of computerized environment apply equally to the dematerialization process. Unforeseen failures, intentional or otherwise, on the part of the individuals entrusted with protecting data integrity, could lead to chaos .
2. Additional record keeping – In built provisions for rematerialization exist to take care of the needs of individuals who wish to hold securities in physical form. Companies will invariably need to maintain records on a continuous basis for securities held in physical form. Periodical reconciliation between demat segment and physical segment is very much necessary.
3. Cost of Depository Participant (DP) – For transacting business, investors have to deal not only with brokers but also with depository participant which acts as an additional tier in the series of intermediaries. A one time fee is levied by the depository participant which small investors consider to be an avoidable cost.
4. Human Fraud – Dematerialization is not a remedy for all ills. Unlawful transfers by individuals against whom insolvency proceedings are pending or transfers by attorney holders with specific or limited powers are possible.

(d) Leading means advancing a payment i.e. making a payment before it is due. Lagging involves postponing a payment i.e. delaying payment beyond its due date.
In forex market Leading and lagging are used for two purposes: -

(a) Hedging foreign exchange risk: A company can lead payments required to be made in a currency that is likely to appreciate. For example, a company has to pay $100000 after one month from today. The company apprehends the USD to appreciate. It can make the payment now. Leading involves a finance cost i.e. one month's interest cost of money used for purchasing $100000.

A company may lag the payment that it needs to make in a currency that it is likely to depreciate, provided the receiving party agrees for this proposition. The receiving party may demand interest for this delay and that would be the cost of lagging. Decision regarding leading and lagging should be made after considering (i) likely movement in exchange rate (ii) interest cost and (iii) discount (if any).

(b) Shifting the liquidity by modifying the credit terms between inter - group entities: For example, A Holding Company sells goods to its 100% Subsidiary. Normal credit term is 90 days. Suppose cost of funds is 12% for Holding and 15% for Subsidiary. In this case the Holding may grant credit for longer period to Subsidiary to get the best advantage for the group as a whole. If cost of funds is 15% for Holding and 12% for Subsidiary, the Subsidiary may lead the payment for the best advantage of the group as a whole. The decision regarding leading and lagging should be taken on the basis of cost of funds to both paying entity and receiving entity. If paying and receiving entities have different home currencies, likely movements in exchange rate should also be considered.

(e) In ordinary case, the company taken over is the smaller company; in a 'reverse takeover', a smaller company gains control of a larger one. The concept of takeover by reverse bid, or of reverse merger, is thus not the usual case of amalgamation of a sick unit which is non-viable with a healthy or prosperous unit but is a case whereby the entire undertaking of the healthy and prosperous company is to be merged and vested in the sick company which is non-viable. A company becomes a sick industrial company when there is erosion in its net worth. This alternative is also known as taking over by reverse bid.

The three tests should be fulfilled before an arrangement can be termed as a reverse takeover are specified as follows:

(i) The assets of the transferor company are greater than the transferee company,
(ii) Equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital, and
(iii)The change of control in the transferee company through the introduction of a minority holder or group of holders.

Question 24 **Nov 2018 – Paper**

Write short notes on:

a) Enumerate 'Strategy' at different levels of hierarchy.
b) Benefits to the issuer of Commercial Paper.
c) Define any four Pre-conditions for an Efficient Money Market.
d) Distinguish between future contract and option contract.
e) What are the various reasons for demerger or divestment.

Solution

a) Strategies at different levels are the outcomes of different planning needs. There are basically three types of strategies:

1. Corporate Strategy: At the corporate level planners decide about the objective or objectives of the firm along with their priorities and based on objectives, decisions are taken on participation of the firm in different product fields. Basically a corporate strategy provides with a framework for attaining the corporate objectives under values and resource constraints, and internal and external

realities. It is the corporate strategy that describes the interest in and competitive emphasis to be given to different businesses of the firm. It indicates the overall planning mode and propensity to take risk in the face of environmental uncertainties.

