CA FINAL

SUBJECT- CAPITAL MARKETS

Test Code –

(Date :)

(Marks - 100)

The question Paper comprises **five** case study questions. The candidates are required to answer any **four** case study questions out of five.

CASE STUDY : 1

The board of directors of the ABC Ltd, at its meeting held on June 11, 2019, has, with the subsequent approval of the members of the Company, by way of a special resolution through Postal Ballot ("Special Resolution"), results of which were declared on 5th August, 2019, approved the proposal to buy back its own fully paid-up Equity Shares of face value of Rs. 5 each ("Equity Shares") from the members of the Company (other than the Promoters, the Promoter Group and Persons in Control of the Company) payable in cash, for an amount aggregating to Rs. 8,260 crores ("Maximum Buyback Size") at a price not exceeding Rs. 800 per Equity Share ("Maximum Buyback Price"), under the open market route through the stock exchanges, in accordance with Companies Act, 2013 and the SEBI Buyback Regulations.

The Buyback has been implemented by the Company by way of Open Market Purchases through the stock exchanges; by the order matching mechanism except "all or none" order matching system, as provided under the Buyback Regulations. The buyback was completed within 6 weeks of the commencement date. Present EPS is Rs. 35.64 with total earnings off Rs. 15,570 Crore. Present P/E multiple is 21.24.

Relevant financial details are as below (All figures are in Rs. Crores):

As on	**Mar 31, 2019**	**Mar 31, 2018**	**Mar 31, 2017**	**Mar 31, 2016**
Equity Share Capital	2,184	1,092	1,148	1,148
Reserves and surplus*	60,749	62,410	66,869	59,934
Net worth/ Shareholders equity	62,933	63,502	68,017	61,082
Total debt**	20,000	18,000	16,000	15,000

Annexure '1'

Shareholding Pattern

Shareholders	Pre Buyback		Post Buy Back	
	Equity Shares	**% age**	**Equity Shares**	**% age**
Promoters and / or persons who are in the control and / or acting in concert (Promoter Group)	56,01,82,338	12.82%		
Indian Financial Institutions	31,73,073	0.07%		
Banks	17,09,234	0.04%		
Mutual Funds	58,46,44,086	13.38%		
Indian Public & Corporates	95,54,85,110	21.87%		
Foreign Institutional Investors	1,49,15,64,414	34.14%		
NRIs	2,58,96,923	0.59%		
Foreign Nationals and Overseas Corpora Bodies	21,618	0.01%		
American Depository Shares **(ADS)**	74,62,54,648	17.08%		
Total	**4,36,89,31,444**	**100.00%**		

Annexure '2' Share Price Scenarios

Week No.	No. of Shares offered in each week	Opening Price of Week (Rs.)	Closing Price of Week (Rs.)	Volume weighted avg price of shares (Rs.)
Week prior to 1	NA	740	745	750
1	Nil	760	765	755
2	1 .5 crores	750	760	740
3	2 crores	748	755	760
4	2.5 crores	775	778	785
5	3 crores	764	773	775
6	1.325 crores	770	785	790

Post closure of Buyback average closing price for ABC Ltd in Week 7 was 800, Week 8 was 810 and Week 9 was 805. It hit all-time new high of 840 in the meantime.

1.1 The 'Buyback Period' as per SEBI Guidelines is defined as period between: **(2 Marks)**

(A) The date of Board of Directors resolution to authorize the buyback of shares and the date on which the payment of consideration to shareholders who have accepted the buyback offer is made.

(B) The date of voting of postal ballot for special resolution to authorize the buyback of shares and the date on which the payment of consideration to shareholders who have accepted the buyback offer is made.

(C) The record date and the date on which the payment of consideration to shareholders who have accepted the buyback offer is made.

(D) The opening date of buyback on recognized stock exchange and the closing date of buyback on the recognized stock exchange.

1.2 The mode through which the Buyback can be executed as per SEBI Guidelines are: **(2 Marks)**

(A) Spot Transaction
(B) Private Arrangement
(C) Tender Offer
(D) Negotiated Deals

1.3 The letter of offer is dispatched on 5th June 2019 (Wednesday). Please calculate the date of opening of offer and closure of offer **(2 Marks)**

(A) 10th June 2019 and 25th June 2019
(B) 14th June 2019 and 28th June 2019
(C) 12th June 2019 and 25th June 2019
(D) 16th June 2019 and 30th June 2019

