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Further, in the Elective Papers which are Case Study based, the solutions have been worked out on the basis of certain assumptions/views derived from the facts given in the question or language used in the question. It may be possible to work out the solution to the case studies in a different manner based on the assumptions made or views taken.

PAPER 6B: FINANCIAL SERVICES AND CAPITAL MARKETS - ELECTIVE PAPER

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

While answering the multiple choice question, candidates are required to indicate the alphabet of their choice in capital letters.

In case, any candidate answers extra question(s)/ sub-question(s) over and above the required number, then only the requisite number of questions first answered in the answer book shall be valued and subsequent extra question (s) answered shall be ignored.

CASE STUDY 1

Recently, Ajay has been appointed as a managing Director (MD of XYZ Ltd., which hitherto was a shell company having no operating activities. The promoter of the Company has given a mandate to the MD to evaluate various options for setting up either an investment banking company or a company which can play an active role in the stock markets (Proposed Company).

The MD is a stock market expert and has experience of operational activities in stock markets. The MD, however, has limited experience in the context of setting up a company. In this connection, he has reached out to you to advise him on various questions or thoughts relating to setting up of a company so that a workable plan can be presented to the promoter.

The MD is also keen in understanding the funding mechanism in a stock market and how the Proposed Company can play a role in this segment of the market. He is also interested in knowing whether the Proposed Company can lend to investors who invest in the stock markets. The other areas of interest is in taking up the issue management services as an offering. However, the concern is attracting right talent for this job. One of the entities, where MD's friend is working, is evaluating options for delisting, and they have been in talks with the MD in this respect. The MD is keen in providing the right advice as this will set the ball rolling when it comes to creating an impression with his promoter on his business expansion skills.

The previous company, in which the MD was working, is also on the lookout for an additional equity issue for its holding company and getting another group company listed. They are in talks with the MD for understanding how the pricing for the stocks work and also to evaluate whether Qualified Institutions Placement (QIP) is a better route or they should better settle for a bank borrowing. Although the Proposed Company is yet to be incorporated, the MD is encouraging all these discussions in order to evaluate possible opportunities. He believes this will help him in drawing a clear roadmap for the Proposed Company. He is also discussing with the promoter to understand whether the Proposed Company can be formed as a merchant banker or as one of the intermediaries in the stock market.

The MD, based on his discussions with other companies, believes M&A is another area where the Proposed Company can play a huge role. He is also keenly watching what is happening on

the merger front in terms of the market, and is someone who takes active interest in contributing his thoughts from a strategy perspective to his friends and well-wishers. The MD wants you to support him in setting up the Proposed Company and evaluation of various options of the businesses that can be carried within the objectives of the Proposed Company.

The MD has a meeting lined up with the promoter in the coming week. The promoter has informed him that an independent expert will join the meeting in order to assess and provide input on the Proposed Company's roadmap. The MD has informed you that this could very well be a sort of an interview for him to sell his ideas through and he wants to be well prepared before attending the meeting. Based on his discussions with the promoter and what he has shared with the promoter, he believes that the discussions could largely be centred on fund raising, stock market operations, listing obligations, and investment banking. He has prepared a list of questions, which he has in mind, and he has asked you to go through the same and provide your specific responses/views on each of those items on the table that could be useful for him in the scheduled meeting with the promoter.

The promoter has another company within the group which is named as MNOP Ltd. As at 01.04.2021, the composition of the Board of Directors of MNOP Ltd. comprised of 7 directors which is mentioned below:

S.No.	Name	Designation
01	Mr. A	Executive Chairman (Executive and Non-Independent)
02	Mr. B	Managing Director and CEO (Executive and Non-Independent)
03	Mr. C	Women Director (Non-independent)
04	Mr. W	Independent
05	Mr. X	Independent
06	Mr. Y	Independent
07	Mr. Z	Independent

As at 01.04.2021, the constitution of the Audit Committee comprised of the following Directors.

Name	Designation
Mr. B	Chairman
Mr. A	Member
Mrs. C	Member
Mr. Z	Member

The majority of the members of the Audit Committee have the ability to read and understand the financial statements but none of them have accounting or related financial management expertise. During August, 2021 MNOP Ltd. went for an Initial Public Issue (IPO) and got its shares listed on both NSE and BSE.

The Board of Directors of another listed group company named as PQR Ltd, at their meeting held on November 1, 2020 approved the proposal to issue bonus shares in the ratio of 1: 1 Such bonus issue is authorized by its Articles of Association (AOA) for issue of bonus shares and capitalization of reserves. PQR Ltd. implemented the bonus issue on 15th November, 2020 and issued bonus shares out of free reserves built out of genuine profits and securities premium account collected in cash.

Considering large number of listed companies within the Group, the promoter wants you to make a presentation about the 'material subsidiary' of each listed company for its effective disclosure and control

1.1 A facility in which investors can provide some amount of money from their pocket to invest in shares and the rest of the amount being financed by the banks is known as:

- (A) Working capital funding.
- (B) Project financing.
- (C) Margin trading.
- (D) Reinvestment.

(2 Marks)

1.2 'Offer document' used in the case of a book-built public issue in which all relevant details except that of the price or number of shares being offered is disclosed, is known as:

- (A) Prospectus.
- (B) Abridged Prospectus
- (C) Red Herring Prospectus
- (D) Letter of Offer.

(2 Marks)

1.3 The term 'material subsidiary' of a listed entity means.

- (A) A subsidiary, whose income or net worth exceeds twenty five percent of the consolidated income or net worth respectively of the listed entity and its subsidiaries in the immediately preceding accounting year.
- (B) A subsidiary, whose income or net worth exceeds twenty five percent of the consolidated income or net worth respectively of the listed entity and its subsidiaries in the immediately two preceding accounting year.
- (C) A subsidiary, whose income or net worth exceeds twenty percent of the consolidated income or net worth respectively of the listed entity and its subsidiaries in the immediately preceding accounting year.
- (D) A subsidiary, whose income or net worth exceeds fifty percent of the consolidated income or net worth respectively for the listed entity and its subsidiaries in the immediately preceding accounting year.