2. Business Strategy: It is the managerial plan for achieving the goal of the business unit. However, it should be consistent with the corporate strategy of the firm and should be drawn within the framework provided by the corporate planners. Given the overall competitive emphasis, business strategy specifies the product market power i.e. the way of competing in that particular business activity. It also addresses coordination and alignment issues covering internal functional activities. The two most important internal aspects of a business strategy are the identification of critical resources and the development of distinctive competence for translation into competitive advantage.
3. Functional Strategy: It is the low level plan to carry out principal activities of a business. In this sense, functional strategy must be consistent with the business strategy, which in turn must be consistent with the corporate strategy. Thus strategic plans come down in a cascade fashion from the top to the bottom level of planning pyramid and performances of functional strategies trickle up the line to give shape to the business performance and then to the corporate performance.

b) CPs have been introduced in the Indian market so as to provide a diversified source of funding to the borrowers as well as an additional investment option to the investors. CP can now be issued as a low cost alternative to ban financing to meet a part of working capital requirements Benefits to the Issuer – The following are major benefits t issuer of CP

i. Low interest expenses: The interest cost associated with the issuance of CP is normally expected to be less than the cost of bank financing, as among other things, it is related to the inter-corporate money market rate, which in normal times is within the cost of bank finance.

ii. Access to short term funding: CP issuance provides a company with increased access to short term funding sources. By bringing the short term borrower into direct contact with investors, the CP market will, to some extent, disintermediate the established role of banks and pass on the benefit to both issuers and investors.

iii. Flexibility and liquidity: CP affords the issuer increased flexibility and liquidity in matching the exact amount and maturity of its debt to its current working capital requirement.

iv. Investor recognition: The issuance of CP provides the issuer with favourable exposure to major institutional investors as well as wider distribution of its debt.

v. Ease and low cost of establishment: A CP programme can be established with ease at a low cost, once the basic criteria have been satisfied.

c) Development of money market into a sophisticated market depends upon certain conditions. They are:

- Institutional development.
- Banks and other players in the market have to be licensed and effectively supervised by regulators.
- Demand and supply must exist for idle cash.
- Electronic Fund Transfer (EFT), Depository System, Delivery versus Payment (DVP), High Value Inter-bank Payment System, etc. are pre-requisites.

- Market should have varied instruments with distinctive maturity and risk profiles to meet the varied aptitude of the players in the market.
- Govt. /Central Bank should intervene to moderate liquidity profile.
- Market should be integrated with the rest of the markets in the financial system to ensure perfect equilibrium.

d) Difference between future contract and option contract.

Futures	Options
A futures contract is a legal agreement to buy or sell a particular commodity or asset at a predetermined price at a specified time in the future.	An options contract is an agreement between two, parties to facilitate a potential transaction on the underlying security at a preset price, referred to as the strike price, prior to the expiration date.
Exchange Traded	Exchange Traded as well as OTC
Initial Value is zero	Initial value equal to option premium.
Neither the buyer nor the seller needs to pay any amount to the other party while entering the contract	Option buyer has to pay option premium to the seller
Both buyer and seller deposit margin with clearing house.	Only option seller is required to provide margin
Both parties enjoy right as well as suffer obligation	Option buyer enjoys right while option seller suffers an obligation.
Unlimited profit and loss potential for both parties	Buyer has unlimited profit buy limited loss while seller has unlimited loss but limited profit.

e) There are various reasons for divestment or demerger viz.,

i. To pay attention on core areas of business;
ii. The Division's/business may not be sufficiently contributing to the revenues;
iii. The size of the firm may be too big to handle;
iv. The firm may be requiring cash urgently in view of other investment opportunities.

Question 25 **Nov 2018 (New) – RTP**

(a) Explain the key elements of a well-functioning financial system.
(b) Describe the various parameters to identity the currency risk.
(c) Explain the challenges to Efficient Market Theory.