1.4 A Small Shareholder as per SEBI Guidelines is defined as

(A) who holds shares or other specified securities whose market value, on the basis of opening price of shares or other specified securities, on the recognized stock exchange in which highest trading volume in respect of such securities, as on record date is not more than two lakh rupees.
(B) who holds shares or other specified securities whose market value, on the basis of closing price of shares or other specified securities, on the recognized stock exchange in which highest trading volume in respect of such securities, as on record date is not more than five lakh rupees.
(C) who holds shares or other specified securities whose market value, on the basis of closing price of shares or other specified securities, on the recognized stock exchange in which highest trading volume in respect of such securities, as on date of offer letter is not more than two lakh rupees.
(D) who holds shares or other specified securities whose market value, on the basis of closing price of shares or other specified securities, on the recognized stock exchange in which highest trading volume in respect of such securities, as on record date is not more than two lakh rupees. **(2 Marks)**

1.5 If the Buy-back is through Book Building Process then the number of Bidding Centers should be:

(A) Not less than thirty and there shall be at least one electronically linked computer terminal at all the bidding centers.
(B) Not less than sixty centres spread across India.
(C) In all capital cities of the states as well as union Territories of India.
(D) None of the options **(2 Marks)**

QUESTIONS :

1.6 You are a Financial Advisor to Mr. B, a HNI, who wants to participate in the upcoming buyback of ABC Ltd.

Mr. B holds 5000 shares of ABC Ltd. He had bought them at an average price of Rs. 580. He offered his 2000 shares in Week 2, 2500 shares in Week 3 and balance 500 shares in Week 6.

Please advise him whether he should participate in the same or not with specific focus on:

(A) Necessity of buyback for any company and its shareholders **(1 Marks)**

(B) Pre and Post Buyback shareholding pattern - Use format in Annexure 'I' and assume that the Maximum Buyback Size is completed. **(1 Marks)**

(C) Financial returns for Mr. B and your recommendation. Please refer Annexure '2' for relevant inputs. **(3 Marks)**

1.7 You are a CFO of ABC Ltd. Please elaborate the step by step process which will be followed in such buyback issues with specific focus on :

(A) Calculate the amount that will have to be offered in Escrow Account with 50% in cash deposit and 50% in Bank Guarantee form. **(3 Marks)**

(B) The calculation of pay-out amount to investors if Maximum Buyback Size has been executed. Refer Annexure '2' for inputs. **(2 Marks)**

1.8 You are a Head-Compliance (SEBI), who looks after the compliance with various guidelines of SEBI. Please highlight the buyback related compliance for the proposed transaction.

(A) Discuss the compliance with 'Maximum Buyback Size' and identify the 'Minimum Buyback Size' as on the commencement of the buyback. **(3 Marks)**

(B) Calculate & discuss the compliance with Debt Equity Ratio for the buyback.

(2 Marks)

CASE STUDY : 2

You are practicing in the area of advisory services giving opinions on technical issues relating to the capital markets and financial instruments. The following questions have been raised by different clients for whom you need to explain your answers or give your opinion. Your clients range from well informed CFOs of companies to ordinary individuals.

(A) Answer the following:

(i) What is meant by a recognized stock exchange? Is there any stock exchange which is functional that is not recognized? (**2 Marks)**

(ii) Does SEBI (ICDR) Regulations 2009 (amended in 2017) apply to preference shares? If so, under which regulation? Explain in detail. **(2 Marks)**

(iii) Point out the flaws or the irregularities of the following proposal and state how rectification may be done, quoting relevant rules or sections or procedures and the authority:

IJK Ltd. wants to publicly issue for the first time, 10,00,000 equity shares of a face value of Rs. 10 by book building process. It wants to keep the bid open from the 14th of May 2018 up to 5th June 2018. The price band offered is to be fixed between Rs. 30 to Rs. 40 per share. The promoter intends to contribute to 15% of the shares proposed to be offered at Rs. 30 per share and hold the investment up to two years. To what extent can anchor investors provide the support necessary? **(3 Marks)**

(iv) In case the promoter is an individual, can his holding be counted for the limit applicable for a retail individual investor? State the regulation in support of your answer. **(2 Marks)**

(v) A soap manufacturing company has requested SEBI's prior approval to use a popular actor to advertise for the proposed equity issue to public. The same actor has been employed by the company to promote the sales of its soaps. Is it alright to grant approval? **(1 Marks)**

(vi) X is an individual having a surplus of Rs. 5 lacs. He is interested in investing the amount in shares of a company in an initial public offer. He has a preference for A Ltd. which is to open for subscription on 30th May 2018. The market predictions indicate an oversubscription of that issue. If he does not get any allotment or if he is allotted shares for any lesser value, he would like to invest in Company B Ltd. whose offer is to open on July 1st. He fears that his money will be blocked in the first issue and may not be refunded to him in time for him to apply for B Co. Ltd.'s issue. If he does not want to borrow any money for that purpose, how will he overcome the problem? Discuss. **(1 Marks)**