(2 Marks)

- 1.4 Which of the following is not an intermediary in the capital market?
- (A) Merchant bankers
 - (B) Underwriters.
 - (C) Debenture trustees
 - (D) Venture capitalist. **(2 Marks)**
- 1.5 When the investment bank helps clients in identifying suitable buyers, they render:
- (A) Merchant banking services.
 - (B) Credit rating services.
 - (C) Sell side services.
 - (D) Buy side services. **(2 Marks)**
- 1.6 If you are hired as a consultant to review the composition of the Board of Directors of MNOP Ltd., what would be your reasoned response to the following:
Whether the present constitution of the Audit Committee can continue post listing of its equity shares on both NSE and BSE. **(3 Marks)**
- 1.7 What are the three different sets of provisions for delisting of equity shares and under which regulations and circumstances are those applicable? **(3 Marks)**
- 1.8 The MD is keen to know the process of applications supported by blocked amount (ASBA). Elaborate the process of application supported by ASBA. **(3 Marks)**
- 1.9 Has PQR Ltd contravened any provisions of the Securities Exchange Board of India (SEBI) Regulations? Give reasoned answer. **(3 Marks)**
- 1.10 The MD wants to know about the QIP issue. What type of issue would be classified as QIP? What are the conditions that a listed company has to comply for a QIP issue? **(4 Marks)**

ANSWER TO CASE STUDY 1:

- 1.6 Provision of Regulation 18 of SEBI (LODR) Regulations, 2015
- (i) According to Regulation 18 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, every listed entity shall constitute a qualified and an independent audit committee which shall have:
 - (a) Minimum three directors as members,
 - (b) Two-thirds of the members of audit committee shall be independent directors.
 - (c) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

ANALYSIS OF THE FACTS OF THE CASE:

As per the facts of the question, the company listed its securities in recognized stock exchange in the month of August 2021. In order to comply with the requirements of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, the company requires doing the following:

The audit committee of the company already has 3 directors as members, which is in compliance. The audit committee has 3 directors who are Non-Independent. However, once the company gets listed, at least 2 [i.e. $3 \times (2/3)$] directors shall be independent directors. Thus, they need to change the composition of audit committee once the company gets listed on the stock exchange.

In the existing audit committee, though majority of the members have the ability to read and understand the financial statements, but none of them has accounting or related financial management expertise. However, once the company gets listed, it is required that all members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Hence, it is required that the company should appoint at least one member in the audit committee who shall have accounting or related financial management expertise.

Conclusion

In view of above, the existing audit committee cannot continue after listing of its securities on both NSE and BSE.

Also, according to Section 177(1) of the Companies Act, 2013 read with Rule 6 of the Companies (Meetings of Board and its Powers) Rules, 2014, if the Company was required to have the audit committee, the existing audit committee is also not in order as it does not have majority of the members as independent directors.

1.7 Delisting in Indian capital market is governed by the SEBI (Delisting of Equity Shares) Regulations, 2009. These regulations provide three different sets of provisions for delisting of equity shares under different circumstances which are as follows:

- (i) **Voluntary Delisting:** It means delisting of equity shares of a company voluntarily on an application of the company under these regulations. The main de-listing provision pertains to the voluntary delisting sought by the promoters of a company from the only recognized stock exchange giving exit opportunity to all public shareholders.
- (ii) **Compulsory Delisting:** It means delisting of equity shares of a company by a recognised stock exchange on any ground prescribed in the Rules made under Section 21 A of the Securities Contracts (Regulation) Act, 1956.
- (iii) **Special provision for delisting of small companies** not frequently traded or with small number of shareholders.

- 1.8 Meaning of ASBA:** The Application Supported by Blocked Amount (ASBA) is an alternate payment system for book built issue launched by SEBI in August 2008.

ASBA is made mandatory by SEBI for applying to any public issue of equity shares from 1st January, 2016. ASBA is basically an application by investors subscribing to an issue containing an authorization to block the application money in a bank account.

An alternative payment mode for applying in primary shares, ASBA has helped investors do away with getting demand drafts or cheques made for payment of application money. Therefore, one's money stays in one's bank account until allotment of the issue takes place. There is no hassle of refunds - in case of less or no allotment of shares. The advantage is that one get to earn interest even on the blocked amount until it is debited for allotment.

THE PROCESS:

- (i) An ASBA investor shall submit an application to the Self Certified Syndicate Bank (SCSB) with whom the bank account to be blocked is to be maintained.
- (ii) The SCSB will then block the application money in the bank account specified in the ASBA. The application money will remain blocked in the bank account till the allotment of securities or till the withdrawal/failure of the issue or till withdrawal or rejection of the application.
- (iii) The SCSB shall upload the details in the electronic bidding system of the BSE or the NSE.
- (iv) After the basis of allotment is finalized, the registrar to an issue shall send a request to the SCSB for unblocking the bank account and transferring the allotment money to the issuers escrow account. In case of withdrawal of issue, the bank account' shall be unblocked on the information received from pre issue merchant bankers.

1.9 Provisions of SEBI (ICDR) Regulations, 2018

According to the provisions of Chapter XI of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR) a listed issuer may issue bonus shares to its members if it is authorized by its Articles of Association for issue of bonus share, capitalization of reserves, etc.

An issuer, announcing a bonus issue after the approval of its Board of Directors and not requiring shareholders' approval for capitalization of profits or reserves for making the bonus issue, shall implement the bonus issue within fifteen days from the date of approval of the issue by its Board of Directors. According to the stated facts, Board of Directors of PQR approved the proposal to issue of bonus shares in the meeting held on 1st November 2020. This issue of bonus shares is without requiring shareholders' approval. Accordingly, PQR implemented the bonus issue within fifteen days from the date of, approval of the issue by its board of directors (i.e. on 15th November 2020).

So, PQR is in compliance with the SEBI (ICDR) Regulation, 2018 regarding bonus issue and thus has not contravened any of the provisions.

1.10 (i) Type of Issue that would be classified as Qualified Institutions Placement (QIP)

When a listed issuer issues equity shares or non-convertible debt instruments along with warrants and convertible securities other than warrants to qualified institutional buyers only, in terms of the provision of Chapter VI of SEBI (ICDR) Regulations, 2018, it is called a Qualified Institutions Placement (QIP).

(ii) CONDITIONS FOR QIPs

A listed issuer may make qualified institutions placement, if it satisfies the following conditions:

- (a) A special resolution approving the QIP has been passed by the Company's shareholders and the special resolution shall, among other relevant matters, specify that the allotment is proposed to be made through QIP and the relevant date referred to in sub-clause (ii) of clause (b) of regulation 171.
- (b) The equity shares of the same class, which are proposed to be allotted through QIP or pursuant to conversion or exchange of eligible securities offered through QIP has been listed on a recognised stock exchange having nationwide trading terminal for a period of at least one year prior to the date of issuance of notice to its shareholders for convening the meeting to pass the special resolution.
- (c) An issuer shall be eligible to make a qualified institutions placement if any of its promoters or directors is not a fugitive economic offender .
Provided that the issuer shall seek approval under Rule 19(7) of the Securities Contracts (Regulation) Rules, 1957, if applicable.
- (d) A QIP has to be managed by merchant bankers registered with the Board of SEBI who shall exercise due diligence.
- (e) The QIP shall not be issued at a price not less than the average of the weekly high and low of the closing prices of the equity shares of the same class quoted on the stock exchange during the two weeks preceding the relevant date.
- (f) The minimum number of allottees for each placement of eligible securities made under QIP shall not be less than:
 - (i) Two, where the issue size is less than or equal to two hundred and fifty crores;
 - (ii) Five, where the issue size is greater than ₹ 250 crores. Provided that no single allottee shall be allotted more than 50 of the issue size.

