# AFM
# THEORY NOTES

**INDEX - MAY 2024**

- Covers all theory question from past papers, RTPs & MTPs
- Key words highlighted.
- Important questions marked
- Memory techniques will be shared on YouTube

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# NOTE

Hey there,

Happy to have you here!

Do read this note on how to us this AFM theory notes. It will help you to prepare for 16 marks theory questions in your exam.

"Theory is most scoring and quick part in AFM exam"

As per the new course AFM exam pattern, there will be 4 theory questions in your exam of 4 marks each so, even if you leave 1 theory question in optional (although not advisable to leave theory question in optional) there is mandatory theory of 12 marks in your exam.

These theory notes cover all the questions from past exam, RTPs and MTPs. In AFM theory, ICAI doesn't ask new questions and repeat the same questions so, do prepare well from these notes so, that you can score maximum marks in theory.

Salient Features

- Covers all theory question from past papers, RTPs & MTPs
- Key words highlighted for exam purpose.
- Important questions marked with "***" (Must do on last day)
- Memory techniques will be shared on YouTube

All the best!

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# Trend Analysis

This trend analysis covers the theory questions asked in AFM exam in last 12 attempts. Few chapters are asked in every exam and highlighted in green as category A chapter.

| No. | Chapter Name | Nov 23 | May 23 | Nov 22 | May 22 | Nov 21 | May 21 | Jan 21 | Nov 20 | Nov 19 | May 19 | Nov 18 | May 18 | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Financial Policy and Corporate Strategy | 4 | 4 | - | 4 | - | 4 | 4 | - | 4 | - | - | 4 | **28** |
| 2 | Risk Management | 4 | - | 4 | 4 | 4 | 4 | - | - | - | 4 | 4 | - | **28** |
| 3 | Advance Capital Budgeting Decision | New Chapter added from May-2024 | | | | | | | | | | | | |
| 4 | Security Analysis | 4 | - | - | - | 4 | - | - | 4 | - | - | - | - | **12** |
| 5 | Security Valuation | - | - | - | - | - | - | - | - | - | - | - | - | **-** |
| 6 | Portfolio Management | - | - | - | - | 4 | - | 4 | - | - | - | - | - | **8** |
| 7 | Securitization | 4 | 4 | 8 | 4 | 4 | 4 | 8 | 4 | 6 | 4 | 4 | 8 | **62** |
| 8 | Mutual Funds | - | 4 | - | - | - | 4 | - | 4 | - | - | - | - | **12** |
| 9 | Derivatives Analysis And Valuation | 4 | 4 | - | - | - | - | - | - | - | - | - | 4 | **12** |
| 10 | Foreign Exchange Exposure And Risk Management | - | - | 4 | - | - | - | - | - | - | - | - | - | **4** |
| 11 | International Financial Management | - | - | - | 4 | - | - | - | - | 4 | 4 | - | - | **12** |
| 12 | Interest Rate Risk Management | - | 4 | 8 | 4 | 4 | 4 | - | - | - | - | - | - | **24** |
| 13 | Business Valuation | - | - | - | - | - | - | - | 4 | - | - | - | - | **4** |
| 14 | Mergers Acquisitions & Corporate Restructuring | - | - | - | - | - | - | - | - | - | 4 | - | - | **4** |
| 15 | Startup Finance | 8 | 8 | 4 | 8 | 8 | 8 | 8 | 8 | 8 | 4 | 4 | 4 | **80** |

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| 3 | Advance Capital Budgeting Decision | No Theory Qns Asked | |
| 4 | Security Analysis | 7 | 11 |
| 5 | Security Valuation | No Theory Qns Asked | |
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| | **Total** | 87 Qns | 41 Pages |

# Ch.1 Financial Policy And Corporate Strategy

| QA | Description | Ref. |
| --- | --- | --- |
| Q1 | Describe the main function of corporate level strategy and state which three basic questions it should be able to answer | SA.N23 |
| Q1 | What do you mean by Corporate Level Strategy? Also explain three basic questions Corporate Level Strategy should be able to answer. | MTP.A24 |
| A1<br>*** | 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.<br>Corporate level strategy should be able to answer three basic questions:<br>**(i) Suitability**: Whether the **strategy would work** for the accomplishment of common objective of the company.<br>**(ii) Feasibility**: Determines the kind and **number of resources required** to formulate and implement the strategy.<br>**(iii) Acceptability**: It is concerned with the **stakeholders' satisfaction** and can be financial and non-financial. | |
| Q2 | What makes an organization financially sustainable? Discuss. | SA.M23 |
| Q2 | Explain the traits that an organisation should have to make itself financially sustainable | RTP.M21 |
| Q2 | What makes an organization sustainable as well as financially sustainable? | MTP.O23 |
| Q2 | Explain the various requirements that makes an organisation sustainable. | MTP.A23 |
| A2<br>*** | In order to be sustainable, an organisation must:<br>❖ have a **clear strategic direction**;<br>❖ be able to **scan its environment** or context to **identify opportunities** for its work;<br>❖ be able to **attract, manage and retain competent staff**; have an adequate administrative and financial infrastructure;<br>❖ be able to **demonstrate its effectiveness** and impact in order to leverage further resources; and<br>❖ get **community support** for, and involvement in its work.<br><br>To be **financially sustainable**, an organisation must:<br>❖ have **more than one source of income**;<br>❖ have more than one way of **generating income**;<br>❖ do strategic, action and financial **planning regularly**;<br>❖ have **adequate financial systems**;<br>❖ have a **good public image**;<br>❖ be **clear** about its **values** (value clarity); and<br>❖ have **financial autonomy**. | |
| Q3 | Explain the outcomes of Financial Planning | SA.M22 |
| Q3 | Financial Resources, Financial Tools and Financial Goals are outcomes of Financial Planning. Do you agree with this statement? | MTP.N21 |
| A3<br>*** | **Financial planning** is a systematic **approach** whereby the financial planner **helps** the **customer to maximize** his existing **financial resources** by utilizing **financial tools** to achieve his **financial goals**. Financial Resources, Financial Tools and Financial Goals are **not the outcomes** of Financial Planning rather these are **components** of Financial Planning.<br><br>**Outcomes** of the financial planning are:<br>**(i) Financial Objectives**: Financial objectives are to be decided at the very outset so that rest of the decisions can be taken accordingly. The objectives need to be **consistent with the corporate mission** and corporate objectives.<br>**(ii) Financial Decision Making**: Financial decision making helps in **analyzing the financial problems** that are being faced by the corporate and accordingly **deciding the course of action** to be taken by it.<br>**(iii) Financial Measures**: The financial measures like ratio analysis, analysis of cash flow statement etc. are used to **evaluate the performance of the Company**. The selection of these measures again depends upon the corporate objective. | |

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| Q4 | State the strategy at different hierarchy levels | SA.M21 |
| Q4 | Explain the term Corporate Level Strategy and what are the three basic questions it answers? | MTP.S23 |
| A4 *** | 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.<br><br>(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:<br>❖ **Suitability**: Whether the strategy would work for the accomplishment of common objective of the company.<br>❖ **Feasibility**: Determines the kind and number of resources required to formulate and implement the strategy.<br>❖ **Acceptability**: It is concerned with the stakeholders' satisfaction and can be financial and non-financial.<br><br>(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.<br><br>(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. | |
| Q5 | As a financial strategist you will depend on certain key financial decisions. Discuss. | SA.J21 |
| Q5 | As a financial strategist you will depend on certain key financial decisions. Discuss. | MTP.M23 |
| Q5 | Explain key decisions that fall within the scope of financial strategy. | RTP.N20 |
| Q5 | Discuss briefly the key decisions which fall within the scope of financial strategy | SA.N19 |
| A5 *** | The key decisions falling within the scope of financial strategy are the following:<br><br>1. **Financing decisions:** These decisions deal with the mode of financing or **mix of equity capital and debt** capital.<br>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.<br>3. **Dividend decisions**: These decisions determine the **division of earnings** between payments to shareholders and reinvestment in the company.<br>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. | |

| Q6 | Explain the interface of Financial Policy and Strategic Management. | SA.M18 |
|---|---|---|
| A6 | The interface of strategic management and financial policy will be clearly understood if we appreciate the fact that the **starting point of an organization is money** and the **end point of that organization is also money**. No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both i.e. internally and externally mobilized financial base.<br>**Sources of finance and capital structure are the most important dimensions** of a strategic plan. The need for fund mobilization to support the expansion activity of firm is very vital for any organization. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and / or preference shares for mobilizing ownership capital and debenture to raise borrowed capital. **Policy makers should decide on the capital structure** to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio.<br><br>However this ratio in its ideal form varies from industry to industry. Another important dimension of strategic management and financial policy interface is the **investment and fund allocation decisions**. A planner has to frame policies for **regulating investments in fixed assets and for restraining of current assets**. **Investment proposals** mooted by different business units may be divided into **three groups**.<br>One type of proposal will be for **addition of a new product**, **increasing the level of operation of an existing product and cost reduction** and efficient utilization of resources through a new approach and or closer monitoring of the different critical activities. **Dividend policy** is another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the organization.<br><br>It may be noted from the above discussions that **financial policy of a company cannot be worked out in isolation of other functional policies**. It has a wider appeal and closer link with the overall organizational performance and direction of growth. As a result preference and patronage for the company depends significantly on the financial policy framework. Hence, attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself. | |
| Q7 | In the current scenario of globalization and growth in information and communication technologies etc. the responsibilities of CFOs have been drastically expanded. Explain. | RTP.M24 |
| A7 | **Traditionally**, the **main role of CFO** was concentrated to **wealth maximisation** for shareholders by taking care of financial health of an organization and overseeing and implementing adequate financial controls. However, in recent time because of globalization, growth in information and communications, pandemic situation etc. their range of responsibilities has been drastically expanded, driven by complexity, and changing expectations.<br>Now a days in addition to fulfilling traditional role relating to governance, compliances and controls, and business ethics as a part of the leadership of role **CFOs are also expected to contribute their support in strategic and operational decision making**.<br><br>In post-pandemic time their role has been advanced in the following areas in addition to traditional role:<br>a. **Risk Management:** Now a days the CFOs are expected to look after the overall functioning of the framework of Risk Management system of an organisation.<br>b. **Supply Chain:** Post pandemic supply chain management system has been posing the challenge for the company to maintain the sustainable growth. Since CFOs are care takers of finance of the company, considering the financial viability of the Supply Chain Management their role has now become more critical.<br>c. **Mergers, acquisitions, and Corporate Restructuring:** Since in recent period to maintain the growth and capture the market share there has been a spate of Mergers and Acquisitions and hence the role of CFOs has become more crucial because these are strategic decision and any error in them can lead to collapse of the whole business.<br>d. **Environmental, Social and Governance (ESG) Financing:** With the evolving of the concept of ESG their role has been shifted from traditional financing to **sustainability financing**.<br><br>Thus, from above discussion it can be concluded that in today's time CFOs are taking a leadership role in Value Creation for the organisation and that too on sustainable basis for a longer period. | |

| Q8 | How financial goals can be balanced vis-à-vis sustainable growth? | RTP.M20 |
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| A8 | 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.<br><br>**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. | |
| Q9 | Explain the concept of Sustainable Growth Rate and also state assumptions of Sustainable growth model. | MTP.M24 |
| A9 | 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 equity ratio**; and the **retention rate**, which is defined as the fraction of earnings retained in the business.<br><br>SGR = ROE x (1- Dividend payment ratio)<br><br>Sustainable growth model assume that the business wants to:<br>1) maintain a **target capital structure** without issuing new equity;<br>2) maintain a **target dividend payment** ratio; and<br>3) **increase sales** as rapidly as market conditions **allow**. | |