(vii) What do you mean by large cap, mid cap and small cap stocks? **(2 Marks)**

(viii) S & P BSE Sensex was 32840.5 on a certain day. On the same day, Nifty 50 was 10,287.70. Explain the vast difference between the numbers and the underlying concept. **(2 Marks)**

(ix) Will the equity share prices of a company be the same in both BSE and NSE at the same point in time? If so, explain the concept. If not, explain why they could differ? If they differ, will an investor not be able to profit by buying at a lower price and simultaneously selling it at a higher price? **(1 Marks)**

(x) Identify suitable investments (indicate broad category rather than specific instruments) that may ideally fit into the investment objectives of the following individuals:

Investment Objective	***Instrument***	***Instrument***
Growth and appreciation in value		
Regular Income		
Liquidity		
Capital Preservation		

(1 Marks)

(B) Choose the most appropriate answer from the following and give your reason:

(1 Marks x 5 = 5 Marks)

(You are required to only state the Roman numeral and the alphabet of choice in capital letters rather than copy the entire question into the answer books) :

(i) The following is true:

(A) An investment Bank needs no licence from RBI

(B) SEBI has to approve the draft prospectus within thirty days of submission to it. If no reply is received within 30 days of submission, it is deemed to have no objection and the company may proceed with public issue,

(C) A Merchant Banker shall not apply for the shares of its client company,

(D) An Asset Management Company is a Banking Company governed by the RBI to deal with a mutual fund's investments in different sections of the financial market.

(ii) The following commodity is not traded in the Indian Commodity Exchange:

(A) Diamonds

(B) Tomatoes

(C) Crude Oil

(D) Pepper

(iii) A company has receivables of Rs. 150 crores from four borrowers. It converts these into smaller portions of Rs. 500 each and sells these to smaller investors in the secondary market. This fragmentation of the loan is called

(A) Debt unit scheme

(B) Mutual fund scheme

(C) Debt securitization

(D) Asset Reconstruction

(iv) Margin Trading is the following:

(A) Stock brokers trade on the client's behalf up to the variation margin maintenance.

(B) Stockbrokers trade on the clients' behalf even consuming the initial margin.

(C) Investors buy more number of shares than they have money for by paying a lower proportion of the cost and getting the balance funded by their bankers.

(D) A stockbroker keeps a margin in his account with the stock exchange for the netting position shortfall among his clients.

(v) AM Inc., an American company wants to set up its marketing company in India. The following process does not violate Indian Regulations:

(A) AM has identified 205 entities / individuals in India who are willing to subscribe to the shares of the new company. AM would like to raise money from these persons and not invoke the provisions relating to public issue.

(B) AM will restrict the issue to about 150 persons and raise the capital without having to comply with SEBI regulations.

(C) AM will set up a Mutual Fund and offer its units to either the 150 or the 205 persons and use the proceeds to set up its new company and will comply with the SEBI (Mutual Fund) Regulations.

(D) AM will get a banking licence in India and set up the new company as the subsidiary of the banking company.

(C) Fill in the blanks : (The blank is not restricted to one word. There could be one to four words to fill the blanks. The question Roman numeral and the content filling the blank will be sufficient for presentation in the answer books)

(i) ___________is an arrangement between parties A and B, where A has given a loan to C and is afraid that C may not pay it back and in that case, B will make good A's loss. In return for this, B will charge a periodic premium from A. **(1 Mark)**

(ii) When shares are traded in the ________, the company's share capital account is not affected.

(1 Mark)

(iii) A group of engineers has designed an air conditioning machine which is a revolutionary product that efficiently admits fresh air circulation. This will replace the wide air conditioning market within the country. The new product has been successfully tested and is being patented. The group has had a start-up venture as a private limited company. A big company that enjoys over 50% of the air conditioning market, which is threatened by this product should attempt a ____________to retain its market leadership.

(1 Mark)

CASE STUDY : III

Suraksha Mutual Fund is one of the successful Mutual Funds operating in India and among other things, they have Index Fund and also Exchange Traded Fund (both NIFTY plans).

Table- A gives the Portfolio of Index Fund NIFTY Plan and Exchange Trade Fund (NIFTY Plan) of Suraksha MF.

Table- B gives the Key information of Index Fund NIFTY Plan of Suraksha MF.

Table- C gives the Key information of Exchange Trade Fund (NIFTY Plan) of the same Mutual Fund.

These have been given for illustrative purposes only. Not all of the data required as per the statutory disclosure policy have been presented in the above tables. Information may not have been presented with intent or for the reason that it is irrelevant.