The aggregate of the proposed QIP and all previous QIPs made by the issuer in the same financial year shall not exceed five times the net worth of the issuer as per the audited balance sheet of the previous financial year.

- (g) The tenure of the convertible or eligible securities issued through the QIP shall not exceed 60 months from the date of allotment

The eligible securities allotted under the QIP shall not be sold by the allottee for a period of one year from the date of allotment, except on a recognised stock exchange. The issuer shall not make any subsequent QIP until the expiry of two weeks from the date of the prior QIP made pursuant to one or more special resolutions.

CASE STUDY: 2

You have been appointed as a fellow researcher in the Scholar Institute of Advanced Finance and Accounts based in Berlin, Germany. This is a huge opportunity that has been provided to you and the Professor, with whom you did your college, has asked you to work him for the next 15 days. During this period, he will provide you an overview of the research profile and how best you should use the opportunity.

The Professor has asked you to ensure that you come prepared for the session, and this will serve as a pre-cursor for all the research work that you will be undertaking in Berlin. He has also informed you that the world's best minds in the finance and accounting world would be there and you should ensure that you make the best use of the opportunity that is being provided.

Amongst various things that the Professor has asked you to prepare are listed below (which would be necessary for your work):

- *The way the banking sector is undergoing a change.*
- *How banks are setting up their treasury operations and how they go about measuring their risks.*
- *Risk management framework employed by banks and financial institutions across the world.*
- *Trading in the stock markets and how the capital and secondary markets across the world are shaping up.*
- *How sovereign risks are being assessed and focused upon by companies and financiers.*

The Professor has also arranged a call for you with a Chief Finance Officer (CFO) of a leading company as well as a Managing Director (MD) of another company, who were his ex-students, and he is very proud of the way they have shaped up their careers in finance. Both the MD and the CFO shared their thoughts with you in terms of how to use the opportunities and asked you to be well-prepared for the session. They suggested that you should not hesitate to put in the extra house and get the best out of this opportunity.

The CFO was very keen that you spend good amount of time in understanding how international financing works and what are the benefits of products such as bill discounting and factoring. He also asked you to focus on items such as buyer's credit and choose a line of expertise which you should thoroughly explore during your stint. The CFO also said items such as two -factoring

system is excellent and does not have any limitations and suggested you to do a thorough analysis of this and present a paper on items such as this. He shared with you experiences about debt fund management and how his team uses duration and convexity to management. Although you have read about yield curve but what excited you is the use of the same in practice. In fact, the CFO also told you how central bank across the globe manage yield curve by using various tools available with them. The other topic of discussion between them was 'structured finance'. You got a complete picture of asset securitization process used in practice. Another key element of discussion was Loan -to- Value (LTV) ratio. The LTV is a key tool used by banks to monitor risks in housing loan portfolios. After the discussion you realized that you also had the opportunity to see its application by banks while doing bank audit but somehow you missed it. Now you know that it is a commonly computed ratio for securitized products backed by housing loans. The Reserve Bank of India (RBI) also used LTV as one of the tools for this purpose. Once the meeting got over with the CFO, you briefed the Professor about the interaction. As in any securitization, structure is used to protect against various risks, the Professor has asked you prepare a brief not on external risk and internal risk involved in an auto loan asset based securitization.

The MD and the Professor emphasized that it is important you do your research on aspects of what went wrong recently in the accounting and finance world in India and how you should build you case studies on the same., they gave you some insights on the reasons for failure of two high profile failures in NBFC sector in India which affected the entire NBFC sector. The credit-rating agencies were criticised for their role as top-rated NBFCs defaulted. They also informed that a similar thing happened during subprime crisis when credit-rating agencies were heavily criticized for understating risks related to complex securities like mortgage backed securities and collateralized debt obligations that fuelled the housing loan bubble in the USA. While they agree that credit-rating agencies need to be more vigilant and continuously improve their rating process, the limitation of credit-rating should also be understood by the investors and they cannot rely only on the credit ratings while making investments. You are now very clear that a complete understanding of the rating exercise and especially if it is related to 'structured finance' is necessary before making any investment. The Professor has also asked you to prepare a brief note on the key areas that rating agencies typically focus in rating a structured -finance securitization. The MD was keen in telling you during the call that the focus as investment bankers, commercial banks, mutual funds etc., and how each of them can play a role in the smooth functioning of the financial markets.

You have surplus fund and want to make investment in mutual funds. In fact the current mania for exchange-traded funds (ETFs) are the major reason of attraction and hence understanding of the same would help you in deciding whether to make investment or not in such financial instruments. You want to pick this topic for the research. The Professor encouraged you to look into the same and evaluate the performance of five mutual funds identified by him and rank them based on Sharpe's Ratio, Treynor's Ratio and Alpha. The Professor, the MD and the CFO summed provided you some useful inputs and they wished you good luck. The Professor summed up the discussions and asked you to come prepared for the session and he said he

will mail you a list of items or questions which you should come with your answers before joining the session.

- 2.1 Which one of the following is incurred with respect to ETFs?
- (A) They are pre-assembled portfolios that model a composite benchmark
 - (B) They can be bought and sold in a single transaction and traded on exchanges like stocks.
 - (C) They are actively managed funds.
 - (D) They do not charge back-end redemption fees. **(2 Marks)**
- 2.2 Which one of the following is incorrect about the use of Sharpe's and Treynor's Ratio when they are used for evaluating fund performance?
- (A) In respect of sector specific funds, it will be more appropriate to use Treynor's Ratio
 - (B) When the ranking based on Sharpe's Ratio and Treynor's Ratio agree then it may not indicate that a mutual funds has performed better than the market.
 - (C) Treynor's Ratio is also called reward-to volatility ratio.
 - (D) Sharpe's Ratio measures risk adjusted returns where risk considered is the total risk. **(2 Marks)**
- 2.3 The 'Alpha' one of the performance measurement tools of mutual funds. Which one of the following is incorrect about the 'Alpha'?
- (A) Alpha can be used to compare performance of two mutual funds having different beta.
 - (B) Alpha can be used to compare performance of two mutual funds having same beta.
 - (C) The value of Alpha can be either positive or negative or zero.
 - (D) The excess return shown by Alpha may not be commensurate with the unsystematic risk taken. **(2 Marks)**
- 2.4 Which one of the following is incorrect with respect to yield curve when using portfolio's duration and convexity to measure the exposure to interest rates?
- (A) It is assumed that the yield curve will shift in a parallel way.
 - (B) It is assumed that the yield curve will shift in a non-parallel way.
 - (C) Yield curve risk is the exposure of a portfolio to a shift in the yield curve.
 - (D) A simple way to measure yield curve risk is an analysis of cash flow distribution of a portfolio relative to a benchmark. **(2 Marks)**
- 2.5 Which one of the following is not correct with respect to the LTV?
- (A) There is an incentive for the borrower not to default, when LTV is below one.
 - (B) There is no incentive for the borrower not to default, when LTV is below one

