

MOCK TEST PAPER 2

FINAL (NEW) COURSE: GROUP – II

PAPER – 6B: FINANCIAL SERVICES AND CAPITAL MARKETS

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

- (A) ABC Ltd is engaged in the manufacturing of garments. For this purpose, machinery is required. The company is thinking of buying machinery by resorting to borrowing. Another option before the company is to take machinery on lease. The company asks the finance team for its advice. The finance team elaborates the following advantages and disadvantages of leasing to enable the management to make an informed decision.

Advantages

The first and foremost advantage of a lease agreement is its flexibility. The leasing company in most of the cases would be prepared to modify the arrangement to suit the specific requirements of the lessee. The ownership of the leased equipment gives them added confidence to enable them to be more accommodative than the banks and other financial institutions. The other advantages of lease financing are as follows:

- (i) The leasing company may finance 100% cost of the equipment without insisting on any initial disbursement by the lessee, whereas 100% finance is generally never allowed by banks/financial institutions.
- (ii) Banks/financial institutions may involve lengthy appraisal and impose stringent terms and conditions to the sanctioned loan. The process is time-consuming. In contrast, leasing companies may arrange for immediate purchase of equipment on mutually agreeable terms.
- (iii) Lengthy and time-consuming documentation procedure is involved for term loans by banks/institutions. The lease agreement is very simple in comparison.
- (iv) In short-term lease (operating lease) the lessee is safeguarded against the risk of obsolescence. It is also an ideal method to acquire use of an asset required for a temporary period.
- (v) The use of leased assets does not affect the borrowing capacity of the lessee as lease payments may not require normal lines of credit and are payable from income during the operating period. This neither affects the debt-equity ratio or the current ratio of the lessee.
- (vi) Leased equipment is an 'off the balance sheet' asset being economically used by the lessee and does not affect the debt position of the lessee.
- (vii) By employing 'sale and lease back' arrangement, the lessee may overcome a financial crisis by immediately arranging cash resources for some emergent application or for working capital requirements.
- (viii) Piecemeal financing of small equipment is conveniently possible through lease arrangement only as debt financing for such items is impracticable.
- (ix) Tax benefits may also sometimes accrue to the lessee depending upon his tax status-

Disadvantages

The lease financing has certain disadvantages also which are discussed as follows:

- (i) The lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in the case of term loans from financial institutions. The lease arrangement may, therefore, not be suitable for setting up the new projects as it would entail cash outflows even before the project comes into operation.
- (ii) The leased assets are purchased by the lessor who is the owner of the equipment. The seller's warranties for satisfactory operation of the leased assets may sometimes not be available to the lessee.
- (iii) Lessor generally obtains credit facilities from banks etc. to purchase the leased equipment which is subject to hypothecation charge in favour of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.
- (iv) Lease financing has a very high cost of the interest as compared to interest charged on term loans by financial institutions/banks.

Despite all these disadvantages, the flexibility and simplicity offered by lease finance have made it popular.

- (B) ABC Ltd is also listed on BSE and NSE. Its management is concerned about the recent insider trading in the mid-cap and small-cap companies and consequently the SEBI's latest very sophisticated tracking mechanism to detect insider trading. And because of the stock market reaching new highs selling by insiders has increased a lot.

In July 2021, insiders have sold shares worth more than ₹ 10,000 crores. And in May and June 2021 about ₹ 7,000 each. But selling was slow during April 2021 following a correction in the market because of the dangerous second wave of the pandemic. And because of regulatory requirements, companies must disclose to the stock exchanges any buying or selling by promoters or key managerial personnel.

Recently, several top executives of banks and other financial institutions are witnessed to have sold their holdings. Further, promoters of several mid and small-cap companies have reduced their holdings.

However, the liquidation of holdings by insiders doesn't always imply that these persons are trying to take advantage of the bullish scenario. While some of them have sold their holdings to accumulate funds to purchase shares in the fresh employees' stock option scheme, others had been selling at regular intervals to meet other requirements.