Monthly Portfolio Statement as on December 31,2017		**INDEX FUND-NIFTY PLAN (An open ended scheme replicating/ tracking NIFTY 50)**	**ETF NIFTY BSES (An Open Ended Index Exchange Traded Fund)**
Name of the Instrument	**Industry / Rating**	**% to NAV**	**% to Net Assets**
Equity & Equity related			
(a) Listed / awaiting listing on Stock Exchanges			
HDFC Bank Limited	Banks	10.46%	10.47%
Reliance Industries Limited	Petroleum Products	8.81%	8.82%
Housing Development Finance Corporation Limited	Finance	7.45%	7.45%
Infosys Limited	Software	5.75%	5.75%
ITC Limited	Consumer Non - Durables	5.54%	5.55%
ICICI Bank Limited	Banks	5.33%	5.33%
Tata Consultancy Services Limited	Software	4.57%	4.57%
Larsen & Toubro Limited	Construction Project	4.07%	4.08%
Kotak Mahindra Bank Limited	Banks	3.85%	3.85%
Hindustan Unilever Limited	Consumer Non - Durables	2.98%	2.99%
State Bank of India	Banks	2.55%	2.55%
Axis Bank Limited	Banks	2.52%	2.53%
Maruti Suzuki India Limited	Auto	2.28%	2.28%
IndusInd Bank Limited	Banks	1.88%	1.88%
Mahindra & Mahindra Limited	Auto	1.72%	1.72%
Bajaj Finance Limited	Finance	1.44%	1.44%

Asian Paints Limited	Consumer Non - Durables	1.42%	1.42%
HCL Technologies Limited	Software	1.23%	1.23%
NTPC Limited	Power	1.16%	1.16%
Sun Pharmaceuticals Industries Limited	Pharmaceuticals	1.09%	1.09%
Oil & Natural Gas Corporation Limited	Oil	1.06%	1.06%
Power Grid Corporation of India Limited	Power	1.05%	1.05%
Tech Mahindra Limited	Software	1.04%	1.04%
UltraTech Cement Limited	Cement	0.96%	0.96%
Bharti Airtel Limited	Telecom-Services	0.95%	0.95%
Coal India Limited	Minerals/Mining	0.93%	0.93%
Hero MotoCorp Limited	Auto	0.93%	0.93%
Tata Steel Limited	Ferrous Metals	0.90%	0.90%
Bajaj Finserve Limited	Finance	0.90%	0.90%
Titan Company Limited	Consumer Durables	0.89%	0.89%
Vedanta Limited	Non-Ferrous Metals	0.86%	0.86%
Wipro Limited	Software	0.86%	0.86%
Bajaj Auto Limited	Auto	0.85%	0.85%
Yes Bank Limited	Banks	0.77%	0.77%
India Oil Corporation Limited	Petroleum Products	0.76%	0.76%
Hindalco Industries Limited	Non-Ferrous Metals	0.76%	0.76%
Grasim Industries Limited	Cement	0.75%	0.75%
GAIL (India) Limited	Gas	0.75%	0.75%
Eicher Motors Limited	Auto	0.74%	0.74%
Dr. Reddy's Laboratories Limited	Pharmaceuticals	0.73%	0.73%
Tata Motors Limited	Auto	0.72%	0.72%
JSW Steel Limited	Ferrous Metals	0.72%	0.72%
Adani Ports and Special Economic Zone Limited	Transportation	0.70%	0.70%
Bharat Petroleum Corporation Limited	Petroleum Products	0.67%	0.67%
Indiabulls Housing Finance Limited	Finance	0.65%	0.65%
UPL Limited	Pesticides	0.64%	0.64%
Zee Entertainment Enterprises Limited	Media & Entertainment	0.61%	0.61%
Cipla Limited	Pharmaceuticals	0.61%	0.61%
Bharti Infratel Limited	Telecom - Equipment & Accessories	0.51%	0.51%

Hindustan Petroleum Corporation Limited	Petroleum Products	0.43%	0.43%
Subtotal	**99.80%**	**99.86%**	
(b) UNLISTED			
Subtotal	NIL	NIL	
Total	99.80%	99.86%	
Money Market Instruments	-	-	
Triparty Repo	0.36%	2.36%	
Total	**0.36%**	**2.36%**	
Cash Margin - CCIL $	-	-	
Net Current Assets	**-0.16%**	**-2.22%**	
GRAND TOTAL	**100.00%**	**100.00%**	
$ Less Than 0.01% of NAV			

TABLE -B - Key information

SURAKSHA INDEX FUND NIFTY PLAN

The Product is suitable for Investors who are seeking

• Long Term Capital Growth

• Investment in Equity & equity related securities and portfolios replicating the composition of the NIFTY 50.

