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This Theory Note Is Applicable For CA Final New Course Students Appearing On Nov 2010 ; May 2011 & Nov 2011

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The Best CA Final

SFM

STRATEGIC FINANCIAL MANAGEMENT

Strictly As Per New Syllabus

tHEORY bOOK

In the World of Darkness, Let There Be Light!

"To be a star, you must shine your own light, follow your own path, and don't worry about the darkness, for that is when the stars shine brightest"

By

CA Aaditya Jain

Surbhi Agarwal A Student Of Aditya Sir For Securing All India First Rank in CA Final Nov 2008

ALL INDIA CA-TOPPER

Photo of prize distribution ceremony held On Sunday,the 18th January, 2009

The woods are lovely, dark and deep,
But I have promises to keep,
And miles to go before I sleep,
And miles to go before I sleep

WISHING ALL MY STUDENTS TO Always aim high in life and proceed in the direction of realising your goals with total determination ''Firm determination and hard work is always rewarding,''

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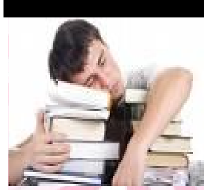

Dream is not that what u see in Sleep, Dream is the thing which does'nt allow u to Sleep"

Rise,Awake and Stop Not Until The Goal Is Achieved

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MAFA/SFM

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Theory Question

Covering All Past Year New Course Question Paper

Presented By

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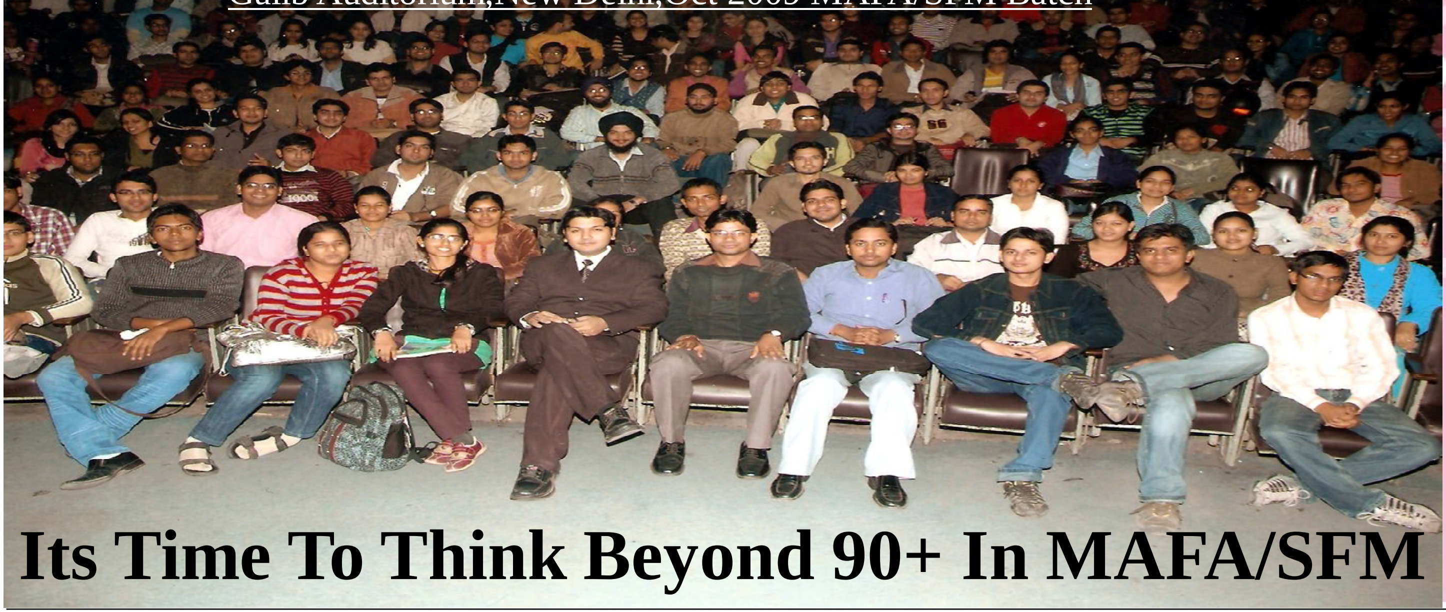

Its Time To Think Beyond 90+ In MAFA/SFM

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I will act now. I will act now. I will act now. Henceforth, I will repeat these words each hour, each day, everyday, until the words become as much a habit as my breathing, and the action which follows becomes as instinctive as the blinking of my eyelids. With these words I can condition my mind to perform every action necessary for my success. I will act now. I will repeat these words again and again and again. I will walk where failures fear to walk. I will work when failures seek rest. I will act now for now is all I have. Tomorrow is the day reserved for the labor of the lazy. I am not lazy. Tomorrow is the day when the failure will succeed. I am not a failure. I will act now. Success will not wait. If I delay, success will become wed to another and lost to me forever. This is the time. This is the place. I am the person.

Acknowledgements

Dedicated to My Main Source Of Inspiration - Sri Rani Sati Dadi , Father (Mr Bimal Kumar Jain), Mother (Mrs Sumitra Devi Jain)my Uncle (Mr. Mool Chand Jain) ,Aunty (Mrs Sarla Devi Jain)

I wish to express my great fullness to a large number of discerning students who offered valuable suggestions and for having spread word accross the student community their positive opinion about the book.The wide acceptance of the book in all parts of the country gives me boundless happiness and satisfaction.

-CA Aditya Jain

If you want to be successful, it's just this simple: Know what you're doing. Love what you're doing. And believe in what you're doing. -- Will Rogers

From the desk of CA Aaditya Jain

The Importance Of Patience In CA Career

Sometimes in life there are situations which makes you to loose your patience. The best way to react at these situation is not to react at all. These situations are meant just to distract you from your goal. Believe it or not a one minute involvement in such situation will take away your 2-5 hours of precious time or sometimes even more. When ever you encounter such situation just keep your head cool and try to get out of the atmosphere if posssible and afterwards just relax your mind by cracking a joke or by taking 14-15 long breathes in a single stroke.

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Believe me it''ll work. So be ready to face such situations

Murphy's Law " If anything can go wrong,it will ".....Everything for the first time looks tough.

REMEMBER .....

A, B , C , D ....was also tough for you one day
Practice makes a man perfect......Follow the proper approach you will definitely succeed

Ending in this high note said by late Dhiru Bhai Ambani
" For Those Who Dare n Dream There is A Whole world to win "
Jinke honslo mein udaan hoti hai wo aasmaan ki uchayion se nahi darte
" I Welcome You as a Bright Future CA in This Amazing World of Finance "

"In Every Man There is Something of Which I May Also Learn, and in All That He is My Teacher"
I Wish All My Students to Always Aim High in Life.You have to grow From Inside Out.None Can Teach You,None Can Make You Spiritual.There is no Other Teacher But Your Own Soul.

"Life is not measured by the number of breaths we take,
but by the moments that take our breath away."

The only thing that will stop you from fulfilling your dreams is you

Now You Can Also Dream Of Scoring Good Marks In MAFA/SFM

"Targetting 90+ In Mafa/SFM"

"All your life you are told the things you cannot do. All your life they will say you're not good enough or strong enough or talented enough; they will say you're the wrong height or the wrong weight or the wrong type to play this or be this or achieve this. THEY WILL TELL YOU NO, a thousand times no, until all the no's become meaningless. All your life they will tell you no, quite firmly and very quickly.
AND YOU WILL TELL THEM YES."

MAFA-May 2010 Theory Questions [18 Marks]

QUESTION NO. 1 What is a depository ? Who are the major players of a depository system ?What advantage the depositorysystemoffertotheclearing member ? 4 Marks

QUESTION NO. 2 What do you know about swaptions and their uses ? 4 Marks

QUESTION NO. 3 What are the reasons for stock index futures becoming more popular financial derivatives over stock futures segment in India ? 6 Marks

QUESTION NO. 4 What is the role of Financial Advisor in PSU? 4 Marks

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LIST OF ALL PAST YEARS NEW COURSE QUESTION PAPER

[All questions are incorporated in this book]

SFM-Nov 2008 Theory Questions [24 Marks]

QUESTION NO. 1 What are the drawbacks of investments in Mutual Funds ? (4 Marks)

QUESTION NO. 2 Write short notes on any four of the following :
(a) Financial restructuring (b) Cross border leasing (c) Embedded derivatives (d) Arbitrage operations (e) Rolling settlement. (4×5=20 Marks)

SFM-May 2009 Theory Questions

No Theory Question was Asked In This Attempt

SFM-Nov 2009 Theory Questions [10 marks]

QUESTION NO. 1 What are the limitations of Credit Rating? (4 Marks)

QUESTION NO. 2 What is the impact of GDRs on Indian Capital Market? (6 Marks)

SFM-May 2010 Theory Questions [20 Marks]

QUESTION NO. 1 List and briefly explain the main functions of an investment bank. 4 Marks

QUESTION NO. 2 How is a stock market index calculated? Indicate any two important market indices. 4 Marks

QUESTION NO. 3 Write a short note on Debt Securitisation. 4 marks

QUESTION NO. 4 Write a short note on Exchange Traded Funds (ETFs) 4 marks

QUESTION NO. 5 Explain briefly, how financial policy is linked to Strategic Management. 4 Marks

SFM-Nov 2010 & May 2011 Expected Marks in Theory Questions : 20 Marks-25Marks

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The Following Theory Questions Are The List Of Most Important Theory Question Which Are Most Expected For Exams.Students Who Wants To Cover Full Theory May Purchase Full Text Theory Book From Leading Book Stores.

QUESTION NO.1 Write a short note on the SENSITIVITY ANALYSIS:-(Also known as "What if" Analysis)?

➦**Meaning : Sensitivity Analysis** enables managers to assess how responsive the NPV is to changes in the variables which are used to calculate it.
➦**Example :** Sensitivity Analysis answers questions like,
(i) What happens to the Net Present Value if inflows are, say Rs. 50,000 than the expected Rs. 80,000?
(ii) What will happen to NPV if the economic life of the project is only 3 years rather than expected 5 years?
➦**Importance :** It directs the management to pay maximum attention towards the factor where minimum percentage of adverse change causes maximum adverse effect.
➦**Computation** : Sensitivity of a variable is calculated by using following relation : Sensitivity (%) = Change/Base x 100
➦**Procedure:**
(1) Set up relationship between the basic underlying factors (quantity sold, unit Sales Price, life of project etc.) & N.P.V. (Some other criterion of merit).
(2) Estimate the range of variation and the most likely value of each of the basic underlying factors.
(3) Study the effect of N.P.V. of variations in the basic variables (One factor is valued at a time.)
➦**Merits:**
(1) Forces management to identify underlying variables and their inter- relationship.
(2) Shows how robust / vulnerable a project is to changes in underlying variables.
(3) Indicates the need for further work.If N.P.V. and I.R.R. is highly sensitive to changes in some variable, it is desirable to gather further information about the variable.
➦**Demerits:**
(1) Fail to provide leads - if sensitivity analysis presents a complicated set of switching values, (switching value of a variable is its value for which N.P.V. becomes 0.) it may not shed light on the risk characteristics of the project.
(2) Study of impact of variation in one factor at a time, holding other factors constant may not be very meaningful when underlying factors are likely to be inter-related.What sense does it make to consider the effect of variation in price when holding quantity (which is likely to be closely related to price) remains unchanged?

QUESTION NO.2 Write a short note on the CAPITAL BUDGETING UNDER CAPITAL RATIONING ?

➦**Meaning : "**Capital Rationing refers to a situation where a company cannot undertake all positive NPV projects it has identified because of shortage of capital ".
➦**Reasons For Capital Rationing :**
External Factors : Under this the firm does not have funds & it also cannot raise them from financial markets.Some reasons can be : **(i)** Imperfections in capital markets **(ii)** Non-availability of market information **(iii)** Investor's attitude **(iv)** Firm's lack of credibility in market **(v)** High Flotation costs
Internal Factors :Internal Capital Rationing arise due to the self-imposed restrictions imposed by management .Under this though the funds can be arranged but firm itself impose restrictions on investment expenditure . Some reasons can be :
(i) not to take additional burden of debt funds **(ii)** laying down a specified minimum rate of return on each project **(iii)** No further Equity Issue to prevent dilution of control **(iv)** Divisional Budgets used to prevent any inefficiency or wastage of funds by them
➦**Different Situations of Capital Rationing :**
(i) Single Period Capital Rationing : Funds limitation is there only for one year. Thereafter , no Financial constraints.
(ii) Multi Period Capital Rationing : Funds limitaton is there in more than one years.
(iii) Divisible Projects : These are the projects which can be accepted fully as well as in fractions. NPV is also adjusted to the same fraction as cash outflows.
(iv) Indivisible Projects : These are the projects which can only be accepted fully, not in fractions.
➦**Ways of Resorting Capital Rationing :** There are various ways of resorting to capital rationing, some of which are :
(i) By Way of Retained Earnings : A firm may put up a ceiling when it has been financing investment proposals only by way

of retained earnings (ploughing back of profits). Since the amount of capital expenditure in that situation cannot exceed the amount of retained earnings, it is said to be an example of capital rationing.

(ii) By Way of Responsibility Accounting : Capital Rationing may also be introduced by following the concept of 'responsibility accounting', whereby management may introduce capital rationing by authorising a particular department to make investment only upto a specified limit, beyond which the investment decisions are to be taken by higher-ups.

(iii) By Making Full Utilization of Budget as Primary Consideration : In Capital Rationing it may also be more desirable to accept several small investment proposals than a few large investment proposals so that there may be full utilisation of budgeted amount. This may result in accepting relatively less profitable investment proposals if full utilisation of budget is a primary consideration. Thus Capital Rationing does not always lead to optimum results.

QUESTION NO. 3 Write a short note on Cross Border Leasing ? ***(SFM Nov 2008)***

➦**Meaning :** In case of cross-border or international lease, the lessor and the lessee are situated in two different countries. Because the lease transaction takes place between parties of two or more countries, it is called cross-border lease.

➦It involves relationships and tax implications more complex than the domestic lease.

➦Cross-border leasing 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 – 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.

➦**Basic Prerequisites Of Cross Border Leasing :** 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.

➦**Objective Of Cross Border Leasing :**A major objective of cross-border leases 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.Other important objectives of cross border leasing include the following :

(i) 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.

(ii) Also, depending on the structure, in some countries the lessor can utilize very favourable "leveraged lease" financial accounting treatment for the overall transacftion.

(iii) 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.

(iv) Leasing provides the lessee with 100% financing.

➦**Principal Players Of Cross Border Lease :** The principal players are **(i)** one or more equity investors; **(ii)** a special purpose vehicle formed to acquire and own the equipment and act as the lessor; **(iii)** one or more lenders, and **(iv)** the lessee. The lease itself is a "triple-net lease" under which the lessee is responsible for all costs of operation,maintenance and insurance.

➦**Benefits Of Cross Border Leasing :** Cross border lease benefits are more or less the same as are available in domestic lease viz. 100% funding off-balance sheets financing, matching of expenditure with earnings from the assets, the usual tax benefits on leasing, etc. In addition to these benefits, the following are the more crucial aspects which are required to be looked into:

(i) appropriate currency requirements can be met easily to match the specific cash flow needs of the lessee;

(ii) funding for long period and at fixed rate which may not be available in the lessee home market may be obtained internationally;

(iii) maximum tax benefits in one or more regions could be gained by structuring the lease in a convenient fashion;

(iv) tax benefits can be shared by the lessee or lessor accordingly by pricing the lease in the most beneficial way to the parties;

(v) choice of assets for cross border lease is different than domestic lease because those assets may find here attractive bargain which are internationally mobile , have adequate residual value and enjoy undisputed title.

QUESTION NO. 4 Write a short note on Rolling Settlement ? ***(SFM Nov 2008)***

➦**Meaning :** A rolling settlement is that settlement cycle of the stock exchange, where all trades outstanding at end of the day have to settled, which means that the buyer has to make payments for securities purchased and seller has to deliver the securities sold.

➦**<u>Example</u> :** Suppose if we have T+2 settlement cycle it means that a transaction entered into on Day 1 has to be settled on the Day 1+2 working days. <u>For example</u>

Jan 1	Jan 2	Jan 3	Jan 4	Jan 5	Jan 6	Jan 7	Jan 8
Mon	Tue	Wed	Thu	Fri	Sat	Sun	Mon

Stocks purchased/sold on Jan 1 should be settled on Jan 3. Stocks purchased/sold on Jan 4 should be settled on Jan 8 (Note that Sat & Sun, being holidays are again excluded for the T+2 count).

➦**<u>Benefits of Rolling Settlement</u>** : **(a)** In rolling settlements, payments are quicker than in weekly settlements. Thus, investors benefit from increased liquidity. **(b)** It keeps cash and forward markets separate. **(c)** Rolling settlements provide for a higher degree of safety.**(d)** From an investor's perspective, rolling settlement reduces delays. This also reduces the tendency for price trends to get exaggerated.Hence, investors not only get a better price but can also act at their leisure

➦**<u>Indian Scenario</u>** :Rolling settlement was first introduced in India by OTCEI.The rolling settlement prevailing in India is T+2, implying that the outstanding positions at the end of the day 'T' are compulsorily settled 2 days after the trade date.

➦**<u>International Scenario</u>** : Internationally, most developed countries follow the rolling settlement system. For instance, both the US and the UK follow a rolling settlement (T+3) system, while the German stock exchanges follow a (T+2) settlement cycle.

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<u>QUESTION NO. 5</u> Write a short note on CAPM? OR Write a short note on Assumptions of CAPM?

➦The Capital Assets Pricing Model was developed by Sharpe Mossin and Linter in 1960. The model explain the relationship between the expected return, non-diversifiable risk and the valuation of security.

➦Under CAPM, the expected return from a Security can be expressed as :

Expected Return = Risk Free Rate + Beta of a Security (Market Return - Risk Free Rate)

➦CAPM only takes into account Systematic Risk. The CAPM is an economic model that describe how securities are priced in the market place.

➦**<u>Assumption Of CAPM</u> :** The CAPM is based on following eight assumptions :

(i) <u>Efficient Market</u> : It is the first assumption of CAPM. Efficient market refers to the existence of competitive market where financial securities and capital assets are bought and sold with full information of risk and return available to all participants.

In an efficient market, the price of individual assets will reflect a real or intrinsic value of a share as the market prices will adjust quickly to any new situation.

(ii) <u>Rational Investment Goals</u> : Investors desire higher return for any acceptable level of risk or the lowest risk for any desired level of return.

(iii) Risk aversion in efficient market is adhered to although at times risk seeking behaviour is adopted for gains.

(iv) CAPM assumes that all assets are divisible and liquid assets.

(v) Investors are able to borrow freely at a risk less rate of interest i.e. borrowings can fetch equal return by investing in safe Government securities.

(vi) Securities can be exchanged without payment of brokerage, commissions or taxes and without any transaction cost.

(vii) Securities or capital assets face no bankruptcy or insolvency.

➦**<u>Security Market Line</u> :**A graphical representation of CAPM is the Security Market Line, (SML).

➦**<u>Advantages of CAPM</u> :** The advantages of CAPM can be listed as:

(i) <u>Risk Adjusted Return</u> : It provides a reasonable basis for estimating the required return on an investment which has risk in built into it. Hence it can be used as Risk Adjusted Discount Rate in Capital Budgeting.

(ii) <u>No Dividend Company :</u> It is useful in computing the cost of equity of a company which does not declare dividend.

➦**<u>Limitations of CAPM</u>**

(a) <u>Reliability of Beta</u> : Statistically reliable Beta might not exist for shares of many firms. It may not be possible to determine the cost of equity of all firms using CAPM. All shortcomings that apply to Beta value applies to CAPM too.

(b) <u>Other Risks</u> : By emphasing only on systematic risk it ignores unsystematic risks.Unsystematic Risks are also important to share holders who do not possess a diversified portfolio.

(c) <u>Information Available</u> : It is extremely difficult to obtain important information on risk free interest rate and expected return on market portfolio as there is multiple risk free rates for one while for another, markets being volatile it varies over time period.

<u>QUESTION NO. 6</u> Write a short note on EMBEDDED DERIVATIVES ? ***(SFM Nov 2008)***

➦**Meaning** : 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.

➦**How They Arise** : 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 arrangements. Even purchase and sale contracts that qualify for executory contract treatment may contain embedded derivatives.

➦**Illustration :** A coal purchase contract may include a clause that links the price of the coal to a pricing formula based on the prevailing electricity price or a related index at the date of delivery. The coal purchase contract, which qualifies for the executory contract exemption, is described as the host contract, and the pricing formula is the embedded derivative. The pricing formula is an embedded derivative because it changes the price risk from the coal price to the electricity price.

➦**When must embedded derivatives be accounted for**? An embedded derivative is split from the host contract and accounted for separately if:

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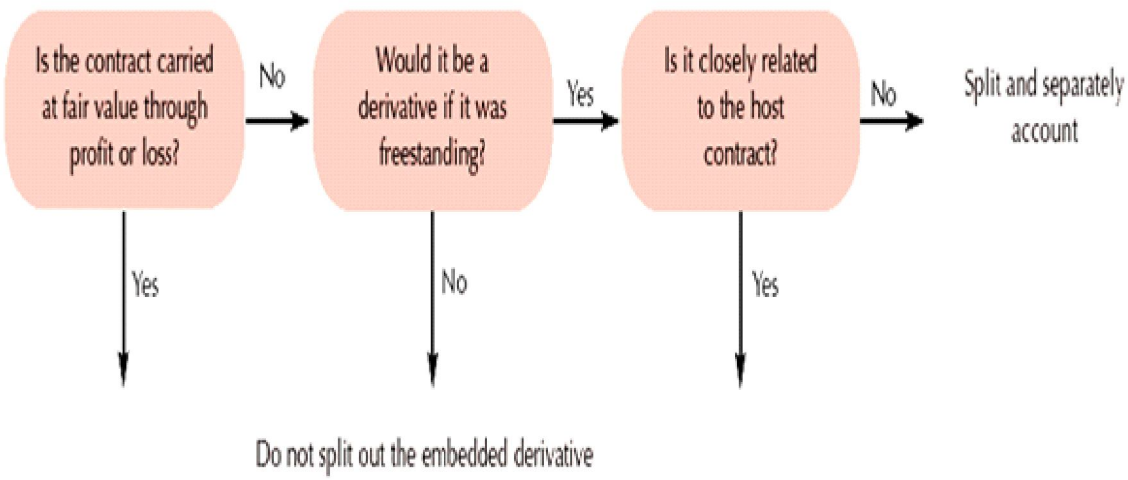
(i) Its economics are not 'closely related' to those of the host contract;

(ii)A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(iii) The entire contract is not carried at fair value through profit or loss.



➦**Closely Related & Not Closely Related** : An embedded derivative that modifies an instrument's inherent risk (such as a fixed to floating interest rate swap) would be considered closely related. Conversely, an embedded derivative that changes the nature of the risks of a contract is not closely related.

➦**Examples**

Closely related- Examples of embedded derivatives that need not be separated

• A derivative embedded in a host lease contract is closely related to the host contract if the embedded derivative comprises contingent rentals based on related sales;

• An inflation index term in a debt instrument as long as it is not leveraged and relates to the inflation index in the economic environment in which the instrument is denominated or issued;

Not closely related- Examples of embedded derivatives that must be separated

• Equity conversion feature embedded in a debt instrument e.g. investment in convertible bonds;

• Option to extend the term of a debt instrument unless there is a concurrent adjustment of the interest rate to reflect market prices;

Other Examples : The table below provides further examples of embedded derivatives that are closely related and those that are not.

Not Closely Related	Closely Related
Enquity conversion or 'put' option in dept intrument	Interest-rate swap embedded in a debt instrument
Fixed -rate debt extension option	Inflation-indexed lease contracts
Dept security with interest or principal linked to commodity or	Cap and floor in a sale and purchase contracts

equity prices
Credit derivatives embedded in the host debt instrument
Sale or purchese not in
(1) measurement currency of either party
(2) currency in which products are routinely denominated in international commerce, or
(3) currency commonly used in economic environment in which the transaction takes place.

Prepayment option in the mortgage where the option's exercise price is approximately equal to the the mortgage's amortised cost on each exercise date
A forward foreign exchange contract that results in payments in either party's reporting currency
Dual currency bonds
Foreign currency denominated debt

<u>QUESTION NO. 7</u> Write a short note on Systematic and Unsystematic Risk?

Total Risk = Systematic Risk + Unsystematic Risk

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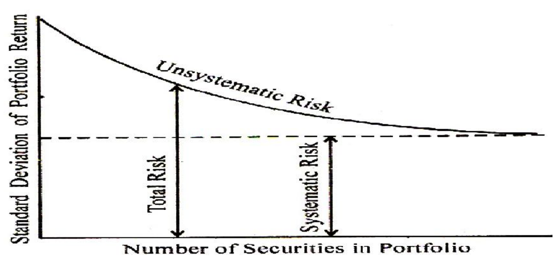
A portfolio of asset possesses two types of risk :
(a) Unsystematic risk that can be diversified out, and
(b) Systematic risk that cannot be diversified out through investment in domestic securities.

<u>Systematic Risk or Non-Diversiable Risk or Market Risk</u>
➦This risk affects <u>all companies</u> operating in the market.
➦They are <u>beyond the control</u> by the management of entity.
➦<u>Example</u> : Interest Rate; Inflation ; Taxation; Political Development ; Credit Policy.
➦Systematic Risk is also called <u>non-diversiable risk</u> as it cannot be reduced with the help of diversification.