But some insiders are being clever, which is evident in their increased activity when the markets have reached record highs, and valuations are also high in comparison to historical levels. A lot of stocks are currently overvalued. Therefore, insiders are taking benefit from these opportunities from the stock market.

The market regulator, SEBI is therefore refurbishing its surveillance mechanism as insider trading is getting savvier. Previously, company insiders or their proxies would buy and sell shares based on insider information. But now they are using complex derivative strategies to make some quick profit.

This has urged the market regulator to develop an internal mechanism to scan all derivative trades and mark suspicious transactions. Experts who are abreast of the system pointed out that the new system will scan about 20 million trades every day.

The experts have also opined that the system scans derivative trading in listed companies based on overall delta positions. In simple words, the system tries to find out large unhedged positions taken by individuals in each stock and analyses them. It is rather strange for a normal trader to take such large unhedged positions unless he knows about some information about the company.

Alerts generated by the new systems are significantly more vibrant than the existing insider trading alerts, and they have given a boost to SEBI's surveillance in the complex derivatives market consisting of futures and options contracts. The performance of the system doesn't finish there. It also creates a database of suspected transactions along with traders who have undertaken the transaction.

This platform will help the market regulator to build patterns. If some trader frequently undertakes such transactions, the platform will catch those and caution the market regulator. Then more details can be dug out to see if the trader is connected to any of the brokers.

Questions

Based on above, answer the following questions:

1. ABC Ltd. requires a machinery costing ₹ 20,00,000. It will be utilized over a period of 5 years. It has two financing options in this regard:
 - (i) Arrangement of a loan of ₹ 20,00,000 at an interest rate of 12 percent per annum; the loan being repayable in 5 equal year end installments; the equipment can be sold at the end of fifth year for ₹ 2,00,000.
 - (ii) Leasing the equipment for a period of five years at an early rental of ₹6,60,000 payable at the year end.

The rate of depreciation is 15 percent on Written Down Value (WDV) basis, income tax rate is 30 percent and discount rate is 10 percent.

Show by way of detailed calculations which of the financing options should ABC Ltd. avail and why?

(7 Marks)

2. Mr. Amit, an insider of the company wants to sell 1000 shares to his colleague Sumit who is also an insider. Will selling these shares by Amit be considered to be an insider trading? If not, then what precautions are to be taken?

(5 Marks)

3. Discuss briefly the regulations relating to maintenance of code of conduct which is required to be complied with by ABC Ltd.

(3 Marks)

4. Multiple Choice Questions:

(10 Marks)

- (i) among the following is not a connected person as per the insider trading regulations
 - (a) A member of the board of directors
 - (b) A banker of the company
 - (c) An official of a stock exchange
 - (d) A broker of the insider
- (ii) The trading plan shall not entail commencement of trading on behalf of the insider earlier than from the public disclosure of the plan
 - (a) six months
 - (b) three months
 - (c) one month
 - (d) one week
- (iii) Every person on appointment as a shall disclose his holding of securities of the company within seven days of such appointment.
 - (a) Key Managerial Personnel
 - (b) Director

- (c) Promoter
- (d) any one of the above
- (iv) Under method, lessor enters into an arrangement with the seller, to market the latter's product through its own leasing operations.
 - (a) Operating Lease
 - (b) Financial Lease
 - (c) Sales and Lease Back
 - (d) Sales-Aid-Lease
- (v) From lessee's perspective..... method of evaluating a leasing proposal segregates the financial and tax aspects of lease financing.
 - (a) Present Value Analysis
 - (b) Internal rate of return analysis
 - (c) Bower-Herringer-Williamson Method
 - (d) None of the above

CASE STUDY: 2

Suryanshi Limited, a start-up in the field of business to business (B2B) e-commerce segment came out with an Initial Public Offer (IPO) recently and get itself listed with both the National Stock Exchange of India (NSE) as well as the Bombay Stock Exchange of India (BSE). It was somewhat sceptical about the shifting of the settlement cycle from T + 2 to T + 1 and how it would affect its company. It sought the advice of its financial advisor, Mr. Vipin Maheshwari about the repercussion of this transition. Mr. Vipin discussed the issue with the Chief Executive Officer (CEO) of the company and elaborated the entire process with its pros and cons which has been explained in the following paragraphs:

Recently, the stock market regulator, the Securities and Exchange Board of India (SEBI) has decided to reduce the settlement cycle from T + 2 to T + 1. The aim is to enforce the settlement and transfer of funds and securities within one working day of a given trade, from the current cycle of T + 2. However, the new cycle will be introduced from January 1, 2022, and will be optional.