# Ch.2 Risk Management

| QA | Description | Ref. |
|---|---|---|
| Q1 | List out the four methods for Identification and Management of Financial Risk. What are the parameters to identify the currency risk? | SA.N23 |
| Q1 | Explain briefly the parameters to identify the currency risk. | RTP.N19 |
| Q1 | DESCRIBE the various parameters to identity the currency risk | RTP.N18 |
| Q1 | What are the parameters to identify currency risk? List out the ways to minimize such risk. | MTP.A24 |
| Q1 | Explain some of the parameters to identify the Currency Risk. | MTP.A23 |
| A1<br>*** | Following are the four methods for identification and **management of financial risk:**<br>❖ **Counter Party risk**<br>❖ **Political risk**<br>❖ **Interest Rate Risk**<br>❖ **Currency Risk**<br><br>Parameters to identity the currency risk are as follows:<br>(1) **Government Action**: The Government action of any country has visual impact in its currency.<br>(2) **Nominal Interest Rate**: As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest of that country.<br>(3) **Inflation Rate**: Purchasing power parity theory discussed in later chapters impact the value of currency.<br>(4) **Natural Calamities**: Any natural calamity can have negative impact.<br>(5) **War, Coup, Rebellion etc.**: All these actions can have far reaching impact on currency's exchange rates.<br>(6) **Change of Government**: The change of government and its attitude towards foreign investment also helps to identify the currency risk.<br><br>Ways to **minimize such risk** are:-<br>(1) Money Market **Hedging**.<br>(2) Currency **Options**.<br>(3) **Forward** Contract.<br>(4) Make Invoice in **Home Currency**. | |
| Q2 | What are the applications of Value At Risk (VAR) ? | SA.N22 |
| Q2 | List out the areas where the concept of Value at Risk (VAR) can be applied? | MTP.M24 |
| Q2 | List the main applications of Value At Risk (VAR). | SA.M19 |
| A2<br>*** | VAR can be applied<br>a. to **measure** the **maximum possible loss** on any portfolio or a trading position.<br>b. as a **benchmark for performance measurement** of any operation or trading.<br>c. to **fix limits for individuals** dealing in front office of a treasury department.<br>d. to enable the management to **decide the trading strategies**.<br>e. as a tool for **Asset and Liability Management** especially in banks. | |

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| Q3 | Briefly explain:<br>(a) Compliance risk and<br>(b) Operational risk | SA.M22 |
| A3 | **(a) Compliance Risk:** Every business needs to **comply with rules and regulations**. For example, with the advent of Companies Act, 2013, and continuous updating of SEBI guidelines, each business organization has to comply with plethora of rules, regulations and guidelines. Noncompliance leads to penalties in the form of fine and imprisonment.<br>However, **when a company ventures into a new business** line or a new geographical area, **the real problem then occurs**. For example, a company pursuing cement business likely to venture into sugar business in a different state but laws applicable to the sugar mills in that state are different. So, that poses a compliance risk. If the company **fails to comply with laws related to a new area or industry or sector, it wil pose a serious threat** to its survival.<br><br>**(b) Operational Risk:** This type of risk relates to **internal risk**. It also relates to **failure** on the part of the company **to cope with day-to-day operational problems**. Operational risk **relates to 'people' as well as 'process'**. We will take an example to illustrate this.<br>For example, an employee paying out ` 1,00,000 from the account of the company instead of ` 10,000. This is a people as well as a process risk. An organization can employ another person to check the work of that person who has mistakenly paid ` 1,00,000 or it can install an electronic system that can flag off an unusual amount. | |
| Q4 | Which type of risk covers the default by the counterparty? List out the ways to manage this type of risk. | SA.D21 |
| A4 | 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.<br>The various **techniques to manage** this type of risk are as follows:<br>(1) Carrying out **Due Diligence** before dealing with any third party.<br>(2) Do **not over commit to a single entity** or group or connected entities.<br>(3) Know your **exposure limits**.<br>(4) **Review the limits** and procedure for credit approval regularly.<br>(5) **Rapid action** in the event of any likelihood of **defaults**.<br>(6) Use of **performance guarantee**, insurance or other instruments | |
| Q5 | Describe the main features of Value-at-Risk (VAR). | SA.M21 |
| Q5 | What is Value at Risk? Identify its main features | RTP.M20 |
| Q5 | Describe the main features of Value-at-Risk (VAR). | MTP.M23 |
| Q5 | DESCRIBE Value at Risk and its application | RTP.M18 |
| A5<br>*** | 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 –**<br>(i) What is **worst case scenario**?<br>(ii) What will be **loss**?<br>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.<br><br>Following are **main features** of VAR:<br>(i) **Components of Calculations:** VAR calculation is based on following three components:<br>(a) Time Period<br>(b) Confidence Level – Generally 95% and 99%<br>(c) Loss in percentage or in amount<br>(ii) **Statistical Method:** It is a type of statistical tool based on Standard Deviation.<br>(iii) **Time Horizon:** VAR can be applied for different time horizons say one day, one week, one month.<br>(iv) **Probability:** Assuming the values are normally attributed, probability of maximum loss can be predicted.<br>(v) **Risk Control:** Risk can be controlled by setting limits for maximum loss.<br>(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. | |

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| Q6 | How different stakeholders view the financial risk? | SA.N18 |
| Q6 | What is Financial Risk? How it can be evaluated from point of views. | RTP.N20 |
| Q6 | Explain how financial risk can be evaluated from different point of views | MTP.S23 |
| A6 *** | The financial risk can be viewed by **different stakeholders** as follows:<br>**(i) From shareholder's and lender'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 the event of winding up of a company they will be least be given priority. 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.<br>**(ii) 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.<br>**(iii) From Government's point of view:** From Government's point of view, the financial risk can be viewed as **failure of any bank** (like Lehman Brothers) or **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. | |
| Q7 | Explain how an organization interested in making investment in foreign country can assess Country Risk and mitigate this risk. | RTP.M21 |
| A7 | Organisation can assess **country risk**<br>(1) By referring **political ranking** published by different business magazines.<br>(2) By evaluating **country's macro-economic** conditions.<br>(3) By analyzing the **popularity of current government** and assess their stability.<br>(4) By taking **advises from the embassies** of the home country in the host countries.<br><br>Further, following techniques can be used to **mitigate this risk**.<br>(i) **Local sourcing** of raw materials and labour.<br>(ii) Entering into **joint ventures**<br>(iii) **Local financing**<br>(iv) **Prior negotiations** | |

# Ch.4 Security Analysis

| QA | Description | Ref. |
|---|---|---|
| Q1 | In a rational, well ordered and efficient market, technical analysis may not work very well". Is it true? List out the reasons for this statement regarding Technical Analysis. | SA.N23 |
| A1 | The reasons for the statement "In a rational, well ordered and efficient market, technical analysis may not work very well" are as follows:<br><br>**(i)** Most technical analysts are **not able to offer a convincing explanation** for the tools employed by them.<br>**(ii)** **Empirical evidence** in support of **random walk hypothesis** cast its shadow over the usefulness of technical analysis.<br>**(iii)** **By the time an uptrend and down trend** may have been **signalled** by technical analysis it may already have taken place.<br>**(iv)** Ultimately technical analysis must be a **self-defeating proposition**. With more and more people employing it, the value of such analysis tends to decline. | |
| Q2 | Describe briefly on which principles Technical Analysis is based. | SA.D21 |
| A2 | Technical analysis is based on the following **three principals**:<br><br>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.<br>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.<br>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. | |
| Q3 | In an efficient market, technical analysis may not work perfectly. However, with imperfections, inefficiencies and irrationalities, which characterises the real world, technical analysis may be helpful. Critically analyse the statement | SA.N20 |
| A3<br>*** | Yes, this statement is correct.<br>Arguments **for** technical analysis:<br>a) Under influence of crowd psychology **trend persists for some time**. Technical analysis helps in identifying these trends early which is helping decision making.<br>b) **Shift in demand and supply is gradual rather than instantaneous**. Technical analysis helps in detecting this shift rather early<br>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.<br><br>Arguments **against** technical analysis:<br>a) Technical are **not able to offer a convincing explanation** for tools employed by them.<br>b) Empirical evidence in support of **random walk hypothesis** cast its shadow on it<br>c) **By the time trends are signaled** by technical analysis, trends have **already taken place**. | |

| Q4 | Explain various "Market Indicators". | RTP.N20 |
|---|---|---|
| A4 | The various market indicators are as follows:<br><br>**(i) Breadth Index**: It is an index that **covers all securities traded**. It is computed by **dividing the net advances or declines in the market by the number of issues traded**. The **breadth index either supports or contradicts** the movement of the **Dow Jones Averages**. If it supports the movement of the Dow Jones Averages, this is considered sign of technical strength and if it does not support the averages, it is a sign of technical weakness i.e. a sign that the market will move in a direction opposite to the Dow Jones Averages. The breadth index is an addition to the Dow Theory and the movement of the Dow Jones Averages.<br>**(ii) Volume of Transactions:** The volume of shares traded in the market provides **useful clues on how the market would behave** in the near future. A rising index/price with increasing volume would signal buy behaviour because the situation reflects an unsatisfied demand in the market. Similarly, a falling market with increasing volume signals a bear market and the prices would be expected to fall further. A rising market with decreasing volume indicates a bull market while a falling market with dwindling volume indicates a bear market. Thus, the volume concept is best used with another market indicator, such as the Dow Theory.<br>**(iii) Confidence Index**: It is supposed to reveal **how willing the investors are to take a chance** in the market. It is the **ratio of high-grade bond yields to low-grade bond yields**. It is used by market analysts as a method of trading or timing the purchase and sale of stock, and also, as a forecasting device to determine the turning points of the market. A rising confidence index is expected to precede a rising stock market, and a fall in the index is expected to precede a drop in stock prices. A fall in the confidence index represents the fact that low-grade bond yields are rising faster or falling more slowly than high grade yields. The **confidence index is usually, but not always a leading indicator** of the market. Therefore, it should be used in conjunction with other market indicators.<br>**(iv) Relative Strength Analysis:** The relative strength concept suggests that the **prices of some securities rise relatively faster in a bull market or decline more slowly in a bear market than other securities** i.e. some securities exhibit relative strength. Investors will earn higher returns by investing in securities which have demonstrated relative strength in the past because the relative strength of a security tends to remain undiminished over time. **Relative strength can be measured in several ways**. Calculating rates of return and classifying those securities with **historically high average returns as securities with high relative strength** is one of them. Even ratios like security relative to its industry and security relative to the entire market can also be used to detect relative strength in a security or an industry.<br>**(v) Odd - Lot Theory:** This theory is a **contrary - opinion theory**. It assumes that the **average person is usually wrong** and that a **wise course of action is to pursue strategies contrary to popular opinion**. The odd-lot theory is used primarily to predict tops in bull markets, but also to predict reversals in individual securities. | |
| Q5 | Explain the factors affecting economic analysis. | RTP.M20 |
| A5<br>*** | Some of the factors affecting economic analysis are discussed as under:<br><br>**(i) Growth Rates of National Income and Related Measures**: For most purposes, what is important is the difference between the nominal growth rate quoted by GDP and the 'real' growth after taking inflation into account. The estimated growth rate of the economy would be a pointer to the prospects for the industrial sector, and therefore to the returns investors can expect from investment in shares.<br>**(ii) Growth Rates of Industrial Sector**: This can be further broken down into growth rates of various industries or groups of industries if required. The **growth rates in various industries are estimated based on the estimated demand for its products.**<br>**(iii) Inflation:** Inflation is measured in terms of either wholesale prices (the Wholesale Price Index or WPI) or retail prices (Consumer Price Index or CPI). The demand in some industries, particularly the consumer products industries, is significantly influenced by the inflation rate. Therefore, firms in these industries make continuous assessment about inflation rates likely to prevail in the near future so as to fine-tune their pricing, distribution and promotion policies to the anticipated impact of inflation on demand for their products.<br>**(iv) Monsoon:** Because of the **strong forward and backward linkages**, monsoon is of great concern to investors in the stock market too. | |

