MAY18 RTP QUESTIONS

14. DISTINGUISH between:
    (a) Banking and Non-Banking financial institutions
    (b) Primary participants and secondary participants in securitization
    (c) Islamic Finance and Conventional Finance
15. (a) DESCRIBE Value at Risk and its application.
    (b) EXPLAIN the concept of Bootstrapping and describe the various methods of bootstrapping used by start ups.
    (c) DESCRIBE the guidelines for SME listing and its benefits.

MAY18 MOCK TEST QUESTIONS

MTP 1

- Compare and contrast start-ups and entrepreneurship. Describe the priorities and challenges which start-ups in India are facing. **(1B)**
- Explain financial risk from the point of view of Stakeholder, Company and Government.**(2C)**
- Describe the Various Islamic Finance Instruments. **(3C)**
- Explain Dow Jones Theory. **(4C)**
- Describe the role of financial market in economic development. (Or) Describe various Securitization instruments. **(5C)**

MTP2

- Repeated **(MTP1 1B)**
- Explain any four features of VAR. **(2C)**
- Describe any four Constituents of International Finance centre. **(3C)**
- Explain Random Walk theory **(4C)**
- Describe Various Problems faced in Securitization. **(5C)**

14. (a) **Distinction between Banking and Non-Banking financial institutions**

Basis for comparison	Banking Institutions	Non-Banking Institutions
Meaning	Bank is a financial intermediary which provides banking services to general people. And it requires a bank license for that.	Non-banking institutions are basically company form of organization that provides banking services to people without holding a banking license.
Transaction Services	Banks provide transaction services like providing overdraft facility, issue of cheque books, travelers cheque, demand draft, transfer of funds, etc.	The non-banking institutions do not provide any transaction services.
Money supply	Bank deposits constitute a major part of the national money supply.	The money supply of the nonbanking institutions is small.
Credit creation	Banks create credit.	Non-banking institutions do not create credit.

Compliance	Banks are required to comply with some of the legal requirements like Cash Reserve Ratio (CRR), Statutory Liquidity Ratio and Capital Adequacy Ratio (CAR).	Non-banking institutions are not required to comply with these legal requirements.
Demand Deposit	They are not accepted.	They are accepted.
Payment and settlement system	Contains an integral part of the system.	Not a part of the system.

(b) Distinction between Primary Participants and Secondary Participants in securitization

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

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

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

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

Secondary Participants

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

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

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

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

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

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

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

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

(c) Distinction between Islamic Finance and Conventional Finance

How Islamic Finance is different from Conventional Finance

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

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

	not involve trade not allowed as per Islamic principles such as alcohol, armaments, pork and other socially detrimental products.	

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

(i) What is worst case scenario?

(ii) What will be loss?

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

Features of VAR

Following are main features of VAR

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

(a) Time Period

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

(c) Loss in percentage or in amount

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

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

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

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

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

Application of VAR

VAR can be applied

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

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

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

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

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

(b) An individual is said to be boot strapping when he or she attempts to found and build a company from personal finances or from the operating revenues of the new company.

A common mistake made by most founders is that they make unnecessary expenses towards marketing, offices and equipment they cannot really afford. So, it is true that more money at the inception of a business leads to complacency and wasteful expenditure. On the other hand, investment by startups from their own savings leads to cautious approach. It curbs wasteful expenditures and enable the promoter to be on their toes all the time.

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

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

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

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

(c) Guidelines for SME Listing

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

(ii) Trading lot size

- ❖ The minimum application and trading lot size shall not be less than ₹ 1,00,000/-.

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

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

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

Benefits of Listing in SME

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

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

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

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

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

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

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

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

(b) Differences between a startup and entrepreneurship

Startups are different from entrepreneurship. The major differences between them have been discussed in the following paragraphs:

(i) Start up is a part of entrepreneurship. Entrepreneurship is a broader concept and it includes a startup firm.

(ii) The main aim of startup is to build a concern, conceptualize the idea which it has developed into a reality and build a product or service. On the other hand, the major objective of an already established entrepreneurship concern is to attain opportunities with regard to the resources they currently control.

(iii) A startup generally does not have a major financial motive whereas an established entrepreneurship concern mainly operates on financial motive.

Priorities and challenges which startups in India are facing

The priority is on bringing more and more smaller firms into existence. So, the focus is on need based, instead of opportunity based entrepreneurship. Moreover, the trend is to encourage self-employment rather than large, scalable concerns.