<u>Unsystematic Risk or Diversiable Risk or Specific Risk</u>
➦This risk affects only a <u>particular security / company</u> .
➦They <u>can be controlled</u> by the management of entity.
➦<u>Example</u> : Strikes, change in management, special export order, the research & development expert of company leaves; a formidable competitor enters the market, the company loses a big contract in a bid etc .
➦Unsystematic Risk are also called <u>Diversifiable Risk</u> as they can be eliminated through Diversification.



<u>QUESTION NO. 8</u> Write a short note on Private Placement ?

➦**<u>Meaning</u> :** A private placement, which involves the selling of debt or equity to private investors, resembles both a public offering and a merger. They are usually the province of small companies aiming ultimately to go public .
➦**<u>Difference Between Private Placements & Public Offerings</u> :**
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.
Also, a typical private placement deal is smaller than a public issue.
One difference is that private placements do not require any securities to be registered with the Stock Exchange, nor do they involve a roadshow.In place of the prospectus, Investment banks draft a detailed Private Placement Memorandum (PPM) which divulges information similar to a prospectus.
Despite these differences, the primary reason for a private placement - to raise capital - is fundamentally the same as a public offering. Often, firms wishing to go public may be advised by investment bankers to first do a private placement, as they need to gain critical mass or size to justify an IPO.
➦**<u>Role Of Investment Banker</u> :** The investment banker's work involved in a private placement is quite similar to sell-side M&A representation. The bankers attempt to find a buyer by writing the PPM and then contacting potential strategic or financial buyers of the client.Investment bankers function as negotiators for the company, helping to convince the investor of the value of the

firm.
➦**Fees** involved in private placements work are like those in public offerings. Usually they are a fixed percentage of the size of the transaction.
➦**Sale of shares to few selected investors**:Private placement involves the sale of shares(or other securities)by a company to few selected investors,particularly the institutional investors like the Unit Trust of India,Life Insurance Corporation of India etc.
➦**Advantage :**
(i) It is helpful to issue small amount of funds.
(ii) It is less expensive. There is a cost cutting on account of underwriting commission, expense relating to applications, allotment of shares and the stock exchange requirements relating to contents of the prospectus and its advertisement. In the case of public issue of securities, issue costs are very high which can be avoided through private placement.
(iii) It take less time to raise funds through private placement, say less than 3 months. Public issues involves a number of requirements to be fulfilled and thus requires a lot of time to raise capital.
(iv) This method is generally adopted by small companies with unsatisfactory financial performances.

QUESTION NO. 9 What is a depository ? Who are.the major players of a depository system ?What advantage the depository system offer to the clearing member ? ***(May 2010) 4 Marks***

➦The term 'Depository' means a place where something is deposited for safe keeping; Depository system is concerned with conversion of securities from physical to electronic form, settlement of trades in electronic segment, electronic transfer of ownership of shares and electronic custody of securities. All securities in the depositories are identical in all respects and are thus fungible.The system results in instant transfer as compared to six to eight weeks time under physical mode.
➦**Physical Vis-a-Vis Dematerialised Share Trading**

Physical	Dematerialised
(1) Actual Delivery of Share is to be exchanged	**(1)** No Actual Delivery of shares is needed
(2) Open Delivery can be kept	**(2)** Not possible to keep delivery open
(3) Processing time is long	**(3)** Processing time is less
(4) Stamp Charges @ 0.5%(approx) are levied for transfer	**(4)** No Stamp Charges are required for transfer
(5) For sales transaction,no charges other than brokerage are levied	**(5)** Sales transactions are also charged
(6) For buy transaction, delivery is to be sent to company for Registration	**(6)** No need to send the document to the company for Registration.

➦ **Major players of a depository system:** The Depository System consists of the following constituents to serve the beneficial owners through**1.** Issuers or company **2.** Issuer Registrar **3.** Depository Participants **4.** Clearing members **5.**Stock brokers **6.**Clearing corporations **7.**Investors
➦**Pros And Cons Of Depository Services:**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 fast by the use of electronic clearing system.
9. Securities held in electronic form can be locked in and frozen from 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.

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QUESTION NO. 10 Write a short note on Advantages Of Mutual Fund ?

(1) Professional Management: The funds are managed by skilled and professionally experienced managers with a back up of a Research team.

(2) Diversification: Mutual Funds offer diversification in portfolio which reduces the risk.

(3) Convenient Administration: There are no administrative risks of share transfer, as many of the Mutual Funds offer services in a demat form which save investor's time and delay.

(4) Higher Returns: Over a medium to long-term investment, investors always get higher returns in Mutual Funds as compared to other avenues of investment.

(5) Low Cost of Management: No Mutual Fund can increase the cost beyond prescribed limits of 2.5% maximum and any extra cost of management is to be borne by the AMC.

(6) Liquidity: In all the open ended funds, liquidity is provided by direct sales / repurchase by the Mutual Fund and in case of close ended funds, the liquidity is provided by listing the units on the Stock Exchange.

(7) Transparency: The SEBI Regulations now compel all the Mutual Funds to disclose their portfolios on a half-yearly basis. However, many Mutual Funds disclose this on a quarterly or monthly basis to their investors. The NAVs are calculated on a daily basis in case of open ended funds and are now published through AMFI in the newspapers.

(8) Other Benefits: Mutual Funds provide regular withdrawal and systematic investment plans according to the need of the investors. The investors can also switch from one scheme to another without any load.

(9) Highly Regulated: Mutual Funds all over the world are highly regulated and in India all Mutual Funds are registered with SEBI and are strictly regulated as per the Mutual Fund Regulations which provide excellent investor protection.

QUESTION NO. 11 What are the limitations/drawbacks of investing in Mutual Fund? ***(RTP,Nov 2009)***

(1) No guarantee of Return – There are three issues involved :

(a) All Mutual Funds cannot be winners. There may be some who may under perform the benchmark index i.e. it may not even perform well as a beginner who invests in the stocks constituting the index.

(b) A mutual fund may perform better than the stock market but this does not necessarily lead to a gain for the investor. The market may have risen and the mutual fund scheme increased in value but the investor would have got the same increase had he invested in risk free investments than in mutual fund.

(c) Investors may forgive if the return is not adequate. But they will not do so if the principal is eroded. Mutual Fund investment may depreciate in value.

(2) Diversification – Diversification may minimize risk but does not guarantee higher return.

(3) Selection of Proper Fund – It may be easier to select the right share rather than the right fund. For stocks, one can base his selection on the parameters of economic,industry and company analysis. In case of mutual funds, past performance is the only criteria to fall back upon. But past cannot predict the future.

(4) Cost Factor/ High Management Fee – Mutual Funds carry a price tag. Fund Managers are the highest paid executives. While investing, one has to pay for entry load and when leaving he has to pay for exit load. Such costs reduce the return from mutual fund. The fees paid to the Asset Management Company is in no way related to performance.The Management Fees charged by the Fund reduces the return available to the investors.

(5) Unethical Practices – Mutual Funds may not play a fair game.There may be unethical practices e.g. diversion of Mutual Fund amounts by Mutual Funds to their sister concerns for making gains for them.

(6) Others-

-Mutual Funds systems do not maintain the kind of transparency they should maintain

-Many MF scheme are, at times, subject to lock in period, therefore, deny the market drawn benefits

-At times, the investments are subject to different kind of hidden costs.

-Redressal of grievances, if any , is not easy

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QUESTION NO. 12 Write short note on 'Factors Influencing the selection of Mutual Fund '?

(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 = (NAV1 – NAV0) + D1 / NAV0.

(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.

(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.

QUESTION NO.13 Write short note on'Signals Highlighting The Exit Of The Investor From The Mutual Fund Scheme'

(1) When the mutual fund consistently under performs the broad based index, it is high time that it should get out of the scheme. It would be better to invest in the index itself either by investing in the constituents of the index or by buying into an index fund.

(2) When the mutual fund consistently under performs its peer group instead of it being at the top. In such a case, it would have to pay to get out of the scheme and then invest in the winning schemes.

(3) When the mutual fund changes its objectives e.g. instead of providing a regular income to the investor, the composition of the portfolio has changed to a growth fund mode which is not in tune with the investor's risk preferences.

(4) When the investor changes his objective of investing in a mutual fund which no longer is beneficial to him.

(5) When the fund manager, handling the mutual fund schemes, has been replaced by a new entrant whose image is not known.

QUESTION NO.14 Write short note on'Exchange Traded Funds' ? ***(May 2010)***

➦**Meaning :** Exchange-Traded Funds (ETFs) are mutual fund schemes that are listed and traded on exchanges like any other stocks.An Exchange Traded Fund (ETF) is a hybrid product that combines the features of an index fund.

➦ETFs invest in a basket of stocks and try to replicate a stock market index such as the S&P CNX Nifty or BSE Sensex

➦**Advantage** :

1.By owning an ETF, you get the diversification of an index fund as well as the ability to sell short, buy on margin and purchase as little as one share.
2.Another advantage is that the expense ratios for most ETFs are lower than those of the average mutual fund.They have very low operating and transaction costs , since there are no loads required to purchase ETFs.
3.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.
4.A great reason to consider Exchange Traded Funds is that they simplify index and sector investing in a way that is easy to understand. If investors feel a turnaround is around the corner, they can go long. If, however, they think ominous clouds will be over the market for some time, they have the option of going short.
5.The combination of the instant diversification,low cost and the flexibility that Exchange Traded Funds offer makes these instruments one of the most useful innovations and attractive pieces of financial engineering to date.
➦**Indian Scenario**: The following Exchange Traded Funds (ETFs) are being presently traded at National Stock Exchange of India:

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- S&P CNX Nifty UTI Notional Depository Receipts Scheme
- Liquid Benchmark Exchange Traded Scheme (Liquid BeES)
- Junior Nifty BeES
- Nifty BeES
- Bank BeES

➦**History** :They first came into existence in the USA in 1993. It took several years for their public interest. But once they did, the volumes took off with a vengeance. Over the years more than $ 120 billion (as on June 2002) is invested in about 230 ETFs on the American Stock Exchange .The most popular are QQQs (Cubes) based on the Nasdaq-100 Index, SPDRs (Spiders) based on the Index, I SHARES based on MSCI indices and TRAHK (Tracks) based on the Hand . The average daily trading volume in QQQ is around 89 million shares.

QUESTION NO. 15 Write a short note on Key Players of Mutual Fund ?

Mutual Fund is formed by a trust body. The business is set up by the sponsor, the money invested by the asset management company and the operations monitored by the trustee.There are five principal constituents and three market intermediaries in the formation and functioning of mutual fund.The five constituents are :
(1) Sponsor: A company established under the Companies Act forms a mutual fund.
(2) Asset Management Company: An entity registered under the Companies Act to manage the money invested in the mutual fund and to operate the schemes of the mutual fund as per regulations. It carries the responsibility of investing and managing the investors' money.
(3) Trustee: The trust is headed by Board of Trustees. The trustee holds the property of the mutual fund in trust for the benefit of unit holders and looks into the legal requirements of operating and functioning of the mutual fund. The trustee may also form a limited company under the Companies Act in some situations.
(4) Unit Holder: A person/entity holding an undivided share in the assets of a mutual fund scheme.
(5) Mutual Fund: A mutual fund established under the Indian Trust Act to raise money through the sale of units to the public for investing in the capital market. The funds thus collected are passed on to the Asset Management Company for investment. The mutual fund has to be registered with SEBI.
The three market intermediaries are:**(1) Custodian (2) Transfer Agents (3) Depository.**
(1) Custodian : A custodian is a person who has been granted a Certificate of Registration to conduct the business of custodial services under the SEBI (Custodian of Securities) Regulations 1996. Custodial services include safeguarding clients' securities along with incidental services provided. Maintenance of accounts of clients' securities together with the collection of benefits / rights accruing to a client falls within the purview of custodial service. Mutual funds require custodians so that AMC can concentrate on areas such as investment and management of money.
(2) Transfer Agents : A transfer agent is a person who has been granted a Certificate of Registration to conduct the business of transfer agent under SEBI (Registrars to an Issue and Share Transfer Agents) Regulations Act 1993. Transfer agents' services include issue and redemption of mutual fund units, preparation of transfer documents and maintenance of updated investment records. They also record transfer of units between investors where depository does not function.

(3) Depository : Under the Depositories 1996, a depository is body corporate who carries out the transfer of units to the unit holder in dematerialised form and maintain records thereof.

QUESTION NO. 16 What is the difference between Capital Market and Money Market?

Basics	**Money Market**	**Capital Market**
(i) Tenure	It is a market for lending and borrowing of short term funds, upto one year .	Capital markets deals in long term securities for a period beyond one year.
(ii) Well defined place	It is a not a well-defined market where business is done .	It is a well defined market where business is done e.g. stock exchange.
(iii) Short Term /Long Term	It deals in short term financial assets e.x .interbank call money, treasury bills,commercial paper, etc.	It deals in medium & long term financial assets e.g equity shares, debentures etc.
(iv) Classification	There is no sub-division in money market .	Capital Market is classified between Primary Market and Secondary Market.
(v) Volume of business	The total value of transaction in money market far exceeds the capital market .According to DFHI only in call money market daily volume is Rs. 6000 crores arround	Capital market lag behind the total value of transaction done in money market.
(vi) No. of instrument	The number of instruments dealt in money market are various, e.g.**(a)** Interbank call money **(b)** Notice money upto 14 days **(c)** Short term deposits upto 3 months **(d)** 91 days treasury bill **(e)** 182 days treasury bill **(f)** Commercial paper etc.	The number of instruments in capital market are shares and debentures.
(vii) Participants	The participants in money market are Bankers, RBI and Government .	The participants in capital market are general investors, brokers, merchant bankers,registrars to issue, underwriters,corporate investors,Flls & Bankers.
(viii) Liquidity	The important features of money market instrument is that it is liquid.	Whereas Capital market are not as liquid as money market instrument.
(viii) Regulator	It is regulated by the guidelines of RBI	It is regulated by the guidelines of SEBI.

QUESTION NO. 17 Write a short note on the following topics :

A. FCCB (Foreign Currency Convertible Bonds)

➦A type of convertible bond issued in a currency different than the issuer's domestic currency. In other words, the money being raised by the issuing company is in the form of a foreign currency.A convertible bond is a mix between a debt and equity instrument.It acts like a bond by making regular coupon and principal payments,but these bonds also give the bondholder the option to convert the bond into stock.These types of bonds are attractive to both investors and issuers.The investors receive the safety of guaranteed payments on the bond & are also able to take advantage of any large price appreciation in the company's stock.

➦**Advantages of FCCBs**

1. The convertible bond gives the investor the flexibility to convert the bond into equity at a price or redeem the bond at the end of a specified period, normally three years if the price of the share has not met his expectations.

2. Companies prefer bonds as it defers the dilution of equity and earnings per share .

3. FCCBs are easily marketable as investors enjoys option of conversion into equity if resulting to capital appreciation. Further investor is assured of a minimum fixed interest earnings .

➦**Disadvantages of FCCBs**

1. Exchange Risk is more in FCCBs as interest on bonds would be payable in foreign currency. Thus companies with low debt equity ratios, large forex earnings potential only opt for FCCBs.

2. FCCBs mean creation of more debt and a forex outgo in terms of interest which is in foreign exchange.

3. There is exchange risk on the interest payment as well as re-payment if the bonds are not converted into equity shares.

➦**Recent Example :** In the first quarter of 2007 Reliance Communications company raised $1 billion FCCB. It was one of the biggest FCCBs from India.With the stock market bouncing back, India Inc is once again tapping the foreign currency convertible bonds (FCCBs) for funds with nearly $3 billion in fresh issues in 2010 as against next to nothing, a year ago.However, buyers of these bonds seem to be treading much more cautiously than they did last time. Conversion prices are now being set closer to the current market prices and the bonds also carry higher interest rates than earlier.

Data compiled by news agency Bloomberg show total FCCB issuances for 2009-10 at $2.88 billion, a big jump compared with the measly $24 million in 2008-09, but much lower than the 2007-08 number of $5.6 billion. Tata Motors, Tata Power, Sesa Goa, Jaiprakash Power Ventures, Sterlite Industries and Larsen and Toubro were a few big issuers who took the FCCB route.

B. GDR (Global Depository Receipts) or Impact of GDRs on Indian Capital Market (SFM,Nov 2009)

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➦A depository receipt is basically a negotiable certificate, denominated in US dollars, that represents a non US company's publicly - traded local currency (Indian rupee) equity shares.Rule 144A of the Securities and Exchange Commission of USA permits companies from outside USA to offer their GDRs to certain institutional buyers.These are known as Qualified Institutional Buyers(QIBs)

➦GDR are negotiable instruments issued to Overseas Depository Bank on behalf of an Indian Company to raise funds abroad.

➦**The mechanics of a GDR issue may be described with the help of following diagram.**

Company issues
↓
Ordinary shares
↓
Kept with Custodian/depository banks
↓
against which GDRs are issued
↓
to Foreign investors

➦**Impact of GDRs on Indian Capital Market** :After the globalization of the Indian economy, accessibility to vast amount of resources was available to the domestic corporate sector. One such accessibility was in terms of raising financial resources abroad by internationally prudent companies. Among others, GDRs were the most important source of finance from abroad at competitive cost. Global depository receipts are basically negotiable certificates denominated in US dollars, that represent a non-US company's publicly traded local currency (Indian rupee) equity shares. Companies in India, through the issue of depository receipts, have been able to tap global equity market to raise foreign currency funds by way of equity.Since the inception of GDRs, a remarkable change in Indian capital market has been observed. Some of the changes are as follows:

(i) Indian capital market to some extent is shifting from Bombay to Luxemburg and other foreign financial centres.

(ii) There is arbitrage possibility in GDR issues. Since many Indian companies are actively trading on the London and the New York Exchanges and due to the existence of time differences, market news, sentiments etc. at times the prices of the depository receipts are traded at discounts or premiums to the underlying stock. This presents an arbitrage opportunity wherein the receipts can be bought abroad and sold in India at a higher price.

(iii) Indian capital market is no longer independent from the rest of the world. This puts additional strain on the investors as they now need to keep updated with worldwide economic events.

(iv) Indian retail investors are completely sidelined. Due to the placements of GDRs with Foreign Institutional Investor's on the basis free pricing, the retail investors can now no longer expect to make easy money on heavily discounted right/public issues.

(v) A considerable amount of foreign investment has found its way in the Indian market which has improved liquidity in the capital market.

(vi) Indian capital market has started to echo by world economic changes, good or bad.

(vii) Indian capital market has not only been widened but deepened as well.

(viii) It has now become necessary for Indian capital market to adopt international practices in its working including financial innovations.

➦**Markets of GDR'S**

(i) GDR's are sold primarily to institutional investors.

(ii) Demand is likely to be dominated by emerging market funds.
(iii) Switching by foreign institutional investors from ordinary shares into GDRs is likely.
(iv) Major demand is also in UK, USA, South East Asia (Hong kong, Singapore), and to some extent continental Europe (principally France and Switzerland) .

➦**Profile of GDR investors :** The following parameters have been observed in regard to GDR investors.
(i) Dedicated convertible investors
(ii) Equity investors who wish to add holdings on reduced risk or who require income enhancement.
(iii) Fixed income investors who wish to enhance returns.
(iv) Retail investors: Retail investment money normally managed by continental European banks which on an aggregate basis provide a significant base for Euro-convertible issues.

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➦**Characteristics**
(i) Holders of GDRs participate in the economic benefits of being ordinary shareholders though they do not have voting rights.
(ii) GDRs are settled through CEDEL & Euro-clear international book entry systems.
(iii) GDRs are listed on the Luxemberg stock exchange.
(iv) Trading takes place between professional market makers on an OTC (over the counter) basis.

➦**Advantages of GDRs :**
(a) The issuer has the benefit of collecting the issue proceeds in foreign currency which may be utilized for meeting the foreign exchange component of the project cost,repayment of foreign currency / loan etc.
(b) It has been perceived that a GDR issue has been able to fetch higher prices from international investors than those that a domestic public issue would have been able to extract from Indian investors.
(c)GDR does not entitle the holder to any voting rights,so there is no fear of loss of management and control.
(d)GDR does not involve any foreign exchange risk to the issuing company , as the shares represented by GDR are expressed in rupees.

➦**Indian Example :**Among the Indian companies,Reliance Industries Ltd. was the first company (1992) to raise funds through a GDR Issue.Recently Tata Motors on 9th Oct 2009 raised $375 million through a GDR issue,becoming the third company from the Tata Empire,after Tata Steel and Tata Power.

C. Amercian Depository Receipts

➦**Meaning :** Depository receipts issued by a company in the United States of America (USA) is known as American Depository Receipts (ADRs).In other words An American Depository Receipt (ADR) is a negotiable receipt which represents one or more depository shares held by a US custodian bank, which in turn represent underlying shares of non-issuer held by a custodian in the home country.

➦**Statutory Compliance :** Such receipts have to be issued in accordance with the provisions stipulated by the Securities and Exchange Commission of USA (SEC) which are very stringent.Regulations include requirement such as minimum size of issue,reporting to SEC,adherence to US GAAP in reporting etc.

➦**Mechanism for ADR issue** : An ADR is generally created by the deposit of the securities of a non-United States company with a custodian bank in the country of incorporation of the issuing company. The custodian bank informs the depository in the United States that the ADRs can be issued. ADRs are United States dollar denominated and are traded in the same way as are the securities of United States companies.The pictorial representation of the process is given below :

Indian Company
↓ ← Securities & Dividend
Domestic Depository Bank
↓
Overseas Depository Bank
↓
Overseas Investor

➦**Types of ADRs** : There are three types of ADRs:
Unsponsored ADRs are issued without any formal agreement between the issuing company and the depository, although the issuing company must consent to the creation of the ADR facility. For the issuing company, they provide a relatively inexpensive method of accessing the United States capital markets (especially because they are also exempt from most of reporting require-

ments of the Securities and Exchange Commission).

Sponsored ADRs are created by a single depository which is appointed by the issuing company under rules provided in a deposit agreement. There are two broad types of sponsored ADRs

Restricted ADRs (RADRs) These are restricted with respect to the type of buyer which is allowed and are privately placed. They are allowed to be placed only among selected accredited investors and face restrictions on their resale. As these are not issued to the general public, they are exempt from reporting requirements of the Securities and Exchange Commission and are not even registered with it. Restricted ADR issues are sometimes issued by companies that seek to gain some visibility and perhaps experience in the United States capital markets before making an unrestricted issue.

Unrestricted ADRs (URADRs) are issued to and traded by the general investing public in United States capital markets. There are three classes of URADR, each increasingly demanding in terms of reporting requirements of the Securities and Exchange Commission, but also increasingly attractive in terms of degree of visibility provided. The three classes of Unrestricted ADRs are **(i)** Level 1 URADRs , **(ii)** Level II URADRs and **(iii)** Level III URADRs

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➦**Benefit of ADR for US investors** ADR is an attractive investment to US investors willing to invest in securities of non US issuers for following reasons

(a) ADRs provide a means to US investors to trade the non US company's shares in US dollars.The trading in ADR effectively means trading in underlying shares.

(b) ADRs facilitates share transfers. ADRs are negotiable and can be easily transferred among the investors like any other negotiable instrument. The transfer of ADRs automatically transfers the underlying share.

(c) The transfer of ADRs does not involve any stamp duty.

(d) The dividends are paid to the holders of ADRs in US dollars.

➦**Benefits of ADR Issue to Indian Company**

(a) Better corporate image both in India & abroad which is useful for strengthening the business operation in the overseas market.

(b) Exposure to international markets and hence stock prices in line with international trends.

(c) Means of raising capital abroad in foreign exchange.

(d) Use of foreign exchange proceeds for activities like overseas acquisitions, setting offices abroad & other capital expenditure.

(e) Increased recognition internationally by bankers, customers, suppliers etc.

(f) No risk of foreign exchange fluctuations as the company will be paying the interest and dividends in Indian rupees to the domestic depository bank.

Types of ADRs

Unsponsored
No formal arrangement exists between issuing company and the depository.
Some elements of costs are borne by investor.
For issuer, a relatively inexpensive method of raising capital

Sponsored

Restricted to
select investors, by way of private placements. Exempt from the requirements of SEC

Unrestricted
All public

Levels I, II & III

➦**Documents used in ADRs** A public offering of ADRs by a non US private issuer will require, in general, the following documents :**(a)** Form F1 **(b)** Form F6 **(c)** Listing Application **(d)** Blue Sky Survey **(e)** Deposit Agreement **(f)** Custodian Agreement **(g)** Underwritting Agreement

➦**Example of Indian ADRs :**Only few Indian companies have gone for ADRs so far.Some of which are **(1)** Infosys, **(2)** Wipro, **(3)** MTNL, **(4)** VSNL,**(5)** Silverline, **(6)** Dr. Reddy.These are listed on two stock exchanges **(i)** NASDAQ (National Association of Securities Dealers Automatic Quotes) and **(ii)** New York Stock Exchange, both have their head offices at New York.

" Life never seems to be the way we want it, but we live it the best way we can. There is no perfect life but we can fill it with perfect moments."

D. <u>Indian Depository Receipts(IDRs)</u>

➦IDR means any instrument in the form of depository receipt created by the domestic depository in India against the underlying equity shares of the issuing foreign company .

➦Companies incorporated outside the country can now raise resources from the Indian capital market through the issue of Indian Depository Receipts (IDRs).

➦An IDR is a financial instrument similar to a Global Depository Receipt (GDR) and American Depository Receipt (ADR), the objective of which is to provide a platform to foreign firms to directly raise capital in India. For Indian investors, IDRs would provide a route to invest in foreign firms.