| Q6 | DESCRIBE the factors affecting Industry Analysis | RTP.M19 |
|---|---|---|
| A6 | The following factors may particularly be kept in mind while assessing the factors relating to an industry.<br><br>**(i) Product Life-Cycle**: An industry usually exhibits **high profitability in the initial and growth** stages, medium but steady profitability in the maturity stage and a sharp decline in profitability in the last stage of growth.<br>**(ii) Demand Supply Gap**: Excess supply reduces the profitability of the industry because of the decline in the unit price realization, while **insufficient supply tends to improve the profitability** because of higher unit price realization.<br>**(iii) Barriers to Entry:** Any industry with high profitability would attract fresh investments. The potential entrants to the industry, however, face different types of barriers to entry. Some of these barriers are innate to the product and the technology of production, while other barriers are created by existing firms in the industry.<br>**(iv) Government Attitude:** The attitude of the government towards an industry is a crucial determinant of its prospects.<br>**(v) State of Competition in the Industry**: Factors to be noted are- firms with leadership capability and the nature of competition amongst them in foreign and domestic market, type of products manufactured viz. homogeneous or highly differentiated, demand prospects through classification viz customer-wise/area-wise, changes in demand patterns in the long/immediate/ short run,type of industry the firm is placed viz. growth, cyclical, defensive or decline.<br>**(vi) Cost Conditions and Profitability:** The price of a share depends on its return, which in turn depends on profitability of the firm. Profitability depends on the state of competition in the industry, cost control measures adopted by its units and growth in demand for its products.<br>**(vii) Technology and Research:** They play a vital role in the growth and survival of a particular industry. Technology is subject to change very fast leading to obsolescence. Industries which update themselves have a competitive advantage over others in terms of quality, price etc. | |
| Q7 | EXPLAIN the challenges to Efficient Market Theory | RTP.N18 |
| A7 | Challenges to the Efficient Market Theory<br><br>**(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.<br>**(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.<br>David Dreman maintained that under conditions of anxiety and uncertainty, with a vast interacting information grid, the market can become a giant.<br>**(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.<br>**(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. | |

# Ch.6 Portfolio Management

| QA | Description | Ref. |
|---|---|---|
| Q1 | Buy and hold is one of the policies of portfolio rebalancing. Briefly explain other policies of portfolio rebalancing. | SA.D21 |
| A1 | While one policy of rebalancing portfolio is Buy and Hold the two policies are as follows:<br><br>**(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 when there is change in the prices of share at a predetermined percentage.<br><br>**(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:<br>**Target Investment in Shares = Multiplier (Portfolio Value – Floor Value)**<br>Multiplier is a fixed constant whose value shall be more than 1. | |
| Q2 | Risks are inherent and integral part of the market. Discuss. | SA.J21 |
| A2 | 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. | |

# Ch.7 Securitization

| QA | Description | Ref. |
|---|---|---|
| Q1 | "Lack of existence of a well-developed debt market in India, is an obstacle that hinders the growth of the Secondary Market of securitized or asset backed Securities". Is it true? What are the other problems in Securitization Process? (Any three) | SA.N23 |
| Q1 | State the problems faced in growth of securitization instruments in Indian context. | SA.M21 |
| Q1 | Discuss briefly the problems faced in the growth of Securitization of Instruments in Indian context. | RTP.N20 |
| Q1 | State the main problems faced in Securitization in India? | SA.N19 |
| Q1 | Though in recent period of time the concept of securitisation has become popular in India as a source of Off Balance Sheet source of financing but its level of growth is still far behind" Explain. | MTP.S23 |

**A1** ***

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 stated 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**.
6) **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 proper ty in event of default by the borrower.

| QA | Description |
|---|---|
| Q2 | Pay through securities' are in the nature of participation certificates that enable the investors to take a direct exposure on the performance of the securitized assets. 'Pass Through Certificates', on the other hand, gives investors only a charge against the securitized assets. Do you agree with the statement? May23 |
| Q2 | Distinguish between Pass Through Certificates (PTC) and Pay Through Securities (PTS). (Nov-20) |

**A2** ***

**Not agreed** with the statement.

In **Pass Through Certificate** originator (seller of the assets) **transfers the entire receipt of cash** in the 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.
In contrast to Pass Through Certificate **in Pay Through Security**, SPV debt **securities are backed by the assets** and hence **it can restructure different tranches** from varying maturities of receivables. In other words, this structure **permits de-synchronization 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.

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| Q3 | What are the features of Securitization? | SA.N22 |
| Q3 | "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. | RTP.M23 |
| Q3 | Explain the various features of Securitization. | MTP.A23 |
| Q3 | Not only Bundling and Unbundling is only feature of Securitisation, there are other features too of the same. Explain. | MTP.S23 |
| Q3 | The process of securitisation 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. | SA.J21 |
| A3 *** | The securitization has the following features:<br>**(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.<br>**(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**.<br>**(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**.<br>**(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.<br>**(v) Trenching** – Portfolio of different receivable or loan or asset are **split into several parts** based on risk and return they carry called 'Tranche'. Each Trench carries a different level of risk and return.<br>**(vi) 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**. | |
| Q4 | What do you mean by Bootstrapping? Explain the method of Trade Credit used by the startup firms in bootstrapping. | SA.N22 |
| A4 | 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.<br><br>**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.<br><br>Communication skills are important here. The financial plan has to be shown. The owner or the financial officer has to be explained about the business and the need to get the first order on credit in order to launch the venture. The owner or financial officer may give half the order on credit and balance on delivery. The trick here is to **get the goods shipped and sell them before paying to them**. One can also borrow to pay for the good sold but there is interest cost also. So trade credit is one of the most important way to reduce the amount of working capital one needs. This is especially true in retail operations. | |

Space for self-note :)

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| Q5 | What are the benefits of Securitization? | SA.M22 |
| Q5 | Explain the benefits of Securitization from the perspective of both originator as well as the investor. | SA.M18 |
| Q5 | Explain the benefits of Securitization from the point of view of originator. | RTP.N19 |
| Q5 | Explain various benefits that accrues to an investor by investing money in the Securitized Instruments. | MTP.A23 |
| Q5 | Identify the benefits of Securitization from the angle of Originator. | SA.N19 |
| Q5 | Explain various benefits that accrues to an investor by investing money in the Securitized Instruments. | MTP.M23 |

A5 ***

The benefits of securitization can be viewed from the angle of various parties involved as follows:

(A) From the **angle of originator**

Originator (entity which sells assets collectively to Special Purpose Vehicle) achieves the following benefits from securitization.

**(i) Off – Balance Sheet Financing**: When loan/receivables are securitized it **releases a portion of capital tied up in these assets** resulting in off Balance Sheet financing leading to improved liquidity position which helps in expanding the business of the company.

**(ii) More specialization in main business**: By transferring the assets the entity could **concentrate more on core** business as servicing of loan is transferred to SPV. Further, in case of non-recourse arrangement even the burden of default is shifted.

**(iii) Helps to improve financial ratios:** Especially in case of Financial Institutions and Banks, it helps to manage Capital –To-Weighted Asset Ratio effectively.

**(iv) Reduced borrowing Cost:** Since securitized papers are rated due to credit enhancement even they can also be issued at reduced rate as of debts and hence the originator earns a spread, resulting in reduced cost of borrowings.

(B) From the **angle of investor**

Following benefits accrues to the investors of securitized securities.

**(i) Diversification of Risk**: Purchase of securities backed by different types of assets provides the diversification of portfolio resulting in reduction of risk.

**(ii) Regulatory requirement:** Acquisition of asset backed belonging to a particular industry say micro industry **helps banks to meet regulatory requirement** of investment of fund in industry specific.

**(iii) Protection against default**: In case of recourse arrangement if there is any default by any third party then originator shall make good the least amount. Moreover, there can be insurance arrangement for compensation for any such default.

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| Q6 | Explain the pricing of the securitized instruments | SA.D21 |
| Q6 | Explain pricing of the securitized instruments | RTP.N23 |
| Q6 | "While pricing the securitized instruments, it is important that it should be acceptable to both originators as well as to the investors". Explain. | MTP.N21 |

A6 ***

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.

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| Q7 | Participants are required for the success of the securitisation process. Discuss their roles. | SA.J21 |
| Q7 | Discuss about the Primary Participants in the process of Securitization | SA.N18 |
| Q7 | Explain the Secondary Participants involved in the process of Securitization of Instruments. | RTP.M21 |
| Q7 | Explain the Secondary Participants involved in the process of Securitization of Instruments. | MTP.M23 |
| Q7 | Primary participants and secondary participants in securitization | RTP.M18 |
| Q7 | Explain the Secondary Participants involved in the process of Securitization of Instruments. | MTP.O23 |

A7 ***

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

**Primary Participants**

a) **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.

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 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**

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.

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| Q8 | Briefly explain the steps involved in Mechanism of Securitization. | SA.M19 |
| Q8 | Discuss briefly the steps involved in the Securitization mechanism. | SA.M18 |
| Q8 | Discuss briefly the steps in securitization mechanism. | RTP.M20 |

A8 ***

The steps involved in mechanism of securitization are as follows:

**(i) Creation of Pool of Assets:** The process of securitization begins with creation of pool of assets by segregation of assets backed by similar type of mortgages in terms of interest rate, risk, maturity and concentration units.

**(ii) Transfer to SPV**: Once assets have been pooled, they are transferred to Special Purpose Vehicle (SPV) especially created for this purpose.

**(iii) Sale of Securitized Papers**: SPV designs the instruments based on nature of interest, risk, tenure etc. based on pool of assets. These instruments can be Pass Through Security or Pay Through Certificates.

**(iv) Administration of assets:** The administration of assets in subcontracted back to originator which collects principal and interest from underlying assets and transfer it to SPV, which works as a conduit.

**(v) Recourse to Originator:** Performance of securitized papers depends on the performance of underlying assets and unless specified in case of default they go back to originator from SPV.

**(vi) Repayment of funds:** SPV will repay the funds in form of interest and principal that arises from the assets pooled.