- (C) LTV changes overtime.
- (D) In case of housing loan, when the purpose of the loan is to refinance an existing loan, the LTV is dependent on the requested balance of the new loan the market value of the property. **(2 Marks)**
- 2.6 Briefly explain four key areas that typically a credit-rating agency would focus while making analysis of structured-finance securitization? **(5 Marks)**
- 2.7 How would you address external risk and internal risk involved in an auto loan securitization? **(3 Marks)**
- 2.8 The CFO while discussing two-factor system of factoring has mentioned that factoring has no limitation. Do you agree with the view of the CFO? **(1 Marks)**
- You have been further asked to answer the following questions relating to two-factor system of factoring.
- (a) How many parties are involved in a two-factor system and who are those parties? **(1 Marks)**
- (b) What is the key information that the exporter would need to provide the export factor? **(2 Marks)**
- (c) What are the key functions of an import factor? **(2 Marks)**
- (d) Explain the fee to be paid by exporter and/or importer in case of the two -factor system of factoring? **(1 Marks)**

ANSWERS TO CASE STUDY: 2

- 2.6 The four key areas a credit rating agency would focus are:
- (1) **Collateral Analysis:** Securitized assets may include housing loans, credit card receivables, auto loans, trade receivables etc. Each one has its own characteristics and performance drivers. The key driver is the defaults. In case default happens, what would be the asset value? Therefore, in this analysis, what is assessed, is the probability of default and the amount or percentage of recovery.
 - (2) **Financial Analysis of the Structure:** This analysis involves review of credit protection or credit enhancement that support a class or several classes of bonds. The common credit enhancements are senior/subordinate structure, over collateralization, excess spread, letter of credit, bond insurance etc.
 - (3) **Legal Review of the Structure and Documentation:** This involves review of the transfer of assets, securities and cash with respect to each of the parties involved. The issuer of securities must be independent from the seller for the securities issued to receive a higher rating than long- term financial rating of the seller.
- The legal documentation depends upon on the structure of each transaction. This is reviewed to ensure that documents reflect the correct terms and structure of the

transaction. These include loan documents, organizational documents of SPE, sale agreement, trust deeds, custodial agreement, collaterals etc.

- (4) **Review of the Parties such as Seller /Services:** Services are responsible for the processing of payments from borrowers as well as recovery efforts. The other key party is the originators.

The review typically involves financial condition, management experience, past track record, staff and training, servicing and loan administration, current volume and capacity, credit underwriting, property valuation, internal controls, policies and procedures adopted, use of technology etc.

2.7 External Risk

The cash flow from the collateral is the key for repayment of the auto-loan securitization. Therefore it is essential that the owner of securitized instruments should get exclusive benefit of the collateral.

This is possible when collateral is isolated from the insolvency risk; this can be achieved by legal transfer of loan from the originating entity to a SPE or SPY. Ideally such SPE or SPY should be restricted to incur debt, pledge asset or merge or reorganize.

Internal Risk

Internal risks inherent to the transaction is - default risk and servicing risk. The first risk can be reduced to a great extent by credit enhancement reviewing the quality of loan underwriting of the originator. There should be a provision for transferring services to a backup servicer in case originator/servicer fails.

2.8 (i) VIEWS OF THE CFO

The two-factor system has limitations like delay in credit decisions, remittance of fund due to involvement of many party and hence the views of the CFO is not entirely correct.

- (a) The most important form of factoring is a two factor system. transaction is based on operation of two factoring companies. In different countries involving in all, four parties, namely:
- (i) The Exporter,
 - (ii) The Importer,
 - (iii) The Export Factor in Exporter's Country and
 - (iv) The Import Factor in Importer's Country.
- (b) The exporter approaches the export factor with relevant information, which inter-alia, may include:
- Type of business
 - Names and addresses of the debtors in various importing countries

- Annual expected export turnover to each country
 - Number of invoices/credit notes per country
 - Payment terms and
 - Line of credit required for each debtor.
- (c) Import factor is primarily engaged in the areas of :
- Maintaining books of exporter in respect of sales to the debtors of his country .
 - Collection of debts from the importers and remitting proceeds of the same to the export factor.
 - Providing credit protection in case of financial inability on the part of any of the debtors.
- (d) The entire factoring fee is debited to the exporters account and the export factor remits the mutually agreed commission to his import counterpart. There is no fee to be paid by the importer.

CASE STUDY :3

You have been appointed as a finance controller in TPS Ltd which is evaluating options to set up a banking company (Proposed Bank). On the first day of your work, you had a meeting with the Managing Director (MD) of TPS Ltd. and he was very impressed and happy to have a full-time finance professional to support him in this exercise.

The MD has mentioned to you that there are serious discussions currently happening for setting up of a bank and he is exploring options for obtaining banking licenses and go through the regulatory processes.

Whilst he is taking external help from consultants to help him in the process, he also believes that a lot of internal measures and mechanisms that have to be put in place for a bank to function smoothly. He has outlined some of the thoughts with you:

The products that the bank should get into at this time-he wants you to look into aspects such as loan products, investment products and do a risk profile analysis of each of these so that they can decide on which to get into and at what point in time.

Operations on foreign markets and foreign currencies-the MD wants you to explore whether this is something which should be considered at this point in time.

He is keen in understanding the capital structure that would be ideal for banks to operate in and the regulations surrounding the same that should be considered.

The risk management framework that should be put in place and what are the various types of risk that need to be presented to stakeholders before going ahead with the decision.

- *With the economic downturn that is currently happening, is also keen to know how the working capital products would play out in the existing scenario.*

- Form an income enhancement perspective, he is interested in understanding how they should map their risks and return and what priorities should be given the overall structure that is being considered.

You have provided your inputs for some of the above and indicated to the MD that in your previous organization you had an opportunity to work on some of these in great detail. You informed the MD that your areas of expertise included:

- Working capital management and credit risk management.
- Derivative products.
- Setting up a risk management team
- Devising a risk management framework.

You have also informed the MD that you have extensive knowledge in BASEL norms that is being prescribed. There is a lot talk going on in the media about countercyclical buffer considering the level of NPAs. There are practitioners who are against this concept while the others argue in favour of the same. You will consider all the best practices in your presentation about BASEL norms including countercyclical buffer.