The main challenge with the startup firms is getting the right talent. And, paucity of skilled workforce can hinder the chances of a startup organization's growth and development. Further, startups had to comply with numerous regulations which escalates it's cost. It leads to further delaying the chances of a breakeven or even earning some amount of profit.

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

(a) **From stakeholder's point of view:** Major stakeholders of a business are equity shareholders and they view financial gearing i.e. ratio of debt in capital structure of company as risk since in event of winding up of a company they will be least prioritized.

Even for a lender, existing gearing is also a risk since company having high gearing faces more risk in default of payment of interest and principal repayment.

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

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

willful defaulters. This can also be extended to sovereign debt crisis.

(c) Although there are number of Islamic Finance products, but some of common products/instruments are as follows:

Mudaraba: The Mudaraba is a kind of profit sharing arrangement wherein one party provides 100% of the capital involved and other party provides specialized knowledge and entrusted with exclusive responsibility of working. In case there is profit it shared among them in the pre-decided ratio and if there is loss only financier will borne the same.

Musharaka: It is a kind of joint business venture wherein all parties provide the capital in the business in agreed ratio and also have right to participate in the business. While the loss is strictly shared in the ratio of their capital contribution, the profit is shared as per pre-agreed ratio.

Sukuk: It is one of the most popular Islamic financial products. It is a kind of 'Debt Certificate' representing ownership in business or assets and through this instrument company borrows the money. Although it appears to be conventional debt instruments but is differs in following aspects:

- To have share in profit of assets.
- To have share in the underlying assets on realization of assets.

Ijara: It is a kind of lease financing arrangement wherein one party transfer the asset to other partly for some specific time for specific fee which includes capital cost of assets and profit margin of the lessor. In this arrangement, the responsibility for maintenance of the leased items remains with the lessor.

Murabaha: Also, known as cost plus contract it is a kind of trade credit or loans and mainly helps exporters and importer in meeting their funding requirements. The main feature of this arrangement is that profit margin of the financier is known to the buyer. In this arrangement financier buys thee assets and sells to the client (buyer) and buyer pays to the financier in installments consisting of following two elements:

- Cost of asset financed.
- Financier's profit on acquisition of asset.

Istisna: It is a kind of funding arrangements for long term construction contracts wherein client pays some initial amount and balance amount is payable is repaid in installments. The whole project is funded by the financer and completion of project it is delivered to the client.

Salam: It is analogues to forward contract in the conventional finance. Though cash is received by the seller immediately on sale but goods as per pre-decided quality, quantity and time shall only be delivered in future. This sale shall be at the discounted price so that financer could make some profit out of the deal. However, it is important to note that Salam is prohibited in commodities such a gold, silver and other type of monetary assets.

(c) The Dow Theory is one of the oldest and most famous technical theories. It was originated by Charles Dow, the founder of Dow Jones Company in late nineteenth century. It is a helpful tool for determining the relative strength of the stock market. It can also be used as a barometer of business.

The Dow Theory is based upon the movements of two indices, constructed by Charles Dow, Dow Jones Industrial Average (DJIA) and Dow Jones Transportation Average (DJTA). These averages reflect the aggregate impact of all kinds of information on the market. The movements of the market are divided into three classifications, all going at the same time; the primary movement, the secondary movement, and the daily fluctuations. The primary movement is the main trend of the market, which lasts from one year to 36 months or longer. This trend is commonly called bear or bull market. The secondary movement of the market is shorter in duration than the primary movement, and is opposite in direction. It lasts from two weeks to a month or more. The daily fluctuations are the narrow movements from day-to-day. These fluctuations are not part of the Dow Theory interpretation of the stock market. However, daily movements must be carefully studied, along with primary and secondary movements, as they go to make up the longer movement in the market.

Thus, the Dow Theory's purpose is to determine where the market is and where is it going, although not how far or high. The theory, in practice, states that if the cyclical swings of the stock market averages are successively higher and the successive lows are higher, then the market trend is up and a bullish market exists. Contrarily, if the successive highs and successive lows are lower, then the direction of the market is down and a bearish market exists.

Charles Dow proposed that the primary uptrend would have three moves up, the first one being caused by accumulation of shares by the far-sighted, knowledgeable investors, the second move would be caused by the arrival of the first reports of good earnings by corporations, and the last move up would be caused by widespread report of financial well-being of corporations. The third stage would also see rampant speculation in the market. Towards the end of the third stage, the far-sighted investors, realizing that the high earnings levels may not be sustained, would start selling, starting the first move down of a downtrend, and as the non-sustainability of high earnings is confirmed, the second move down would be initiated and then the third move down would result from distress selling in the market.