**(vii) Credit Rating to Instruments:** Sometime before the sale of securitized instruments credit rating can be done to assess the risk of the issuer.

| Q9 | Briefly explain Blockchain transaction. List the risks associated with Blockchain | MTP.A24 |
|---|---|---|
| A9 | Blockchain, sometimes referred to as **Distributed Ledger Technology (DLT)** is a **shared, peer-to-peer, and decentralized open ledger of transactions system with no trusted third parties in between**. This ledger database has every entry as permanent as it is an append-only database which cannot be changed or altered. All **transactions are fully irreversible** with any change in the transaction being recorded as a new transaction.<br>Some of the risk associated with the use blockchain technology are as follows:<br>**(i)** With the use of blockchain, organizations need to consider risks with a wider perspective as **different members of a particular blockchain may have different risk appetite**/risk tolerances that may further lead to **conflict when monitoring controls are designed for a blockchain**. There may be questions about **who is responsible** for managing risks if no one party is in-charge, and **how proper accountability is to be achieved in a blockchain.**<br>**(ii)** The **reliability** of financial transactions **is dependent on the underlying technology** and **if this underlying** consensus mechanism has been **tampered** with, it could render the financial information stored in the ledger to be **inaccurate and unreliable**.<br>**(iii)** In the **absence of any central authority to administer and enforce protocol amendments**, there could be a challenge in the development and maintenance of process control activities and in such case, users of public blockchains find difficult to obtain an understanding of the general IT controls implemented and the effectiveness of these controls.<br>**(iv)** As blockchain involves humongous data getting updated frequently, **risk related to information overload could potentially challenge** the level of monitoring required. Furthermore, to find competent people to design and perform effective monitoring controls may again prove to be difficult. | |
| Q 10 | Tokenization to some extent resembles the process of Securitization. Explain the term "Tokenization " and also illustrate the similarities between Tokenization and Securitization. | MTP.M24 |
| A 10 | Tokenization is a **process of converting tangible and intangible assets into blockchain tokens**. Digitally representing anything has recently acquired a lot of traction. It can be effective in conventional industries like real estate, artwork etc. Tokenization and Securitization Since **tokenization of illiquid assets attempts to convert illiquid assets into a product that is liquid and tradable** and hence to some extent it **resembles the process of Securitization**. Hence, following are some similarities between Tokenization and Securitization:<br>**(i) Liquidity**: - First and foremost both Securitization and Tokenization **inject liquidity** in the market for the assets which are otherwise illiquid assets.<br>**(ii) Diversification**: - Both help investors to diversify their portfolio thus managing risk and optimizing returns.<br>**(iii) Trading:** - Both are tradable hence helps to generate wealth.<br>**(iv) New Opportunities:** - Both provide opportunities for financial institutions and related agencies to earn income through collection of fees | |

# Ch.8 Mutual Funds

| QA | Description | Ref. |
|---|---|---|
| Q1 | Index Funds is one of the Special Funds. What are other funds in Special Funds category? | SA.M23 |
| A1 | The other funds in Special Fund category are as follows:<br><br>a) **International Funds**: A mutual fund located in India to **raise money in India** for **investing globally**.<br>b) **Offshore Funds:** A mutual fund located in India to **raise money globally** for **investing in India**.<br>c) **Sector Funds**: They invest their entire fund in a **particular industry** e.g. utility fund for utility industry like power, gas, public works.<br>d) **Money Market Funds**: These are predominantly **debt-oriented schemes**, whose main objective is preservation of capital, easy liquidity and moderate income. To achieve this objective, liquid funds invest predominantly in safer short-term instruments like Commercial Papers, Certificate of Deposits, Treasury Bills, G-Secs etc.<br>e) **Fund of Funds**: Fund of Funds (FoF) as the name suggests are schemes which **invest in other mutual fund** schemes. The concept is popular in markets where there are number of mutual fund offerings and choosing a suitable scheme according to one's objective is tough. Just as a mutual fund scheme invests in a portfolio of securities such as equity, debt etc., the underlying investments for a FoF is the units of other mutual fund schemes, either from the same fund family or from other fund houses.<br>f) **Capital Protection Oriented Fund**: The term 'capital protection oriented scheme' means a mutual fund scheme which is designated as such and which endeavours **to protect the capital invested** therein **through suitable orientation of its portfolio structure**. The orientation towards protection of capital originates from the portfolio structure of the scheme and not from any bank guarantee, insurance cover etc.<br>g) **Gold Funds**: The objective of these funds is to **track the performance of Gold**. The units represent the value of gold or gold related instruments held in the scheme. Gold Funds which are generally in the form of an Exchange Traded Fund (ETF) are listed on the stock exchange and offers investors an opportunity to participate in the bullion market without having to take physical delivery of gold.<br>h) **Quant Funds**: Quant Fund works on a **data-driven approach** for stock selection and investment decisions based on a **pre-determined rules or parameters** using statistics or mathematics-based models. | |
| Q2 | Describe Tracking error. List the reasons for it. | SA.M21 |
| A2 | Tracking error can be defined as the **divergence or deviation of a fund's return from the benchmarks return** it is following.<br>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.<br>The tracking error can be **calculated** on the **basis of corresponding benchmark return vis a vis quarterly or monthly average NAVs**.<br><br>**Reasons of Tracking Error**:<br><br>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:<br>• **Transaction cost**<br>• **Fees charged by AMCs**<br>• **Fund expenses**<br>• **Cash holdings**<br>• **Sampling biasness**<br>Thus, from above it can be said that to replicate the return to any benchmark index the tracking error should be near to zero. | |

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| Q3 | Side Pocketing enhances the value of the Mutual Fund. Do you agree? Briefly explain the process of side pocketing. | SA.N20 |
| Q3 | EXPLAIN the concept of side pocketing in mutual funds | RTP.M19 |
| A3 *** | 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.<br>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.<br>Thus, from the above it can be said that Side Pocketing helps to enhance the value of fund for the investors to some extent. | |
| Q4 | Briefly explain the concept of Exchange Traded Fund. | RTP.N19 |
| A4 | Exchange Traded Funds (ETFs) were introduced in US in 1993 and came to India around 2002. ETF is a **hybrid product** that **combines the features of an index mutual fund and stock** and hence, is **also called index shares**. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.<br>**ETF can be bought and sold like any other stock** on stock exchange. In other words, they can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day. NAV of an ETF is the value of the underlying component of the benchmark index held by the ETF plus all accrued dividends less accrued management fees.<br>There is no paper work involved for investing in an ETF. These can be bought like any other stock by just placing an order with a broker.<br>Some other important features of ETF are as follows:<br>1. It gives an investor the benefit of **investing in a commodity without physically purchasing** the commodity like gold, silver, sugar etc.<br>2. It is **launched by an asset management company** or other entity.<br>3. The investor does **not need to physically store** the commodity or bear the costs of upkeep which is part of the administrative costs of the fund.<br>4. An ETF **combines the valuation feature of a mutual fund** or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. | |
| Q5 | Explain briefly the financial measures that help in evaluation of performance of any Mutual Fund. | MTP.A24 |
| A5 | Financial Measures: - There are some financial measures that help in evaluation of performance of any Mutual Fund which are as follows:<br>a) **Expense Ratio**: - Discussed in earlier section, it ultimately impacts the return of a Mutual Fund Scheme.<br>b) **Sharpe Ratio**: - As discussed in the chapter on Portfolio Management, this ratio measures the Mutual **Fund's performance** measured **against the total risk (both systematic and unsystematic) taken**.<br>c) **Treynor Ratio:** - As discussed in the chapter on Portfolio Management, beta **measures the volatility of return** of a security **vis-à-vis to the market**, in mutual funds the Beta of a mutual fund measures volatility of a fund's return to return from its Benchmark. Treynor Ratio measures performance of a mutual fund against the systematic risk it has taken.<br>d) **Sortino Ratio**: - A **variation of Sharpe Ratio** that considers and uses downside deviation instead of total standard deviation in denominator. | |

# Ch.9 Derivatives Analysis And Valuation

| QA | Description | Ref. |
|---|---|---|
| Q1 | Explain in brief the following:<br>(i) Conversion factor in Interest Rate Futures.<br>(ii) VEGA and RHO in OPTION VALUE. | SA.N23 |
| A1 | (i) **Conversion factor**: All the deliverable bonds have different maturities and coupon rates. **To make them comparable to each other, and also with the notional bond**, RBI introduced Conversion Factor. Conversion factor for each deliverable bond and for each expiry at the time of introduction of the contract is being published by NSE.<br>**(Conversion Factor) x (futures price) = actual delivery price for a given deliverable bond.**<br>(ii) **Vega: Sensitivity of option value to change in volatility**. Vega indicates an absolute change in option value for a one percent change in volatility.<br>For example, a Vega of 0.09 indicates an absolute change in the option's theoretical value will increase by 0.09 if the volatility percentage is increased by 1.0 or decreased by 0.09 if the volatility percentage is decreased by 1.0. Results may not be exact due to rounding. It can also be stated as the change in option price given a one percentage point change in volatility. Like delta and gamma, Vega is also used for hedging.<br>**Rho:** Rho is the **change in option price given a one percentage point change in the risk free interest rate**. It is the sensitivity of the option value to change in interest rate. Rho indicates an absolute change in option value for a one percentage change in the interest rate.<br>For example, a Rho of 0.06 indicates the option's theoretical value will increase by 0.06 if the interest rate is decreased by 1.0 | |
| Q2 | "The commodity characteristic approach defines feasible commodities for derivatives trading based on an extensive list of required commodity attributes." What are the required attributes? | SA.M23 |
| A2 | The following attributes are considered crucial for qualifying for the derivatives trade:<br>(1) A commodity should be **durable and** it should be **possible to store** it;<br>(2) Units must be **homogeneous**;<br>(3) The commodity must be subject to frequent **price fluctuations with wide amplitude**; supply and demand must be large;<br>(4) Supply must **flow naturally to market** and there must be breakdowns in an existing pattern of forward contracting. | |
| Q3 | Explain the difference between Forward and Future Contract. | RTP.N20 |

| Features | Forward | Futures |
|---|---|---|
| Trading | Forward contracts are traded on **personal basis** or on telephone or otherwise. | Futures Contracts are traded in a **competitive arena** |
| Size of Contract | Forward contracts are individually tailored and have **no standardized size** | Futures contracts are **standardized** in terms of quantity or amount as the case may be |
| Organized exchanges | Forward contracts are traded in an **over-the-counter** market. | Futures contracts are traded on **organized exchanges** with a designated physical location. |
| Settlement | Forward contracts **settlement takes place on the date** agreed upon between the parties. | Futures contracts **settlements are made daily** via. Exchange's clearing house. |
| Delivery date | Forward contracts **may be delivered on the dates** agreed upon and in terms of actual delivery. | Futures contracts **delivery dates are fixed** on cyclical basis and hardly takes place. However, it does not mean that here is no actual delivery. |
| Transaction costs | Cost of forward contracts is based on **bid – ask spread** | Futures contracts **entail brokerage fees** for buy and sell orders. |
| Margins | **Margins are not required** in forward contract | In futures contracts every participants is subject to **maintain margin** as decided by the exchange authorities |
| Credit risk | In forward contract, **credit risk** is born by each party and, therefore, every party has to bother for the creditworthiness. | In futures contracts the transaction is a two way transaction, hence the parties need **not to bother for the risk**. |

| Q4 | EXPLAIN cash settlement and physical settlement in derivative contracts and their relative advantages and disadvantages. | RTP.M19 |
|---|---|---|
| A4 | The **physical settlement** in case of derivative contracts means that **underlying assets are actually delivered** on the specified delivery date. In other words, traders will have to take delivery of the shares against position taken in the derivative contract.<br><br>In case of **cash settlement**, the seller of the derivative contract **does not deliver the underlying asset but transfers the Cash**. It is similar to Index Futures where the purchaser, who wants to settle the contract in cash, will have to pay or receive the difference between the Spot price of the contract on the settlement date and the Futures price decided beforehand since it is impossible to effect the physical ownership of the underlying securities.<br><br>The **main advantage of cash settlement** in derivative contract is **high liquidity** because of more derivative volume in cash segment. Moreover, the underlying stocks in derivative contracts has constricted bid-ask spreads. And, trading in such stocks can be effected at lower impact cost. If the stock is liquid, the impact cost of bigger trades will be lower.<br>Further, **an adverse move can be hedged**. For example, the investors can take a covered short derivative position by selling the future while still holding the underlying security.<br>Also, a liquid derivative market **facilitates the traders to do speculation**. The speculative trading may worry the regulators but it is also true that without speculative trading, it will not be possible for the derivative market to stay liquid.<br><br>So, this leads to some arguments in favour of physical settlement in derivative contract. **One advantage of physical settlement** is that it is **not subject to manipulation by both the parties** to the derivative contract. This is so because the entire activity is monitored by the broker and the clearing exchange.<br>However, one main **disadvantage of physical delivery** is that it is almost **impossible to short sell a stock** in the Indian Market.<br><br>Therefore, in the end, it can be concluded that, though, physical settlement in derivative contract does curb manipulation it also affects the liquidity in the derivative segment. | |
| Q5 | While in securitization the securities issued by SPV are backed by the loans and receivables the CDOs are backed by pool of bonds, asset backed securities, REITs, and other CDOs. Describe the main types of risk associated with investment in CDOs | MTP.M24 |
| A5<br>*** | The main types of risk associated with investment in CDOs are as follows:<br><br>**(i) Default Risk**: - Also called 'credit risk', it emanates from the default of underlying party to the instruments. The prime sufferers of these types of risks are equity or junior tranche in the waterfall.<br>**(ii) Interest Rate Risk**: - Also called Basis risk and mainly arises due to different basis of interest rates. For example, asset may be based on floating interest rate but the liability may be based on fixed interest rates. Though this type of risk is quite difficult to manage fully but commonly used techniques such as swaps, caps, floors, collars etc. can be used to mitigate the interest rate risk.<br>**(iii) Liquidity Risk:** - Another major type of risk by which CDOs are affected is liquidity risks as there may be mismatch in coupon receipts and payments.<br>**(iv) Prepayment Risk:** - This risk results from unscheduled or unexpected repayment of principal amount underlying the security. Generally, this risk arises in case assets are subject to fixed rate of interest and the debtors have a call option. Since, in case of falling interest rates they may pay back the money.<br>**(v) Reinvestment Risk:** - This risk is generic in nature as the CDO manager may not find adequate opportunity to reinvest the proceeds when allowed for substitutions.<br>**(vi) Foreign Exchange Risk:** - Sometimes CDOs are comprised of debts and loans from countries other than the country of issue. In such a case, in addition to above mentioned risks, CDOs are also subject to the foreign exchange rate risk. | |

