HARE KRISHNA

MAFA

IMPORTANT

THEORETICAL QUESTIONS
(with answers)

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**** *Q. No. 104 - 111*
*** ***Most Important Questions***
** ***Important Questions***
* ***Not so Important***

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****Q. No. 1 :** Write a short note on Internal Rate of Return. **(CA Final , May 1996)**

Answer :

- Internal rate of Return (IRR) is that discount rate at which the NPV of a project is zero.

$$NPV = -C_0 + \frac{C_1}{(1+YTM)^1} + \frac{C_2}{(1+YTM)^2} + \ldots + \frac{C_n}{(1+YTM)^n} = 0$$

- It is the rate of return on the investment calculated on the basis of discounted cash flow approach.
- It is inclusive of cost of capital. For example, if the cost of capital is 12%, and IRR is 20%; then our total return (inclusive of cost of capital) is 20%, out of which 12% meets the cost of capital and 8% is the return over and above cost of capital.
- For calculating IRR, (i) we find approximate pay back period (undiscounted) on the basis of average cash flows. (ii) locate the figure of Approximate pay back period in the annuity table against no. of years equal to the life of the project, the corresponding rate is Approximate IRR (iii) find NPV at this rate (iv) if NPV is positive find the NPV at some other higher rate and vice –versa (v) find IRR by interpolating the two NPVs using the following formula :

$$IRR = \text{Lower rate} + \frac{\text{NPV at lower rate}}{\text{NPV at Lower rates} - \text{NPV at higher rates}} \times \text{Difference in rates}$$

- IRR presents the financial effect of all the factors affecting the project by way of single figure which is easy to understand and compare.
- The assumption of the IRR method is that the funds released by the project are invested (till completion of the project) at a rate equal to IRR itself. This assumption of IRR is quite unrealistic. Suppose, we are evaluating two projects *A* and *B*, A's IRR is 20% and B's IRR is 25%,while calculating IRRs we assume that cash generated by *A* will be invested at 20 per cent and cash generated by *B* will be invested at 25 per cent. This is quite unrealistic situation. There is no difference in quality of cash generated by project *A* or project *B*. There is no reason that if cash generated by *B* can be invested at 25 per cent, cash generated by *A* has to be invested at a lower rate of 20 per cent. Thus IRR suffers from superficiality of reinvestment rate assumption.
- The IRR method has some complications. For example, some projects may have more than one IRR and others may have no IRR. Most investment projects involve a cash outflow at the time of initial outlay, followed by net cash inflow in all future years. The sign applicable to all cash flows is reversed only once, it is negative for initial investment and positive for all subsequent cash flows. However a project can have more than one sign reversal. For example, the initial outlay may be followed by

positive cash inflows in one or more periods, followed by negative cash flows in some periods, again to be followed by positive cash flows in one or more periods. This type of situation can cause a single project to have more than one IRR or IRR may be indeterminate.

- Decision criterion: The project may be accepted if IRR is greater than the cost of capital. It may not be accepted if it is less than the cost of capital. If it is equal to cost of capital, project may be taken up only if non-financial benefits are there.

****Q. No. 2:** Write a short note on capital rationing. **(May, 2004; May 2006)**

Answer:

Capital rationing occurs whenever there is a ceiling on the amount of funds that can be invested during a specific period of time, i.e., it is a situation in which a firm has several attractive investment opportunities but does not have enough funds to invest in all of them. In other words, capital rationing involves the allocation of a fixed amount of capital among competing and economically desirable projects. The ceiling on the amount of funds to invest can be caused by an internal budget ceiling being imposed by management (it referred as soft capital rationing), or by external limitations being applied to the company, i.e. when additional borrowed funds cannot be obtained (it is referred as hard capital rationing)

Suppose A company has investible funds of Rs.20 Lakh and is considering the following projects:

Project	*Outlay (Rs.)*	*N.P.V. (Rs.)*
A	20,00,000	8,00,000
B	17,50,000	7,50,000
C	16,00,000	6,00,000
D	18,00,000	6,50,000

Non-Divisible Projects and Capital Rationing

In this case, we define all feasible combinations of the project and choose the combination that has highest NPV. In other words, we select a package of the projects that is within our resources yet givens the highest amount of NPV. Assuming that in the above example the projects are indivisible, we shall find NPVs all possible combinations and we shall recommend the combination with highest amount of NPV.

Divisible Projects and Capital Rationing

By divisible project, we mean that if a project meets our selection criterion but we cannot finance it fully, then there are other persons who are willing to join us i.e.

they are willing to become our partner in the project. Naturally, we shall be sharing the NPV on the basis of proportion of the investment. The feature of such projects is that we shall not be left with any uninvested amount.

In this case, we calculate net profitability index. Net profitability index is obtained by dividing the NPV with investments out of limited funds.. (For example, in the above referred case, Net Profitability Index of Project A is (8,00,000 / 20,00,000) i.e. 0.40. Assuming that in the above example the projects are divisible, we shall find Net Profitably Index of all the projects and we shall take investment decisions on the basis of Net Profitably Index; our first choice of investment will be the project with Highest Net Profitability Index, then the project with second highest profitability index and so on.

Q. No. 3: Write short note on Social cost Benefit analysis. **(Nov. 2003)**

Answer: Social Cost Benefit Analysis (SCBA) is a part of process of evaluating the proposal regarding undertaking a project. The concept of SCBA is that while evaluating the proposal regarding investment in a project, the entrepreneur should consider not only its financial soundness and technical feasibility but also make cost benefit analysis of the project from the point of society and economy as a whole. A project be financially and technically feasible but from the viewpoint society in general and economically as a whole may not be viable and vice-versa. For example, a project of providing rail links to some under developed area may be financially unsound but from the social and economic angles it is quite desirable (it will help in development of that area).

For every action, there is reaction. For (almost) every project, there are some hidden social-economical disadvantages (these are referred as negative externalities) and also there are such advantages (these are referred as positive externalities). The examples of disadvantages (negative externalities) are: dislocations of the persons whose land is acquired for the project, environmental damage, ecological disturbances, damage to heritage buildings in the long run, etc. The advantages (positive externalities) may be: employment opportunities, availability of merit quality products at reasonable prices, foreign exchange earnings, construction of road, etc., for the project which may be used by other persons of that area and which may help in development of some other economic activities, etc. Hence, besides financial and technical angles, a project should also be evaluated on the basis of its social costs and social benefits.

There are two schools of thought regarding projects' evaluation.

As per **first school of thought** a project should be accepted,

- Either when the social benefits are more than its social costs,

- or the entity which wants to implement the project should try to make good the loss of the society Þ for example Þ restoration of environmental damages, providing employment of dislocated persons, etc.

As per the **second school of thought**, project evaluation should involve three steps:

(i) Identify all costs and benefits of the project. The costs of the project are divided into two parts (a) private cost and (b) negative externalities. The benefits of the projects are also divided into two parts (a) private benefits, and (b) positive externalities.

(ii) Use money as a unit of measuring all above costs and benefits. Measurement of private costs and benefits generally does not pose any problem. Measurement of externalities in terms of money is certainly a difficult task and requires some thoughtful steps.

(iii) Find NPV of the project (using the concept of time value of the money) on the basis of above-mentioned all costs and benefits.

Example: Currently there is no bus or rail service between two towns "A" and "B". A large numbers of persons commute between these two towns everyday. They use either their own vehicles (which is quite costly and tiresome) or tempos (which are costly, tiresome and inconvenient). A company is planning a project of operating a bus service between these two towns. Considering the details given below, opine whether the project should be undertaken or not (as per the second school of thought):

Cost of bus Rs.10,00,000
Scrap value Rs.1,00,000
Annual operating cash cost Rs.3,00,000
Savings of time 100000 hours annually which can be valued@ Re. 1 per hour
Life 10 years
Scrap value Rs.1,00,000
Cost of capital 10 per cent
Noise and other damage to environment, its cost can be taken as Rs.25000 each year
Annual revenue Rs.7,00,000

NPV=[-1000000]+[(700000+100000-300000-25000)x(6.145)]+[100000x0.386]= 19,57,475

****Q. No.4:** Write a short on project appraisal under inflationary conditions. **(May 1998; Nov. 2003)**
Answer:

The term project appraisal refers to the process of judging the sound feasibility and soundness of the project. Project analysis is indispensable because projects require resources which are scarce and have alternative uses. There are three parts of project appraisal: (1) Market Analysis (2) Studying the feasibility of the project, and (3) Making the ecological study.

The term i**nflation** refers to rise in general (on an average basis) price level of goods and services in the economy, i.e., fall in purchasing power of money. It creates a number of uncertainties because of rising prices of inputs, outputs and factors of production. Inflation also muddies project planning. Hence, while appraising the projects under inflationary conditions, the finance manager may consider the following points:

(i) Inflation makes the project riskier. Hence, project with smaller pay back period may be preferred.

(ii) Inflationary conditions may result in requirement of additional funds (for fixed assets as well as working capital) to be invested. Such funds may be planned; arrangements with the suppliers of funds may be made.

(iii) Inflation may necessitate the rise in the sale price of the output. Its impact on demand may be considered.

(iv) Inflation may result in increase in the cost of output. This affects the profitability of the project. This fact may be considered while appraising the project.

(v) If the project is to be evaluated on discounted cash flow techniques, all the cash flows may be taken on nominal basis and discounted by nominal cost of capital. If all the components of the cash flow are affected by general rate of inflation, in that case an alternative approach can also be followed. In this alternative approach, all the cash flows are taken on real basis and discounted at the rate of real cost of capital.

(vi) Financial viability of the project may change on account of the inflation. The finance manager should examine this fact very carefully.

(vii) Reliable measure of rate of inflation should be developed / recognized.

Inflation makes the task of project appraisal quite difficult. Hence, the finance manager should consult various experts on specific matters. For example, economists may be consulted for possible inflation rate and the impact on the interest rates, marketing experts may be consulted for possible increase in selling prices and impact on the demand, production manager may be consulted for possible increase on cost of production, purchase manager may provide some clue for possible increase in material price and also about possible substitute of material.

Q. No. 5: What is the sensitivity analysis is capital budgeting? **(Nov. 2002)**

Answer:
There are seven important determinants of NPV, besides some others :

(i) Selling price
(ii) sales quantity
(iii) cash cost
(iv) cost of capital, and
(v) Amount of investment .
(vi) Value of scrap
(vii) Life of the project

Sensitivity analysis is a tool to measure the risk surrounding a capital expenditure project. The analysis measures how responsive/sensitive the project's NPV is to change in the variables that determine NPV.

This analysis is carried on the projects reporting positive NPVs. It requires the calculation of % change, in value of each determinant of the NPV, that may reduce the NPV to zero. These percentages are put in ascending order. The item corresponding to minimum change is considered to be most sensitive/risky. The concept of the sensitivity suggests that management should pay maximum attention to this item as even a small adverse change in this item may result in big unfavourable results. Sensitivity analysis therefore provides an indication of why a project might fail.

Critics of sensitivity analysis suggest that the management should pay maximum attention to the item which has the highest probability of adverse change.

Q. No. 6: Write short note on Certainty Equivalent Approach. (**May. 2002)**
Answer:
The certainty equivalent approach adjusts downwards the value of the expected annual after-tax cash flows on account of uncertainty In other words, a risk less set of cash flows is substituted for the original set of cash flows between both of which the management is indifferent.

Under this approach, we multiply the cash flow estimates with certainty — equivalent coefficient (CEC). Once risk is taken out of the cash flows, those cash flows are discounted back to present at the risk-free rate of interest and the project's net present value or profitability index is determined.

CEC depends upon management's attitude towards risk. Suppose acceptance of a risky project is likely to result in 5 annual cash flows of Rs.10,000 each. As it is a risky project, i.e., actual results may vary with the estimated ones, a smaller amount may be acceptable to the firm provided that there is no uncertainty. Suppose management is willing to accept Rs. 6,000 (certain amount) in place of Rs. 10,000 (uncertain amount). In that case CEC = 0.60.

$$\text{CEC} = \frac{\text{Certain cash flow}}{\text{Uncertain cash flow}}$$

The certainty equivalent method allows each cash flow to be treated individually. For example, the CEC of first year may be different from that of second year and so on.

Q. No.7: Distinguish between Net present value and IRR. **(May, 2002)**

Answer:

There are two important methods for evaluating the desirability of investments or projects (i) NPV (ii) IRR. Both the methods consider the time value of money.

NPV is defined as the difference between PV of inflow and PV of outflow.

$$\text{NPV} = -C_0 + \frac{C_1}{(1+r)^1} + \frac{C_2}{(1+r)^2} + \ldots\ldots + \frac{C_n}{(1+r)^n}$$

Internal rate of Return (IRR) is that discount rate at which the NPV of a project is zero.

$$\text{NPV} = -C_0 + \frac{C_1}{(1+YTM)^1} + \frac{C_2}{(1+YTM)^2} + \ldots\ldots + \frac{C_n}{(1+YTM)^n} = 0$$

Some of the points of distinction between NPV and IRR have been outlined in the following table :

NPV	IRR
(1) NPV is calculated in terms of amount.	(1) IRR is expressed in terms of the percentage return a firm expects the capital project to return;
(2) It is the amount by which the shareholders wealth will change on its implementation.	(2) IRR does not measure the change in the shareholders on the implementation of the project. Even a very high IRR may result in only small increase in the shareholders wealth as the amount of investment may be very small. A very low IRR may result in

	substantial increase in the shareholders wealth if the amount of investment is very large.
(3) NPV assume that the cash generated by the project are reinvested at the rate equal to cost of capital.	(3) IRR assume that the cash generated by the project are reinvested at the rate of IRR itself.
(4) Even if a project has more than one sign reversal (For example, the initial outlay may be followed by positive cash inflows in one or more periods, followed by negative cash flows in some periods, again to be followed by positive cash flows in one or more periods) calculation of NPV does not face any problem.	(4)If a project has more than one sign reversal (For example, the initial outlay may be followed by positive cash inflows in one or more periods, followed by negative cash flows in some periods, again to be followed by positive cash flows in one or more periods) calculation of IRR may create complications. if a project has more than one sign reversal (For example, the initial outlay may be followed by positive cash inflows in one or more periods, followed by negative cash flows in some periods, again to be followed by positive cash flows in one or more periods) calculation of NPV does not face any problem.
(5) NPV of different projects is not easy to compare as there may be different initial investments.	(5) IRR presents the financial effect of all the factors affecting the project by way of single figure which is easy to understand and compare.
(6) Cost of capital (Required rate of return) is required for calculating the NPV.	(6) Cost of capital (Required rate of return) is not required for calculating the IRR.
(7) Decision criterion : If NPV is positive the project may be taken up. If NPV is zero, project may be taken up only if non-financial benefits are there. If NPV is negative project may not be taken up.	(7) The project may be accepted if IRR is greater than the cost of capital. It may not be accepted if it is less than the cost of capital. If it is equal to cost of capital, project may be taken up only if non-financial benefits are there.

Q. No. 8: Do the profitability index and the NPV criterion of evaluating investment proposals lead to the same acceptance – rejection and ranking decisions? In what situations will they give conflicting results? **(Nov. 1999)**

Answer:

If we have to evaluate only one project, we may either calculate NPV or PI, both will give same result.

If we have to evaluate two or more projects:

(i) if funds are not key factors we should evaluate the project on the basis of NPV as our aim is maximization of wealth of the shareholders. (NPV of a project is defined as the amount by which firm's wealth will increase on implementation of the project.)

(ii) If funds are key factors we should evaluate the project on the basis of P.I. In other words, if we want to maximize the rate of return on funds employed, PI should be applied.

Let's have an example to understand this point. A person is offered two jobs and he can accept either. First job will give him Rs.350 per day of 7 hours (Rs.50.00 per hour). Second job will give him Rs.380 per day of 8 hours (Rs.47.50 per hour), which job he should accept? If time is key factor for him, i.e., if he wants to maximize his earning per hour he should go for the first job. If time is not key factor for him and he wants to maximize his total earnings, he should go for the second job. Let's have another example.

Suppose, a businessman has to evaluate two capital expenditure proposals. First will require on investment of Rs.40,000 initially and will result in cash flows at present value amounting to Rs.60,000 (NPV = 20,000, PI = 1.50). Second will require on investment of Rs.50,000 and will result in cash inflows at present value amounting to Rs.72,000 (NPV = 22,000, PI = 1.44). If funds are key factor, he should go for the first project, i.e., he should maximize the rate of return. If funds are not key factor, i.e., he wants to maximize his profit, he should go for the second project.

Q. No. 9: What are the issues that need to be considered by an Indian investor and incorporated within the NPV model for the evolution of foreign investment proposals? **(Nov. 2000)**

Answer:

An Indian investor investing in foreign country should consider the following points and incorporate them in the NPV model:

(i) Political uncertainties: Political uncertainties affect economics. Change in government may affect the outcome of the project. This uncertainty should be incorporated by considering various probabilities for calculating expected NPV.

(ii) Possibilities of change in economic policies particularly regarding overseas investments. Even without political uncertainties, it is possible that the government of host country may change its economic policies particularly regarding overseas investments. This may affect the out come of the investment This uncertainty should be incorporated by considering various probabilities for calculating expected NPV.

(iii) Possibility of change in policy regarding repatriation of money back to the investor's country. This uncertainty should be incorporated by considering various probabilities for calculating expected NPV.

(iv) Taxation: (a) whether there is double taxation avoidance agreement with the host country or not. (b) Whether the host country is highly taxed nation, moderately taxed nation, low taxed nation or tax haven. (c) What are deductions and exemptions? *These factors will affect cash flows and in turn affect the NPV.*

(v) Inflation: Inflation affects the outcome of the investment. It can be considered either by taking nominal cash flows and nominal cost of capital or by taking real cash flows and real cost of capital.(for more details refer to the note regarding capital budgeting under inflationary conditions)

(vi) Interest rates: If borrowed funds are to be used for the investment, change in interest rate should be considered using various probabilities.

(vii) Currency exchange rates: NPV should be considered on the basis of probable exchange rate between rupee and host country's currency.

Lease

**** Q..No.10 :** What are the characteristic features of Financial and operating lease. **(Nov. 2006)**

Answer :
A **lease** is a contract conveying from one person (the lessor) to another person (the lessee) the right to use and control some article of property over the span of the lease term, without conveying ownership, in exchange for some consideration (usually a periodic payment.). Leasing is a viable financing alternative to buying with a loan. Leasing may allow the enterprise to conserve cash. It also allows to avoid buying equipment which may not be required for long. Companies routinely use leasing for some of their financing. Airlines lease their airplanes. Car-rental companies lease their fleets of rental vehicles. Most

companies lease some or all of their office, warehousing, and retailing space.

Basic types of leases:
Finance leases . In this case, the lessor transfers substantially all the risks and reward of the leased asset to the lessee. Generally this type of lease satisfies one or more of following conditions:
1. lessee acquires title by the end of lease period
2. option to purchase at bargain price
3. lease period covers major portion of useful life
4. present value of rental payments equals or exceeds asset's fair market value.
5. lease contract is generally non-cancelable.

Operating leases : A lease which is not finance lease is known as operating lease.
Features of operating lease:
(i) The lease does not cover the major portion of useful life.
(ii) Lease is generally cancelable.
(iii) Risk of Obsolescence is born by the lesser.
(iv) Generally the cost of maintenance and repair are born by the lessor.

****Q..No.11 :** What are the advantages of lease financing?

Answer :
- It offers fixed rate financing. The lessee has pay lease rent at the same rate periodically.
- There is less upfront cash outlay. The lessee does not need to make large cash payments for the purchase of needed equipment.
- Leasing better utilizes equipment. Lessee leases and pays for equipment only for the time it is needed.
- Lessee has an option to buy equipment at end of lease term. (only in case of finance lease)
- Upgrading. As new equipment becomes available the lessee can upgrade to the latest models each time the lease ends. One of the reasons for the popularity of leasing is the steady stream of new and improved technology.

- There are a variety of ways in which a lease can be structured. This provides greater flexibility so that the lease is structured to best accommodate the
- individual cash flow requirements of a specific business. For example, there may be balloon payments, step up or step down payments, deferred payments or even seasonal payments.
- Generally, it is easier to obtain lease financing than loans from commercial lenders.
- It offers potential tax benefits depending on how the lease is structured.

****Q. No. 12 :** Many companies calculate the internal rate of return of the incremental after-tax cash flows from financial leases. What problems do you think this may give rise to? To what rate should the IRR be compared? Discuss. **(May, 2001)**

Answer:
Calculation of cost of lease by IRR is one of the methods of evaluation of Lease vs. buy proposals. Under this method, five steps are there

(i) Find cash flows under lease proposal

(ii) Find cash flows under buy proposal (Here we make an assumption that we do not have to borrow funds i.e. we have funds to buy the asset and there is no cost of these funds, we shall be withdrawing this assumption under 5th step.

(iii) Find incremental cash flows i.e. "cash flows of lease minus cash flows of buy"

(iv) Find IRR i.e. cost of lease on the basis of incremental cash flows.

(v) We withdraw the assumption we have made under step (ii). We find cost of borrowed funds for buying the asset. Compare this cost of borrowed funds with the cost of lease (calculated under step iv). If cost of lease is more than cost of borrowed funds, buying is recommended. In otherwise situation, lease is recommended.

Problems which may arise in this method:

(i) IRR may me indeterminate (This may happen if more than one sign reversal in cash flows is there.)
(ii) Multiple IRRs may be there (This may happen if more than one sign reversal in cash flows is there.)
(iii) Generally the cash outflows calculated under step (iii) are negative. The method assumes that funds required for these cash outflows will be arranged at a cost equal to cost of lease by IRR method.
(iv) Life of the asset may not be equal to the period for which lease is to be taken. This may complicate the decision.

FINANCING

****Q. No. 13:** Discuss briefly the impact of taxation on corporate financing. **(Nov. 1996, May 2000)**

Answer : Finance managers should base their financing decisions on three considerations : (i) Try to minimize the cost of funds raised (ii) Try to reduce the impact of corporate tax and (iii) Finance risk should be kept at optimal level. (The level of optimum finance risk is determined after considering the operating risk. If operating risk is high, the finance risk may be kept at low level. If operating risk is low, finance risk may be kept at high level.)

Corporate Financing decisions are affected by corporate taxation. Regarding the impact of corporate taxation on corporate financing, the following points are worth consideration:

(i) Debt : Debt is most attractive source of financing from the point of view of corporate taxation as it is allowed as deduction for the purpose of calculating the taxable income. For example, if debt is raised at the interest rate of 10%, the effective cost will be only 6.634 % after considering the tax (including surcharge and education cess). There is tax saving on debt issue expenses as well.

(ii) Equity share capital : Return on equity shares can be provided to the shareholders by two ways (i) Dividend and (ii) Bonus shares. The first option is quite inferior option from the angle of taxation. On one hand, the amount of dividend is not allowed as deduction for computing the taxable income of the company, on the other hand the company has to pay an all inclusive corporate dividend tax (The dividend is tax exempt in the hands of the receiver of dividend). The second option is not so inferior. Though the amount of bonus shares is not allowed as deduction while calculating taxable income of the company, the company does not have to pay corporate dividend tax. The allottee of bonus shares (i.e. the shareholder) , if needs cash , can sell these shares. If the shares are listed in the stock exchange and these are sold through the stock exchange after paying Security transaction tax (which is quite negligible), the shareholder may not have to pay tax (if from taxation angle, the transaction results in transfer of long term capital asset) or tax at [10 % + surcharge at the prescribed rate, if applicable + education cess], if from the tax angel it is the transfer of short term capital asset.

(iii) Preference share capital : Return on preference shares can be provided to the shareholders by way of dividend This is quite inferior way from the angle of taxation. On one hand, the amount of dividend is not allowed as deduction for computing the taxable income of the company, on the other hand the company has to pay an all inclusive corporate dividend tax (corporate dividend tax + surcharge + education cess)(The dividend is tax exempt in the hands of the receiver of dividend).

(iv) Retained earnings: If the company retains the earnings and uses them for further requirements of funds, it does not have to pay any corporate dividend tax. If return on retained earnings is provided to the shareholders by way of dividend, the company has to pay corporate dividend tax. If the same is provided by way of bonus shares, there will be no corporate dividend tax .

(v) Depreciation: Depreciation is a resource of funds. It is allowed as deduction for tax purposes. It does not result in cash outflow and hence, and amount equal to depreciation is reinvested in the business.

****Q. No. 14 :** Write short note on Restrictive covenants placed by a lender on a borrower in cases of term lending for projects. **(Nov. 2001)**

Answer:
Term lending for projects means lending for new business activity and that too on long term basis. This enhances the risk for the lender and the possibility of default by the borrower. To safe guard their interests, the lenders generally put some restrictions on the borrowers to monitor the progress of the project from implementation until the loan is repaid along with interest. Such restrictions are referred as restrictive covenants with reference to the project financing. The restrictive covenants can be divided into two parts :
(i) Positive restrictive Covenants and (ii) Negative restrictive covenants.

Positive restrictive covenants :
(a) *Supplying relevant information to the lenders* : The borrowers are required to supply, to the lenders, the relevant information regarding implementation and the progress of the project. They may be required to submit certain certificates issued various professionals in this matter , for example Chartered Accountants, Consulting Engineers etc.
(b) *Guidance and control* : Sometimes, the lenders reserve the right of appointing one or more persons as members of the Board of Directors for guidance and Control purposes.
(c) *Convertibility covenants* : The lender may keep the option of getting their loan (either partly or fully) amount converted into equity shares of the borrower at the predetermined rate/ predetermined method of calculating the rate.
(d) *Policy Covenants* : The borrowers may be required to follow certain policies and conditions which are ultimately going to benefit the borrowers – like maintaining lower debt equity ratio, minimum current ratio . Some times the lenders may expect the borrowers to follow certain business ethics (for example, in one case the loan agreement provided that the products of the project will contain a warning clause that their over usage may be harmful in long run, though it was not statutorily required; in another case the lender imposed tougher environmental restrictions than required by the Government)

Negative restrictive covenants :
(a) *Assets related restrictive covenants* – The borrower may be required to maintain net assets i.e. in case of cost overrun or losses the promoters may be

expected to bring additional equity funds. The borrower may not be allowed to sell certain assets (particularly fixes assets) without prior permission of the lender.

(b) *Liability related restrictive covenants* – The borrowers rights regarding raising further loans may be restricted or may be subject to the permission of the original lender. The borrower is not allowed to create other charges on the assets. There may be restrictions regarding redemption of loans & preference shares and buy back of equity shares.

(c) *Cash flow related restrictive covenants* : The most important covenant in this category is restriction on dividends, for example the borrower may put a ceiling on pay out ratio. The other covenants may be related to restrictions on capital expenditure, directors' remuneration etc.

(d) *Risk related restrictive covenants* : The borrower may put under the restriction of not taking such decisions and actions which may prove very risky for the project. (for example, in one case it was provided that just to harm the competitors the goods would not be sold below cost , there may condition regard adequate and timely insurance of various assets)

****Q. No. 15 :** "Promoters contribution is one of the principles means of financing the project" **(May, 1997)**

Answer : Large industrial and infrastructure projects require huge amount of funds, some times it runs into thousands of Crores of rupees. It is not possible for the promoters of the projects to provide such huge amount of funds from their own resources. Hence, they take the help of development financial institutions. Such institutions include IFCI, IDBI, ICICI, SIDBI, IFC, etc. When the promoters require huge funds, even one bank/development institution may not find it feasible/desirable to arrange all the finance. This leads to syndicated financing. The banks/development institutions, etc., form a syndicate to provide the finance. They among themselves decide about the proportion of funds each of them will be providing. The promoters have to deal with any one of them only.

This type of project financing requires that the promoters must contribute a portion of the project finance. This confirms promoters interest and seriousness of the promoters. Promoters contributions assure the financial institutions that a large amount of promoters money is at stake in successful completion of the project and that the promoters are not fly over night promoters, i.e., promoters contribution to assure the dedication and commitment of the promoters towards to the project. This also assures safety of funds of financial institutions and banks as in case of project failure, the promoters will be among the maximum losers (as their contribution is either in the form of equity or unsecured loan).