➦In an IDR, foreign companies would issue shares, to an Indian Depository (say National Security Depository Limited – NSDL), which would in turn issue depository receipts to investors in India.

➦**<u>Recent Example</u>**:Standard Chartered is planning to list its shares in India through an issue of Indian Depository Receipts (IDRs).The UK bank had recently received an approval from the RBI for the issue.

➦**<u>Listing</u>:** These IDRs would be listed on stock exchanges in India and would be freely transferable.

➦**<u>Benefits to Indian Investors</u>:** IDR is an additional investment opportunity for Indian investors for overseas investment.Indian citizens will be able to easily improve their portfolio diversification as well as a chance to sample new companies that would otherwise not be available for investment.

<u>QUESTION NO. 18</u> Write a short note on ARBITRAGE ? (SFM Nov 2008)

➦**<u>Meaning :</u>** Arbitrage by definition is a financial transaction that makes an immediate profit without involving any risk. Arbitrage is a strategy to take advantage of price differential of a product in different markets.An arbitrageur makes money by buying an asset at low price in a market and selling it in any other market at a relatively higher price.

➦**<u>For instance</u>**, If one can buy an asset for $5, sell it for $20 and make a profit of $15 that is arbitrage. The $15 gain represents an arbitrage profit.

➦Arbitrage profits are the result of **(i)** the difference in exchange rates at two different exchange centres, **(ii)** the difference. due to interest yield which can be earned at different exchanges. Thus depending upon the nature of deal, arbitrage may be of space and time arbitrage. The space arbitrage is because of separation of two exchange markets due to physical dispersion wherein the rates may vary while on the other hand in the time arbitrage an investor may gain by executing a spot and forward deal to buy and sell a currency.

➦**<u>Types of Arbitrage</u>**

(i) <u>Geographical/Space Arbitrage</u> - It occurs when one currency sells for two prices in two different markets.

(ii) <u>Cross - Rate Arbitrage</u> - In a given market, exchange rates for currencies A and B and for currencies A and C imply an exchange rate called a cross - rate between currencies B and C. If the rate implied for C does not match the actual rate between C in some other market, an arbitrage opportunity exists.

(iii) <u>Time Arbitrage</u> - In time arbitrage, an investor may gain by executing a spot and forward deal to buy and sell a currency.

(iv) <u>Covered Interest Arbitrage</u> : This arbitrage occur when there is mismatch of interest rate between two countries .

<u>QUESTION NO. 19</u> Write a short note on Financial Restructurings ? (SFM Nov 2008)

➦When a company cannot pay its cash obligations - for example, when it cannot meet its bond payments or its payments to other creditors (such as vendors) - it goes bankrupt. In this situation, a company can, of course, choose to simply shut down operations and walk away. On the other hand, it can also **restructure** and remain in business.

➦**<u>What does it Mean to Restructure</u>?** The process can be thought of as two-fold: financial restructuring and organizational restructuring.

➦Restructuring from a **<u>financial viewpoint</u>** involves renegotiating payment terms on debt obligations, issuing new debt, and restructuring payables to vendors.

➦From an **<u>organizational viewpoint</u>**, a restructuring can involve a change in management,strategy and focus.

➦Restructuring can take many forms. Some typical approaches to financial restructuring include:

(i) Vertical Restructuring ;**(ii)** Horizontal Restructuring ;**(iii)** Corporate Restructuring

➦Financial restructuring refers to a kind of internal changes made by the management in Assets and Liabilities of a company with the consent of its various stakeholders. This is a suitable mode of restructuring for corporate entities who have suffered from sizeable losses over a period of time. Consequent upon losses the share capital or networth of such companies get substantially eroded. In fact, in some cases, the accumulated losses are even more than the share capital and thus leading to negative networth, putting the firm on the verge of liquidation. In order to revive such firms, financial restructuring is one of the technique to bring into health such firms who are having potential and promise for better financial performance in the years to come.

➦To achieve this desired objective, such firms needs to re-start with a fresh balance sheet free from losses and fictitious assets and shows share capital at its real true worth.To nurse back such firms a plan of restructuring need to be formulated involving a number of legal formalities (which includes consent of court, and other stake-holders viz., creditors,lenders and shareholders etc.). An attempt is made to do Refinancing and rescue financing while Restructuring. Normally equity shareholders make maximum sacrifice by foregoing certain accrued benefits, followed by preference shareholders and debenture holders,lenders and creditors etc. The sacrifice may be in the form of waving a part of the sum payable to various liability holders. The foregone benefits may be in the form of new securities with lower coupon rates so as to reduce future liabilities. The sacrifice may also lead to the conversion of debt into equity. Sometime, creditors, apart from reducing their claim, may also agree to convert their dues into securities to avert pressure of payment.This measures will lead to better financial liquidity.

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➦The financial restructuring leads to significant changes in the financial obligations and capital structure of corporate firm,leading to a change in the financing pattern, ownership and control and payment of various financial changes.

➦In nutshell it may be said that financial restructuring (also known as internal re-construction) is aimed at reducing the debt/ payment burden of the corporate firm. This results into **(i)** Reduction/Waiver in the claims from various stakeholders; **(ii)** Real worth of various properties/assets by revaluing them timely; **(iii)** utilizing profit accruing on account of appreciation of assets to write off accumulated losses and fictitious assets (such as preliminary expenses and cost of issue of shares and debentures) and creating provision for bad and doubtful debts.

QUESTION NO.20 You have been asked by the Board of Directors of XYZ & Co. Ltd. to submit a project feasibility report on the introduction of a new product 'A' in the paint market as a Chief Finance Officer.Write a Specimen Of Project Feasibility Report ?

To
The Board of Directors,
XYZ & Co. Ltd.
From:
The Chief Finance Officer

RE: IN DEPTH STUDY OF A PRODUCT 'A' BEING INTRODUCED IN THE MARKET PROPOSED.

The Company proposes to introduce a new product 'A' in the paint Market at Delhi. The present study is an effort to see whether the project under consideration should be taken up or not.

COMMERCIAL VIABILITY (MARKET):

Aim in Market Share :

The in depth market study and research reveals the following facts:

Total Demand of the product 'A' type	- 1,00,000 tonnes p.a.
Installed Capacity	- 90,000 tonnes p.a.
Production	- 80,000 tonnes p.a.
Potential Demand Gap	- 20,000 tonnes p.a.

The company proposes to manufacture 10,000 tonnes of 'A' thus aiming at 10% share of the market or 50% of unfulfilled demand.

Market Leader & Competition :

The market leader of this group of products has a share of 40% and rest of market is shared by a number of small manufacturers. Thus company expects little competition from the market leader.

Availability of Inputs:

Raw Materials:

Raw Materials constitute a major portion of the total cost of output. In fact, 70% of value added output cost is raw material. About 5% of petroleum by products are used as additives and these are subject to price fluctuations due to change in international prices.Such increases are passed on to the consumers in the shape of increased prices thereby keeping contribution margin in tact. As government is the sole supplier of additives there is a fear that company may have to stop production if supply is discontinued.

Power:

As the project will require very little power it is expected that power shortage will not create a very big hazard.

Capital Cost of the Project -	**Rs. (lakhs)**
(1) Land & Building	5.00
(2) Plant & Machinery	6.00
(3) Other Fixed Assets including Tanks	4.00
(4) Pre Operative Expenses	1.00
(5) Margin Money for Working Capital	2.00
(6) Provision for contingencies	2.00
	20.00

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Financial Plan -	**Rs. (lakhs)**
(1) Equity Shares	5.00
(2) Retained Earnings	5.00
(3) Term Loans	10.00
	20.00

Technical Feasibility:

Knowhow: As the total investment in Plant & Machinery is Rs.6 (lakhs), it is presumed that complex technical know how is not required.

Right Plant & Machinery: The company being the market leader in paints it has been able to select the right kind of plant & Machinery at optimum cost. As per market quotations, the cost of Plant & Machinery, seems to be reasonable.

Storage Tanks: The cost that will incur if storage tanks are erected is estimated at Rs. 2 (lakhs) and the expense has been considered very much necessary for the purpose.

New Factory/(Industrial Estate New Co.): The company is proposing to set up a factory nearer to the existing one where locational facilities are available (Nearness to market, transport facilities, Tax Holiday Benefits, Availability of skilled labour, free trade zone etc.)

Plant layout, Blue Print: A plant layout, blue print as per engineer's and technician's report has been attached with the schedule.

Financial Feasibility:

Projected Profitability and Cash Flow Statement Rs. (Lakhs)

Year	**Profit after Tax**	**Depreciation**	**Cash Flow**	**PVF@10%**	**PV**
1	8.00	1.50	9.50	.909	8.6355
2	5.00	1.50	6.50	.826	5.369
3	5.00	1.50	6.50	.751	4.8815
4	5.00	1.50	6.50	.683	4.4395
5	5.00	1.50	6.50	.621	4.0365
6	5.00	1.50	6.50	.564	3.666
7	4.00	1.50	5.50	.513	2.8215
8	4.00	1.50	5.50	.467	2.5685
9	4.00	1.50	5.50	.424	2.332
10	5.00	1.50	6.50	.386	2.509
Total	50.00	15.00	65.00		41.259

The cash flow when discounted at the company's cost of capital rate of 10% gives net cash flow of Rs.41.259 (lakhs) in Present Value terms. Hence net present value of Rs.21.259 (lakhs) is available [Net Cash Flow – Capital Cost]. Thus the project seems to be feasible.

Disposal of Waste/Effluents/Pollution Control: The production process is such that it will release very little waste & effluents and so disposal is not a very great problem. Public health is thus not endangered. No special measures are required to be undertaken for pollution control.

Repayment Schedule: A loan repayment schedule (Subject to negotiation) is being given herewith.

Years	**Repayment** (Rs. in Lakhs)
1	-

2	2
3	2
4	2
5	2
6	2
Total	10

S/d

Dated Chief Finance Officer

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QUESTION NO.21 What are the Contents Of a Project Report ?

The following aspects need to be taken into account for a Project Report -

1. Promoters: Their experience, past records of performance form the key to their selection for the project under study.

2.Industry Analysis: The environment outside & within the country is vital for determining the type of project one should opt for.

3. Economic Analysis: The demand and supply position of a particular type of product under consideration, competitor's share of the market along with their marketing strategies, export potential of the product, consumer preferences are matters requiring proper attention in such type of analysis.

4. Cost of Project: Cost of land, site development, buildings, plant and machinery,utilities e.g. power, fuel, water, vehicles, technical know how together with working capital margins, preliminary/pre-operative expenses, provision for contingencies determine the total value of the project.

5. Inputs: Availability of raw materials within and outside the home country, reliability of suppliers cost escalations, transportation charges, manpower requirements together with effluent disposal mechanisms are points to be noted.

6. Technical Analysis: Technical know-how, plant layout, production process, installed and operating capacity of plant and machinery form the core of such analysis.

7. Financial Analysis: Estimates of production costs, revenue, tax liabilities profitability and sensitivity of profits to different elements of costs and revenue, financial position and cash flows, working capital requirements, return on investment, promoters contribution together with debt and equity financing are items which need to be looked into for financial viability.

8. Social Cost Benefit Analysis: Ecological matters, value additions, technology absorptions, level of import substitution form the basis of such analysis.

9. SWOT Analysis: Liquidity/Fund constraints in capital market, limit of resources available with promoters, business/financial risks, micro/macro economic considerations subject to government restrictions, role of Banks/Financial Institutions in project assistance, cost of equity and debt capital in the financial plan for the project are factors which require careful examinations while carrying out SWOT analysis.

10. Project Implementation Schedule: Date of commencement, duration of the project,trial runs, cushion for cost and time over runs and date of completion of the project through Network Analysis have all to be properly adhered to in order to make the project feasible.

QUESTION NO. 22 Explain the Interface of Strategic Management and Financial Policy ? or Explain briefly, how financial policy is linked to strategic Management. ***(Nov 2009)(May2010)***

➦The inter face 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 again. Offer of the organization is only a vehicle that links up the starting point and the end point.No organization can run the existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base.

➦Financial policy required the resource deployments such as materials, labour etc.,whereas strategic management considers all markets such as material, labour and capital as imperfect and changing. Strategies are developed to manage the business firm in uncertain and imperfect market conditions and environment, for forecasting planning and formulation of financial policies, for generation and allocation of resources, the finance manager is required to analyse changing market conditions and environment.

➦The strategy focuses on how to compete in a particular product-market segment or industry. For framing strategy it is considered that the shareholders are not the only interested group in the unit. There are many other influential constituents such as lenders, employees, customers, suppliers etc. The success of a company depends on its ability to service in the product market environment which is possible only when the company considers to maintain and improve its product market positions. The strategic management is multi-dimensional. It focuses on growth profitability and flow of funds rather than only on the maximization of market value of shares. This focus helps the management to create enough corporate wealth for achieving market dominance and the ultimate successful survival of the company.

➦Hence, the financial policy of a company is closed linked with its corporate strategy. The corporate strategy establishes an efficient and effective match between its competences and opportunities and environmental risks. Financial policies of a company should be developed in the context of its corporate strategy. Within the overall framework of a company's strategy, there should be consistency between financial policies- investment,
debt and dividend.

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QUESTION NO.23 Write a short note on Social Cost Benefits Analysis ?

➦**Meaning : Social Cost Benefit Analysis** is a systematic evaluation of an organisation's social performance as distinguished from its economic performance. Social Cost Benefits Analysis is an approach for evaluation of projects.It assesses gains/losses to society as a whole from the acceptance of a particular project.

Features

(1) It includes many economic activities having indirect effects on which there is no possibility of putting a market value.

(2) If savings are inadequate; money going into investment is regarded more valuable than money going into current consumption.

(3) Society values given quantum of additional consumption going to different sections of the population differently. So distributional considerations are important.

(4) For society, taxes are transferred from the project in hand to government and does not involve real cost.

(5) Relative valuation placed on future consumption compared to current consumption is different for the society. Also effect of perceived uncertainties may be different.

(6) Society may want to discourage consumption of certain goods and promote that of others.

(7) External effects exist on consumption side e.g. person getting inoculation against infectious disease will be conferring some benefit to society by preventing the spreading over of the disease.

(8) Output from large projects has significant impact on the market for the good/services and neither pre project market price nor expected post project market price would be correct indicators of the social value of project output. Market prices are not true indicators of social gains/losses but can be suitably adjusted to reflect social valuations.

Limitations:

(i) Successful application depends upon reasonable accuracy and dependability of the underlying forecasts as well as assessment of intangibles.

(ii) Technique does not indicate whether given project evaluated on socio-economic considerations is best choice to reach national goals or whether same resources if employed in another project would yield better results.

(iii) Cost of evaluation by such technique could be enormous for smaller projects.

(iv) Social Cost Benefit Analysis takes into consideration those aspects of social costs and benefits which can be quantified.

Indian Scenario: The introduction of CNG in certain vehicles and switching of some portion of the transport demand to the metro rail have resulted in a significant reduction of atmospheric pollution in Delhi. The Delhi Metro provides multiple benefits: reduction in air pollution, time saving to passengers, reduction in accidents, reduction in traffic congestion and fuel savings. There are incremental benefits and costs to a number of economic agents: government, private transporters, passengers, general public and unskilled labour. The **social cost-benefit analysis of Delhi Metro** conducted tries to measure all these benefits and costs from Phase I and Phase II projects covering a total distance of 108 kms in Delhi. Estimates of the social benefits and costs of the project are obtained using the recently estimated shadow prices of investment, foreign exchange and unskilled labour as well as the social time preference rate for the Indian economy for a study commissioned by the Planning Commission, Government of India and done at the Institute of Economic Growth.

QUESTION NO. 24 Write a short note on Book Building ?

➦Book-building means a process by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of notice/ circular / advertisement/ document or information memoranda or offer document.

➦The book-building system is part of Initial Public Offer (IPO) of Indian Capital Market. It was introduced by SEBI on recommendations of Mr. Y.H. Malegam in October 1995.It is most practical, fast and efficient management of Mega Issues. Book Building involves sale of securities to the public and the institutional bidders on the basis of predetermined price range.

➦Book Building is a price discovery mechanism and is becoming increasingly popular as a method of issuing capital. The idea behind this process is to find a better price for the issue.

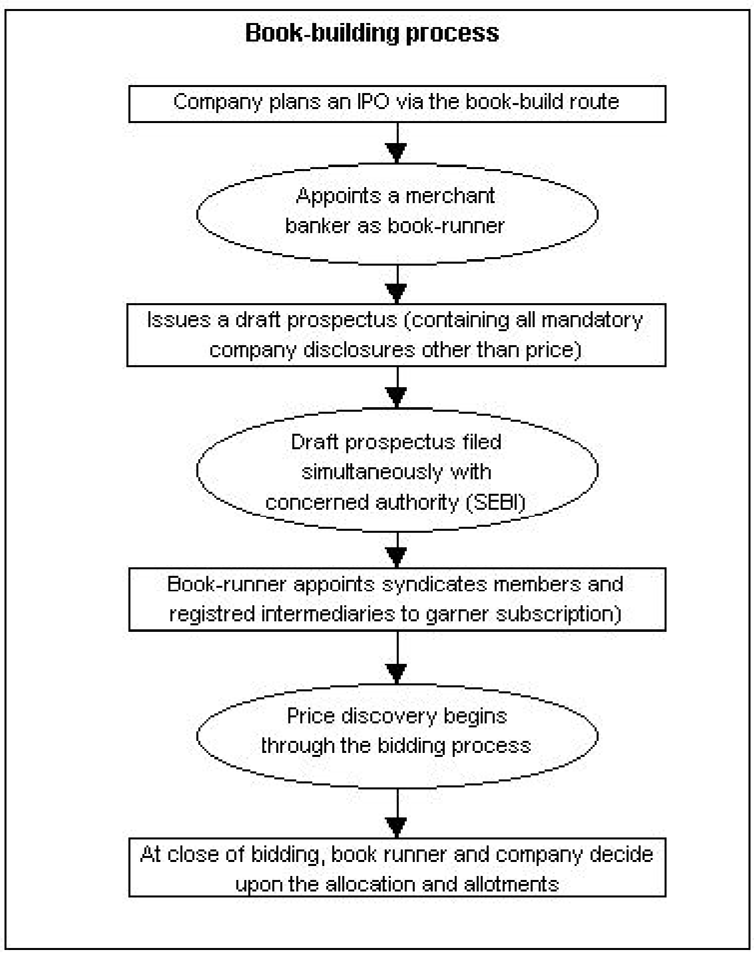
➦The issue price is not determined in advance.Book Building is a process wherein the issue price of a security is determined by the demand and supply forces in the capital market.

➦Book building is a process used for marketing a public offer of equity shares of a company and is a common practice in most developed countries.

➦Book building is called so because it refers to the collection of bids from investors, which is based on an indicative price range. The issue price is fixed after the bid closing date.The various bids received from the investors are recorded in a book,that is why the process is called Book Building.

➦Unlike international markets, India has a large number of retail investors who actively participate in Intial Public Offer (IPOs) by companies. Internationally, the most active investors are the mutual funds and other institutional investors, hence the entire issue is book built. But in India, 25 per cent of the issue has to be offered to the general public. Here there are two options with the company.

➦An issuer company may make an issue of securities to the public through a prospectus in the following manner
• 100% of the net offer to the public through the book building process or
• 75% of the net offer to the public through the book building process and 25% at the price determined through the book building.



➦**Procedure For Bidding**

The bid should be open for at least five days and not more than 10 days, which may be extended to 13 days in case the price band is revised. The advertisement should also contain the following:

• the date of opening and closing of the bidding (not less than five days);
• the name and addresses of the syndicate members as well as the bidding terminals for accepting the bids;
• the method and process of bidding;Bidding should be permitted only if an electronically linked transparent facility is used.

➦**Advantage**

(i) The book building process helps in discovery of price & demand.
(ii) The costs of the public issue are much reduced.
(iii) The time taken for the completion of the entire process is much less than that in the normal public issue.
(iv) In book building, the demand for the share is known before the issue closes. Infact, if there is not much demand, the issue may be deferred.
(v) It inspires investors confidence leading to a large investor universe.
(vi) Issuers can choose investors by quality.
(vii) The issue price is market determined.

➦**Disadvantage**

(i) There is a possibility of price rigging on listing as promoters may try to bail out syndicate members.
(ii) The book building system works very effeciently in matured market conditions. But, such conditions are not commonly found in practice.
(iii) It is appropriate for the mega issues only.
(iv) The company should be fundamentally strong & well known to the investors without it book building process will be unsuccessful.

➦**Recent Example :** Recent example of a book buliding process in Indian context is the IPO of Reliance Power. The issue was made through 100 % book building process .The price band for the the book buliding pocesss was between Rs 405 and Rs 450 with Rs 20 discount for retail investors .

QUESTION NO. 25 Write a short note on Derivatives ? What are different types of Derivative Risk ?

➦A derivative is a financial instrument which derives its value from some other financial price. This 'other financial price' is called the underlying.

➦**User & Purpose :** Derivative serve as a method to hedge and reduce risks .

Users	Purpose
(i) Corporation	To hedge currency risk and inventory risk
(ii) Individual Investors	For speculation, hedging and yield enhancement.
(iii) Institutional Investor	For hedging asset allocation, yield enhancement and to avail arbitrage opportunities.
(iv) Dealers	For hedging position taking, exploiting inefficiencies and earning dealer spreads.

➦**Example :** The most important derivatives are Futures, Options, Forward, Swaps

➦**Types of Derivative Market : (a)** Exchange Traded Derivatives **(b)** OTC (Over the Counter) Derivatives

Exchange-traded derivatives : Derivatives which trade on an exchange are called **'Exchange-traded derivatives'.** Trades on an exchange generally take place with anonymity. Trades at an exchange generally go through the clearing corporation. Example : Interest rate futures, Interest rate options, Currency futures, Currency options.

OTC derivative : A derivative contract which is privately negotiated is called an **OTC derivative.** OTC trades have no anonymity, and they generally do not go through a clearing corporation. Example :Interest rate swaps, Currency swaps, Caps, collars, floors, forward.

➦The different types of derivatives risks are:

(a) Credit risk: Credit risk is the risk of loss due to counterparty's failure to perform on an obligation to the institution. Credit risk in derivative products comes in two forms:

(i) Pre-Settlement Risk: It is the risk of loss due to a counterparty defaulting on a contract during the life of a transaction. The level of exposure varies throughout the life of the contract and the extent of losses will only be known at the time of default.

(ii) <u>Settlement risk</u>: It is the risk of loss due to the counterparty's failure to perform on its obligation after an institution has performed on its obligation under a contract on the settlement date. Settlement risk frequently arises in international transactions because of time zone differences. This risk is only present in transactions that do not involve delivery versus payment and generally exists for a very short time (less than 24 hours).

(b) <u>Market risk</u>: Market risk is the risk of loss due to adverse changes in the market value (the price) of an instrument or portfolio of instruments. Such exposure occurs with respect to derivative instruments when changes occur in market factors such as underlying interest rates, exchange rates, equity prices, and commodity prices or in the volatility of these factors.

(c) <u>Liquidity risk</u>: Liquidity risk is the risk of loss due to failure of an institution to meet its funding requirements or to execute a transaction at a reasonable price. Institutions involved in derivatives activity face two types of liquidity risk : market liquidity risk and funding liquidity risk.

(i) <u>Market liquidity risk</u>: It is the risk that an institution may not be able to exit or offset positions quickly, and in sufficient quantities, at a reasonable price. This inability may be due to inadequate market depth in certain products (e.g. exotic derivatives, longdated options), market disruption, or inability of the bank to access the market (e.g. credit down-grading of the institution or of a major counterparty).

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(ii) <u>Funding liquidity risk</u>: It is the potential inability of the institution to meet funding requirements, because of cash flow mismatches, at a reasonable cost. Such funding requirements may arise from cash flow mismatches in swap books, exercise of options,and the implementation of dynamic hedging strategies.

(d) <u>Operational risk</u>: Operational risk is the risk of loss occurring as a result of inadequate systems and control, deficiencies in information systems, human error, or management failure. Derivatives activities can pose challenging operational risk issues because of the complexity of certain products and their continual evolution.

(e) <u>Legal risk</u>: Legal risk is the risk of loss arising from contracts which are not legally enforceable (e.g. the counterparty does not have the power or authority to enter into a particular type of derivatives transaction) or documented correctly.

(f) <u>Regulatory risk</u>: Regulatory risk is the risk of loss arising from failure to comply with regulatory or legal requirements.

(g) <u>Reputation risk</u>: Reputation risk is the risk of loss arising from adverse public opinion and damage to reputation.

<u>QUESTION NO.26</u>What are the major advantages & disadvantages of Futures Trading as compared to Stock Trading ?

<u>The Major Advantages of Futures Trading Vs. Stock Trading</u>: Compared to directly trading stocks, stock futures provide several major advantages:

(i) <u>Leverage</u>: Compared to buying stock on margin, investing in futures is less costly.An investor can use leverage to control more stock with a smaller cash outlay.

(ii) <u>Ease of Shorting</u>: Taking a short position in futures is simpler, less costly and may be executed at any time - there is no requirement for an uptick.

(iii) <u>Flexibility:</u> Future investors can use the instruments to speculate, hedge, spread or for use in a large array of sophisticated strategies.

Stock Futures also have disadvantages. These include:

(i) <u>Risk:</u> In a stock future contract, there is the risk of losing significantly more than the initial investment (margin deposit).

(ii)<u>No Stockholder Privileges:</u> The future owner has no voting rights and no rights to dividends.

