SECURITIZATION

(I) Participant in Securitization

Primary Participants

(a) Originators
- Sells assets & receive funds

(b) Special Purpose Vehicles
- Payment to originators
- Issue the securities

(c) Investors
- Buyer of securitized papers.

Secondary Participants

(a) Obligors
- The parties who owe money to the firm

(b) Rating Agency
- Assets have to be assessed by rating agency

(c) Receiving & Paying Agent (RPA)
- Collect the payment from obligors & passes it to SPV

(d) Trustee
- Takes care of interest of investors

(e) Credit Enhancer
- Originators provides his comfort in from of over collateralization
- Third party provides surety bonds

(f) Structurer
- Brings together originators investors credit enhancer etc.

(II) Benefits of Securitization

From the angle of originators

(a) Off – Balance Sheet Financing

- It releases a portion of capital tied up

(b) More Specialization in Main Business

- Concentrate more on core business
- Burden of default is shifted

(c) Helps to Improve Financial Ratio

- Capital to weighted asset ratio improve

(d) Reduced Borrowing Cost

- Securitized papers issued at reduced rate due to credit enhancement.

From the angle of investors

(a) Diversification of Risk

- Securities backed by different assets

(b) Regulatory Requirement

- Helps bank to meet regulatory requirement & investment

(c) Protection Against Debt

- Recourse :- Originator make good
- Non Recourse :- Insurance arrangement

(III) Mechanism of Securitization

1. Creation of Pool of Assets
   - Segregation of assets
2. Transfer to SPV
   - Assets transferred
3. Sale of Security Paper
   - Issues securities
     - Pass through securities
     - Pay through securities
4. Administration of Assets
   - Just like RPA
5. Recourse to Originators
   - In case of default go back to originators
6. Repayment of Fund
   - SPV will repay to investors
7. Credit Rating to Instruments
   - Credit rating can be done to assess the risk

(IV) Features of Securitization

1. Creation of Financial Instruments
   - Process of creation of financial product.
2. Bundling & Unbundling
   - Bundling :- Combined in one pool
   - Unbundling :- Broken into instrument
3. Tool of Risk Management
   - If securitization on non recourse basis then risk of default shifted
4. Structure Finance
   - Meet the risk return trade off profile of investors.
5. Trenching
   - Different loans all split into several parts.
6. Homogeneity
   - Securities issued are of homogenous nature.

(V) Securitization Instruments

Pass Through Certificates (PTC)

- Entire receipt of cash transferred proportionately including prepayment of loan.
- All securities are terminated simultaneously
- Single mature

Pay Through Security (PTS)

- Varying maturity
- Reinvest surplus fund
- Prepayment of loan can be used for investment

Stripped Securities

Interest Only Security

- Receive only interest
- Interest rate in market rise then IO security increase
- Prepayment of principal, IO security fall

Principal Only Security

- Receive only principal
- YTM increase, PO security fall

(VI) Problems in Securitization

1. **Stamp Duty**
   - Mortgage debt stamp duty goes upto 12% [high cost]
2. **Taxation**
   - Absence of any specific provision in income tax
3. **Accounting**
   - Accounting in the books of originators difficult
4. **Lack of Standardization**
   - Following own format for documentation
5. **Inadequate Debt Market**
   - Lack of growth of secondary market of asset backed securities.
6. **Ineffective Foreclosure Law**
   - Lenders face difficulty in transfer of property in event of default b borrower.

(VII) Pricing of Securitized Instruments

From Originators

Instrument can be priced at a rate at which originator has to incur an outflows

From Investors Angele

Discounting of best estimated future cash flows

RISK MANAGEMENT

(I) Type of Risk

1. **Strategic Risk**
   - Company's strategy becomes less effective.
   - Technological change, new competitor entering the market, shift in customer demand, etc.
   - KODAK & NOKIA, SAMSUNG, XEROX.
2. **Compliance Risk**
   - If company fails to comply with law, it will pose a serious threat to its survival cement business & sugar business.
3. **Operational Risk**
   - Internal risk
   - It relates to people as well process.
4. **Financial Risk**
   - Unexpected changes in financial conditions.
   - Exchange rate, Credit rating, Interest rate etc.

(II) Financial Risk

Types

1. **Counter Party Risk**
   - Failure to deliver goods for payment already mode.
   - Credit Risk.
2. **Political Risk**
   - Faced by overseas investors.
   - Restriction of borrowing, patent etc.
3. **Interest Rate Risk**
   - Important for banking company.
   - Fixed v/s floating.
4. **Currency Risk**
   - Affect the firm dealing with foreign currency ₹ v/s $.
5. **Liquidity Risk**
   - Mismatch of assets & liabilities.