The promoters contributions may be any one of the following forms :

(i) Equity share capital.

(ii) Preference share capital.

(iii) Convertible debentures.
(iv) Unsecured loan.
(v) Seed capital (to be provided by Seed Capital Foundation).
(vi) Venture capital.
(vii) Retained earnings of the business. The promoters' contribution should not be less than 20 per cent of total project cost. In case of backward areas, this condition is relaxed by the FIs.

Q. No. 16 : Write a short note on Bridge Financing. **(Nov. 1997)**

Answer : A Bridge Loan is a loan that is used for a short duration of time until permanent financing is put in place. Bridge loan can be raised from banks/financial institutions.

Non-Banking Finance companies are not permitted to raise Bridge Loans.

BRIDGE LOAN BY BANKS

(I) The banks sanction bridge loans against term loans sanctioned by other bank(s)/financial institution(s) when such bank(s)/financial institution(s) are unable to disburse the sanctioned loans due to temporary liquidity constraints being faced by them. RBI has put four conditions in this case :

- The bank extending the bridge loan must obtain the approval of the other bank(s)/financial institution(s) which have sanctioned the loan.
- The bank (providing bridge finance) must also obtain a commitment from the bank(s)/ financial institution(s) that the latter would directly remit the amount due on account of bridge loan to it at the time of disbursement of sanctioned loan.
- The period of such loan should not exceed four months .
- The bridge loan amount is to be utilized only for the purpose for which term loan has been sanctioned by the other bank(s)/financial institution(s).

(II) The banks also provide bridge loans to the companies against expected cash flows from equity issue (whether in India or abroad).

BRIDGE LOAN BY FINANCIAL INSTITUTIONS:

(i) The FIs sanction bridge loan against commitments made by other bank(s)/financial institution(s) when the lending institution faces temporary liquidity constraints subject same four conditions which have been mentioned in the case of bridge loan by banks.

(ii) The FIs sanction bridge loans to the companies for commencing work on projects pending completion of formalities against their own commitments.

(iii) The financial institutions sanction bridge loans against expected cash flows of public equity issue (whether in India or abroad) However, FIs should not grant any advance against Rights issue.

****Q. No. 17 :** Write a short note on call option and put option with references to debentures. **(Nov. 1997)**

Answer:

Call option: It is the option with the issuer of the bonds. This option provides the issuer to call back (i.e. to redeem) the bonds before their maturity as per the terms of the call option. For example, the issuer issues the bonds with 7 years maturity. The terms of the issue provides that the issuer has the right (not the obligation) to call back the bonds at any time after 3 years of the date of issue at a premium of 10% of the face value.

Indian capital market witnessed the exercise of a call option of very large magnitude by IDBI in the year 2000. IDBI issued deep discount bonds in 1996 offering a return of about 16% with 25 years maturity. The issue received overwhelming response from the investors planning their retirement, education of children etc. The investors got a shocking news in the year 2000 that the IDBI has decided to call back (i.e. to redeem) the bonds. Many investors filed their grievances against IDBI with SEBI, Ministry of Finance etc but these could not be redressed as the offer document clearly mentioned the option clause (which perhaps no body cared to go through).

By getting the bonds allotted, the holders write the call option in favour of the issuer. Call option has adverse impact on the value of the bond.

Put option: It is an option written by the issuer of the bond in favour of the buyer of the bond. Under this option, the buyer may get the bonds redeemed before the maturity as per the terms of the put option. For example, a company issues 10% Bonds with 10 years maturity. The bonds contain put option under which the Bonder may get the bonds redeemed at any time after three years at a discount of 5% if redeemed after 3 years but up to 5th year, at a discount of 3% if redeemed after 5 years but up to 8th year and at a discount of 1% if after that.

By issuing the bonds, the issuer writes the put option in favour of the investor. Put option has positive impact on the value of the bond.

****Q. No. 18 :** What is refinancing ? Briefly explain indicating at least two institutions which offer such refinancing. **(Nov. 2006)**

Answer: Refinancing is a system of borrowing by a bank or other financial intermediary from apex institutions on the strength of loans/finance provided by it to its customers. It is termed as whole-sale financing. Under this system, the bank/financial intermediary provide loan to the ultimate users and gets the amount reimbursed from the re-finance providing organization. For example, State Bank of India discounts the Bill Receivable of a customer, say Rs1m; it can get the bill rediscounted with Discount and Finance House of India. Suppose SBI charged the customer the discount of 15% p.a. and the Discount and Finance House Ltd charged SBI the discount of 12%, the difference between the two rates is the profit for SBI for taking the risk. (There is no default risk for Discount and Finance House Ltd as it has lent to SBI. There is risk of default for SBI)

Thus, for instance, IDBI and NABARD provide refinance to a host of banks and institutions vis-à-vis the loans made by the latter to ultimate borrowers. IDBI provides indirect financial assistance through refinancing of loans extended by State-level financial institutions and banks and by way of rediscounting of bills of exchange arising out of sale of indigenous machinery on deferred payment terms. NABARD provides refinance to lending institutions in rural areas

SIDBI caters to the need of funds of Primary Lending Institutes for financing small-scale industries. Under the scheme, SIDBI grants refinance against term loans granted by the eligible Primary Lending Institutes to industrial concerns for setting up industrial projects in the small scale sector as also for their expansion / modernization / diversification.

*** **Q. No. 19:** Explain the role of merchant bankers in Public issues. **(May, 2003)**

Answer:

Merchant bankers play the vital role in the success of any public issue. They ensure (I) the investors' protection (ii) that all legal provisions and regulations are being followed, and (iii) smooth completion of the issue

Their functions include

- Advising the Corporates regarding capital structure, size of the issue, timings of the issue and price at which the securities should be issued.
- Appointing various intermediaries such as bankers, registrar and underwriters to the issue and coordinating their activities
- To draft various documents including prospectus (or Red Herring Prospectus, in case of Book-Building) , submit them with SEBI and the Registrar of the companies and obtaining the permission of the public issue
- Arranging the underwriting of the securities
- Marketing of public issue
- Offering the securities to the public

- Ensuring smooth completion of the issue
- Determination of final issue price (in case of Book Building)
- To allot the shares, to issue allotment letters and refund the excess amount paid by the applicants.
- Getting the shares listed on the stock exchanges
- Exercise of Greenshoe option

***Q. No. :20** Write a short note on Green Shoe option. **(Nov. 2003)**

Answer: Greenshoe option means an option of issuing securities in excess of the securities included in public issue. The Disclosure and Investors Protection Guidelines of SEBI allows inclusion of this option in the public issue of equity shares (subject to provisions contained in chapter VIII A of the Guidelines). 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.

This option is used to operate a post-listing price stabilizing mechanism i.e. the purpose of this option is to check the market price falling below the issue price. Under this option, the issuer company appoints a Stabilizing Agent (SA) , who should be one of the issue management team. The SA is given a fixed fee for operating the Price Stability Mechanism (PSM) for a certain period (subject to maximum of 30 days from the date of start of trading of the shares in the Stock exchange) The SA is also given an option of getting additional shares (maximum up to 15% of size of public issue) issued from the issuer company at the issue price, if the Price stabilization mechanization so warrants. (This option given to the SA is known as GSO).

Under PSM, the SA borrows shares from the promoters or pre-issue shareholders (maximum up to 15 % of the size of the public issue). The issuer company issues the shares "offered as public offer as well the shares borrowed by the SA" in the form of public issue. The proceeds from the issue of the borrowed shares is kept in a separate bank account known as GSO Bank account.

If the market price of the shares (in the stock exchange) falls below the issue price during the stabilization period, the SA buys the shares from the market. The payment for these shares is made from the GSO Bank account. These shares are returned to the lenders of the shares. On expiry of the stabilization period, in case the SA does not buy shares to the extent of borrowed shares, the issuer company shall allot shares to the SA to the extent of shortfall. The amount of these shares, calculated on the basis of issue price, is transferred from GSO Bank account to company's ordinary bank account. The SA transfers these shares to the lenders.

The balance in the GSO Bank account, after meeting the fee and expenses of the SA, is transferred to the Investors protection fund account of the stock exchange in which the shares of the company are listed. (If any shortfall is there, that is met the issuer company as a part of share issue expenses.) If the shares are listed on more than one stock exchange, the surplus is divided equally among the Investor protection funds of all these stock exchanges.

***Q. No.21: Write a note about the functions of the merchant bankers.(May, 2005)**

Answer: Merchant Banker has been defined under the Securities & Exchange Board of India (Merchant Bankers) Rules, 1992 as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management".

- issue management – public as well right issues – equity as well debt

  (a) advisory services – timing, size & composition and pricing of issue
  (b) preparation of offer documents with due care & diligence and compliance of legal formalities
  (c) offering the securities to the public/ shareholders
  (d) underwriting of the securities
  (e) ensuring smooth completion of the issue
  (f) Post issue services – allotment, exercise of Greenshoe option

- Management of buy back of shares – Buy back is used by cash rich companies to (i) increase the value of shares (ii) avoid hostile takeover (iii) delisting the shares (iv) optimization of the capital structure.

  (a) Compliance of the provisions of Company Law and SEBI regulations
  (b) Smooth completion of the buy back

(ii) Loan syndication

  (a) negotiation with loan provides like banks, financial institutions
  (b) preparation of information memorandum
  (c) presentation of information memorandum
  (d) negotiating the terms

(e) smooth completion of transaction

(iii) Private placement of equity as well debt

(a) preparation of Information Memorandum
(b) legal compliances – particularly in case of listed companies
(c) placement of the securities to high net worth individuals, financial institutions and other buyers like Private equity (Placement with private equity is done only in case of listed companies)

(iv) Amalgamations and Absorptions

- Advisory services
- Valuation of both the companies for deciding the swap ratio
- Legal compliances – meetings of share holders, filing petition with High court
- Liaison with stock exchange(s) for listing of the securities issued as purchase consideration and delisting of the shares of the amalgamated company
- Ensuring completion deal

(v) Takeover and acquisition :

- Advisory services
- Valuation of both the companies for deciding the swap ratio
- SEBI compliances – meetings of share holders, filing petition with High court
- Liaison with stock exchange(s) for listing of the securities issued as purchase consideration
- Ensuring completion deal

(vi) Research and develop opinions on securities, markets, and economies

(vii) Management of investment portfolios – cash rich companies place their surplus cash with the investment banks for investing in various securities for obtaining appropriate return and maintaining the risk at affordable levels.

(viii) Trading in the securities:

(ix) Securitization :

****Q. No.22:** Write short note on Random Walk theory. **(Nov. 1996)**
Answer :

Random walk theory is stock market theory that states that the past movement or direction of the price of a stock or overall stock market cannot be used to predict its future movement. The theory asserts that stock market's price movement will not follow any pattern or trends and that the past price movements cannot be used to predict future price movement, in other words whatever has come before is meaningless for predicting what is ahead. As per this theory, market prices follow a random path up and down, i.e., the chance of a stock's future price going up is the same as it is for going down, in short run, making it impossible to predict with any accuracy which direction the market will move at any point of time.

A random walk considers a walker who is drunk, he starts somewhere, it is not possible to predict the direction or size of his successive steps, he may even pause for random amount of time. The pattern of steps he has taken cannot be used to estimate his further steps. Hence, no strategy can be formed to beat the market (to make abnormal gains using some analysis of past or so) at least in short run.

Technical Analysis

Technical analysis believes that future share price movement can be obtained by studying the historical price movement of the share prices. They construct charts depicting share prices on various days. By looking at the charts of past price movements, Technical analysts can (i) identify patterns which have occurred in the past, and (ii) anticipate future price movements. The Technical Analysis believes in the maxim that the history repeats itself. Random walk theory is diametrically opposed to technical analysis. The advocates of Random Walk theory hold the view that technical analysis is futile because the market is simply responding to information as it and when becomes available, and that whatever has happened in the past is meaningless for predicting what's ahead.

Random Walk Theory was conceived by a French mathematician Louis in 1900. It gained popularity in 1973 when Burton Malkiel opined that as the share market follows a random path, it is not a reliable source of yield in short run, if one invests taking short term horizon he may gain or he may lose. While many still follow his preaching, others believe that the investing scenario is quite different than it was when he wrote his book. Today, everyone has easy and fast access to relevant news, information and stock prices.

How much truth is there in this theory? It is tough to say. There is evidence that supports both the sides of the debate. The great thinkers of the investment world hold stock market as the place for investing with long-run time horizon; if an investor wants to make money in the stock market, in short run, he is taking additional risk.

****Q. No. 23:** Write a short note on Advantages of a depository system. **(Nov,2001)**

Explain briefly the advantages of holding securities in ‘Demat’ form rather than in Physical form. **(Nov. 2006)**

Answer: Under depository system, the securities (shares, debentures, bonds, government securities, units of mutual funds, etc.) of the investors are held in electronic form. It is a process by which an investor surrenders the share certificates which are returned to the Company or Registrars and subsequently destroyed. An equivalent number of shares are credited (electronically) to the investor's account with the Depository. Whilst in the Company's records, NSDL/CDSL will be the Registered Holder of the dematerialized shares, the Investor continues to be the Beneficial Owner and consequently, all corporate benefits like Dividend, Rights, Bonus, etc. will be issued to the shareholders holding shares in electronic form.

Advantages of depository system:

For the Capital Market:

The following are the advantages of depository system. All these advantages (i) provide liquidity in the capital market (ii) increase the volumes and (iii) help in the development of the capital market.

(i) Shares can be lent under Securities Lending Scheme. It provides liquidity in the capital markets
(ii) Bad deliveries are eliminated. This helps in the development of the capital market.
(iii) It leads to faster settlement cycle
(iv) The system solves the problem of odd lots.
(v) Quick settlements
(vi) Reduction in transaction cost, lower rate of brokerage.
(vii) Bonus shares, stock split, stock consolidation, change in the name of the issuer, effects of amalgamation, etc., are immediately accounted for without any action/instruction of the investor.
(viii) Shares issued under public offer or right offer are automatically and immediately credited to the account of the depositor.

For the Investors: (Advantages of holding the securities in 'Demat' form)

(i) Safe custody of investment certificates.
(ii) Immediate transfer on purchase as well as sale. When one purchases the securities, he can give his depository account details to the broker/issuer, the securities will automatically be credited to his account. Similarly, when one sells the securities, it has to issue a delivery slip to the depository and the securities will be transferred to the account of the concerned person. Instructions can be given on internet also. Depository system has simplified the settlement procedure. Faster realization of sale proceeds
(iii) Dematerialized securities can be easily hypothecated for getting loan against such securities. There could be a reduction in rates of interest

on loans granted against pledge of dematerialized. securities by various banks.

(iv) Nomination facility is provided under this system.

(v) The holding of investments can be verified on internet, the depository also provides transaction statements periodically. Enquiries can also be made on telephones.

(vi) Bonus shares, stock split, stock consolidation, change in the name of the issuer, effects of amalgamation, etc., are immediately accounted for without any action/instruction of the investor.

(vii) Shares issued under public offer or right offer are automatically and immediately credited to the account of the depositor.

(viii) Change of address (for all securities) will be recorded just in one stroke.

(ix) Different types of securities like shares, debentures, Government securities, bonds, Units of Mutual Funds and even Kisan Vikas Patra (the facility of issuing KVP in dematerialized form is available in only selected Post Offices of Mumbai/it is also provided by ICICI Bank) can be held in only one account.

(x) If the investor is not to sell/transfer the securities in near future, he can instruct the depository to freeze the account to enhance the safety.

(xi) No stamp duty on transfer of shares.

(xii) Reduced record keeping. It eliminates handling of huge volumes of paper work involved in filling in transfer deeds and lodging the transfer documents & Share Certificates with the Company.

(xiii) Elimination of risks associated with physical form of certificates like bad delivery, fake securities, loss, theft, mutilation etc.

(xiv) Reduction in transaction cost, lower rate of brokerage, No courier/postal charges

(xv) Shares can be lent under Securities Lending Scheme.

For the issuers of the securities:

(i) Eliminates the threatening problem of fake securities

(ii) Reduction in costs of maintaining the shareholders record.

(iii) Reduction in the cost of transfer of shares.

(iv) Reduction in the cost of Right shares, Bonus shares, public issue, share split and share consolidation.

(v) Large volume of transactions in the stock market. This increases the image of the company.

Q. No. 24: Write a short note on Asset Securitization. **(Nov. 2002)**

Answer : The term Asset Securitization is used is in two references :

(i) The Securities and Reconstruction of Financial Assets and Enforcement of Security Interest, 2002 (popularly known as Securitization Act)

(ii) Debt Securitization

Under Securitization Act: Banks and FIs in India are facing the severe problem of default (in repayment of loans and payment of interest on loans advanced by them) by a large number of borrowers in spite of the fact that most of these loans and advances are secured against the assets of the borrowers. The issue has become unimaginable and threatening to the very existence of the lenders.

In order to help the banks and FIs, the Securities and Reconstruction of Financial Assets and Enforcement of Security Interest, 2002 (popularly known as Securitization Act) was enacted by the parliament. The enactment of this Act has empowered the banks and FIs to attach the assets (on which the lenders have charge) of the defaulters without intervention of time-consuming court procedures. The lenders can issue notices to the defaulters to pay up the dues and the borrowers have to clear their dues within 60 days. Once the borrower receives such notice, the secured assets mentioned in the notice cannot be transferred by the borrower without permission of the lender. The notice requires the borrower that either pay the dues within 60 days or the assets mentioned in the notice will be attached. Besides the assets, the bank can also takeover the management of the borrower establishment. The main purpose of the notice is to bring the defaulters on the negotiation table. (Banks and FIs resort to attachment only as a last resort for two reasons: (i) Sale value of second hand assets is generally very low and (ii) They are not in the business of attachment and sale of assets, they are in the business of financial services.)

On receiving the notice, the borrower has the right of filing an appeal against the notice to the Debt Recovery Tribunal (DRT). In this situation, the lenders cannot dispose off the assets mentioned in the notice without permission of DRT. However, it is mandatory for borrowers who prefer an appeal to the Debt Recovery Appellate Tribunal (DRAT), to deposit upfront 50 per cent of the amount decreed by the DRT (Debt Recovery Tribunal). However, the DRT can reduce the upfront payment to 25 per cent.

Debt Securitization: It is a process under which non-marketable assets such as mortgages, automobiles leases and credit card receivables (such assets are referred as commercial / consumer credits) are converted into marketable securities that can be traded among the investors. Under this process, the consumer / commercial credits (which are assets for financing companies providing credit) are sold to a specially formed separate entity called as Special Purpose Vehicle or trust . The SPV / Trust issues securities (promissory notes or other debt instruments) to the investors based on inflows of these assets. The inflows from the assets (i.e. commercial / consumer credits) are collected in a separate bank account. The investors who have invested in promissory notes or other debt instruments (issued by the SPV or Trust) are first to be paid from this account.

The securities issued by the SPV / Trust are rated independently by the credit rating agencies i.e. credit rating of these securities is based on cash flow pattern of the underlying assets (consumer / commercial credits) and not upon the credit worthiness of the credit originator. It is used mainly by Housing Finance Companies because of the initiative taken by National Housing Bank.

****Q. No. 25:** Write a note on Buy-Back of shares by companies**. (May.2003)**

Briefly explain 'Buy Back of securities' and give the management objectives of Buying Back the Securities. **(Nov. 2004)**

Answer : Buy-back of shares means a company buying back its own shares. It is a company sponsored initiative and has several positive benefits.

In India, buy-back of equity shares is governed by the Companies Act, 1956. In case of listed companies, it is regulated by SEBI's Guidelines 1998. In case of unlisted companies, the buy- back is regulated by the rules framed by the Central Government. Buy-back is allowed, subject to provision in the Articles, out of free reserves or share premium or the proceeds of any shares or other specified securities.

There are five major objectives of the management of buying back of equity shares:

(a) Preventing hostile takeovers

(b) Returning surplus cash to shareholders

(c) Increasing the value of share

(d) To increase the share price when it is low for unwarranted reasons

(e) To achieve/maintain optimum capital structure.

Listed Company

A listed company may buy-back of its equity shares by any one of the following methods:

(a) From the existing shareholders on a proportionate basis through the tender offer (tender offer means an offer by a company to buy-back its equity shares through a letter of offer to the holders of the equity shares of the company)[1].

(b) From the open market through, (i) Book building process[2], (ii) Stock exchange[3], (c) From odd-lot holders[4]

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[1] .*Buy-back through tender offer*: In this case, the company should make a public announcement, the notice should include various details regarding the tender offer like necessity to buy-back, authority to buy-back, management discussion and analysis on likely impact on EPS, etc. The public announcement should contain the specific cut-off date for the purpose of determining the names of the shareholders to whom the offer shall be made. A copy of the public announcement should be sent to SEBI within seven days of the public announcement. The company should send letters of offer to the shareholders and its copy to the SEBI. The offer should remain open for minimum 15 days and maximum 30 days. They should decide about the offer within 15 days of the close of the offer. The company should make payment to the shareholders and extinguish the physical form certificates and destroy the dematerialized shares as per procedure laid by the SEBI in this connection.

[2] *Buy-back from the open market through book building process*: The company should appoint a SEBI approved merchant banker and make a public announcement (containing besides other details, the maximum price at which the company is going to buy-back the shares. A copy of the public announcement should be sent to the SEBI within two days of announcement. The buy-back offer should remain open for not less than 15 days and not more than 30 days. The final buy-back price shall be decided by the company and the merchant banker. The final buy-back price, which shall be the highest price accepted shall be paid to all bidders whose bids have been accepted. The company should extinguish the physical form certificates and destroy the dematerialized shares as per procedure laid by the SEBI in this connection.

[3] *Buy-back from the open market through stock exchange* : The company should appoint a SEBI approved merchant banker and make a public announcement (containing besides other details, the maximum price at which the company is going to buy-back the shares) in this regard. A copy of the public announcement should be sent to the SEBI (within two days of announcement). The buy-back shall be made only on those stock exchanges which have electronic trading system. Under this method, the shares of promoters or persons in control of the company cannot be bought. The company should extinguish the physical form certificates and destroy the dematerialized shares as per procedure laid by the SEBI in this connection.

A company cannot buy-back its shares from any person through negotiated deal or private arrangement.

Unlisted Company

An unlisted company can buy-back its equity shares by either of the following two methods:

(i) From the existing shareholders on proportionate basis through private offer.

(ii) By purchasing shares issued under stock option scheme to the employees.

The company should prepare a letter of offer. Before sending it to the shareholders, a copy should be sent to the Registrar of Companies. The offer should remain offer for not less than 15 days and not more than 30 days. After the buy-back is complete, a return should be filed with the Registrar and the bought back shares should be extinguished.

Though many Indian companies have opted for the buy-back scheme (Reliance, Siemens, Punjab Communication, Reliance Energy, Sun Pharma, Mastek, Britania Indian Motor Parts and Accessories, Indian Forge and Stampings, Fineline Circuits, Avery India, etc., to name a few), it has not been a big drive in India because the companies are neither so cash rich nor they face the dangers of hostile takeovers because of SEBI regulations regarding takeovers.

*****Q. No. 26: Write a note on Book Building. (Nov. 2003)**

What is the procedure for the book building process? Explain the recent changes made in the allotment procedure. (May, 2006)

Answer : Public issue of shares can be made in two ways:

- Fixed price method, and
- Book-building method.

Fixed price issues are issues in which the issuer fixes the issue prices of the shares offered to the public. Prospectus is filed with the SEBI, stock exchanges and the registrar of companies.

In case the issuer chooses to issue securities through the book building route then as per SEBI guidelines, an issuer company can issue securities in the following manner:

[4] Same provisions as applicable to buy-back through tender offer.

a. 100% of the net offer to the public through the book building route.
b. 75% of the net offer to the public through the book building process and 25% through the fixed price portion.

Book-building is a process used for discovery of demand at various prices and efficient price in public offers. The issuer set base price / a band within which the investor is allowed to bid for shares. For example, the price band may be Rs.100-Rs.120. It involves a mechanism where, during the period for which book building for the issue in open, bids are made by investors at various prices, which are above or equal to floor price (minimum price at which bid can be made) or which are based on a price band. The process helps the issuer to get better idea of investors' perception about the public issue. The offer price is determined after the bid closing date.

In this case the Red Herring Prospectus is filed with SEBI. It is a draft prospectus which is used in book built issues. It contains all disclosures except the price and is used for testing the market reaction to the proposed issue.

The various bids received from the investors are recorded in a book, that is why the process is called as book building. The offer price is determined after the bid closing date. Investors bidding at a price below the cut-off price are not allotted the shares and their money is being refunded.. So those investors who apply at a price higher than the cut-off price have a higher chance of getting the stock. Allotment is made through a proportionate allotment system.

The allotment should be made as follows :

(1) Qualified institutional Buyers (QIBs) (Scheduled Commercial Banks, Public financial institutions, FII registered with SEBI, State financial corporations, Venture capital funds registered with SEBI, Mutual funds, foreign venture capital funds registered with SEBI) – Maximum 50 % of net public offer. 5% of net public offer is reserved for the Mutual funds. The QIBs are required to pay only 10% amount at the time of bid, they have to pay the balance on allotment.

(2) 35% (Minimum) of net offer to the retail investors . Retail individual investor' means an investor who applies or bids for
securities of or for a value of not more than Rs.1,00,000.

(3) 15% (minimum) of net offer to the non-institutional investors including High Net Worth Individuals.

In case the size of issue is less than 25% of the post issue capital, 60% (maximum)of the issue shall be shall be allotted to the QIBs , 10% to NIBs and

30% to the retail individual investors. Suppose a company's issued capital is Rs. 100 Crores, it goes for public offer of Rs. 20 Crores, these limits would be applicable.

The recent amendments are :

(i) Mutual funds are covered under QIBs. Out of total limit for the QIBs,5% of net public offer is reserved for the Mutual fund (Earlier there was no reservation for the Mutual funds). For the remaining shares to be allotted to the QIBs, the MFs shall be treated at par with the other QIBs.
(ii) QIBs are required to pay 10% of the bid. (Earlier these institutions were not required to pay any amount at the time of bid). They have to pay the balance of the amount at the time of allotment.
(iii) Allotment to QIBs is being done on prorata basis. (Earlier the allotment was totally at the discretion of the company and the Book-runner Lead manager.
(iv) At present the retail individual investor means an investor who applies or bids for securities of or for a value of not more than Rs.1,00,000. (Earlier the limit was Rs……….)
(v) The companies are supposed to allot 50% shares to QIBs, 15% to Non-institutional buyers (High net-worth individuals) and 35% to retail investors. Earlier it was 50% shares to QIBs and 25% each to Non-institutional buyers (High net-worth individuals) and retail investors.

Q. No. 27: Write a note on Stock Lending Scheme. **(Nov. 2004)** Stock Lending Scheme – Its meaning, advantages and risk involved.**(May, 2005)**

Answer : Securities Lending Scheme, a scheme formulated by SEBI, came into effect from the 6 February, 1997. The objects of the scheme are:

(i) To improve the liquidity in the stock market.
(ii) To facilitate the timely settlement of transaction of the securities.
(iii) To help in correcting the imbalances in supply and demand in the stock market.

The scheme permits the lending of the securities, through SEBI registered intermediary,[1] to a borrower under an agreement for a specified period with the condition that the borrower will return the securities at the end of the specified period. (Under the scheme, borrower cannot discharge his liabilities of returning the securities through cash or kind.) All the benefits like bonus shares, dividend, etc., will be accruing to the lender. The legal title of the securities is temporarily transferred to the borrower who will be entitled to deal with or dispose of the securities so borrowed. The securities lender uses this scheme for maximizing yields on his investments, he is entitled to receive an agreed amount of fees. It is used by the borrowers to avoid settlement failures. Sometimes, some market participants, expecting fall in price in future, borrow securities, sell them on spot, later on purchase at decreased price to return the securities to the lender.