(iii)<u>Required Vigilance</u>: Stock Futures are investments that require investors to monitor their positions more closely than many would like to do. Because future accounts are marked to the market every business day, there is the possibility that the brokerage firm might issue a margin call, requiring the investor to decide whether to quickly deposit additional funds or liquidate the position.

<u>QUESTION NO. 27</u> What is Green Share Option or Green Shoe Option ? Explain the working mechanism ?

➦Green Shoe Option (GSO) means an option available to the company issuing securities to the public to allocate shares in excess of the public issue and operating a post-listing price stabilising mechanism through a stabilising agent.

➦This option acts as a safety net for the investors and is a standard global practice.

➦The name comes from the fact that Green Shoe Company was the first entity to use this option.

➦SEBI inserted a new Chapter No. VIII-A, with effect from August 14, 2003, in the SEBI (Disclosure and Investors Protection)

Regulations, 2000 to deal with the GSO.

➦ The GSO is available to a company which is issuing equity shares through book-building mechanism for stabilising the post-listing price of the shares. The following is the mechanism process of GSO :

1. The Company shall appoint one of the leading book runners as the Stabilising Agent (SA), who will be responsible for the price stabilising process.

2. 'The promoters of the company will enter into an agreement with SA to lend some of their shares to the latter, not exceeding 15% of the total issue size.

3. The borrowed shares shall be in the dematerialised form.These shares will be kept in a separate GSO Demat A/c.

4. In case of over subscription, the allocation of these share shall be on pro-rata basis to all applicants.

5. The money received from allotment of these shares shall also be kept in a 'GSO Bank A/c', distinct from the issue account , and the amount will be used for buying shares from the market during the stabilization period.

6. The shares bought from the market by SA for stabilization shall be credited to GSO Demat Account.

7. These shares shall be returned to the promoters within 2 days of closure of stabilisation process.

8. In order to stabilise post-listing prices, the SA shall determine the timing and quantity of shares to be bought.

9. If at the expiry of the stabilisation period, the SA does not purchase shares to the extent of over-allocated shares, then shares to the extent of shortfall will be allotted by the company to the GSO Demat A/c multiplied by the issue price. Amount left in the GSO Bank A/c (after meeting expenses of SA), shall be transferred to the Investors Protection Fund.

➦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% of the offer made to public. In certain situations, the green-shoe option can even be more than 15%.

Examples of GSO issues in India

➦In April, 2004 the ICICI bank Ltd. became the first Indian company to offer GSO. The ICICI Bank Ltd. offered equity shares of Rs. 3050 crores through 100% book building process to the investors. The issue was over subscribed by 5.14 times.

➦IDBI has also come up with their Flexi Bonds (Series 4 and 5) under GSO.

➦More recently Infosys Technologies has also excercised GSO for its issue. This offer initially involved 5.22 million depository shares, representing 2.61 million domestic equity shares.

QUESTION NO. 28 Explain the concept of interest rate swap by giving appropriate examples.[Also Refer Class Register for its practical part]

➦**Meaning** : An Interest Rate Swap is a transaction involving an exchange of one stream of interest obligations for another.In an interest rate swap, no exchange of principal takes place but interest payments are made on the notional principal amount.

➦**Condition** : To facilitate a interest swap, the two parties must have opposite view on interest rates. One party should expect interest rates to harden and the other should expect it to soften.

➦Interest payments can be exchanged between two parties to achieve changes in the calculation of interest on the principal, for example :**(a)**Floating to fixed;**(b)**Fixed to floating;**(c)**LIBOR to prime - based;**(d)**Prime to LIBOR;

➦**Major Players :** The major players in the swap markets are banks (or other intermediaries on the one side) and medium and large size corporates on the other. Individual borrowers generally do not perform swap.

➦**Features of Interest Rate Swap :**

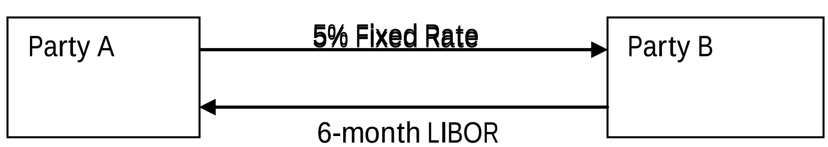
(a) It is treated as an off - the balance sheet transaction.

(b) It is structured as a separate contract distinct from the underlying loan agreement.

(c) There is no exchange of principal repayment obligations.

(d) It effectively translates a floating rate borrowing into a fixed rate borrowing and vice versa.

(e) The motivation of interest rate swap is to save interest cost.



➦**Types of Interest Rate Swaps :**

(a) Liability Swap - Where there is an exchange of interest obligation i.e., interest is to be paid, the swap is liability swap.
(b) Asset Swap - Where there is an exchange of interest receipts i.e., interest is to be received, the swap is asset swap.
➦**Purpose:**Interest Rate Swap is intended to hedge against the intetrest rate fluctuations to some extent through careful planning with the help of swap dealer .
➦**Provision of Interest Rate Swaps :**Some of the provisions of IRS are as follows :
1. The notional principal value upon which the interest rate is to be applied.
2. The fixed interest rate to be exchanged for another rate.
3. Formula type of index used to determine the floating rate.
4. Frequency of payments, such as quarterly or every six months is also agreed.
5. Life time of the swap.
➦**Examples On IRS:**
Consider two companies rated AAA and BBB. AAA has higher credit rating than BBB. Hence they are rated differently by the market and are offered loans at following rates:

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	Fixed Rate	Floating Rate
AAA	10%	LIBOR + .50
BBB	11%	LIBOR+.75

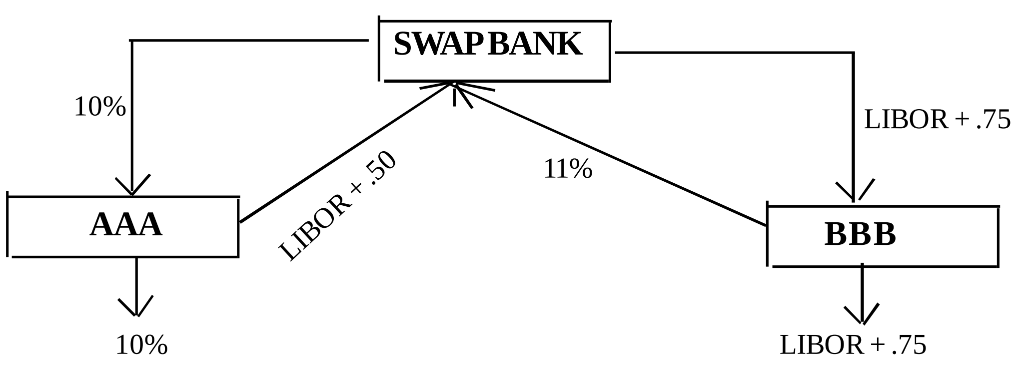
Both are planning to raise loan of $1 million. AAA is interested in raising loan under floating rate. BBB is interested in raising loan under fixed rate. An intermediary brings them on table and interest swap is arranged. The benefit of interest swap is to be shared equally by the three parties. Find out net interest burden (%) for AAA and BBB?
Solution : If no Swap is arranged, total interest cost to both the parties if they borrow as per their plan :

AAA:	LIBOR + .50
BBB:	11%
Total (A)	LIBOR + 11.50%

Using the principle of comparative advantage, both parties could benefit from a swap arrangement in the following manner., AAA should borrow on fixed basis and BBB on floating basis, total interest cost in this situation is :

AAA	10%
BBB	LIBOR + .75
Total (B)	LIBOR + 10.75%

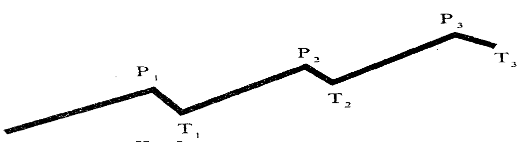
Saving on Interest Cost : A – B = (LIBOR + 11.50%) – (LIBOR + 10.75%) = .75
Since Savings is to be distributed equally as per the requirement of the question we have
Saving for AAA = .25; Saving for BBB = .25; Commission for intermediary = .25.
∴ Net Interest Burden = Cost under own choice – Share in saving.
For AAA : (LIBOR + .50) – .25 = LIBOR + .25 **For BBB** : 11% – .25 = 10.75 %



QUESTION NO. 29 What is the Dow Jones Theory to Portfolio Management?[Also Refer Class Register for its practical part]
➦The Dow Jones Theory is probably the most popular theory regarding the behaviour of stock market prices.The theory derives its name from Charles H. Dow, who established the Dow Jones & Co., and was the first editor of the Wall Street Journal- a leading publication on financial and economic matters in the U.S.A.

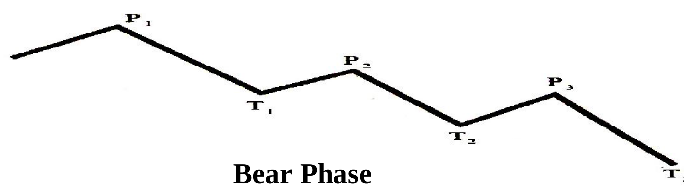
➦The Dow Theory is one of the oldest and most famous technical theories.
➦It is a helpful tool for determining the relative strength of the stock market.
➦The Dow Theory is based upon the movements of two indices, constructed by Charles Dow,Dow Jones Industrial Average (DJIA) and Dow Jones Transportation Average (DJTA).
➦The Dow Theory's purpose is to determine where the market is and where is it going.
➦The Dow Jones theory classifies the movements of the prices on the share market into three major categories:
1. Primary Movements. **2.** Secondary Movements.**3.** Daily Fluctuations.

1. Primary Movements : They reflect the trend of the stock market & last from one year to three years, or sometimes even more During a bull phase, the basic trend is that of rise in prices. Graph I shows the behaviour of stock market prices in bull phase. As can be seen from the graph that prices do not rise consisitently even in a bull phase. They rise for some time and after each rise, they fall. However, the falls are of a lower magnitude than rise . As a result, prices reach higher levels with each rise. Once the prices have risen very high, the bear phase in bound to start, i.e.price will start falling. Graph 2 shows the typical behaviour of prices on the stock exchange in the case of a bear phase. It would be seen that prices are not falling consistently and, after each fall, there is a rise in prices. However, the rise is not much as to take the prices higher than the previous peak.



Bull Phase

Graph 1 .



Bear Phase

Graph 2 .

Hence in Graph 1 above,Primary Trend is Rising and in Graph 2,Primary Trend is Falling

2. Secondary Movements : We have seen that even when the primary trend is upward, there are also downward movements of prices. Similarly, even where the primary trend is downward, there is upward movements of prices also. These movements are known as secondary movements and are shorter in duration and are opposite in direction to the primary movements. These movements normally last from three weeks to three months and ranges from 1/3 (33 %) to 2/3 (66 %) of the previous advance in a bull market or previous fall in the bear market.

Hence in Graph 1 above,Secondary Trend is Falling and in Graph 2,Secondary Trend is Rising

3. Daily Movements : There are irregular fluctuations which occur every day in the market. These fluctuations are without any definite trend. Thus if the daily share market price index for a few months is plotted on the graph it will show both upward and downward fluctuations. These fluctuations are the result of speculative factors. An investment manager really is not interested in the short run fluctuations in share prices since he is not a speculator. It may be reiterated that anyone who tries to gain from short run fluctuations in the stock market, can make money only by sheer chance. Speculation is beyond the scope of the job of an investment manager.

➦**Benefit Of Dow- Jones Theory :**

(a) Timings of Investments : Investor can choose the appropriate time for his investment / divestment .Investment should be made in shares when their prices have reached the lowest level, and sell them at a time when they reached the highest peak.

(b) Identification of Trend : Using Dow-Jones theory, the correct and appropriate movement in the Market Prices can be identified, and depending on the investors preference, decisions can be taken.

QUESTION NO. 30 Write a short note on Portfolio Rebalancing ?[Also Refer Class Register for its practical part]

➦**Meaning :**It means the value of portfolio as well as its composition.
➦There are three policies of portfolio rebalancing- Buy and hold policy, Constant mix policy, and Constant proportion portfolio insurance policy (CPPI). These policies have different pay off under varying market conditions.
➦**Purpose of Rebalancing (i)** For increasing returns & **(ii)** Maintaining risk profile
➦**Benefits of Portfolio Rebalancing**

(i) Disciplined investing :Rebalancing is a vital part of investment policy - there can be no asset allocation target without the discipline to preserve that target.

(ii) Reduces risk :A plan may incur higher risk if no rebalancing policy exists.

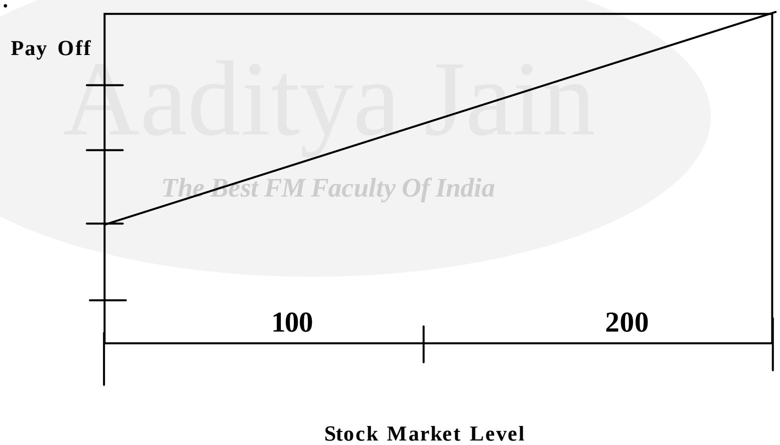
(iii) <u>Buy low, sell high</u> : Rebalancing is a mechanism for sensible timing - the process naturally buys low and sells high. This strategy ensures that the portfolio returns are enhanced.

(iv) A clear rebalancing policy <u>avoids the risks of ad-hoc and costly portfolio revisions</u>.

(a) <u>Buy and Hold Policy</u>:

The initial mix that is bought is held. This is basically a 'do nothing' policy in respect of what happens to relative values of rebalancing if done.

The graph shows the pay off diagram for a buy and hold policy; if the initial stock: bond mix is 50:50. It illustrates the following features of buy and hold policies :



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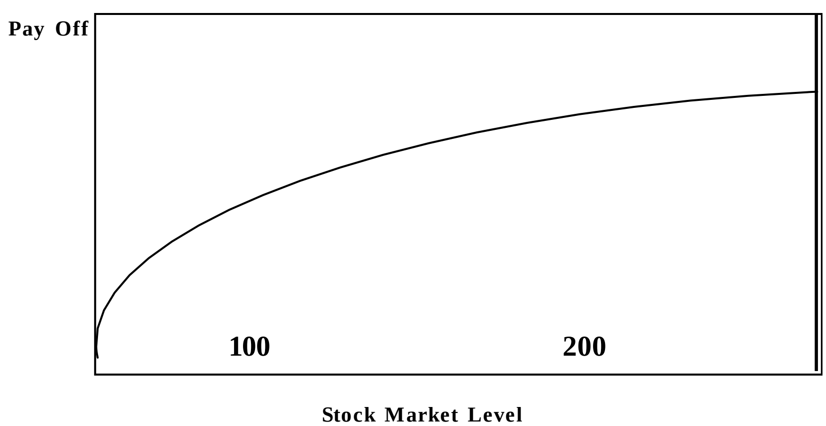
Pay off Diagram For a Buy and Hold Policy

(i) The value of portfolio is linearly dependent to that of stock market.

(ii) While the portfolio value can't fall below the value of initial investment in bonds it's upside potential is unlimited.

(iii) When stock outperforms bond, the higher the initial percentage in stocks, the better is the performance of the buy and hold policy. On the other hand, when stock underperforms bond, the higher the initial percentage in stocks the worst the performance of the buy and hold policy.

(b) <u>Constant Mix Policy</u>: The constant mix policy calls for maintaining an exposure to stocks which is a constant proportion of portfolio value. If the desired constant mix of stock and bonds is 50:50 this policy calls for rebalancing the portfolio when relative values of its components change so that the target proportions are maintained. Thus this policy unlike the buy and hold policy is a "do something" policy. The pay off associated with constant mix policy is show in the graph.



Constant Mix Policy

(c) <u>Constant Proportion Portfolio Insurance Policy (CPPI)</u>: It takes the following form :

Investment in stocks = m (Portfolio value – Floor value) when m>1

Floor value means value which the market expects.

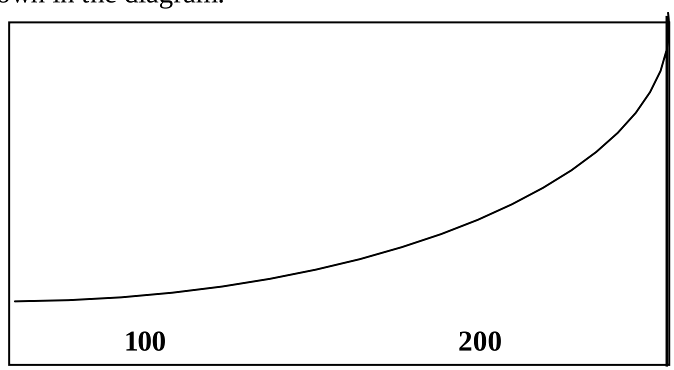
Illustration : If one has wealth of 100000 and Floor of 75000 and multiplier of 2 the pattern of investment associated with such a policy may be illustrated in the following manner.

Solution

Condition I: As the initial cushion (different between portfolio value and floor) is Rs.25,000 i.e (1,00,000-75000)]. The initial investment in stock is 50,000 i.e (twice of initial cushion 25,000 x2). So the initial portfolio means 50,000 in stocks and 50,000 in bonds.

Condition II: If the stock market falls from 100 to 80 value of stocks in the portfolio falls from 50,000 to 40,000; this means that the value of portfolio declines to 90,000 (stock 40,000 and bond 50,000) thereby reducing the cushion to 15,000(90,000-75,000). As per CPPI policy stock component would be 30,000 (15,000 x2). So 10,000 of stock should be sold and proceeds invested in bonds if stock decline further more bonds should be purchased.

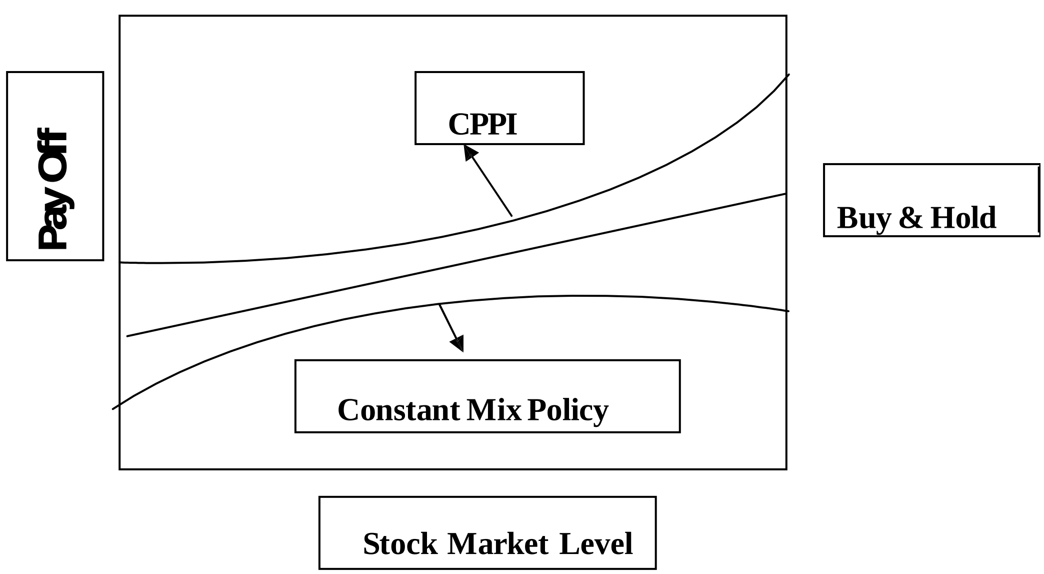
Condition III: If the stock market rises from 100 to 150, value of stock in portfolio jumps from 50,000 to 75,000 i.e (150/100 x 50,000) and a value of portfolio rises to 1,25,000 i.e (75,000 stock + 50,000 bond), thereby raising the cushion by 50,000 (1,25,000-75,000).As per CPPI policy stock component should go up to 1,00,000 (50,000 x 2). This calls for selling bonds worth 25,000 and reinvesting the proceed in the stocks, if stock rises further in value more stocks should be bought and so on. Thus the CPPI policy necessitates selling stock as they fall and buying stocks as they rise, this implies that this policy is the opposite of constant mix policy which calls for buying stocks as they fall and selling stocks as they rise. Hence the pay off curve is convex in nature as shown in the diagram.



Stock Market Level

Comparative Evaluation: The pay off associated with buy and hold policy constant mix policy and constant proportion portfolio insurance policy are represented by straight line, concave and convex curve. The graph shows these pay off.

From the graph if the stock market move only in one direction the best policy is CPPI policy and the worst policy is constant mix policy in between lies buy and hold policy.



Pay off Associated with Various Rebalancing Policies

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If the stock market reverses itself frequently rather then move in the same direction,constant mix policy seems to be superior to other policies.

Consider a payoff from initial investment of 100000 when the market moves from 100 to 80 and back to 100 under three policies

(a) Buy and hold policy under which the initial stock bond mix is 50:50.

(b) Constant mix policy under which the stock bond mix is 50:50

(c) A CPPI policy which takes to form investment in stock = 2 (Portfolio value – 75000 i.e.floor value)

The portfolio compositions and their values for the three policies are tabulated as follows.

Portfolio Composition and Payoff for the Three Policies Market Level 100

	Portfolio		
	Stock	**Bond**	**Total**
Buy and hold policy	50000	50000	100000
Constant mix policy	50000	50000	100000
CPPI policy	50000	50000	100000

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Market level falls to 80

	Portfolio Before Rebalancing			**Portfolio After Rebalancing**		
	Stock	**Bonds**	**Total**	**Stock**	**Bond**	**Total**
Buy-Hold	40000	50000	90000	40000	50000	90000
Constant-mix	40000	50000	90000	45000	45000	90000
CPPI	40000	50000	90000	30000	60000	90000

Market level again rises to 100

	Portfolio Before Rebalancing			**Portfolio After Rebalancing**		
	Stock	**Bonds**	**Total**	**Stock**	**Bond**	**Total**
Buy-Hold	50000	50000	100000	50000	50000	100000
Constant-mix	56250	45000	101250	50625	50625	101250
CPPI	37500	60000	97500	45000	32500	97500

The performance feature of the three policies may be summed up as follows:

(a) Buy and Hold Policy

(i) Gives rise to a straight line pay off.

(ii) Provides a definite downside protection.

(iii) Performance between Constant mix policy and CPPI policy.

(b) Constant Mix Policy

(i) Gives rise to concave pay off drive.

(ii) Doesn't provide much downward protection and tends to do relatively poor in the up market.

(iii) Tends to do very well in flat but fluctuating market.

(c) CPPI Policy

(i) Gives rise to a convex pay off drive.

(ii) Provides good downside protection and performance well in up market.

(iii) Tends to do very poorly in flat but in fluctuating market.

QUESTION NO. 31 Explain the Randon Walk Theory to Portfolio Management?

➦Many investment managers and stock market analysts believe that stock market prices can never be predicted because they are not a result of any underlying factors but are mere statistical ups and downs. ➦This hypothesis is known as Random Walk hypothesis which states that the behaviour of stock market prices is unpredictable and that there is no relationship between the present prices of the shares and their future prices.➦ Proponents of this hypothesis argue that stock market prices are independent. ➦In other words, the fact that there are peaks and troughs in stock exchange prices is a mere statistical happening - successive peaks and troughs are unconnected. ➦In the layman's language it may be said that prices on stock exchange behave exactly the way a drunk would behave while walking in a blind lane i.e. up and down, with an unsteady way going in any direction he likes, bending on the one side to other side .

➦The supporters of this theory put out a simple argument. It follows that:

(a) Prices of shares in stock market can never be predicted.
(b) The reason is that the price trends are not the result of any underlying factors, but that they represent a statistical expression of past data.
(c) There may be periodical ups or downs in share prices, but no connection can be established between two successive peaks (high price of stocks) and troughs (low price of stocks).

QUESTION NO. 32 State the Objectives of Portfolio Management?

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(i) Security/Safety of Principal The objective is to keep the capital / principal amount intact, in terms of value and in terms of purchasing power. The capital or the principal amount invested should not erode , either in value or in terms of purchasing power.
(ii) Stability of Income so as to facilitate planning more accurately & systematically the reinvestment or consumption of income.
(iii) Capital Growth which can be attained by reinvesting in growth securities or through purchase of growth securities.
(iv) Marketability i.e. the case with which a security can be bought or sold. This is essential for providing flexibility to investment portfolio.
(v) Liquidity i.e. nearness to money. It is desirable for the investor so as to take advantage of attractive opportunities upcoming in the market.
(vi) Diversification : The basic objective of building a portfolio is to reduce the risk of loss of capital and income , by investing in various types of securities and over a wide range of industries.
(vii) Favourable Tax Status : The effective yield an investor gets from his investment depends on tax to which it is subject. By minimising the tax burden, yield can be effectively improved.

QUESTION NO. 33 State two basic principles for effective Portfolio Management?