Evaluation of Financial Risk

1. **From stockholder's point of view**
   - High gearing faces more risk.
2. **From company's point of views**
   - Borrow excess or lend excess but default risk of liquidation.
3. **Government's point of view**
   - Lehman brothers.
   - Distrust among society.

Method for Identification & Management of Financial Risk

1. **Counter Party Risk.**
2. **Political Risk.**
3. **Interest Rate Risk.**
4. **Currency Risk**

(III) Value At Risk

- VAR is a measure of risk of investment.
- Given the normal market condition in a set of period, it estimates how much an investment might lose.

Features

1. **Components**
    - Time.
    - Confidence.
    - Loss in % or Amount
2. **Statistical Method**
3. **Time Horizon**
4. **Probability**
5. **Risk Control**
6. **Z Score**

Applications

1. **To measure maximum loss.**
2. **Benchmark for performance.**
3. **Fix limit for individual dealing.**
4. **Decide trading strategy.**
5. **Tool for asset management in bank.**

STARTUP FINANCE

(I) Innovative Ways to Finance a Startup

1. **Personal Financing**
   - Personal saving.
   - Personal contribution must to attract others.
2. **Personal Credit Line**
   - Personal credit effort.
   - Business has endues cash flows to repay.
3. **Family & Friends**
   - Should always be in writing.
4. **Peer-to-Peer lending**
   - Group of people come together & lend money to each other.
5. **Crowd Funding**
   - Small amount of capital from large no of individuals thrash website.
6. **Micro Loans**
   - Aggregated across a number of individuals.
7. **Vendor Financing**
   - Company lends money to one of its customers.
   - Defer payment until goods are sold.
8. **Purchase Order Financing**
   - Purchasing order financing company advance the required fund directly to the supplier.
9. **Factoring Account Receivables**
   - Facility is given to seller to fund his receivables till amount fully received.

(II) Pitch Presentation

1. **Introduction**
   - Introduction in short & sweet.
2. **Team**
   - People behind the scenes.
   - Investors are interested in the team.
3. **Problems**
   - Explain the problems.
   - Facebook v/s Orkut (Privacy)
4. **Solution**
   - How the company is planning to solve the problem.
   - Flipkart [Payment problem, Supply chain system]
5. **Marketing /Sales**
   - Investors interested in market size.
   - Target customers.
6. **Projection or Milestones**
   - Income statement, Cash flow statement, BLS
7. **Competition**
   - Necessary to highlight.
   - How product different from others.
8. **Business Model**
   - Purpose, Process, Target customers, Strategies etc.

(III) Modes of Financing For Startup

(i) Bootstrapping

From Personal Finances Or From Operating Revenue

(a) Trade Credit

- Suppliers are reluctant to give trade credit.
- Need to get the first order on credit.

(b) Factoring

- Account receivables of business are sold to commercial finance company.

(c) Leasing

- Take the equipment on lease

(ii) Angel Investors

- Invest in small startup in early stage.
- Exchange for owner equity or convertible debts.
- Use their own money

(iii) Venture Capital

- Investment vehicles that manage funds of investors.
- They finance in rapidly growing company purchase equity & active participation.

I. Characteristics

i) Long Time Horizon

- 3 to 10 years.

ii) Lack of Liquidity

- Less liquidity on equity.

iii) High Risk

- Works on principal of high risk & high return.

iv) Equity Participation

- Investing in the from of equity of a company.

II. Advantages

- Long term equity finance.
- Sharing both the risk & rewards.
- Provide practical advice.
- Contact in many areas.
- Providing additional round of funding
- Experience in the process of IPO.

III. Stages

1. **Seed Money**
   - New idea, R & D, 7-10 years.
2. **Start Up**
   - Marketing & product development 5-9 years.
3. **First Round**
   - Sales & Manufacturing 3-7 years
4. **Second Round**
   - Working capital need 3-5 years
5. **Third Round**
   - Market expansion acquire new profitable company 1-2 years
6. **Fourth Round**
   - Public issue 1-3 years

IV. VC Investment Process

1. **Deal Origination**
   - Inform about sector, Stages, Promoter, Turnover.
2. **Screening**
   - By committee.
3. **Due Diligence**
   - Verify the veracity of documents.
4. **Deal Structures**
   - About stakes by VC.
5. **Post Investment Activity**
   - Participate in BOARD.
6. **Exit Plan**
   - Sell to 3rd party.
   - Buy back by promoters.