The Central Board of Direct Taxes (CBDT) has clarified that lending securities, under this scheme, does not constitute transfer and hence, it does not attract tax under Income-tax Act, 1961.

Under the scheme, the borrower has to deposit collateral securities, which could be cash, bank guarantee, government securities or other securities or certificates of deposits with the intermediary. In case of default by the borrower in returning the securities, the intermediary is expected to liquidate the collateral securities. The intermediary should inform the SEBI immediately. Full credit risk on the securities lent is born by the approved intermediaries. Lending and borrowing of securities is not permitted directly (i.e., without SEBI approved intermediary) between two persons.

Advantages of Stock Lending Scheme :

To the lender : (i) The lender can maximize the return on his portfolio as he gets the lending charges.(ii) No safe keeping fees

To the Borrower : (i) Avoidance of settlement failure (ii) Profit through short Sales

To the Capital market : (i) improvement of liquidity as the securities which otherwise would have been inactive are traded in the market (ii) Avoidance of settlement (iii) reduced market volatility.

To the intermediary: (i) Source of extra income.

Risks involved in Stock Lending scheme :

For the intermediary : The borrower may default (not return the securities on maturity date) and collateral being held is insufficient repurchase the loaned shares in the open market.

For Borrower : By the time the borrower is supposed to return the securities, the prices may go up and the borrower has to purchase the shares at high prices for returning the same to the lender. This may cause loss to the borrower.

For the lender : The default by the intermediary may cause loss to the lender.

The scheme could not gain popularity, because

(i) the lender has to sacrifice the opportunity of selling the securities during the period for which the security has been lent even case of boom, and

(ii) the cost of borrowing of securities being exorbitantly high. The scheme is not considered as efficient and effective by the market participants and hence, practically it is defunct.

A working group of the SEBI has suggested special banks for securities lending and borrowers, where market participants may lend (in the same way in which they deposit their money with bank, i.e., in current account where any time withdrawal is permitted, savings account where restricted withdrawals are permitted and in fixed deposit account where withdrawal is permitted only on maturity) and from where the borrowers may borrow.

****Q. No. 28:** Explain the term Insider 'Trading' and why it is punishable**. (Nov. 2004)**

Answer :

Insider trading is the trading of a security of a company (e.g., shares) by an *insider*, a person who knows information that is not accessible to the public. It is abuse of the confidential information by the persons who are insiders and are in possession of such information and as such is unethical, immoral, breach of fiduciary position of trust and confidence.

An example of insider trading may be that a Chief Executive Officer, knowing that his company is going to be taken over which is expected to bring upward movement in share prices, purchases shares of his own company (before this piece of information is known to the stock exchange).

SEBI (Prohibition of Insider Trading) Regulations, 1992 (the "Insider Trading Regulations") have been framed to prevent prohibit and penalize insider trading in India. The Insider Trading Regulations prohibit an "insider"[5] from dealing, either on their own behalf or on behalf of any other person, in the securities of a company listed on any stock exchange when in possession of unpublished price sensitive information[6]. The insider is prohibited from communicating, directly or indirectly, any unpublished price sensitive information or giving investment advice about relevant securities to any other person.

The Insider Trading Regulations make it compulsory for listed companies to establish an internal code of conduct to prevent insider trading. The Insider

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[5] Directors, officers and other designated employees. [Designated employees include (a) All employees in the managerial grade (b) All employees in Accounts department (c)Secretarial Officers(d) Personal assistants of whole time directors & presidents

[6] Price-sensitive information" has been defined as periodical financial results of companies, dividend declaration, issue or buy-back of securities, any major expansion plans or execution of new projects, amalgamation, mergers or takeovers, disposal of whole or substantial part of undertaking and significant changes in policies, plans or operations of the company. – S K Lokeswarri – The Hindu Business Line 29th April, 2007.

Regulations provide a model code for this purpose. The model code provides that All Directors/Officers/Designated Employees shall obtain prior approval of the Compliance Officer in the prescribed form while entering into the deals of securities of the company where the trade exceeds above a minimum threshold limit (to be decided by the company). Directors/Officers/Designated Employees who violate the Code shall be subject to disciplinary action by the Company which may include wage freeze, suspension, ineligibility for further participation in ESOPs, etc. In the event of any contravention of the Code by any Director/Officer/Designated Employee, the Compliance Officer shall inform the same to SEBI.

The Insider Trading Regulations were significantly amended for the first time in 2002 to plug certain loopholes revealed during the case of Hindustan Lever Ltd Vs SEBI; Rakesh Agarwal Vs SEBI etc, which introduced mandatory disclosures by persons holding 5% or more voting rights, directors or officers of the listed companies, and restrictions in respect of insiders trading during vital announcements. SEBI has proposed some amendments[7] to the regulations to curb the insiders trading. Under the proposed regulations, the insider would be asked to surrender the profits made through trading in shares of the company as well as its parent and subsidiaries, if the purchase and sale transactions are conducted within a period of six months.

Insider trading is prohibited by the SEBI as (i) it results into unfair gains to insiders and harms the interest of other shareholders (ii) it downgrades the image of the company (iii) it drives away the investors from the market (iv) it causes unwarranted volatility in the prices of the shares of the company.

Indian capital markets are increasingly becoming global. In this scenario, we must develop legislative and regulatory mechanisms to protect investors and build confidence in capital markets from both domestic and international perspectives. It is very important for the regulator to check the practice of insider trading so as to maintain investor confidence.

****Q. No. 29:**. Explain the term 'Offer for sale' **(May, 2005)**

Answer: The term 'offer for sale' is used in two references :

(A) An offer of securities by existing shareholder(s) of a company to the public for subscription, through an offer document. In this way the company facilitates one or more existing shareholder(s) to dispose off its/their holding through an offer for sale. This term is quite popular in India these days as the Central Government has offered its holdings in Public Sector Undertakings (For example, Maruti Udyog Ltd, IPCL, GAIL, ONGC, CMC) to the public mainly through this method

[7] The draft amendments have been on the internet site of SEBI for public comments. The comments should reach the SEBI on or before 28th March, 2008.

(The offer is referred as Offer for sale by the President of India). The offer document is prepared by the company and it has to be submitted to SEBI before the offer is made. The securities can be offered for sale only subject to SEBI permission. Recently, there have been some other cases of offer for sale. For example, in 2007, ICRA[8] offered its about 26 Lakhs shares to the public through a 100% book-building process. The offer was actually an offer for sale by its three shareholders (i) Specified Undertaking of UTI (ii) IFCI and (iii) SBI.

(B) Offer for sale is the most common way of making a new issue of shares by the companies in USA and European countries. Under this method, the sponsors of the issue (usually an Investment Bank or a group of Investment banks) purchase the shares from the issuer and offer them for sale to the investors through an offer document, stating the terms of issue and opening and closing dates for receiving the applications. This method of issuing the shares is cheaper than a direct invitation to the public by the issuing company itself to subscribe for new shares.

The sponsors offer shares to the public by inviting subscriptions from investors by either of the two methods :
(a). Offer for sale by fixed price - the sponsor fixes the price prior to the offer.
(b). Offer for sale by tender - investors state the price they are willing to pay. The issue price is established by the sponsors after receiving all the bids.

***Q. No. 30 :** write a short note on Debt Securitization **(May 2005)**
What is securitization? What are its various instruments ? **(Nov. 2005)**

Explain what is meant by Debt Securitization. **(May, 2004)**

Answer : The term securitisation refers to Debt Securitisation. It is a process under which non-marketable assets such as mortgages, automobiles leases and credit card receivables (such assets are referred as commercial / consumer credits) are converted into marketable securities that can be traded among the investors. Under this process, the consumer / commercial credits (which are assets for financing companies providing credit) are sold to a specially formed separate entity called as Special Purpose Vehicle or trust . The SPV / Trust issues securities (promissory notes or other debt instruments) to the investors based on inflows of these assets. The inflows from the assets (i.e. commercial / consumer credits) are collected in a separate bank account. The investors who have invested in promissory notes or other debt instruments (issued by the SPV or Trust) are first to be paid from this account.
The securities issued by the SPV / Trust are rated independently by the credit rating agencies i.e. credit rating of these securities is based on cash flow pattern of the underlying assets (consumer / commercial credits) and not upon the credit worthiness of the credit originator. (It is the main reason for the recent sub-prime mortgage in USA)

[8] Investment Information and Credit Rating Agency of India

Features of a debt securitization transaction are :

(i) Legal sale of assets (consumer /commercial credits) to an SPV with narrowly defined purposes and activities

(ii) Issuance of securities (promissory notes, other debt instruments etc), by the SPV to investors , collateralized by the underlying assets (consumer / commercial credits purchased).

(iii) Investors rely on the performance of collateralized assets and not upon the credit of originator (the seller) or the SPV (the issuer).

(iv) The bankruptcy of the seller or the issuer does not affect the investor.

(v) Independent credit rating , on the basis of collateralized assets.

Instruments of debt securitization :

(i) Pass Through certificates: In the pass through structure, investors (those who have invested in the securities issued by the SPV) are serviced as and when the cash is actually generated by the underlying assets. Even prepayments are passed on to the investors.

(ii) Pay Through certificates : A pay-through security is a general obligation of the issuer secured on a pool of mortgages. The investors (those who have invested in the securities issued by the SPV) are serviced on fixed dates. The surplus cash generated from the underlying assets are invested for short terms.

Debt securitization has not got the support it deserves (as a tool of unlocking the locked non-marketable securities) in spite of the fact that the RBI has permitted the banks to invest in the securities issued by the SPVs. The instrument has been used mainly by Housing Finance Companies because of the initiative taken by National Housing Bank.

To make this instrument more popular, the following reforms are required :

(i) Separate legislation

(ii) Abolition of stamp duty levied by the State Governments

(iii) Clarification regarding taxability of income arising the SPV under the Income Tax Act, 1961.

****Q. No. 31**: Explain the terms ESOS and ESPS with reference to SEBI guidelines for the Employees Stock Option Plans. (**Nov. 2004**)

Answer: EMPLOYEE STOCK OPTIONS PLANS

ESOPs are used as a way by the companies to reward the management and the employees and link their interests with those of the company and other shareholders. Many companies use employee stock options plans to compensate, retain, and attract employees. These plans are contracts between a company and its employees that give employees the right to buy a specific number of the company's shares at a fixed price within a certain period of time. Employees who are granted stock options hope to profit by exercising their options. Here's an example of an employee stock option plan: an employee is granted the option to purchase 1,000 shares of the company's stock at the price of Rs.20 per share. The Plan allows the employee to exercise his options after 3 years[9] provided the employee continues in service of the company. Exercise period is 2 years[10]. Suppose after three years the price of the stock increases to Rs.100 per share, for example, the employee may exercise his option and buy 1000 shares @ Rs.20 per share.

SEBI Guidelines :
(I)The ESOP shall be approved by the shareholders by a special resolution. The resolution shall contain terms and conditions of the Plan.

(II) Lock-in period, vesting and exercise of options
(i) There should be a minimum period of one year between the grant of options and vesting.
(ii) There should be a maximum period of eight years between the grant of options and vesting.
(iii) Employee options must be exercised within a maximum period of five years from the date of vesting.
(iv) Shares issued in exercise of options shall not be subject to any lock-in period.

(III) Options are not be transferable.

(IV) Board of Directors shall disclose either in the Directors Report or in the annexure to the Director's Report, the details of the operation of the ESOP.

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[9] Here the vesting period is three years. Vesting means getting the right to exercise the option. In this example, the employee gets the right of exercising the option after three years from the date of the grant of the option provided he continues in the employment of the company.

[10] Suppose the option is granted on 1.1.2003. The employee gets the right of exercising the option on 1.1.2006. He may exercise the option up to 1.1.2008 i.e. on or after 1.1.2006 and up to 1.1.2008, he may apply to the company to issue him 1000 shares against the payment of Rs. 20 per share. If the exercise period lapses the vested option lapses and no right shall accrue to the employee thereafter. The employee may exercise all the options vested in him in one stroke or choose to exercise a number of options within the exercise period.

Upon vesting, the employee gets an unfettered right to apply for the issue of shares . In the event of an employee resigning from the services of the company or his employment being terminated for whatever reasons, all unvested options shall expire as on that date, but the employee would retain all the vested options (except only when the employment is being terminated for some misconduct)

(V) the Board of Directors shall at each AGM place before the members a certificate from the auditors of the company that the scheme has been implemented in accordance with SEBI guidelines and in accordance with the resolution of the company in general meeting.

EMPLOYEE STOCK PURCHASE PLANS

Employee Stock Purchase Plan (ESPP) means a plan under which the company offers shares to employees as part of a public issue. Such plans are designed to promote employee stock ownership broadly within the firm. Many companies such plans to compensate, retain, and attract employees.

SEBI Guidelines

- The ESPP should be approved by the shareholders by a special resolution which should specify the price of the shares and also the number of shares to be offered to each employee. The number of shares offered may be different for different categories of employees.

- Companies have full freedom to price the shares under an ESPP at any level.

- Shares issued under an ESPP shall be locked in for a period of one year. However if the ESPP is part of a public issue and the shares are issued to employees at the same price as in the public issue, the shares shall not be subject to any lock-in.

- The details of the shares issued under the ESPP and the terms and conditions thereof shall be disclosed in the Directors' report or in an annexure thereto.

****Q. No. 32 :** Distinguish between Forward and Futures contracts. **(May 2002, Nov. 2002, May 2006)**

Answer : Basic differences between forward and futures contracts :

(1) *Regulation*: The forward market is self-regulating. Future market is regulated by futures exchange.

(2) *Size of Contract*: Forward contracts are individually tailored and tend to be much larger than the standardized contracts on the futures market. Futures contracts are standardized in terms of currency amount..

(3) *Delivery Dates*: Banks offer forward contracts for delivery on any date. Futures contracts mature on only specified dates.

(4) *Settlement*: Forward contract settlement occurs on the date agreed upon between the bank and it customer. Future contract settlement are made daily via the exchanges clearing house; gains on position values may be

withdrawn and losses are collected daily. The practice is known as marking to market.

(5) *Quotes*: Forward prices generally are quoted in units of local currency per U.S. dollar. Future contracts are quoted in American terms (dollars per one local currency unit).

Q. No. 33: Distinguish between intrinsic value and Time value of the option. **(Nov. 2004 , May 2006)**

Answer : Let's understand the concept with the help of an example. Suppose, the spot price is Rs. 300. three months call option (with a strike price of Rs. 270 is being quoted in the market at a price of Rs. 37.99). Mr. X is interested in buying one share.(He wants to gift this share to some one after three months). He is considering two alternatives. Under the first alternative, he will pay Rs. 300 today, buy one share today and gifts it after three months from today. Under the second alternative, he can purchase a call at a strike price of Rs. 270. Mr. X will have two savings (i) he shall be paying thirty rupees less and (ii) there shall be a savings of interests because a major part of price (i.e. Rs. 270) shall be payable after three months (instead of today).

The first saving is referred as intrinsic value. Intrinsic value is the difference between spot price and strike price. The intrinsic value of an option reflects the effective financial advantage which would result from the immediate exercise of that option. In this example, Rs. 30 is intrinsic value.

	Call	Put
Strike price < spot price	Intrinsic value >0	Intrinsic value = 0
Strike price > spot price	Intrinsic value = 0	Intrinsic value > 0
Strike price = spot price	Intrinsic value = 0	Intrinsic value = 0

The second saving is referred as extrinsic value (it is also refereed as time value) of the option. It is equal to total value of the option minus intrinsic value of the option. In this example, the extrinsic value is Rs.7.99. If intrinsic value is zero, the total value of the option is extrinsic value. It depends upon the remaining lifespan of the option, the volatility and the interest rates.

Example :

	Strike price	Spot price	premium	Intrinsic value	Time value
Call	38	39	3	1	2
Put	38	39	1	0	1
Call	38	38	1	0	1
Put	38	38	0.75	0	o.75
Call	39	38	0.75	0	0.75
Put	39	38	3	1	2

****Q. No. 34:** Write a brief note about regulation of NBFCs in India**. (May, 2005)**

Answer :

A NBFC is a company engaged in the business of providing credits, acquisition of marketable securities, hire purchase and/ leasing business. These companies:

- can not accept demand deposits
- can not issue cheque books.
- The deposits in such companies are not covered by deposit insurance.
- Such companies must be registered with RBI, minimum capital Rs.2 Crores
- Maximum interest rate that can be paid by such companies is 12.50%.

All NBFCs are not entitled to accept public deposits. Only those NBFCs holding a valid Certificate of Registration with authorization to accept Public Deposits can accept/hold public deposits. The NBFCs are allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months. They cannot accept deposits repayable on demand.

RBI regulates the NBFC through the following measures :

(i) Mandatory Registration.
(ii) Minimum owned funds.
(iii) Only RBI authorised NBFCs can accept public deposits.
(iv) RBI prescribes the ceiling of interest rate.
(v) RBI prescribes the period of deposit.
(vi) RBI prescribes the prudential norms regarding utilization of funds.
(vii) RBI directs their investment policies.
(viii) RBI inspectors conduct inspections of such companies.
(ix) RBI prescribes the points which should be examined and reported by the auditors of such companies.
(x) RBI prescribes the norms for preparation of Accounts particularly provisioning of possible losses.

If any of interest or principal or both is/ are due from any customer for more than 6 months, the amount is receivable (interest or principal or both) is termed as non-performing asset.

Every NBFC shall classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes namely,

(i) Standard assets; (ii) Sub-standard assets;
(iii) Doubtful assets; and (iv) Loss assets

(i)Standard asset – no risk of recovery (other than normal business risk)

(ii)Sub standard asset

- an asset classified as non-performing for period not more than 18 months
- not one year of satisfactory performance expired for renegotiated loans

(iii) Doubtful asset

- term loan, lease asset , hire purchase asset or any other asset which remains sub-standard for exceeding 18 months
- equity shares of loss making company
-

(iv) loss asset

- identified as such by NBFC or auditors or RBI inspectors
- the recovery from the asset received as security becomes doubtful

Provisioning requirements:

(a) Loss assets – 100%

(b) Sub- standard asset – 10 %

(c) Doubtful asset

- non-secured portion – 100%
- for secured portion

Period for which considered as doubtful	% of provision
Up to one year	20
One to three years	30
More than three years	50

Capital adequacy Norms: Every NBFC shall maintain a minimum capital ratio consisting Tier I and Tier II capital (not exceeding 100 % of Tier I capital) which shall not be less than 12 % of aggregate of Weighted risk assets and risk adjusted value of off Balance-Sheet items.

Q. No. 35: What is credit rating? **(May, 2006)**

Briefly explain the meaning and importance of 'Credit Rating'**. (May, 2002)**

Write a short note on credit rating in India.**(Nov. 2003)**

Answer

Credit rating is, essentially, the opinion of the credit rating agency on the relative ability of the issuer of a debt instrument to meet the debt service obligations (about that particular debt) as and when they arise. This opinion is given on the basis of past performance and all available information (audited financial statements, audit reports, information from management, banks and FIs, industry trends and management capabilities). The rating is for a particular instrument and not for the company as a whole, two debt instruments issued by one issuer may have different ratings.

Credit rating is an opinion expressed by an independent professional organization, after making detailed study of all relevant factors. Such opinion is of great assistance to the investors as it helps them in taking investment decisions. It also helps the issuer in determining the price and interest rate of the debt instrument under consideration. Regulators like RBI and SEBI have stipulated that obtaining rating is obligatory in many cases. For example, RBI guidelines provide that commercial papers can be issued only on the basis of suitable rating.

There are three important credit rating agencies in India :

(i) Credit Rating Information Services of India Limited (CRISIL).

(ii) Investment Information and Credit Rating Agency of India (ICRA).

(iii) Credit Analysis & Research Limited (CARE).

Credit rating is expressed in the form of symbols, this helps in their easy understanding. (For example : CRISIL's AAA expresses a long-term debt's highest safety and timely payment of principal and interest.) Plus symbol is used to indicate finer distinctions within a rating category.

A rating is an opinion given at a particular point of time. As the time passes, many things change affecting the debt servicing capacity, the change may upgrade or downgrade the rating.

A rating is neither an investment advice nor it is a recommendation to buy or sell the security that has been rated by the credit agency.

A credit rating is not a guarantee against future losses.

Credit rating agencies are an integral part of the financial markets. In India, for carrying the activities of a credit rating, the credit rating agency (CRA) should obtain a certificate of registration from the SEBI. The certificate granted by the SEBI has a validity of three years after that it can be renewed.

SEBI has provided a Code of Conduct for the CRAs:

(1) A CRA in the conduct of its business shall observe high standards of integrity and fairness in all its dealings with its clients.

(2) A CRA shall not indulge in unfair competition.

(3) A CRA shall not make any exaggerated statement.

(4) A CRA shall not divulge any confidential information about its client, which has come to its knowledge.

(5) A CRA shall not make untrue statement or suppress any material fact in any documents, reports, papers or information furnished to the Board or to public or to stock exchange.

(6) A CRA or any of his employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media.

****Q. No. 36:** Explain briefly the two basic principles of effective portfolio management**. (May 1996; Nov. 1999)**

Answer :

The two basic principles of effective portfolio management are :

(i) Invest on the basis of fundamentals of the security.

(ii) Review and update the portfolio regularly.

The object of the portfolio management is to provide maximum return on the investments by taking only optimum risk. To achieve these objectives, the portfolio manager should invest in diversified securities and see that the coefficient of correlation between these securities is as less as possible (only then the portfolio will be able to reduce the risk). This is the foundation of portfolio management. The portfolio manager should follow the above-mentioned principles to further strengthen his targets of higher returns and optimum risk.

The first principle suggests that investment should be made only in those securities which are fundamentally strong. The strength of a security depends upon three strengths: (a) strength of the company, (b) strength of the industry, and (c) strength of the economy. The strength of the company depends upon various factors like (i) intelligent, dedicated and motivated human resources, (ii) management having positive values and vision, (iii) policy regarding encouraging R&D, (vi) integrity of promoters, and (v) long range planning for profits. The fundamentals of the industry depend upon the product Þ consumer surplus the product provides to its users, various possible alternative uses of the product, and availability (rather we should say non-availability of the substitutes). Economy, here, means national economy. By fundamentals of the economy we mean Þ recession/boom, tax policy, monetary policy, budgetary policies, stability of government, possibility of war and its impact on economy, closed/open economy and finally the government's attitude towards business houses. The portfolio manager should see that most of the fundamentals are favourably placed.

The second principle suggests that the portfolio should be reviewed continuously and if need be, revised immediately. The Fundamentals of the company, industry and economy keep on changing. Accordingly, the portfolio should be revised according to emerging situations. For example, in case of monsoon failure, investments should move from fertilizer companies to irrigation companies, in case some sick-minded person takes over as CEO of the company, perhaps desired step will be to disinvest the securities of the company, in case cheaper substitutes have emerged for any industry's product, better move to some other industry, etc.

Two more points regarding the second principle

(i) Sometimes, after making the investment in some securities, portfolio manager realizes that his decision of investing in that security is wrong, he should not wait for happening of some event which will make his decision as a right one (if there is some loss on that investment, he should not even wait for breakeven); rather he should move immediately liquidate his position in that security. [Remember that no portfolio manager has ever made 100 per cent correct decisions (Warren Buffet is perhaps exception)

(ii) Do not bother much about transaction cost related to reshuffling of the portfolio, consideration of such small costs generally result in heavy losses or foregone opportunities of earning profit.

****Q. No. 37:** " Higher the return, higher will be the risk". In this context discuss the various risks associated with portfolio planning**. (Nov. 1996)**

Answer :

First deserve and then desire is an old maxim. The wisdom of this maxim is that higher return should be expected only by those who are willing to bear higher risk. If an investor is not willing to go for higher risk, he should invest in risk-free securities (say, for example Government securities) and naturally he should not expect the higher return. There are two parts of return from investment (i) Risk-free return, and (ii) risk premium. It is the risk premium that enhances the return from the investment. Risk premium is a function of risk. Risk premium changes in direct proportion of risk (return does not change in direct proportion of risk). Hence, higher return should be expected only by those who bear higher degree of risk.

The statement that Higher the return, higher will be risk needs to be amended. The word will should be substituted by the word may. Higher risk may result in one of the following three mutually exclusive cases : (i) Higher return, (ii) Lower return, (iii) Negative return. Taking higher return is no guarantee of higher return. Everyone wants higher return; if taking higher risk is guarantee of higher return, no one will go for lower risk.

Higher risk may not result in higher return because of the following risks associated with the investments:

Unsystematic Risk

It is also known as micro level risk. It is concerned with the company or industry. Strike, wrong decisions by the management, change in management, increase in input costs (without increase in sale price), change in government policy regarding particular type of companies or products, emerging of substitutes of the company's product(s), cancellation of export order, key-person leaving the company, fire, embezzlement by employees, unexpected tax demand, major problem in the plant, etc. The incidence of such risks can be reduced through effective portfolio selections. The two serious unsystematic risks are:

(i) Business risk: Financial risk is the possibility of adverse change in EBIT. Examples are: Reduction in demand for company’s products, increase in costs of inputs, change in import-export policy concerning the company, Labour strike, some key-person’s leaving the company, cancellation of large sized export order etc.

(ii) Financial risk: It is the possibility of bankruptcy. It arises because of dependence on borrowed funds and that to it high interest rates.

Systematic Risk

It is known as macro level risk. It is concerned with the economy as a whole. The factors causing this type of risk affect all the investments in a similar fashion (and not in a similar degree). Examples are : failure of monsoon, change in government, change in credit policy, recession, war, change in tax policy, etc. Every portfolio has to bear this risk. The two most serious systematic risks are :
(i) Interest rate risk : increase in interest rates generally have adverse effects on the financial position and earnings of the companies.
(ii) Inflation risk : inflation disturbs business plans of the most of the organizations. Labour cost goes up.

Q. No. 37: Write a short note on the objectives of portfolio management. **(Nov. 1998)**

Answer: OBJECTIVES OF PORTFOLIO MANAGEMENT

There are seven objectives of portfolio management:

Return

Portfolio management is technique of investing in securities. The ultimate object of investment in the securities is return. Hence, the first objective of portfolio management is getting higher return.

Capital Growth

Some investors do not need regular returns. Their object of portfolio management is that not only their current wealth is invested in the securities; they also want a channel where their future incomes will also be invested.

Liquidity

Some investors prefer that the portfolio should be such that whenever they need their money, they may get the same.

Availability of Money at Pre-decided Time

Some persons invest their money to use it at pre-decided time, say education of children, etc. Their objective of portfolio planning would be that they get their money at that time.

Favourable Tax Treatment

Sometimes, some portfolio planning is done to obtain some tax savings.

Maintaining the Purchasing Power

Inflation eats the value of money, i.e., purchasing power. Hence, one object of the portfolio is that it must ensure maintaining the purchasing power of the investor intact besides providing the return.

Risk Reduction through Diversification

It is the perhaps most important object of the portfolio management. All other objectives (mentioned above) can be achieved even without portfolio, i.e., through investment in a single security, but reduction (without sacrificing the return) is possible only through portfolio.

Single most important objective of the portfolio management is risk reduction through diversification.

If we invest in a single security, our return will depend solely on that security; if that security flops, our entire return will be severely affected. Clearly, held by itself, the single security is highly risky. If we add nine other unrelated securities to that single security portfolio, the possible outcome changes Þ if that security flops, our entire return won't be as badly hurt. By diversifying our investments, we can substantially reduce the risk of the single security. Diversification substantially reduces the risk with little impact on potential returns. The key involves investing in categories or securities that are dissimilar.

****Q. No. 38 :** Write a short note on systematic and unsystematic risk in connection with the portfolio investment. **(May, 1999)**

Distinguish between Systematic and Unsystematic risk**. (Nov. 2004)**

Discuss various kinds of systematic and unsystematic risks. **(Nov. 2006)**

Answer : Unsystematic Risk

It is also known as micro level risk. It is concerned with the company or industry. Strike, wrong decisions by the management, change in management, increase in input costs (without increase in sale price), change in government policy regarding particular type of companies or products, emerging of substitutes of the company's product(s), cancellation of export order, key-person leaving the company, fire, embezzlement by employees, unexpected tax demand, major problem in the plant, etc. The incidence of such risks can be reduced through effective portfolio selections. The two serious unsystematic risks are:

(i) Business risk: Business risk is the possibility of adverse change in EBIT. Examples are: Reduction in demand for company’s products, increase in costs of inputs, change in import-export policy concerning the company, Labour strike, some key-person’s leaving the company, cancellation of large sized export order etc.