Basic Principles of Portfolio Management : There are two basic principles for effective portfolio management.
Effective investment planning for the investment in securities by considering the following factors :
(a) Fiscal, Financial and Monetary Policies of the Government of India and the Reserve Bank of India.
(b) Industrial and economic environment and its impact on industry prospects in terms of prospective technological changes, competition in the market, capacity utilisation with industry and demand prospects etc.
(ii) Constant Review of Investment : Portfolio managers are required to review their investment in securities and continue selling and purchasing their investment in more profitable avenues. For this purpose they will have to carry the following analysis:
(a) Assessment of quality of management of the companies in which investment has already been made or is proposed to be made.
(b) Financial & trend analysis of companies balance sheet/profit&loss account to identify sound companies with optimum capital structure & better performance & to disinvest the holding of those companies whose performance is found to be slackening.
(c) The analysis of securities market and its trend is to be done on a continuous basis.
The above analysis will help the portfolio manager to arrive at a conclusion as to whether the securities already in possession should be disinvested and new securities be purchased. If so, the timing for investment or dis-investment is also revealed.

QUESTION NO. 34 Write a short note on Benefits of International Portfolio Management ?

International Diversification of portfolio of assets helps to obtain higher risk adjusted returns i.e. reduce risk and raise return through international investment. Some of the benefits are listed as under:
(a) Reduce Risk & Diversification Benefits: International investment aids to diversify risk. The different sectors in an individual economy in some way or the other are interrelated and as a whole subject to the same impact of the entire domestic policy. The returns on investment in a domestic economy depend on the prospects of domestic activity together with the uncertainty attached thereto. The gains from diversification within a country are therefore very much limited.Though 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. Thus foreign investment provides diversification benefits which a

domestic investment does not.

(b) <u>Raise Return through better Risk – Return Trade off</u> : 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.

<u>QUESTION NO. 35</u> Write a short note on Traditional Position/Graham and Dodd Model on dividend policies ?
[Also Refer Class Register for its practical part]

➦According to the traditional position expounded by Graham and Dodd, the stock market places considerably more weight on dividends than on retained earnings.

➦For them, the stock market is overwhelmingly in favour of liberal dividends as against niggardly dividends. Their view is expressed quantitatively in the following valuation model:

➦Symbolically Po= $m \times \left(D + \frac{E}{3}\right)$

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➦Under this model the weights attached to dividend is equal to four times the weights attached to retained earnings.

Proof : Po= $m \times \left(D + \frac{E}{3}\right) \Rightarrow$ Po= $m \times \left(D + \frac{D+R}{3}\right) \Rightarrow$ Po= $m \times \left(\frac{4D}{3}\right) + m \times \left(\frac{R}{3}\right)$

➦The weights provided by Graham and Dodd are based on their subjective judgments and not derived from objective empirical analysis. Notwithstanding the subjectivity of these weights, the major contention of the traditional position is that a liberal payout policy has a favourable impact on stock prices.

<u>QUESTION NO. 36</u> Write a Short Note on Repo [Repurchase Option] Agreement ? Briefly state the difference between Repo & Reverse Repo? Or What is Repo and Reverse Repo .

➦A **Repurchase Agreement (or repo)** is an agreement of sale of a security with a commitment to repurchase or buy the security back at a specified price and on a specified date .

➦**Reverse repo** is a term used to describe the opposite side of a repo transaction.Reverse Repo is a purchase of security with a commitment to sell at a pre-determined price and date .Accordingly, there are **two possible motives for entering into a reverse repo:**short-term investment of funds, or to obtain temporary use of a particular security.

➦**<u>Repos/Reverse Repos are used</u> :**

(i) to meet shortfall in cash position **(ii)** augment returns on funds held **(iii)** to borrow securities to meet regulatory requirement **(iv)**An SLR surplus bank and a CRR deficit bank can use the Repo deals as a convenient way of adjusting CRR/SLR positions simultaenously **(v)**RBI uses Repo and Reverse Repo deals as a convenient way of adjusting liquidity in the system.

➦**The securities eligible for trading under Repo/Reverse Repo are: (i)**GOI & State Govt. Securities **(ii)**Treasury Bills**(iii)**PSU bonds, **(iv)**FI bonds & Corporate bonds held in Dematerialised form

➦**Issuer :** In India, only RBI, Banks and PDs are allowed to enter into Repos. Financial institutions and others specified can only do reverse Repos.

➦The essential features of the Repo transaction are:

1. A financial institution places certain securities (presently restricted to Treasury Bills) with the buyer and borrows a certain amount of money.
2. On a given date specified in advance (between 14 days to 1 year) the entire transaction is reversed.
3. The difference between the purchase and sale price is the interest or gain to the buyer. Sometimes the seller may also gain from a transaction. This is when the buyer is in need of securities and initiates the transaction.

➦**<u>Coupon/Interest terms</u> :**

(a) Computation : Interest for the period of Repo is the difference between Sale Price and Purchase Price .The amount of interest earned on funds invested in a Repo is determined as follows :

Interest earned = Funds Invested × Repo Rate × Number of Days/365

(b) Recognition : Interest should be recognized on a time -proportion basis , both in the books of the buyer and seller.

(c) Time Period : Interest to be payable on maturity and rounded-off to the nearest rupee.Interest to be calculated on an actual/ 365-day year basis.

➦**Maturity :**Repos are normally done for a minimum maturity period of one day & a maximum maturity period of fourteen days.
➦**Minimum denomination and transaction size :** Generally Repo transactions are done in market lots of Rs 5 crores.

Difference Between Repo & Reverse Repo :

➦**Reverse repo** is a term used to describe the opposite side of a repo transaction.
➦The term Repurchase Agreement (Repo) and Reverse Repurchase Agreement (Reverse Repo) refer to a type of transaction in which money market participant raises funds by selling securities and simultaneously agreeing to repurchase the same after a specified time generally at a specified price, which typically includes interest at an agreed upon rate.
➦Such a transaction is called a Repo when viewed from the perspective of the seller of securities (the party acquiring funds) and Reverse Repo when described from the point of view of the supplier of funds.
➦Thus, whether a given agreement is termed a Repo or a Reverse Repo depends largely on which party initiated the transaction.
➦Under a Repo transaction, there are two counter parties : a lender and a borrower. The borrower in a Repo borrows cash and pledges securities. The lender lends cash and purchases the securities and is said to enter into a Reverse Repo transaction. Hence borrowing by pledging securities is a Repo transaction and lending by accepting the pledge is a Reverse Repo transaction.
➦Hence, essentially, there is no difference between a 'REPO' and a 'REVERSE REPO'transaction excepting that the identification is from a different point of view.Hence a transaction is a Repo for one party and a Reverse Repo for the other party.

QUESTION NO. 37 Write a short note on External Commercial Borrowings (ECB) ?

➦The foreign currency borrowings raised by the Indian corporates from confirmed banking sources outside India are called "External Commercial Borrowings" (ECBs).
➦These Foreign Currency borrowings can be raised within ECB Policy guidelines of Govt. of India/ Reserve Bank of India applicable from time to time.
➦External Commercial Borrowings (ECB) are defined to include

1. commercial bank loans,
2. buyer's credit,
3. supplier's credit,
4. securitised instruments such as floating rate notes, fixed rate bonds etc.,
5. credit from official export credit agencies,
6. commercial borrowings from the private sector window of multilateral financial institutions such as IFC, ADB, AFIC, CDC etc. and
7. Investment by Foreign Institutional Investors (FIIs) in dedicated debt funds

➦Applicants are free to raise ECB from any internationally recognised source like banks,export credit agencies,suppliers of equipment,foreign collaborations, foreign equity -holders, international capital markets etc. Offers from unrecognised sources will not be entertained.
➦**Benefits :** The ECBs route is beneficial to the Indian corporates on account of following :-

1. It provides the foreign currency funds which may not be available in India.
2. The cost of funds at times works out to be cheaper as compared to the cost of rupee funds.
3. The availability of the funds from the International market is huge as compared to domestic market and corporates can raise large amount of funds depending on the risk perception of the International market.
4. ECBs provided an additional source of funds to the Indian companies, allowing them to supplement domestically available resources and to take advantage of lower international interest rates.
5. ECB encourage infrastructure/core and export sector financing which are crucial for overall growth of the economy.

➦**Recent Example :** About 812 companies have raised about $20.24 billion through ECBs in the April 2006-February 2007 period. That would be equivalent to about Rs 88,000 crore.The top fundraiser was Reliance Industries, which raised $700 million, followed by Reliance Communication, which raised $500 million.Units in SEZ are permitted to use ECBs under a special window.

QUESTION NO. 38 Write a short note on Exchange Rate Forecasting ?

➦**Meaning:** The foreign exchange market has changed dramatically over the past few years.The amounts traded each day in the foreign exchange market are now huge. In this increasingly challenging and competitive market, investors and traders need tools to select and analyze the right data from the vast amounts of data available to them to help them make good decisions. Corporates need to do the exchange rate forecasting for taking decisions regarding hedging, short-term financing, short-term investment, capital budgeting, earnings assessments and long-term financing.

➦**Techniques Of Exchange Rate Forecasting :** There are numerous methods available for forecasting exchange rates. They can be categorized into four general groups- technical, fundamental, market-based, and mixed.

(a) Technical Forecasting: It involves the use of historical data to predict future values.For example time series models. Speculators may find the models useful for predicting day-to-day movements. However, since the models typically focus on the near future and rarely provide point or range estimates, they are of limited use to MNCs.

(b) Fundamental Forecasting: It is based on the fundamental relationships between economic variables and exchange rates. For example subjective assessments,quantitative measurements based on regression models and sensitivity analyses.In general, fundamental forecasting is limited by:

(i) the uncertain timing of the impact of the factors,
(ii)the need to forecast factors that have an immediate impact on exchange rates,
(iii)the omission of factors that are not easily quantifiable, and
(iv)changes in the sensitivity of currency movements to each factor over time.

(c) Market-Based Forecasting: It uses market indicators to develop forecasts. The current spot/forward rates are often used, since speculators will ensure that the current rates reflect the market expectation of the future exchange rate.

(d) Mixed Forecasting: It refers to the use of a combination of forecasting techniques.The actual forecast is a weighted average of the various forecasts developed.

QUESTION NO. 39 What is the difference between Futures & Forward Contracts ?

There major differences between the traditional forward contract and a futures contract.These are tabulated below:

Feature	Forward Contract	Futures Contract
Amount	Flexible	Standard amount
Maturity	Any valid business date agreed to by the two parties	Standard date.Usually one delivery date such as the second Tuesday of every month
Currencies traded	All currencies	Majors
Cross rates	Available in one contract;Multiple contracts avoided	Usually requires two contracts
Market-place	Global network	Regular markets-futures market and exchanges
Price fluctuations	No daily limit in many currencies	Daily price limit set by exchange
Risk	Depends on counter party	Minimal due to margin requirements
Honouring of contract	By taking and giving delivery	Mostly by a reverse transaction
Cash flow	None until maturity date	Initial margin plus ongoing variation margin because of market to market rate and final payment on maturity date
Trading hours	24 hours a day	4 - 8 hours trading sessions

Other Distinction between forward and futures contracts are as follows:

1. Organised exchanges: Forward contracts are traded in over the counter market. Futures contracts are traded on organised exchanges with a designated physical location for example : Stock Exchange .

2. Transaction costs: Cost of forward contracts is based on bid-ask spread. Futures contracts entail brokerage fees for buy and sell orders.

3. Marking to Market: Forward contracts are not subject to marking to market. Futures contracts are subject to marking to market in which the loss or profit is debited or credited in the margin account on daily basis due to change in price.

4. Margins: Margins are not required in forward contract. In futures contracts every participant is subject to maintain margin as decided by the exchange authorities.

5. Liquidity : Forward contracts is exposed to the problem of liquidity whereas in futures there is no liquidity problem as they are traded in stock exchange.

6. Disclosure : In forward contracts, price are not publicly disclosed whereas in future contracts price is transparent.

QUESTION NO. 40 Write a short note on Buyouts ? or Write a short note on LBO ?

➦**Meaning :** A **Leveraged buy-out (LBO)** is an acquisition of a company in which the acquisition is substantially financed through debt. Typically in the LBO 90% or more of the purchase price is financed with debt.

➦While some leveraged buyouts involve a company in its entirety most involve a buisness unit of a company. After the buyout, the company invariably becomes a Private Company.

➦The success of the entire operation depends on their acquirer company's abilty to improve the performence of the unit, curtail its buisness risk, exercise cost controls and liquidate disposable asset. If they fail to do so, the high fixed financial costs can jeopardize the venture.

➦An **attractive candidate for acquisition through leveraged buyout** should possess three basic attributes :

(a) If firm have a good position in its industry with a solid profit history and reasonable expectations of growth.

(b) The firm should have a relatively low level of debt and a high level of bankable assets that can be used as loan collateral.

(c) It must have a stable and predictable cash flows that are adequate to meet interest and principle payment of the debt and provide adequate working capital.

➦Typical **advantages** of the leveraged buy-out method include:

(a)Low capital or cash requirement for the acquiring entity

(b)Synergy gains, by expanding operations outside own industry or business,

(c)Efficiency gains by eliminating the value-destroying effects of excessive diversification,

(d)Improved Leadership and Management :Sometimes managers run companies in ways that improve their authority (control and compensation) at the expense of the companies' owners, shareholders, and long-term strength. Takeovers weed out or discipline such managers. Large interest and principal payments can force management to improve performance and operating efficiency.This "discipline of debt" can force management to focus on certain initiatives such as divesting non-core businesses, downsizing, cost cutting or investing in technological upgrades that might otherwise be postponed or rejected outright.

(e)Leveraging: as the debt ratio increases, the equity portion of the acquisition financing shrinks to a level at which a private equity firm can acquire a company by putting up anywhere from 20-40% of the total purchase price.

(f) Acquiring Company **pay less taxes** because interest payments on debt are tax-deductible

➦**Critics of Leveraged buy-outs** :

(a) The major risk of the leveraged buyout is **bankruptcy** of the acquired company.If the company's cash flow and the sale of assets are insufficient to meet the interest payments arising from its high levels of debt, the LBO is likely to fail and the company may go bankrupt.

(b) The risk associated with a leveraged buyout is that of financial distress,and unforeseen events such as recession, litigation, or changes in the regulatory environment can lead to difficulties meeting scheduled interest payments, technical default (the violation of the terms of a debt covenant) or outright liquidation.

(c) Leveraged buyouts **can harm the long-term competitiveness** of firms involved

(d) Attempting an LBO can be particularly dangerous for companies that are **vulnerable to industry competition or volatility** in the overall economy.

(e) If the company does fail following an LBO, this can cause **significant problems for employees and suppliers**, as lenders are usually in a better position to collect their money.

(f) Another disadvantage is that paying high interest rates on LBO debt **can damage a company's credit rating**.

(g) Finally, it is possible that management may propose an LBO only for **short-term personal profit**.

➦**Recent example:** India has experienced a number of buyouts and leveraged buyouts . A successful example of LBO is the acquisition of Tetley brand, the biggest tea brand of Europe by TATA Tea of India at 271 million pounds. It was one of the biggest cross border acquisition by an Indian Company. Another recent example of a leveraged buyout is **Tata Steel** (India) acquiring **Corus** (United Kingdom) for $11.3 billion .

QUESTION NO. 41 What is a Takeover by Reverse Bid or Reverse Takeover?

➦**Meaning** : It is the act of a smaller company gaining control over a larger one .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.

➦**Tests For Indentifying Takeover by Reverse Bid :**

The three tests in a takeover by reverse bid that are required to be satisfied are, namely,

(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 introduciton of a minority holder or group of holders.

Takeover by reverse bid could happen where already a significant percent of the shareholding is held by the transfer company, to exploit economies of scale, to enjoy better trading advantages and other similar reasons.

➦**Application of the concept of 'takeover by reverse bid'** The concept of takeover by reverse bid has been successfully employed in schemes formulated for revival and rehabilitation of sick industrial companies under the Sick Industrial Companies (Special Provisions) Act 1985.

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➦**Indian Example:** A recent example of a non-sick unit 'reverse merger' was that of ICICI Bank (smaller unit) merging with ICICI Ltd. (larger unit) to form ICICI Bank Ltd. The aim was to give the company an identity of a 'Universal Banking Company'.

QUESTION NO. 42 Explain the various types of risks to which the Swap Dealer is exposed to ? *(RTP May 2010)*

In the process of swap, the role of swap dealer is significant in so far as it brings together two counter-parties whose interests are complementary to each other. For this role, it takes a small part of the interest payment flow. Since the principal amount is large, even a small percentage of the interest payment adds considerably to its profit. But, on the other hand, the swap dealer has to face a variety of risks. These different forms of risks as follows:

(a) Interest-rate Risk : Interest-rate risk arises when the interest rate on a particular loan fails to keep abreast of the movement of the market interest rate. Thus it can be said that the fixed loans under the swap carry higher risk. On the contrary,floating interest rate should not be risky because it changes with the changing profile of the money market. But it does carry risk at least between two reset dates when the interest rate of a particular loan may not be reset despite changes in the market interest rates. The swap dealer is faced with the interest-rate risk, especially when it has a naked position in the swap. Suppose the swap dealer pays fixed-rate interest to the counter-party; and in exchange it receives LIBOR. If LIBOR moves to the swap dealer's disadvantage, it will have to pay more in form of interest. But the risk can be reduced if the swap dealer does not have a naked position and passes on the risk to another counter-party.

(b) Exchange-rate Risk : Changes in the exchange rate are a common affair in the foreign exchange market. If the swap dealer pays fixed rate of interest on a loan denominated in a currency which is going to depreciate, it will have to pay a greater amount of interest to the end-user. Here it may be noted that if the swap dealer faces both the interest-rate risk and the exchange-rate risk simultaneously, the quantum of risk will be very large. If the two risks are positively correlated, the risk will be still higher. But if they are negatively correlated or uncorrelated, the risk will not be so high.

(c) Credit Risk : Credit risk arises when a counter-party defaults payment to the swap dealer. In such cases, the contract is terminated. However, termination of the contract does not protect the swap dealer from loss. This is because the contract is terminated only with one counter-party. The other needs payment which the swap dealer has to make.

(d) Mismatch Risk : There are occasions when it is difficult for the swap dealer to find a perfect match for a counter-party. When a perfect match is not available, the swap dealer offers concessions to attract suitable counter-party. Any such concession causes loss to it. Sometimes after giving concessions, perfect match is not available on different counts, such as notional principal, maturity, swap coupon, reset dates,etc. The swap dealer may have to pay more interest.

(e) Sovereign Risk: Sovereign risk arises when the government of a country to which one of the two counter-party belongs, puts restrictions on the flow of foreign exchange. This entails upon payments received by the swap dealer. It should not be called to default risk or credit risk because the counter-party is willing to make payments. It is the governmental restriction that comes in the way.

(f) Delivery Risk: Delivery risk arises when the two counter-parties are located in two different time zones so that the date of maturity differs by one day. However, the swap dealer is not very much affected by it.

QUESTION NO. 43 What is the role of Financial Advisor in PSU? ***(May 2001) (May 2007)(May2010)***

The financial adviser occupies an important position in all public sector undertakings (PSU). He functions as the principal advisor to the chief executive of the enterprise on all financial matters. The committee on public sector undertakings has specified the following functions and responsibilities for a financial adviser:
(i) Determination of financial needs of the firm and the ways these needs are to be met.
(ii) Formulation of a programme to provide most effective cost-volume profit relationship.
(iii) Analysis of financial results of all operations and recommendations concerning future operations.
(iv) Examination of feasibility studies & detailed project reports from the point of view of overall economic viability of the project.
(v) Conduct of special studies with a view to reduce costs and improve efficiency and profitability.

QUESTION NO. 44 Write a short note on CAMEL MODEL In Credit Rating ?

CAMEL Stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the Rating Agencies deserves special attention, it focuses on the following aspects:
(a) Capital – Composition of Retained Earnings and External Funds raised; Fixed dividend component for preference shares and fluctuating dividend component for equity shares and adequacy of long term funds adjusted to gearing levels; ability of issuer to raise further borrowings.
(b) Assets – Revenue generating capacity of existing / proposed assets, fair values, technological / physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues. Size, ageing and recoverability of monetary assets viz receivables and its linkage with turnover.
(c) Management – Extent of involvement of management personnel, team-work,authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.
(d) Earnings – Absolute levels, trends, stability, adaptability to cyclical fluctuations ability of the entity to service existing and additional debts proposed.
(e) Liquidity – Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.
These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive / negative aspects under each of these five categories and these are factored in for making the overall rating decision.

QUESTION NO. 45 What are the Advantages of Online Trading ?

1. Investors can have benefit of direct access to stock analysis.
2. They can put their trades as it gives the advantage of the real time live rates and real time transactions.
3. They can stream news and researsh, also get an advantage of viewing various charts and creating their own strategies.
4. It gives the investors a real access to the market.
5. Trade privacy is a key point which online trading offers. There is an increase in the trust and confidence of invetors, both large and small which has resulted in increased online traders.
6. Since trading is totally internet based they get direct access to their trading platform from any place and any computer in the world.
7. Online trading has a great speed transparency at a very low cost.

QUESTION NO. 46 Write a short note on Debit Cards ?

➦**Meaning :** Debit cards are also known as cheque cards. Debit cards look like credit cards or ATM (automated teller machine) cards, but operate like cash or a personal cheque. When one uses a debit card his money is quickly deducted from his savings account.Debit cards are accepted at many locations, including grocery stores, retail stores, gasoline stations, and restaurants. One can use his card anywhere.They offer an alternative to carrying a cheque book or cash.
➦**Difference Between Debit Cards and Credit Cards :**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.Debit cards are different from credit cards. While a credit card is to "pay later," a debit card is to "pay now."

➦**Benefits of Debit Cards :**

(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.

➦**Use Of Debit Cards/Precaution to be taken while using Debit Cards :**

(1) If the card is lost or stolen, report the loss immediately to the financial institution.
(2) If one suspects his card is being fraudulently used, report it immediately to his financial institution.
(3) Hold on to the receipts from debit card transactions. A thief may get name and debit card number from a receipt and order goods by mail or over the telephone. The card does not have to be missing in order for it to be misused.
(4) If one has a PIN number, memorizing is required. Never keep PIN number with the card. Also, never choose a PIN number that a smart thief could figure out, such as phone number or birthday date.
(5) Never give PIN number to anyone. Keep the PIN private.
(6) Always know how much money you have in your account. Don't forget that your debit card may allow you to access money that you have set aside to cover a cheque which has not cleared your bank yet.
(7) Keep your receipts in one place – for easy retrieval and better oversight of your bank account.

QUESTION NO. 47 Write a short note on Forward Rate Agreements?[Also Refer Class Register for its practical part]

➦**Meaning:** In finance, a **forward rate agreement** (**FRA**) is a forward contract in which one party pays a fixed interest rate, and receives a floating interest rate and vice versa .In other words, Agreement to borrow or lend at a specified future date at an interest rate that is fixed today.

➦**Objective** :The aim of a FRAs is to safeguard the interest charges for a future period.FRA is very popular method of hedging interest rate risk.

➦**Settlement On Net Basis Over Notional Basis** : The payments are calculated over a **notional amount** over a certain period, and netted, i.e. only the differential is paid. A **forward rate agreement** (FRA) is a **cash-settled** forward contract on a short-term loan.A Forward Rate Agreement is an agreement between two parties to settle the difference between an agreed level of interest(FRA Rate) and an actual future level of interest.(Reference Rate)

How It Is Quoted : FRAs are quoted in the format AxB, with (A) representing the number of months until the loan is set to begin, and (B) representing the number of months until the loan ends. To find the length of the loan, subtract A from B.

For Example :

A 1 x 4 quote would mean a 3 month loan, set to begin 1 month in the future.
A 9 X 12 FRA has a contract period beginning nine months hence, ending 12 months hence.

➦**Payoff formula** :The netted payment made at the effective date is:

$$\frac{\text{Notional Amount Of Loan x (Rate At Expiration or LIBOR or Reference Rate} - \text{FRA or Fixed Rate)} \times \frac{\text{Days in Underlying Rate or FRA Days}}{360}}{1 + \text{Rate At Expiration or LIBOR or Reference Rate} \times \frac{\text{Days in Underlying Rate or FRA Days}}{360}}$$

Buyer Of An FRA :

➦The payer of the fixed interest rate is also known as the borrower or the buyer.
➦The buyer hedges against the risk of rising interest rates.
➦The buyer of an FRA agrees to pay a fixed-rate coupon payment (at the exercise/contract rate) and receive a floating-rate payment against a notional principal amount at a specified future date.
➦The buyer of an FRA will receive (pay) cash when the actual interest rate at settlement is greater (less) than the exercise/

contract rate (specified fixed-rate).

Seller Of An FRA :

➦The receiver of the fixed interest rate is the lender or the seller.

➦The seller hedges against the risk of falling interest rates.

➦The seller of an FRA agrees to make a floating-rate payment and receive a fixed-rate payment against a notional principal amount at a specified future date.

➦The seller of an FRA will receive (pay) cash when the actual interest rate at settlement is less (greater) than the exercise rate.

Main features of the FRA : The main features of the FRA as follows:

➦An FRA is a simple agreement between two parties, with details confirmed directly between themselves.

➦An FRA achieves approximately the same result as futures or forward contracts, but offers much greater flexibility. Start dates, interest periods and notional principal amount are agreed by the two parties to the contract. An FRA can therefore be exactly tailored to suit a customer's specific requirements.

➦The customer agrees a future rate with a bank and at the beginning of the specific period (value date), receives or pays a cash sum representing the interest differential between the agreed rate and LIBOR. No initial or variation margins are involved.