V. Structure of Venture Capital Fund In India

(a) Domestic

- Domestic Vehicles
- Separate Investment Adviser

(b) Off Shore

Off Shore Structure

- Investment Vehicle Outside India.
- Managed by Off Shore Manager.

Unified Structure

- Domestic Investor Participate.

(IV) Startup India Initiative

Startup Means

- Private limited, LLP, partnership firm upto a period of 10 years of DOI.
- Turnover has not exceeded one hundred crore rupees.
- Innovation, Development, Improvement & High potential of employment generation.
- Splitting up or reconstruction of existing business shall not be considered a 'Start UP'.

FINANCIAL POLICY & COPORATE STRATEGY

1. Strategic Financial Decision Making Framework

Introduction

- Wealth creation.
- Selecting optimum investment & financial opportunity.
- Maximum expected return.
- Optimum allocation of fund.
- Fundamental essential of business.
  - Strategy.
  - Financial Resources.
  - Right Management Team.

Functions

- Search for best.
- Selection of the best.
- Optimal Mix.
- Established system for internal control.
- Analysis of result.

Key Decision of Financial Strategy

1. Financing Decision :- Mix of debt & equity.
2. Investment Decision :- Utilization of fund.
3. Dividend Decision :- Division of earning.
4. Portfolio Decision :- Evaluation of aggregate performance.

2. Strategy at Different Hierarchy Level

1. Corporate Level Strategy

- Strategy of selection of business.
- Answer three basic question
  - (i) Suitability
  - (ii) Feasibility
  - (iii) Acceptability

2. Business Unit Level Strategy

- Profit centre planned independently.
- Coordination of operating unit.

3. Functional Level Strategy

- Level of operating division & department R & D, Operation, Manufacturing, Marketing, Finance etc.
- Providing input to business level.
- Function activities are highest importance during top down & bottom up interaction of planning.

3. Financial Planning

- Back bone of business planning.
- Maximize existing financial resources.
- 3 Major component
  - (i) Financial resources.
  - (ii) Financial tool.
  - (iii) Financial goals.
- Outcomes of financial planning
  - (i) Financial objective.
  - (ii) Financial decision making.
  - (iii) Financial measures.

4. Interface of Financial Policy & Strategic Management

- **Starting point is money & end point is money**
- **Strategic plan**

(i) Sources of Finance & Capital Structure

- Generation of fund.
- Owner capital or borrowed capital.
- Equity, preference, debentures, public deposits, overdraft, cash credit etc.
- Desired mix of debt – equity.

(ii) Investment & Fund Allocation Decision

- Investment decision may be divided into three groups
  i) Addition of a new product.
  ii) Increase the level of operation.
  iii) Cost reduction & efficient utilization of resource.

(iii) Dividend Policy

- Earnings distributed v/s earnings retained
- Policy (i) Stable dividend policy
  (ii) Constant percentage
  (iii) Minimum dividend plus additional
- Cash dividend v/s stock dividend.

5. Balancing Financial Goal VIS-À-VIS Sustainable Growth

- **Growth objective should be consistent.**
- **Fuel industry.**
- **Sustainable growth is important for long term development.**
- **Organizational financial sustainable.**
  - ✓ More than one source of income.
  - ✓ Planning regularly.
  - ✓ Adequate financial system.
  - ✓ Good public image.
  - ✓ Financial autonomy.
- **Sustainable grow rate**

SGR = ROE × (1 – Dividend payment ratio)

Assumption

(i) Maintain target capital structure.
(ii) Maintain target dividend payout ratio.
(iii) Increase sales as market condition allow.

Question – 01

An individual attempts to found and build a company from personal finances or from the operating revenues of the new company. What this method is called? Discuss any two methods.

Answer

When an individual attempts to found and build a company from personal finances or from the operating revenues of the new company, it is called Boot Strapping.

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.

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

(a) 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.

The owner or financial officer may give half the order on credit, with the balance due upon delivery. Of course, the trick here is to get the goods shipped, and sell them before one has to pay for them. One could borrow money to pay for the inventory, but you have to pay interest on that money. So, trade credit is one of the most important ways to reduce the amount of working capital one needs. This is especially true in retail operations.

(b) 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. It can reduce costs associated

with maintaining accounts receivable such as bookkeeping, collections and credit verifications.

In addition to reducing internal costs of a business, factoring also frees up money that would otherwise be tied to receivables. This money can be used to generate

Question - 02

Side Pocketing enhances the value of the Mutual Fund. Do you agree? Briefly explain the process of side pocketing.