| Q6 | Explain briefly the various factors that affect the value of an Option | MTP.A23 |
|---|---|---|
| Q6 | Explain briefly the various factors that affects the value of option. | MTP.O23 |

A6 ***

Factors affecting the value of an option are:

a) **Price Movement of the Underlying**: The value of calls and puts are affected by changes in the underlying stock price in a relatively straightforward manner. When the stock price goes up, calls should gain in value and puts should decrease. Put options should increase in value and calls should drop as the stock price falls.

b) **Time till expiry**: The option's future expiry, at which time it may become worthless, is an important and key factor of every option strategy. Ultimately, time can determine whether your option trading decisions are profitable. To make money in options over the long term, you need to understand the impact of time on stock and option positions.
With stocks, time is a trader's ally as the stocks of quality companies tend to rise over long periods of time. But time is the enemy of the options buyer. If days pass without any significant change in the stock price, there is a decline in the value of the option. Also, the value of an option declines more rapidly as the option approaches the expiration day. That is good news for the option seller, who tries to benefit from time decay, especially during that final month when it occurs most rapidly.

c) **Volatility in Stock Prices**: Volatility can be understood via a measure called Statistical (sometimes called historical) Volatility, or SV for short. SV is a statistical measure of the past price movements of the stock; it tells you how volatile the stock has actually been over a given period of time.
But to give you an accurate fair value for an option, option pricing models require you to put in what the future volatility of the stock will be during the life of the option. Naturally, option traders don't know what that will be, so they have to try to guess. To do this, they work the options pricing model "backwards" (to put it in simple terms). After all, you already know the price at which the option is trading; you can also find the other variables (stock price, interest rates, dividends, and the time left in the option) with just a bit of research. So, the only missing number is future volatility, which you can calculate from the equation.

d) **Interest Rate**: Another feature which affects the value of an Option is the time value of money. The greater the interest rates, the present value of the future exercise price are less.

# Ch.10 Foreign Exchange Exposure & Risk Mgmt

| QA | Description | Ref. |
|---|---|---|
| Q1 | Write a short note on Money Market Hedging | SA.N22 |
| A1<br>*** | At its simplest, a **money market hedge** is an agreement to **exchange a certain amount of one currency for a fixed amount of another currency, at a particular date**. For example, suppose a business owner in India expects to receive 1 Million USD in six months. This Owner could create an agreement now (today) to exchange 1Million USD for INR at roughly the current exchange rate. Thus, if the USD dropped in value by the time the business owner got the payment, he would still be able to exchange the payment for the original quantity of U.S. dollars specified.<br>**Advantages** of Money Market Hedging<br>**(i)** Fixes the future rate, thus eliminating downside risk exposure.<br>**(ii)** Flexibility with regard to the amount to be covered.<br>**(iii)** Money market hedges may be feasible as a way of hedging for currencies where forward contracts are not available.<br>**Disadvantages** of Money Market Hedging<br>**(iv)** More complicated to organize than a forward contract.<br>**(v)** Fixes the future rate - no opportunity to benefit from favorable movements in exchange rates. | |
| Q2 | Briefly discuss the concept of Purchasing Power Parity. | RTP.N19 |
| A2 | **Purchasing Power Parity (PPP)**: Purchasing Power Parity theory focuses on the '**inflation – exchange rate' relationship**. There are two forms of PPP theory:-<br><br>The **ABSOLUTE FORM**, also called the **'Law of One Price'** suggests that "**prices of similar products** of **two different countries should be equal when measured in a common currency**". If a discrepancy in prices as measured by a common currency exists, the demand should shift so that these prices should converge.<br><br>The **RELATIVE FORM** is an alternative version that **accounts for the possibility of market imperfections such as transportation costs**, tariffs, and quotas. It suggests that 'because of these market imperfections, prices of similar products of different countries will not necessarily be the same when measured in a common currency.' However, it states that the rate of change in the prices of products should be somewhat similar when measured in a common currency, as long as the transportation costs and trade barriers are unchanged.<br>The formula for computing the forward rate using the inflation rates in domestic and foreign countries is as follows:<br><br>**Forward Rate = Spot Rate(1+ domestic inflation)/(1+Inflation Rate in foreign country)**<br><br>Thus PPP theory states that the exchange rate between two countries reflects the relative purchasing power of the two countries i.e. the price at which a basket of goods can be bought in the two countries. | |
| Q3 | All dealings in Foreign Exchange effect the Exchange Position whether delivery has taken place or not, but Cash Position is effected only when actual delivery has taken place. Explain. | MTP.N21 |
| A3 | Yes, this statement is correct because while **Exchange Position is referred to total of purchases or sale of commitment of a bank to purchase or sale foreign exchange whether actual delivery has taken place or not**. In other words, all transactions for which bank has agreed with counter party are entered into exchange position on the date of the contract.<br>While Cash Position is outstanding balance (debit or credit) in bank's Nostro account. Since **all foreign exchange dealings of bank are routed through Nostro account it is credited for all purchases and debited for sale by bank**.<br>Therefore, all transactions effecting Cash position will affect Exchange Position not vice versa. | |

# Ch.11 International Financial Management

<table>
<tr><th>QA</th><th>Description</th><th>Ref.</th></tr>
<tr><td>Q1</td><td>What are Foreign Currency Convertible Bonds? What are their advantages?</td><td>SA.M22</td></tr>
<tr><td>A1</td><td colspan="2">A type of convertible bond issued in a currency different than the issuer's domestic currency. In other words, the money being raised by the issuing company is in the form of a foreign currency.<br><br>A convertible bond is a mix between a debt and equity instrument. It acts like a bond by making regular coupon and principal payments, but these bonds also give the bondholder the option to convert the bond into stock.<br><br>Advantages of FCCBs<br>(i) The convertible bond gives the investor the flexibility to convert the bond into equity at a price or redeem the bond at the end of a specified period, normally three years if the price of the share has not met his expectations.<br>(ii) Companies prefer bonds as it leads to delayed dilution of equity and allows company to avoid any current dilution in earnings per share that a further issuance of equity would cause.<br>(iii) FCCBs are easily marketable as investors enjoys option of conversion into equity if resulting to capital appreciation. Further investor is assured of a minimum fixed interest earnings.</td></tr>
<tr><td>Q2</td><td>List the main objectives of International Cash Management</td><td>SA.N19</td></tr>
<tr><td>A2</td><td colspan="2">The main objectives of an effective system of international cash management are:<br>1) To minimise currency exposure risk.<br>2) To minimise overall cash requirements of the company as a whole without disturbing smooth operations of the subsidiary or its affiliate.<br>3) To minimise transaction costs.<br>4) To minimise country's political risk.<br>5) To take advantage of economies of scale as well as reap benefits of superior knowledge<br><br>International Cash Management has two basic objectives:<br>1. Optimising Cash Flow movements.<br>2. Investing excess cash.</td></tr>
<tr><td>Q3</td><td>Discuss briefly the important constituents of International Financial Centre (IFC).</td><td>SA.M19</td></tr>
<tr><td>Q3</td><td>DESCRIBE the constituents of International Financial Centers (IFC)</td><td>RTP.N18</td></tr>
<tr><td>A3<br>***</td><td colspan="2">Some of the important constituents of International Financial Centre (IFC) are as follows:<br>(i) Highly developed Infrastructure: - A leading edge infrastructure is prerequisite for creating a platform to offer internationally completive financial services.<br>(ii) Stable Political Environment: - Destabilized political environment brings country risk investment by foreign nationals. Hence, to accelerate foreign participation in growth of financial centre, stable political environment is prerequisite.<br>(iii) Strategic Location: - The geographical location of the finance centre should be strategic such as near to airport, seaport and should have friendly weather.<br>(iv) Quality Life: - The quality of life at the centre showed be good as centre retains highly paid professional from own country as well from outside.<br>(v) Rationale Regulatory Framework: - Rationale legal regulatory framework is another prerequisite of international finance centre as it should be fair and transparent.<br>(vi) Sustainable Economy: - The economy should be sustainable and should possess capacity to absorb all the shocks as it will boost investors' confidence.</td></tr>
</table>

| | | |
|---|---|---|
| Q4 | Briefly explain how a Centralized Cash Management system helps MNCs in their treasury management | RTP.N22 |
| A4 | A Centralized Cash Management system helps MNCs in their treasury management as follows:<br>a) To **maintain minimum cash balance** during the year.<br>b) To manage **judiciously liquidity requirements of the centre**.<br>c) To optimally use various **hedging strategies** so that MNC's foreign **exchange exposure is minimised**.<br>d) To aid the centre to **generate maximum returns** by **investing all cash resources optimally**.<br>e) To aid the centre to take **advantage of multinational netting** so that **transaction costs and currency exposure are minimised**.<br>f) To make **maximum utilization of transfer pricing** mechanism so that the firm enhances its profitability and growth.<br>g) To **exploit currency movement** correlations:<br>(i) **Payables & receivables** in different currencies having **positive correlations**.<br>(ii) **Payables** of different currencies having **negative correlations**.<br>(iii) **Pooling of funds allows for reduced holding** – the variance of the total cash flows for the entire group will be smaller than the sum of the individual variances. | |
| Q5 | There exists a vast difference between Project and Parent cash flow? What are these factors? Briefly discuss. | RTP.M22 |
| A5 | There exists a big difference between the project and parent cash flows due to tax rules, exchange controls.<br>**Management and royalty payments** are returns to the parent firm. The **basis on which a project** shall be evaluated depend on **one's own cash flows, cash flows accruing to the parent firm or both**.<br>Evaluation of a project on the **basis of own cash flows** entails that the project should compete favourably with domestic firms and earn a return higher than the local competitors. If not, the shareholders and management of the parent company shall invest in the equity/government bonds of domestic firms. A comparison cannot be made since foreign projects replace imports and are not competitors with existing local firms. Project evaluation based on **local cash flows avoid currency conversion and eliminates problems associated with fluctuating exchange rate**. | |
| Q6 | Describe the salient features of Foreign Currency Convertible Bonds. | RTP.M21 |
| A6 | The salient features of FCCBs are as follows:<br>1. FCCB is a bond **denominated in a foreign currency** issued by an Indian company which **can be converted into shares** of the Indian Company denominated in Indian Rupees.<br>2. **Prior permission** of the Department of Economic Affairs, **Government** of India, Ministry of Finance is required for their issue<br>3. There will be a **domestic and a foreign custodian** bank involved in the issue<br>4. FCCB shall be issued subject to all **applicable Laws** relating to issue of capital by a company.<br>5. Tax on FCCB shall be as per provisions of **Indian Taxation Laws and Tax will be deducted at source**.<br>6. **Conversion of bond to FCCB** will **not give rise** to any **capital gains tax** in India. | |