➦If the customer's view of the market changes, he can close out his FRA by taking out a reversing FRA (an equal and opposite FRA at a new price). The price of the reversing FRA will reflect the market rate for the period at the time of closing the hedge.

➦FRAs are widely used by corporates, especially in historically high and volatile interest rate countries, such as the UK and Australia, where FRAs are commonly used to hedge against the risk of rising interest rates by a company with a borrowing. In general, FRA's are used by corporates for the following broad purposes:

To lock in the cost of borrowing on an existing floating-rate loan.

To guarantee the rate of interest a company has to pay on future draw downs.

To guarantee the interest rate earned on surplus funds for any period.

-FRAs are available in any amount, generally from Euro500,000 or the equivalent upwards,and are now available in a broad range of currencies, including US dollars, sterling,Swiss Francs, Deutschemarks, French francs, Yen, Guilders and Australian dollars.

-FRAs are widely quoted out to two years in Europe and US. Customers can transact for any period over one month, including 'broken' or non-standard dates. However, a customer may have to pay a wider spread for a broken-date FRA (such as 11/2 on 41/2).

Users of FRAs :

1. FRAs are far more widely used than futures by corporates. Usually, this is because corporates, being less interest-rate sensitive on the whole than financial institutions,do not place such a high value on the facility futures offer of being in and out of the market in minutes. The forward rate agreement provides corporate treasurers with approximately the same hedging benefits of futures, but with none of the technical and administrative difficulties.

2. Banks are also heavy users of the FRA market. The most common use of FRAs by banks is to iron out mismatches in the short-term structure of their assets and liabilities.

Example: The following example illustrates the mechanics of a transaction involving an FRA.Suppose two banks enter into an agreement specifying:

• a forward rate of 5 percent on a Eurodollar deposit with a three-month maturity;
• a $1 million notional principal; and
• settlement in one month.

Such an agreement is termed a 1x4 FRA because it fixes the interest rate for a deposit to be placed after one month and maturing four months after the date the contract is negotiated. If the three-month LIBOR is 6 percent on the contract settlement date, the seller would owe the buyer the difference between 6 and 5 percent interest on $1 million for a period of 90 days. Thus, if 90-day LIBOR turns out to be 6 percent on the contract maturity date the buyer would receive

= $2,500 ÷ [1 + 0.06(90/360)] = $2,463.05

QUESTION NO. 48 What do you know about swaptions and'their uses ? ***(May 2010 4 Marks)***

➦Swaptions first came into vogue in the mid-1980s in the US on the back of structured bonds tagged with a callable option issued by borrowers. With a callable bond, a borrower issues a fixed-rate bond which he may call at par from the investor at a specific date(s) in the future. In return for the issuer having the right to call the bond issue at par, investors are offered an enhanced yield.

➡A swaption gives the buyer the right but not the obligation to pay (receive) a fixed rate on a given date and receive (pay) a floating rate index. It is designed to give the holder the benefit of the agreed upon strike rate if the market rates are higher, with the flexibility to enter into the current market swap rate if they are lower. The converse is true if the holder of the swaption receives the fixed rate under the swap agreement. If the strike rate of the swap is more favorable than the prevailing market swap rate then the swaption will be exercised.

➡Like any other option, if the swaption is not exercised by maturity it expires worthless. Swaptions fall into three main categories, depending upon the exercise rights of the buyer: **(a)** European Swaptions give the buyer the right to exercise only on the maturity date of the option. **(b)** American Swaptions, on the other hand, give the buyer the right to exercise at any time during the option period. **(c)** Bermudan Swaptions give the buyer the right to exercise on specific dates during the option period.

➡There are two types of swaption contracts:

-A **payer swaption** gives the owner of the swaption the right to enter into a swap where they pay the fixed leg and receive the floating leg.

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-A **receiver swaption** gives the owner of the swaption the right to enter into a swap where they will receive the fixed leg, and pay the floating leg.

➡The buyer and seller of the swaption agree on:

-the premium (price) of the swaption

-the strike rate (equal to the fixed rate of the underlying swap)

-length of the option period (which usually ends two business days prior to the start date of the underlying swap),

-the term of the underlying swap,

-notional amount,

-amortization, if any

-frequency of settlement of payments on the underlying swap

<u>Uses Of Swaptions</u>

➡Swaptions can be applied in a variety of ways for both active traders as well as for corporate treasurers.

➡Swap traders can use them for speculation purposes or to hedge a portion of their swap books.

➡The attraction of swaptions for corporate treasurers is that the forward element in all swaptions provides the attractions of the forward-start swap,and to the owner of the put or call, also the flexibility to exercise or not, as may be considered appropriate. It is therefore a valuable tool when a borrower has decided to do a swap but is not sure of the timing.

➡Swaptions have become useful tools for hedging embedded optionality which is common to the natural course of many businesses.

➡Swaptions are useful to borrowers targeting an acceptable borrowing rate. By paying an upfront premium, a holder of a payer's swaption can guarantee to pay a maximum fixed rate on a swap, thereby hedging his floating-rate borrowings. The borrower is therefore allowed to remain in low floating-rate funds while at the same time being assured of protection should rates increase expectedly (i.e. when the yield curve is positive) or unexpectedly (i.e. when the yield curve is flat or negative).

➡Swaptions are also useful to those businesses tendering for contracts. Businesses need to settle the question whether to commit to borrowings in the future in their own currency in terms of a tender on a future project. A business would certainly find it useful to bid on a project with full knowledge of the borrowing rate should the contract be won.

➡Swaptions also provide protection on callable/putable bond issues.

➡Swap also provide arbitrage opportunity.The more innovative borrowers can use this arbitrage opportunity to their advantage in order to bring down their funding cost.

<u>QUESTION NO. 49</u> List and briefly explain the main functions of an investment bank. (May 2010)

Investment banking provides all the financial services to the corporate, governments and government agencies, other business entities, non-profit organizations and high net worth individuals. They provide total financial services at one-stop shop. Their services include:

(i)Issue of IPO/issue management – public as well right issues – equity as well debt

(a) advisory services – timing, size & composition and pricing of issue **(b)**preparation of offer documents with due care & diligence and compliance of legal formalities **(c)** offering the securities to the public/ shareholders**(d)** underwriting of the

securities**(e)** ensuring smooth completion of the issue **(f)** Post issue services – allotment, exercise of Greenshoe option
From an investment banking perspective, the IPO process consists of these three major phases: hiring the mangers, due diligence, and marketing.
(ii)Management of buy back of shares – Buy back is used by cash rich companies to
(a) increase the value of shares**(b)**avoid hostile takeover**(c)** delisting the shares**(d)** optimization of the capital structure.**(e)**Compliance of the provisions of Company Law and SEBI regulations**(f)**Smooth completion of the buy back
(iii)Loan syndication
(a) negotiation with loan provides like banks, financial institutions **(b)** preparation of information memorandum **(c)**presentation of information memorandum **(d)**negotiating the terms **(e)** smooth completion of transaction
(iv)Private placement of equity as well debt
(a)preparation of Information Memorandum **(b)**legal compliances – particularly in case of listed companies **(c)**placement of the securities to high net worth individuals, financial institutions and other buyers like Private equity
(v)Amalgamations and Absorptions
(a) Advisory services **(b)**Valuation of both the companies for deciding the swap ratio **(c)**Legal compliances – meetings of share holders, filing petition with High court **(d)**Liaison with stock exchange(s) for listing of the securities issued as purchase consideration and delisting of the shares of the amalgamated company **(e)** Ensuring completion deal
(vi)Research and develop opinions on securities, markets, and economies
(vii)Management of investment portfolios – cash rich companies place their surplus cash with the investment banks for investing in various securities for obtaining appropriate return and maintaining the risk at affordable levels.
(viii) Trading in the securities.
(ix) Securitization Debt.
(x) Follow-on offering 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. One reason for a follow-on offering is the same as a major reason for the initial offering: a company may be growing rapidly, either by making acquisitions or by internal growth, and may simply require additional capital.
(xi)Issue of Debt :

QUESTION NO. 50 Write a short on Credit Cards As A Part Of Consumer Finance ***(May 2008)***

➦**Meaning :** Credit cards are primarily seen as a means of convenience in meeting ones expenses. A person who holds a credit card need not pay in cash at the time of every expenditure. Instead, he can deposit a lump sum in the bank or the agencies of which he holds the credit card, to meet the expenditures.Credit Cards are a good substitute for cash and the resultant safety and convenience, the competition in this business has made credit cards a source of short-term finance also for individuals.
➦**Parties Involved In Credit Card Transaction :** Every transaction on a credit card involves three parties : **(1)** The credit card issuer **(2)** The credit cardholder and **(3)** The party to whom the cardholder is supposed to pay, say the merchant outlet (MO). Examples of MO are : a departmental store, hotel, railways, airlines etc.
➦**Advantages & Disadvantages:**
Advantages :
(i) They allow you to make purchases on credit without carrying around a lot of cash. This allows you a lot of flexibility.
(ii) They allow accurate record-keeping by consolidating purchases into a single statement.
(iii) They allow convenient remote purchasing - ordering/shopping online or by phone. They allow you to pay for large purchases in small, monthly installments.
(iv) Under certain circumstances, they allow you to withhold payment for merchandise which proves defective.
(v) They are cheaper for short-term borrowing - interest is only paid on the remaining debt, not the full loan amount.
(vi) Many cards offer additional benefits such as additional insurance cover on purchases, cash back, air miles and discounts on holidays.
(vii) Beside this, the credit-card may also expend the benefit of roll over credit, supplementary cards and travel assistance.
(viii) Credit cards enable a person to track and document all his expenses
(ix) It is safer to carry Credit Cards rather than cash as it provides 100% safety of cash against theft
Disadvantages:

(i) You may become an impulsive buyer and tend to overspend because of the ease of using credit cards. Cards can encourage the purchasing of goods and services you cannot really afford.
(ii) Credit cards are a relatively expensive way of obtaining credit if you don't use them carefully, especially because of the high interest rates and other costs.
(iii) Lost or stolen cards may result in some unwanted expense and inconvenience.
(iv) The use of a large number of credit cards can get you even further into debt.
(v) Using a credit card, especially remotely, introduces an element of risk as the card details may fall into the wrong hands resulting in fraudulent purchases on the card. Fraudulent or unauthorized charges may take months to dispute, investigate, and resolve.

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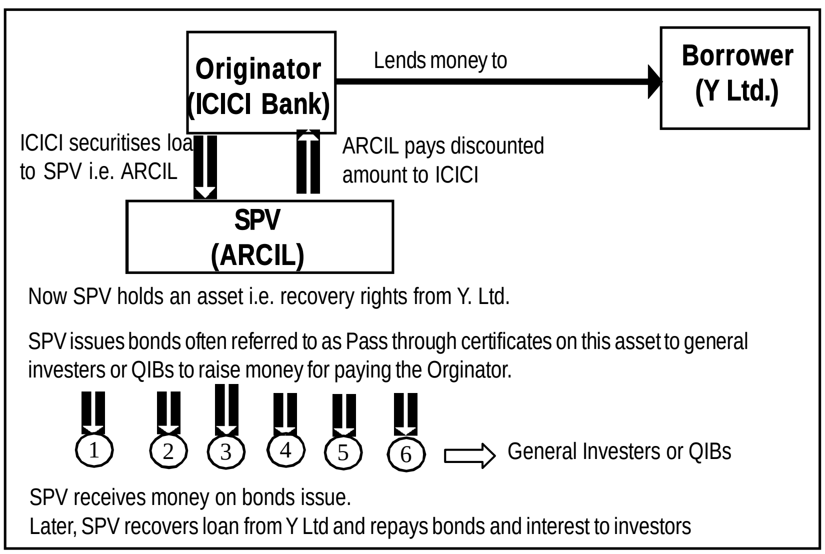
QUESTION NO. 52 Write a short note on Debt Securitisation?or What are the advantages of Debt Securitisation?OR What is securitisation? What are its various instruments ?OR Write a short note on Asset Securitisation (May 10)

➦**Meaning : Securitisation** is a process of pooling and repackaging homogeneous illiquid financial assets into marketable securities that can be sold to investors.Securitisation is the process by which financial assets are transformed into securities .
➦**Process :** For example a bank lends Rs. 10 lakhs each to 300 borrowers as part of its loan portfolio. The total debt thus on the books of the bank will be Rs. 30 crores. By way of securitisation, the bank can break the entire portfolio of loan/debt of Rs. 30 crores into a paper of Rs. 300 each for instance, and market it in the secondary market to investors.
➦Debt Securitisation will thus provide liquidity to the instrument.
➦In other words **Debt/Asset securitisation** is a method of recycling of funds. Securitisation is a process of transformation of illiquid assets into security, which may be traded later in the open market.

The digrame bellow illustrates the process of Scuritisation in India



➦**Steps involved in a Securitisation Process :**
The basic debt securitisation process can be classified in the following three functions.
(i) The Origination Function : A borrower seeks a loan from a finance company, bank, housing company or a lease from a leasing company. The creditworthiness of the borrower is evaluated and a contract is entered into with repayment schedule structured over the life of the loan.
(ii) 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 SPV - (Special Purpose Vehicle), which acts as a trustee for the investor. Once the assets are transferred, they are held in the originators' portfolios.
(iii) The Securitisation Function : It is the SPV's job now to structure and issue the securities on the basis of the asset pool. The securities carry a coupon and an expected maturity, which can be asset based 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 funds, insurance companies etc.

➦**<u>Parties involved in Securitisation Process :</u>**

(i) <u>The Originator</u> : This is the entity in whose books the assets , to be securitised , originate.

(ii) <u>Special Pupose Vehicle (SPV)</u> : This is the entity through which the securitisation transaction is actually operated i.e who buys the assets to be securitised & then issues marketable securities backed by those assets.

(iii) <u>The Investor</u> : These are the entities that are looking for investment opportunity for their surplus funds.They buy the securities issued by SPV and get returns in the form of interest and principal repayment as per agreed schedule.

(iv) <u>Other Parties</u> : Obligators, Rating Agencies, Administrator, Agent and Trustee.

➦**<u>Instruments of Securitisation</u> :**Under this process securities issued by SPV are in the form of Pass Through Certificate (PTC), Pay Through Securities (PTS) and Stripped Securities. Securities may be Asset Backed Securities and Mortgaged Backed Securities .

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(i) <u>Asset Backed Securities</u> : These are securities backed by other assets like credit card receivable , trade receivables etc .

(ii) <u>Mortgage Backed Securities</u> : These are the securities where the assets collaterised are mortgage loans i.e loans secured by a mortgage of specified immovable property .

➦**<u>Benefits to the Originator</u>** :

1. The assets are shifted off the balance sheet, thus giving the originator recourse to <u>off balance sheet funding.</u>

2. It <u>converts illiquid assets to liquid portfolio</u>.

3. It facilitates better balance sheet management as assets are transferred off balance sheet facilitating <u>satisfaction of capital adequacy norms.</u>

4. The <u>originator's credit rating enhances</u>.

➦**<u>Benefits to the Investor</u>** :

1. For the investor securitisation <u>opens up new investment avenues</u>.

2. Though the investor bears the credit risk, the <u>securities are tied up to definite assets.</u>

3. Securitisation helps to convert a stream of cash receivables into a <u>source of long-term finance.</u>

4. Securities are rated by <u>Credit Rating Agencies</u> and it becomes easier for an investor to compare risk return profile and <u>make an informed choice.</u>

➦**<u>Recent Scenario</u> :** In Indian context Debt Securitisation has began to take off. The ideal candidates for this are hire purchase and leasing companies, asset finance and real estate finance companies.The first securitisation deal was structured by Citibank in 1991.National Housing Bank,Housing and Urban Development Corporation,LIC Housing and HDFC have emerged as key players in the securitisation market .The experiment has already been initiated in India by the Housing Development Finance Corporation (HDFC) by selling a part of its loan to the Infrastructure Leasing and Financial Services Ltd. (ILFS) and has therefore become a pacesetter for other kinds of debt securitisation as well.The Industrial Credit and Investment Corporation of India (ICICI) as well as other private financial companies have been trying similar deals for lease rentals.

<u>QUESTION NO. 53</u> What are the methods of Venture Capital Financing(VCF)?

➦**<u>Meaning</u> :** The **Venture Capital Financing** refers to financing of new high risky ventures promoted by qualified entrepreneurs who lack experience & funds to give shape to their ideas.In broad sense,under venture capital financing venture capitalist make investment to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with a potential of success.

➦**<u>Methods of Venture Capital Financing</u> :** The venture capitalist generally finance ventures which are in national priority areas such as energy conservation, quality upgradation, etc,. Some common methods of venture capital financing are as follows:

(i) <u>Equity Financing</u> The venture capital undertakings generally requires funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, the venture capital finance is generally provided by way of equity share capital. The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur. Hence such a mode is useful since there is no compulsion to pay dividend or interest in initial stages.

(ii) <u>Conditional Loan</u> : 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. In India venture capital financers charge royalty ranging between 2 and 15 per cent; actual rate depends on factors such as gestation period, cash flow patterns, riskiness and any other factors of the enterprise. Some Venture capital financers give a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sounds .

(iii) Income Note : It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBl's VCF(Venture Capital Fund) provides funding equal to 80 -87.5% of the projects cost for commercial application of indigenous technology.

(iv) 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 is charged upto a particular level of operations, after that, a high rate of interest is required to be paid.

➦The following are the **criteria** which may be applied to find out the eligibility of an undertaking for Venture Capital Financing **(i)**The venture must be a technically feasible proposition**(ii)**It should be commercially viable**(iii)**The entreprenuers must be technically competent & having manegerial skill **(iv)**The undertaking must have a long run competitive advantage over other units

➦**Benefits Of Venture Capital Financing :**

(i) This is the only feasible source of funds available for new enterprising projects , since bank loan & public issues are quite difficult at start up stage .

(ii) There is flexibility in structuring the mode of finance i.e debt or equity.

(iii) Tax concessions available for VCF help in promoting and increasing the availability of venture capital .

➦**Limitations Of Venture Capital Financing :**

(i) Availability of Venture Capital is limited in practice & it depends mostly on the personal contacts of the entrepreneurs.

(ii) It is a very expensive source of finance and also dilutes managerial control of the entrepreneur.

➦**Example of Indian Venture Capital Funds :** Some of the important Indian venture capital funds are : ICICI Venture Funds Ltd. IFCI Venture Capital Funds Limited (IVCF), SIDBI Venture Capital Limited (SVCL), Gujarat Venture Finance Limited (GVFL).The important overseas venture capital funds operating in India are : Walden International Investment Group, SEAF India Investment & Growth Fund, BTS India Private Equity Fund Limited.

Infosys Technologies co-founder and chairman NR Narayana Murthy recently sold company shares worth around $37 million to set up a venture capital fund for incubating Indian start-ups.A statement issued by Infosys said the venture capital fund would encourage and support young entrepreneurs having brilliant business ideas.The Fund will primarily invest in India and may on a case-to-case basis consider investing overseas," it added.This news has come as big boost for the market and especially budding entrepreneurs.In fact, the country saw over 71% drop in Venture Investments this year. Total VC Investments in the first nine months of 2009 is at $201 million against $709 million investment for the corresponding period last year. So, with more Venture Funds we can see the revival of venture investments in India soon.

QUESTION NO. 54 What are the Constraints on Paying Dividends ?

(i) Legal : Under Section 205(1) of the Companies Act 1956, dividend is to be paid out of current profits or past profit after providing for depreciation. Central Government can allow a company to pay dividend for any financial year out of profits of the company without providing for depreciation if it is in public interest. Dividend is to be paid in cash .Capital profit may also be distributed as dividends if articles permit.

(ii) Liquidity : Payment of dividends means outflow of cash. Ability to pay dividends depends on cash and liquidity position of the firm. A mature company does not have much investment opportunities, nor are funds tied up in permanent working capital and,therefore has a sound cash position. For a growth oriented company inspite of good profits, it will need funds for expanding activities and permanent working capital. So it is not in a position to declare dividends.

(iii) Access to the Capital Market : By paying large dividends, cash position is affected. If new shares have to be issued to raise funds for financing investment programmes and if the existing shareholder cannot buy additional shares, control is diluted. Payment of dividends may be withheld and earning utilised for financing firm's investment opportunities.

(iv) Investment Opportunities : If investment opportunities are inadequate, it is better to pay dividends and raise external funds whenever necessary for such opportunities.

QUESTION NO. 55 What are the Differences between Primary & Secondary Markets?

Basis	Primary Markets	Secondary Markets
(a) Meaning	A primary market refers to the set up	The secondary market is market for subsequent

	which helps the industry to raise funds by issuing different types of securities.	sale/purchase and trading in the securities.
(b) Nature of Securities	It deals with new securities, i.e. securities which were not previously available, and are offered for the first time to the investors.	It is a market for old securities which have been issued already.
(c) Sale/ Purchase	Securities are acquried from issuing Companies themselves.	Securities are purchased and sold by the investors without any involvement of the companies.
(d) Nature of Financing	It provides funds to new enterprises & also for expansion and diversification of the existing one.	It does not supply additional funds to the company since the company is not involved in transaction
(e) Liquidity	It does not lend any liquidity to the securities	The secondary market provides facilities for the continuous purchase and sale of securities, thus lending liquidity and marketability to the securities.
(f) Organisati-onal Differe-nce	It is not rooted in any particular spot and has no geographical existence. It has neither any tangible form nor any administrative organisational set up.	Secondary market has physical existence in the form of stock exchange and are located in a particular geographical area having an administrat--ve organisation set up.

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<u>QUESTION NO. 56</u> What are the Similarities between Primary and Secondary Market ?

(a) <u>Listing</u> : One aspect of inseparable connection between them is that the securities issued in the primary market are invariably listed on a secondary market (recognized stock exchange) for dealings in them. The practice of listing of new issues on the stock market is of immense utility to the potential investors who can be sure that when they receive an allotment of new issues, they will subsequently be able to dispose them off any time in the Stock Exchange.
(b) <u>Control</u> : The stock exchanges exercise considerable control over the organization of new issues. The new issues of securities which seek stock quotation/listing have to comply with statutory rules as well as regulations framed by the stock exchanges. If the new issues do not conform to the prescribed stipulations, the stock exchanges would refuse listing facilities to them. This requirement obviously enables the stock exchange to exercise considerable control over the new issues market and is indicative of close relationship between the two.
(c) <u>Mutual Interdependence</u> : The markets for new and old securities are, economically, an integral part of a single market - the capital market. Their mutual interdependence from the economic point of view has two dimensions.
One, the behavior of the stock exchanges has a significant bearing on the level of activity in the primary market and, therefore, its responses to new issues increase when share values are rising and vice versa.
The <u>second</u> dimension of the mutual interdependence of the two parts of the market is that the prices of new issues are influenced by the price movements on the stock market. The quantitative predominance of old securities in the market usually ensures that it is these, which set the tone of the market as a whole and govern the prices and acceptability of the new issues.

<u>QUESTION NO. 57</u> What are the functions of the Stock Exchanges?

The Stock Exchange is a market place where investors buy and sell securities.Functions of the stock exchanges can be summarized as follows:
(a) <u>Liquidity and Marketability of Securities</u>: The basic function of the stock market is the creation of a continuous market for securities, enabling them to be liquidated, where investors can convert their securities into cash at any time at the prevailing market price. It also provides investors the opportunity to change their portfolio as and when they want to change, i.e. they can at any time sell one security and purchase another,thus giving them marketability.
(b) <u>Fair Price Determination</u>: This market is almost a perfectly competitive market as there are large number of buyers and sellers. Due to nearly perfect information, active bidding take place from both sides. This ensures the fair price to be determined by demand and supply forces.
(c) <u>Source for Long term Funds</u>: Corporates, Government and public bodies raise funds from the equity market. These securities are negotiable and transferable. They are traded and change hands from one investor to the other without affecting the long-term availability of funds to the issuing companies.

(d) <u>Helps in Capital Formation</u>: They are the nexus between the savings and the investments of the community. The savings of the community are mobilized and channeled by stock exchanges for investment into those sectors and units which are favoured by the community at large, on the basis of such criteria as good return,appreciation of capital, and so on.

(e) <u>Reflects the General State of Economy</u>: The performance of the stock markets reflects the boom and depression in the economy. It indicates the general state of the economy to all those concerned, who can take suitable steps in time. The Government takes suitable monetary and fiscal steps depending upon the state of the economy.

<u>QUESTION NO. 58</u> Write a short note on Bollinger Bands ?[Also Refer Class Register for its practical part]

➡**Bollinger Bands** are a <u>technical analysis</u> tool invented by John Bollinger in the 1980s. Having evolved from the concept of trading bands, Bollinger Bands can be used to measure the <u>highness or lowness</u> of the price relative to previous trades.

➡When stock prices continually touch the upper Bollinger band, the prices are thought to be <u>overbought</u>; conversely, when they continually touch the lower band, prices are thought to be <u>oversold</u>, triggering a buy signal.In other words The closer the prices move to the upper band, the more overbought the market, and the closer the prices move to the lower band, the more oversold the market.

➡A band is plotted <u>two standard deviations away from a simple moving average</u>. Because standard deviation is a measure of volatility, bollinger bands adjust themselves to the market conditions.

➡When the markets become more volatile, the <u>bands widen</u> (move further away from the average), and during less volatile periods, the <u>bands contract</u> (move closer to the average). The tightening of the bands is often used by technical traders as an early indication that the volatility is about to increase sharply.

➡<u>Standard deviation</u> is a statistical unit of measure that provides a <u>good assessment of a price volatility</u>.The higher the standard deviation, the more the security's price fluctuates from its average price.

