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For Students Appearing On May 2010, Nov 2010 & May 2011

Presented By

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“It’s Time To Be Busy BECAUSE Today Will Be Yesterday Very Soon ”

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 : $\text{Sensitivity (\%)} = \frac{\text{Change}}{\text{Base}} \times 100$

➔ **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

" Don't be upset or disappointed about something that happened; just think, will it really matter 10 years from now?"

" If you want to WIN; think that there is no TOMORROW. If you LOSE; think that there is a TOMORROW."

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 transaction.

(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.

➤ **Example :** 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. For example

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

" Always follow your dreams, and never let the flame in your heart burn out. The day you're born is the day you start to die, so make every day count. Every new day bring new light and hope."

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).

➔ **Benefits of Rolling Settlement** : (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

➔ **International Scenario** : 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.

QUESTION NO. 5 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 Lintner in 1960. The model explains 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 describes how securities are priced in the market place.

➔ **Assumption Of CAPM** : The CAPM is based on following eight assumptions :

(i) **Efficient Market** : 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) **Rational Investment Goals** : 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.

➔ **Security Market Line** : A graphical representation of CAPM is the Security Market Line, (SML).

➔ **Advantages of CAPM** : The advantages of CAPM can be listed as:

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

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

➔ **Limitations of CAPM**

(a) **Reliability of Beta** : 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) **Other Risks** : By emphasizing only on systematic risk it ignores unsystematic risks. Unsystematic Risks are also important to share holders who do not possess a diversified portfolio.

(c) **Information Available** : 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.

QUESTION NO. 6 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.

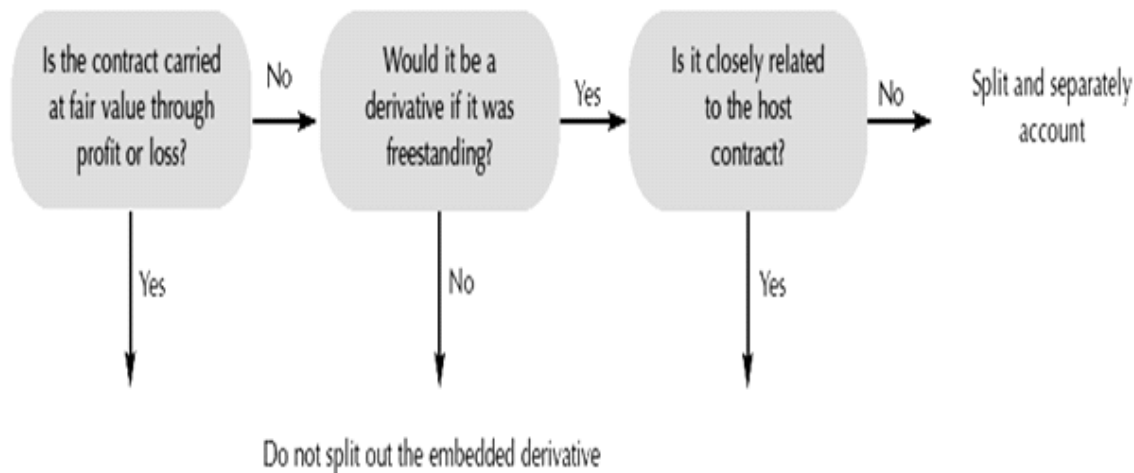
➔ **How They Arise** : An embedded derivative can arise from deliberate financial engineering and intentional shifting of certain risks between parties. Many embedded derivatives, however, arise inadvertently through market practices and common contracting arrangements. Even purchase and sale contracts that qualify for executory contract treatment may contain embedded derivatives.

“Let others lead small lives, but not you. Let others argue over small things, but not you. Let others cry over small hurts, but not you. Let others leave their future in someone else’s hands, but not you.” –Jim Rohn

➔ **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:

- (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

Equity conversion or 'put' option in debt instrument
 Fixed-rate debt extension option
 Debt security with interest or principal linked to commodity or equity prices
 Credit derivatives embedded in the host debt instrument
 Sale or purchase not in
 (1) measurement currency of either party
 (2) currency in which products are routinely denominated in

Closely Related

Interest-rate swap embedded in a debt instrument
 Inflation-indexed lease contracts
 Cap and floor in a sale and purchase contracts
 Prepayment option in the mortgage where the option's exercise price is approximately equal to the mortgage's amortised cost on each exercise date
 A forward foreign exchange contract that results in payments

" To be where you've never been before, You have to do what you've never done before."