Current Investment Philosophy

The Scheme employs an investment approach designed to track the performance of the NIFTY 50 Index. The Scheme seeks to achieve this goal by investing in securities constituting the NIFTY 50 Index in same proportion as in the Index

Benchmark	**NIFTY 50**
Fund Size	Rs. 135.89 crores (Month End :137.23 crores)
NAV as on	Regular Growth Plan: Rs. 18.1422
31/12/2017 Direct	Direct Growth Plan: Rs. 18.7067
Volatility Measure	Standard Deviation 4.18 Beta 0.98 Sharpe Ratio 0.10
Load Structure	Entry Load: Nil
Exit Load: 0.25% if redeemed or switched out on or before completion of 7 days from the date of allotment of units. Nil thereafter.	
Total Expense Ratio	Regular, other than Direct 1.05% Direct 0.29%

TABLE - C - Key information

SURAKSHA EXCHANGE TRADED FUND NIFTY PLAN

The Product is suitable for Investors who are seeking

- • Long Term Capital Growth
- • *Investment in Equity & equity related securities and portfolios replicating the composition of the NIFTY 50*

Current Investment Philosophy

The Scheme employs a passive investment approach designed to track the performance of NIFTY 50 Index. The Scheme seeks to achieve this goal by investing in securities constituting NIFTY 50 Index in same proportion as in the Index.

Benchmark	***NIFTY 50***
Fund Size	999,14 crores (Month End: 1048.98 crores)
NAV as on 31/12/2017	Rs. 1136.2932
Volatility Measure	Standard Deviation 4.16 Beta 0.98
Sharpe Ratio	0.12
Load Structure	Entry Load: Nil Exit Load: Nil
Total Expense Ratio	0.11 %
Pricing (per unit)	1/10th of Index
Exchange	Listed NSE

PART – A

You are required to select the most appropriate answer.
(Where reasons have to be given, the same is indicated in the question)

1. An investor is required to have a------------ and----------- to purchase/sell an ETF of a Mutual Fund as distinguished from an Index Fund/Others funds of a Mutual Fund: **(2 Marks)**

(A) Share Trading Account and DP Account
(B) ISIN Account and Fund Account
(C) MF Trading Account and MF Holding Account
(D) Securities Ledger Account and Bank Account

2. The Index Fund is expected to Mirror the underlying benchmark in terms of return. However there is always a difference between the returns of an Index Fund and the returns of the underlying benchmark. **(2 Marks)**

(A) Trailing error
(B) Tracking error
(C) Mirror error
(D) Random error

3. The main advantage(s) of.an Exchange Traded Fund over an Indexed Fund is **(2 Marks)**

(A) Low Expense Ratio.
(B) At Par returns with Underlying benchmark
(C) Transaction in Small quantities
(D) All of the above

4. Both the Index Funds & ETF of Mutual Funds are expected to closely mimic the underlying index in terms of gross returns. In this regard which of the following is true? **(2 Marks)**

(A) The returns of both, ETF & Index Funds are identical to the underlying index.
(B) The return of ETF is closer to the underlying index than the Index Fund of a similar nature.
(C) The return of Index Fund is closer to the underlying index than the ETE Fund of a similar nature.
(D) None of the above

5. Which of the following is true of ETF? **(2 Marks)**

(A) ETFs can be used for generating returns through intra-day trading.
(B) ETFs can be invested to generate returns of the market.
(C) ETFs can be used as an ideal investment for hedging / arbitrage.
(D) All of the above

6. Which of the following statement describes the NIFTY ETF the best? **(3 Marks)**

(A) The NIFTY ETF is closest representation of NIFTY Index Fund.
(B) NIFTY ETF can itself be viewed as a Stock.
(C) NIFTY ETF is a distinct security with no relation to NIFTY Index Fund nor does it have any features of a stock.
(D) NIFTY ETF is a NIFTY Index Fund in the form of a stock.

7. Write in the relevant column against each statement, given below, if it is True or False as regards an Index Fund / ETF. (Reproduce this in your answer sheet) **(6 x 2 = 12 Marks)**

Sl. No.	Statement	True or False
1	Request for purchase / sale of an index fund can be done outside market hours.	
2	An Index Fund provides for taking advantage of Intraday price movements.	
3	Liquidity or redemption is a problem associated with the Index Fund.	
4	ETFs and Index Funds follow a passive fund allocations strategy.	
5	ETFs allow for diversification beyond geographical boundaries without underlying knowledge of foreign stocks.	
6	ETF can be replicated only in respect of Stock Based Indices	

CASE STUDY : IV

Vishika graduated from All India Commerce College in year 2017. She and her friend, Aradhya decided to on a trip to Sikkim before striving to enter into working world. They booked air tickets and third Thursday of December 2017, they were in Sikkim. They were very excited and thrilled. They visited various sights they had planned. They experienced local food and culture as well as bought some souvenirs for their near and dear ones.