➡Bollinger Bands consist of: **(i)**a middle band **(ii)**an upper band **(iii)** a lower band.In other words Bollinger Bands consist of a moving average and two standard deviations charted as one line above and one line below the moving average. The line above is two standard deviations added to the moving average. The line below is two standard deviations subtracted from the moving average.

➡**<u>Formula</u>** : The Bollinger band formula consists of the following:

BOLU = MA (TP, n) + m * SD [TP, n]

BOLD = MA (TP, n) - m * SD [TP, n]

Where,BOLU = Upper Bollinger Band ; BOLD = Lower Bollinger Band ;n = Smoothing Period ;m = Number of Standard Deviations (SD) which is generally 2;SD = Standard Deviation over Last n Periods Typical Price (TP) = (HI + LO + CL) / 3

Note:If Typical Price is not given we can use Closing Price.

➡Bollinger recommends using a 20-day simple moving average for the center band and 2 standard deviations for the outer bands.The default choice for the average is a simple <u>moving average</u>.

➡The technician can be relatively certain that almost all of the price data needed will be found between the two bands.

➦Bollinger Bands serve two primary functions:
-To identify periods of high and low volatility
-To identify periods when prices are at extreme, and possibly unsustainable, levels.
➦**Using Bollinger Band "Bands" To Gauge Trends:** Bollinger bands are one of the most popular technical indicators for traders in any financial market - stocks, bonds or foreign exchange (FX). Many traders use them primarily to determine overbought and oversold levels,selling when price touches the upper bollinger band and buying when it hits the lower bollinger band. In range-bound markets, this technique works well, as prices travel between the two bands like balls bouncing off the walls of a racquetball court.
➦A Word of Caution! Bollinger bands are a useful tool - but need combining with other indicators, as with any single indicator, they should not be used in isolation.

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QUESTION NO. 59 Write a note on Arbitrage Pricing Theory(APT)?[Also Refer Class Register for its practical part]

➦Unlike the CAPM which is a single factor model, the APT is a multi factor model having a whole set of Beta Values – one for each factor.
➦Arbitrage Pricing Theory states that the expected return on an investment is dependent upon how that investment reacts to a set of individual macro-economic factors (degree of reaction measured by the Betas) and the risk premium associated with each of those macro – economic factors.
➦The APT developed by Ross (1976) holds that there are several factors which explain the risk premium relationship of a particular security. Several factors being identified e.g. inflation and money supply, interest rate, industrial production and personal consumption have aspects of being inter-related.
➦In APT Expected Return = $R_f + \lambda_1\beta_1 + \lambda_2\beta_2 + \lambda_3\beta_3 + \lambda_4\beta_4$

$\lambda_1, \lambda_2, \lambda_3, \lambda_4$ are average risk premium for each of the four factors in the model and $\beta_1, \beta_2, \beta_3, \beta_4$ are measures of sensitivity of the particular security to each of the four factors.Rf is the Risk Free Rate of Return.

QUESTION NO. 60 Write a short note on Hedge Funds ?

➦Hedge Fund is an aggressively managed portfolio of investments that uses advanced investment strategies such as leverage, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark).
➦In other words,A hedge fund is a fund that can take both long and short positions, use arbitrage, buy and sell undervalued securities, trade options or bonds, and invest in almost any opportunity in any market where it foresees impressive gains at reduced risk.
➦**Benefits Of Hedge Funds :**There are many advantages of hedge funds. Some of the important advantages are:
(a) Many hedge fund strategies have the ability to generate positive returns in both rising and falling equity and bond markets.
(b) Inclusion of hedge funds in a balanced portfolio reduces overall portfolio risk and volatility and increases returns.
(c) Huge variety of hedge fund investment styles – many uncorrelated with each other – provides investors with a wide choice of hedge fund strategies to meet their investment objectives. Academic research proves hedge funds have higher returnsn and lower overall risk than traditional investment funds.
(d) Hedge funds provide an ideal long-term investment solution, eliminating the need to correctly time entry and exit from markets.
(e) Adding hedge funds to an investment portfolio provides diversification not otherwise available in traditional investing.
➦**Main Features Of Hedge Funds :**The key characteristics of hedge funds can be stated as follows:
(a) Hedge funds utilize a variety of financial instruments to reduce risk, enhance returns and minimize the correlation with equity and bond markets. Many hedge funds are flexible in their investment options (can use short selling, leverage, derivatives such as puts, calls,options, futures, etc.).
(b) Hedge funds vary enormously in terms of investment returns, volatility and risk. Many,but not all, hedge fund strategies tend to hedge against downturns in the markets being traded.
(c) Many hedge funds have the ability to deliver non-market correlated returns.

(d) Many hedge funds have as an objective consistency of returns and capital preservation rather than magnitude of returns.
(e) Most hedge funds are managed by experienced investment professionals who are generally disciplined and diligent.
(f) Pension funds, endowments, insurance companies, private banks and high net worth individuals and families invest in hedge funds to minimize overall portfolio volatility and enhance returns.
(g) Most hedge fund managers are highly specialized and trade only within their area of expertise and competitive advantage.
(h) Hedge funds benefit by heavily weighting hedge fund managers' remuneration towards performance incentives, thus attracting the best brains in the investment business. In addition, hedge fund managers usually have their own money invested in their fund.
➦**Hedging Strategies:**Wide ranges of hedging strategies are available to hedge funds. For example:
(i) Selling Short : Selling shares without owning them, hoping to buy them back at a future date at a lower price in the expectation that their price will drop.
(ii) Using Arbitrage : Seeking to exploit pricing inefficiencies between related securities -for example, can be long convertible bonds and short the underlying issuer's equity.
(iii) Trading Options or Derivatives : Contracts whose values are based on the performance of any underlying financial asset, index or other investment.
(iv) Investing in Anticipation of a Specific Event : Merger transaction, hostile takeover,spin-off, exiting of bankruptcy proceedings, etc.
(v) Investing in Deeply Discounted Securities : Of companies about to enter or exit financial distress or bankruptcy, often below liquidation value.
(vi) Many of the strategies used by hedge funds benefit from being non-correlated to the direction of equity markets.
Hedge Funds Industry Scenario Of The World : The hedge funds industry around the world is estimated to be $300-$400 billion and is growing at about 20% per year with between 4,000 and 5,000 active hedge funds.
Reasons For Investing In a Hedge Fund : There are two basic reasons for investing in a hedge fund: to seek higher net returns (net of management and performance fees) and/or to seek diversification.
(a) Potential for Higher Returns, Especially in a Bear Market: If your outlook is bearish, hedge funds should be an attractive asset class compared to buy-and-hold or long-only mutual funds.
(b) Diversification Benefits: Many institutions invest in hedge funds for the diversification benefits. If you have a portfolio of investments, adding uncorrelated (and positive-returning) assets will reduce total portfolio risk. Hedge funds employ derivatives, short sales or non-equity investments tend to be uncorrelated with broad stock market indices.
Demerits Of Hedge Funds -
(i) Hedge fund investors are exposed to multiple risks, and each strategy has its own unique risks. For example, long/short funds are exposed to the short-squeeze.The traditional measure of risk is volatility, that is, the annualized standard deviation of returns.
(ii)Fat Tails Are The Problem: The problem is that hedge fund returns do not follow the symmetrical return paths implied by traditional volatility. Instead, hedge fund returns tend to be skewed. Specifically, they tend to be negatively skewed, which means they bear the dreaded "fat tails", which are mostly characterized by positive returns but a few cases of extreme losses.

QUESTION NO. 61 Write a note on "Credit Rating" in India?OR Briefly explain the meaning and importance of "Credit Rating"? Write a short note on Credit Rating Process ?

➦**Meaning** Credit Rating is an act of assigning values to credit instruments by assessing the solvency i.e. the ability of the borrower to repay debt.Thus Credit Rating is:
(1) An expression of opinion of a rating agency.**(2)** The opinion is in regard to a debt instrument.**(3)** The opinion is as on a specific date.**(4)** The opinion is dependent on risk evaluation.**(5)** The opinion depends on the probability of interest and principal obligations being met timely.
➦**What Credit Rating do not indicate** It may be noted that credit rating is only an opinion and not the guarantee or protection against default.It is not a recommendation to buy, or sell, or hold a security.Thus Credit Rating does not in any way linked with **(1)** Performance Evaluation of the rated entity unless called for.**(2)** Investment Recommendation by the rating agency to invest or not in the instrument to be rated.**(3)** Legal Compliance by the issuer-entity through audit.**(4)** Opinion on the holding company, subsidiaries or associates of the issuer entity.
➦**Credit Rating in India** **(i)** CRISIL (Credit Rating & Information Services of India Ltd.) **(ii)** ICRA (Investment Information

and Credit Rating Agency of India)**(iii)** CARE (Credit Analysis and Research Limited)**(iv)**Fitch Ratings India (P) Ltd.
CRISIL was the first credit rating agency in India, incorporated in 1987 jointly by ICICI and the UTI. CRISIL has pioneered the concept of Credit Rating in India.

Credit Rating Process

(1) Request from issuer and analysis – A company approaches a rating agency for rating a specific security. A team of analysts interact with the company's management and gathers necessary information. Areas covered are : historical performance, competitive position, business risk profile, business strategies, financial policies and short/long term outlook of performance. The team of analysts makes an assessment of the issuer's prospects in the light of information available from management. Also factors such as industry in which the issuer operates, its competitors and markets are taken into consideration.

(2) Rating Committee – On the basis of information obtained and assessment made the team of analysts present a report to the Rating Committee. The issuer is not allowed to participate in this process as it is an internal evaluation of the rating agency. The nature of credit evaluation depends on the type of information provided by the issuer.

(3) Communication to management and appeal – The Rating decision is communicated to the issuer and then supporting the rating is shared with the issuer.If the issuer disagrees, an opportunity of being heard is given to him. Issuers appealing against a rating decision are asked to submit relevant material information.The Rating Committee reviews the decision although such a review may not alter the rating. The issuer may reject a rating and the rating score need not be disclosed to the public.

(4) Pronouncement of the rating – If the rating decision is accepted by the issuer, the rating agency makes a public announcement of it.

(5) Monitoring of the assigned rating – The rating agencies monitor the on-going performance of the issuer and the economic environment in which it operates. All ratings are placed under constant watch. In cases where no change in rating is required, the rating agencies carry out an annual review with the issuer for updating of the information provided.

(6) Rating Watch – Based on the constant scrutiny carried out by the agency it may place a rated instrument on Rating Watch. The rating may change for the better or for the worse. Rating Watch is followed by a full scale review for confirming or changing the original rating. If a corporate which has issued a 5 year 8% debenture merges with another corporate or acquires another corporate, it may lead to the listing of the specified debenture rating under this policy.

(7) Confidentiality of information – As the information provided by the issuers is very sensitive in nature; the rating agencies are required to keep them strictly confidential and cannot use such information for any other purpose.

(8) Rating Credibility – The rating agencies follow a thorough and transparent evaluation so as to lend credibility to their findings. The policies followed are

(a) Clear and Specific ideas for a rating score.**(b)** Rationale and Sensitiveness behind the ratings being made public.**(c)** Publication of the limitations of rating, adequacy of information and validity of the rating score.**(d)** Limiting dependence on information from third parties viz auditors, trustees, consultants, experts.**(e)** Not carrying out a rating exercise on an unsolicited basis.**(f)** Withdrawing the ratings after expiration of the tenure and following a strict policy of not disclosing the rejected ratings except when required.

(9) Rating Coverage – Ratings are not limited to specific instruments. They also include public utilities; financial institutions; transport; infrastructure and energy projects; Special Purpose Vehicles; domestic subsidiaries of foreign entities. Structured ratings are given to MNCs based on guarantees or Letters of Comfort and Standby Letters of Credit issued by the banks. The rating agencies have also launched Corporate Governance Ratings with emphasis on quality of disclosure standards and the extent to which regulatory obligations have been complied with.

(10) Rating Scores – A comparative summary of Rating Score used by four rating agencies in India is given below.

Sample of Rating Scores

Debentures	**CRISIL**	**ICRA**	**CARE**	**FITCH**
Highest Safety	AAA	LAAA	CARE AAA (L)	AAA (ind)
High Safety	AA	LAA	CARE AA (L)	AA (ind)
Adequate Safety	A	LA	CARE A (L)	A (ind)
Moderate Safety	BBB	LBBB	CARE BBB (L)	BBB (ind)
Inadequate Safety	BB	LBB	CARE BB (L)	BB (ind)
High Risk	B	LB	CARE B (L)	B (ind)
Substantial Risk	C	LC	CARE C (L)	C (ind)
Default	D	LD	CARE D (L)	C (ind)

Fixed Deposits

Highest Safety	FAAA	MAAA	CAREAAA	TAAA
High Safety	FAA	MAA	CAREAA	TAA
Adequate Safety	FA	MA	CAREA	TA

<u>QUESTION NO. 62</u> Write a short note on Limitations Of Credit Rating ? **(SFM Nov 2009)**

(1) <u>Rating Changes</u> – Ratings given to instruments can change over a period of time. They have to be kept under rating watch. Downgrading of an instrument may not be timely enough to keep investors educated over such matters.
(2) <u>Industry Specific rather than Company Specific</u> – Downgrades are linked to industry rather than company performance. Agencies give importance to macro aspects and not to micro ones; over-react to existing conditions which come from optimistic / pessimistic views arising out of up / down turns.
(3) <u>Cost Benefit Analysis</u> – Rating being mandatory, it becomes a must for entities rather than carrying out Cost Benefit Analysis. Rating should be left optional and the corporate should be free to decide that in the event of self rating, nothing has been left out.
(4) <u>Conflict of Interest</u> – The rating agency collects fees from the entity it rates leading to a conflict of interest. Rating market being competitive there is a distant possibility of such conflict entering into the rating system.
(5) <u>Corporate Governance Issues</u> – Special attention is paid to **(a)** Rating agencies getting more of its revenues from a single service or group.**(b)** Rating agencies enjoying a dominant market position engaging in aggressive competitive practices by refusing to rate a collateralized / securitized instrument or compelling an issuer to pay for services rendered.**(c)** Greater transparency in the rating process viz. in the disclosure of assumptions leading to a specific public rating.

<u>QUESTION NO. 63</u> Write short note on NAV (Net Asset Value)?[Also Refer Class Register for its practical part]

➦**<u>Meaning</u>** : It is the amount which a unit holder would receive if the mutual fund were wound up. An investor in mutual fund is a part owner of all its assets and external liabilities.It is the basis for assessing the return that an investor has earned.
➦There are three aspects which need to be highlighted :
(i) It is the net value of all assets less liabilities. NAV represents the market value of total assets of the Fund less total external liabilities attributable to those assets.
(ii) NAV changes daily. The value of assets and liabilities changes daily. NAV today will not be NAV tomorrow or day later.
(iii) NAV is computed as a value per unit of holding.
➦**<u>NAV Asset Valuation Rule</u>**

<u>Nature of Asset</u>	**<u>Valuation Rule</u>**
Liquid Assets e.g. cash held	As per books.
All listed and traded securities (other than those held as not for sale)	Closing Market Price
Debentures and Bonds	Closing traded price or yield
Illiquid shares or debentures	Last available price or book value whicheveris lower. Estimated Market Price approach to be adopted if suitable benchmark is available.
Fixed Income Securities	Current Yield.

➦**<u>Netting the Asset Values</u> :**The asset values obtained from above have to be adjusted as follows :

<u>Additions</u>	**<u>Deductions for Liabilities</u>**
Dividends and Interest accrued	Expenses accrued
Other receivables considered good	Liabilities towards unpaid assets
Other assets (owned assets)	Other short term or long term liabilities

➦**<u>Computation of NAV</u> :**The funds net assets are defined as the assets less external liabilities.
Symbolically : NAV = Net asset of the scheme/Number of units outstanding
Where net assets of the scheme is defined as :Net Assets of the Scheme = Market value of investments + Receivables + Other accrued income + other assets - Accrued Expenses - Other Payables - Other Liabilities
➦**<u>Example</u> :** If total assets of a scheme are Rs. 200 lacs and liabilities are Rs. 20 lacs and there are 10 lacs unit holders, the NAV

per unit is Rs. 18

QUESTION NO. 64:Write a short note on INTER-BANK PARTICIPATION CERTIFICATE (IBPC) ?

➦**Meaning :** A IBPC is a deed of transfer through which a bank, sells or transfers to a third party (transferee) a part or all of a loan made to its clients (borrowers).In other words The Inter Bank Participation Certificates are short term instruments to even out the short term liquidity within the Banking system particularly when there are imbalances affecting the maturity mix of assets in Banking Book.

➦**Why it is called so ? :** It is called a participation certificate because through it, the PC holder participates in a bank loan, and so also in the interest, the security of the loan, and risk of default on a proportionate basis.

➦**Objective:** The primary objective is to provide some degree of flexibility in the credit portfolio of banks & to smoothen the consortium arrangements.

➦**Who can Issue & Subscribe:** The IBPC can be issued by scheduled commercial bank and can be subscribed by any commercial bank.

➦**Issued against underlyng Advance :** The IBPC is issued against an underlying advance, classified standard during the currency of the participation.

➦**Types :** The participation can be issued in two types, viz. with and without risk to the lender.
While the participation without risk can be issued for a period not exceeding 90 days. Participation with risk can be issued for a period between 91 days and 180 days.

➦**Benefits :** The scheme is beneficial both to the issuing and participating banks. **The issuing bank** can secure funds against advances without actually diluting its asset-mix. A bank having the highest loans to total asset ratio and liquidity bind can square the situation by issuing IBPCs. **To the lender**, it provides an opportunity to deploy the short term surplus funds in a secured and profitable manner.The IBPC with risk can also be used for capital adequacy management.

➦**Interest Rate:**The interest rate on IBPC is freely determined in the market. The certificates are neither transferable nor prematurely redeemable by the issuing bank.

➦**Current Scenario :** Despite its advantages, the IBPC scheme has not become a popular money market instrument.One of the reason for this may be the prohibition against transferability as the participants are not allowed to transfer the certificates. Secondly due to the absence of a ceiling on the interest rate the borrower bank has to pay the issuing bank a rate higher than that agreed with the borrower.

QUESTION NO. 65 What are the reasons for stock index futures becoming more popular financial derivatives over stock futures segment in India ? ***(May 2010 6 Marks)***

➦Trading in stock index futures contracts was introduced by the Kansas City Board of Trade on February 24, 1982.In April 1982, the Chicago Mercantile Exchange (CME) began trading in futures contract based on the Standard and Poor's Index of 500 common stocks. The introduction of both contracts was successful, especially the S&P 500 futures contract, adopted by most institutional investors.

➦In India, both the NSE and the BSE have introduced index futures in the S&P CNX Nifty and the BSE Sensex.

➦**Uses of Stock Index Futures:** Investors can use stock index futures to perform myriad tasks. Some common uses are:
(i)to speculate on changes in specific markets;
(ii)to change the weightings of portfolios;
(iii)to separate market timing from market selection decisions; and
(iv)to take part in index arbitrage, whereby the investors seek to gain profits whenever a futures contract is trading out of line with the fair price of the securities underlying it.
(v) Using Indexes to Hedge Portfolio Risk**:** Aside from the above uses of indexes, investors often use stock index futures to hedge the value of their portfolios. To implement a hedge, the instruments in the cash and futures markets should have similar price movements.

➦**Main reasons to trade stock index futures are**:
(i) Add flexibility to one's investment portfolio. Stock index futures add flexibility to his or her portfolio as a hedging and trading instrument.

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(ii) Create the possibility of speculative gains using leverage. Because a relatively small amount of margin money controls a large amount of capital represented in a stock index contract, a small change in the index level might produce a profitable return on one's investment if he or she is right about the market's direction.
(iii) Provide hedging or insurance protection for a stock portfolio in a falling market.
(iv) There is no time value erosion of the futures position.
(v) Maintain one's stock portfolio during stock market corrections.
(vi) Sell as easily as one can buy. One of the major advantages of futures markets, in general, is that one can sell contracts as readily as he or she can buy them and the amount of margin required is the same.
(vii) Transfer risk quickly and efficiently. Whether one is speculating, looking for insurance protection (hedging), or temporarily substituting futures for a later cash transaction, most stock index futures trades can be accomplished quickly and efficiently. Stock index futures give individual the opportunity to get into or out of a position whenever he or she wants.

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QUESTION NO. 66 How is a stock market index calculated? Indicate any two important market indices.(May 2010) [Also Refer Class Register for its practical part]

Stock Market Index is representative of the entire stock market. Movements of the index represent the average returns obtained by investors in the stock market.A market Index acts as a barometer for market behavior.

How is the index calculated : A share price Index is used to monitor and measure the share price movements over a period of time as compared to the base year. Share market indexes (also called as indices) are meant to capture the overall behavior of equity markets. A stock market index is created by selecting a group of stocks that are representative of the whole market or a specified sector. An Index is calculated with reference to a base period and a base index value.
Index calculation is based on the weighted aggregate method . The appropriate formula is :

$$\frac{\text{Today's Market Capitalisation}}{\text{Yesterday's Market Capitalisation}} \times \text{Yesterday's Index Point}$$

Example : If the market capitalization of 10 securities (considered to be the index) as at the beginning of 01.04.2008 amount to Rs. 5 crores is taken as base and equated to 100 and at day end market capitalization amounts to Rs. 5.50 crores, then the index at the end of 01.04.2008 will be 110 .

i.e $$\text{Opening Index} \times \frac{\text{Closing Market Capitalization}}{\text{Opening Market Capitalization}} = 100 \times \frac{5.50}{5.00} = 110$$

If at the end 02.04.2008 , the market capitalization is Rs. 6.30 crores , then the index value would be 126.

$$\text{Opening Index} \times \frac{\text{Closing Market Capitalization}}{\text{Opening Market Capitalization}} = 110 \times \frac{6.30}{5.50} = 126$$

Two important market indices
Sensex and Nifty are two important share indices in India.
Sensex is an index number that measures the relative average change in prices of 30 shares listed in the Bombay Stock Exchange Ltd (BSE). . The base year of SENSEX is 1978-79 and the base value is 100.. It is calculated on a free-float market capitalization methodology.
Nifty tracks the performance of equity share of 50 important companies listed on NSE. The base of the index is the close of prices on November 3, 1995. The base value of the index has been set at 1000.. It is also calculated on a free-float market capitalization methodology.

QUESTION NO. 67 Highlight the importance of due diligence in M&A ?

➦In the past, various authors have emphasized the importance of due diligence in M&A. The concept of due diligence has many dimensions such as:Due diligence is research, its purpose in M&A is to support the valuation process, arm negotiators, test the accuracy of representations and warranties contained in the merger agreement, fulfill disclosure requirements to investors, and inform the planners of post-merger integration.
➦It is the opposite of negligence.Weaknesses in the due diligence process may cause an M&A to fail.

➦A due diligence process should focus at least on the following issues:
(i) Legal issues: These include examining documents of asset ownership and associated liabilities; and whether the target company is in compliance with government regulations.
(ii) Financial and tax issues: These include examining accounting records and reports to determine whether the target companies are in compliance with generally accepted accounting principles. In addition, the target company's compliance with tax laws and regulations should be examined.
(iii)Marketing issues: These include strengths and weaknesses of products and services provided by the target company and their domestic and foreign competition.
(iv)Cross-border issues: These include foreign currency exchange risks, foreign laws and regulations, investment promotional agency and investment incentives, foreign banking and credit agencies, accounting principles, and local tax rules.
(v)Cultural and ethical issues: These cover cultural differences between the acquirer and target companies and how to deal with these differences; the degree of compliance with the acquirer's ethical guidelines; and the exposure to liabilities and legal proceedings on unethical conduct such as patent and copyright violations, price fixing and others.

QUESTION NO. 68 What are the various types of Foreign Exchange Risk ?

There are several types of risk that an investor should consider and pay careful attention to. Deciding the potential return while respecting risk is the age-old decision that investors must make.
1.Financial Risk: It is the potential loss or danger due to the uncertainty in movement of foreign exchange rates, interest rates, credit quality, liquidity position, investment price,commodity price, or equity price, as well as the unpredictability of sales price, growth, and financing capabilities. Balance sheet and cash flow hedges as well as derivatives tools mitigate financial risks by reducing uncertainty faced by firms.
2.Business Risk: On a micro scale, business risk involves the variability in earnings due to variation in the cash inflows and outflows of capital investment projects undertaken. This risk, also known as investment risk, may materialize because of forecasting errors made in market acceptance of products, future technological changes,and changes in costs related to projects. The firm can reduce this risk, also referred to as portfolio risk, by seeking out capital projects and merger candidates that have a low or negative correlation with its present operations.
3.Credit or Default Risk: This is the risk that a company or individual will be unable to pay the contractual interest or principal on its debt obligations. This type of risk is of particular concern to investors who hold bonds within their portfolio. Government bonds have the least amount of default risk and least amount of returns while corporate bonds tend to have the highest amount of default risk but also the higher interest rates. Bonds with lower chances of default are considered to be "investment grade," and bonds with higher chances of default are considered to be junk bonds.
4.Country Risk: This refers to the risk that a country would not be able to honour its financial commitments. When a country defaults it can harm the performance of all other financial instruments in that country as well as other countries it has relations with.Country risk applies to stocks, bonds, mutual funds, options and futures that are issued within a particular country. This type of risk is most often seen in emerging markets or countries that have a severe deficit.
5.Interest Rate Risk: It refers to the change in the interest rates. A rise in interest rates during the term of an investor's debt security hurts the performance of stocks and bonds.
6.Political Risk: This represents the financial risk that a country's government will suddenly change its policies.
7.Market Risk: It is the day-to-day fluctuations in a stocks price. Also referred to as volatility. Market risk applies mainly to stocks and options. As a whole, stocks tend to perform well during a bull market and poorly during a bear market.
8.Foreign Exchange Risk: When investing in foreign countries one must consider the fact that currency exchange rate can change the price of the asset as well. Foreign exchange risk applies to all financial instruments that are in a currency other than your domestic currency. As an example, if you are a resident of America and invest in some Canadian stock in Canadian dollars, even if the share value appreciates, you may lose money if the Canadian dollar depreciates in relation to the American dollar.