It is not because things are difficult that we do not dare, it is because we do not dare that things are difficult.

international commerce, or
(3) currency commonly used in economic environment in which the transaction takes place.

in either party's reporting currency
Dual currency bonds
Foreign currency denominated debt

QUESTION NO. 7 Write a short note on Systematic and Unsystematic Risk?(May 1999)

$$\text{Total Risk} = \text{Systematic Risk} + \text{Unsystematic Risk}$$

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.

Systematic Risk or Non-Diversifiable Risk or Market Risk

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

Unsystematic Risk or Diversifiable Risk or Specific Risk

- This risk affects only a particular security / company .
- They can be controlled by the management of entity.
- Example : 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 Diversifiable Risk as they can be eliminated through Diversification.

QUESTION NO. 8 Write a short note on Limitations Of Credit Rating ?**(SFM Nov 2009)**

- (1) **Rating Changes** – 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) **Industry Specific rather than Company Specific** – 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) **Cost Benefit Analysis** – 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) **Conflict of Interest** – 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) **Corporate Governance Issues** – 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.

QUESTION NO. 9 Write a short note on Depository Services ?

➤ 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**

- (1) Actual Delivery of Share is to be exchanged
- (2) Open Delivery can be kept
- (3) Processing time is long
- (4) Stamp Charges @ 0.5%(approx) are levied for transfer

Dematerialised

- (1) No Actual Delivery of shares is needed
- (2) Not possible to keep delivery open
- (3) Processing time is less
- (4) No Stamp Charges are required for transfer

When God takes away something from your hands , dont think that he is punishing you . He is just leaving you empty handed to receive something better.Think of it.

- (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. (6) No need to send the document to the company for Registration.

➔ **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 expedited 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.

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. This is already seen from excellent returns, Mutual Funds have provided in the last few years.
- (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.

Don't fear failure so much that you refuse to try new things. The saddest summary of a life contains three descriptions: could have, might have, and should have.

(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

QUESTION NO. 12 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. Capital market lag behind the total value of transaction done in money 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 trading is Rs. 6000 crores around

(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

The participants in capital market are

What is "Faith" ? Once all the people of a village decided to pray for rain and assembled in a temple. On the day of prayer all the people gathered but only one boy came with umbrella. That's Faith .

and Government .

- (viii) Liquidity The important features of money market instrument is that it is liquid.
- (viii) Regulator It is regulated by the guidelines of RBI

general investors, brokers, merchant bankers, registrars to issue, underwriters, corporate investors, FIs & Bankers. Whereas Capital market are not as liquid as money market instrument. It is regulated by the guidelines of SEBI.

QUESTION NO. 13 Write a short note on Impact of GDRs on Indian Capital Market (SFM, Nov 2009)

Since the inception of GDRs a remarkable change in Indian capital market has been observed as follows.

- (i) Indian stock market to some extent is shifting from Bombay to Luxemburg.
 - (ii) There is arbitrage possibility in GDR issues.
 - (iii) Indian stock 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-world wide economic events.
 - (iv) Indian retail investors are completely sidelined. By placement of GDRs to Foreign Institutional Investors' plus free pricing implies that retail investors can no longer expect to make easy money on heavily discounted rights/public issues.
- As a result of introduction of GDRs a considerable foreign investment has flown into India.

QUESTION NO. 14 Write a short note on ARBITRAGE (SFM Nov 2008)

➤ **Meaning :** 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.

➤ **For instance,** 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.

➤ **Types of Arbitrage**

- (i) **Geographical/Space Arbitrage** - It occurs when one currency sells for two prices in two different markets.
- (ii) **Cross - Rate Arbitrage** - 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) **Time Arbitrage** - In time arbitrage, an investor may gain by executing a spot and forward deal to buy and sell a currency.

QUESTION NO. 15 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.

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

➤ Restructuring from a **financial viewpoint** involves renegotiating payment terms on debt obligations, issuing new debt, and restructuring payables to vendors.

➤ From an **organizational viewpoint**, 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

Never blame a day in your life. Good days give you " Happiness ". Bad days give you Experience .Both are essential in life. Start everyday with a smile.

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 need 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 measure will lead to better financial liquidity.

