

TYPES OF FINANCING

Question 1

Explain in brief the features of Commercial Paper.

(PCC-May 2007)(3 marks)

Answer

Features of Commercial Paper (CP)

A commercial paper is an unsecured money market instrument issued in the form of a promissory note. Since the CP represents an unsecured borrowing in the money market, the regulation of CP comes under the purview of the Reserve Bank of India which issued guidelines in 1990 on the basis of the recommendations of the Vaghul Working Group. These guidelines were aimed at:

- (i) Enabling the highly rated corporate borrowers to diversify their sources of short term borrowings, and
- (ii) To provide an additional instrument to the short term investors.

It can be issued for maturities between 7 days and a maximum upto one year from the date of issue. These can be issued in denominations of Rs. 5 lakh or multiples therefore. All eligible issuers are required to get the credit rating from credit rating agencies.

Question 2

Explain the term 'Ploughing back of Profits'.

(PCC-May 2007 & Nov. 2009)(2 marks)

Answer

Ploughing back of Profits: Long-term funds may also be provided by accumulating the profits of the company and by ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company. A public limited company must plough back a reasonable amount of its profits each year keeping in view the legal requirements in this regard and its own expansion plans. Such funds also entail almost no risk. Further, control of present owners is also not diluted by retaining profits.

Question 3

Discuss the features of deep discount bonds.

(PCC-Nov. 2007& 2008)(2 marks)

Answer

Features of Deep Discount Bonds: Deep discount bonds are a form of zero-interest bonds. These bonds are sold at discounted value and on maturity; face value is paid to the investors. In such bonds, there is no interest payout during the lock-in period. The investors can sell the bonds in stock market and realise the difference between face value and market price as capital gain.

IDBI was the first to issue deep discount bonds in India in January 1993. The bond of a face value of Rs. 1 lakh was sold for Rs. 2700 with a maturity period of 25 years.

Question 4

Explain the concept of Indian depository receipts. (PCC-Nov. 2007)(2 marks)

Answer

Concept of Indian Depository Receipts: The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian capital market through the issue of Indian Depository Receipts (IDRs). Foreign companies can issue IDRs to raise funds from Indian market on the same lines as an Indian company uses ADRs/GDRs to raise foreign capital. The IDRs are listed and traded in India in the same way as other Indian securities are traded.

Question 5

Explain the methods of venture capital financing. (PCC-Nov. 2007)(3 marks)

Answer

Some Common Methods of Venture Capital Financing

- (a) *Equity financing:* The venture capital undertaking requires long-term funds but is unable to provide returns in initial stage so equity capital is the best option.
- (b) *Conditional Loan:* A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans.
- (c) *Income note:* It is hybrid security; the entrepreneur has to pay both interest and royalty on sales but at substantially low rates.
- (d) *Participating debenture:* Such security carries charges in three phases - in the start-up phase, no interest is charged, next stage a low rate of interest up to a particular level of operation is charged, after that, high rate of interest is required to be paid.

Question 6

Discuss the features of Secured Premium Notes (SPNs). (PCC-May 2008)(2 marks)

Answer

Secured premium notes are issued along with detachable warrants and are redeemable after a notified period of say 4 to 7 years. This is a kind of NCD attached with warrant. It was first introduced by Tisco, which issued the SPNs to existing shareholders on right basis. Subsequently the SPNs will be repaid in some number of equal instalments. The warrant attached to SPNs gives the holder the right to apply for and get allotment of equity shares as per the conditions within the time period notified by the company.

Question 7

Explain the concept of closed and open-ended lease. (PCC-May 2008)(2 marks)

Answer

In the close-ended lease, the assets gets transferred to the lessor at the end of lease, the risk of obsolescence, residual values etc. remain with the lessor being the legal owner of the assets. In the open-ended lease, the lessee has the option of purchasing the assets at the end of lease period.

Question 8

Discuss the advantages of preference share capital as an instrument of raising funds. (PCC-May 2008)(2 marks)

Answer

Advantages of Issue of Preference Shares are:

- (i) No dilution in EPS on enlarged capital base.
- (ii) There is no risk of takeover as the preference shareholders do not have voting rights.
- (iii) There is leveraging advantage as it bears a fixed charge.
- (iv) The preference dividends are fixed and pre-decided. Preference shareholders do not participate in surplus profit as the ordinary shareholders
- (v) Preference capital can be redeemed after a specified period.