The MD was very impressed with your responses, but was also keen to know how exactly you can contribute in the whole journey. He said, whilst your experiences are in the context of a specific entity, you should be able to contribute for setting up good systems and you should come up with specific ideas surrounding many of the aspects discussed above. Initially, the Proposed Bank will focus more on loans to MSME where assessment of credit risk is a big challenge. The MD has asked you to prepare a brief note about the credit risk that the Proposed Bank is likely to face considering the focus area of operations. While developing operational strategies for the Proposed Bank, the MD also asked you to focus more on documentary collection business which is less risky for a bank.

The MD has introduced you to his friend on whom he has huge confidence and informed you that the friend would provide you with a list of matters that he would want your immediate response as this would provide an assessment platform for him to plan this entire journey as well as consider the extent of your involvement in this process.

A cyber security instrument which has been recently developed by in-house team is in great demand. The product though is costly but there are number of interested parties on a lease basis. Details about the product are given below:

Cost of the Machine	150 lakhs
Expected Useful Life	5 Years
Salvage value of the machine at the end of 5 years	10 lakhs
Cost of Capital	14%
Applicable tax rate	35%

The machine will constitute a separate block for depreciation. Assume the cost of negotiation, lease administration as Nil and assume that the lease rental is payable on the last day of each year.

Given below are the PV factors @ 14%

Years	1	2	3	4	5
PVIF @ 14%	0.877	0.769	0.675	0.592	0.519

3.1 Countercyclical buffer:

- (A) Has been introduced to make sure that the banks maintain a balance of capital that can be used to absorb losses during periods of financial and economic stress.
- (B) Has been introduced with the objective to enhance capital requirements in good times and reduce the same in bad times.
- (C) Is a concept in Base I norms.
- (D) Helps the companies to maintain a healthy working capital ratio. **(2 Marks)**

3.2 The entire mechanism of operations through letter of credit is gradually going out of favour throughout the world primarily on account of what is known as:

- (A) Doctrine of Strict Compliance.
- (B) Compliance with the Strict Doctrine.
- (C) Doctrine of the USA.
- (D) Doctrine of the United Kingdom. **(2 Marks)**

3.3 The cash management remains in the hands of the bank in case of:

- (A) Working capital demand loan
- (B) Cash credit
- (C) Long term borrowing.
- (D) Bill discounting. **(2 Marks)**

3.4 Which of the following is incorrect with respect to credit risk?

- (A) Credit risk includes default risk and credit spread risk.
- (B) Credit rating can be used to gauge credit default risk.
- (C) Credit risk can be measured using credit VaR.
- (D) Downgrade risk is related to credit default risk. **(2 Marks)**

3.5 Which one of the following is incorrect with respect to documentary collections?

- (A) The exporter retains the control of the goods until the importer has paid or is legally bound to pay.

- (B) Documentary collections are less expensive than documentary credits.
- (C) In a document against payment (D/P) collection the importer must pay the amount of the sight draft to the collecting bank before the documents are released.
- (D) It is not important for the exporter to understand the creditworthiness of the importer in a document against acceptance (D/A) collection. **(2 Marks)**
- 3.6 Explain what your understanding of interest rate risk is. Specify the various techniques to manage Interest rate risk. **(4 Mark)**
- 3.7 Before a quote is given to the prospective customer the MD wants to know the Break-Even Lease Rental (BELR). What would be the BELR of the cyber security product? **(4 Mark)**
- 3.8 Explain to the MD, what are the key functions that typically the Proposed Bank's treasury will have. **(4 Marks)**
- 3.9 The MD wants to know the various risk management limits that can be established to control the risks. Provide any three examples of such limits. **(3 Marks)**

ANSWERS TO CASE STUDY :3

3.6 Interest Rate Risk

Interest risk is the change in price of bonds that could occur because of change in interest rates. It also considers the change in impact on interest income due to changes in the rate of interest. In other words, price as well as reinvestment risks require focus.

The techniques to manage Interest Rate Risk includes:

Maturity Gap Analysis - This is to measure the interest rate sensitivity of earnings. Gap is a static report showing balance sheet and off balance sheet position on a particular date. It determines number of time buckets and the length of each time bucket.

Duration- To measure the interest rate sensitivity of capital - is a measure of percentage change in economic value of a position that may happen if there is a small change in level of interest rate.

Simulation- It attempts to remove the disadvantages of gap and duration approach by computer modelling the bank's interest rate sensitivity.

Value at Risk - V AR is a measure of risk of investment.

3.7. WORKING NOTE - 1 :

Salvage Value = ₹10,00,000

PV of Salvage Value = ₹ 5,19,400/-

WORKING NOTE - 2:

PVF@14 %

= 0.5194

Table showing calculation of PV of Tax benefit on Depreciation

Year	Opening WDV	Dep @ 25%	Closing WDV	PVF @14%	PV
1	150,00,000	37,50,000	11,250,000	0.877	32,88,750
2	112,50,000	28,12,500	84,37,500	0.769	21,62,813
3	84,37,500	21,09,375	63,28,125	0.675	14,23,828
4	63,28,125	15,82,031	47,46,094	0.592	9,36,562
					78,11,953

Tax Benefit on Depreciation = ₹78,11,953 X 0.35 = ₹ 27,34,184

WORKING NOTE - 3:

PV of Tax benefit on Short Term Capital Loss (STCL)

WDV at the beginning of 5 year as per above table = ₹ 47,46,094

Less: Salvage Value = ₹ 10,00,000

STCL = ₹ 37,46,094

Tax Benefit = ₹ 13,11,133

PVF at 14% = 0.519

PV of Tax Benefit on STCL = ₹ 6,80,478

NOTE: Rate of Depreciation (WDV) is taken at 25%

BREAK EVEN LEASE RENTAL:

Cost of Machine ₹ 1,50,00,000

Less: PV of Salvage Value ₹ 5,19,400

(Working Note -1)

Less: PV of Tax benefit on Depreciation ₹ 27,34,184

(Working Note - 2)

Less: PV of Tax Saving on STCL at the

End of 5 year (Working Note - 3) ₹ 6,80,478

₹ 110,65,938

PVIF A for 5 YEARS @14% 3.433

After Tax BELR = 1,10,65,938 /3,433 = 32,23,400/

Before Tax BELR = 32,23,400/ (1- 0.35) = ₹ 49,59,100

3.8 The bank's treasury function mainly involves:

- (a) Reserve Management - The reserve management involves maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).
- (b) Funds Management and Liquidity Management - Funds are key to banking operations. The banking function involves large scale receipt and payment of cash. The funds management and liquidity management at treasury not only involves arranging and managing aggregation of cash function at the branches of the bank, but also managing the CRR of the bank, thus would involve lending of money to interbank market participants/RBI and also borrowing money from interbank participants/RBI.
- (c) Investment and Optimizing Return on Bank Funds- The treasury function involves investment of bank's fund not only the investment requirement in government securities due to SLR requirement, but also investments over and above the SLR requirement in government securities, non-SLR bonds and debentures, investment in equity shares, venture funds, mutual funds etc.
- (d) Trading of Investment Products for Trading Profit - Trading function is key to any treasury functions. Banks are the most active trader in the markets with an eye on trading profit, which involves same day trading or holding the investment for a longer term and then off loading the same in marking with trading profit.
- (e) Forex Treasury Operation: The banks treasury function also involves trading in foreign exchange markets both in the capacity of proprietary trading or on behalf of the corporate as part of the merchant activities for a margin.
- (f) Derivative Transactions - The treasury function also involves derivative transactions to hedge its own book or on behalf of its clients or corporate.