➤ 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.16 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 byproducts 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

Memories play a very confusing role...They make you laugh when u remember the time u cried. But make you cry when you remember the time u laughed

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	<u>2.00</u>
	<u>20.00</u>

Financial Plan - Rs. (lakhs)

(1) Equity Shares	5.00
(2) Retained Earnings	5.00
(3) Term Loans	<u>10.00</u>
	<u>20.00</u>

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:

Year	Projected Profitability and Cash Flow Statement			Rs. (Lakhs)
	<u>Profit after Tax</u>	<u>Depreciation</u>	<u>Cash Flow</u>	
1	8.00	1.50	9.50	
2	5.00	1.50	6.50	
3	5.00	1.50	6.50	
4	5.00	1.50	6.50	
5	5.00	1.50	6.50	
6	5.00	1.50	6.50	
7	4.00	1.50	5.50	
8	4.00	1.50	5.50	
9	4.00	1.50	5.50	
10	5.00	1.50	6.50	
Total	50.00	15.00	65.00	

The cash flow of Rs.65 (lakhs) when discounted at the company's cost of capital rate gives net cash flow of Rs.30 (lakhs) in Present Value terms. Hence net present value of Rs.10 (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)
-------	--------------------------

The corporate world is highly competitive. As an ordinary employee with nothing new or exceptional to offer, you can easily get lost in the crowd. However a CA with special knowledge of Finance could open new doors of opportunity.

1	-
2	2
3	2
4	2
5	2
6	2
Total	10

Dated

S/d
Chief Finance Officer**QUESTION NO.17 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.

➔ UNIDO advocates aggregate consumption as unit of measurement. OED advocates, on the other hand, use of uncommitted social income in the hands of the government as yardstick of measurement since consumption has both time dimension (present/future) and distributional dimension (consumption by group/region of the country).

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. 18 Write a short note on Book Building ?

Be a life long student. The more you learn, the more you earn and more self confidence you will have. - Brian Tracy
"Teachers open the door, but you must enter by yourself"

➤ 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.

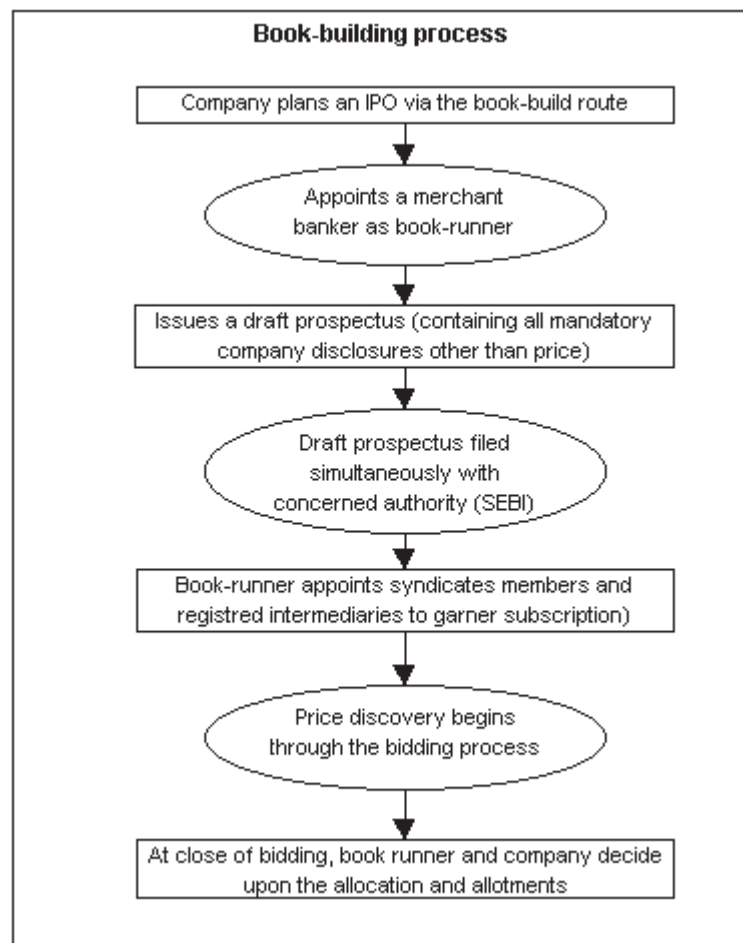
➤ Book building is a process used for marketing a public offer of equity shares of a company and is a common practice in most developed countries.

➤ 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 Initial 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. 19 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.

➡ 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) **Settlement risk:** 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) **Market risk:** 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) **Liquidity risk:** 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) **Market liquidity risk:** 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).

(ii) **Funding liquidity risk:** It is the potential inability of the institution to meet funding requirements, because of cash flow

This goes out especially to people who don't work hard enough to make their dreams come true and blame their fate for their failure. I want to motivate you to put forward one hundred percent for achieving success in life.