Solution

(a) Key elements of a well-functioning financial system are explained as below:

(i) A strong legal and regulatory environment – Capital market is regulated by SEBI which acts a watchdog of the securities market. This has been ensured through the passing of SEBI Act, Securities Contract Regulation Act and numerous SEBI rules, regulations and guidelines. Likewise money market and foreign exchange market is regulated by RBI and this has been ensured through various provisions of the RBI Act, Foreign Exchange Management Act etc. Thus, a strong legal system protects the rights and interests of investors and acts as a most important element of a sound financial system.

(ii) **Stable money** – Money is an important part of an economy. Frequent fluctuations and depreciations in the value of money lead to financial crises and restrict the economic growth.

(iii) **Sound public finances and public debt management** – Sound public finances means setting and controlling public expenditures and increase revenues to fund these expenditures efficiently. Public debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding. It also includes developing and maintaining an efficient market for government securities.

(iv) **A central bank** – A central bank supervises and regulates the operations of the banking system. It acts as a banker to the banks and government, manager of money market and foreign exchange market and also lender of the last resort. The monetary policy of the Central Bank is used to keep the pace of economic growth on a higher path.

(v) **Sound banking system** – A well-functioning financial system must have large variety of banks both in the private and public sector having both domestic and international operations with an ability to withstand adverse national and international events. They perform varied functions such as operating the payment and clearing system, and foreign exchange market. Banks also undertake credit risk analysis and assess the expected risk and return o f a project before giving any loan for a proposed project.

(vi) **Information System** – All the participants in the financial system requires information at some stage or the other. Proper information disclosure practices form basis of a sound financial system for e.g. the corporates has to disclose their financial performance in the financial statements. Similarly, at the time of initial public offering, the companies have to disclose a host of information disclosing their financial health and efficiency.

(vii) **Well functioning securities market** – A securities market facilitates the issuance of both equity and debt. An efficient securities market helps in the deployment of funds raised through the capital market to the required sections of the economy, lowering the cost of capital for the firms, enhancing liquidity and attracting foreign investment.

(b) Just like interest rate risk the currency risk is dependent on the Government action and economic development. Some of the parameters to identity the curre ncy risk are as follows:

(i) **Government Action:** The Government action of any country has visual impact in its currency. For example, the UK Govt. decision to divorce from European

(ii) Union i.e. Brexit brought the pound to its lowest since 1980's.

(iii) **Nominal Interest Rate:** As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest of that country.

(iv) **Inflation Rate:** Purchasing power parity theory discussed in later chapters impact the value of currency.

(v) **Natural Calamities:** Any natural calamity can have negative impact.

(vi) **War, Coup, Rebellion etc.:** All these actions can have far reaching impact on currency's exchange rates.

(vii) **Change of Government:** The change of government and its attitude towards foreign investment also helps to identify the currency risk.

(c) Challenges to the Efficient Market Theory

(i) *Information inadequacy* – Information is neither freely available nor rapidly transmitted to all participants in the stock market. There is a calculated attempt by many companies to circulate misinformation.

(ii) *Limited information processing capabilities* – Human information processing capabilities are sharply limited. According to Herbert Simon every human organism lives in an environment which generates millions of new bits of information every second but the bottle necks of the perceptual apparatus does not admit more than thousand bits per seconds and possibly much less.
David Dreman maintained that under conditions of anxiety and uncertainty, with a vast interacting information grid, the market can become a giant.

(iii) *Irrational Behaviour* – It is generally believed that investors' rationality will ensure a close correspondence between market prices and intrinsic values. But in practice this is not true. J. M. Keynes argued that all sorts of consideration enter into the market valuation which is in no way relevant to the prospective yield. This was confirmed by L. C. Gupta who found that the market evaluation processes work haphazardly almost like a blind man firing a gun. The markeseems to function largely on hit or miss tactics rather than on the basis of informed beliefs about the long term prospects of individual enterprises.

(iv) *Monopolistic Influence* – A market is regarded as highly competitive. No single buyer or seller is supposed to have undue influence over prices. In practice, powerful institutions and big operators wield grate influence over the market. The monopolistic power enjoyed by them diminishes the competitiveness of the market.