3.9 Examples of Risk Management Limits to control the risks

- (1) Exposure Limits - It is the limit set for having exposure on a particular class of assets within the financial market segments such as equity, debt etc.
- (2) Cut Loss Limits - It allows the dealer to exit for a position at a pre determined loss due to adverse movement of the rate on the position.
- (3) VaR Limits - Value at Risk is a measure of volatility and a risk measurement technique, which is defined as an estimate of potential loss of a given position given holding period and given level of certainty.
- (4) Forex Limits- It involves setting limits for the open positions in foreign currency transactions.
- (5) Counterparty Limits - These are fixed for a counter party so that default risk of the counter party is taken care of.

CASE STUDY: 4

The Managing Director (MD) of a well -performing start-up company named PPP Ltd. Has reached out to you to take your advice on some specific aspects relating to this Company and few other companies of the Group. He is also on the Board of a listed company named RQR Ltd, which is part of the Group, and is in the business of salt manufacturing. RQR Ltd. Has a huge surplus cash. The Board of RQR has been deliberating about buy-back of equity shares since last two board meeting. In the next Board meeting the same is likely to be approved, once permitted modes are evaluated.

You are a well-known finance expert who is engaged in advising investors as well as companies in fund raising, financing strategic buy-outs etc., and your expertise in the investment banking field has grown in the recent years. You also are well connected with a huge network of venture capitalist and are therefore well sought-after in the industry when it comes to aspects such as return, right set of investments, exit routes for an investor etc.

The MD has arranged an initial kick-off meeting for you to understand the profile of PPP Ltd and other companies of the Group. He explained in detail how companies were set up, and shared his vision about future course of actions. He has some specific aspects that he sought your views on:

He is interested in raising additional rounds of funds through Private Equity (PE) investors or Venture Capitalists (VC) for PPP Ltd. He wants to understand what the key factors PE/VC consider before making investment in an entity.

He wants you to advise on the right options to choose and how he should proceed for raising funds for PPP Ltd.

He is evaluating multiple options to buy back equity shares of RQR Ltd. He wants to understand about the procedures related to follow-on offer in respect of another listed company of the Group named ReX Ltd which has a plan for expansion of its sugar manufacturing unit.

He has heard from his colleagues that normally the term-sheet that the PE investors put in is very complex and it is difficult for him to comprehend it fully as he is not a finance person. He wants your guidance when that phase reaches. He also wants to understand about the break-fee which is a commonly used term in the private investment space.

He is aware of an instance where some of his relatives has a difficult time in providing the right exit route to PE investors. He asked you to advise on how he should look at these in the discussions with the investors.

He is curious to know if you have seen an instance where there have been non-compliance on the investment terms and conditions by the promoters or the external investors and how the same would be viewed when it comes to protecting the larger interests of the promoters.

As PPP Ltd. is also in the finance sector, he was also keen on introducing divisions which will deal with aspects of investment banking advisory and risk management for its customers. As

you have expertise in these areas, he has suggested that you maybe the right person to look into these aspects and provide him guidance.

Last year credit-rating of PPP Ltd was not as per expectation of the management. There were lot of issues that could have been managed well and would have resulted in a better credit-rating. This time MD wants to go through the entire process in advance so that they can present the case well before the credit-rating agency. However, the problem is that the in-house time is not fully conversant with the credit-rating process. The MD wants your help in this exercise.

You have informed the MD that you are happy to help in the areas identified by him and can also offer your services relating to investment banking.

The MD has asked you to provide an overview of some of the specific aspects he touched upon and make a presentation. He has asked his secretary to provide a suitable time as well the list of questions that he would like you to provide him responses.

4.1 The VC firm considers number of factors before making investment. Which one of the following is correct to evaluate possibility of investment by a VC firm in a prospective company?

- (A) Revenue perspective*
- (B) Brand recall value*
- (C) Capital required*
- (D) All of the above*

(2 Marks)

4.2 Follow -on offering is the same as:

- (A) Primary offering and relates to an equity listed entity issuing debt instruments to public again.*
- (B) Secondary offering and relates to a debt listed entity issuing equity shares to public again.*
- (C) Secondary offering and relates to an equity listed entity issuing debt instruments to promoters of the company.*
- (D) Secondary offering and relates to an equity listed entity issuing equity shares to public again.*

(2 Marks)

4.3 Break-fee is:

- (A) A fee typically payable to investor if the company declines the investment described in the term-sheet.*
- (B) A fee typically payable to investor if the company or funders comply with the exclusivity or other bidding provisions of the term-sheet.*
- (C) A fee paid to the investment banker for arranging funds*

- (D) A fee typically paid to the investor for complying with the investment described in the term-sheet. **(2 Marks)**
- 4.4 Which one of the following is the permitted mode through which by back of equity shares of RQR Ltd can be made pursuant to SEBI Regulation?
- (A) Private Arrangement
 (B) Spot Transaction.
 (C) Negotiated Deals.
 (D) Tender Offer. **(2 Marks)**
- 4.5 The MD has approached you to understand the type of risks credit-rating agency generally covers in the credit-rating process. Which one of the following is correct about the general methodology adopted by credit-rating agencies to analyse various aspects of a business:
- (A) Business risk, counterparty risk, management analysis and business evaluation.
 (B) Business risk, financial risk, management evaluation and business environment analysis.
 (C) Business risk, strategic risk, compliance risk and operation risk.
 (D) Business risk, political risk, management evaluation and currency risk. **(2 Marks)**
- 4.6 The MD wants to understand the possible ways of exit available PE. Discuss the possible ways of exit available to a PE? **(4 Marks)**
- 4.7 The MD wants to know about the term-sheet of a VC. Provide a brief overview of the items that are normally included in the term-sheet. **(5 Marks)**
- 4.8 Outline the key differences between investment banks and commercial banks. **(4 Marks)**
- 4.9 The MD wants to understand the tradeoff between risk and return in the context of credit risk. In trying to achieve this trade off, what are the key decisions you would consider? **(2 Mark)**

ANSWERS TO CASE STUDY: 4

- 4.6 Possible ways of Exit available to a PE:** There are five ways to exit out for a PE investor once the horizon period is met or otherwise by a management decision.