# Ch.12 Interest Rate Risk Management

<table>
<tr><th>QA</th><th>Description</th><th>Ref.</th></tr>
<tr><td>Q1</td><td>Swaptions can be applied for speculation purposes or to hedge a portion of their swap books. What are the other areas of its application?</td><td>SA.M23</td></tr>
<tr><td>A1<br>***</td><td colspan="2">The other areas of application of Swaption other than for speculation are as follows:<br>a) It can be applied in a variety of ways for both active traders as well as for corporate treasurers.<br>b) It have become useful tools for hedging embedded optionality which is common to the natural course of many businesses.<br>c) It is useful to borrowers targeting an acceptable borrowing rate.<br>d) It is also useful to those businesses tendering for contracts.<br>e) It also provides protection on callable/puttable bond issues.</td></tr>
<tr><td>Q2</td><td>Briefly explain Asset and Liability Management (ALM).</td><td>SA.N22</td></tr>
<tr><td>A2</td><td colspan="2">Asset-Liability Management (ALM) is one of the important tools of risk management in commercial banks of India. Indian banking industry is exposed to a number of risks prevailing in the market such as market risk, financial risk, interest rate risk etc. The net income of the banks is very sensitive to these factors or risks.<br>ALM is a comprehensive and dynamic framework for measuring, monitoring and managing the market risk of a bank. It is the management of structure of Balance Sheet (liabilities and assets) in such a way that the net earnings from interest are maximized within the overall risk preference (present and future) of the institutions. The ALM functions extend to liquidly risk management, management of market risk, trading risk management, funding and capital planning and profit planning and growth projection.<br><br>Banks and other financial institutions provide services which expose them to various kinds of risks like credit risk, interest risk, and liquidity risk. Asset liability management is an approach that provides institutions with protection that makes such risk acceptable. Asset-liability management models enable institutions to measure and monitor risk, and provide suitable strategies for their management.<br><br>It is therefore appropriate for institutions (banks, finance companies, leasing companies, insurance companies, and others) to focus on asset-liability management when they face financial risks of different types. Asset-liability management includes not only a formalization of this understanding, but also a way to quantify and manage these risks.<br><br>In a sense, the various aspects of balance sheet management deal with planning as well as direction and control of the levels, changes and mixes of assets, liabilities, and capital.</td></tr>
<tr><td>Q3</td><td>Define Interest Rate Swaption. State its principal features</td><td>SA.M21</td></tr>
<tr><td>A3</td><td colspan="2">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.<br>There are two types of swaption contracts: -<br>• A fixed rate payer swaption (also called Call Swaption).<br>• A fixed rate receiver swaption (also called Put Swaption).<br><br>Principal Features of Swaptions<br>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.<br>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.<br>C. The 'option period' refers to the time which elapses between the transaction date and the expiry date.<br>D. The swaption premium is expressed as basis points.<br>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.</td></tr>
</table>

| Q4 | Explain various methods of hedging of interest rate risk | SA.N22 |
|---|---|---|
| A4<br>*** | Methods of Hedging of Interest Rate Risk can be broadly divided into following two categories:<br>**(A) Traditional Methods**: These methods can further be classified in following categories:<br>**(i) Asset and Liability Management (ALM):** ALM is a comprehensive and dynamic framework for measuring, monitoring and managing the market risk of a bank. It is the management of structure of Balance Sheet (liabilities and assets) in such a way that the net earnings from interest are maximized within the overall risk preference (present and future) of the institutions.<br>**(ii) Forward Rate Agreement (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. 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 interest cost if Reference Rate fall below the forward rate.<br><br>(B) Modern Methods: These methods can further be classified in following categories:<br>**(i) Interest Rate Futures (IRF)**: An interest rate future is a contract between the buyer and seller agreeing to the future delivery of any interest-bearing asset. The interest rate future allows the buyer and seller to lock in the price of the interest-bearing asset for a future date.<br>**(ii) Interest Rate Options (IRO):** Also known as Interest Rate Guarantee (IRG) as option is a right not an obligation and acts as insurance by allowing businesses to protect themselves against adverse interest rate movements while allowing them to benefit from favourable movements.<br>It should be noted that the IRO is basically a series of FRAs which are exercisable at predetermined bench marked interest rates on each period say 3 months, 6 months etc.<br>**(iii) Interest Rate Swaps:** In an interest rate swap, the parties to the agreement, termed the swap counterparties, agree to exchange payments indexed to two different interest rates. Total payments are determined by the specified notional principal amount of the swap, which is never actually exchanged.<br>**(iv) Swaptions:** 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. | |
| Q5 | What is Net interest position risk and Price risk? | SA.M22 |
| A5 | **Net Interest Position Risk**: The **size of non-paying liabilities** is one of the significant factors **contributing towards profitability of banks**. Where banks have more earning assets than paying liabilities, interest rate risk arises when the market interest rates adjust downwards. Thus, banks with positive net interest positions will experience a reduction in NII as the market interest rate declines and increases when interest rate rises. Thus, **large float is a natural hedge against the variations in interest rates**.<br>**Price Risk:** Price risk **occurs when assets are sold before their stated maturities**. In the financial market, bond prices and yields are inversely related. The price risk is closely associated with the trading book, which is created for making profit out of short-term movements in interest rates.<br>Banks which have an active trading book should, therefore, formulate policies to limit the portfolio size, holding period, duration, defeasance period, stop loss limits, marking to market, etc. | |
| Q6 | What are the main features of Forward Rate Agreements (FRA)? | SA.D21 |
| A6 | A Forward Rate Agreement (FRA) is an **agreement between two parties through which a borrower/ lender protects itself from the unfavourable 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**.<br>• 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.<br>• It is an **off-Balance Sheet instrument**.<br>• 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.<br>• 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 speci fied 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 interest cost if Reference Rate fall below the forward rate. | |

# Ch.13 Business Valuation

| QA | Description | Ref. |
|---|---|---|
| Q1 | Differentiate between Economic Value Added (EVA) and Market Value Added (MVA) | SA.N20 |
| A1 | **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-<br>**EVA = NOPAT – (Invested Capital * WACC)**<br>**Or**<br>**NOPAT – Capital Charge**<br><br>**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. | |
| Q2 | Explain how Cash flow-based approach of valuation is different from Income based approach and also explain briefly the steps involved in this approach. | RTP.M21 |
| A2 | As opposed to the asset based and income-based approaches, the **cash flow approach takes into account the quantum of free cash that is available in future periods**, and discounting the same appropriately to match to the flow's risk.<br>Simply speaking, if the present value arrived post application of the discount rate is more than the current cost of investment, the **valuation of the enterprise is attractive to both stakeholders as well as externally interested parties** (like stock analysts). It attempts to overcome the problem of over-reliance on historical data.<br>There are essentially five steps in performing DCF based valuation:<br>**(i)** Arriving at the '**Free Cash Flows'**<br>**(ii)** Forecasting of **future cash flows** (also called projected future cash flows)<br>**(iii)** Determining the **discount rate** based on the cost of capital<br>**(iv)** Finding out the **Terminal Value** (TV) of the enterprise<br>**(v)** Finding out the **present values** of both the free cash flows and the TV, and interpretation of the results. | |
| Q3 | Relative Valuation approach is a significant departure from Intrinsic Value approach. Explain | MTP.N21 |
| A3 | To some extent this statement is correct as in practical implementation of fair value within the valuation context it would be **better to identify assets that are similar to the ones held by the acquiree company so that the values can be compared**. Trying to get a value that would be the nearest to the market price would mean that the valuation of a particular portfolio, or a divestiture in an entity, would happen at an agreeable price that fits into the normal distribution.<br>In one sense, **we are indeed using the relative valuation** in a limited approach **when we speak about expected market returns**, or when we are adopting an index-based comparative. The more the asset pricing gets correlated to the similar assets in the market, the more inclusive it gets. Thus, when we are comparing bonds, the **closer the YTM of the bond to the government index of return, the more credible it gets when it comes to pricing**.<br><br>The Relative valuation, also referred to as **'Valuation by multiples,' uses financial ratios to derive at the desired metric** (referred to as the 'multiple') and then compares the same to that of comparable firms. Comparable firms would mean the ones having similar asset and risk dispositions and assumed to continue to do so over the comparison period. In the process, there may be extrapolations set to the desired range to achieve the target set. | |

| Q4 | What is the difference between Management Buy Out and Leveraged Buyout? State the purpose of a leveraged buyout with the help of an example. | RTP.M20 |
|---|---|---|
| A4<br>*** | The difference between Management Buy Outs and Leveraged Buy Outs has been discussed as below:<br><br>**Management Buy Outs**<br>**Buyouts initiated by the management team** of a company are known as a management buyout. In this type of acquisition, the company is bought by its own management team. MBOs are considered as a useful **strategy for exiting those divisions that does not form part of the core business** of the entity.<br><br>**Leveraged Buyout (LBO)**<br>**An acquisition of a company or a division of another company which is financed entirely or partially (50% or more) using borrowed funds is termed as a leveraged buyout.** The target **company no longer remains public** after the leveraged buyout; hence the transaction is **also known as going private**. The deal is usually secured by the acquired firm's physical assets.<br><br>The intention behind an LBO transaction is **to improve the operational efficiency** of a firm and increase the volume of its sales, thereby increasing the cash flow of the firm. This extra cash flow generated will be used to pay back the debt in LBO transaction. After an, LBO the target entity is managed by private investors, which makes it easier to have a close control of its operational activities. The LBOs do not stay permanent. **Once the LBO is successful in increasing its profit margin and improving its operational efficiency and the debt is paid back**, **it will go public again**. Companies that are in a leading market position with proven demand for product, have a strong management team, strong relationships with key customers and suppliers and steady growth are likely to become the target for LBOs. In India the first LBO took place in the year 2000 when Tata Tea acquired Tetley in the United Kingdom. The deal value was ` 2135 crores out of which almost 77% was financed by the company using debt. The intention behind this deal was to get direct access to Tetley's international market. The largest LBO deal in terms of deal value (7.6 Billion) by an Indian company is the buyout of Corus by Tata Steel. | |