(ii) Financial risk: It is the possibility of bankruptcy. It arises because of dependence on borrowed funds and that to it high interest rates.

(iii) Default risk: The major customer of the company may go bankrupt.

Systematic Risk

It is known as macro level risk. It is concerned with the economy as a whole. The factors causing this type of risk affect all the investments in a similar fashion (and not in a similar degree). Examples are : failure of monsoon, change in government, change in credit policy, recession, war, change in tax policy, etc. Every portfolio has to bear this risk. The two most serious systematic risks are :
(i) Interest rate risk : increase in interest rates generally have adverse effects on the financial position and earnings of the companies.

(ii)Inflation risk : inflation disturbs business plans of the most of the organizations. Input costs m ay go up, all the increase in input costs may not been passed to the customers.

(iii) Political risk : This risk involves (a) change in government policies and (political instability.

** **Q. No. 39 :** Write note on factors affecting investment decisions in portfolio management. (**May, 2000)**

Answer;

Factors affecting investment decisions in portfolio/asset allocation in portfolio are as follows:

Risk Tolerance

RISK refers to the volatility of portfolio's value. The amount of risk the investor is willing to take on is an extremely important factor. While some people do become more risk averse as they get older; a conservative investor remains risk averse over his life-cycle. An aggressive investor generally dares to take risk throughout his life. If an investor is risk averse and he takes too much risk, he usually panic when confronted with unexpected losses and abandon their investment plans mid-stream and suffers huge losses.

Return Needs

This refers to whether the investor needs to emphasize growth or income. Most younger investors who are accumulating savings will want returns that tend to emphasize growth and higher total returns, which primarily are provided by equity shares. Retirees who depend on their investment portfolio for part of their annual income will want consistent annual payouts, such as those from bonds and dividend-paying stocks. Of course, many individuals may want a blending of the two Þ some current income, but also some growth.

Investment Time Horizon

The time horizon starts when the investment portfolio is implemented and ends when the investor will need to take the money out. The length of time you will be investing is important because it can directly affect your ability to reduce risk. Longer time horizons allow you to take on greater risks Þ with a greater total return potential Þ because some of that risk can be reduced by investing across different market environments. If the time horizon is short, the investor has greater liquidity needs Þ some attractive opportunities of earning higher return has to be sacrificed and the result is reduced in return. Time horizons tend to vary over the life-cycle. Younger investors who are only accumulating savings for retirement have long time horizons, and no real liquidity needs except for short-term emergencies. However, younger investors who are also saving for a specific event, such as the purchase of a house or a child's education, may have greater liquidity needs. Similarly, investors who are planning to retire, and those who are in retirement and living on their investment income, have greater liquidity needs.

Tax Exposure

Investors in higher tax brackets prefer such investments where the return is tax exempt, others will have no such preference.

****Q. No. 40:** Briefly explain Capital asset Pricing Model. **(Nov 1997; May 2003)** Assumptions of CAPM. **(May, 2006)**

Answer:

For appreciating the CAPM, we have to understand different types of risks on the investments.

The required rate of return on the investments depends on the riskiness of the investments. Lesser the risk, lesser the required rate of return and vice-versa. The risks on the investments can be decomposed in two parts:

(i) Systematic Risk
(ii) Unsystematic risk

Systematic risk refers to variability in return on investment due to market factors that affect all investments in a similar fashion. Examples of such factors are: Level of economic activities (recession or boom), inflation, political developments, etc. Unsystematic risk arises from such factors which are concerned with the firm. Examples are: strike, change in management, special export order, etc.

Theme of the CAPM is that the investors need to be compensated for (i) Time value of money and (ii) Risk they have taken.

The required rate of return can be divided in two parts:
(i) Compensation for time value of money. It is represented by Risk free rate of return
(ii) Compensation for taking the risk i.e. Risk premium.

- The required risk premium on account of systematic risk can be estimated with the help of Beta.

BETA

Beta is an indicator of an investment's systematic risk. It measures systematic risk associated with an investment in relation to total risk associated with market portfolio. Suppose the beta value of a particular security is 1.20, it means that if return of market portfolio varies by one per cent, the return from that security is likely to vary by 1.20 per cent. Therefore, this security is riskier than the market because we expect its return to fluctuate more than the market on a percentage basis. This beta measures the riskiness of individual security relative to market portfolio. It is a ratio of "its covariance with the market" to "the variance of market as a whole". A security with beta greater than one is called as aggressive security; with beta less than one is called as defensive security and with beta equal to one is called as neutral security.

CAPM explains the required return (i.e. the minimum rate of return which induces the investors to select a particular investment) in the form of the following equation:

K	=	RF + RP
K	=	Required rate of return
RF	=	Risk free rate of return
RP	=	Risk premium

Risk premium is additional return expected by the investor for bearing the additional Systematic risk associated with a particular investment. It is calculated as:

Beta X (RM-RF)

Where RM is expected return on market portfolio. The Beta value that we take here should be corresponding with security. For example, if we have to find the required rate of return of a share, we should consider the Beta of that share; if we have to find the required rate of return of a debenture, we should consider the Beta of that debenture; if we have to find the required rate of return of a portfolio, we should consider the Beta of that portfolio.

Suppose beta of a security is 1.21

RF = 7 per cent, RM = 13 per cent

K = 7 + 1.21 (13 - 7) = 14.26 per cent

- Investor will require a return of 14.26 per cent return from this investment.
- He can get 7 per cent return without taking any risk.
- Market portfolio offers him extra 6 per cent return where risk is lesser as compared to risk from this security.
- Risk from this security is 1.21 times as compared to risk from market portfolio. Hence premium is 6 x 1.21 = 7.26 per cent.
- Thus required rate of return is equal to risk free return + risk premium.

The attraction of the CAPM is its powerfully simple logic and intuitively pleasing predictions about how to measure risk and about the relation between expected return and risk.

CAPM is based on the following assumptions :

- There are no taxes or transaction costs.
- Investors always desire more return to less, and they are risk averse;
- All investors have identical investment time horizons.
- All investors have identical opinions about expected returns and volatilities
- There are no restrictions on the borrowing and lending of money at the risk-free rate of interest.
- All investments are traded in the market, the assets are infinitely devisable, and there are no restrictions on short selling.
- The market is perfectly efficient. That is, every investor receives and understands the same information and processes it accurately
- All investors have expectations. They know that higher returns can be earned only by taking enhanced risk. They are rational and know their risk tolerance capacity.
- There are no arbitrage opportunities.
- Returns are distributed normally.
- No inflation and no change in the level of interest rate exists.

****Q. No. 41: (i)** What sort of investor normally views the variance (or Standard Deviation) of an individual security's return as security's proper measure of risk? **(May, 2004)**

(ii) What sort of investor rationally views the beta of a security as the security's proper measure of risk? In answering the question, explain the concept of beta. **(May, 2004)**

Answer : (i) Investor with long-term time horizon (investing from long term point of view) view SD as the proper measure of security's risk. SD is a measure of total risk and if the investment is from long term point of view total risk should be considered.
Longer the period , larger the risk - as in long run fundamentals of the economy as well as company may change. All these changes are reflected in SD of past returns of security (the implied assumption is that the history repeats itself).

(ii) Investor with short run time horizon view beta as the proper measure of risk. Beta measures systematic risk of the security. Any bad news (say no-trust motion against government , slightest possibility of war, death or serious illness of some key person of the economy) may upset the market and result is adverse impact on the price of the security. If beta of the security is high, even slight adverse factor resulting in slight adverse impact on the market may have substantial adverse impact on price of the security.

Concept of Beta: Beta is an indicator of an investment's systematic risk. It measures systematic risk associated with an investment in relation to total risk associated with market portfolio. Suppose the beta value of a particular security is 1.20, it means that if return of market portfolio varies by one per cent, the return from that security is likely to vary by 1.20 per cent. Therefore, this security is riskier than the market because we expect its return to fluctuate more than the market on a percentage basis. This beta measures the riskiness of individual security relative to market portfolio. It is a ratio of "its covariance with the market" to "the variance of market as a whole". A security with beta greater than one is called as aggressive security, with beta less than one is called as defensive security and with beta equal to one is called as neutral security.

****Q. No. 42 (i)** Who can be appointed as Asset Management company (AMC)**?**

(ii) Write the conditions to be fulfilled by an AMC.

(iii) What are the obligations of AMC? **(May, 2005)**

Answer : (i) A company, incorporated under companies Act, 1956, registered with SEBI to work as an asset management company can be appointed as Asset Management company to manage the investments of a Mutual fund.

(ii) Conditions to be fulfilled : (i) Minimum net worth Rs. 10 Crores (3) good reputation (iii) Directors have the knowledge about capital market (iv) AT least

50% directors should be independent (v) Chairman of the AMC should not be the trustee of the MF trust.

(iii) Obligation : (i) Due care of investment (ii) follow code of conduct prescribed by SEBI (iii) To see that (a) SEBI regulations regarding MFs and (b) the provisions regarding the trust deed are not violated (iv) responsible for the omissions and commissions of the employees (v) Quarterly report regarding the investment activities to sponsors (vi) should declare the investments made by its key-personnel(for more details refer to Suggested Answers May 2005)

****Q. No. 43 :** Explain Briefly the advantages of investing in mutual funds**. (May , 2007)**

Advantages of investing in a mutual fund :

(1) Professionally managed portfolio
(2) Diversified portfolio
(3) Low cost of investment
(4) Liquidity
(5) Transparency
(6) Simplicity

****Q. No. 44:** Write short note on the role of Mutual funds in the financial market**. (May, 2003)**

Answer : Mutual funds are important segments of the financial market. They channallize the savings and invest in the financial market, mainly in capital market and money market. Ordinary investor has neither skill nor time to recognize the investment opportunity and act immediately. MFs, on their behalf, make use of investment opportunities to earn attractive returns. They provide a good balance of risk and return with different options to suit the various needs of various investors.

Mutual Funds and Household Savings

Savings is encouraged when it finds safe and proper channels for investments. MFs have encouraged savings by providing such channels. In the absence of MFs, the household savings would have been at low levels.

Mutual Funds and Capital Market

MFs constitute one of important segments of capital market. A major part of savings of ordinary households will not come to capital market except through mutual funds. Mutual funds aim to strike a balance between risk and return, and give best of both to its unit holders. They also provide the unit holders with liquidity. The result is that a large portion of household savings come to capital markets through mutual funds. With large funds under their management, MFs strongly support the capital market. Their action, based on intelligent decisions, reduce the volatility of capital markets. Many times, the actions of MFs have helped in controlling the unwarranted crash in the capital market. On other occasions, their actions has controlled unreasonable increase in prices. Corporate debt market, in India, survives mainly due to MFs. They are major investors of debt issues particularly of long term maturities.

Mutual Funds and Money Market

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

Mutual Funds and Corporate Finance

Corporates require huge amount of funds for their workings, MFs provide these funds some times directly by way of participation in public offers and private placements and other times indirectly by being important part of capital and money markets.

****Q. No. 45:**Explain, how to establish a Mutual fund. **(Nov. 2003)**

Answer : (1) MF must be in the form of trust. It should be registered with SEBI.

(2) MF is established by a sponsor having a sound record and experience.

(3) The sponsor should appoint a trustee-company or a Board of Trustees. If a company is appointed as trustee, its Board of Directors will constitute the Board of Trustees for the trust. 2/3 members of the Board of Trustees should be independent persons, not related to sponsors.

(4) The sponsor/Board of trustees should appoint an Asset Management company (AMC) as investment manager of the MF trust. Sponsor should hold at least 40 per cent of net worth of the AMC. The minimum net worth

of the AMC should be Rs. 10 crore. The AMC should be registered with SEBI.

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(4) The sponsor/Board of trustees should appoint an Asset Management company (AMC) as investment manager of the MF trust. Sponsor should hold at least 40 per cent of net worth of the AMC. The minimum net worth of the AMC should be Rs. 10 crore. The AMC should be registered with SEBI.

(5) The sponsor/Board of Trustees should appoint (i) a SEBI registered custodian for safe custody of the assets of the MF, and (ii) a registrar to handle the registry work of the unit holders.

An Example:

Let's understand the contents of above-mentioned four paragraphs with the help of an example : Prudential Plc (a UK insurance company) and ICICI Ltd. (now ICICI Bank Ltd., an Indian company) formed a joint venture. This joint venture formed a trust under Indian Trust Act, 1882. The trust deed was registered under Indian Registration Act, 1808. The trust is MF (registered with SEBI) and the joint venture is the sponsor. The sponsor formed two companies:

(a) Prudential ICICI Trust Ltd.

(b) Prudential ICICI AMC Ltd.

The first company has been appointed as trustee-company (its directors constitute the Board of Trustees of the trust). The second company has been appointed as the investment manager of the trust. (Prudential and ICICI hold 55 per cent and 45 per cent shares respectively of the AMC). The AMC is registered with SEBI.

****Q. No. 46:** Explain briefly about Net Asset Value (NAV) of a mutual fund scheme. **(Nov. 2004)**

Answer : The net assets value of any MF scheme is the current value of its all assets net of its liabilities. Division of this amount by number of outstanding units of the scheme, we get NAV per unit. NAV per unit represents the amount which the holder of one unit will get if the scheme is dissolved or liquidated (for this calculation, forced or distress sale is not assumed, moreover the liquidation or dissolution costs are not considered). NAV per unit is generally called as NAV (ignoring the phrase per unit).

NAV of a fund scheme is equal to :

(1) Market value of traded listed securities
+(2) Estimated value of
  (i) non-traded listed securities
  (ii) unlisted securities
+(3) Liquid assets/cash
+(4) Accrued dividend/interest
-(5) Accrued expenses
-(6) Other liabilities

The most important part of calculation of NAV is valuation of non-traded listed securities and unlisted securities. (non-traded listed security is a security , which though listed, has not been traded in any stock exchange for a period of 60 days prior to the valuation date.) Non-traded listed securities and unlisted securities should be valued by Asset management company in good faith on the basis of appropriate methods. The auditors are supposed to give their opinion on such valuations, For valuation of such securities, following principles should be followed :

(1) Equity shares should be valued either on the basis of PE ratio or in combination with net assets value. The basis of PE ratio method is PE ratio of comparable PE ratio of comparable traded security. For example, equity shares of X Ltd. is non-traded security. Its EPS is Rs.20. PE ratio of Y Ltd's equity shares (which is a comparable traded security) is 10. For the purpose of valuation of equity shares, PE ratio should be taken as less than 10 (because of lower liquidity of equity shares of X Ltd.), say 8. The value of equity shares of X Ltd. may be taken as 20x8 i.e. Rs.160.

(2) Debt instruments should be valued on the basis of Yield to maturity of the asset to be valued and adjusted YTM of the comparable traded security. Suppose face value of a debenture of X Ltd. is Rs.100. Its yield to maturity is 8%. YTM of a comparable traded security is 10% i.e. normal rate of a comparable security is 10%. Normal rate of debentures of X Ltd. may be taken slightly on higher side, say 10.50%, as Debentures of X ltd. are unlisted (lower liquidity). In this case, the value of debenture of X Ltd. would be (8/10.50)x100 = Rs 76.19.

Q .No. 47: What are the rights and obligations under Mutual Fund Regulations?

Explain different methods for evaluating the performance of Mutual Fund. **(Nov. 2005)**

Answer : Rights of a Mutual Fund Investor

1. Receive unit certificates or statements of accounts confirming your title within 30 days from the date of closure of the subscription under open-end schemes or within 6 weeks from the date of request for a unit certificate received by the Mutual Fund;
2. Receive information about the investment policies, investment objectives, financial position and general affairs of the scheme (Every investor has the right to receive a copy of the annual statement);
3. Receive dividend within 30 days[11] of their declaration and receive the redemption or repurchase proceeds within 10 days from the date of redemption or repurchase;
4. Vote in accordance with the Regulations to:
   a. change the Asset Management Company; and
   b. wind up the schemes;
5. To receive communication from the Trustee about change in the fundamental attributes of any scheme or any other changes which would modify the scheme and affect the interest of the investors and to have option to exit at prevailing Net Asset Value without any exit load in such cases;
6. Inspect the documents of the Mutual Funds specified in the scheme's offer document;
7. Investors have proportionate right in the beneficial ownership of the scheme's assets as well as any dividend or income declared under the scheme; and
8. To inspect major documents i.e. material contracts, Memorandum of Association and Articles of Association (M.A. & A.A) of the AMC, Offer document etc.

Obligations of a Mutual Fund Investor

(i) To study the offer document carefully before investing, and

(ii) To study the various reports sent by the Mutual Fund from time to time.

[11] SEBI has laid down the limit of 6 weeks. Association of Mutual Funds of India has laid down the limit of 30 days.

CRITERIA FOR EVALUATION OF MUTUAL FUNDS PERFORMANCE

$$\textbf{SHARPE RATIO} = \frac{\text{Likely Return - RF}}{\text{SD}}$$

This ratio measures the risk premium earned per unit of total risk. (Higher, Better). This is also known as reward to variability ratio.

Likely return means the return that we expect to get on the basis of past experience or the return that we actually got.

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$$\textbf{TREYNOR RATIO} = \frac{\text{Likely Return - RF}}{\text{Beta}}$$

This ratio measures the risk premium earned per unit of systematic risk. (Higher, Better).The ratio is also known as reward to volatility ratio.

Likely return means the return that we expect to get on the basis of past experience or the return that we actually got.

JENSON'S ALPHA = Likely Return – [RF + Beta(RM-RF)]

The ratio measures the excess return earned over the expected return. (By expected return we mean, the return that should be earned considering the risk that has been undertaken).

Likely return means the return that we expect to get on the basis of past experience or the return that we actually got.

For a well diversified mutual fund (scheme), Treynor ratio is an appropriate ratio for performance evaluation. There are two reasons for the same:

(i) In such mutual funds, there is almost negligible unsystematic risk (because of diversification). Systematic risk is taken care of by Treynor Ratio.

(ii) This ratio considers Market S.D. as well as coefficient of correlation (for calculation of Beta). These are ignored by Sharpe Ratio.

For Comparing mutual funds of almost similar types, Jenson's Alpha may be used.

For other cases, Sharpe ratio is quite appropriate as it takes care of total risk.

*** **Q .No. 48:** Write short note on 'Buyout'. **(Nov. 2003)** (It is also referred as Boughtout)

Answer : The term refers to buying all or substantially all shares of a company to own and control it. Generally the shares are delisted after the buyout (BO) to avoid the expenses and regulations associated with remaining listed on a stock exchange. (That's why buyout is some times referred as going private.)

MBO

When the management of a company goes for the buyout, it is referred as Management Buyout (MBO) of company. The force behind the concept of buyout is that when the staff and management will become owners of the business, they may pull out the concern out red as (i) they fully understand that business and (ii) they will take full interest in running company as their fortunes will be linked with the success / failure of the company. "The MBO usually turns the previous workers and managers into owners, thereby increasing their incentive to work hard[12]. The purpose of such a buyout from the managers' point of view may be to save their jobs, either if the business has been scheduled for closure or if an outside purchaser would bring in its own management team. They also want to share the fortunes arising out of making a company financially viable.

The sellers favour MBO as
(i) it is much quicker than other form of buyouts as

- in this case the due diligence process is likely to be limited as the buyers already have full knowledge of the company, they are going to own.
- the seller is also unlikely to give any but the most basic warranties to the buyers, as the buyers know more about the company than the sellers do.

(ii) Confidentiality – the sellers may not like to reveal the sensitive information about the business to other parties; it is unavoidable in case of any other type of sale of company.
(iii)They may not like the company going in the control of their competitors.

Venture Capital Buyout
Generally, a major portion of the funds required are provided by venture capitalists. In that case it is referred as Venture Capital Buyout. Venture capitalists are always in search of such opportunities where the expected profits are phenomenally high in spite of the fact there may be quite risk. When some running sick business is for sale and the venture capitalists feel that they can bring it into black, they provide funds to the managers and staff for buying the business.

LBO
In a leveraged buyout (LBO) a small group investors, usually including current management, acquires a company financed primarily with debt. A leveraged buyout is a strategy involving the acquisition of some company using a significant amount of borrowed money to meet the cost of acquisition. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital. Generally the shares are delisted after the buyout (BO) to avoid the expenses and regulations associated with remaining listed on a stock exchange. (That's why buyout is some times referred as going private.)

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In many cases, the intention of the acquirers is to run the company for a few years, make it a strong business entity and sell the same or sell the shares in the form of public issue.

In a successful LBO, equity holders often receive very high returns because the debt providers get a fixed return, while the equity holders receive the benefits from capital gains arising on appreciation of the share values. As the interest on loan is allowed as deduction for income tax purposes, LBO is termed as tax efficient.

The positive features of the LBOs are :

(i) Low investment of own funds
(ii) Tax efficiency
(iii) Change in Management behavior: Large interest and principal payments forces the management to improve the financial as well as the operating efficiency. This is described as the 'discipline of debt' that improves the management behaviour.

A suitable LBO target should have an existing strong balance sheet, initial debt levels and adequate stable cash flows.

This concept of Buyout is quite popular in western countries. In India, efforts were made to use this approach for revival of some sick public sector undertakings. The efforts did not meet success because (i) the venture capitalists did not come forward; they opined that it is not possible to bring such companies into black mainly because of overstaffing (ii) the workers were not interested as (a) the buyout would have resulted in continuance of the company and in that case they not entitled to compensation on account of voluntary retirement and (b) their other retirement benefits were at risk and (iii) borrowed funds were not available for this type of arrangements.

*** **Q. No. 49:** Write a note on Leveraged Buyout. **(May, 2007)**

Answer : In a leveraged buyout (LBO) a small group investors, usually including current management, acquires a company financed primarily with debt. A leveraged buyout is a strategy involving the acquisition of some company using a significant amount of borrowed money to meet the cost of acquisition. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to invest a lot of capital. Generally the shares are delisted after the buyout (BO) to avoid the expenses and regulations associated with remaining listed on a stock exchange. (That's why buyout is some times referred as going private.)

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***Q .No. 50:** Write short note on Take over by reverse Bid. **(Nov. 2002, May, 2006)**

Answer: Generally, a big company takes over a small company . In case of reverse take-over, a small company takes over a big company. (The recent case in Indian corporate world is that the announcement of Henkel Spic India's proposed merger with its subsidiary Henkel India Ltd.) The acquired company is said to be big if any one of the following conditions is satisfied:

(1) The net assets of the acquired company are more than those of acquirer company. For example, the net assets of the Acquired Ltd amounts to Rs.1 Billion while that of Acquirer Ltd Rs.700 Million
(2) Equity capital to be issued by the acquirer company, as purchase consideration, exceeds the equity capital of acquirer (before issuing equity capital as purchase consideration) (Suppose the issued share capital of Acquirer Ltd is 1m equity shares of Rs.10 each; the purchase consideration is 1.50m equity shares of Acquirer Ltd.
(3) The change in control of acquirer i.e. after takeover the control is acquired by shareholders of the acquired company. A Ltd acquires B Ltd. As per agreement between the two companies, after takeover, the control of new company is taken over by the management of erstwhile B Ltd as the most of the top management people of A Ltd wanted to retire on account of their old age.

Reverse takeover takes place in the following cases:

(1) When the acquired company (big company) is a financially weak company
(2) When the acquirer (the small company) already holds a significant proportion of shares of the acquired company (small company)
(3) When the people holding top management positions in the acquirer company want to be relived off of their responsibilities.

***Q .No. 51:** Write a note on Demerger **(Nov. 2002)**

Answer : When one company, say Varindavan Ltd. having many undertakings, transfers one or more (but not all) of its undertakings to another company, say Gokul Ltd., it is a case of demerger. The company whose undertaking is transferred is called the De-merged company and the company (or the companies) to which the undertaking is transferred is referred to as the resulting company. In this case Varindanva Ltd is the demerged company and Gokul Ltd is the resulting company. Demerger is a corporate strategy to sell of a part of a company.

A demerger is referred as Spin-off if both of the following two conditions are satisfied :

(i) The resulting company is a new company

(ii) The purchase consideration:

- is paid only in the form of shares of the resulting company
- to the shareholders of the demerged company.

Why Demerger :

- Demerger allows the management to pay their full attention to the core-activities and relize their true value of their business.
- It may be required to undo a previous merger or acquisition which has proved unsuccessful.
- The division or the undertaking , which is to be transferred, may be poorly performing. This may be making the whole company unattractive to the investors. Demerger may overcome this problem.
- Sometimes, demerger helps in raising the required additional funds.

Procedure:

For demerger, a company has to pass a special resolution in the meeting of the shareholders and get the sanction of the high court. The demerged company has to take the following steps :

(i) Prepare a scheme of demerger and get it approved by the board of Directors of the company.
(ii) Determine some expert (generally Merchant Bankers) to suggest the exchange ratio.
(iii) In case of the listed company, inform the stock exchange(s) where the company's shares are listed.
(iv) Obtaining the court's orders for holding a combined meeting of the shareholders and shareholders.
(v) Reporting the result of the meeting to the court and getting court's sanction.

Income Tax:

A demerger (which is in the form of a spin off) is tax-neutral under Income Tax Act, 1961 (subject to fulfillment of certain conditions). The concept can be summarized as follows:

(i) Demerger expenses are allowed as deduction to the demerged company for Income tax purpose.

(ii) No Income benefit is lost.

(iii) Neither Demerged or the resulting company attracts any tax liability on account of demerger.

(iii) No tax liability of the shareholders

****Q .No. 52:** Write a note on the important financial issues to be taken into consideration while negotiating for a foreign technical collaborations. **(Nov. 2002)**

An Indian company is desirous of obtaining foreign technology. Write a brief note explaining the important financial considerations it should take into account in **this context. (Nov. 2006)**

Answer : The acquirer of the technology should give due consideration to the following points before taking the final decision about the proposed foreign collaboration :

(i) Tax aspect : The acquirer of the technology should consider the tax angle from his own point of view as well as from the point of view of supplier of the technology. He should find out whether the payment to be made under the collaboration would be allowed as deduction or not, if yes whether in the first or year or over a period of years. He should also find out whether tax is to be deducted before making payment. If no, bargaining for lower price of the technology may yield positive results.

(ii) Cash flow Aspects : The host collaborator should see when he has to make the payment and how he will arrange the cash, particularly when cash is to be paid before cash inflow starts.

(iii) Foreign Exchange risk : If payment is to be made on future dates, the possibility in foreign exchange rates should be considered. The method of containing the risk should also be considered.

(iv) Business risk : The host collaborator should also consider the business risks associated with the proposal. The business risks may include: (a) emergence of new technology, (ii) customers losing interest in the product or service to be produced/provided using the technology, (iii) competitors acquiring the technology from other parties or from the same party, etc.

Q .No. 53: Write a brief note on the tax issues relating to a foreign Collaboration Agreements. **(Nov. 2004)**

Answer : The tax issues relating to foreign collaborations can be studied in two parts :

(i) Tax issues from the point of Indian company

(ii) Tax issues relating to the foreign collaborator

Tax issues from the point of view of Indian company:

(i) Lump sum up front payment – whether it shall be allowed as deduction in one year or it shall be amortized over many years.

(ii) Royalty payable – whether it would be allowed deduction on payment basis or accrual basis

(iii) Change in amount to be paid on account of foreign currency fluctuations- whether allowed from tax point of view or not.

(iv) Whether TDS is to be deducted

Tax issues relating to foreign collaborator:

(i) Whether withholding tax is applicable or not and who will bear its burden.

(ii) Is there Double Taxation Avoidance agreement with the country of the foreign collaborator? If yes, to what extent the foreign collaborator will gain.