It was Tuesday night and both Vishika and Aradhya were packing their stuff to return to Delhi next day. Aradhya felt very tired so she went to sleep after packing while Vishika continued. While sorting things in her handbag, Vishika found something - there were some fallen leaves she had collected on her sightseeing. Luckily she got a stamp pad on the hotel room study table. She pulled out a clean unruled sheet of paper from her travel journal and pressed fallen leaves soaked in stamp pad ink against it. Vishika was smiling wholeheartedly looking at the sheet for it was not just a sheet but a beautiful creation of art. She posted the art on Facebook and slept. Next morning, when she opened her Facebook page, all she could find was bounties of appreciation and some people even requested to buy her art. She showed it to Aradhya who too was moved by the beauty of the creation. The entire return journey was a discussion between the two friends and they landed Delhi with a decision to set up a business of personalised items using recycled materials.

Since then, it has been 5 years and they are proud owners of a firm, Vrikshya. Vrikshya has been getting bulk orders and generating handsome revenue. With an employee count of 100 under the leadership of Vishika and Aradhya, the firm has so far witnessed growth and profits.

It's May 2019. Both Vishika and Aradhya are studying firm MIS and they realise that as the business has expanded, they had less time available to focus on credit control. Collections from accounts receivable has deteriorated and despite high profits, firm is using more of overdraft facility to pay for business expenses that became due sooner than they get paid. They need cash flow to pay employees, vendors and cover other business expenses. At first, they decided to approach their bank for assistance.

Based on the firm performance record, the bank was ready to sanction a fund- based working capital limit of 2 crores and interest rate is Base Rate +2% p.a, payable at monthly basis.

However, somewhere in her mind, Aradhya was not convinced with idea of cash credit from bank and insisted to look for other alternatives. They referred a local firm specialising in credit management consultancy. It suggested that they either employ a credit admin or factor accounts receivable. Factoring was new to both Vishika and Aradhya. The local firm suggested Expert Associates to Vrikshya partners for factoring services. Expert Associates was known to provide factoring services involving advancing 80% of the receivables at 12% p.a. and 2% factoring commission.

While the discussion was going on, Vishika received a call from her team that Vrikshya has received an international order, big enough in terms of contribution to profits.

QUESTIONS:

Based on above, answer the following:

1. While discussing about factoring, the manager of the local firm specialising in credit management consultancy mentions:

   "In factoring, the factor not only finance trade debts but also performs various other functions". Justify this statement. **(5 Marks)**

2. Following information is available:
   - Total credit sales of Vrikshya for last year were Rs 6.40 crores and average collection period is 50 days. Sales are expected to increase by 20% over the next year.
   - Employs a good credit admin would cost 13,00,000 per annum to the business. It is estimated that the average collection period can then be reduced to 45.
   - Availing factoring services from Expert associates will reduce average collection period to 30.
   - Current overdraft rates are 11% per annum.

You have to determine whether it is financially beneficial for Vrikshya to factor its accounts receivables for the next year, as compared to employing a credit admin. Assume that there are 360 days in a year. **(5 Marks)**

3. Vrikshya received an international order, big enough in terms of contribution to profits. The factoring firm, Expert Associates, specialised in domestic factoring only. This led the firm partners to approach Global Associates, a firm specialising in international factoring services to understand factoring in context of international orders.
As a team member of the Global Associates, prepare a summary of the distinct advantages of factoring over other methods of finance/facilities provided to an exporter. **(5 Marks)**

4. <u>Multiple choice questions</u>: (10 Marks)

(i) Using the following figures, the gross working capital for Vrikshya is:

Trade receivables	40,00,000
Cash and cash equivalents	5,00,000
Trade Payables	14,00,000
Short term provisions	2,00,000
Short term borrowings	2,00,000

(a) Rs 31,00,000
(b) Rs 29,00,000
(c) Rs 27,00,000
(d) Rs 45,00,000

(ii) All the following statements are correct about two factor international factoring except?

(a) The responsibilities relating to book- keeping and collection of debts remain vested with the import factor.
(b) Import factor provides the credit protection in case of financial inability on the part of any of the debtors.
(c) Factoring commission is shared by export factor with import factor at mutually agreed rate.
(d) The export factor bases his credit decision on the financing standing of the availing bank.