# Ch.14 Mergers Acquisitions & Corporate Restruct.

<table>
<tr><th>QA</th><th>Description</th><th>Ref.</th></tr>
<tr><td>Q1</td><td>Explain the reasons of Reverse Stock Split</td><td>SA.M19</td></tr>
<tr><td>A1<br>***</td><td colspan="2">‘Reverse Stock Split’ is a process whereby a company decreases the number of shares outstanding by combining current shares into fewer or lesser number of shares. For example, in a 5:1 reverse split, a company would take back 5 shares and will replace them with one share.<br>Although, reverse stock split does not result in change in Market value or Market Capitalization of the company but it results in increase in price per share. Considering above mentioned ratio, if company has 100 million shares outstanding before split up, the number of shares would be equal to 20 million after the reverse split up.<br>Reasons for Reverse Split Up<br>Generally, company carries out reverse split up due to following reasons:<br><br>(i) Avoiding delisting from stock exchange: Sometimes as per the stock exchange regulation if the price of shares of a company goes below a limit it can be delisted. To avoid such delisting company may resort to reverse stock split up.<br>(ii) Avoiding removal from constituents of Index: If company’s share its one of the constituents of market index then to avoid their removal of scrip from this list, the company may take reverse split up route.<br>(iii) To avoid the tag of “Penny Stock”: If the price of shares of a company goes below a limit it may be called “Penny Stock”. In order to improve the image of the company and avoiding this stage, the company may go for Reverse Stock Split.<br>(iv) To attract Institutional Investors and Mutual Funds: It might be possible that institutional investors may be shying away from acquiring low value shares to attract these investors the company may adopt the route of “Reverse Stock Split” to increase the price per share.</td></tr>
<tr><td>Q2</td><td>Explain some of the ‘sell-side’ imperatives in Mergers & Acquisitions</td><td>MTP.A24</td></tr>
<tr><td>A2</td><td colspan="2">The following are some of the ‘sell-side’ imperatives<br>➢ Competitor’s pressure is increasing.<br>➢ Sale of company seems to be inevitable because company is facing serious problems like:<br>• No access to new technologies and developments<br>• Strong market entry barriers. Geographical presence could not be enhanced<br>• Badly positioned on the supply and/or demand side<br>• Critical mass could not be realised<br>• No efficient utilisation of distribution capabilities<br>• New strategic business units for future growth could not be developed<br>• Not enough capital to complete the project<br>➢ Window of opportunity: Possibility to sell the business at an attractive price<br>➢ Focus on core competencies<br>➢ In the best interest of the shareholders – where a large well known firm brings-up the proposal, the target firm may be more than willing to give-up.</td></tr>
</table>

| Q3 | Explain different forms of divestitures | RTP.N22 |
|---|---|---|
| A3 | Different ways of divestment or demerger or divestitures are as follows:<br>a) **Sell off / Partial Sell off**: A sell off is the **sale of an asset**, factory, division, product line or subsidiary by one entity to another for a purchase consideration payable either in cash or in the form of securities. **Partial Sell off**, is a form of divestiture, wherein the firm **sells its business unit** or a subsidiary to another **because it deemed to be unfit with the company's core business strategy**. Normally, sell-offs are done because the subsidiary doesn't fit into the parent company's core strategy. The market may be undervaluing the combined businesses due to a lack of synergy between the parent and the subsidiary. So, the management and the board decide that the subsidiary is better off under a different ownership. Besides getting rid of an unwanted subsidiary, sell-offs also raise cash, which can be used to pay off debts. In the late 1980s and early 1990s, corporate raiders used debt to finance acquisitions.<br>b) **Spin-off**: In this case, a **part of the business is separated and created as a separate firm**. The existing shareholders of the firm get proportionate ownership. So, there is **no change in ownership** and the same shareholders continue to own the newly created entity in the same proportion as previously in the original firm. The management of spin-off division is however, parted with. Spin-off does not bring fresh cash. The **reasons for spin off** may be:<br>**(i)** **Separate identity** to a part/division.<br>**(ii)** To **avoid the takeover attempt** by a predator by making the firm unattractive to him since a valuable division is spun-off.<br>**(iii)** To create **separate Regulated and unregulated** lines of business.<br>c) **Split-up**: This involves **breaking up of the entire firm into a series of spin off** (by creating separate legal entities). The **parent firm no longer legally exists and only the newly created entities survive**. For instance, a corporate firm has 4 divisions namely A, B, C, D. All these 4 divisions shall be split-up to create 4 new corporate firms with full autonomy and legal status. The original corporate firm is to be wound up. Since de-merged units are relatively smaller in size, they are logistically more convenient and manageable. Therefore, it is understood that spin-off and split-up are likely to enhance shareholders value and bring efficiency and effectiveness.<br>d) **Equity Carve outs**: This is **like spin off**, however, **some shares of the new company are sold in the market by making a public offer**, so this brings cash. More and more companies are using equity carve-outs to boost shareholder value. A parent firm makes a subsidiary public through an initial public offering (IPO) of shares, amounting to a partial sell-off. A new publicly listed company is created, but the parent keeps a controlling stake in the newly traded subsidiary.<br>A **carve-out is a strategic avenue a parent firm may take when one of its subsidiaries is growing faster and carrying higher valuations than other businesses** owned by the parent. A carve-out generates cash because shares in the subsidiary are sold to the public, but the issue also unlocks the value of the subsidiary unit and enhances the parent's shareholder value. | |
| Q4 | Unrelated companies come together to form an entity. What this relationship is called? Discuss briefly the features of this entity. | RTP.M22 |
| A4 | Unrelated companies come together to form an entity. Such relationship is called **conglomerate merger**. Such **mergers involve firms engaged in unrelated type of business** operations. In other words, the business activities of acquirer and the target are neither related to each other horizontally (i.e., producing the same or competing products) nor vertically (having relationship of buyer and supplier).<br>Features:<br>• In a pure conglomerate merger, there are **no important common factors** between the companies in production, marketing, research and development and technology.<br>• There may however be **some degree of overlapping in one or more of these common factors**. Such mergers are in fact, unification of different kinds of businesses under one flagship company.<br>• The **purpose of merger remains utilization of financial resources**, enlarged debt capacity and also **synergy of managerial functions**. | |

| Q5 | Can a company with no commercial operations raise capital via an IPO? Discuss | RTP.N21 |
|---|---|---|
| A5 | Although the statement "a company with no commercial operation can launch an IPO" appears to be absurd but this is a fact that even if company does not have any business, it can float an IPO. In recent time the concept of **Special Purpose Acquisition Companies (SPACs) has come into existence wherein an entity is set up with the objective to raise funds through an IPO to finance a merger or acquisition of an unidentified target within a specific time period**. It is commonly known as a **blank cheque company.**<br><br>The **main objective of SPAC is to raise money**, despite having any operations or revenues. The **money raised** from the public is **kept in an escrow** account, which can be accessed while making the acquisition. However, in case the **acquisition is not made within stipulated period** of time of the IPO, the SPAC is delisted and the **money is returned** to the investors. Shareholders have the option to redeem their shares if they are not interested in participating in the proposed merger. Finally, if the merger is approved by shareholders, it is executed, and the target private company or companies become public entities. Once a formal merger agreement has been executed the SPAC target is usually publicly announced.<br><br>**New investment opportunities in Indian companies have resurfaced** and have set up new platform for SPAC transactions. The implementation of SPACs might face certain challenges since India does not have a specific regulatory framework guarding these transactions.<br><br>The current **regulatory framework in India does not support the SPAC transactions**. Further as per the Companies Act, 2013, the **Registrar of Companies is authorized to strike-off the name of companies that do not commence operation within one year of incorporation**. SPACs generally take 2 to 3 years to identify a target and performing due diligence and before it could get operationalized its name can be stricken off and hence enabling provisions relating to SPAC need to be inserted in the Companies Act in order to make it functional in India.<br><br>Though, **SPACs do not find acceptance under the Securities and Exchange Board of India (SEBI)** Act as it does not meet the eligibility criteria for public listing however SEBI is planning to come out with a framework for SPACs.<br><br>The **International Financial Services Centres Authority (IFSCA),** being the regulatory authority for development and regulation of financial services, financial products and financial institutions in the Gujarat International Finance Tec-City, has recently **released a consultation paper defining critical parameters** such as offer size to public, compulsory sponsor holding, minimum application size, minimum subscription of the offer size, etc. SPAC approach offers several advantages over traditional IPO, such as providing companies access to capital, even when market volatility and other conditions limit liquidity. SPACs help to lower the transaction fees as well as expedite the timeline in becoming a public company. Raising money through a SPAC is easier as compared to traditional IPO since the SPAC has already raised money through an IPO. This implies the company in question only has to negotiate with a single entity, as opposed to thousands of individual investors. This makes the process of fundraising a lot easier and quicker than through an IPO. The involvement of skilled professionals in identifying the target makes the investment a well thought and a well governed process.<br><br>However, the **merger of a SPAC with a target company presents several challenges,** such as **complex accounting and financial reporting**/registration requirements , to meet a public company readiness timeline and being ready to operate as a public company within a period of three to five months of signing a letter of intent.<br>It is typically **more expensive for a company to raise money through a SPAC than an IPO**. Investors' money invested in a SPAC trust to earn a suitable return for up to two years, could be put to better use elsewhere. | |

# Ch.15 Startup Finance

| QA | Description | Ref. |
|---|---|---|
| Q1 | NIYA Healthcare is a proprietary concern engaged in the manufacture and development of Pharmaceutical products since last five years. To scale up the business operations and increase the present turnover which is hovering around 500 Million, the proprietor decides to convert his existing business into a Private Limited Company. He also wants to get access to various tax benefits, easier compliances under the startup India initiative and get recognized as a startup company.<br>Advise whether NIYA Healthcare can be recognized as a startup company in view of the criteria considered eligible for the startup recognition initiated by the Government of India? | SA.N23 |
| Q1 | Enlist the criteria for an entity to be classified as a Startup entity under the Startup India Scheme initiated by the Government of India. | SA.M22 |
| Q1 | Explain the conditions that are required to be satisfied by an entity to be considered as a Startup vide GSR Notification 127 (E) dated 19th February 2019. | MTP.A23 |
| Q1 | As per GSR Notification dated 19th February 2019, what conditions an entity need to satisfy to be considered as a startup? | RTP.N23 |
| Q1 | What is a startup to avail the benefits of government scheme ? | SA.N19 |
| A1<br>*** | As per Government of India notification an entity can be considered as a Startup:<br>**(i)** If it is incorporated as a **private limited company** or registered as a **partnership** firm or a **limited liability partnership** in India upto a period of **10 years from date of incorporation** or registration.<br>**(ii)** **Turnover** of the entity for any of the financial years since incorporation/ registration has **not exceeded 100 crore rupees**.<br>**(iii)** Entity is **working towards innovation, development or improvement** of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.<br>Provided that an **entity formed by splitting up** or **reconstruction** of an existing business shall **not be considered a 'Startup'**.<br>**Advise**: In the present scenario, NIYA healthcare is converted into a private limited company. In other words there is a reconstruction of an exiting propriety business into a private limited company. In view of the above the company cannot be recognised as a startup company. | |
| Q2 | "In Deal Structuring, in many structures to facilitate the exit, the Venture Capital may put a tag-along clause". What do you mean by that clause? Explain Deal Structuring and Exit Plan to Venture Capital Investment Process. | SA.N23 |
| A2 | **Tag-alone clause** means VC is put by condition that **promoter must sell a part of his/ her stake along with the VC**.<br>**Deal Structuring:** Once the **case passes through the due diligence it would now go through the deal structuring**. The deal is structured in such a way that both parties win. In many cases, the convertible structure is brought in to ensure that the promoter retains the right to buy back the share.<br>**Exit plan:** At the **time of investing**, the **VC would ask the promoter** or company to spell out in detail the **exit plan**. Mainly, exit happens in two ways:<br>a) One way is **'sell to third party**(ies)'. This sale can be in the form of IPO or Private Placement to other.<br>b) The second way to exit is that **promoter would give a buy back commitment** at a pre agreed rate (generally between IRR of 18% to 25%). In case the exit is not happening in the form of IPO or third-party sell, the promoter would buy back. In many deals, the promoter buyback is the first refusal method adopted i.e. the promoter would get the first right of buyback. | |
| Q3 | Define Angle Investors, are these only individuals? If not, list the entities | SA.M22 |
| A3 | Despite being a country of many cultures and communities traditionally inclined to business and entrepreneurship, **India still ranks low on comparative ratings across entrepreneurship**, innovation and ease of doing business. The reasons are obvious. These include our old and outdated draconian rules and regulations which provides a hindrance to our business environment for a long time. Other reasons are red-tapism, our time-consuming procedures, and lack of general support for entrepreneurship. Off course, things are changing in recent times. | |