QUESTION NO. 69 Write a short note on Netting ?[Also Refer Class Register for its practical part]

➦**Meaning : Exposure Netting** refers to offsetting exposures in one currency with Exposures in the same or another currency, where exchange rates are expected to move in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure.

➦**Objective :**The objective of the exercise is to offset the likely loss in one exposure by likely gain in another.

➦It is a technique of optimising cash flow movements with the combined efforts of the subsidiaries thereby reducing administrative and transaction costs resulting from currency conversion.

➦There is a co-ordinated international interchange of materials, finished products and parts among the different units of MNC with many subsidiaries buying /selling from/to each other. Netting helps in minimising the total volume of inter-company fund flow.

➦Advantages derived from netting system includes :

(1) Reduces the number of cross-border transactions between subsidiaries thereby decreasing the overall administrative costs of such cash transfers

(2) Reduces the need for foreign exchange conversion and hence decreases transaction costs associated with foreign exchange conversion.

(3) Improves cash flow forecasting since net cash transfers are made at the end of each period

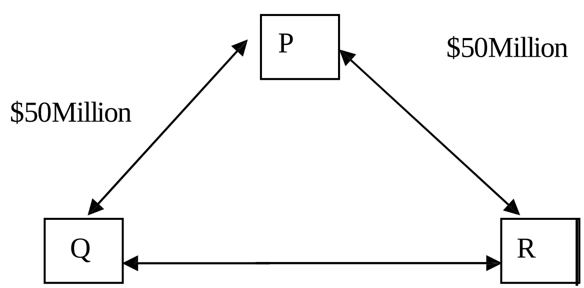
(4) Gives an accurate report and settles accounts through co-ordinated efforts among all subsidiaries

➦There are two types of Netting :

(1) Bilateral Netting System – It involves transactions between the parent and a subsidiary or between two subsidiaries. If subsidiary X purchases $ 20 million worth of goods from subsidiary Y and subsidiary Y in turn buy $ 30 million worth of goods from subsidiary X, then the combined flows add up to $ 50 million. But in a bilateral netting system subsidiary X would pay subsidiary Y only $10 million. Thus bilateral netting reduces the number of foreign exchange transactions and also the costs associated with foreign exchange conversion. A more complex situation arises among the parent firm and several subsidiaries paving the way to multinational netting system.

(2) Multilateral Netting System – Each affiliate nets all its inter affiliate receipts against all its disbursements. It transfers or receives the balance on the position of it being a net receiver or a payer thereby resulting in savings in transfer / exchange costs. For an effective multilateral netting system, these should be a centralised communication system along with disciplined subsidiaries. This type of system calls for the consolidation of information and net cash flow positions for each pair of subsidiaries.

Subsidiary P sells $ 50 million worth of goods to Subsidiary Q, Subsidiary Q sells $ 50 million worth of goods to Subsidiary R and Subsidiary R sells $ 50 million worth of goods to Subsidiary P. Through multilateral netting inter affiliate fund transfers are completely eliminated.



➦**Example** : The netting system uses a matrix of receivables and payables to determine the net receipt / net payment position of each affiliate at the date of clearing. A US parent company has subsidiaries in France, Germany, UK and Italy. The amounts due to and from the affiliates is converted into a common currency viz. US dollar and entered in the following matrix.

Inter Subsidiary Payments Matrix (US $ Thousands)

Receiving affiliate			**Paying affiliate**		
	France	**Germany**	**UK**	**Italy**	**Total**
France	—	40	60	100	200
Germany	60	—	40	80	180
UK	80	60	—	70	210
Italy	100	30	60	—	190
Total	240	130	160	250	**780**

Without netting, the total payments are $ 780 Thousands. Through multinational netting these transfers will be reduced to $ 100 Thousands, a net reduction of 87%. Also currency conversion costs are significantly reduced. The transformed matrix after consolidation and net payments in both directions convert all figures to US dollar equivalents to the below form :

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Netting Schedule (US $ Thousands)

	Receipt	Payment	Net Receipt	Net Payments
France	200	240	—	40
Germany	180	130	50	—
UK	210	160	50	—
Italy	190	250	—	60
			100	**100**

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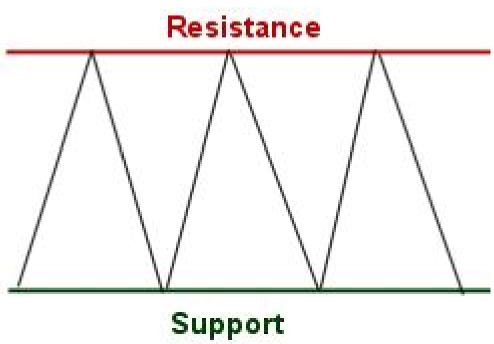
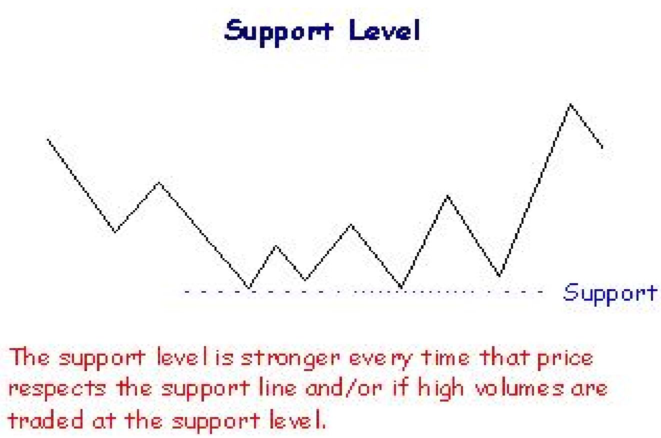
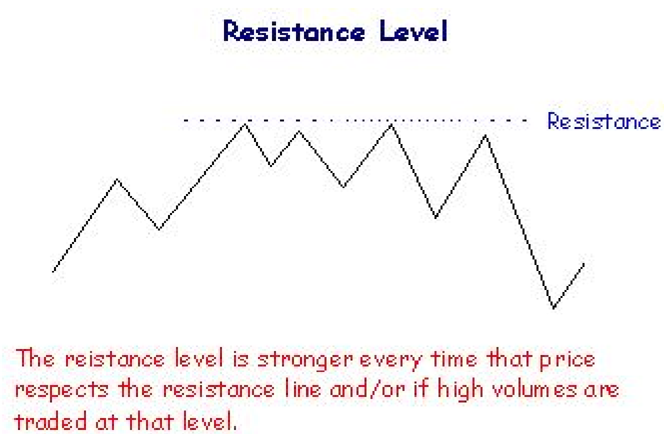
<u>QUESTION NO. 70</u> Write a short note on Support and Resistance Levels ?

➦Support and resistance is one of the most widely used concepts in trading.
➦When the index/price goes down from a peak, the peak becomes the resistance level.Resistance levels act like a ceiling for the price of a stock. As the price rises up to a resistance level, it tends to stop, turn around and move lower.
➦When the index/price rebounds after reaching a trough subsequently, the lowest value reached becomes the support level.Support levels are based on past pricing and act like a floor for the price of stock. As the price of a stock drops down to a support level it tends to stop at that point, turn around and move higher. ➦The price is then expected to move between these two levels.
➦Whenever the price approaches the resistance level, there is a selling pressure because all investors who failed to sell at the high would be keen to liquidate, while whenever the price approaches the support level, there is a buying pressure as all those investors who failed to buy at the lowest price would like to purchase the share.
➦Support levels indicate the price where the most of investors believe that prices will move higher. Resistance levels indicate the price at which the most of investors feel prices will move lower.
➦A breach of these levels indicates a distinct departure from status quo, and an attempt to set newer levels.When a resistance level is successfully broken through, that level becomes a support level. Similarly, when a support level is successfully broken through, that level becomes a resistance level.➦Support and resistance levels can be identified by <u>trend lines</u>







QUESTION NO. 71 Write a short note on Commodity Swaps ?

➦**Meaning**: A swap where exchanged cash flows are dependent on the price of an underlying commodity. This is usually used to hedge against the price of a commodity. The vast majority of commodity swaps involve oil.Commodity swaps are used to lock-in the price of a commodity.Commodity swaps are becoming increasingly common in the energy and agricultural industries, where demand and supply are both subject to considerable uncertainty.It is a swap in which at least one set of payments is based on the price of a commodity, such as oil.

➦**Types Of Commodity Swaps :**There are two types of commodity swaps: fixed-floating or commodity-for-interest.

(a) Fixed-Floating Swaps: They are just like the fixed-floating swaps in the interest rate swap market with the exception that both indices are commodity based indices.General market indices in the international commodities market with which many people would be familiar include the Goldman Sachs Commodities Index (GSCI) and the Commodities Research Board Index (CRB). These two indices place different weights on the various commodities so they will be used according to the swap agent's requirements.

(b) Commodity-for-Interest Swaps: are similar to the equity swap in which a total return on the commodity in question is exchanged for some money market rate (plus or minus a spread).

➦**Valuing Commodity Swaps :**In pricing commodity swaps, we can think of the swap as a strip of forwards, each priced at inception with zero market value (in a present value sense).Thinking of a swap as a strip of at-the-money forwards is also a useful intuitive way of interpreting interest rate swaps or equity swaps.

➦Commodity swaps are characterized by some distinctive peculiarities, though.These include the following factors for which we must account (at a minimum):

(i) The cost of hedging
(ii) The institutional structure of the particular commodity market in question
(iii) The liquidity of the underlying commodity market
(iv) Seasonality and its effects on the underlying commodity market
(v) The variability of the futures bid/offer spread
(vi) Brokerage fees
(vii) Credit risk, capital costs and administrative costs.

QUESTION NO. 72 Write a short note on Asset Allocation Strategies ?

Many portfolios containing equities also contain other asset categories, so the management factors are not limited to equities. There are four asset allocation strategies :

(a) Integrated Asset Allocation : Under this strategy, capital market conditions and investor objectives and constraints are examined and the allocation that best serves the investor's needs while incorporating the capital market forecast is determined.

(b) Strategic Asset Allocation : Under this strategy, optimal portfolio mixes based on returns, risk, and co-variances is generated using historical information and adjusted periodically to restore target allocation within the context of the investor's objectives and constraints.

(c) Tactical Asset Allocation : Under this strategy, investor's risk tolerance is assumed constant and the asset allocation is changed based on expectations about capital market conditions.

(d) Insured Asset Allocation : Under this strategy, risk exposure for changing portfolio values (wealth) is adjusted; more value means more ability to take risk.

QUESTION NO. 73 What are the complexities involved in International Capital Budgeting ?

Complexities Involved in International Capital Budgeting :

(a) Cash flows from foreign projects have to be converted into the currency of the parent organization.
(b) Parent cash flows are quite different from project cash flows
(c) Profits remitted to the parent firm are subject to tax in the home country as well as the host country
(d) Effect of foreign exchange risk on the parent firm's cash flow
(e) Changes in rates of inflation causing a shift in the competitive environment and thereby affecting cash flows over a specific

time period
(f) Restrictions imposed on cash flow distribution generated from foreign projects by the host country
(g) Initial investment in the host country to benefit from the release of blocked funds
(h) Political risk in the form of changed political events reduce the possibility of expected cash flows
(i) Concessions/benefits provided by the host country ensures the upsurge in the profitability position of the foreign project
(j) Estimation of the terminal value in multinational capital budgeting is difficult since the buyers in the parent company have divergent views on acquisition of the project.

QUESTION NO. 74 What are the complexities involved in International Working Capital?

Complexities Involved in International Working Capital : The management of working capital in an international firm is very much complex as compared to a domestic one. The reasons for such complexity are:
(1) A multinational firm has a wider option for financing its current assets. Host country funds can be used if needed. Funds flow from different units of the same firm. Approach is made from the international financial market. However, domestic firms find it difficult to avail such funds.
(2) Interest and tax rates vary from one country to the other. A manager associated with a multinational firm has to consider the interest/ tax rate differentials while financing current assets. This is not the case for domestic firms.
(3) A multinational firm is confronted with foreign exchange risk due to the value of inflow/outflow of funds as well as the value of import/export are influenced by exchange rate variations. Restrictions imposed by the home or host country government towards movement of cash and inventory on account of political considerations affect the growth of MNCs. Domestic firm limit their operations within the country and does not face such problems.
(4) With limited knowledge of the politico-economic conditions prevailing in different host countries, a multinational manager often finds it difficult to manage working capital of different units of the firm operating in these countries. The pace of development taking place in the communication system has to some extent eased this problem but it is still there very much.
(5) Intra flow of funds is available with multinational firms as cash positioning and cash mobilization, an important aspect of international working capital management becomes easier to handle. This is not possible for domestic firms.
A study of International Working Capital Management requires knowledge of Multinational Cash Management, International Inventory Management and International Receivables Management.

QUESTION NO. 75 Write a short note on Leading And Lagging ?

➦This technique is used by subsidiaries for optimizing cash flow movements by adjusting the timing of payments to determine expectations about future currency movements.
➦ MNCs accelerate (lead) or delay (lag) the timing of foreign currency payments through adjustment of the credit terms extended by one unit to another.
➦The technique helps to reduce foreign exchange exposure or to increase available working capital.
➦Firms accelerate payments of hard currency payables and delay payments of soft currency payables in order to reduce foreign exchange exposure.
➦A MNC in the USA has subsidiaries all over the world. A subsidiary in India purchases its supplies from another subsidiary in Japan. If the Indian subsidiary expects the rupee to fall against the yen, then it shall be the objective of that firm to accelerate the timing of its payment before the rupee depreciates. Such a strategy is called Leading. On the other hand, if the Indian subsidiary expects the rupee to rise against the yen then it shall be the objective of that firm to delay the timing of its payment before the rupee appreciates. Such a strategy is called Lagging. MNCs should be aware of the government restrictions in such countries before availing of such strategies.
➦The advantages associated with Leading and Lagging are :
(1) No formal recognition of indebtedness is required and the credit terms can be altered by increase / decrease of the terms on the accounts.
(2) It helps in minimizing foreign exchange exposure and helps in transferring liquidity among affiliates by changing credit terms and is dependent on the opportunity cost of funds to both paying and receiving units.
(3) It is an aggressive technique aimed at taking advantage of expected revaluations and devaluations of currency movements.

Positive Feedback About The Theory Books And Classes

[mafabycaaadityajain] hello friends
Friday, 10 April, 2009 5:46 PM
From: "Sweta Kothari" <swetakothari@ymail.com>
To: mafabycaaadityajain@yahoogroups.com
I stay in Kolkata..I am appearing my CA finals in this June.. I have previously taken tutions for MAFA from a teacher..
Though he was good but i was always scared of MAFA..By taking classes by Aditya Jain Sir, now i am feeling very good & comfortable in MAFA even though i am not his regular student..He makes us understand the concepts in a very easy manner.. I just want to thank sir for removing my fear for MAFA..Before taking classes from sir i just used to target 45-50 in MAFA.. But now i am targeting much more..
Thank you sir.. Thank you so much.. Regards.. Sweta Kothari Kolkata

THANKS FOR YOUR THEORY BOOK
Wednesday, 25 February, 2009 8:49 PM
From: "Priyanka Agarwal" <priyans26186@gmail.com>
To: ca_kumaraaditya@yahoo.co.in
This is Priyanka Agarwal from Kolkata.I have purchased ur theory book from Jayesh Sir and is extremely benefitted by it.Now I regret that
why havenot I joined u.Actually when I did my MAFA classes I even didnot know your name.Your theory book is just marvellous.No doubt I am getting immense knowledge from it but one more thing is there which I got from your book.The Confidence,most important thing for gaining courage and facing the exams.I would definitely ask all my friends to join your classes.I have heard that your classes are really awesome.I would like to request you that please give some of your valuable suggestions to me for passing the exams in all the subjects. A very heartful thanks to you for publishing such a nice book.

Monday, 8 June, 2009 3:28 PM
From: "Rajeev Nagpal" <rajeev@investbank.ae>
To: ca_kumaraaditya@yahoo.co.in
Hello Aditya Sir,
I came across your book and I must complement you on writing an excellent book. I have never seen such a simple and excellent presentation of any subject by any one. I am badly stuck up in Group-I of C.A. (Final). I wish I could get your complete notes. I am sure it will prove to be extremely helpful.
Regards,Rajeev Nagpal,Assistant Financial Controller,Head Office Finance Control Department,Invest Bank,Sharjah,U.A.E.
Tel : 06- 5694440 Ext. 350;Mob : 050-4996818;Fax :06-5681174

Wednesday, June 3, 2009 12:20 PM
From: "Ashish Singla" <ashishsinglaca@gmail.com>
To: cafinalmafa@yahoo.com
Dear Mr. Aditya Jain,
I owe it to you, that today, I can heave a sigh of relief after my MAFA Exam. I happened to read only your Suggested Compilation for June 2009 exam during my revision time. And, Im not regretting it one bit. I dont know how you did it, but so many questions came from your compilation (Which was obviously advantageous to me). Thanks a lot for putting in such a diligent effort to compile the same.
Regards, Ashish
P.S - I think there is not much chance that this mail shall come before your eyes because Im sending to a general id of yours BUT I believe youve made me one of your die hard word of mouth advertisers.

Abhishek Jakhetiya
CA Final-Roll No. 26804 MAFA Marks-74
CS Inter-Roll No.17926 Securities Market Paper-70 Marks
DOB: 12th September 1985
Email: ca.abhishekj@yahoo.com
Addres: H.N 1391, Sector-4, Gurgaon-122001
Exam Completion in CA : May 2008
Comments on your Classes: Finally Delhi has got some good MAFA classes as well. Aaditya Jain Sir has not only made us fearless but also made us think of MAFA as a high scoring paper just as Accounts or Indirect Taxes.Your Study material is fantastic . Thankyou

STARS OF Aaditya Jain's FM Class

Congratulating Surbhi Agarwal For Securing All India Rank 1 In CA Final -Nov 2008 Exam

A Student Of Aditya Jain Sir

From the Desk Of Surbhi Agarwal-All India Rank 1

I am excited and feeling great today…I must say that hard work and dedication is the path to success.. I take this opportunity to thank my family, friends and of course my Teachers whose guidance and support has always been with me.. "I suggest the students to study the subjects not with the intention to mug up things but to gain knowledge. Given that we have eight subjects you cannot cram all of them so the best way out is to understand, comprehend and revise it again and again so that it settles deep into your sub-conscious mind."I will further like to thank Aditya Sir to make my MAFA conceptually clear.Finally Delhi has got a good FM teacher.His notes are really excellent and updated .

-Surbhi Aggarwal,Rank Holder in PE-1,PE-2 and Final

Also Congratulating *Amar Nilange* Roll No. 01059 for scoring 87 Marks in May 08 in MAFA One of All India Highest a student of **Aaditya Jain**

Abhishek Kapuria

Securing All India Rank 1 in ICFAI - MBA with 85 Marks in FM Subject an all India Highest

Anjana Gupta

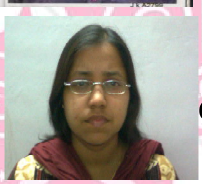
CA Final-Roll No. 26804, MAFA Mks-85 in Nov2008 One Of All India Highest

Abhishek Jakhetiya : **CA Final-Roll No. 26804 MAFA Marks-74 & CS Inter-Roll No.17926 Securities Market Paper-70 Marks Rank 36**

Sourav Goenka **:80 Mks in MAFA in May2008 Roll No. 26120 with All India 16th Rank**

Sunny Jain-All India 27th Rank in CA-PEII Nov 08 Roll No. 23298 with 70 Marks in Cost-FM

Shivangi Patil -All India 10th Rank in CA-PCC Roll No.62937 with 92 Marks in Cost-FM.Also Scored Rank 1 in PE-1 Roll No. 10415.Also completed CA Final MAFA from Aaditya Sir.Final Attempt May10



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Dimpy Jindal All India 1st Rank in CA-PCC & All India 7th Rank in CA-CPT taking MAFA Classes From Aaditya Sir

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Archana Jhunjhunwala

cleared her CA After 15 years of enrollment due to high score of
71 Marks In MAFA *Roll No.40251*

The Power Of Determination



From The Desk Of Archana Jhunjhunwala...

I finally cleared my CA in Nov 2009 Exam scoring 71 Marks in MAFA.For me MAFA was always a nightmare.My first CA Final Attempt was due in May2000 which i was unable to clear due to MAFA.Then i got married but i always wanted to become CA.However MAFA was still a nightmare for me.I was unable to recover from that.My husband supported me a lot and arranged lots of Books and Notes relating to MAFA.But I was not confident.Finally i heard about Aaditya Sir and joined him in June 2009.After taking classes from Sir ,the most important thing which i got is the Confidence to crack the paper.He made Mafa very simple with his unique Concept Question Approach.His main strength is his simplified notes,extensive coverage,giving proper balance to both Concept & question,examination oriented.By taking classes I developed a special interest in Finance.The subject which was once a nightmare for me became my strength.Now just because of MAFA I am a CA.This is like a Dream come true.I dedicated this success to my husband,my children and to one and only Aaditya Sir. Thank you sir from the bottom of my heart.

From The Desk Of Aaditya Sir

There will be many times when you will want to quit, give up, and go back to doing something else, but the one quality that will guarantee your success is the willingness to stick with it, to see it through to the end -- to refuse to settle for anything less than your dream. The longer you hang in there, the greater the chance that something will happen in your favor. No matter how hard it seems, the longer you persist, the more likely your success will be.

More than 4000 years ago in China, Confucius wrote: "Our greatest glory is not in never falling, but in rising every time we fall."
Always be solution-oriented in your thinking
"We all have dreams. But in order to make dreams come into reality, it takes an awful lot of determination, dedication, self-discipline, and effort."
--Aaditya Jain

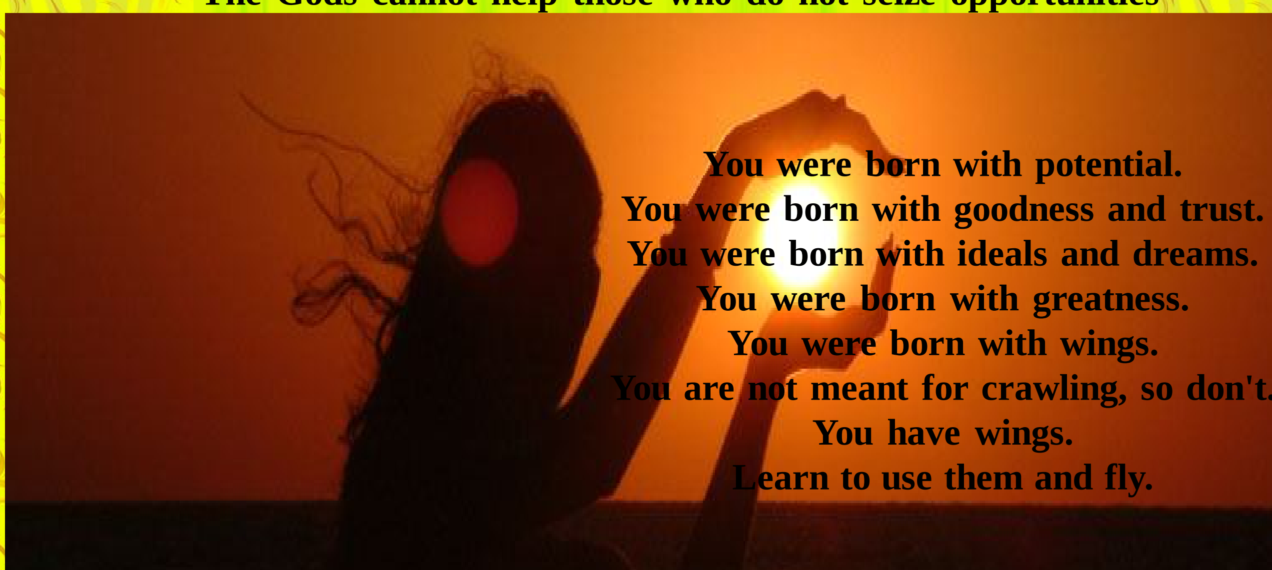
CAs are on High Demand................Are You Ready

Its Time To Fullfill Your and Your Parents's Dream

Highest pay offer at ICAI up 3-fold

The best offer so far at the Institute of Chartered Accountants of India (ICAI) has been from Olam International to six students, whose annual salaries will be more than Rs 70 lakh each. Compared to this, the maximum salary offered to the new ICAI recruits in 2009 was an annual package of Rs 23 lakh offered by Tolaram Group. BS REPORTER

A second ago is gone, and a second from now might be. Now is all you've got. Go for it!
Your big opportunity may be right where you are now.
In the middle of every difficulty lies opportunity.
"The Gods cannot help those who do not seize opportunities"



Don't be afraid of opposition.
Remember that a kite rises against - not with - the wind.
Imagination is the highest kite that one can fly.
Live to Fly

" I would like to sign off with a prayer to the Almighty-"God! Give me the courage to do whatever is possible,serenity to know what is not possible and the wisdom to know the difference"