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) Operational risk: 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) Legal risk: 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) Regulatory risk: Regulatory risk is the risk of loss arising from failure to comply with regulatory or legal requirements.

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

QUESTION NO.20 What are the major advantages & disadvantages of Futures Trading as compared to Stock Trading ?

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

(i) Leverage: 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) Ease of Shorting: 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) Flexibility: 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) Risk: In a stock future contract, there is the risk of losing significantly more than the initial investment (margin deposit).

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

(iii) Required Vigilance: 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.

QUESTION NO. 21: 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

"Where the willingness is great, the difficulties cannot be great"

I think success has no rules, but you can learn a lot from failure.

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 exercised GSO for its issue. This offer initially involved 5.22 million depository shares, representing 2.61 million domestic equity shares.

QUESTION NO. 22 Explain the concept of interest rate swap by giving appropriate examples.

Notes On IRS

➤ **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 interest 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:

	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 :

Do not count what you have lost. Just see what you have now because past never comes back but sometimes future can give us back our lost things.

AAA:	LIBOR + .50
BBB:	11%
Total (A)	<u>LIBOR + 11.50%</u>

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	<u>LIBOR + .75</u>
Total (B)	<u>LIBOR + 10.75%</u>

Saving on Interest Cost : $A - B = (\text{LIBOR} + 11.50\%) - (\text{LIBOR} + 10.75\%) = .75$

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 : $(\text{LIBOR} + .50) - .25 = \text{LIBOR} + .25$ **For BBB** : $11\% - .25 = 10.75\%$

QUESTION NO. 23 What is the Dow Jones Theory to Portfolio Management?

➤ 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).

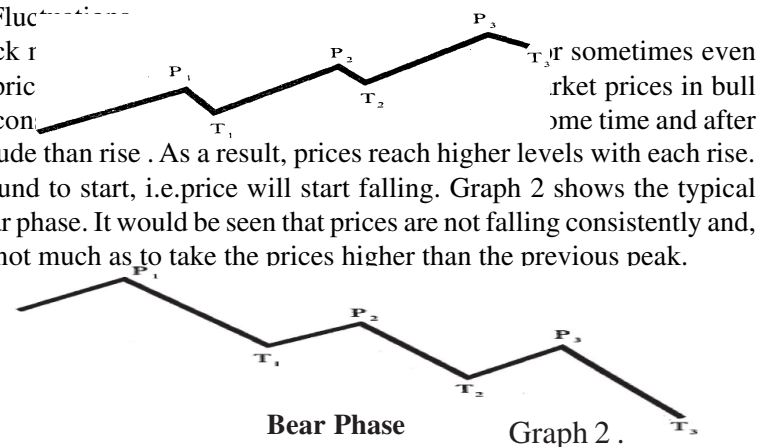
➤ The Dow Theory's purpose is to determine where the market is and where it is going.

➤ 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. During a bull phase, the basic trend is that of rise in price. As can be seen from the graph that prices do not rise continuously. 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 is 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.



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.

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.

No Dreamer is ever too small and no Dream is ever too big. The future belongs to those who Dare to Dream and are ready to work for it

➔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. 24 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.

➔Repos/Reverse Repos are used :

(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 simultaneously (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.

➔Coupon/Interest terms :

(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 a transaction is a Repo for one party and a Reverse Repo for the other party.

QUESTION NO. 25 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.

"Always follow your dreams,& never let the flame in your heart burn out.The day you're born is the day you start to die,so make every day count.Every new day bring new light & hope"

➔ 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. 26 What is the difference between Futures & Forward Contracts ?

Distinction between Futures and Forward Contracts

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

<u>Feature</u>	<u>Forward Contract</u>	<u>Futures Contract</u>
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.

Beautiful pictures are developed by negatives in a dark room so if you see darkness in ur life assume that God is making a beautiful picture for you.

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. 27 What 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 business unit of a company. After the buyout, the company invariably becomes a Private Company.

➔ A large part of the borrowings is secured by the firms assets, and the lenders, because of a high risk, take a portion of the firms equity. Junk bonds have been routinely used to raise amounts of debt needed to finance LBO transaction.

➔ The success of the entire operation depends on their ability to improve the performance of the unit, curtail its business 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

What is "Faith" ? Once all the people of a village decided to pray for rain and assembled in a temple. On the day of prayer all the people gathered but only one boy came with umbrella. That's Faith .