Furthermore, the exchanges will decide which stocks would be transferred to T + 1. Before doing that, it has to give a one month's notice before switching the settlement period of stock. Once the settlement cycle is switched, the stock will remain on T + 1 for a minimum period of six months. After six months, it can be transferred back to T + 2, but again, by giving a one- month's notice. However, the netting is not possible, if the stock is available on both T + 2 and T + 1, on different exchanges.

The shift to this shorter cycle will bring quicker cash flows and faster security transfers. It will also reduce the chances of default and also enable an increase in trading volumes as it will free up margin capital and securities faster. Further, the price risks in volatile stocks will also reduce. So, this shift to T + 1 from the present T + 2 settlement regime is expected to benefit the market in the situation of high stress and volatility.

The Securities and Exchange Board of India has attempted to reduce the rolling settlement cycle after a gap of 18 years, allowing the stock exchanges to offer T+1 from January 2022. The market regulator in 2003 had shifted from T+3 to T+2.

This change of settlement cycle has affected the market participants. The effect on them has been discussed as follows:

Retail, Domestic Investors

The shift to T + 1 will help the retail domestic investors. A shorter settlement cycle will lead to faster movement of cash and stocks and will also augment the trading turnover. As mentioned in the previous paragraphs also

the move is expected to increase speculation as it helps the investors to encash an arbitrage opportunity on a particular stock with different stock exchanges.

Further, the domestic mutual funds will also benefit from this transition as they will get cash quickly and allow them to redeem the investor's money quickly. Presently, mutual fund investors get their redemption amount from the equity schemes in a T+3 cycle, or within three days of the transaction. However, T+1 settlement will present them some difficulties in calculating the net asset value as a stock with different settlement cycles on NSE and BSE will have different prices.

Exchanges

The National Stock Exchange of India Ltd., the largest stock exchange in India has a 94% share in stock trading in Financial Year 2021 against 6% of Bombay Stock Exchange of India Ltd., the oldest stock exchange in South Asia.

So, it seems that volumes are tilted heavily in favour of NSE and it seems improbable that the two exchanges will agree on the same list of stocks with T+1 stocks.

Therefore, while the BSE may introduce T+1 on the stocks of a particular company, the NSE may not. So, the stock of that company will have two settlement cycles. A shorter cycle will help release more cash and enable the quicker transfer of stock in the case of BSE which has more bulk and block deals. So, the two stock exchanges may prefer a separate list, according to market participants.

Foreign Portfolio Investors (FPI's)

FPI's will most probably be unwilling to participate in the new settlement cycle as T+1 would require them to bring funds before the trading takes place, which they don't do globally because it involves foreign exchange.

Foreign investors have also expressed their concerns about the operational issues they would face if they function from different time zones. This will affect their information flow process and foreign exchange problems. So, if T + 1 system is there, it will be difficult for the foreign investors to hedge their net India exposure in dollar terms at the end of the day.

Further, the securities settlement for FPIs has operational complexity which involves coordination among various intermediaries like fund managers, custodians, brokers, clearing members, and exchanges. So, in a way, for American and European investors, the current T+2 cycle works as T+1, as investors have to arrange funds for transactions and pre-settlement matching a day before the settlement of trades.

Therefore, in this backdrop, it can be said that shifting to a T+1 settlement would invariably lead to booking foreign exchange on the trading day itself for local custodians. Also, the tax consultants generally calculate tax on T+2 or T+3 days. So, it may happen that pay-in is received on T+1, but clients will be forced to keep their funds in Indian rupees for one or two days because of the pendency of calculation of tax.