Answer

Side Pocketing: Yes, Side Pocketing enhances the value of a mutual fund. In simple words, a side pocketing in mutual fund leads to separation of risky assets from other investments and cash holdings. The purpose is to make sure that money invested in a mutual fund, which is linked to stressed assets, gets locked, until the fund recovers the money from the company or could avoid distress selling of illiquid securities. Process of Side Pocketing: The modus operandi is simple. Whenever, the rating of a mutual fund decreases, the fund shifts the illiquid assets into a side pocket so that current shareholders can be benefitted from the liquid assets. Consequently, the Net Asset Value (NAV) of the fund will then reflect the actual value of the liquid assets. Therefore, the process of side pocketing ensures that liquidity is not the problem even in the circumstances of frequent allotments and redemptions. Thus, from the above it can be said that Side Pocketing helps to enhance the value of fund for the investors to some extent

Question – 03

In an efficient market, technical analysis may not work perfectly. However, with imperfections, inefficiencies and irrationalities, which characterizes the real world, technical analysis may be helpful. Critically analyze the statement.

Answer

Yes, this statement is correct.

Arguments for technical analysis:

(a) Under influence of crowd psychology trend persists for some time. Technical analysis helps in identifying these trends early which is helping decision making.

(b) Shift in demand and supply is gradual rather than instantaneous. Technical analysis helps in detecting this shift rather early

(c) Fundamental information about a company is observed and assimilated by the market over a period of time. Hence price movements tend to more or less in same direction till the information is fully assimilated in the price of the stock.

Arguments against technical analysis:

(a) Technical are not able to offer a convincing explanation for tools employed by them.

(b) Empirical evidence in support of random walk hypothesis cast its shadow on it

(c) By the time trends are signaled by technical analysis, trends have already taken place.

Question – 04

Distinguish between Pass Through Certificates (PTC) and Pay Through Securities (PTS).

Answer

Pass Through Certificates (PTC) - In case of PTCs, the originator transfers the entire receipt of cash in the form of interest or principal repayment from the asset sold. Thus, PTC represent a direct claim of the investors on all assets securitized. Investors carry a proportional benefit. Skewness of cash flow occurs at an early stage in case of prepayment of principals.

Pay Through Securities (PTS) – In PTS, SPV debt securities are backed by the assets and hence it can restructure different tranches from varying maturities of receivables. PTS also permits the SPV to reinvest surplus funds for short term as per there requirement.

Question – 05

Differentiate between Economic Value Added (EVA) and Market Value Added (MVA)

Answer

Economic Value Added (EVA) – EVA is a holistic method of evaluating a company's financial performance in terms of its contribution to the society at large. The core concept behind EVA is that a company generates 'value' only if there is a creation of wealth in terms of returns in excess of its cost of capital. The formula is as below

EVA = NOPAT – (Invested Capital * WACC)

OR

NOPAT – Capital Charge

Market Value Added (MVA) – MVA means Current Market Value of the firm minus Invested Capital. It is an alternative way to gauge performance efficiencies of an enterprise, albeit from a market capitalization point of view, the logic being that the market will discount the efforts taken by the management fairly. Hence, MVA is the true value added that is perceived by the market while EVA is a derived value added that is for the more discerning investor.

Question – 06

As a financial strategist you will depend on certain key financial decisions. Discuss.

Answer

The key decisions falling within the scope of financial strategy are the following:

1. Financing decisions: These decisions deal with the mode of financing or mix of equity capital and debt capital.
2. Investment decisions: These decisions involve the profitable utilization of firm's funds especially in long-term projects (capital projects). Since the future benefits associated with such projects are not known with certainty, investment decisions necessarily involve risk. The projects are therefore evaluated in relation to their expected return and risk.
3. Dividend decisions: These decisions determine the division of earnings between payments to shareholders and reinvestment in the company.

4. Portfolio decisions: These decisions involve evaluation of investments based on their contribution to the aggregate performance of the entire corporation rather than on the isolated characteristics of the investments themselves.

Question – 07

"The process of securitization can be viewed as process of creation of additional financial product of securities in the market backed by collaterals." What are the other features? Describe.

Answer

The other features of Securitization are as follows:

(i) 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.

(ii) 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.

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

(iv) Trenching – Portfolio of different receivable or loan or asset are split into several parts based on risk and return they carry called 'Trench'. Each Trench carries a different level of risk and return. (v) Homogeneity – Under each tranche the securities issued are of homogenous nature and even meant for small investors who can afford to invest in small amounts.

Question – 08

Venture Capital Funding passes through various stages. Discuss.

Answer

Stages of Venture Capital Funding:

The various stages of Venture Capital Funding are as follows:

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.

Question – 09

Non-bank Financial Sources are becoming popular to finance Start-ups. Discuss.