Question 9

Explain the concept of Debt securitization. (PCC-May 2008)(3 marks)

Answer

Debt securitization is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this assets pool, market securities can be issued. The debt securitization process can be classified in the following three functions.

Financial Management

1. *The origination function:* The credit worthiness of a borrower seeking loan from a finance company, bank, housing company or a leasing company is evaluated and a contract is entered into and repayment schedule is structured over the life of the loan.
2. *The pooling function:* Similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a special purpose vehicle (SPV).
3. *The securitization function:* After structuring, issue the securities on the basis of asset pool. The securities carry a coupon and an expected maturity, which can be asset based or mortgaged based. These are generally sold to investors through merchant bankers.

The process of securitization is generally without recourse i.e. the investor bears credit risk or risk of default and the user is under an obligation to pay to investor only if the cash flow are received by him from the collateral.

Question 10

Explain briefly the features of External Commercial Borrowings (ECBs).

(PCC-May 2008)(3 marks)

Answer

External Commercial Borrowings are loans taken from non-resident lenders in accordance with exchange control regulations. These loans can be taken from:

- ◆ International banks
- ◆ Capital markets
- ◆ Multilateral financial institutions like IFC, ADB, IBRD etc.
- ◆ Export Credit Agencies
- ◆ Foreign collaborators
- ◆ Foreign Equity Holders.

ECBs can be accessed under automatic and approval routes depending upon the purpose and volume.

In automatic there is no need for any approval from RBI / Government while approval is required for areas such as textiles and steel sectors restructuring packages.

Question 11

What is meant by "Venture Capital Financing"?

(PCC-Nov. 2008)(2 marks)

Answer

Venture Capital Financing: The venture capital financing refers to financing of new high risky ventures promoted by qualified entrepreneurs who lack experience and funds to give shape to

their ideas. In broad sense, under venture capital financing, venture capitalists make investments to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with a potential of success.

Question 12

Name the various financial instruments dealt with in the international market.

(PCC-Nov. 2008)(2 marks)

Answer

Financial Instruments in the International Market: Some of the various financial instruments dealt with in the international market are:

- (a) Euro Bonds
- (b) Foreign Bonds
- (c) Fully Hedged Bonds
- (d) Medium Term Notes
- (e) Floating Rate Notes
- (f) External Commercial Borrowings
- (g) Foreign Currency Futures
- (h) Foreign Currency Option
- (i) Euro Commercial Papers.

Question 13

Discuss the concept of American Depositary Receipts. *(PCC-June 2009)(2 marks)*

Answer

Concept of American Depositary Receipts

American Depositary Receipts (ADRs) are securities offered by non- US companies who want to list on any of the US exchanges. It is a derivative instrument. It represents a certain number of company's shares. These are used by depository bank against a fee income. ADRs allow US investors to buy shares of these companies without the cost of investing directly in a foreign stock exchange. ADRs are listed on either NYSE or NASDAQ. It facilitates integration of global capital markets. The company can use the ADR route either to get international listing or to raise money in international capital market.

Question 14

Discuss the benefits to the originator of Debt Securitization. *(PCC-June 2009)(2 marks)*

Answer

Benefits to the Originator of Debt Securitization

The benefits to the originator of debt securitization are as follows:

Financial Management

- (a) The assets are shifted off the balance sheet, thus giving the originator recourse to off balance sheet funding.
- (b) It converts illiquid assets to liquid portfolio.
- (c) It facilitates better balance sheet management as assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.
- (d) The originator's credit rating enhances.

Question 15

Differentiate between Factoring and Bills discounting.

(PCC-Nov. 2009)(2 marks)

Answer

Differentiation between Factoring and Bills Discounting

The differences between Factoring and Bills discounting are:

- (a) Factoring is called as "Invoice Factoring" whereas Bills discounting is known as 'Invoice discounting.'
- (b) In Factoring, the parties are known as the client, factor and debtor whereas in Bills discounting, they are known as drawer, drawee and payee.
- (c) Factoring is a sort of management of book debts whereas bills discounting is a sort of borrowing from commercial banks.
- (d) For factoring there is no specific Act, whereas in the case of bills discounting, the Negotiable Instruments Act is applicable.