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. 28 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 insofar 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 enduser or 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. 29 What is the difference between Cash and the Derivative Market ?

(RTP May 2010)

The basic differences between Cash and the Derivative market are as follows :

(a) In cash market tangible assets are traded whereas in derivative markets contracts based on tangible or intangibles assets like index or rates are traded.

(b) In cash market, we can purchase even one share whereas in Futures and Options minimum lots are fixed.

(c) Cash market is more risky than Futures and Options segment because in "Futures and Options" risk is limited upto 20%.

(d) Cash assets may be meant for consumption or investment. Derivative contracts are for hedging, arbitrage or speculation.

(e) The value of derivative contract is always based on and linked to the underlying security. Though this linkage may not be on point-to-point basis.

(f) In the cash market, a customer must open securities trading account with a securities depository whereas to trade futures a customer must open a future trading account with a derivative broker.

(g) Buying securities in cash market involves putting up all the money upfront whereas buying futures simply involves putting up

Every king was once a crying baby and every great building was once a blueprint. Its not where you are today but where you will reach tomorrow that counts.

the margin money.

(h) With the purchase of shares of the company in cash market, the holder becomes part owner of the company. While in future it does not happen.

QUESTION NO. 30 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. 31 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 research, 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 investors, 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. 32 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." Credit is money made available by a bank or other financial institution, like a loan.

➔ **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.

**"The heights by great men reached and kept,
Were not obtained by sudden flight
But they, while their companions slept,
Were toiling upward in the night."**

- (3) Using a debit card frees him from carrying cash or a cheque book.
- (4) Using a debit card means he no longer has to stock up on traveller's cheques or cash when he travels
- (5) Debit cards may be more readily accepted by merchants than cheques, in other states or countries wherever the card brand is accepted.
- (6) The debit card is a quick, "pay now" product, giving one no grace period.
- (7) Returning goods or canceling services purchased with a debit card is treated as if the purchase were made with cash or a cheque.

➔ **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. 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 Swaptions ?

➔ 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

If there is Something to Gain and Nothing to Lose by Asking, by all means Ask!

"If you think you can, or somebody who believes in you thinks you can, then of course - you can !"

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.

-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

Principal Features Of Swaptions

➡ A swaption is effectively an option on a forward-start IRS, where exact terms such as the fixed rate of interest, the floating reference interest rate and the tenor of the IRS are established upon conclusion of the swaption contract.

➡ A 3-month into 5-year swaption would therefore be seen as an option to enter into a 5-year IRS, 3 months from now.

➡ The underlying instrument on which a swaption is based is a forward-start IRS.

➡ The buyer of a payer/receiver swaption pays a premium for the right but not the obligation to pay/receive the fixed rate and receive/pay the floating rate of interest on a forward-start IRS.

➡ The swaption premium is expressed as basis points.

➡ These basis points are applied to the nominal principal of the forward-start IRS. A borrower would amortise the premium over the life of the option if the swaption is entered into for the reasons of hedging an underlying borrowing.

➡ Swaptions can be cash-settled; therefore at expiry they are marked to market off the applicable forward curve at that time and the difference is settled in cash.

➡ Marking to market of a swaption depends on the strike rate of the swap and the relationship of the strike price to the underlying, where the underlying is the forward start IRS.

➡ In the event of the swaption being cash-settled, the counterparties end up without actually transacting an IRS with each other - the advantage here being an effective management of credit limits. The inherent credit element of swaption pricing can therefore be lessened to a certain extent.

Uses Of Swaptions

➡ 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/puttable 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.

QUESTION NO. 35 Write a short note on Forward Rate Agreements ?**Meaning**

➡ A forward rate agreement is an agreement between two parties to protect themselves against future movements in interest rates. Under the contract, the two parties agree to an interest rate that applies to a notional loan or deposit of an agreed amount, which is to be drawn or placed on an agreed future date for a specified term. In a forward rate agreement, the bank quoting prices agrees to pay its customer (a corporate or another bank) the difference resulting from a change in LIBOR (or another reference rate) in a specified direction compared with the agreed FRA rate, based on a notional principal amount loaned for a notional period of time. ➡ If $LIBOR > FR$ the seller owes the payment to the buyer, and if $LIBOR < FR$ the buyer owes the seller the absolute value of the payment amount.

Other Points

➡ FRAs are cash-settled forward contracts on interest rates traded among major international banks active in the Eurodollar market.

➡ An FRA can be viewed as the OTC equivalent of a Eurodollar futures contract.