Answer

Non-bank Financial Sources to finance Start-ups:

(i) Personal financing. It may not seem to be innovative but you may be surprised to note that most budding entrepreneurs never thought of saving any money to start a business. This is important because most of the investors will not put money into a deal if they see that you have not contributed any money from your personal sources.

(ii) Personal credit lines. One qualifies for personal credit line based on one's personal credit efforts. Credit cards are a good example of this. However, banks are © The Institute of Chartered Accountants of India 18 FINAL (NEW) EXAMINATION: JANUARY 2021 very cautious while granting personal credit lines. They provide this facility only when the business has enough cash flow to repay the line of credit.

(iii) Family and friends. These are the people who generally believe in you, without even thinking that your idea works or not. However, the loan obligations to friends and relatives should always be in writing as a promissory note or otherwise.

(iv) Peer-to-peer lending. In this process group of people come together and lend money to each other. Peer to peer to lending has been there for many years.

Many small and ethnic business groups having similar faith or interest generally support each other in their start up endeavors.

(i) Crowd funding. Crowdfunding is the use of small amounts of capital from a large number of individuals to finance a new business initiative. Crowdfunding makes use of the easy accessibility of vast networks of people through social media and crowdfunding websites to bring investors and entrepreneurs together.

(ii) Micro Loans. Microloans are small loans that are given by individuals at a lower interest to a new business ventures. These loans can be issued by a single individual or aggregated across a number of individuals who each contribute a portion of the total amount.

(iii) Vendor financing. Vendor financing is the form of financing in which a company lends money to one of its customers so that he can buy products from the company itself. Vendor financing also takes place when many manufacturers and distributors are convinced to defer payment until the goods are sold. This means extending the payment terms to a longer period for e.g. 30 days payment period can be extended to 45 days or 60 days. However, this depends on one's credit worthiness and payment of more money.

(iv) Purchase order financing. The most common scaling problem faced by start-ups is the inability to find a large new order. The reason is that they don't have the necessary cash to produce and deliver the product. Purchase order financing companies often advance the required funds directly to the supplier. This allows the transaction to complete and profit to flow up to the new business.

(v) Factoring accounts receivables. In this method, a facility is given to the seller who has sold the good on credit to fund his receivables till the amount is fully received. So, when the goods are sold on credit, and the credit period (i.e. the date up to which payment shall be made) is for example 6 months, factor will pay most of the sold amount up front and rest of the amount later. Therefore, in this way, a start-up can meet his day to day expenses.

Question – 10

Participants are required for the success of the securitization process. Discuss their roles.

Answer

Role of various participants in the process of securitization is as follows:

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

(b) Special Purpose Vehicle: 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.

(c) The Institute of Chartered Accountants of India 22 FINAL (NEW) EXAMINATION: JANUARY 2021 (c) 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.

(d) Obligors: The amount due from the obligor is transferred to SPV and hence they form the basis of securitization process and their credit standing is of paramount importance in the whole process.

(e) 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.

(f) 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. Generally, an originator or its affiliates acts as servicer.

(g) 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.

(h) 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.

(i) 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.

Question – 11

Risks are inherent and integral part of the market. Discuss.

Answer

Yes, Risk is an integral part of market and this is a type of systematic risk that affects prices of any particular share move up or down consistently for some time periods in line with other shares in the market. A general rise in share prices is referred to as a bullish trend, whereas a general fall in share prices is referred to as a bearish trend. In other words, the share market moves between the bullish phase and the bearish phase. The market movements can be easily seen in the movement of share price indices such as the BSE Sensitive Index, BSE National Index, NSE Index etc.

Question – 12

State the strategy at different hierarchy levels.

Answer

Strategies at different levels are the outcomes of different planning needs. Three levels of Strategy – Corporate level; Business unit level; and Functional or departmental level.

(1) Corporate Level Strategy: Corporate level strategy fundamentally is concerned with selection of businesses in which a company should compete and with the development and coordination of that portfolio of businesses.

Corporate level strategy should be able to answer three basic questions:

- ❖ Suitability: Whether the strategy would work for the accomplishment of common objective of the company.
- ❖ Feasibility: Determines the kind and number of resources required to formulate and implement the strategy.
- ❖ Acceptability: It is concerned with the stakeholders' satisfaction and can be financial and non-financial.

(2) Business Unit Level Strategy: Strategic business unit (SBO) may be any profit centre that can be planned independently from the other business

units of a corporation. At the business unit level, the strategic issues are about practical coordination of operating units and developing and sustaining a competitive advantage for the products and services that are produced.