However, the main advantage is that since cash is locked in for just a day in a T+1 settlement, it will reduce counterparty risk borne by the clearing corporation and the FPIs and reduce the cost of transactions.

Custodians

Mostly, the custodians are global banks that keep securities and cash in their custody and they have pointed out some difficulties which may be encountered with this shift.

Their first concern is foreign exchange management. While the custodians will most probably be able to manage the two-settlement cycle in a day with the technical prowess they currently possess, it will put an additional burden on their backend.

Further, the time period for the processing of contract notes would have to be shortened and the clearing corporations would have to provide sufficient time to the custodian to complete the process.

Foreign portfolio investors which are having their financial centres in New York, London, and Singapore and invest in various markets arrange their trades through global custodians such as State Street, Bank of New York, Citi, and Northern Trust, who then deal with local custodians basically MNC banks in respective

markets. In order to confirm a trade, the global custodian for example in New York has to transfer the funds to the local custodian in India.

Presently, under T+2, the funds are sent the next day i.e., T+1. However, with a T+1 settlement, the global custodian has to send the money earlier i.e., on the same day the trade happens or, T+0. However, experts pointed out that this would be difficult for the global custodians to comply.

Clearing Corporations

Clearing corporations, which takes care of confirmation, settlement, and delivery, have expressed to the market regulator they would need some time i.e. at least four to five months to be able to be fully compatible with the two-settlement cycles framework.

Brokers

Association of National Exchange Members of India which is a lobby of brokers also conveyed their concerns by mentioning that pay-in and pay-out cycles are not regular even under the current T+2 cycle. Further, settlement files are not received from the exchanges and clearing corporations on time.

The new system will put pressure on the existing infrastructure of the broker, who may have to put in long unending working hours. So, it has to be seen what changes the stock exchanges will make to their systems to let buyers select either of the T+1 and T+2 settlement cycles on the front end and allow brokers to execute it at the back end.

Furthermore, the financial advisor of Suryanshi Ltd. concluded the discussion by pointing out that the “block mechanism” introduced some time back allows the shares of a client intending to make a sale transaction to be blocked in the client’s Demat account in favour of the clearing corporation concerned. If the sale transaction is not executed, shares will remain in the client’s Demat account and will be unblocked at the end of the T Day.

Questions:

Based on above, answer the following:

1. Sudbuddhi purchased 100 shares of Infosys limited at ₹ 1500 on 30th August, 2021 i.e. Monday. Assuming that T + 2 settlement cycle is followed, explain the process to be followed in the Indian capital market through which Sudbuddhi will get the acquired shares in his Demat Account. **(5 Marks)**
2. Some of the market experts have viewed that foreign investor may face some difficulties while shifting from T + 2 to T + 1. Discuss those difficulties. Do you think that considering these difficulties, is it viable for the market regulator to go ahead with the transition plan? **(6 Marks)**
3. Explain with examples the benefits which will be received with this transition. Also outline the safeguards which shall be taken while shifting to T + 1. **(4 Marks)**
4. Multiple Choice Questions (MCQs) **(10 Marks)**
 - (i) If the stock of ABC Ltd. is traded under T + 1 settlement in NSE while T + 2 settlement in BSE, the foreign portfolio investors may prefer the exchange offering settlement.
 - (a) T + 1
 - (b) T + 2
 - (c) Both of them
 - (d) None of them
 - (ii) The situation in (i) above will impact the stock prices and create a/an opportunity.
 - (a) Hedging
 - (b) Speculative

- (c) Arbitrage
 - (d) All of the above
- (iii) Which among the following risks will be reduced for the clearing corporation and the foreign portfolio investors, if T + 1 settlement is adopted?
- (a) Credit Risk
 - (b) Liquidity Risk
 - (c) Counter Party Risk
 - (d) Market Risk
- (iv) Which of the following is an advantage of recent blocking mechanism introduced by SEBI?
- (a) Securing investors' securities balances
 - (b) Improving overall margin efficiency
 - (c) Saving time and cost
 - (d) All of the above
- (v) Aakansha, an investor, buys 100 shares of Reliance at ₹ 2540 on Monday and sell those shares at ₹ 2560 each on the same day. As per the T + 2 settlement, her net obligation in terms of funds and securities will be calculated on
- (a) Monday
 - (b) Tuesday
 - (c) Wednesday
 - (d) Thursday