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| | **Angle Investors invest in small startups** or entrepreneurs. Often angle investors are among the entrepreneur's family and friends.<br>Though **angel investors usually represent individuals**, the **entity that actually provides the fund may be a limited liability company, a business, a trust** or an investment fund, among many other kinds of vehicles. | |
| Q4 | Personal Financing is one of the innovative ways to finance a startup. Discuss any four other methods | SA.M23 |
| Q4 | Explain briefly the sources for funding a Start-up. | SA.M19 |
| Q4 | Mr. R has completed his studies and wants to start his new online business. For a successful online business there are various expenditure costs with regards to advertisement & application development. To make the business successful he wants to raise funds. Explain some of the innovative sources for funding a start-up. | RTP.N21 |
| Q4 | What are some of the innovative ways to finance a start up? | RTP.M20 |
| Q4 | Non-bank Financial Sources are becoming popular to finance Start -ups. Discuss. | SA.J21 |
| Q4 | How Peer to Peer funding different from Crowd Funding ? | MTP.O23 |
| A4<br>*** | Innovative ways to finance startup are as follows:<br>**(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.<br>**(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 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.<br>**(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.<br>**(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 endeavours.<br>**(v) Crowdfunding**. 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.<br>**(vi) 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.<br>**(vii)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.<br>**(viii) 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.<br>**(ix) 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. | |
| Q5 | Explain alternatives available to offshore investors for making investments in Venture Capital Funds in India. | MTP.N21 |

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| Q5 | "A Limited Partnership Entity, in India, is not recognized for the purpose of Venture Capital Fund." Do you agree? Briefly explain the structure of Venture Capital Fund in India. | SA.M23 |
| A5 *** | Yes, agree with the statement.<br>Three main **types of fund structure** exist: one for domestic funds and two for offshore ones:<br>a) **Domestic Funds**: Domestic Funds (i.e. one which raises funds domestically) are usually structured as:<br>(i) A **domestic vehicle for** the **pooling of funds** from the investor, and<br>(ii) A **separate investment adviser** that carries those duties of asset manager.<br>The choice of entity for the pooling vehicle falls between a trust and a company, (India, unlike most developed countries does not recognize a limited partnership), with the trust form prevailing due to its operational flexibility.<br>b) **Offshore Funds**: Two common alternatives available to offshore investors are: the "offshore structure" and the "unified structure".<br>**<u>Offshore structure</u>**<br>Under this structure, an investment vehicle (an LLC or an LP organized in a jurisdiction outside India) makes **investments directly into Indian portfolio companies**. Typically, the assets are **managed by an offshore manager**, while the investment advisor in India carries out the due diligence and identifies deals.<br>**<u>Unified Structure</u>**<br>When **domestic investors are expected to participate** in the fund, a unified structure is used. **Overseas investors** pool their assets in an **offshore vehicle** that invests in a locally managed **trust**, whereas **domestic investors directly contribute to the trust**. This is later device used to make the local portfolio investments. | |
| Q6 | Write a short note on Venture Capital Fund. | SA.N22 |
| A6 | Venture Capital Fund means **investment vehicle that manage funds** of investors seeking **to invest in startup** firms and small businesses **with exceptional growth potential**. Venture capital is money provided by professionals who alongside management invest in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture Capitalists generally<br>• Finance **new and rapidly growing** companies<br>• Purchase **equity** securities<br>• Assist in the **development** of new products or services<br>• **Add value** to the company through active participation. | |
| Q7 | 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. | SA.D21 |
| Q7 | Explain the methods in which a Stratup firm can bootstrap. | RTP.N20 |
| Q7 | EXPLAIN the concept of Bootstrapping and describe the various methods of bootstrapping. | RTP.M18 |
| Q7 | 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 methods. | SA.N20 |
| A7 *** | When a person **attempts to found & build a company from personal finances** or from the **operating revenues** of the new company is called 'Bootstrapping'.<br>Some of the methods of this mode are as follows:<br>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.<br>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.<br>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. | |

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| Q8 | Write the characteristics of venture capital Financing | SA.D21 |
| Q8 | Venture Capital Financing is a unique way of financing Startup'. Discuss | RTP.M21 |
| Q8 | State the characteristics of Venture Capital financing | MTP.O23 |
| Q8 | State briefly the basic characteristics of venture capital financing? | SA.N19 |

A8 ***

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.

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| Q9 | Explain Indicative Risk Matrix of each stages of funding for Venture Capital Financing | SA.M21 |
| Q9 | Explain Indicative Risk Matrix of each stage of funding for Venture Capital Financing. | RTP.M23 |

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

| Financial Stage | 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 involve low level of financing.For supporting a concept or idea |
| 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 Stage | 3-5 | Sufficiently high | Expanding market and 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. |

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| Q10 | Venture Capital Funding passes through various stages. Discuss. | SA.J21 |

A10

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.

| Q11 | Explain Pitch Presentation. List the methods for approaching a Pitch Presentation | SA.M21 |
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| Q11 | During Pitch Presentation to convince the investors to put money into the proposed business how promoters deal with following points:<br>(i) Problem (ii) Solution (iii) Marketing/Sales (iv) Business Model | MTP.S23 |
| A11<br>*** | 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.<br>Some of the methods as how to approach a pitch presentation are as follows:<br><br>**1) Introduction**: Introduction of the start up and a brief account of yourself.<br>**2) Team:** What sort of team is working with the startup and their core competence need to be highlighted.<br>**3) Problem**: The promoter should be able to explain the problem he is going to solve and solutions emerging from it.<br>**4) Solution**: It is very important to describe in the pitch presentation as to how the company is planning to solve the problem.<br>**5) 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.<br>**6) 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.<br>**7) 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.<br>**8) 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.<br>**9) 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. | |
| Q12 | Peer – to – Peer Lending and Crowd funding are same and traditional methods of funding. Do you agree? Justify your stand. | SA.N20 |
| A12 | • No, I do not agree with the given statement because while **peer-to-peer lending is in existence for many years the crowd funding is contemporary source of finance** for Startup finance.<br>• Further in **peer-to-peer lending a group of people come together and lend money to each other**. Many small and ethnic business groups having similar faith or interest generally support each other in their start up endeavors.<br>• On the other hand, **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. | |
| Q13 | What do you mean by the term Unicorn? State the features a Start-up should possess to be referred as a Unicorn? | MTP.M24 |
| A13 | A Unicorn is a **privately held start-up** company which has **achieved a valuation US$ 1 billion**. This term was coined by venture capitalist Aileen Lee, first time in 2013. Unicorn, a mythical animal represents the statistical rarity of successful ventures.<br>A start-up is referred as a Unicorn if it has following features:<br>**(i)** A **privately held** start-up.<br>**(ii)** Valuation of start-up reaches **US$ 1 Billion**.<br>**(iii)** Emphasis is on the **rarity of success** of such start-up.<br>**(iv)** Other common **features are new ideas, disruptive innovation, consumer focus**, high on technology etc.<br>However, it is important to note that in case the valuation of any start-up slips below US$ 1 billion it can lose its status of 'Unicorn'. Hence a start-up may be Unicorn at one point of time and may not be at another point of time. | |

| Q14 | Explain Angel Investors. | SA.N18 |
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| Q14 | Who are Angel Investors and how they are different from Venture Capitalists. | MTP.N21 |
| A14 | Angel investors invest in **small startups or entrepreneurs**. Often, angel investors are entrepreneur's **family and friends**. The capital angel investors provide may be a one-time investment to help the business propel or an ongoing injection of money to support and carry the company through its difficult early stages.<br><br>Angel investors **provide more favorable terms** compared to other lenders, since they usually invest in the entrepreneur starting the business rather than the viability of the business. Angel investors are focused on helping startups take their first steps, rather than the possible profit they may get from the business. Essentially, angel investors are the opposite of venture capitalists.<br><br>**Angel investors are also called informal investors**, angel funders, private investors, seed investors or business angels. These are **affluent individuals who inject capital for startups in exchange for ownership equity or convertible debt**. Some angel investors invest through crowdfunding platforms online or build angel investor networks to pool in capital.<br><br>Angel investors typically **use their own money**, unlike venture capitalists who take care of pooled money from many other investors and place them in a strategically managed fund.<br>Though **angel investors usually represent individuals, the entity that actually provides the fund may be a limited liability company, a business, a trust or an investment fund**, among many other kinds of vehicles.<br><br>Angel investors who seed startups that fail during their early stages lose their investments completely. This is why professional angel investors look for opportunities for a defined exit strategy, acquisitions or initial public offerings (IPOs). | |
| Q15 | Explain the advantages of bringing venture capital in the company | SA.M18 |
| A15 | Advantages of bringing VC in the company:<br><br>❖ It **injects long- term equity** finance which provides a solid capital base for future growth.<br>❖ The venture capitalist is a **business partner, sharing both the risks and rewards**. Venture capitalists are rewarded with business success and capital gain.<br>❖ The venture capitalist is able to **provide practical advice** and assistance to the company based on past experience with other companies which were in similar situations.<br>❖ The venture capitalist also has a **network of contacts** in many areas that can add value to the company.<br>❖ The venture capitalist may be capable of **providing additional rounds** of funding should it be required to finance growth.<br>❖ Venture capitalists are **experienced in the process of preparing a company for an initial public offering** (IPO) of its shares onto the stock exchanges or overseas stock exchange such as NASDAQ.<br>❖ They can also **facilitate a trade sale**. | |

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| Q16 | Succession planning is a good way for companies to ensure that businesses are fully prepared to promote and advance all employees—not just those who are at the management or executive levels. Explain the above statement. | RTP.M24 |
| Q16 | Why is there a need for succession planning in business? Explain | MTP.A24 |
| A16 *** | Succession planning is the **process of identifying the critical positions** within an organization and **developing action plans for individuals to assume those positions**. A succession plan identifies future need of people with the skills and potential to perform leadership roles.<br><br>Taking a holistic view of current and future goals, this type of **preparation ensures that the right people are available for the right jobs today and in the years to come**. It can also provide a liquidity event, which enables the transfer of ownership in a going concern to rising employees.<br><br>**Need for succession** planning can be explained below:<br>❖ **Risk mitigation** – If existing leader quits, then searches can take six-nine months for suitable candidate to close. Keeping an organization without leader can invite disruption, uncertainty, conflict and endangers future competitiveness.<br>❖ **Cause removal** – If the existing leader is culpable of gross negligence, fraud, wilful misconduct, or material breach while discharging duties and has been barred from undertaking further activities by court, arbitral tribunal, management, stakeholders or any other agency.<br>❖ **Talent pipeline** – Succession planning keep employees motivated and determined as it can help them obtaining more visibility around career paths expected, which would help in retaining the knowledge bank created by company over a period of time and leverage upon the same.<br>❖ **Conflict Resolution Mechanism** – This planning is very helpful in promoting open and transparent communication and settlement of conflicts.<br>❖ **Aligning** – In family owned business succession planning helps to align with the culture, vision, direction and values of the business. | |
| Q17 | Compare and contrast start-ups and entrepreneurship. Describe the priorities and challenges which start-ups in India are facing. | RTP.N19 |
| A17 | Differences between a start-up and entrepreneurship<br>Startups are different from entrepreneurship. The major differences between them have been discussed in the following paragraphs:<br>**(i)** **Start up is a part of entrepreneurship**. **Entrepreneurship is a broader concept** and it includes a startup firm.<br>**(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.<br>**(iii)** A **startup generally does not have a major financial motive** whereas an established **entrepreneurship concern mainly operates on financial motive**.<br><br><u>Priorities and challenges which start-ups in India are facing</u><br>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.<br>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 escalate its cost. It leads to further delaying the chances of a breakeven or even earning some amount of profit. | |