(3) Functional Level Strategy: The functional level is the level of the operating divisions and departments. The strategic issues at this level are related to functional business processes and value chain. Functional level strategies in R&D, operations, manufacturing, marketing, finance, and human resources involve the development and coordination of resources through which business unit level strategies can be executed effectively and efficiently. Functional units of an organization are involved in higher level strategies by providing input to the business unit level and corporate level strategy, such as providing information on customer feedback or on resources and capabilities on which the higher level strategies can be based. Once the higher-level strategy is developed, the functional units translate them into discrete action plans that each department or division must accomplish for the strategy to succeed.

Among the different functional activities viz production, marketing, finance, human resources and research and development, finance assumes highest importance during the top down and bottom up interaction of planning. Corporate strategy deals with deployment of resources and financial strategy is mainly concerned with mobilization and effective utilization of money, the most critical resource that a business firm likes to have under its command. Truly speaking, other resources can be easily mobilized if the firm has adequate monetary base. To go into the details of this interface between financial strategy and corporate strategy and financial planning and corporate planning let us examine the basic issues addressed under financial planning.

Question – 13

Describe the main features of Value-at-Risk (VAR)

Answer

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.

(a) Risk Control: Risk can be controlled by setting limits for maximum loss.

(b) 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.

Question – 14

Explain Indicative Risk Matrix of each stages of funding for Venture Capital Financing.

Answer

Risk in each stage is different. An indicative Risk matrix is given below:

Financial Stage	Period (Funds locked in years)	Risk Perception	Activity to be financed
Seed Money	7-10	Extreme	For supporting a concept or idea or R&D for product development and involves low level of financing.
Start Up	5-9	Very High	Initializing prototypes operations or developing products and its marketing.
First Stage	3-7	High	Started commercials production and marketing.
Second	3-5	Sufficiently	Expanding market and

Stage		high	growing working capital need though not earning profit.
Third Stage	1-3	Medium	Market expansion, acquisition & product development for profit making company. Also called Mezzanine Financing.
Fourth Stage	1-3	Low	Facilitating public issue i.e. going public. Also called Bridge Financing.

Question – 15

Explain Pitch Presentation. List the methods for approaching a Pitch Presentation.

Answer

Pitch Presentation is a short and brief presentation (not more than 20 minutes) to investors explaining about the prospects of the company and why they should invest into the startup business. So, pitch deck presentation is a brief presentation basically using PowerPoint to provide a quick overview of business plan and convincing the investors to put some money into the business. Pitch presentation can be made either during face-to-face meetings or online meetings with potential investors, customers, partners, and co-founders.

Some of the methods as how to approach a pitch presentation are as follows:

(i) Introduction: Introduction of the start up and a brief account of yourself.

(ii) Team: What sort of team is working with the startup and their core competence need to be highlighted.

(iii) Problem: The promoter should be able to explain the problem he is going to solve and solutions emerging from it.

(iv) Solution: It is very important to describe in the pitch presentation as to how the company is planning to solve the problem.

(v) Marketing/Sales: This is a very important part where investors will be deeply interested. The market size of the product must be communicated to the investors. The promoter can brief the investors about the growth and forecast future revenue.

(vii) Projections or Milestones: Both financial and physical projections can be made. Some projected statements may be presented like, Income Statement, Cash Flow Statement, Balance Sheet etc.

(viii) Competition: Every business organization has competition even if the product or service offered is new and unique. It is necessary to highlight in the pitch presentation as to how the products or services are different from their competitors.

(ix) Business Model: The term business model is a wide term denoting core aspects of a business including purpose, business process, target customers, offerings, strategies, infrastructure, organizational structures, sourcing, trading practices, and operational processes and policies including culture.

(x) Financing: If a startup business firm has raised money, it is preferable to talk about how much money has already been raised, who invested money into the business and what they did about it.

Question – 16

State the problems faced in growth of securitization instruments in Indian context.

Answer

Following are main problems faced in growth of Securitization of instruments especially in Indian context:

(1) 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.

(2) 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 SPV as a trustee is liable to be taxed in a representative capacity then others 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.

(3) Accounting: Accounting and reporting of securitized assets in the books of originator is another area of concern. Although securitization is slated to be 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.

(4) Lack of standardization: Every originator following his own format for documentation and administration having lack of standardization is another obstacle in the growth of securitization. (5) 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.

(5) Ineffective Foreclosure laws: For many years efforts are 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.

Question – 17

Define Interest Rate Swaption. State its principal features.

Answer

An interest rate swaption is simply an option on an interest rate swap.It gives the holder the right but not the obligation to enter into an interest rate swap at a specific date in the future, at a particular fixed rate and for a specified term.