(iii) Another firm, True factor Financial Services agreed to factor Vrikshya receivables involving advance 80% of the receivables at 10% p.a. and 2% factoring commission. Following information is available:

- Annual credit sales 1.2 crore and average collection period 50 days
- The past experience indicates that bad debt losses are around 2% of credit sales
- The factoring is expected to save 50,000 in administration costs and also to eliminate all bad debt losses.
- Assume 365 days in a year

(iv) The amount remitted to Vrikshya is:
(a) 12,82,192
(b) 13,15,068
(c) 12,64,628
(d) 11,53,973

(v) Net factoring cost in case of Truefactor Financial Services above is:

(a) 5.95%

(b) 6.19%

(c) (18.94)%

(d) (2.56)%

CASE STUDY : V

Aditya is a credit rating analyst with FAIR Ratings, a reputed credit rating agency in India. FAIR Ratings not only provides grading and rating services but also conducts analytical studies and surveys on the economy, money market and corporate performances. The manager of Aditya asked Aditya to study ABC India Limited and gather relevant information.

ABC India Limited is an Indian banking and financial services company headquartered in Mumbai. As of March 31, 2019, the Bank's distribution network was at 500 branches across 264 cities.

Business

The bank is divided into two divisions:

The Consumer Bank

This division is retail-focused and the clients served are individuals and small businesses. The product offered by this division include advances, deposits, mortgages, personal loans, wealth management services, trade credit, business finance and cash management services. The Bank recorded 23% growth in the retail deposits in the previous year.

The Wholesale Bank

The wholesale bank's clients are large corporations, government and financial institutions. The products and services include working capital and term Loans as well as trade credit, cash management, supply chain financing, foreign exchange, and investment banking services. The Wholesale Banking business recorded a healthy 29% percent growth.

Risk Architecture of the bank

The key risks that the Bank is broadly exposed to in the course of its business are Credit Risk, Liquidity Risk, Market Risk, and Operational Risk. The Board of Directors assumes the oversight responsibility for all the risks assumed by the Bank and specific Board Committees have been constituted to facilitate focussed risk management. The Board has in place approved Risk Strategy and Policies whose implementation is supervised by the Risk Management Committee. The committee periodically reviews the risk levels and ensures timely action for the risk identified.

Credit Risk

Credit Risk is defined as the possibility of losses associated with diminution in the credit quality of borrowers or counter parties. Losses stem from outright default or reduction in portfolio value. The Bank has sufficient policies, procedures and systems for managing credit risk in both its retail and wholesale businesses.

Given the granularity of individual exposures, risk management in Retail business is largely on a portfolio basis across various products and customer segments. The factors considered while sanctioning retail loans include income, demographics, credit history of the borrower and the tenure of the loan.

Risk in Wholesale business is managed on an individual as well as portfolio basis. Credit risk is managed by capping exposures on the basis of borrower group, industry, credit rating grades and country amongst others. This is backed by portfolio diversification, stringent credit approval processes and periodic post-disbursement monitoring and remedial measures.

Market and Liquidity risk

Market risk stems from the movement in interest rates, foreign exchange rates, credit spreads and equity prices. Liquidity Risk is the risk that a bank may not be able to meet its short term financial obligations due to an asset– liability mismatch or interest rate fluctuations. The bank is structurally exposed to market risks and liquidity risks because of statutory liquidity ratio requirement as well as capital and liquidity requirements. These risks are managed through a well-defined Board approved Investment Policy, Asset Liability Management Policy and Market Risk Policy. The risk measures include position limits, gap limits, tenor restrictions and sensitivity limits.

Operational Risk

This is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This could include fraud or other misconduct by employees or outsiders, unauthorised transactions by employees and third parties, misreporting or non-reporting with respect to statutory, legal or regulatory reporting and disclosure obligations, operational errors including clerical and record keeping and system failures. To manage operational risks, the Bank has put in place a system of internal controls, systems and procedures to monitor transactions, key back-up procedures and undertakes regular contingency planning. The governance and framework for managing operational risks is defined in the Operational Risk Management Policy.

Recent developments

1. The bank announced the launch of its first Collateralized Loan Obligation.

   The bank pooled 80% of its institutional loan and assigned all the future receivables from them to a SPV as collateral. The institutional loans, represent Rs 450 crores bank loans to 10 companies from various sectors with existing track record of repayment and average residual maturity of about 3 years. The SPV here is close-ended debt scheme under the PQR Securities Fund, a mutual fund registered with SEBI. The Scheme offers three classes of units:

- The Class A units (senior tranche) representing 60% of collateral, being offered for investment are rated AAA(SO) by CARE. The Class A units will be offered to institutional investors through the book-building process.
- The Class B units (Mezzanine tranche) representing 25%, are rated A+ (SO) by CARE and would be subscribed by the XYZ Bank subject to regulatory approvals. Class B is subordinate to Class A.
- The Class C units (equity tranche) representing 15%, unrated would be subscribed by PQR. Class C is subordinate to both Class A and Class B.
- Under the Scheme, each unit will have a face value of Rs 50 lacs with a minimum investment of Rs 2 crore.