If the foreign collaborator is favorably placed from tax angle, the Indian party should negotiate to get the favourable terms.

***Q .No. 54:** Write a short note on Global Depository Receipts.
(May 1996, May, 2003, May 2004))

Answer : A GDR is negotiable certificate that represents a non-US company's one or more publicly-traded equity shares. A GDR is denominated in dollar terms. The equity shares comprising in each GDR are denominated in local currency of issuing company. For example, a GDR issued at $ 30 may comprise two equity shares with a par value of Rs. 10 each.

Issue of GDRs creates equity shares of the issuing company. Equity shares are registered in the name of an intermediary abroad called Overseas Depository Bank (for example, Bank of England). The share certificates are delivered to another intermediary called the Domestic Custodian Bank (for example, State Bank of India)who acts as agent of "the Overseas Depository Bank" in India. The GDRs are issued by Overseas Depository Bank to non-resident investors.

GDRs are freely transferable outside India without any reference to the issuing company. The dividends in respect of the shares represented by the GDRs are paid in Indian rupees only.
If a GDR holder wants to exchange his GDR into shares, he can surrender his GDR with such request to the Overseas Depository Bank. The Overseas Depository Bank will instruct the Domestic Custodian Bank to release the shares. Depending upon the nature of the request, the Domestic Custodian Bank will either sell the shares through the stock exchange and remit the sale proceeds to him or arrange to get his name registered as a member of the company. Thereafter, the said shares are subject to the usual conditions applicable to the company's shares.

To the extent, the GDRs are converted into shares, shares can also be converted into GDRs. For example, a company has issued 100000 GDRs, each representing 2 shares of issuing company. Holders of 1000 GDRs get their GDRs converted into 2000 shares. Now the company can convert 2000 shares (held by its shareholders) into 1000 GDRs.
Thus GDRs can be converted into shares. Shares can be converted into GDRs. This is called "two – way fungibility"

Two **new developments in the field of Euro-issue** are :
(i) Some Indian companies are planning to get their GDRs converted into ADRs. For this purpose, they have to get their depository receipts (already issued as GDRs) listed in some US stock exchange. The lead has been taken by Tata Motors. (Now

Tata Motors shares are listed on NYSE; this step has shown positive results, dealing volumes have gone up, higher prices have been prevailing)

(ii) Sponsored ADRs : To the extent, the ADRs/GDRs have been converted into shares, the issuer company can issue fresh ADRs/GDRs. For example, one ADR of ICICI Bank Ltd. represents two equity shares of ICICI Bank. Suppose, 100000 ADRs of ICICI Bank get converted into 200000 equity shares. Now ICICI Bank can convert its 200000 existing equity shares into ADRs. These ADRs are sold in the US stock exchange (where the ADRs are already listed) and the proceeds are distributed among those shareholders who got their shares converted into ADRs. The country gets foreign exchange in the process.

- This process is beneficial for the shareholders when ADRs/GDRs are quoted at premium (over prices in India) in overseas market. In March, 2005, the ICICI Bank took this step. The Indian shareholders realised a price of about Rs. 450 per share through this process against the price of about Rs.400 prevailing in the Indian market at that time,

Important Features of GDRs

1. *Collection in Foreign Currency:* The issuer enjoys the benefit of collection of issue proceeds in foreign currency and may utilize the same for meeting the foreign exchange requirements.

2. No Exchange Risk: If the GDR holder surrenders the GDRs for conversion into shares and request for the sale of such shares, the Domestic Custodian Bank sells the shares. The Domestic Custodian Bank converts the net sales proceeds into foreign exchange at the market rate. Hence, no foreign exchange risk for issuing company.

3. Listing: GDRs are generally listed at LUXEMBOURG.

4. Lock-in-Period: Lock–in-period is 45 days, i.e. 45days after the allotment, the GDR holder can get it converted into shares.

5. Marketing: Marketing of GDRs issue is done by the underwriters by organising the road shows which are presentations made to potential investors.

6. No Voting Rights: The GDR does not entitle the holder to any voting rights, so there is no fear of loss of management control.

***Q .No. 55:** Write a short note on Euro Convertible Bonds.**(May 1996, May, 1998May, 2003)**

Answer : A convertible bond is a debt instrument with gives the holder of the bond an option to convert the bond into a pre-determined number of equity shares of the company. The bonds carry a fixed rate of interest. The bonds are listed and traded in one or more stock exchanges abroad. Till conversion, the company has to pay interest on the bonds in foreign currency and if the conversion option is not exercised, the redemption also has to be done in foreign currency. The bonds are unsecured. These bonds are issued to non-residents against foreign currency.
If the issuing company so desires, the issue of such bonds may carry two options.

1. *Call Option*: Where the terms of issue of the bonds contain a provision for call option, the issuer company has the option of calling (buying) the bonds for redemption before the date of maturity of the bonds. Where the issuer's share price has appreciated substantially, i.e. far in excess of the redemption value of the bonds, the issuer company can exercise this option. Thus call option forces the investors to convert the bonds into equity.

   The investor must also be provided with some protection from a call of the bonds in the early years. It is customary in most issues today, that the bonds should not be 'callable' for three years from the date of issue after which they will only be callable if issuer's share price has risen over the conversion price, say by 30 per cent (or more) and has remained above such a level for a minimum period of time (normally 30 consecutive trading days).

2. *Put Option*: A provision of put option gives the holders of the bonds a right to sell his bonds back to the issuer company at a predetermined price and date. The inclusion of put option enables the issuer to reduce the coupon rate. This is because the put option (i) reduces the risk for investors and (ii) increases liquidity, and therefore, they accept lower interest rate.

Q. No. 56: Write Short note on forfeiting**. (Nov. 2002)**

Answer: Forfeiting is a mechanism of financing exports by discounting exports receivables evidenced by Bill of exchange/promissory note without recourse to the exporter. It is an act of buying an exporter's receivables at discount by making him 100 per cent payment immediately (net of deduction of service charges including interest, commission, etc). The forfeiter, i.e., the purchaser of the receivables, becomes the entity to whom the importer is obliged to pay. Forfeiting provides the exporter with immediate money and frees him from various risks like country risk, foreign exchange rates fluctuations, credit risk, possibility of delay in payments, etc. Forfeiting does not involve much risk for the forfeiter as the importer's obligations are generally supported by a Letter of Credit. Forfeiting is particularly beneficial for such export contracts which involve longer credit period, for example export of capital goods, projects exports, etc.

Foreign banks are major players in Forfeiting market. A few years back RBI permitted EXIM Bank and Authorised Dealers (Banks) to offer Forfeiting services in India. Global Trade Finance Pvt. Ltd., a joint venture of EXIM Bank (India), WESTLB (Germany) and IFC (Washington), is a leading player in this field.

Forfeiting has not been popular in India as concessional finance is abundant to exporters and the credit risk is taken care of by the letter of credit from the importer's bank.

**** Q. No.57:** Explain the term 'Exposure Netting'**. (Nov. 2004**

Answer : Sometimes, a company is both importer and exporter and so has assets and liabilities in the same currency and with same maturity date. For example, A Ltd exports goods to USA invoiced at $ 1.00 Million payable after three months from today. At the same time, A Ltd. imported goods amounting to $ 1.20 Million , again payable after three months from today. One amount can be netted off against the other, leaving the balance of $ 0.20 Million liability to be hedged by other means, say by forward contract.

Exposure netting is also referred as natural hedging

**** Q. No. 58:** Distinguish between Forfeiting and factoring**. (Nov. 2004)**

Answer: Factoring is a trade financing vehicle. Factors buy a company's trade receivables (arising on account of genuine transactions) at a discount, thereby their immediately conversion into cash. Factoring is an ongoing arrangement between the client and factor, where invoices raised on account of sales of goods and services are regularly assigned to the factor for financing and collection. Most factoring is done on non-recourse basis, which means that the factor assumes the risk of bad debts.

Forfeiting is a mechanism of financing exports by discounting exports receivables evidenced by Bill of exchange/promissory note without recourse to the exporter. It is an act of buying an exporter's receivables at discount by making him 100 per cent payment immediately (net of deduction of service charges including interest, commission, etc). The forfeiter, i.e., the purchaser of the receivables, becomes the entity to whom the importer is obliged to pay. Forfeiting provides the exporter with immediate money and frees him from various risks like country risk, foreign exchange rates fluctuations, credit risk, possibility of delay in payments, etc.

Some important points of distinction between the two are given below:

Factoring	Forfeiting
1. Does not involve Bill of exchange/ promissory note.	1. Involves Bill of exchange/ promissory note.
2. No refinancing facility for the factor	2. There is refinancing facility for the forfeiting.
3. Factoring is an ongoing arrangement between the client and factor, where invoices raised on account of sales of goods and services are regularly assigned to the factor for financing and collection.	3. It is generally for a specific transaction.
4. A technique of short term financing	4. A technique of medium term financing.
5. This may be with or without recourse to the client. (Generally without recourse)	5. It is always without recourse.
6. Factor has to bear only one risk i.e. the risk of default (only case of factoring without recourse)	6. Forfeiting involves risks of (i) default (though the risk is negligible as the money is being secured on account of Letter of credit) (ii) Currency fluctuation risk.

*****Q. No. 59:** Write a brief note on External Commercial Borrowings. **(Nov. 2005)**

Answer: The foreign currency borrowings raised by the Indian corporates[13] from outside India are called "External Commercial Borrowings" (ECBs). ECBs occupy a very important position as a source of funds for Corporates. These Foreign Currency borrowings can be raised within ECB Policy guidelines of Govt. of India/ Reserve Bank of India applicable from time to time. The intention of GOI/RBI is to maintain prudent limits for total external borrowings and to provide flexibility to Corporates in external borrowings. The main emphasis of guidelines is:

- to keep borrowing maturities long,
- to keep borrowing costs low,
- to encourage infrastructure, and to increase export sector financing.

[13] In some cases, NGOs and co-operative societies are also permitted to raise funds through ECBs.

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 form the International market is huge as compared to domestic market and corporates can raise large amount of funds at competitive prices depending on the risk perception of the International market.

ECB GUIDELINES :
External Commercial Borrowing (ECB) refers to commercial loans [in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments (e.g. floating rate notes and fixed rate bonds)] availed from non-resident lenders with minimum average maturity of 3 years. The ECG Guidelines are also applicable to Foreign Currency Convertible Bonds.ECB can be accessed under two routes, (i) Automatic Route and (ii) Approval Route.

I. (A) AUTOMATIC ROUTE : ECB under Automatic Route do not require approval of Government of India / RBI.

i) Eligible borrowers
(a) Corporates [registered under the Companies Act except financial intermediaries (such as banks, financial institutions (FIs), housing finance companies and NBFCs)] are eligible to raise ECB.
(b) Non-Government Organisations (NGOs) subject to satisfaction of certain conditions laid by RBI.
(c) Units in Special Economic Zones (SEZ) are allowed to raise ECB for their own requirement.

ii) Recognized Lenders
(a) Borrowers can raise ECB from internationally recognised sources such as (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC etc.,), (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders.
(b) Overseas organisations and individuals may provide ECB to Non-Government Organisations (NGOs) subject to fulfillment of certain conditions laid by RBI.
iii) Amount and Maturity
(a) The maximum amount of ECB which can be raised by a corporate is USD 500 million or equivalent during a financial year.
(b) ECB up to USD 20 million or equivalent in a financial year with minimum average maturity of three years

(c) ECB above USD 20 million and up to USD 500 million or equivalent with minimum average maturity of five years.
(d) NGOs can raise ECB up to USD 5 million during a financial year. Designated AD bank has to ensure that at the time of drawdown the forex exposure of the borrower is hedged.

iv) All-in-cost ceilings
All-in-cost includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees. The all-in-cost ceilings for ECB are indicated from time to time. The current ceilings are as below:

Average maturity period	All-in-cost Ceilings
Three years and up to five years	LIBOR + 200 bp
More than five years	LIBOR + 350 bp

I. (B) APPROVAL ROUTE
The following types of proposals for ECB are covered under the Approval Route.

- **Eligible borrowers**

a) Financial institutions dealing exclusively with infrastructure or export finance such as IDFC, IL&FS, Power Finance Corporation, Power Trading Corporation, IRCON and EXIM Bank are considered on a case by case basis.
b) Banks and financial institutions which had participated in the textile or steel sector restructuring package as approved by the Government.
c) ECB with minimum average maturity of 5 years by Non-Banking Financial Companies (NBFCs) .
d) Foreign Currency Convertible Bonds (FCCB) by housing finance companies.
e) Multi-State Co-operative Societies engaged in manufacturing activity satisfying the following criteria i) the Co-operative Society is financially solvent and ii) submits its up-to-date audited balance sheet.
f) Cases falling outside the purview of the automatic route limits and maturity period .

ii) Recognised Lenders
Borrowers can raise ECB from internationally recognised sources such as (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions (such as IFC, ADB, CDC etc.,), (iv) export credit agencies, (v) suppliers' of equipment, (vi) foreign collaborators and (vii) foreign equity holders.

(**iii)All-in-cost ceilings** : Same as under automatic route.

***Q. No. 60 :** Write a short note on American Depository receipt. **(Nov. 1996, Nov. 2002)**

Answer. A depository is negotiable certificate that represents a non-US company's one or more publicly-traded equity shares. It is denominated in dollar terms. The equity shares comprising in each depository receipt are denominated in local currency of issuing company. For example, a depository receipt issued at $ 30 may comprise two equity shares with a par value of Rs. 10 each.

Depository receipts issued by a company in the United States are known as ADRs. The ADRs must be listed in some US stock exchanges. Such receipts have to issued in accordance with the provisions stipulated by the Securities and Exchange Commission of USA. These provisions are very strict. Not many Indian companies have gone for ADRs issue because: (i) they are not fully geared to meet the strict requirement of Securities and Exchange Commission of USA, (ii) the cost of issuing ADRs is quite high the listing fee is quite hefty, and (iii) the US is most litigious market in the world. 11 Indian companies have issued ADRs so far. These are:(1)Infosys (2)Wipro (3) MTNL (4)VSNL (5) Rediff. (6) Silverline (7) Dr. Reddy.(8) Satyam Infoway. (9) Satyam Computers (10) ICICI Bank. (11) ICICI. After merger of ICICI with ICICI Bank, ADRs of 10 Indian companies are listed on American Stock Exchanges. These are listed on two stock exchanges (i) NASDAQ (National Association of Securities Dealers Automatic Quotes) and (ii) New York Stock Exchange, both have their head offices at New York. The ADRs of one more Indian company, Tata Motors, are listed on New York Stock Exchange. The company got its depository receipts (already issued as GDR)m listed in New York Stock Exchange.

Issue of ADRs creates equity shares of the issuing company. Equity shares are registered in the name of an intermediary abroad called Overseas Depository Bank (for example, Bank of America). The share certificates are delivered to another intermediary called the Domestic Custodian Bank (for example, State Bank of India)who acts as agent of "the Overseas Depository Bank" in India. The ADRs are issued by Overseas Depository Bank to non-resident investors.

ADRs are freely transferable outside India without any reference to the issuing company. The dividends in respect of the shares represented by the ADRs are paid in Indian rupees only.
If a ADR holder wants to exchange his ADR into shares, he can surrender his ADR with such request to the Overseas Depository Bank. The Overseas Depository Bank will instruct the Domestic Custodian Bank to release the shares. Depending upon the nature of the request, the Domestic Custodian Bank will either sell the shares through the stock exchange and remit the sale proceeds to him or arrange to get his name registered as a member of the company.

Thereafter, the said shares are subject to the usual conditions applicable to the company's shares.

To the extent, the ADRs are converted into shares, shares can also be converted into ADRs. For example, a company has issued 100000 ADRs, each representing 2 shares of issuing company. Holders of 1000 ADRs get their ADRs converted into 2000 shares. Now the company can convert 2000 shares (held by its shareholders) into 1000 ADRs.
Thus ADRs can be converted into shares. Shares can be converted into ADRs. This is called "two – way fungibility"

Important Features of ADRs

(i) *Collection in Foreign Currency:* The issuer enjoys the benefit of collection of issue proceeds in foreign currency and may utilize the same for meeting the foreign exchange requirements.
(ii) No Exchange Risk: If the ADR holder surrenders the ADRs for conversion into shares and request for the sale of such shares, the Domestic Custodian Bank sells the shares. The Domestic Custodian Bank converts the net sales proceeds into foreign exchange at the market rate. Hence, no foreign exchange risk for issuing company.
(iii) Listing: ADRs are listed at New York Stock Exchange or NASDAQ.
(iv) No Voting Rights: The ADR does not entitle the holder to any voting rights, so there is no fear of loss of management control.

****Q. No. 61 :** Explain the term 'foreign exchange risk' **(Nov. 1992)**

- **Answer :** Foreign exchange rate is the rate of one currency in terms of other currency.

- Foreign exchange risk is defined as the possibility of adverse movement in foreign exchange rates.

- If one has to sell the foreign currency in future, the possibility of decline in the rate/price of that currency is foreign exchange rate risk. For example, an Indian firm exports goods when one US dollar is equal to Rs. 45. By the time it receives the payment, one US dollar may be equal to Rs. 44. The result is that the Indian firm will receive lesser amount in terms of rupees.

- If one has to buy some foreign currency, the possibility of increase in the rate/price of that currency is foreign exchange rate risk. For example, an Indian firm enters into a contract of import when US $ is equal to Rs. 45.

By the time it has to pay, the rate may be Rs. 46, i.e. the Indian firm has to pay more amount of rupees. One more example, an Indian firm borrowed in US $ when one US $ was equal to rupee 45, it has to repay, when one US $ is equal to Rs. 47, the Indian firm has to pay more amount as principal amount as compared to what it received.

- To conclude : Foreign exchange rate risk refers to such movements in foreign exchange rate that results in loss.

Q. No. 62 : Cross currency roll over contracts**. (May, 1997)**

Answer : : The term cross currency Roll over refers to roll over of cross currency forward contracts. Hence to under this term, we have to under two terms : (a) Roll over forward contract and (c) Cross currency forward contracts.

Roll over forward Contract :
There are situations like foreign currency loan being repaid in installments over a number of years or imports being made on deferred payment terms and the amount is to be paid on different dates. The duration of such payment may be long. Therefore, exchange risk is involved. Forward contracts for dates falling after six months are practically not available. In such a situation, roll-over-forward contracts are used to cover the exchange risk.
Roll-over-forward contract is one where forward contract is initially booked for the total amount of loan, etc. to be re-paid. As and when installment falls due, the same is paid by the customer in foreign currency at the exchange rate fixed in forward exchange contract. The balance amount of the contract is rolled over (extended) till the due date of next installment. The process of extension continues till the loan amount has been repaid.

Cross-Currency forward Contract :

A forward contract in which two foreign currencies are involved is known as cross-currency forward contract. For example, a contact by an Indian firm to purchase certain amount of Kuwaiti Dinar at the rate of one Kuwaiti Dinar for four US dollar, one month after the contract, is a cross-currency forward contract.

When cross-currency forward contracts are rolled over, they are known as cross-currency-roll-over.

Q. No. 63 : Write short note on Financial swaps. **(May, 1997)**

Answer : Financial swaps are private arrangements between two parties to exchange cash flows in future according to a pre-determined formula.(Swaps are generally arranged by the intermediaries like banks). The two commonly used swaps are :

(I) Interest swap – In interest swap, two parties agree to pay each other's interest obligation for there mutual benefits. Under interest swap, the parties raise loans as per the method suggested by the intermediary. Savings in interest (because of borrowing by the method suggested by the intermediary as compared to the method of their own choice), are shared by the intermediary (as a commission for its services) and each of the two parties as per agreement between all three i.e. intermediary and the two parties.

Currency swaps – These contain swapping both principal and interest between the parties, with cash flows in one direction being in a different currency than those in opposite direction. Currency swaps are regarded as combination of forward contracts. In other words, in a currency swap, two parties agree to pay each other's debt obligation denominated in different currencies. A currency swap involves: (i) an exchange of principal amounts today, (ii) an exchange of interest payments during the currency of loan, and (iii) a re-exchange of principle amounts at the time of maturity.

****Q. No. 64 :** Write short note on Forward as hedge instrument. **(Nov, 1997)**

Answer: Forward exchange contracts are used to hedge against the adverse movement in exchange rate. For example, let us consider an exporter in India exporting shirts to USA. Cost per shirt Rs. 44. Selling price: US $ 1 (to be paid after one month). Exchange rate (spot). 1 US $ = Rs. 46. He expects a profit of Rs.2/- shirt. However, when the receives the payment after one month, the exchange rate may be Rs.43/-. He will suffer a loss of rupee one per shirt. Therefore, he would like to fix the exchange rate now only. He can enter into a forward exchange contract under which he will sell dollars to bank after one month at rate determined now, say Rs. 45.50 That means, he is assured of profit of Rs. 1.50 per shirt irrespective of what happens to the exchange rate till he receives the payment.

Forward exchange contract is a contract wherein out of two parties (in India one party compulsorily being a bank) one agrees to deliver a certain amount of foreign exchange at an agreed rate at a fixed future date or up to a fixed future date to the other party.

Exchange Control Requirements

(i) Forward contract facility is available if the party is exposed to genuine risk on account of exchange rate movement. (There is one exception to this rule : Individuals can book and cancel forward $ contracts up $1,00,000 per year without proof of exposure to foreign exchange risk.)

(ii) Contracts for forward purchase or sale of foreign currency can be entered into only in permitted currencies.
(iii) Exporters and importers in Indian can book forward contracts only with those banks which are authorized to deal in foreign exchange (ADs).
(iv) The banks can undertake inter-bank transactions for conversion of one foreign currency against another with a bank in India or in the overseas market for covering the customer / operational requirements.

Ingredients of Forward Contracts

Contract Amount: Forward exchange contracts have to be for definite amounts. The amount of the forward contract is expressed in foreign currency and equivalent rupee (round off).

Parties to the Contract: There are always two parties in a forward contract. Two parties in the forward contract can be two banks, a merchant customer and a bank, a bank in India and an overseas bank.

Rate: Rate of exchange at which the sale/ purchase of foreign exchange is to be made should be mentioned.

Individuals can book and cancel forward $ contracts up $1,00,000 per year without proof of exposure to foreign exchange risk.

****Q No. 65 :** X co. Ltd , an Indian company, has to make payment of 3 million USD after six months against import of machinery. What are the different alternatives to hedge against this foreign exchange currency exposure? Give explanations. **(May, 1999)**

Answer : The following four alternatives are available to X Co. Ltd. :

Forward : Under this alternative, X may enter into a forward contract of buying 3 million USD , maturity six months, with the bank. Suppose, today, six months forward rate is : 1 $ = Rs. 44.90 / 45.00. X may enter into a contact with bank today; under the contract the bank will sell 3 million USD to X @ Rs.45 after 6 months from today, whatever may be USD – Rupee rate on that day (after 6 months from today). This method is quite popular in India.

Option : Under this option, X may buy call option for 3 million USD. It has to pay option price / premium today. Suppose X buys call option for 3 million USD , maturity 6 months, with strike price of Rs.45 by paying premium of Rs. 15,00,000. If on maturity, the foreign exchange rate is Rs.45 or more, it may buy 3 million USD from the option writer (to whom X paid Rs.15,00,000 as premium), if the rate is below Rs.45, X may just ignore the option and buy the required dollars in the spot market. This method is not popular in India.

Currency Swap : X has to pay 3 million dollars after 6 months from today. Through some intermediary, X may be able to find some party, which has to pay equivalent amount in rupees after 6 months from today. (The equivalent amount is calculated at current foreign exchange rate). Suppose today the rate is Rs. 45 / $ .X may enter into a contract with that party under which that party will pay $ 3.00 million to X after six months from today and X will party equivalent amount of rupees (3 million x 45) to that party at that time. This method is not popular in India.

Money Market operations. Suppose USD can be lent at the interest rate of 6 % p.a. X Ltd may purchase $ (30,00,000 / 1.03) i.e. $29,12,621 in the spot market, invest this dollar amount @ 6% p.a. for six months. After 6 months , X will get 3 million from this investment and this amount may be used for paying for the imported machinery. The amount required to purchase $29,12,621 in the spot market may be borrowed in home currency. This method is not popular in India.

****Q No. 66:** Outland Steel has a small but profitable export business. Contracts involve substantial delays in payment, but since the company has had a policy of always invoicing in dollars, it is fully protected against changes exchange rates. More recently the sales force has become unhappy with this, since the company is losing valuable orders to Japanese and German firms that are quoting in customer's own currency. How will you, as Finance Manager, deal with the situation? **(May, 2000)**

Tutorial note – not to be given in the exam)
Let's understand the question : Outland Steel is a US company. It bills to its customers in Dollars, it receives payment in Dollars; it has no foreign exchange risk. It is losing various customers as they want to be billed in their own currencies. The purpose of billing in Dollars is to avoid the foreign exchange risk.

Answer: To avoid the risk of adverse movement in foreign exchange rates, Outland (a US Company) exports its goods only to those customers who are willing to pay in USD. Through this policy the company is protecting itself against the foreign exchange risk but it a paying a very heavy price for it, it is losing valuable orders. Orders are not to be lost, these are to be won. Understanding customers requirements and problems are key to winning the orders and expanding sales, the very basis for survival of business. The present strategy may prove harmful for the company in long run. Besides, losing the opportunities of making profit, the company may earn a bad name in the market as market players may consider the company's management as quite inefficient which is not able to manage its foreign exchange risk. The present policy may hurt the customers as (i) they may consider the policy as a disregard for their own currencies and (ii) Outland has no respect for the customers, it just wants to capitalize its monopolistic position.

The management may positively consider the view of the sales force, the customers may be billed in the own currencies (except when no viable mechanism is there for managing the risk arising from new policy). Having done this, the company may use the services of foreign exchange risk mangers for managing the risk arising out of the change in the policy. Management of foreign exchange risk is not free of cost, Outland has to bear this cost. There is every possibility that this cost will be more than compensated by the additional profit on the additional orders the company will get.

Foreign exchange risk may be managed through various methods. Five important methods are :
1. Forwards
2. Futures (not available in India)
3. Options
4. Currency swaps
5. Money Market Operations.

***Q No. 67:** Write short note on debt route for foreign currency funds. **(May, 2000)**

Answer :

A company can raise foreign currency from one or more of the following methods of debt financing:

(i) External Commercial Borrowings : The foreign currency borrowings raised by the Indian corporates[14] from outside India are called "External Commercial Borrowings" (ECBs). ECBs occupy a very important position as a source of funds for Corporates. These Foreign Currency borrowings can be raised within ECB Policy guidelines of Govt. of India/ Reserve Bank of India applicable from time to time. The intention of GOI/RBI is to maintain prudent limits for total external borrowings and to provide flexibility to Corporates in external borrowings. The main emphasis of guidelines is:

- to keep borrowing maturities long,
- to keep borrowing costs low,
- to encourage infrastructure, and to increase export sector financing.

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. .

[14] In some cases, NGOs and co-operative societies are also permitted to raise funds through ECBs.

(3) The availability of the funds form the International market is huge as compared to domestic market and corporates can raise large amount of funds at competitive prices depending on the risk perception of the International market.

ECB GUIDELINES :
External Commercial Borrowing (ECB) refers to commercial loans [in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments (e.g. floating rate notes and fixed rate bonds)] availed from non-resident lenders with minimum average maturity of 3 years. ECB can be accessed under two routes, (i) Automatic Route and (ii) Approval Route.

ECB under Automatic Route do not require approval of Government of India / RBI. ECB under Approval route requires the approval of Government of India / RBI.

(ii) Foreign Currency Convertible Bonds : A convertible bond is a debt instrument with gives the holder of the bond an option to convert the bond into a pre-determined number of equity shares of the company. The bonds carry a fixed rate of interest. The bonds are listed and traded in one or more stock exchanges abroad. Till conversion, the company has to pay interest on the bonds in foreign currency and if the conversion option is not exercised, the redemption also has to be done in foreign currency. The bonds are unsecured. These bonds are issued to non-residents against foreign currency.