There are two types of swaption contracts: -

- A fixed rate payer swaption (also called Call Swaption).
- A fixed rate receiver swaption (also called Put Swaption).

Principal Features of Swaptions

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

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

(c) The 'option period' refers to the time which elapses between the transaction date and the expiry date.

(d) The swaption premium is expressed as basis points.

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

Question – 18

Describe Tracking error. List the reasons for it.

Answer

Tracking error can be defined as the divergence or deviation of a fund's return from the benchmarks return it is following.

The passive fund managers closely follow or track the benchmark index. Although they design their investment strategy on the same index but often it may not exactly replicate the index return. In such situation, there is possibility of deviation between the returns.

The tracking error can be calculated on the basis of corresponding benchmark return vis a vis quarterly or monthly average NAVs.

Reasons of Tracking Error:

Higher the tracking error higher is the risk profile of the fund. Whether the funds outperform or underperform their benchmark indices; it clearly indicates that fund managers are not following the benchmark indices properly. In addition to the same other reasons for tracking error are as follows:

- Transaction cost
- Fees charged by AMCs

- Fund expenses
- Cash holdings
- Sampling biasness

Thus, from above it can be said that to replicate the return to any benchmark index the tracking error should be near to zero.

Question – 19

What is the mode of financing is called in Startups, when a person attempts to found & build a company from personal finances or from the operating revenues of a new company. Explain briefly the methods of this mode.

Answer

When a person attempts to found & build a company from personal finances or from the operating revenues of the new company is called 'Bootstrapping'. Some of the methods of this mode are as follows:

(a) 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.

(b) 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.

(c) 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.

Question – 20

Which type of risk covers the default by the counterparty? List out the ways to manage this type of risk.

Answer

This risk occurs due to non-honoring of obligations by the counter party which can be failure to deliver the goods for the payment already made or vice-versa or repayment of borrowings and interest etc. Thus, this risk also covers the credit risk i.e. default by the counter party.

The various techniques to manage this type of risk are as follows:

(1) Carrying out Due Diligence before dealing with any third party.

(2) Do not over commit to a single entity or group or connected entities.

(3) Know your exposure limits.

(4) Review the limits and procedure for credit approval regularly.

(5) Rapid action in the event of any likelihood of defaults.

(6) Use of performance guarantee, insurance or other instruments.

Question – 21

Describe briefly on which principles Technical Analysis is based.

Answer

Technical analysis is based on the following three principals:

(1) The Market Discounts Everything: Although many experts criticize technical analysis because it only considers price movements and ignores fundamental factors but the Efficient Market Hypothesis (discussed later in detail) contradicts it according to which a company's share price already reflects everything that has or could affect a company and it includes fundamental factors. So, technical analysts generally have the view that a company's share price includes everything including the fundamentals of a company.

(2) Price Moves in Trends: Technical analysts believe that prices move in trends. In other words, a stock price is more likely to continue a past trend than move in a different direction.

(3) History Tends to Repeat Itself: Technical analysts believe that history tends to repeat itself. Technical analysis uses chart patterns to analyze subsequent market movements to understand trends. While many form of technical analysis have been used for many years, they are still considered to be significant because they illustrate patterns in price movements that often repeat themselves.

Question – 22

Explain the pricing of the securitized instruments.

Answer

Pricing of securitized instruments is an important aspect of securitization. While pricing the instruments, it is important that it should be acceptable to both originators as well as to the investor. On the same basis pricing of securities can be divided into following two categories:

(i) From Originator's Angle: From originator's point of view, the instruments can be priced at a rate at which originator has to incur an outflow and if that outflow can be amortized over a period of time by investing the amount raised through securitization.

(ii) From Investor's Angle: From an investor's angle security price can be determined by discounting best estimate of expected future cash flows using rate of yield to maturity of a security of comparable security with respect to credit quality and average life of the securities. This yield can also be estimated by referring the yield curve available for marketable securities, though some adjustments is needed on account of spread points, because of credit quality of the securitized instruments.

Question – 23

Write the characteristics of venture capital Financing.

Answer

Characteristics of Venture Capital Financing

(i) Long time horizon: The fund would invest with a long-time horizon in mind. Minimum period of investment would be 3 years and maximum period can be 10 years.

(ii) Lack of liquidity: When VC invests, it takes into account the liquidity factor. It assumes that there would be less liquidity on the equity it gets and accordingly it would be investing in that format. They adjust this liquidity premium against the price and required return.

(iii) High Risk: VC would not hesitate to take risk. It works on principle of high risk and high return. So, high risk would not eliminate the investment choice for a venture capital.