Question 26 **Nov 2018 (New) – RTP**

(a) Describe the constituents of International Financial Centers (IFC)
(b) Explain Startup India Initiative
(c) List the ways to arrange finance for Small and Medium Enterprises

Solution

(a) Although there are many constituents for IFC but some of the important constituent are as follows:

(i) *Highly developed Infrastructure:* A leading edge infrastructure is prerequisite for creating a platform to offer internationally completive financial services.

(ii) *Stable Political Environment:* Destabilized political environment brings country risk investment by foreign nationals. Hence, to accelerate foreign participation in growth of financial center, stable political environment is prerequisite.

(iii) *Strategic Location:* The geographical location of the finance center should be strategic such as near to airport, seaport and should have friendly weather.

(iv) *Quality Life:* The quality of life at the center showed be good as center retains highly paid professional from own country as well from outside.

(v) *Rationale Regulatory Framework:* Rationale legal regulatory framework is another prerequisite of international finance center as it should be fair and transparent.

(vi) *Sustainable Economy:* The economy should be sustainable and should possess capacity to absorb all the shocks as it will boost investors' confidence.

(b) Startup India scheme was initiated by the Government of India on 16 th of January, 2016. The definition of startup was provided which is applicable only in case of Government Schemes. Startup means an entity, incorporated or registered in India:

- ❖ Not prior to five years,
- ❖ With annual turnover not exceeding r` 25 crore in any preceding financial year, and
- ❖ Working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.

Provided that such entity is not formed by splitting up, or reconstruction, of a business already in existence. Provided also that an entity shall cease to be a Startup if its turnover for the previous financial years has exceeded ` 25 crore or it has completed 5 years from the date of incorporation/ registration. Provided further that a Startup shall be eligible for tax benefits only after it has obtained certification from the Inter - Ministerial Board, setup for such purpose.

(c) The need for finance can be classified into following types:

- Long and medium term loans
- Short term or working capital requirements
- Risk Capital
- Seed Capital/Marginal Money
- Bridge loans

Financial assistance in India for MSME units is available from a variety of institutions.

The important ones are:

(i) Commercial/Regional Rural/Co-operative Banks.
(ii) SIDBI: Small Industries Development Bank of India (refinance and direct lending)
(iii)SFCs/SIDCs: State Financial Corporations (e.g. Delhi Financial Corporation)/State Industrial Development Corporations.

Long and medium term loans are provided by SFCs, SIDBI and SIDCs. Banks also finance term loans. This type of financing is needed to fund purchase of land, construction of factory building/shed and for purchase of machinery and equipment. The short-term loans are required for working capital requirements, which fund the purchase of raw materials and consumables, payment of wages and other immediate manufacturing and administrative expenses. Such loans are generally available from commercial banks. The commercial banks also sanction composite loan comprising of working capital and term loan up to a loan limit of Rs.1 crore.

Question 27 **Nov 2018 (New) – Paper**

Explain Angel Investors.

Solution

Despite being a country of many cultures and communities traditionally inclined to business and entrepreneurship, India still ranks low on comparative ratings across entrepreneurship, innovation and ease of doing business. The reasons are obvious. These include our old and outdated draconian rules and regulations which provides a hindrance to our business environment for a long time. Other reasons are redtapism, our time consuming procedures, and lack of general support for entrepreneurship. Off course, things are changing in recent times.

As per Investopedia, Angel investors invest in small startups or entrepreneurs. Often, angel investors are among an entrepreneur's family and friends. The capital angel investors provide may be a onetime investment to help the business propel or an ongoing injection of money to support and carry the company through its difficult early stages.

Angel investors provide more favorable terms compared to other lenders, since they usually invest in the entrepreneur starting the business rather than the viability of the business. Angel investors are focused on helping startups take their first steps, rather than the possible profit they may get from the business. Essentially, angel investors are the opposite of venture capitalists.

Angel investors are also called informal investors, angel funders, private investors, seed investors or business angels. These are affluent individuals who inject capital for startups in exchange for ownership equity or convertible debt. Some angel investors invest through crowd funding platforms online or build angel investor networks to pool in capital.