If the issuing company so desires, the issue of such bonds may carry two options.

1. *Call Option*: Where the terms of issue of the bonds contain a provision for call option, the issuer company has the option of calling (buying) the bonds for redemption before the date of maturity of the bonds.

2. *Put Option*: A provision of put option gives the holders of the bonds a right to sell his bonds back to the issuer company at a predetermined price and date.

****Q. No. 68:** Airlines company entered into an agreement with Airbus for buying the planes for a total value of FF1000 million payable after 6 months. The current spot price is Indian Rupees 6.60 /FF. The Airlines co. cannot predict the exchange rate in future. Can the Airlines company hedge its Foreign Exchange risk.? Explain by examples. **(Nov. 2001)**

Answer : The Airlines company can hedge its foreign exchange risk by following methods :

(i) Forward contracts
(ii) Currency options (though these are not so popular in India)
(iii) Currency Swaps (though not easily arranged in India)
(iv) Money market operations

(the answer may be developed on the basis of these lines)

Q. No. 69: Distinguish between Caps and collars. (May, 2002)

Answer: Cap is an option type derivative which is traded over the counter (it is not traded in any exchange) . It is useful for those who borrow money on the basis of floating rate. The buyer of cap pays commission / premium to the cap seller and cap seller undertakes to compensate his loss on account of increase in interest rate. For example, X Ltd. borrows money on the basis of MIBOR + 0.50 and buys cap. In case of increase in MIBOR, X Ltd. has to pay interest at higher rate. Suppose when X Ltd. borrows, MIBOR is 8%. Later on it rises to 9%. X Ltd has to pay interest at 1% higher rate. This extra cost will be compensated by the cap seller. In case MIBOR declines, X Ltd. will be benefited and it won't contract the cap seller.

Floor is also cap type derivative but it is useful for those who deposit/ lend money on the basis of floating rate. For example, an investors deposits his money at MIBOR+ 0.50and buys floor. At the time of investing, MIBOR was 8%. In case MIBOR declines, he will get lower rate of interest (i.e. suffer loss). Suppose MIBOR declines to 6% . He will suffer a loss of 2%. This will be compensated by floor seller.

Collar is a combination of cap and floor. In this case no commission is paid. The collar seller undertakes to compensate the loss of collar buyer (on account of change in interest rate) and option buyer agrees to share with him the profit he will have (on account of change in interest rates). Suppose X Ltd borrows at the rate of MIBOR + 0.50. At the time of borrowing, MIBOR was 8%. If MIBOR rise to 10%, X Ltd. will suffer loss , this loss will be compensated by the collar seller. If MIBOR falls to 6%, X Ltd. will be gainer. X Ltd. will have saving of 2%. X Ltd will share a part of this saving, say 50% i.e.1%, with collar seller.

Q. No. 70 : Write short note on Options. **(Nov. 2002)**

Answer : An option is a contract that gives its owner the right (but not the obligation) to buy or to sell an underlying asset (for example, share of a company, foreign currency etc.) on or before a given date at a fixed price (this fixed price is called as Exercise price, it is also called as Strike price).

Call option gives the buyer of the option the right (but not the obligation) to buy a currency or share.

Put option gives the buyer of the option the right (but not the obligation) to sell a currency or share.

European option An option that can be exercised on the specific date.

American Option: An option that can be exercised on any date up to the expiry date.

Example: A & B enter into a contract under which B pays A Rs. 700 (option premium or option price) and in return A gives him the right of buying 100 shares of X Ltd. on a particular date at Rs. 300 per share. B may buy 100 shares of X Ltd from A at Rs. 300 on that particular date (or he may not buy). Suppose Spot price on that date is below 300, B won't buy the shares. If it is 300, he may or may not buy. If the spot price is above Rs. 300, it is natural that B will exercise his option i.e. he will buy the shares. In this example, B has limited his loss to Rs. 700 but there is no limit to his gain. The option referred in this example is "European Call option"

There are two parties in an option contract:

1) Option writer or option seller – he gives the option to the other party. In the above example, A is option writer. He receives the option premium or option price from the other party. In the above example Rs. 700 is option premium or option price.

2) Option owner or option holder – he gets "the option" or "the right (but not the obligation)" from the option writer against payment of "option premium" or "option price". In the above example, B is option owner.

In-the-money option: An option is said to be "In-the-money" when it is advantageous to exercise it.

Out-of-the money option: An option is said to the "Out-of-the-money" when it is disadvantageous to exercise it. (Naturally, is this situation, the option owner won't exercise it.)

At-the-money option: If the option holder does not lose or gain whether he exercises his option or not, the option is said to be at- the- money. (White solving questions in the examination, it is assumed that if the option is at the money, it is not exercised by its owner).
Value of Call option (to its owner) at expiration:

Max (Spot price-Strike price, 0)

Value of put option (to its owner) at expiration:

Max (Strike price- Spot price, 0)

Q. No. 71 : What is a derivative. Explain briefly the recommendations of the LC Gupta committee on the derivatives. **(May, 2003)**

Answer : The value of a derivative is entirely dependent on the value of its underlying asset. Suppose a person buys Reliance equity call option contract (on 1st June, 2005), under this contract he has the right of buying Reliance shares @ Rs.3000 on 25th April 2008; the value of this contract will rise and fall as the spot price of Reliance equity share rises or falls. Should the spot price of Reliance equity rise, the value of this option will rise and vice versa. (Remember that value of option cannot be negative)

A derivative is in essence a 'claim' on the underlying asset at a pre-determined price and at a pre-determined future date/ period. Unlike spot market transactions, where the assets are bought and sold at spot prices for immediate delivery, derivative market transactions for future delivery at price determined today. Forwards, futures and options are three common derivative instruments. Forwards are customized contracts between two parties to carry out a transaction at a future date at a price determined today. Futures contracts are standardized exchange traded versions of forward contracts. Options provide their buys, the right but not obligation to buy/sell the underlying asset at a pre-determined price. The buyer gets this right by paying premium (also called commission) to the option writer.

In November 1996, SEBI appointed a committee under the chairmanship of Prof. L.C. Gupta to develop appropriate framework for derivatives trading in India. The report of the committee was accepted in May, 1998. One important recommendation of the committee was that derivatives should be declared as 'securities'.

Other important recommendations of the committee **:**

(1) The committee strongly favored the introduction of financial derivatives in order to provide the facility for hedging .
(2) The committee recommended three types of derivatives – equity derivatives, interest rate derivatives and currency derivatives.
(3) The committee recommended both futures and option derivatives. The committee favored the introduction of derivatives in phased manner so that all concerned may understand the complexities involved in derivative trading. Beginning may be made with stock index futures.
(4) The committee recommended two levels of regulations over the derivative trading – stock exchange level regulations and SEBI level regulations.
(5) The SEBI should ensure that derivative trading is totally disciplined.

(6) The committee opined that the entry requirements for brokers for derivative markets should be more stringent than for cash market not only in terms of Capital adequacy requirements but also knowledge requirements in the form of mandatory passing of a certification programmed by brokers and sales persons.
(7) The mutual funds may be allowed use of derivative trading only for hedging and not for speculation.
(8) SEBI should a Derivative cell, a Derivative advisory committee and a Research wing.

****Q. No. 71A :** Write a short note on mark to the market. **(Nov. 2003)**

Answer : Mark-to-market is one of the important features of the futures contracts. Under this feature, the prices of the future contracts are marked to the market on daily basis. This daily settlement feature can best be illustrated with an example:

After the futures contract has been entered into, on the evening of each working day, profit/loss of each party is calculated on the basis of closing price of the futures contract. The party which has suffered loss has to make good the loss and the party which has gained will receive the amount.

Suppose on Monday, Harry enters into a futures contract of purchasing 1,25,000/- Swiss Franks (SF) at the rate of SF 1 = USD 0.75. This contract is to mature on Thursday. On Monday, at the close of trading, the Thursday maturing futures prices were $ 0.755. Harry has gained on account of price fluctuation as the price of what he has purchased has gone up. He will receive the gain i.e 125000X0.005 i.e. $625. In fact, on Monday evening three steps will be taken :

((i) Harry receives a gain of $ 625.
(ii) The original Futures contract will be cancelled
(iii) A new futures contract will be entered into. Under the new futures contract Harry will be required to buy 125000SFs @ 0.755$

At the close of trading on Tuesday & Wednesday, the future prices are $ 0.755, @ 0.745 & 0.795.On Tuesday Harry pays $1250 and on Wednesday he receives $6250 under the mark to market system.

The important point is that the basis of mark-to market on the first day of the futures contract transaction are the price at which the contract is entered into and the futures price of that contract prevailing in the market on the closing of that day. The basis of mark-to-market on the other days are (i) closing price of futures on that day and (ii) closing price of the futures on the previous trading day.

No mark- to market is done on the settlement day. The settlement is done on the basis of futures closing price on previous trading day and the closing spot price on the day of settlement. Suppose on the Thursday the closing spot price was $0.805. Harry will receive $1250 as the final settlement.

Daily settlement reduces the chance of default on a futures contract. As the changes in the value of the underlying asset are recognized on each trading day, there is no accumulation of loss; the incentive to default is reduced. There is extremely low rate of default in futures market and the credit for this goes to the mark-to-market.

**** Q. No. 72 :** Write a short note on Commercial paper **(May, 2003)**

Answer : Commercial paper (CP) is an unsecured money market instrument issued in the form of a promissory note (CP can also be issued in dematerialized form through any depository registered with SEBI). It is to meet the short-term requirements of funds of the issuers. CP can be issued for maturities between a minimum of seven days and a maximum of one year from the date of issue. CP can be issued by (i) Corporates having minimum tangible net worth of not less than Rs. 4. crore as per the latest audited balance, (ii) Primary Dealers, (iii) All India financial institutions. All eligible participants have to obtain the credit rating for issuance of CP from CRISIL or some other credit rating agency specified by RBI. The issuer shall ensure that at the time of issuance of CP that the rating is current and has fallen due for review. Issuance of CP is governed by the guidelines issued by RBI from time to time.

Every issuer must appoint some scheduled bank as Issuing and Paying Agent (IPA).

CP can be issued in denominations of Rs. 500000 or multiples thereof. It is cheaper source of finance as generally the rate of interest on a CP is lower than that charged by banks. It is a liquid asset for the investors as it is transferable. Being a Promissory Note, it is subject to Stamp Duty.

The issue of CP cannot be under written. It is issued at discount to the face value. For example, a CP of Rs. 500000 face value, of six months maturity, will be issued for Rs. (500000/1.04), i.e., Rs. 480769 if rate of interest is 4 per cent for six months. Amount invested by a single investor should not be less than Rs. 500000 (face value). Every issue of CP should be reported to RBI by Issuing and Paying Agent within 3 days from the date of completion of the issue. On maturity the holder CP will get payment through the Issuing and Paying Agent.

CP has grown as a big instrument of money market (market for short funds) in India. RBI has announced that it is considering the introduction of Asset-backed Commercial Paper (ABCP) to further deepen the CP market.

Q. No.73 : Write short note on Treasury bills. **(Nov. 2003)**

Answer :

(i) T-bills are short-term securities issued by RBI on behalf of GOI, for maturities of 14, 91, 182 and 364 days.

(ii) Commercial banks, primary dealers, Mutual Funds, Corporates, Institutions and Insurance companies can participate.

(iii) Periodic auctions are held for their issue and these are tradable in the secondary market, which is quite active.

(iv) T-bills are issued at a discount to face value and are redeemable at par on maturity.

Q. No. 74: Explain briefly 'Call Money' in the context of financial market. **(May, 2004)**

Answer :

The money market is a market for short-term financial assets that are close substitutes of money. The most important feature of a money market instrument is its liquidity. The call money market forms an important segment of the Indian money market. Under call money markets funds are borrowed/ lent on overnight basis.

RBI has permitted only selected players for operating in call money market.

The eligible participants are free to decide on interest rates in call money market. Call money market enables its participants to even out their day-to-day deficits and surplus of money. No collateral security is required in this Market.

Q.No. 75 : Distinguish between Money Market and Capital market. **(Nov. 2004)**

Answer :

Money Market	Capital Market
MONEY market is that segment of financial market where short-term financial assets are dealt with; in this type of market where the funds can be raised as well invested from short-term	CAPITAL market is that segment of financial market where long-term as well as medium-term financial assets are dealt with; in this market the funds can be invested as well as raised from medium/long-term time horizon.

point of view.	
The instruments of the money market are commercial papers, factoring, bills-discounting, call money etc.	The instruments of capital; market are shares, debentures and Loans.
There are no segments of money market.	There are two segments of capital market (i) Primary market (ii) Secondary market.
RBI is the main regulator of this market.	SEBI is the main regulator of this market.

****Q. No. 76 :** What is interest rate risk, reinvestment risk and default risk & what are the types of risk involved in investment in G-sec. ? **(Nov. 2005)**

Answer: The term risk is used to denote the possibility of variability in the returns expected from the investment i.e. the actual return differs from the expected one. Investment in bonds is not entirely risk free. Both systematic and unsystematic risks are associated with the investment in bonds.

Default Risk : The issuer may default in the payment of interest or principal or both on the stipulated dates. This risk is referred as Unsystematic risk of Bond Investments.

Interest Risk : Interest risk refers to change in market interest rate during the holding period. Change in the interest rate causes change in the market price of the Bond. Remember that the bond prices move inversely to market interest rate changes. If interest in the market goes up, the market value of the bond will decline. It is systematic risk of Bond investments.

Reinvestment Risk : Change in market interest rate during the holding period affects the return from the bond investment as the investor shall be reinvesting the interest income of the bond at the changed rate. It is systematic risk of Bond investments.

Two types of risk are involved in G-sec : (i) Interest risk and (ii) reinvestment risk.

*****Q. No.77 :What is a Repo and Reverse Repo ?(Nov. 2005)**

Answer: REPURCHASE OPTION (REPO)

It is a liquidity adjustment facility provided by the RBI to the participants of the repo market (the participants are primary dealers, scheduled commercial banks, utban co-operative Banks and listed companies).

Repo is used for injecting liquidity by RBI to the participants. If the participants of the repo market have less liquidity, they may borrow for overnight from the RBI. For this purpose, the participants sell Government of India securitiesû to the RBI with the undertaking that they will buy-back these securities from the RBI next day at the price determined at the time of selling the securities. The price at which the securities will be bought back is higher than the price at which these are sold. The difference represents interest at the rate announced by the RBI from time to time. Currently the repo rate is 7.75 per cent p.a.

Under Reverse repo, the participants transfer their excess liquidity to the RBI (reverse repo is defined as the process by which RBI absorbs the extra liquidity with the participants of the repo market). If any participant has excess liquidity, it may lend (for overnight) to the RBI. For this purpose, the participant purchases Government of India Securities from the RBI with the under taking that these will be sold back to the RBI next day at the price decided at the time of purchase of such securities. The price at which the securities will be sold back is higher than the price at which these are purchased. The difference is interest (from REBI to the participant). The rate of interest is announced by the RBI by time to time. Currently, the reverse repo rate is 6.00 per cent p.a.

The amount of repo/reverse repo should be in the multiples of Rs. 5 crore (with minimum of Rs. 5 crore).

****Q. No.78:** Write short note on Inter Bank Participation certificate**. (Nov. 2006)**

Answer : The Reserve Bank of India (RBI) norms stipulate that banks must lend up to 40 per cent of their total portfolio as advances towards the priority sector. Of the 40 per cent, 18 per cent is towards agriculture loan, 10 per cent as loans towards the weaker section of the society and the balance towards SSI and home loans.

Sometimes, a bank, say A Bank, finds that it has not achieved these limits i.e. the advances to the priority sector are less than the RBI's requirement. Some other bank, B Bank, might have exceeded these limits. What these bank can do is that B Bank may sell its excess priority advances to A bank to purchased after some time, say 3 months. The interest on priority advances is less than other advances. A Bank has been gainer by advancing less amount to priority sector. This gain will be transferred by A Bank to B Bank by way to purchasing the portfolio of priority advances at a rate higher than the prevailing inter-bank offering rate. Through this process, A Bank could meet the requirements of RBI and B Bank could higher rate of interest. The banks are increasingly issuing IBPCs for this purpose.

IBPCs are short term instruments to even out liquidity within the banking system. This is purely an inter bank instrument. The RBI has authorized the banks to fund their short term needs from within the system through issuance of IBPC.

****Q. No. 78 :**What are the matters to be considered in the context of working capital management is Public Sector undertakings? **(Nov. 1997)**

Answer : Working Capital is the money used to make goods and attract sales. Working capital comprises short-term net assets: stock, debtors, cash and less creditors. Working capital management is to do with management of all aspects of both current assets and current liabilities, so as to minimize the risk of insolvency while providing adequate return on capital employed return, in working capital.

There is only one fundamental difference between the working capital management of PSUs and other business organizations. While primary goal of the working capital management of other business organizations is maximizing the return on capital employed in working capital, it is the secondary goal in case of PSUs (welfare of the people is the primary goal for the PSUs, they can do with less return in the best interest of the people. But return is definitely a goal, though it is secondary, it should not lost sight of the management as it is must for the survival of the PSUs).

Considering this secondary goal, the finance manager may manage the working capital of the PSUs on the basis of following lines :

(i) Well defined rules, decentralization and fixing the responsibilities : PSUs money is basically public money, it should be handled more delicately. PSUs should have clear-cut well defined financial rules, authorities should be delegated to the junior level managers but they should also be held responsible for their decisions. For example, a junior level sales manager may be delegated the authority of extending credit to a customer, but then he should be responsible for collection of the money after on the expiry of extended collection period.

(ii) For control over working capital, the PSU should prepare (a) Working capital budget (b) Projected fund flow statement, Projected cash flow statement, Actual Fund flow statement and Actual Cash flow statement.

(iii) Current and quick ratios should be calculated and analyzed regularly.

The finance manager of PSUs should also consider the following general points of working capital management (these points are applicable to PSUs as well as other business organizations): (a) Make accurate estimation of working capital requirements, (b) decide the sources of financing the working capital requirements like banks, financial institutions, commer-cial papers, (c) Consider the impact of seasonality on working capital requirement and financing, (d) Consider the impact of inflation, (e) Follow proper inventory control Þ generally PSUs have over stocking, this should be avoided, (f) Follow a strict timely collection policy, do not let the customers think and believe that they can afford not to pay, discount for early payments should be encouraged, (g) payment to creditors and for other expenses should be made in time, no harassment of those who have to collect their cheques. If cash discount is available, consider whether it is beneficial to avail it or not; it yes, avail it, (h) follow a well defined cash management policy. Lack of liquidity is generally too costly to be afforded, cost of surplus cash should also be avoided by keeping the cash at required level, (cost of surplus cash includes loss of interest, misuse by staff and fraud, embezzlement, etc.).

****Q.No.79 :** Write short note on special features of Financial Management in Public Sector Undertakings. **(May, 1999)**

Answer : Answer to this may be prepared on the basis of (i) Role of finance manager in PSUs, (ii) Strategic financial planning in public sector, (iii) Corporate social responsibility of public sector undertakings, and (iv) Working capital management of PSUs.

***Q. No. 80 : Write short note on role of Financial Advisor in the Public Sector Undertaking. (May, 2001, May 2007)**

Answer : The finance manager has to perform finance function of the organization whether it is the case of PSU or some other business organization. He should estimate the financial requirements of the organization, decide about sources of raising the finance, decide about investing the funds in project etc. However, there are some peculiar points regarding the role of financial manager in PSUs as compared to ordinary business organizations :

(i) He has to consider that though the goal of the PSU is not maximizing the wealth of the shareholders, it should not ignore the profit target all together, as it is must for its survival. (To meet all the expectations from them, the PSUs have to survive. For their survival, they should definitely earn some return on the funds invested in them. The concept dates all the way to Adam Smith who opined that for its survival, a business has to provide a minimum competitive return on all the capital invested in it. PSUs cannot survive on government subsidies for all the time.)

(ii) The finance manager of a PSU has quite limited role to play in case of dividend decisions.

(iii) All the decisions should be guided the fact that the object of the PSU is welfare of the people and providing help in the economic development of the country. Corporate Social responsibility should be a special consideration in the decision making.

(iv) Money invested in the PSU is people's money (including very poor ones). Hence, it should be handled very delicately.

(v) Cost reduction and efficiency in operation should be given special emphasis.

(vi) Project appraisal should make Social Cost Benefit Analysis.

(vii) To make its products affordable for the low income people, it may follow the price discrimination policy or price differentiation policy (under price differentia-tion policy, those who can afford they are offered a slightly better quality product but at much higher price).

(viii) Cost volume relationship should be established and find whether higher production can be sold at cheaper prices.

(ix) Financial reporting should be of quite high order.

(x) Financial analysis like inflation accounting, Human resource Accounting, EVA statement, cash flow state-ments, and accounting ratios should be part of financial reporting.

***Q. No. 81 :**Write short note on Strategic Financial Planning in Public Sector Undertaking**. (May, 2002)**

Answer : The term strategic financial planning means long-term planning for survival and to achieve the goals of the organization in the face of external environment (competition). Public sector means commercial organizations run by the government. Though the public sector undertakings are run as commercial organizations, their object is not maximization of shareholders wealth. The strategic financial planning of public sector is governed by two guidelines :

(i) The goal of public sector is not profit.

(ii) A commercial organization cannot survive without earning a minimum return on funds employed.

Public sector undertakings are owned, controlled and managed by the public through the government. Their goal is not profit. Their main goal is doing whatever they can for the welfare of the people. They are expected to :

(i) provide infrastructure,
(ii) generate employment opportunities,
(iii) earn foreign exchange,
(iv) provide goods and services to the public at nominal rates (particularly to the poor),
(v) to act as engine of growth,
(vi) to reduce inequalities of income and wealth and.
(vii) carry out other social responsibilities.

They are expected not to :

(i) do any harm to the environment,
(ii) not to compete with small sector undertakings, and
(iii) not to follow cut throat competition policy. They are expected to set lessons of business ethics before the private sector.

To meet all the expectations from them, the PSUs have to survive. For their survival, they should definitely earn some return on the funds invested in them. The concept dates all the way to Adam Smith who opined that for its survival, a business has to provide a minimum competitive return on all the capital invested in it. PSUs cannot survive on government subsidies for all the time.

On the basis of these guidelines, the strategic financial planning of the public sector may involve the following points:

(i) The PSUs are not to be run at loss. Hence, these should be run on such policies that earn minimum return on funds invested. The minimum return should be sufficient for its survival and growth.
(ii) They are meant to provide goods and services to the public, particularly to the poor. Hence, their pricing policy should be such that people get the goods and services at reasonable rates. They may follow price discrimination policies with favourable treatment to the poor. Their pricing policies may be based on cost on one and affordability of the consumer on the other hand.
(iii) They should not follow cut throat competition with other business houses particularly the smaller ones. They may compete with others in terms of quality.

(iv) They should provide depreciation on the basis of replacement cost of the fixed assets. Additional working capital required on account of inflation should be funded out of profits.

(v) Establish sinking funds for replacement of fixed assets and repayment of liabilities.

(vi) They should set financial rules and regulations and see that these are strictly followed.

(vii) Standards of financial efficiencies should be set and met.

(viii) Zero base budgeting and performance budgeting must be followed.

***Q.No. 82 :** Explain reforming the public Sector Enterprises through Green Field Privatization. **(Nov. 2003)**

Answer : The term **Greenfield privatization** refers to allowing the private sector to come and compete in the areas hitherto reserved for public sector. It includes :

(i) **Green field projects**, i.e., new commercial activities to be undertaken by private sector or by joint venture between public and private sectors. There are four way outs :

- **Pure private set-up :** A private entrepreneur sets-up a commercial unit in which the government provides no revenue guarantees. The private developer assumes all the risks for the project. It gets all the rewards. It assumes full responsibilities for setting up and operating it.
- **Build, lease, and own :** A private entrepreneur builds a new commercial unit (generally a facility, say an airport) largely at its own risk, transfers ownership to the government, leases the unit from the government and operates it at its own risk, then receives full ownership of the unit at the end of the pre-decided period.
- **Build, own, operate, transfer :** A private entrepreneur builds a new commercial unit (generally a facility, say a highway road) at its own risk, owns and operates the facility at its own risk, then transfers ownership of the facility to the government at the end of the pre-decided period. The government usually provides minimum revenue guarantees.
- **Build, own, and operate:** A private sponsor builds a new commercial unit (generally a facility, say a power generation unit) at its own risk, then owns and operates it at its own risk. The government usually provides revenue guarantees for bulk supply facilities or minimum revenue guarantees.

(ii) **Disinvestment :** A private entity buys an equity stake in a State-owned enterprise through an asset sale, public offering, or mass privatization programme. Divestitures can be classified in two categories:

- Full : The government transfers 100 per cent of the equity in the PSU to private sector organization(s).
- Partial : The government transfers part of the equity, along with control and management, in the PSU to private sector organization(s).

*****Q. No. 83 :** Write a short note on Walter's Model on Dividend Policy. **(May, 1998)**

Answer : Walter has proposed a model for share valuation which supports the view that the dividend policy of a firm has a bearing on share valuation. He emphasized two factors which influence the market price on a share. The first is dividend payout ratio and the second is the relationship between internal return on retained earning (*r*) and cost of equity capital (K_e).

Walter classified all the firms into three categories: (i) Growth firms, (ii) Declining firms, and (iii) Normal or constant firms.

He refers a firm as growth firm if the rate of return on retained earnings (*r*) exceed its cost of equity capital (K_e). It means if the firm retains the earnings, it can invest the retained funds at higher rate of return than the rate of return to be obtained by shareholders by investing the dividend amount in case the firm does not retain the earnings. In such a situation, the shareholders would like the company to retain maximum amount, i.e., to keep payout ratio quite low because low dividends would be more than compensated by higher returns on retained earnings — Hence in case of such firms there is negative correlation between dividend and market price of shares. Lower the dividend, higher the market price of shares. Higher the dividend, lower the market price of shares.

A firm is referred as constant firm if rate of return on retained earnings is equal to cost of equity capital. It means if the firm would retain the earnings it would obtain return equal to the return to be obtained by shareholders by investing dividend. In this situation, the shareholders would be indifferent about splitting off of the earnings between dividend and retained earnings. Hence market price of share won't be influenced by dividend rate. The correlation between dividend rate and market price of the shares would be nil.

Walter refers a firm as declining firm if its rate of return on investments is lower than its cost of equity capital. It means if the firm retains the earnings, it can invest the retained funds at lower rate of return than the rate which can be obtained by the shareholders by investing the dividend amount (in case the firm does not retain the earnings). In such a situation, the shareholders won't like the firm to retain the profits or to retain only minimum so that they can get higher returns by investing the dividends received by them. Hence, in case of such firms there would be positive correlation between dividend size and market price of the share. Higher dividend, higher market price of the shares. Lower dividend, lower market price of the shares.

Walter concludes: (i) the optimum payout ratio is nil in case of growth firm, (ii) the payout ratio of a constant firm is irrelevant, (iii) the optimum payout ratio for a declining firm is 100 per cent.

Walter's Theory

Category of firm	r v/s Ke	Correlation between dividend size and market price of share	Optimum Pay out ratio
Growth	$r > K_e$	Negative	Nil
Constant	r = Ke	No correlation	Every Payout ratio is optimum
Decline	$r < K_e$	Positive	100%

***Q. No. 84 :** Write short note on factors influencing he Dividend policy of a firm. **(May, 1999, Nov. 2001)**

What are the determinants of Dividend policy. **(Nov. 2002)**

Determinants of Dividend policy **(May, 2006).** What are the determinants of Dividend Policy ?

Answer: Dividend policy of a company is broadly guided by the two considerations :

(i) Maximizing the shareholders wealth
(ii) Financing requirements and policies of the company.

Academicians have suggested two contradictory approaches to dividend policy :

(a) Dividend as an active decision – As per this view, a company should decide the amount it wants to distribute as dividend, and only remaining amount should be retained and reinvested in the business.
(b) Dividend as passive decision : As per this view, a company should find the amount of profit that can be retained and reinvested in the company's

business in a profitable way and only balance, if any, should be paid as dividend. (This is known as residual theory of dividend.)[15]

The professionals view is the dividend decision should regarded as an active and primary variable and not as a passive residual. The availability of investment opportunities is not a matter for serious consideration.