01. INITIAL PUBLIC OFFER (IPO)

IPO represents a highly successful exit strategy, riding on a strong business model. The payback can be instant through selling the own shares immediately on listing on the stock exchange.

02. STRATEGIC ACQUISITION

The share of the PE is acquired by a larger company usually in the same business segment. This is perhaps the most commonly used exit route, and is usually a win-

to-win situation for both the existing investor as well as the management of the enterprise.

03. SECONDARY SALE

The investor PE exits by transferring its share to another PE. Such an exchange is seen when a larger PE finds value in the venture thereby giving a sweetened deal to the smaller PE or where the business may require more money which is not in the capacity of the current equity fund.

04. REPURCHASE BY EXISTING MANAGEMENT MEMBERS) (FOUNDER

This is an ideal scenario type where the founders get back to owning the majority stake in their entity and a golden hand shake to the existing PE. This is also referred to as a "Management Buy Out".

05. LIQUIDATION

This is the least preferred method of exit where the investor leaves out at cash loss on the capital invested. This usually happens where the investor cannot take further losses or had made an over-estimate of returns or a particular idea behind the venture has not really taken-off or well received in the market.

4.7 Meaning of a Term Sheet:

The term sheet is the agreement copy that the Venture Capital (VC) hands over to the management, which contains the terms and conditions, fee structure, payout terms, liquidation rights, anti-dilution provision pre-emptive rights, exit terms etc.

Overview of the items that are normally included in the term sheet:

- (a) **Fee Structure:** The VC will have two types of fee income it earns - a management fee that is based on a fixed percentage and a "carry". The management fee will vary from 10/0 to as high as 5, the normal standard being 2 of the total invested funds in the particular venture. It is not unusual to also find a tapering clause in the fee structure after a specific period, say three years post which the fee percentages starts shrinking to the harvest year. On the other hand, a "carry" clause would mean a carried interest in the profits of the venture either for a certain pre-determined number of years till the harvest.
- (b) **Harvest Year:** The year projected to be the exit year for the PENC.
- (c) **Down Round:** This would mean that the investors pay a lower per share price than what previous investors paid, which indirectly implies that the investors have valued the VC at a lower value in the current round than the previous round. This decline is called the down round.
- (d) **Methods for computing anti-dilution rights:** To avoid a possible dilution to a down round situation, the term sheet will usually contain an anti dilutive clause. This is achieved either by a full ratched method or a weighted average method and the

preferred method is mentioned in the term sheet. In a rare case where it is not explicitly stated, the weighted average method is usually adopted.

(e) **Up Round**

The opposite of down round where successive round of investment has valued the venture at a value higher than the earlier round.

(f) **Break Fee**

A fee typically payable to the investor if the company declines the investment described in the term sheet or if the company or founders breach exclusivity or other binding provisions in the Term sheet.

(g) **Exclusivity Agreement**

A kind of non-compete period during which the company cannot negotiate for investments with outsiders for additional investments In the Company. This is to protect the holding rights of the PE.

4.8

Investment Banks	Commercial Banks
Investments banks help their clients in raising capital by acting as an intermediary between the buyers and the sellers of securities.	Commercial banks are engaged in the business of accepting deposits from customers and lending money to individuals and corporates.
Investment banks do not take deposits from customers.	Commercial banks can legally take deposits from customers.
The Investment banks do not own the securities and only act as an intermediary for smooth transaction of buying and selling securities.	Commercial banks own the loans granted to their customers.
Investment banks earn underwriting commission.	Commercial banks earn interest on loans granted to their customers.

4.9 **The trade off between risk and returns in the context of credit risk calls for the following decisions:**

- (i) How much credit risk should be accepted in return of increase in sale or business in case of banking?
- (ii) How much compensation should be added while pricing the product?
- (iii) Placing of credit cap or limit for each customer.
- (iv) Acceptance or rejection of customer's request.

CASE STUDY: 5

You are working in a leading consulting firm which has large number of reputed clients operating in the banking, finance and insurance sectors. You have been approached by the Group Chief Finance Officer (CFO) of a large size company named SMT Ltd. Seeking specific advice on the below aspects:

- Risk management practices.
- Credit derivative products.
- Currency risk hedging instruments.
- Fund raising and the options that can be considered.

The CFO has informed you that SMT Ltd. Has been operating in a stable manner for a significant part of the last five year cycle and is currently working on building its strategic plan for the next five-year so that it can course correct its growth trajectory.

The CFO has also informed you that SMT Group has a bank named SMT bank and the management is not happy with the current risk management practices. The issues has been raised in a number of board meeting after RBI inspection term identified number of areas where improvement is required. There are four top issues that are bothering the CFO.

The first issue is about stripping credit risk out of SMT bank books. The CFO is interested in using credit derivatives like Credit Default Swap (CDS) and Collateralized Debt Obligation (CDO). But the in-house team lacks expertise and the management wants that before such instruments are approved, understanding of the risk and pricing aspects is duly considered. The CFO also wants to know about the possibility of combining the use of credit derivative with securitization technique.

The second issue of priority is the fund raising that is currently being discussed for SMT Ltd. The CFO is not sure, in a market where equity financing is difficult, whether SMT Ltd. should go for a fresh round of equity financing or a borrowing. The CFO has mentioned that the five-year plan should also fact in the elements that would be best suited for SMT Ltd. In the event SMT Ltd decides to go ahead with the equity issue, the CFO is interested in knowing the various protective mechanisms that should be considered, and who are the right set of investors, SMT Ltd should approach. The CFO also mentioned that whilst they did have a merchant banker as well as some underwriters in their last issue, that was quite some time back and he is keen in getting your advice on some of these aspects. He also said that there are few friends of his in commercial banks who provide expert advice on market issues and was keen in taking your inputs on how he can proceed.

The third issue is about issues that are being currently discussed with a PE player in respect of investment for a subsidiary of SMT Ltd. The subsidiary has opened its first hospital in April, 2020 at a prominent place in Pune. The investors are forcing the management of subsidiary to have Tag-Along and Drag-Along rights as a part of the Shareholding Agreements (SHA). Although

these things are common for the CFO, the management of the subsidiary wants to understand implications of such clauses in the SHA.

SMT Ltd has substantial currency risk which arises mainly due to export and import activities. So far hedging of currency exposures have been infrequent and there is no established procedures in this respect and also there is no written down policies in this respect.

The 4th issue of the CFO is to decide whether to hedge with currency risks derivatives and what types of hedge instruments to choose for the same. He wants to give this assignment to you so that hedging activities are well-monitored and remains within the risk appetite of SMT Ltd. There is an urgent need to address this issue as last year there was breach on loan covenants due to currency exposures. The Group CFO has given you some idea about the currency exposure. They are as under:

SMT has taken loan of 100 billion JPY form a leading bank and it will be repaid in 10 years. The exposure is unhedged and hence it need to be hedged so that both interest risk and current risk is take care of.