CASE STUDY: 3

- (A) Shikshak is an education tutoring app with free access to content limited for 15 days after registration. It was started in September 2018, offering educational content for students from classes 4 to 12 and in 2020 an early learning program has started for classes 1 to 3. It also gives training to students preparing for examinations in India such as IIT-JEE, NEET, CAT, IAS, and international examinations such as GRE and GMAT.

Academic subjects and concepts are explained with 5-15 minute digital animation videos. Shikshak reports to have about 1 crore (10 million) users overall, 10 lakh (1 million) annual paid subscribers and an annual retention rate of about 75%. In 2020, the company announced that it would launch its app in regional Indian languages. It also plans to launch an international version of the app for English-speaking students in other countries.

Recently, Shikshak's launched new programs in its Early Learn App for students of kindergarten as well. In April 2021, the company also announced the launch of " Shikshak's Future School" to be led by Dependable Jr Founder Swaraj Bhatia. The Future School aims to cross the bridge from passive to active learning with an interactive learning platform blended with coding and other subjects like Maths, Science, English, Music, and Fine arts through storytelling. Shikshak 's will launch the Future School in the USA, UK, Australia, Brazil, Indonesia, and Mexico in May 2022.

The initial funding of Shikshak was provided by the Angel Investors. Later, when the company started showing promise, some Private Equity (PE) investors came along and provide funds for its operations. However, the company needs working capital also to keep its operations from going continuously.

Shikshak sold some concise study materials to various educational institutes. It raised invoices on these institutes. Furthermore, it is thinking of utilizing the services of a factor. The finance manager of the company briefed the CEO of Shikshak about the process and the utility of availing of factoring services.

In a factoring transaction, there are three parties – the factor, the client, and the customers of the client. The client is the person who is actually availing of the factoring service. The factor provides the factoring services and the customers are the persons who purchase the goods and services on credit.

The following steps are involved in the process of factoring:

- (i) Customer places an order with the client for purchase of goods and/or services on credit.
- (ii) On the basis of agreement, the client delivers the goods and sends the invoice to customers.
- (iii) The client then assigns the invoice to the factor. This is generally called, “Call sale of book debts by the client firm to the factor”.
- (iv) The factor, then, makes prepayment up to 80 percent of the invoice value to the client.
- (v) The client pays interest on advances of the amount received until the cash is collected from customer.
- (vi) The factor maintains accounts receivable of the client and sends periodical statements to the customer to accelerate the collection.
- (vii) On the due date, the factor collects the invoice amount from the customer.
- (viii) After that, the factor releases the remaining amount to the client after adjusting his commission/fees.

In this Debtor financing process, factoring charges also played a vital role in providing the services. The following factoring charges are levied:

- **Finance charges** – It is computed on the prepayment outstanding in the client’s account at monthly intervals. Finance charges are only for financing that has been availed by the client. These charges are similar to interest levied on the cash credit facilities in a bank.
- **Service fee** – It is a nominal charge at a monthly interval to cover the cost of services namely - collection, MIS reports, sales ledger management etc. Service fee is determined on the basis of total gross value, no. of customers, degree of credit risk etc.

- (B) The National Stock Exchange (NSE) in order to limit the damage from freak trades has decided to prohibit stop-loss orders with market condition from September 2021. The reason is that the traders used to quit market positions at whatever price was available in the market if their bets went incorrect. Henceforth only limit orders that restrict such transactions to a predefined price will be allowed by it.

This is expected to mitigate damage in case freak trades are involved that cause large price swings often because of mistakes in order entry which is made worse by stop-loss orders triggered by freak trades. Freak trades happen when the participants in the market experience that those trades are being done way far from the current market price in Futures and Options contracts.