Angel investors typically use their own money, unlike venture capitalists who take care of pooled money from many other investors and place them in a strategically managed fund.

Though angel investors usually represent individuals, the entity that actually provides the fund may be a limited liability company, a business, a trust or an investment fund, among many other kinds of vehicles.

Angel investors who seed startups that fail during their early stages lose their investments completely. This is why professional angel investors look for opportunities for a defined exit strategy, acquisitions or initial public offerings (IPOs).

Question 28 **Nov 2018 (New) – Paper**

Discuss about the Primary Participants in the process of Securitization.

Solution

Primary Participants are main parties to this process. The primary participants in the process of securitization are as follows:

a. **Originator:** It is the initiator of deal or can be termed as securitizer. It is an entity which sells the assets lying in its books and receives the funds generated through the sale of such assets. The originator transfers both legal as well as beneficial interest to the Special Purpose Vehicle (discussed later).

b. **Special Purpose Vehicle:** Also, called SPV is created for the purpose of executing the deal. Since issuer originator transfers all rights in assets to SPV, it holds the legal title of these assets. It is created especially for the purpose of securitization only and normally could be in form of a company, a firm, a society or a trust. The main objective of creating SPV to remove the asset from the Balance Sheet of Originator. Since, SPV makes an upfront payment to the originator, it holds the key position in the overall process of securitization. Further, it also issues the securities (called Asset Based Securities or Mortgage Based Securities) to the investors.

c. **The Investors:** Investors are the buyers of securitized papers which may be an individual, an institutional investor such as mutual funds, provident funds, insurance companies, mutual funds, Financial Institutions etc.

Since, they acquire a participating in the total pool of assets/receivable, they receive their money back in the form of interest and principal as per the terms agree.

Question 29 **Nov 2018 (New) – Paper**

How different stakeholders view the financial risk?

Solution

The financial risk can be evaluated from different point of views as follows:

a. From stakeholder's point of view: Major stakeholders of a business are equity shareholders and they view financial gearing i.e. ratio of debt in capital structure of company as risk since in event of winding up of a company they will be least prioritized. Even for a lender, existing gearing is also a risk since company having high gearing faces more risk in default of payment of interest and principal repayment.

b. From Company's point of view: From company's point of view if a company borrows excessively or lend to someone who defaults, then it can be forced to go into liquidation.

c. From Government's point of view: From Government's point of view, the financial risk can be viewed as failure of any bank or (like Lehman Brothers) down grading of any financial institution leading to spread of distrust among society at large. Even this risk also includes willful defaulters. This can also be extended to sovereign debt crisis.

Question 30 **Nov 2018 (New) – Paper**

Explain the concept of Riba in Islamic Finance.

Solution

In Islamic Finance, the meaning of Riba is interest or usury. As mentioned earlier in Islamic Finance money is considered as medium of exchange, store of value or unit of measurement only, hence Riba is considered haram i.e. unfair reward to the provider of capital for little or no effort or risk undertaken. Due to this reason, Islamic finance models are based on risks and profit/loss sharing contract (as clear from the financial products discussed above).

Riba is equated with wrongful appropriation of property belonging to others and hence Muslims are asked to accept principal only and forego principal even, if borrower is unable to repay the same.

In this backdrop in Islamic banking a link must be established between money and profit as an alternative to interest. This is in sharp contrast of conventional banking which is simply based on lender borrower's relationship.

Since, interest is not allowed in Islamic Finance, depositors are rewarded by a share in the profit from the underlying business (after deduction of management fees) in which the funds of depositors have been channeled.

Thus, it can be said that money has no intrinsic value i.e. time value of money.

The relationship between depositor and banker can be viewed as:

a. Agent and Principal or

b. Depositor and Custodian

c. Investor and Entrepreneur

d. Fellow joint partners

As mentioned above Islamic finance products are based on profit sharing coming section shall discuss the various Islamic finance products.

Rahul Malkan