(iv) Equity Participation: Most of the time, VC would be investing in the form of equity of a company. This would help the VC participate in the management and help the company grow. Besides, a lot of board decisions can be supervised by the VC if they participate in the equity of a company.

Question – 24

Buy and hold is one of the policies of portfolio rebalancing. Briefly explain other policies of portfolio rebalancing.

Answer

While one policy of rebalancing portfolio is Buy and Hold the two policies are as follows:

(i) Constant Mix Policy: Contrary to above policy this policy is a 'Do Something Policy'. Under this policy investor maintains an exposure to stock at a constant percentage of total portfolio. This strategy involves periodic rebalancing to required (desired) proportion by purchasing and selling stocks as and when their prices goes down and up respectively. In other words this plan specifies that value of aggressive portfolio to the value of conservative portfolio will be held constant at a predetermined ratio. However, it is important to this action is taken only there is change in the prices of share at a predetermined percentage.

(ii) Constant Proportion Insurance Policy: Under this strategy investor sets a floor below which he does not wish his asset to fall called floor, which is invested in some non-fluctuating assets such as Treasury Bills, Bonds etc. The value of portfolio under this strategy shall not fall below this specified floor under normal market conditions. This strategy performs well especially in bull market as the value of shares purchased as cushion increases. In contrast in bearish market losses are avoided by sale of shares. It should however be noted that this strategy performs

very poorly in the market hurt by sharp reversals. The following equation is used to determine equity allocation:

Target Investment in Shares = Multiplier (Portfolio Value – Floor Value) Multiplier is a fixed constant whose value shall be more than 1.

Question – 25

What are the main features of Forward Rate Agreements (FRA)?

Answer

A Forward Rate Agreement (FRA) is an agreement between two parties through which a borrower/ lender protects itself from the unfavorable changes to the interest rate. Unlike futures FRAs are not traded on an exchange thus are called OTC product. Following are main features of FRA.

- Normally it is used by banks to fix interest costs on anticipated future deposits or interest revenues on variable-rate loans indexed to Benchmark Interest Rate e.g. LIBOR, MIBOR etc.
- It is an off-Balance Sheet instrument.
- It does not involve any transfer of principal. The principal amount of the agreement is termed "notional" because, while it determines the amount of the payment, actual exchange of the principal never takes place.
- It is settled at maturity in cash representing the profit or loss. A bank that sells an FRA agrees to pay the buyer the increased interest cost on some "notional" principal amount if Reference Rate of some specified maturity is above a stipulated "Forward Interest Rate" on the contract maturity or settlement date. Conversely, the buyer agrees to pay the seller any decrease in
- Final settlement of the amounts owed by the parties to an FRA is determined by the formula Payment = $\frac{(N)(RR-FR)(\frac{dtm}{DY})}{[1+RR(\frac{dtm}{DY})} \times 100$

Where,

N = the notional principal amount of the agreement;

RR = Reference Rate for the maturity specified by the contract prevailing on the contract settlement date; typically LIBOR or MIBOR

FR = Agreed-upon Forward Rate; and

dtm = maturity of the forward rate, specified in days (FRA Days)
DY = Day count basis applicable to money market transactions which could be 360 or 365 days.

If Reference Rate > FR the seller owes the payment to the buyer, and if Reference Rate < FR the buyer owes the seller the absolute value of the payment amount determined by the above formula.

- The differential amount is discounted at post change (actual) interest rate as it is settled in the beginning of the period not at the end.

Question – 26

Explain the interface of financial Policy and Strategic Management.

Question – 27

Interpret the Capital Asset Pricing Model (CAPM) and its relevant assumptions.

Question – 28

Explain the advantages of bringing Venture Capital in the Company.

Question – 29

Discuss briefly the Steps involved in the Securitization mechanism.

OR

Explain the benefits of Securitization from the perspective of both originator as well as the Investor.

Question – 30

Explain Angel Investors.

Question – 31

Discuss about the Primary Participants in the Process of Securitization.

Question – 32

How different stakeholders view the financial risk ?

Question – 33

List the main application of value At Risk (VAR).

Question – 34

Briefly explain the steps involved in Mechanism of securitization.

Question – 35

Explain briefly the Sources for funding a Start-up.

Question – 36

State briefly the basic characteristics of Venture Capital financing ?

Question – 37

Identify the benefits of Securitization from the angle of Originator.

Question – 38

What is a Start-up to avail the benefits of government Scheme ?

Question – 39

Discuss briefly the key decisions which falls within the Scope of financial Strategy.

Question – 40

State the main problems faced in Securitization in India ?

OR

List the main Objectives of International Cash Management.