Dividend decisions are the decisions of the firm's directors and hence, reflect management's perception of their responsibilities and objectives.

The factors influencing their decision are as follows :

(i) The company's **earnings** and future prospects is a dominating influential factor.

(ii) The company's **cash flow**, current liquidity and future cash needs are regarded as important considerations.

(iii) The **needs and expectations of shareholders** should be given due recognition[16]. For example, if majority of shareholders senior citizen who need dividend money for meeting their day to day expenses, larger amount dividend per share will be more appropriate.

(iv)A company should follow a **stable dividend policy** i.e. year after year the dividend per share may not fluctuate much. This can be taken care of by using Linter model.

(v)**Long-term pay out ratio** should be the guiding force..

(vi) Dividend decisions are affected by **tax considerations**.

[15] . . , a firm would invest the internal funds it generates either within the firm or by acquiring assets of another firm, subject only to the constraint that each new investment has a net present worth greater than zero, i.e., that the expected yield on internal investment is higher than the capitalization rate for earnings of the quality expected. After all such investment opportunities have been exhausted, any internal funds remaining would be distributed to shareholders as cash dividends." (Solomon)

[16] The companies should give share-holders a steady and dependable return without losing sight of the companies' long-term and short-term needs for funds. When deciding whether to distribute earnings, in the form of cash or to retain them for future growth, companies should strive to follow policies that meet the shareholders' needs for income or capital appreciation, and at the same time, preserve the soundness of company finances.

(vii)Dividend decisions are governed by (a) section 205 of Companies Act, 1956 (b) Transfer of profit to reserve Rules,1975&(c)Payment of dividend out of reserve rules, 1975.

(viii) Restrictive covenants: conditions imposed by money lenders, restrictions on Banks by RBI

***Q. No. 85 :** Write short note on effect of a Governemnt imposed freeze on dividends on Stock prices and volume of Capital investment in the background of Miller- Modigliani theory on dividend policy. **(Nov. 2002)**

Answer : Miller and Modigliani have opined that the price of equity shares of a firm depends solely on its earnings power and is not influenced by the manner in which its earnings are split between dividends and retained earnings. They observed "under conditions of perfect capital markets, rational investors, absence of tax discrimination between dividend income and capital appreciation given the firm's investment policy, its dividend policy may have no influence on the market price of the shares." In other words, the price of share is not affected by the size of the dividend. (By the price of the share, MM mean wealth of the shareholders).

The Government imposed freeze on the dividend , according to MM, will have no impact share prices (wealth of the shareholders). The shareholders will be deprived of the dividend but they will be compensated by increase in the value of their shares.

Capital investment, in the real terms, won't be affected by this action as it is neither in favour nor against the capital investment, However, the firms will be raising lesser amount of capital from the market, as a part of requirement of capital for further investment will be available in the form of retained earnings.

****Q.No. 86 :** How tax considerations are relevant in the context of a dividend decision of a company ? **(Nov, 2006)**

Answer : Return on equity shares can be provided to the shareholders by two ways (i) Dividend and (ii) Bonus shares. The first option is quite inferior option from the angle of taxation. On one hand, the amount of dividend is not allowed as deduction for computing the taxable income of the company, on the other hand the company has to pay an all inclusive corporate dividend tax (Corporate Dividend Tax + Surcharge + Education cess). The dividend is tax exempt in the hands of the receiver of dividend. The second option is not so inferior. Though the amount of bonus shares is not allowed as deduction while calculating taxable income of the company, the company does not have to pay corporate dividend tax. The allottee of bonus shares (i.e. the shareholder) , if needs cash , can sell these shares. If the shares are listed in the stock exchange and these are sold through the stock exchange after paying Security transaction tax (which is quite negligible), the shareholder may not have to pay tax (if from taxation angle, the transaction results in transfer of long term capital asset) or tax at "10 % + surcharge + education cess", if from the tax angle it is the transfer of short term capital asset.

Q.No. 87 : Determine the interface of Financial policy with Corporate Strategic Management. **(Nov. 1998)**

Answer :
In the simplest sense, the term **'Interface'** means link. In a more sensible sense, it is a device of link between two. A remote control is an interface between you and a television set. Computer is an interface between you and Internet.

Financial policy : Policies are guides of company, they guide the company towards their goals. Policies are broad guidelines set by the top management in consultation with the experts. The company is expected to follow these guidelines. Financial guidelines provide guidance in the financial matters. For example, a firm's financial policy may be to keep the debt equity ratio at low level, say, 1 by 1. The other policy may be to keep all the foreign exchange risk hedged. It may be that lives of the projects taken by the company should not be more than 10 years etc.

Strategic financial management is the process of applying the financial techniques to strategic financial decisions so that the long term objectives of the firm can be achieved in spite of tough competition.

Financial policies are interface (Link) between:
- the Management people (they are expected to achieve the objective of wealth maximization in the long run through maximization of EPS while keeping the risk at optimum level)
- the strategic financial management (financial decisions).

In other words, the financial policies are guiding force behind the strategic financial decisions. Hence :

(i) the policies should be framed after due consideration of the present and prospective scenarios

(ii) the policies should provide some flexibility to the people who have to take the decisions

(iii) the policies should provide their exceptions i.e. the situations when the deviation from the policies could be made

(iv) the policies should be reviewed from time to time. A policy laid down today, may not be suitable after sometime.

(v) the policies should not be too restrictive, these should provide only broad guidelines.

***Q. No. 88 :** Write short note on inflation and financial management. **(Nov. 1998)**

Answer : Inflation and Financial Management

INFLATION AND DECISION MAKING

THE term **inflation** refers to rise in general (on an average basis) price level of goods and services in the economy, i.e., fall in purchasing power of money. **Financial Management** is the process of financial decision-making. There are three categories of financial decisions: (i) financing decisions, (ii) investment decisions, and (iii) dividend decisions. During inflationary conditions, the financial decisions should be influenced by the impact of the declining purchasing power of money on the company. The single most important maxim of financial management that influences every decision is: Time eats money. This maxim holds good even in the absence of inflation (because of cost of capital), it gains extra strength during the inflationary conditions. The finance manager should consider the following points while taking such decisions during the inflationary conditions:

Basis of Decision-making

The profits reported by the historical accounting are inflated. Hence, such profits should not be the basis for decision-making. For various decisions, like pricing, financing, investing and dividend payments, profit/loss should be calculated after making adjustments for purchasing power decline. Indeed, ignoring the inflation can lead to entrepreneurial error and, thus, to business failure.

Pricing Decisions

The pricing policies undergo a dramatic transformation during inflation. Prices must be revised frequently and sharply to accurately reflect the impact of inflation. The pricing should provide a real profit margin on real costs (i.e., inflation adjusted costs).

Investment Decisions

(i) ***Capital expenditure decisions*** : Capital budgeting is one of the major tools which helps financial managers in evaluating investment proposals. Capital budgeting decisions are seriously distorted by inflation. Inflation affects two aspects of capital budgeting : (a) Projected cash flows, and (b) Discounting rate. Inflation will change the projected cash flows, i.e., in case of inflation (which was not considered at the time of making projections about future cash flows) the cash flows would be different than these would have in the absence of inflation. Inflation also affects interest rates and this in turn may change the cost of capital. Also, the investor should get the returns only in real terms, otherwise he may not get what he expects or he may even suffer loss (in terms of purchasing power of money). Without consideration of inflation, the project may appear to be much more attractive than it really is and this may mislead the decision makers. Hence, the decision about capital expenditure should be taken only after considering the inflation. Overlooking inflation in capital budgeting will be detrimental and will result in irrational resource allocation.

(ii) ***Working capital*** : In the time of rising prices, a firm needs more funds to finance working capital. Hence, it should be planned properly. Cash should never be allowed to remain idle (time eats value of money, i.e., on one hand the company suffers loss of interest and on the other purchasing power of wealth kept as cash declines). Good cash management can provide a major source of profit, while poor cash management can destroy a company in a short time. Inventory valuation should be based on NIFO (next in first out).

Financing Decisions

The finance manager should consider inflation while making financing decisions. Loans may be taken on fixed rate basis (and not on the basis of floating rate as floating rate rises in case of inflation). He should note that the stock market may become an uncertain source of capital. Shareholders will expect real rate of return (in the form of dividend as well as capital appreciation) on their investments otherwise the share prices may go down in the share market.

Dividend Decisions

Cash position becomes a very important determinant of dividend payment as during inflationary conditions generally companies face the shortage of cash. Besides, the finance manager should see that the dividend decision is based on real profit (calculated on the basis of inflation adjustment, after providing depreciation on replacement cost basis) otherwise the company would be consuming its capital.

Other Points

(i) Make absolutely certain that all the managers under-stand time value of money.

(ii) Develop an appropriate inflationary adjustment for capital replacement or capital will disappear.

(iii) Anticipate that the purchasing department will assume a more important role in the long-run survival of the firm.

(iv) Develop methods for estimating rate of inflation.

(v) Anticipate difficulty in maintaining capital expenditure programmes.

Q. No. 89 : Write short note on Inter-relationship between investment, financing and dividend decision. **(Nov. 1999)**

Answer : Financial Management is the process of financial decision-making. There are three categories of financial decisions: (i) financing decisions, (ii) investment decisions, and (iii) dividend decisions. All these decisions are interrelated as each one affects the others and also each one has a single target and that is maximization of wealth of shareholders in the long run (this can be achieved through maximizing EPS while keeping the risk at optimum level).

Financing Decision: Financing decision involves estimating the requirement of funds and raising them at minimum cost of capital while keeping the risk at optimum level.

Financing decisions affect **investment decisions** as investments can be made only if enough funds are raised at reasonable cost of capital. Such decisions also affect **dividend decisions** as adequate dividend should be provided on equity capital raised, otherwise the market price of the shares will go down.

Financing decisions are affected by **investment decisions** as funds are required to be raised only if profitable investment opportunities are present. Such decisions are also affected by **dividend decisions** as equity funds should be raised only if the company shall be earning on these funds at a rate which is higher than the rate of return expected by equity shareholders (which depends upon dividend decisions).

Investment Decision : Such decision involves capital expenditure decision as well as decisions regarding investing in working capital. While making the decisions, it must be ensured that they will earn adequate return on funds invested so that adequate return may be provided to the supplier of funds.

Investment decisions affect **finance decisions** as finance has to be raised only if investment opportunities are there. Such decisions also affect **dividend decisions** as dividend depends upon the return obtained on these investments.

Investment decisions are affected by **finance decisions** as investments can be made only if finance is available at reasonable cost. Such decisions are also affected by **dividend decisions** as only that much amount may be paid as dividend for which profitable investment opportunities are **not** there (Residual theory of dividend).

Dividend Decision : Such decisions are concerned with providing return to equity shareholders. Such returns may be provided through dividend or bonus.

Dividend decisions affect **financing decisions** as equity funds should be raised only if the company hopes to be able to provide adequate return to equity shareholders (otherwise the market price of shares will go down which is not liked by any finance manager). Such decisions also affect **investment decisions** as investment should be made only if the investment will provide adequate (adequate enough to provide return to equity shareholders) return on funds employed.

Dividend decisions are affected by **investment decisions** as dividend depends upon the return provided by the investments. Such decisions are also affected by **financing decisions** as higher the issue price of equity shares, larger should be the amount of dividend per share.

***Q. No. 90:** Write short note on Current Cost Accounting method of adjusting financial statements. **(Nov. 1999)**

Answer : Money measurement concept is one of the many universally accepted concepts of accounting. As per this concept, all business transactions are recorded in the books of accounts in terms of money. It is implicit in this concept that value of money remains stable. Experience of recent history has proved this assumption to be unrealistic. Value of money depends upon its purchasing power which is reflected by price-level. As price level is never constant, the value of money is never stable. The accounts prepared under the assumption of stable value of money become unrealistic during the periods of rapidly changing prices. Hence some changes in accounting system are warranted so that accounting information may be realistic, useful and relevant. The accounting system incorporating such changes is termed as ‘Accounting for Price-level changes’. As we generally witness only one type of price-level change, i.e., inflation, the system is popularly known as Inflation Accounting. Current Cost Accounting (CCA) is one of most popular methods of adjusting the financial statements under inflationary conditions.

CCA is a method of accounting for price-level changes. This method is based on SSAP-16 issued by Accounting Standard Committee of U.K. in 1980. As per the standard, current cost information should be published in addition to historical cost information maintained on historical basis. CCA statements are drawn up in memorandum form only.

There are three important points of CCA: (i) Adjustments are made on the basis of specific changes in prices (and not on the basis of general changes in prices), (ii) Profit and loss A/c adjustments are made on the basis of average index numbers and balance sheet adjustments are made on the basis of closing index numbers, (iii) There are two adjustments regarding balance sheet and four adjustments regarding P&L A/c. The balance sheet adjustments are regarding. fixed assets and stock. These items are shown in CCA balance sheet at their current cost. The difference between current cost and historical cost of these items is recorded in current cost reserve A/c (CCR A/c). CCR A/c records profit arising on account of inflation. The adjustments regarding profit and loss account are: (i) Cost of sales adjustment (COSA), (ii) Depreciation adjustment, (iii) Monetary working capital adjustment (MWCA), and (iv) Gearing adjustment.

Cost of sales adjustment

It is the difference between current cost of goods sold and historical cost of goods sold.

The amount of cost of sales adjustment is debited to CCA Profit and Loss Account and credited to Current Cost Reserve Account

Depreciation Adjustment
Depreciation adjustment is the difference between depreciation calculated on historical basis and the depreciation calculated on the current cost of fixed assets. The depreciation adjustment is debited to Current Cost P&L Account and credited to Current Cost Reserve Account.

Monetary Working Capital Adjustment
In the times of rising prices, a firm needs more funds to finance monetary working capital. This adjustment reflects this need for additional funds.

The amount of monetary working capital adjustment is debited to CCA P&L a/c and credit to current cost reserve account.

Gearing adjustment

To the extent, the assets of a company are financed by borrowing, the shareholders enjoy an advantage over a period of rising prices, because even when the prices are rising, the liability to pay the borrowings remain the same. Hence, gearing adjustment is necessary to determine the profit available for equity shareholders. The amount of gearing adjustment is credited to CCA P. and L. account and debited to current cost reserve.

***Q. No.91 :** Effects of Inflation on inventory management **. (May, 2001)**

Answer : EFFECT OF INFLATION ON INVENTORY MANAGEMENT

The term '**inflation**' refers to rise in general (on an average basis) price level of goods and services in the economy .i. e. fall in purchasing power of money. It creates a number of uncertainties because of rising prices in raw materials, semi-finished and finished goods. Inflation also muddies inventory planning, The management should consider the following points for effective management of inventories under the inflationary conditions :

(i) EOQ : We use inventory carrying cost to determine how much inventory we will keep on-hand. Inflation affects the EOQ model by increasing carrying costs

(because the inflation pushes up the interest rate) (C) which results in a small EOQ level. This small quantity is misleading and results in increase in inventory related costs. Hence, to calculate the optimum order size, cost to carry should be reduced by inflation's impact on interest cost. **To understand this let's have an example** : Cost per unit Rs.5. Cost to order Rs.100 per order. Annual demand 10000 units. Cost to carry 12% p.a. of cost of inventory carried (this is made of 10% interest cost and 2 % storage etc cost). Cost to carry per unit p.a. = Re.0.60. Now suppose inflation is there and data is : Cost per unit Rs. 6, cost to order Rs.110 per order, Cost to carry 14% (including 11.50 % interest cost and 2.50 % other cost like storage etc. Had the inflation not been there, the interest cost would have been 10.50 %). Now for the purpose of calculation of EOQ, cost to carry should be taken as 13% of Rs.6. (otherwise the inflation's impacted on cost to carry per unit be considered twice; once as increased price and other time as increased % of cost to carry)

(ii) NIFO as the basis of valuation of inventory: NIFO assumes that the inventory we sell is purchased at the time of its sale. Generally, this inventory costs more than earlier layers of inventory. As a result, ending inventory is smaller than it otherwise would be. Since ending inventory is smaller, COGS is higher. (COGS is calculated on the basis of replacement cost) Higher COGS means reporting the lower profit, this helps in lower dividend, higher retained profit for replacement of assets and maintaining the capital intact. If inventory is valued on FIFO basis, the profit reported by the books of accounts will contain an element what is referred as inventory profit, "Inventory profits" are never real profits. If inflation continues, the inventory will have to be replaced at tomorrow's higher prices. If inflation stops, inventory profits immediately turn into an inventory loss. Some authorities call inventory gains "Phantom profits," which disappear the moment inventory is replaced.

(iii) Ideally, the inventory-sales ratio should be kept as low as feasible so as to minimize the cost of storage and the cost of money tied up in inventory. But As these prices rise, purchasing managers naturally tempted to buying for forward requirements.. The purchasing manager of course realizes that his cost of storage and tied up money will thereby go up. But he may hold that these costs are more than offset by being able to obtain inventory at lower prices than he could later. Such decisions , for buying for future requirements should be taken after considering the both (i) possible further price movements and (ii) cost to carry including the cost of obsolescence.

****Q. No. 92:** Write short note on Economic Value Added method **. (Nov. 2001)**

Answer :

EVA is an accounting based technique of measuring the performance of an entity. The entity whose performance is being measured could be a division, department, project or the firm itself. The concept of EVA has been developed and popularized by Stern Steward & co.- a US consulting firm.

EVA measures how much an entity has earned over and above its cost of capital[17], which includes both debt and equity. Put simply, EVA is net operating profit[18] minus an appropriate charge for opportunity cost of all capital invested in an enterprise. As such, EVA is an estimate of true "economic" profit, or the amount by which earnings exceed or fall short of the required minimum rate of return that that shareholders and lenders could get by investing in other securities of comparable risk.

EVA = EBIT –TAX on EBIT - [C.E.xWACC]

IMPROVEMENT IN EVA

Improvement in EVA can be achieved in four ways:

(i) Increase operating efficiency.
(ii) Taking on new investments that promise to earn more than WACC.
(iii) Get rid of those parts of business that earn less than WACC.
(iv) WACC is lowered by altering financial strategies.

FIVE FEATURES OF EVA

(i) EVA & Financial Management
(ii) EVA & Incentive compensation
(i) EVA & Divisional performance
(ii) EVA & Goal setting
(iii) EVA & Market valuation

EVA & Financial management

As per EVA concept, the managers should incorporate two basic principles of finance in their decision making . The first is that the primary financial objective of any company is to maximize the wealth of the shareholders. The second is that it is the continuous improvement in EVA that brings continuous increase in shareholders' wealth.

EVA & Incentive Compensation

The objective of incentive compensation is to make managers behave like owners. They should identify themselves with the fortunes of the company. EVA is a useful tool for incentive compensation. When the bonus of managers is linked to increase in EVA, they think and act like owners. They do, all that they can, to improve EVA.

[17] Weighted average cost of equity and borrowed funds. It is calculated on the basis of current cost and not on the bass of historical cost.
[18] Net operating profit = EBIT – Tax on EBIT

EVA & Divisional Performance

EVA is a useful tool for divisional performance appraisal. (The term division here refers to a constituent unit of company, it may be department, product, project or something like this.) By separately measuring the performance of different constituent units, their managers can be held responsible for operations under their direct control and for creation or destruction of wealth. Divisional managers should be given incentive bonus on the basis of increase in EVA of their respective divisions.

EVA & Goal Setting

Most companies set different goals for different managers. Strategic managers are expected to increase market-share, marketing managers are expected to increase the growth in revenue, Production managers are expected to produce at minimum cost and so on. The result is different and, sometimes, conflicting goals

for different managers. Under EVA, there is only one goal for each manager and that is, improve EVA. EVA based goal (i.e. goal of every manager is to improve the EVA of activities under his control) is simple and can be communicated to, and easily understood by , the managers of different levels.

EVA & Market Valuation

Market value of a company depends upon its EVA. There is high degree of correlation between EVA growth and market value addition. Increase in EVA results in increase of market value and vice- versa.

Conclusion

The most valuable resource in any company is the creativity and will to succeed that its people possess. EVA equips them with better information and better motivation to succeed.

** **Q. No. 93 :** Discuss the major sources available to an Indian Corporate for raising foreign currency finances. **(May, 2007)**

Answer :

Debt : A company can raise foreign currency from one or more of the following methods of debt financing:

(i) External Commercial Borrowings : The foreign currency borrowings raised by the Indian corporates[19] from outside India are called "External Commercial Borrowings" (ECBs). ECBs occupy a very important position as a source of funds

[19] In some cases, NGOs and co-operative societies are also permitted to raise funds through ECBs.

for Corporates. These Foreign Currency borrowings can be raised within ECB Policy guidelines of Govt. of India/ Reserve Bank of India applicable from time to time. The intention of GOI/RBI is to maintain prudent limits for total external borrowings and to provide flexibility to Corporates in external borrowings. The main emphasis of guidelines is:

- to keep borrowing maturities long,
- to keep borrowing costs low,
- to encourage infrastructure, and to increase export sector financing.

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 form the International market is huge as compared to domestic market and corporates can raise large amount of funds at competitive prices depending on the risk perception of the International market.

ECB GUIDELINES :
External Commercial Borrowing (ECB) refers to commercial loans [in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments (e.g. floating rate notes and fixed rate bonds)] availed from non-resident lenders with minimum average maturity of 3 years. ECB can be accessed under two routes, (i) Automatic Route and (ii) Approval Route.

ECB under Automatic Route do not require approval of Government of India / RBI. ECB under Approval route requires the approval of Government of India / RBI.

(ii) Foreign Currency Convertible Bonds : A convertible bond is a debt instrument with gives the holder of the bond an option to convert the bond into a pre-determined number of equity shares of the company. The bonds carry a fixed rate of interest. The bonds are listed and traded in one or more stock exchanges abroad. Till conversion, the company has to pay interest on the bonds in foreign currency and if the conversion option is not exercised, the redemption also has to be done in foreign currency. The bonds are unsecured. These bonds are issued to non-residents against foreign currency.

If the issuing company so desires, the issue of such bonds may carry two options.

1. *Call Option*: Where the terms of issue of the bonds contain a provision for call option, the issuer company has the option of calling (buying) the bonds for redemption before the date of maturity of the bonds.

2. *Put Option*: A provision of put option gives the holders of the bonds a right to sell his bonds back to the issuer company at a predetermined price and date.

Equity : Foreign currency finances can be raised by issuing depository receipts . A Deposit Receipt is negotiable certificate that represents a non-US company's one or more publically-traded equity shares.
Depository receipts are of two types: (i) Global depository receipt and (ii) American depository receipt.

GLOBAL DEPOSITORY RECEIPTS

A GDR is negotiable certificate that represents a non-US company's one or more publically-traded equity shares. A GDR is denominated in dollar terms. The equity shares comprising in each GDR are denominated in local currency of issuing company. For example, a GDR issued at $ 30 may comprise two equity shares with a par value of Rs. 10 each.

AMERICAN DEPOSITORY RECEIPTS

Depository receipts issued by a company in the United States are known as ADRs. The ADRs must be listed in some US stock exchanges. Such receipts have to issued in accordance with the provisions stipulated by the Securities and Exchange Commission of USA. These provisions are very strict. Not many Indian companies have gone for ADRs issue because: (i) they are not fully geared to meet the strict requirement of Securities and Exchange Commission of USA, (ii) the cost of issuing ADRs is quite high the listing fee is quite hefty, and (iii) the US is most litigious market in the world. 11 Indian companies have issued ADRs so far. These are:(1)Infosys (2)Wipro (3) MTNL (4)VSNL (5) Rediff. (6) Silverline (7) Dr. Reddy.(8) Satyam Infoway. (9) Satyam Computers (10) ICICI Bank. (11) ICICI. After merger of ICICI with ICICI Bank, ADRs of 10 Indian companies are listed on American Stock Exchanges. These are listed on two stock exchanges (i) NASDAQ (National Association of Securities Dealers Automatic Quotes) and (ii) New York Stock Exchange, both have their head offices at New York.

Important Features of Deposit Receipts

- *Collection in Foreign Currency:* The issuer enjoys the benefit of collection of issue proceeds in foreign currency and may utilize the same for meeting the foreign exchange requirements.

- No Exchange Risk: If the GDR holder surrenders the GDRs for conversion into shares and request for the sale of such shares, the Domestic Custodian Bank sells the shares. The Domestic Custodian Bank converts the net sales proceeds into foreign exchange at the market rate. Hence, no foreign exchange risk for issuing company.

- Listing: GDRs are generally listed at LUXEMBOURG. Listing of ADRs is done either on NASDAQ or New York Stock Exchange.

- No Voting Rights: The Deposit Receipt does not entitle the holder to any voting rights, so there is no fear of loss of management control.

** **Q. No. 94:** Distinguish between factoring and Discounting. **(May, 2002)**

Answer:

Factoring	**Bill Discounting**
In this case, the factor buy a company's trade receivables (arising on account of genuine transactions) at a discount, thereby their immediately conversion into cash.	Through this process, a business house can convert its credit sales to just like cash sales subject to bearing the discounting charges.
Loss on account of bad debts is generally borne by the factor.	Loss on account of bad debts is borne by the party getting the bill discounted.
Factoring is an on-going process i.e. generally the factor factors all the credit sales.	Bill discounting is a specific requirement case.
The process of factoring begins before sales. In many cases, all the orders received by the firm are reviewed by the factor and credit sale is made on the basis of creditworthiness judged by the factor.	The process of Bill discounting begins not only after sales but after the bill has been accepted by the purchaser.
Factoring is not covered by any specific law.	It is covered by Negotiable Instrument Act.
Factor is a complete process of management of debtors i.e. the factors sends reminders to the customers, collects the amounts and maintain the customers accounts.	It is a simply financing technique.

*Q. No. 95:** Write Short Note on: Curvilinear Break-even-Analysis **(May, 2002)**

Answer : Break-even point is the sales level at which there is no profit no loss. In other words, It is the sales level at which total cost is equal to total sales. For calculating the Break even point, we assume that variable cost per unit, selling price per unit and total fixed cost remain unchanged for different levels of operations. If these assumptions hold good, the relation between sales and cost is linear and there is only one Break-even point.

Even if one of the three assumptions do not hold good, the relation between sales and cost is not linear and they be multiple Break-even points. In other words, if one or more of the following conditions are satisfied, the cost-volume relationship is curvilinear (non-linear) and there may be multiple break- even points. This situation is described as curvilinear Break-even-Analysis.

*Q. No. 96:** Write Short Note on Financial intermediation**. (May , 2002)**

Answer Financial intermediation is the routing of savings to investments through financial intermediaries. It is a process through which an economy's savings are transformed into capital investments. In this process, three different groups of people are involved :savers/suppliers of funds, those who need money for productive investment, and the financial intermediaries. The savers/suppliers of funds would like to maximise the return while minimizing the risks. Those in need of money would like to have it as cheaply as possible and with as few conditions attached as possible. The financial intermediaries provide their services to both the groups of people for their own (financial intermediaries') profits. Efficient financial intermediation is the key necessity for economic growth and development.

There are two types of Financial Intermediations : (I) Traditional Financial Inter-mediation; and (II) Contemporary Financial Intermediation.

Traditional Financial Intermediation: In this case, the savers/suppliers of funds deposit their money with the financial intermediaries (for example: banks, financial institutions, non-banking financial companies etc.) and the financial intermediaries lend the money in the way they like (subject to some government regulations). In other words, the savers/suppliers of funds have no say or role in the lending by the financial intermediaries. The risk arising out of lending is borne by the intermediaries, i.e. there is no financial risk for the savers/suppliers of the funds (except in case of bankruptcy of the intermediary).

The main drawback of this approach is that the difference between cost to the borrower and return to the supplier of funds is substantial, i.e. while the borrower has to pay a quite high interest for the funds borrowed; the suppliers of funds generally get only a fraction of it. In the long run, this limitation discourages both

(i) savings (because the saver gets less, this reduces his propensity to save) and (ii) productive investments (because the higher cost of borrowed funds reduces a borrower's profitability).