For instance, the futures contract prices of HDFC reached a level of Rs 3,135 even as the spot price was lingering around Rs 2,850. Such freak trades are most probably happening because of diminished liquidity caused by new strict margin norms of SEBI that have enhanced the capital requirement for traders and speculators that has somewhat subdued the liquidity from the futures market environment.

The move by the National Stock Exchange of India (NSE) to completely discard execution ranges, price bands within which contracts can trade since August 16, 2021 may be another factor behind this.

A seasoned and efficient trader always makes efforts to mitigate all possible risks that are within his control. Hence it is prudent to use limit orders with a price higher than the current market price for buy orders and lower for sell orders. This may result in an effective method to safeguard oneself from a large

loss due to a freak trade while also entering or exiting promptly. This strategy will ensure that you stay protected against freak trades even if you continue placing market orders.

Furthermore, as already stated, the Exchange has discontinued Stop Loss Orders with Market condition (SL-M) for option contracts with effect from September 27, 2021 and hence any order placed with the above-mentioned condition shall be rejected by the Exchange. However, stop Loss order with limit condition (SLL) shall still remain open for all contracts.

For instance, a trader betting that a stock at ₹ 100 will rise to ₹ 120. The trader can have a market stop-loss which will sell the share if it falls instead to ₹ 85. Such stop losses contain instructions to sell at the prevailing market price. This would mean that it would sell at any price from ₹ 85 all the way to zero. Stop – losses as limit orders mean an exit will happen only if the market offers a minimum price, for example, ₹ 95.

Such happenings have witnessed more frequency after the NSE removed restrictions on the price at which a given trade can be carried out. Participants have reported freak trades since then. This included events on August 20, 2021, for options traders in the Nifty 50 index contract, and Nifty Bank Index options on September 7, 2021.

The experts pointed out that the trade execution range was restricting market movements. It restricts the price at which a trade can be executed based on the average of the trade prices during the last one minute. This was over and above the daily price range that decides the maximum movement allowed during the day. As the trade execution range was often narrower, options would stop trading because of relatively small movements in price. This was not allowing the market to discover prices freely. Large swings in price after its removal could be on account of stop losses getting triggered at market prices.

The National Stock Exchange has made available an alert system to prevent freak trades through its software. Some brokers also use other non-exchange solutions. However, there are still some chances of a freak trade as some of the responsibility of risk management is now on brokers.

Questions

Based on above, answer the following questions:

1. The credit sales and receivables of Shikshak Ltd. at the end of a financial year are estimated at ₹ 600 lakhs and ₹ 100 lakhs respectively.

The average variable overdraft interest rate is 6% p.a.

Shikshak Ltd. is considering a factoring proposal for its receivables on a non-recourse basis at an annual fee of 1.5% of credit sales.

As a result, Shikshak Ltd. will save ₹ 2 lakhs p.a. in administrative cost and ₹ 6 lakhs p.a. as bad debts.

The factor will maintain a receivables collection period of 30 days and will provide 80% of receivables as advance at an interest rate of 8% p.a. You may take 300 days in a year for the purpose of calculation of receivables.

Advise Shikshak Ltd. whether it should consider the factoring proposal or not. **(7 Marks)**

2. What is a freak trade? What steps can be taken to mitigate freak trade? Discuss by giving examples.

(4 Marks)

3. What are the provisions relating to composition of the board of directors? If Shikshak Ltd is in the top 2000 listed entities w.e.f. April 1, 2020, what should be the its minimum number of directors? **(4 Marks)**

4. Multiple Choice Questions: **(10 Marks)**

(i) An index call option is trading at ₹ 100. In order to reduce the possibility of a freak trade, it is better to place a buy order at

(a) ₹ 100

- (b) ₹ 102
 - (c) ₹ 98
 - (d) Any of the above
- (ii) The most feasible way to avoid a freak trade is to place a
- (a) Stop loss limit order
 - (b) Stop loss market order
 - (c) Stop loss trailing order
 - (d) None of the above
- (iii) Which among the following is not a service provided by a factor?
- (a) Maintenance of sales ledger
 - (b) Collecting receivables
 - (c) Advisory services
 - (d) Broking services
- (iv) In order to commence its business, factor has to obtain certificate of commencement of business from the
- (a) SEBI
 - (b) RBI
 - (c) Both SEBI and RBI
 - (d) Both RBI and Ministry of Finance
- (v) Every factor shall commence its business within from the date of grant of Certificate of Registration
- (a) one month
 - (b) three months
 - (c) four months
 - (d) six months