(c) The contribution of various types of financial markets in economic development has been discussed as below:

(i) **Capital Market:** Capital market has an important role in India's industrial growth. Capital market is the market where long term debt and equity funds are traded. Industries which require capital on a large scale may tap the capital market. Therefore, the capital market provides the much needed liquidity into the economy and it gives a big boost to the GDP of an economy as it serves as an effective source of allocation of capital to the Industry and Government.

(ii) **Money Market:** Money market is the market where short-term funds are traded. In simple term, it means that all the financial assets or instruments which can be easily converted into money are traded in this market. The short-term money requirement of the borrowers can be easily met with the funds provided by the money market.

(iii) **Foreign Exchange Market:** Foreign exchange earned through foreign direct investment in India can be used to remove the poverty and for other productive purposes.

(iv) **Derivative Market:** The derivatives market is the financial market for derivatives i.e. financial instruments like futures and options, which are derived from other forms of assets. Since all transactions related to derivatives take place in future, it provides individuals with better opportunities because an individual who want to short (sell) some stock for long time can do it only in futures or options hence the biggest benefit of this is that it gives numerous options to an investor or trader to execute all sorts of strategies.

OR

Securitization Instruments

On the basis of different maturity characteristics, the securitized instruments can be divided into following three categories:

(i) **Pass Through Certificates (PTCs):** As the title suggests originator (seller of the assets) transfers the entire receipt of cash in form of interest or principal repayment from the assets sold. Thus, these securities represent direct claim of the investors on all the assets that has been securitized through SPV.

Since all cash flows are transferred the investors carry proportional beneficial interest in the asset held in the trust by SPV.

It should be noted that since it is a direct route any prepayment of principal is also proportionately distributed among the securities holders. Further, due to these characteristics on completion of securitization by the final payment of assets, all the securities are terminated simultaneously.

Skewness of cash flows occurs in early stage if principals are repaid before the scheduled time.

(ii) **Pay Through Security (PTS):** As mentioned earlier, since, in PTCs all cash flows are passed to the performance of the securitized assets. To overcome this limitation and limitation to single mature there is another structure i.e. PTS.

In contrast to PTC in PTS, SPV debt securities backed by the assets and hence it can restructure different tranches from varying maturities of receivables.

In other words, this structure permits desynchronization of servicing of securities issued from cash flow generating from the asset. Further, this structure also permits the SPV to reinvest surplus funds for short term as per their requirement.

Since, in Pass Through, all cash flow immediately in PTS in case of early retirement of receivables plus cash can be used for short term yield. This structure also provides the freedom to issue several debt trances with varying maturities.

(iii) **Stripped Securities:** Stripped Securities are created by dividing the cash flows associated with underlying securities into two or more new securities. Those two securities are as follows:

(i) Interest Only (IO) Securities

(ii) Principle Only (PO) Securities

As each investor receives a combination of principal and interest, it can be stripped into two portions of Interest and Principle.

Accordingly, the holder of IO securities receives only interest while PO security holder receives only principal. Being highly volatile in nature these securities are less preferred by investors. In case yield to maturity in market rises, PO price tends to fall as borrower prefers to postpone the payment on cheaper loans. Whereas if interest rate in market falls, the borrower tends to repay the loans as they prefer to borrow fresh at lower rate of interest. In contrast, value of IO's securities increases when interest rate goes up in the market as more interest is calculated on borrowings.

However, when interest rate due to prepayments of principals, IO's tends to fall. Thus, from the above, it is clear that it is mainly perception of investors that determines the prices of IOs and POs.

(c) Explanation of four features of VAR are as below:

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

(a) Time Period

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

(c) Loss in percentage or in amount

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

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

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

(c) Description of any four constituents of International Financial Centre (IFC) is as follows:

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

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

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

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

(c) Characteristics of Financial Instruments

The important characteristics of financial instruments are enumerated as below:

(a) **Liquidity**: Financial instruments provide liquidity. These can be easily and quickly converted into cash.

(b) **Marketing**: Financial instruments facilitate easy trading on the market. They have a ready market.

(c) **Collateral value**: Financial instruments can be pledged for getting loans.

(d) **Transferability**: Financial instruments can be transferred from one person to another.

(e) **Maturity period**: The maturity period of financial instruments may be short term, medium term or long term.