➡ Most FRAs trade for maturities corresponding to standard Eurodollar time deposit maturities, although nonstandard maturities are sometimes traded.

➡ Trading in FRAs began in 1983 (Norfield 1992).

➡ A forward rate agreement (FRA) is an over-the-counter version of a short interest rate future. Primarily used as an inter-bank hedging instrument in the early 1980s, its use has since spread to a number of corporates as well. FRA is very popular method of hedging interest rate risk.

Under an FRA

-The buyer (borrower) is the party seeking to protect itself against a rise in interest rates.

-The seller (lender) is the party seeking to protect itself against a fall in interest rates.

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, Deutschmarks, 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.

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@yahooogroups.com

I stay in Kolkata..I am appearing my CA finals in this June.. I have previously taken tuttions 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 didnt 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 heartfelt 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

"You don't drown by falling in the water; you drown by staying there."

Life is Finite, While Knowledge is Infinte

Surbhi Agarwal A Student Of Aaditya 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



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

Rise, Awake and Stop Not Until The Goal Is Achieved

Remember Failure Is Not Final, Until You Makes It Final
Wake Up.....Until Its Too Late

I AM NOWHERE
I AM NOWHERE
I AM NOW HERE

SFM is Not Tough, Its Just The Approach That Matters

Finally Delhi Has Got A Good MAFA Teacher

- Surbhi Agarwal All India Rank 1st

*A pessimist anticipates calamity in every opportunity whereas an optimist anticipates opportunity in every calamity
So one should always try to grab silver linings even out of most adverse situations.*

For Getting Last Time SMS Alert On Important Topics Of SFM
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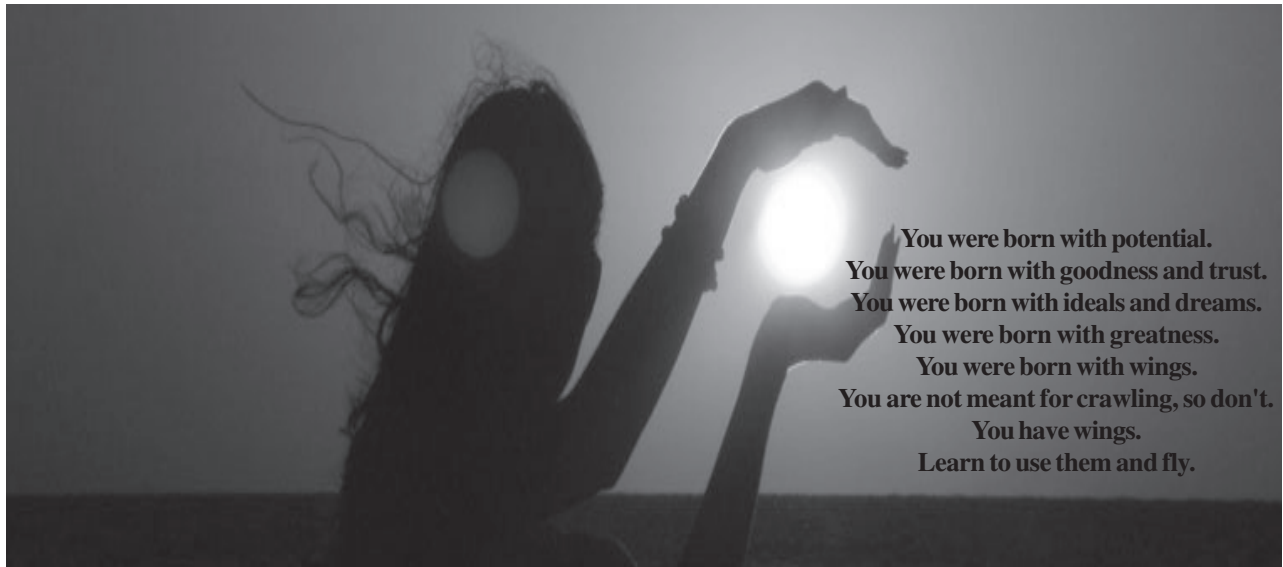
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Mobile Number :

City Of Residence :

By SMS:Delhi-9911442626 ; Kolkata-9339238834 ;By E-mail:cafina1mafa@yahoo.com



**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***

**Memories play a very confusing role...They make you laugh when u remember the time
u cried.But make you cry when you remember the time u laughed**

**The will must be stronger than the skill - by Muhammad Ali
"If opportunity doesn't knock ,build a door"**