2. The bank has a 10-year, unsecured, 8% bond of DEF Limited with Rs 10 crores par value. Last year, the credit rating of the bond was downgraded to BB. Discussion is going on between ABC Bank Limited and MNC Bank to buy a credit default swap.

3. The bank is considering purchasing a bond issued by Government of Nigeria.

Aditya prepared a report on his findings and mailed it to his manager. Next day, his manager called a meeting to have a discussion with Aditya on his report.

Questions:

Based on above, answer the following:

1. In his report, Aditya mentions, "Just like other financial products, Collateralized Loan Obligations (CLO) are also subject to various types of risk." What do you think which risks Aditya is talking about? Explain. **(5 Marks)**

2. Structure a credit default swap between ABC Bank Limited and MNC bank. **(4 Marks)**

3. Aditya commented that ABC Bank Limited is subject to credit risk of 10 year, unsecured 8% bond of DEF Limited. The manager asked him to categorise the risk for better credit analysis. You are required to help Aditya to determine the categories of the credit risk with respect to the aforesaid bond. **(6 Marks)**

4. Multiple choice questions: (10 Marks)

(i) Aditya performed a financial analysis of ABC Bank Limited and few other banks using the CAMEL framework. Banks were ranked as follows:

Bank	**C**	**A**	**M**	**E**	**L**	**Average**	**Rank**
ABC Bank Limited	1	2	2	1	2.5	1.7	1
JKL Bank	3	1	4	4	1	2.6	3
NGO Bank	2	4	1	3	2.5	2.5	2
TMG Bank	4	3	3	2	3	3	4

In the light of above, which statement is correct?

(a) ABC Bank scores highest in terms of Credit worthiness.

(b) JKL Bank scores lowest in Employment Level.

(c) NGO Bank scores par with ABC in Leverage.

(d) TMG Bank scores higher than NGO Bank in Asset quality.

(ii) Aditya noted that the CLO launched by ABC Limited is a form of Cash flow CDO. It differs from a Synthetic CDO. Which statement is correct for unfunded synthetic CDO?

(a) Unfunded synthetic CDO comprises of Credit Linked Notes (CLN) only.

(b) Unfunded synthetic CDO comprises of Credit Default Swap (CDS) only.

(c) Unfunded synthetic CDO comprises partially Credit Default Swap and partially CLN.

(d) None of the above.

(iii) While studying the annual report, Aditya noted that the ABC bank has originated on an average Rs 1500 crores of home loans last year.

Following are the details pertaining to one such home loan advanced by ABC Bank:

- Original Home Value Rs 1.2 crore, Loan to Value 80%, Home Loan Rs96 lakhs
- Outstanding loan 90 lacs, Current home value Rs 84 lacs,
- Probability of Default 50%.

The recovery rate and expected loss on home loan is:

(a) 87.5% and Rs 6,00,000

(b) 70% and Rs 3,00,000

(c) 93.33% and Rs 3,00,000

(d) 100% and Rs 12,00,000

(iv) Which of the following statement is correct with respect to Credit Default Swap (CDS) on 10 year unsecured 8% corporate bond of DEF Limited?

(a) In case a Credit Default Swap (CDS) is entered into, the cost of CDS will be lower.

(b) In case a Credit Default Swap (CDS) is entered into, it will be a naked CDS.

(c) In case a Credit Default Swap (CDS) is entered into, credit risk will be eliminated.

(d) In case a Credit Default Swap (CDS) is entered into, MNC Bank will make profit as long as DEF does not default on the bond.

(v) Which of the following statements by Aditya about country risk in purchasing bond from Government of Nigeria is correct?

(a) The bond carry liquidity risk as the Nigerian government may fail to make timely payments on the bond it issued or actually default on its bond obligations.

(b) The bond carry exchange risk as bonds are priced in local currency and country may inflate their way out of debts by simply issuing more currency, making the debt less valuable.

(c) The bond carry repricing risk as in case of distress, Nigerian government may renegotiate terms of the bond resulting in new bond value.

(d) The bond carry transfer risk as in case of a political instability, change in regime could affect how well an interim or new government may pay its debt.