(f) **Transaction cost**: Financial instruments involve buying and selling cost. The buying and selling costs are called transaction costs.

(g) **Risk**: Financial instruments carry risk. Equity based instruments are riskier in comparison to debt based instruments because the payment of dividend is uncertain. A company may not declare dividend in a particular year. However, payment of principle or interest is more or less certain unless the company gets insolvent.

(h) **Future trading**: Financial instruments facilitate future trading so as to cover risks arising out of price fluctuations, interest rate fluctuations etc.

OR

(c) Problems faced in growth of Securitization of instruments especially in Indian context is as follows:

(i) **Stamp Duty:** Stamp Duty is one of the obstacle in India. Under Transfer of Property Act, 1882, a mortgage debt stamp duty which even goes upto 12% in some states of India and this impeded the growth of securitization in India. It should be noted that since pass through certificate does not evidence any debt only able to receivable, they are exempted from stamp duty.

Moreover, in India, recognizing the special nature of securitized instruments in some states has reduced the stamp duty on them.

(ii) **Taxation:** Taxation is another area of concern in India. In the absence of any specific provision relating to securitized instruments in Income Tax Act experts' opinion differ a lot. Some are of opinion that in SPV as a trustee is liable to be taxed in a representative capacity then other are of view that instead of SPV, investors will be taxed on their share of income. Clarity is also required on the issues of capital gain implications on passing payments to the investors.

(iii) **Accounting:** Accounting and reporting of securitized assets in the books of originator is another area of concern. Although securitization is slated to an off-balance sheet instrument but in true sense receivables are removed from originator's balance sheet. Problem arises especially when assets are transferred without recourse.

(iv) **Lack of standardization:** Every originator follows own format for documentation and administration have lack of standardization is another obstacle in growth of securitization.

(v) **Inadequate Debt Market:** Lack of existence of a well-developed debt market in India is another obstacle that hinders the growth of secondary market of securitized or asset backed securities.

(vi) **Ineffective Foreclosure laws:** For last many years there are efforts are going on for effective foreclosure but still foreclosure laws are not supportive to lending institutions and this makes securitized instruments especially mortgaged backed securities less attractive as lenders face difficulty in transfer of property in event of default by the borrower.

NOV18 RTP QUESTIONS

14. (a) EXPLAIN the key elements of a well-functioning financial system.
    (b) DESCRIBE the various parameters to identity the currency risk.
    (c) EXPLAIN the challenges to Efficient Market Theory.
15. (a) DESCRIBE the constituents of International Financial Centers (IFC)
    (b) EXPLAIN Startup India Initiative
    (c) LIST the ways to arrange finance for Small and Medium Enterprises.

MAY18 MOCK TEST QUESTIONS

MTP 1

- Explain any four elements for a well-functioning financial system.**(1C)**
- Explain Balancing Financial vis-à-vis Sustainable Growth.**(2C)**
- Discuss the types of Commodity Swaps.**(3C)**
- Explain Asset Allocation Strategies.**(4C)**
- Repeated.**(MAY18MTP2 3C)**
- Explain various stages of Venture Capital Funding.**(5C)**
- Repeated.**(MAY18MTP2 2C)**
- Discuss briefly the primary participants in the process of Securitization. (OR) Explain the features of Securitization.**(6C)**

Gain to shareholder = Share of Yes Ltd. in merged entity – Value of Yes Ltd. before merger

= ₹3538.98 lakhs - ₹2708.915 = ₹830.065 lakhs

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

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

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

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

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

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

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

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

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

(1) **Government Action:** The Government action of any country has visual impact in its currency. For example, the UK Govt. decision to divorce from European Union i.e. Brexit brought the pound to its lowest since 1980's.

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

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

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

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

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

(c) Challenges to the Efficient Market Theory

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

(ii) *Limited information processing capabilities* – Human information processing capabilities are sharply limited. According to Herbert Simon every human organism lives in an environment which generates millions of new bits of information every second but the bottle necks of the perceptual apparatus does not admit more than thousand bits per seconds and possibly much less.

David Dreman maintained that under conditions of anxiety and uncertainty, with a vast interacting information grid, the market can become a giant.

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

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

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

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

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

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

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

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

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

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

❖ Not prior to five years,

❖ With annual turnover not exceeding ₹ 25 crore in any preceding financial year, and

❖ Working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.

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

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

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

Financial assistance in India for MSME units is available from a variety of institutions. The important ones are:

(i) Commercial/Regional Rural/Co-operative Banks.