Contemporary Financial Intermediation: Contemporary Financial intermediation is aimed at overcoming the limitation of the traditional intermediation. In other words, on the one hand it aims at providing higher return to the suppliers of funds, and on the other, at making funds available to productive investors at minimum cost. The difference between the borrower's cost and lender's return is the fees (and sometimes expenses also) of the intermediary who simply negotiates the deal. Though the risk is borne by the suppliers of funds, it is minimized/optimized through professional competency of the intermediaries. The suppliers of funds can determine the levels of risk they are ready to bear. Examples of such intermediaries are Mutual funds, Issuing and Paying Agents (appointed for issuing commercial papers) and negotiators of large deals of funds (These are mainly used for international borrowings and lending). Strengthening the operational efficiency and effectiveness of Contemporary Financial Intermediation is a crucial element of financial sector development of any economy, particularly the developing one.

*****Q. No. 97:** Write Short Note on: Shareholder value Analysis**(May , 2002)**

Answer Maximization of shareholders' wealth (in the long run) has been accepted as the object of financial management since Adam Smith's days. The shareholders value analysis got recognition only after 1986, when Prof. Rappaport of USA published his book Creating shareholder value. As per the concept of Shareholder Value Analysis (SVA), all business activity should aim to maximise the value of a company's equity shares in the long run. As per SVA, the primary responsibility of management (not only of the finance manager) is create value for the shareholders. All the decisions of the management should have only one target and that is value creation for the shareholders. Critics argue that concentrating on shareholders value will be harmful for other stakeholders like employees, suppliers, customers, society etc. The advocates of the SVA counter this view and express that shareholders value can be created only after meeting the requirement of these stakeholders. (This concept has been used as a shield by a fairly large number of European and US companies while downsizing their human resources).

*****Q. No. 98: Write Short Note on : Sustainable Growth rate . (May , 2002)**

Answer : The concept of sustainable growth was originally developed by Robert C. Higgins. The sustainable growth rate (SGR) of a firm is the maximum rate of growth in sales that can be achieved, given the firm's profitability, asset utilization, and desired dividend payout and debt (financial leverage) ratios.

The sustainable growth rate depends up on four factors:
(i) Profitability: Net profit to sales
(ii) Assets utilisation : Assets to sales ratio
(iii) Pay out ratio: Dividend per share / EPS
(iv) Financial leverage: Debt equity ratio

If actual growth is less than the Sustainable Growth rate, the company is underperforming. If actual growth rate is more than the SGR, it is an indication that the growth is not likely to sustain unless the management incorporates one or more of the following techniques for sustaining the growth :
(i) Increase the profitability either by increasing the sales or cutting the costs
(ii) Increase the retention ratio
(iii) Increase the debt
(iii) Increase the equity share capital
(v) Increase the operating efficiency i.e. improve the assets to sales ratio.

***Q. No. 99: Write Short Note on: Financial Engineering. (May, 2002)**

Answer Financial Engineering is a process that uses science-based mathematical techniques for financial decision-making. It applies quantitative techniques to the theory of finance to optimize the firm's financial transactions. Financial engineering is a subset of finance.

The term financial engineering came into use after the Black-Scholes option pricing model was developed in the early 1970s. This scientific breakthrough led to a new way to solve practical financial problems using the quantitative techniques. Later on, the use of computer skills vastly increased the scope of financial engineering. A Nobel Prize for the Black and Scholes Model (on 14th October, 1997) gave further recognition to financial engineering.

Decision-makers have to take decisions, and the outcome of their decisions is affected by uncertain future events (on which they have no control). The scientific way of decision making is that the decision should be taken after considering all possible uncertainties. Sometimes, the numbers of uncertainties extend to infinity. Ordinary techniques cannot consider all these uncertainties. Hence, financial engineering is applied. Utilizing various derivatives and other methods, financial engineering aims to precisely control the financial risks that an entity takes on. (Some thinkers on the subject opine that financial engineering is mainly concerned with risk management). It helps in optimum pricing of various financial services and operations, in the face of unlimited uncertainties and combination of uncertainties otherwise their prices cannot be determined.

For example, we have to take a decision regarding a project involving a large amount of investment. The success/failure of the project may be affected by a very large number of uncertain events like different possible prices of the product, variation in wage rates, government policies, economic factors, international markets etc. Hertz's model (based on simulation and computer skills) provides a scientific way to take a decision whether the project should be undertaken or not. (The model considers infinite uncertain possibilities regarding prices, costs, government policies, economic conditions etc.).

**** Q .No. 100:** Write short note on advantages of Debt Securitization. **(May, 2001)**

Answer:

The advantages to the originator :

(i) ILLIQUID assets are converted into liquid assets i.e. the originator has more sources with him for the business operations. This provides the originator to earn more with the help of these resources.

(ii) It helps in achieving / improving the capital adequacy ratio.

(iii) The credit rating of the originator enhances.

The advantages to the investor: The process provides the investors a new venue of investment in asset backed securities.

**** Q. No. 101:** Write short note on Margin Money. **(May, 1996)**

Answer:
Margin money is an advance payment of a portion of the value of a transaction. It is referred as good faith deposit (i.e. payment of this money indicates that the party paying this has good intention of honouring the transaction which it is entering with the other party). The term is used in various references:

(i) When a company approaches the financial institutions and banks for project financing, they prescribe the condition that the company/ promoters should invest a part of cost of the project. This is called as margin money.

(ii) When a company approaches the banks for working capital financing, they prescribe the condition that the company should provide a part funds required for working capital. This is called as margin money.

(iii) When we enter an agreement of buying some asset/ services on a future date, we deposit some money in advance. This is called as initial deposit or margin money.

This term is used in Indian stock exchanges in three contexts:

I) Futures contracts: For entering into a futures contract (either on individual shares or on Index), one has to pay initial margin to the stock exchange (through the broker). The amount of the initial margin is calculated on the basis of riskiness of the underlying asset (i.e. share or index). Besides, these contracts are marked to the market at the end of the each working day i.e. gains, if any, are given to the party entering the contract and losses, if any. are recovered from that party (in both situations payments and recoveries are made through the broker)

II) Option contracts: In this case the option writer has to deposit margin money with the stock broker.

(III) Margin trading: Margin trading is the trading witch is supported by the borrowing facility (provided by brokers) of funds. While trading with the borrowed resources, investors are required to deposit a part of value of the transaction with the broker, this part value of the transaction is called margin money and the phenomenon is called as margin trading. As margin trading provides a facility to investors to trade in the market with the margin money, it essentially is a leverage mechanism. Margin trading has been permitted by SEBI in India. The minimum initial margin to be paid (in cash) by the client for this purpose shall be 50% of the transaction value. Besides, the client shall also be required maintain 'maintenance margin' with the broker. The maintenance margin has been prescribed by SEBI as 40%.

****Q . No. 102 :**Write short note on Venture Capital Financing**. (May, 1999)**

Answer : Venture Capital is the capital contribution in high risk projects with high reward expectations. It is either in the form of equity or combination of equity and debt, generally through equity alone. This type of capital is provided by risk-oriented people to such (generally) first generation entrepreneurs who have vision, but do not have funds. Sometimes the projects are unsuccessful on account of unforeseen reasons. The Venture capital providers may loose the entire investment amount, but they survive because of high returns (sometimes unimaginable) they may get from their other VC investments. The end result is that the average rate of return on their investments is generally high.

There are four types of VC investing :

(i) Equity investment : Equity is the most important component of venture capital financing. The venture capital financier expects a very high rate of return. This can come only in the form of capital gains on equity investments. The founders of the business also prefer it because the business is not obligated to repay the money. For a start-up company, this frees up important cash flow that might otherwise be needed to service debt. The involvement of high-profile equity investors may also help increase the credibility of a new business.

(ii) Convertible Cumulative preference shares : In the case of preference shares, the dividend has to be paid before the same is paid to equity shareholders. If no dividend is paid on equity, no dividend has to be paid on preference shares. The founders of the business like it because it frees up important cash flow that might otherwise be needed to meet the cost of funds. The venture capitalist like it for following two reasons: (i) In future, whenever the company (which has been financed by VC) will pay equity dividend, it has to pay the arrears of preference dividend (ii) On conversion of these preference shares into equity shares, they expect huge amount of capital gain.

(iii) Structured Debt : In this case, debt is so structured that interest at very low rate is paid in earlier years, at average rate before the business reaches take off stage and at very high rate when business takes off. Venture capitalist does suffer loss of interest. The company (which has been financed by VC) is freed from paying high amount of interest in its earlier years.

(iv) Subordinated Debt : It is semi-secured investment in the company ranking below the secured lenders. In case the company (which has been financed by VC) goes into liquidation, such debt is repaid only after paying other secured creditors. This type of debt does not impair the borrowing capability of the company. Venture capitalist favour it as through this arrangement they have to invest only a small amount in the new venture as it (the new venture) can raise funds from other sources as well.

Some of the important Indian venture capital funds are :ICICI Venture Funds Ltd., IFCI Venture Capital Funds Limited (IVCF), SIDBI Venture Capital Limited (SVCL) , Gujarat Venture Finance Limited (GVFL), Kerala Venture Capital Fund Pvt Ltd, Punjab Infotech Venture Fund , Infinity Venture India Fund, Hyderabad Information Technology Venture Enterprises Limited (HITVEL), Canbank Venture Capital Fund ,S BI Capital Markets Limited , IL&FS Trust Company Limited etc. The important overseas venture capital funds operating in India are: Walden International Investment Group , SEAF India Investment & Growth Fund ,BTS India Private Equity Fund Limited .

Q. No. 103 : What are stock futures? What are the opportunities offered by stock futures? How are stock futures are settled ? **(May, 2007)**

Answer :

A stock 'futures' contract is a contract to buy or sell on the 'stock exchange' a standard quantity of a share at a future date at the price agreed to between the parties to the contract. These are standardised contracts that are traded on the share markets. Stock futures are trade in India on BSE and NSE. BSE allows futures trading in about 80 shares. The number is 119 in case of NSE.

- All futures mature on the last Thursday of the month. At a time 3 series of futures are traded in the market. For example, if one wants to enter into futures in the first week of Dec.2007, he may enter into contract maturing on last Thursday of Dec.,2007 (this is referred as same/near month contract) or last Thursday of January ,2008 (this is referred as next month contract) or last Thursday of February, 2008 (this is referred as distant month contact). Distant month contracts are not popular.

There are three important features of the Stock futures :

(i) Exchange traded
(ii) Standard maturities (Last Thursday of near month/ last Thursday of next month/ last Thursday of distant month)
(iii) Standard quantity (for example, the stock futures contract of Reliance Industries Ltd can be entered into for 75 equity shares or multiples there of)

Opportunities offered by Stock Futures :

(I) Stock futures are used for hedging the risk arising out of investment in cash segment of the stock exchange.
(II) Speculation gains (by taking the risk of speculative loss) can be made.
(III) Arbitrage gain can be made by combing the futures market transactions with cash market transactions or options.

Settlement of stock futures : Stock futures are cash settled. No delivery is made. Delivery based settlement was recommended by LC Gupta committee on the derivatives. The recommendation has not been implemented so far.

Profits / losses of future contracts are paid/recovered over everyday at the end of trading day, a practice called marking to market. These profits/ losses are calculated on the futures prices at the close of the trading day.

No mark- to market is done on the settlement day. The settlement is done on the basis of futures closing price on previous trading day and the closing spot price on the day of settlement.

******Q . No. 104 :** Write short note on Carbon Trading **.**

Answer : Carbon Trading : The scientists have been warning since 1960 or so that the temperature of the earth is rising and this is quite dangerous. The principal reasons responsible for this are (i) the burning of greater quantities of oil, gas and coal and (ii) cutting down of forests. The industrial and transport units are throwing excessive quantities of six most dangerous gases (referred as Greenhouse Gases), especially carbon dioxide, in the environment. On the initiative of the UNO, the international community joined hands to find the ways to cope up the problem and an international protocol, known as KYOTO Protocol, was singed. This protocol came into force with effect from 16th December, 2005. The Kyoto protocol aims to tackle global warming by setting target levels for nations to reduce greenhouse gas emission worldwide.
Mechanism : Under this approach, the companies with emission levels less than the prescribed level, are issued certificates by the Secretariat of Kyoto Protocol. These certificates are referred as Carbon Credit certificates. These certificates are tradable. The companies having excess emissions may buy these certificates (other wise they have to pay penalty for excess emissions). Carbon trading has come as a wind fall for many Indian Companies. Companies using biogas, solar energy, windmill etc. are making a fortune on account of this system.

Q. No. 105 ****Write short note on Participatory notes. (P notes , PNs)

Answer :
Participatory Notes International access to the Indian capital market is limited to FIIs registered with SEBI. The other investors, interested in investing in India, can open their account with any registered FII and the FII gets them registered with SEBI as its sub-account. There are some investors who do not want to disclose their identity or who do not want to get registered with SEBI. Such investors invest in Indian stocks through P.Notes. More than 50 per cent of all FII inflows into the domestic markets are estimated to be through P-Notes.

Participatory Notes are instruments issued by FIIs (including their sub-accounts[20]) registered in India to overseas investors who wish to invest in the Indian stock markets without registering themselves with SEBI. Suppose an overseas investor, not registered in India, is interested in buying the shares in Indian stock market, the investors deposits the money with the FII, the FII purchases the shares on its own account and issues the PN to the investor. The details of the investor are not revealed at all in the Indian market or to the SEBI.

[20] Further Issuance of P Notes by sub –accounts has been banned by SEBI on 24th Oct. 2007.

The FII continues to hold the share in its own name. Any dividends or capital gains collected from the share go back to the investor.

The foreign investors prefer P Notes route for the following reasons :

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

FIIs are not allowed to issue P-Notes to Indian nationals, persons of Indian origin or overseas corporate bodies (which are majority owned or controlled by NRIs). This is done to ensure that the P-Note route is not used for money laundering purposes. FIIs are required to report to the SEBI on a monthly basis if they issue, renew, cancel, or redeem P-Notes. The SEBI also seeks some quarterly reports about investing in P-Notes.

P notes are not preferred by SEBI for the following reasons:

(i)There is no way of knowing who owns the underlying securities. (It is suspected that terror organizations may be using this route to make money. It is also suspected that Indian holding unaccounted money abroad may be using this route to make money)
(ii) Large funds acting through P-Notes cause volatility in exchanges.
(iii) P-Notes reflect hot money coming only for short-term fast profits. Its investors do not have much holding capacity.(Enquiries have revealed that most of the investors borrow money on short term for the purpose of buying the P. Notes.) FII investment is generally a long term investment. But investments by P-Notes are generally a short term investment with easy entry and exit options. Investors can borrow money cheaply in the West and invest in emerging market equities for bigger returns.
SEBI Guidelines on P Notes

(i) Further Issuance of P Notes by sub –accounts has been banned by SEBI on 24th Oct. 2007.
(ii) The FIIs, which have issued P notes of more than 40% of their assets under control, can issue further P notes only against cancellation/ redemption of PNs of equivalent amount.
(iii) The FIIs, which have issued P notes of less than 40% of their assets under control, can issue further P notes equal of 5% of AUC every year till the amount is equal to 40% of the AUC.

Participatory Notes are a slap on the face of every citizen who is an investor. To invest in shares one has to fill up many forms and provide proof of residence, PAN number, and so on. But for PN investors, the system is totally silent, even on basic information.

******Q. No. 106 :**Write short note on Indian Depository Receipts.

Answer : The Companies (Issue of Indian Depository Receipts) Rules, 2004, has enabled foreign companies to raise funds from the Indian capital markets by issuing Indian Depository Receipts ('IDRs').

IDRs is 'any instrument in the form of a depository receipt created by domestic depository in India against underlying equity shares of the issuing company'. The issuing company has also to apply and obtain in-principle listing permission from one or more stock exchanges.

The main advantage of IDRs is that Indian investors get a chance to participate in the equity of the multi-national companies.

Eligibility for issue of IDRs

1 Its pre-issue paid-up capital and free reserves are at least US$ 100 millions and it has had an average turnover of US$ 500 million during the 3 financial years preceding the issue.

2 It has been making profits for at least five years preceding the issue and has been declaring dividend of not less than 10% each year for the said period

3 Its pre-issue debt equity ratio is not more than 2:1

Procedure for making an issue of IDRs

1 An issuing company may raise funds in India by issuing IDRs, only after it has obtained the prior permission from the SEBI.

2 An application seeking permission shall be made to the SEBI at least 90 days prior to the opening date of the issue, in such form furnishing such information as may be notified from time to time, with a non-refundable fee of US $10,000:

3 The issuing company shall file through a merchant banker or the domestic depository a due diligence report with the Registrar and with SEBI in the form specified.

4 The issuing company shall, through a merchant Banker file a prospectus or letter of offer with the SEBI and Registrar of Companies, New Delhi, before such issue.

5 The issuing company shall obtain in-principle listing permission from one or more stock exchanges having nation wide trading terminals in India.

The repatriation of the proceeds of issue of IDRs shall be subject to laws for the time being in force relating to export of foreign exchange.

The IDRs should be denominated in Indian Rupees.

****** Q. no. 107** Write short note on Special Economic Zones.

Answer : Special Economic Zones : A Special Economic Zone (SEZ) is a geographical region that has economic laws that are different from and more liberal than a country's economic laws; it is deemed to be foreign territory for the purposes of trade operations, duties and tariffs. Special economic zones are intended to function as zones of rapid economic growth by using tax and business incentives. It is expected that a well-implemented and designed SEZ can bring about many desired benefits for a host-country: increases in employment, FDI attraction, general economic growth, foreign exchange earnings, international exposure, and the transfer of new technologies and skills. Hence, many developing countries are also developing the SEZs with the expectation that they will provide the engines of growth for their economies.

The SEZ Policy, announced by Government of India enables the creation of SEZs in the country, with a view to provide an internationally competitive and hassle-free environment for exports. These zones are designated duty-free enclaves, and are deemed foreign territories for the purpose of trade operations, duties and tariffs. The Policy offers several fiscal and regulatory incentives to developers of the SEZs as well as units within these zones. The SEZ are of two types : (i) specific products or services zones and (ii) multi-product zones.

A Special Economic Zone for multi product shall have an area of 1,000 hectares[21] or more but not exceeding 5000 hectares.

The Government of India's policy is being criticized by many economists on the basis of two grounds :
(i) To establish the SEZs, the state governments are procuring farmland in coercive ways and handing it over to big business groups such as the Ambani brothers, the South Korean steel giant POSCO, the Tatas, Mahindras, Unitech and Sahara. They stand to make huge super-profits. The land is being acquired through special laws legislated for the express purpose of creating SEZs. "India has never before witnessed the transfer of hundreds of thousands of hectares of agricultural land to private industry. Nor probably has any other developing country."[22]

The land procurement process is producing enormous resentment among farmers. The land is being acquired through special laws legislated for the express purpose of creating SEZs.

(ii) They will also result in huge losses on the exchequer through tax breaks and forgone duties. The Indian Finance Ministry estimates the losses at 20 billion US dollars for just 150 zones. This sum is unconsciously large for an investment estimated at about 25 billion dollars. It is a great social cost.

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Q. No. 108: Write a note on Sub-prime Crisis.

Answer : Finance providers provide finance to the prime borrowers (i.e. to those

[21] One Hectare = 2,50 Acres = 10,000 Square meters.
[22] Prof. Sumit Sarkar

have the capacity to pay). If fiancé is being provided to those who do not have capacity to repay, it is called as sub-prime lending.

In view of sharply rising prices of the real-estate in USA for past some years, the Housing Financiers have been providing housing finance very liberally even without considering the repaying capacity of the borrowers. They were holding the view that as they have mortgaged the real estate for which they have provided finance, they could easily recover their dues as the prices of the real-estate were expected to rise sharply. Borrowers were borrowing not only to gain on rising prices of real estate but also assuming they shall be able to meet their obligations to the financier on of rental income.

In 2006, the prices of the real estate started falling, the rents declined at shaper rate. The borrower could not meet their obligations causing huge loss to the housing financiers and this led to crisis.

There is one more dimension to this problem because of which the crisis has spread world widely. This dimension is Debt securitization. The Housing Financiers generally sell their housing loan portfolios to specially formed separate entities called SPVs. The SPVs issue securities (promissory notes or other debt instruments) to the investors based on inflows of these assets. The inflows from the assets are collected in a separate bank account (Called Escrow account).The investors who have invested in promissory notes or other debt instruments (issued by the SPV or Trust) are first to be served from this account. **The most important feature of the Debt securitization is that the securities issued by the SPV / Trust are secured against cash flow pattern of the underlying assets (Housing Loans) and not upon the credit worthiness of the credit originator.**

Most of the Housing Financiers in USA have opted for debt-securitization. The instruments issued by their SPVs have been purchased by the investors (mainly by the Banks and the Financial institutions; in India one Public Bank and one private sector Bank has substantial exposure to such instruments). As neither the borrowers of Housing Finance are meeting their obligations nor the money can be realized from sale of the mortgaged properties (because of crash in their prices; 13 Lakhs such properties are for sale because of this crisis), the investors of the instruments issued by the SPVs (spread all over the world) have suffered huge losses. Many financial institutions have declared bankrupt on this account. Others are facing the crisis never seen after 1929 (the Great Depression)

**** **Q. No. 109:** Write a note on Private Equity..

Answer :

The term Private Equity refers to Private Equity Funds. Owned by private investment organizations, these funds are pools of capital provided by their investors. Such funds are popular in the Europe and the USA, though in most cases these have been registered in tax haven countries like Mauritius etc.

The Private Equity Funds invest mainly in the equity shares of unlisted companies.(In some cases, the investment in made in all or substantially all equity shares of a listed company and then the shares are delisted). “Private equity is medium to long-term finance provided in return for an equity stake in potentially high growth unquoted companies.”[23] The funds are not passive investors, they take active part in the management of the companies in which they invest through representation on the Board etc. Studies have shown that private equity backed companies grow faster than other companies as

Private Equity Funds (i) provide not only equity finance but also management, business experience, technology and other helps like getting orders, getting supplies, making human resource available, and (ii) arrange more finance needed in the form of loans, bridge loans etc.

The funds make profit by selling the shares, purchased by them, in ways : (i) selling the shares after the Initial Public Offer by the company i.e. after their listing (ii) selling the shares to the acquirer in the case of merger or acquisition (iii) selling back the shares to the promoters when they have sufficient funds to buy them, and (iv) sale of shares to some other buyer, for example some other Private Equity Fund.

General partners get three types of fees (i) management fee (as a percentage of the fund's total equity capital) (ii) transaction fees (fees paid to the general partner on making the investment) and (iii) a performance fee, based on the profits generated by the fund.

The performance of private equity funds is relatively difficult to track, as private equity firms are under no obligation to publicly reveal the returns that they have achieved from their investments. London-based research and consultancy firm Private Equity Intelligence collects information from (i) the websites of PEFs and (ii) from the investors, where possible using the provisions of Freedom Of Information Act in the USA and similar Acts in the European countries.

Manager selection in the private equity industry is definitely a vital factor for the success of a PEF. Realising the importance of the special knowledge required by PEFs, various institutes of the USA and the Europe are offering special MBA courses in Private Equity.

There are strong prospects for private equity in the rapidly developing markets of India and China, according to Wharton faculty and private equity experts.

****** Q. No. 110:** Write a note on Hedge Funds.
Answer : Hedge Funds are private investment organizations in Europe and USA.

[23] British Venture Capital Association – A Guide to private equity

These are generally structured as limited liability partnership with the general partner being the portfolio manager, making the investment decisions, and other partners as the investors. The investor partners are super-rich persons like institutions, professionals and wealthy individuals (minimum investment amount ranging anywhere from $2,50,000 to $1 million). Investment is hedge funds in generally for a lock-in-period of one year so. The funds provided by all the partners, including the general partner, are pooled and invested in various financial assets including derivatives. The investment strategy of such funds in generally aggressive and flexible; the funds take all steps, permissible by law, such as leverage, long, short, swaps, futures, options and other derivatives in both domestic and international markets to get high returns on the investments made by the partners.

Hedge funds are subject to the same market rules and regulations as any trader. There are no such restrictions on the hedge funds as are applicable to other pooled investments like mutual funds. No registration is required with Securities and Exchange Commission or Financial Services Authorities (unless a general partner manages more than 15 such funds). No special reports have to be submitted, no investor protection guidelines have to be followed. Of course, like mutual funds, hedge funds are subject to the anti-fraud provisions of securities laws.

First hedge fund was set up by A.W.Jones in 1949 in the USA. This fund was to protect its investors against risk using various techniques i.e. hedging of risk was the central to its investment strategy. Hence, it was referred as Hedge Fund. Today, the term "hedge fund" refers not so much to hedging techniques, which hedge funds may or may not employ, as it does to their status as private and unregistered investment pools. For the majority of these funds the hedging of risk was not the central to their investment strategy.

Hedge funds have generally provided very high returns to their investors even during the periods of falling share prices, though there have been some cases of huge losses, there have been even some of fraud. Such funds are quite popular among such investors who are ready to take high risk in the hope of getting high returns.

Many times the investment strategies of hedge funds have caused in volatility in the markets for three reasons (i) they have large amount of funds to invest at their disposal, (ii) they do not have to follow transparent policies and (iii) they follow aggressive policies.
There is was domestic/foreign hedge fund in India till Sept. 2007. In October, 2007, SEBI has allowed the foreign hedge funds operations in India.
The new development in this field is emergence of funds of hedge funds. These are the organizations which invest in the hedge funds. They attract investment from various investors mainly the small investors.
**** **Q. No. 111:** Write a note on Embedded Options.

Answer : An embedded option is an option that is part of the structure of a bond. It therefore does not trade by itself, but it does affect the value of the bond of which it is a part. It provides either the bondholder or issuer the right to get some thing done by the other party; the other party is obliged to do that. There are 3 types of embedded options:

Call option: It is the option with the issuer of the bonds. This option provides the issuer to call back (i.e. to redeem) the bonds before their maturity as per the terms of the call option. For example, the issuer issues the bonds with 7 years maturity. The terms of the issue provides that the issuer has the right (not the obligation) to call back the bonds at any time after 3 years of the date of issue at a premium of 10% of the face value.

Indian capital market witnessed the exercise of a call option of very large magnitude by IDBI in the year 2000. IDBI issued deep discount bonds in 1996 offering a return of about 16% with 25 years maturity. The issue received overwhelming response from the investors planning their retirement, education of children etc. The investors got a shocking news in the year 2000 that the IDBI has decided to call back (i.e. to redeem) the bonds. Many investors filed their grievances against IDBI with SEBI, Ministry of Finance etc but these could not be redressed as the offer document clearly mentioned the option clause (which perhaps no body cared to go through).

By getting the bonds allotted, the holders write the call option in favour of the issuer. Call option has adverse impact on the value of the bond.

Put option : It is an option written by the issuer of the bond in favour of the buyer of the bond. Under this option, the buyer may get the bonds redeemed before the maturity as per the terms of the put option. For example, a company issues 10% Bonds with 10 years maturity. The bonds contain put option under which the Bonder may get the bonds redeemed at any time after three years at a discount of 5% if redeemed after 3 years but up to 5^{th} year, at a discount of 3% if redeemed after 5 years but up to 8^{th} year and at a discount of 1% if after that.

By issuing the bonds, the issuer writes the put option in favour of the investor. Put option has positive impact on the value of the bond.

Conversion option : Under this option the bondholder may get his bond amount converted into shares as per the terms of the conversion option. For example, a company issued 10% Debentures of Face value of Rs.100 each, maturity 10 years ; the bond holder is given the option of getting the amount of the bond converted into 4 equity shares of Rs.10 each at a premium of Rs.15 per share at any time after 3 years from the date of the issue.

By issuing the bonds, the issuer writes the conversion option in favour of the investor. Conversion option has positive impact on the value of the bond.