The have odd-dates import transactions and they want to go for date -for data -for date hedging.

For export transactions, they are fine with hedge instruments that can either match dates or can be of more than the maturity period of the underlying. In the this category, they want 40% of the exposure to be hedged in a manner that should allow them to take advantage of favourable movement in exchange rate also and within that bracket some portion should be zero cost hedge.

SMT bank is also looking or raise by issuing subordinated debt and the negotiations is going on for last two months with a reputed merchant banker in this respect. Although the Group CFO wants to conclude the deal at the earliest, a newly inducted independent director has raised number or issue in this respect. The Group CFO will give a detailed presentation in this respect to the Board in the upcoming meeting.

SMT Ltd. Has project planned in Kenya. There is a discussion going on with a leading bank for arranging project finance loan. The group CFO wants their lenders to incorporate certain types of risks as a part of the borrowing arrangement and has sought your help in understanding the risks that lender bank can assume.

SMT Ltd. Has invested large part of its surplus cash in money market instruments and the Board has asked to make a presentation on type of instruments chosen and amount invested in securities that are issued at discount.

SMT Ltd is also evaluating the possibility of raising working capital loan either by way of commercial paper (CP) or cash credit. SMT Ltd is eligible for CP issue but a proper evaluation would help in making an informed decision.

5.1 Which one of the following incorrect with respect to sub-ordinated loan?

(A) Usually subordinated debts have the advantage of being short-term.

- (B) usually subordinated debts have the advantage of being long-term
- (C) Subordinated debts are unsecured.
- (D) Subordinated debts can be generally or specifically subordinated. **(2 Mark)**
- 5.2 The management of subsidiary of SMT Ltd. Only wants to allow sale of equity holding of PE investors also when they want to sell their stake to a third party. What kind of clause should be incorporated in the SHA?
- (A) Drag-Along.
- (B) Tag -Along.
- (C) Liquidation Preference
- (D) Predatory rights. **(2 Mark)**
- 5.3 Which of the risk (S) the lender bank is likely to assume in a project finance?
- (A) Sovereign risk
- (B) Foreign exchange risk.
- (C) Political risk.
- (D) All of the above. **(2 Mark)**
- 5.4 Which one of the following is incorrect with respect to raising working capital loan funds by way of CP and cash credit (CC)?
- (A) Both are unsecured.
- (B) CP is a negotiable instrument while CC is not.
- (C) Typically CP is cheaper as compared to CC
- (D) CP is less flexible in terms of drawn as compared to CC. **(2 Mark)**
- 5.5 Which one of the following is incorrect input for pricing of a CDS?
- (A) Risk-free rate interest rate term structure
- (B) The credit term-structure
- (C) The recovery rate.
- (D) Bond Indenture. **(2 Mark)**
- 5.6 Considering the requirements elaborated by the CFO for SMT bank about combining credit derivative with securitization techniques, what kind of credit derivative would you like to suggest? Explain what would be achieved by SMT bank by using the credit derivative suggested by you? **(3 Marks)**
- 5.7 Explain the broad procedures you would like to include in your report to the CFO so that he and his terms can decide whether to hedge forex risk and how to select the hedge instruments for the same? **(6 Mark)**

- 5.8 Explain who can underwrite a debt issue. Explain the limitations in underwriting of debt issue by the commercial banks. **(3 Mark)**
- 5.9 What could be the reasons, in your opinion, for choosing a debt issue rather than equity issue? How raising fund through a debt issue differs in comparison to raising of funds through equity issue? **(3 Mark)**

ANSWERS TO CASE STUDY: 5

5.6 Suggestion regarding the kind of credit derivative:

The SMT bank can use "Synthetic Collateralized Debt Obligation" (CDO) as a kind of credit derivative.

What it would achieve using the credit derivatives:

It would meet the twin objectives of SMT bank. Use of synthetic CDO would help SMT bank in achieving two things.

(a) Transfer of Credit Risk

Synthetic CDO structures enable the credit risk of a loan book to be separated from the interest risk and funding risk and manage on its own. The costs of transferring this risk away are a function of the CDO structure and related to the credit derivative pricing of the reference asset whether they are funded or unfunded.

(b) Regulatory Capital Relief

It can be done by transferring the lower-yield corporate credit risk such as corporate loans off their balance sheet or SMT may transfer higher-rated, lower-yield assets from its balance sheet using CDO transaction. The capital requirements for a synthetic CDO are lower than the corporate loan.

5.7 Broad Procedures and how to select the hedge instruments

Step I: Develop forecasts of distribution of exchange rates in order to determine the probability of adverse moment or use services of forex forecasters.

Step II: Decide whether dynamic hedging or conservative hedging or a mixed approach is required.

Step III: Assess the impact of exchange rate changes on financial performance and position under various scenarios.

Step IV: Decide how much to hedge considering overall risk limits and likely adverse impacts including impact on loan covenants.

Step V: Select appropriate hedging instrument - Decide currency forwards (date for date hedging), currency futures (timing mis-match hedging), currency option (allows favorable advantage) and currency swap (JPY loan hedging), zero cost collar (zero cost hedging) depending upon the type 00 exposures mentioned.

5.8 Who can underwrite a debt issue

The commercial banks can underwrite a debt issue. Commercial banks legally underwrite debt and some of the largest commercial banks have developed substantial expertise in underwriting public bond deals. So not only do these banks make loans utilizing their deposits, they also underwrite bonds through a corporate finance department.

Limitations in underwriting of debt issue by the commercial banks

When it comes to underwriting bond offerings, commercial banks have long competed for this business directly with investment banks. However, only the biggest tier of commercial banks are able to do so, mostly because the size of public bond issues is large and competition for such deals is quite fierce.

5.9 Reasons for choosing a debt issue rather than equity issue.

Sometimes, a company instead of choosing equity for their funding requirements chooses public debt. The reasons for issuing bonds rather than stock are various.

- (i) When the stock price of the issuer is down, and thus a bond issue is a better alternative.
- (ii) The firm does not wish to dilute its existing shareholders by issuing more equity.

The above are both valid reasons for issuing bonds rather than equity. Further, in case the economy is not doing well investors generally avoid the share issue and in such cases issuance of bonds may be resorted to satisfy the company's appetite for funds.

How raising fund through a debt issue differs in comparison to raising of funds through equity issue

The bond offering process resembles the IPO process. The primary difference lies in the focus of the prospectus (a prospectus for a bond offering will emphasize the Company's stability and steady cash flow, whereas a stock prospectus will usually play up the Company's growth and expansion opportunities).

Further, in case of a debt issue, the importance of bond's credit rating cannot be undermined. It is necessary to obtain a good credit rating from a reputed agency. A better credit rating gives an impression that the bond is safe. This has an edge over equity subscriptions.