(ii) SIDBI: Small Industries Development Bank of India (refinance and direct lending)

(iii) SFCs/SIDCs: State Financial Corporations (e.g. Delhi Financial Corporation)/State Industrial Development Corporations.

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

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

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

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

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

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

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

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

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

(c) The concept of sustainable growth can be helpful for planning healthy corporate growth. This concept forces managers to consider the financial consequences of sales increases and to set sales growth goals that are consistent with the operating and financial policies of the firm. Often, a conflict can arise if growth objectives are not consistent with the value of the organization's sustainable growth. Question concerning right distribution of resources may take a difficult shape if we take into consideration the rightness not for the current stakeholders but for the future stakeholders also. To take an illustration, let us refer to fuel industry where resources are limited in quantity and a judicial use of resources is needed to cater to the need of the future customers along with the need of the present customers. One may have noticed the save fuel campaign, a demarketing campaign that deviates from the usual approach of sales growth strategy and preaches for conservation of fuel for their use across generation. This is an example of stable growth strategy adopted by the oil industry as a whole under resource constraints and the long run objective of survival over years. Incremental growth strategy, profit strategy and pause strategy are other variants of stable growth strategy.

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

The sustainable growth rate (SGR), concept by Robert C. Higgins, 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 is a measure of how much a firm can grow without borrowing more money. After the firm has passed this rate, it must borrow funds from another source to facilitate growth. Variables typically include the net profit margin on new and existing revenues; the asset turnover ratio, which is the ratio of sales revenues to total assets; the assets to beginning of period equity ratio; and the retention rate, which is defined as the fraction of earnings retained in the business.

SGR = ROE x (1- Dividend payment ratio)

Sustainable growth models assume that the business wants to: 1) maintain a target capital structure without issuing new equity; 2) maintain a target dividend payment ratio; and 3) increase sales as rapidly as market conditions allow. Since the asset to beginning of period equity ratio is constant and the firm's only source of new equity is retained earnings, sales and assets cannot grow any faster than the retained earnings plus the additional debt that the retained earnings can support. The sustainable growth rate is consistent with the observed evidence that most corporations are reluctant to issue new equity. If, however, the firm is willing to issue additional equity, there is in principle no financial constraint on its growth rate.

(c) There are two types of commodity swaps: fixed-floating or commodity-for-interest.

(a) Fixed-Floating Swaps: They are just like the fixed-floating swaps in the interest rate swap market with the exception that both indices are commodity based indices.

General market indices in the international commodities market with which many people would be familiar include the S&P Goldman Sachs Commodities Index (S&PGSCI) and the Commodities Research Board Index (CRB). These two indices place different weights on the various commodities so they will be used according to the swap agent's requirements.

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

(c) Stages of Venture Capital Funding

1. Seed Money: Low level financing needed to prove a new idea.
2. Start-up: Early stage firms that need funding for expenses associated with marketing and product development.
3. First-Round: Early sales and manufacturing funds.
4. Second-Round: Working capital for early stage companies that are selling product, but not yet turning in a profit.
5. Third Round: Also called Mezzanine financing, this is expansion money for a newly profitable company.
6. Fourth-Round: Also called bridge financing, it is intended to finance the "going public" process.

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

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

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

The main objective of creating SPV to remove the asset from the Balance Sheet of Originator. Since, SPV makes an upfront payment to the originator, it holds the key position in the overall process of securitization. Further, it also issues the securities (called Asset Based Securities or Mortgage Based Securities) to the investors.

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

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

Or

The securitization has the following features:

(i) Creation of Financial Instruments – The process of securities can be viewed as process of creation of additional financial product of securities in market backed by collaterals.

(ii) Bundling and Unbundling – When all the assets are combined in one pool it is bundling and when these are broken into instruments of fixed denomination it is unbundling.

(iii) Tool of Risk Management – In case of assets are securitized on non-recourse basis, then securitization process acts as risk management as the risk of default is shifted.

(iv) Structured Finance – In the process of securitization, financial instruments are tailor structured to meet the risk return trade of profile of investor, and hence, these securitized instruments are considered as best examples of structured finance.

(v) Trenching – Portfolio of different receivable or loan or asset are split into several parts based on risk and return they carry called 'Trenche'. Each Trench carries a different level of risk and return.

(vi) Homogeneity – Under each trenche the securities are issued of homogenous nature and even meant for small investors the who can afford to invest in small amounts.