CASE STUDY: 4

- (a) XYZ Mutual Fund launched its first scheme in October 2009. Since then, it has grown strongly. XYZ attributes its success thus far to its 3 founding principles – long-term wealth creation, outside- in (Customer) view and, Long-term relationship. It invites the growing family of investors and, give shape to their desires.

Its mission is to responsibly manage money and risks to help people feel safe and secure about their investments.

Its product, sales, and service strategy are entirely guided by this. It aims to provide quality financial and investment solutions which help customers feel financially secure and feel confident of a brighter and prosperous future. ABC lays a strong emphasis on risk management and planning. It encourages its investors and partners to take a holistic view that extends beyond mere investing surpluses to investing with an underlying dream, aspiration, or goal.

- (b) The insurance regulator, Insurance Regulatory and Development Authority of India (IRDAI), has given its permission to insurers to invest in debt securities issued by infrastructure investment trusts (InvITs) and real estate investment trusts (REITs). The purpose is to make a vivid market for corporate debt in

India. However, in order to ensure the constant flow of money from the pension and insurance sector to corporate bonds, these bonds have to be made attractive and market-oriented for hedging the risks of interest and exchange rate changes and credit default.

Furthermore, the requirements for long-term investors like insurance companies and pension funds are such that they have to invest in debt securities rated AA or higher. However, the continuing infrastructure projects are rarely rated above BBB, because of construction and other risks. Therefore, there is an urgent need for institutions and regulatory oversight to address default risks on bond payments, with mechanisms such as excess interest spread, cash collateral, and partial credit guarantees. Assets under management by pension and insurance funds have now surpassed Rs 55 lakh crore.

Long-term investors are required to increase their policy coordination to augment their resource allocation for infrastructural investments. Investors also jointly need risk mitigation tools to manage routine currency, interest rate, and credit risks.

Indeed, it is now very much a work in progress. For example, take the case of credit risks. Recently, the law has been changed to allow 'netting' of exposure on derivative instruments. However, the principles for credit default swaps are still to be put in place. Also, take interest rate derivatives. Further, it is true that non-residents can now hedge and trade in the rupee interest rate derivatives market, but constraints are still there for both retail and other participants.

- (c) In the recent budget announcement, foreign direct investment (FDI) limit in the insurance sector has raised from 49% to 74% which is indeed, a very welcome step. With bumper flow of capital, together with the continuous reform of the corporate bond market, not only the availability of long-term funds for infrastructure can be augmented but also the market for high-yield debt instruments such as catastrophe bonds to manage the disaster risks in a better manner.

The recent landslide and glacier burst in Uttarakhand's Chamoli district, and other extreme events nationally highlighted the need to strengthen the financial markets for enhanced risk mitigation. Catastrophe bonds, or cat bonds, provide a measure to transfer hazard risks to a wide array of investors. The bonds provide an adequately attractive rate of interest to cover for the increased risk and have a short maturity period of 3-5 years.

If the disaster does take place, the principal is written off or suitable renegotiation is made. In the case of issuer of cat bonds, insurers, reinsurers, and, increasingly, sovereign entities, it gives large financial protection. So, it is possible for those who are susceptible to natural hazards to insure themselves. They have the option to either buy insurance from a large insurance company, which would issue cat bonds, or the relevant local or state governments could directly issue catastrophe bonds.

Another point of contention would be the determination of interest rates on cat bonds which has to be attractive enough to the investors and it also depends upon the probability of extreme events. All these demands increase awareness of the situation and resultant best practices. Overall, the need is to resort to some sort of proactiveness to manage a whole spectrum of risks using new financial instruments and products.

In this respect, it is also pertinent to highlight that the National Disaster Response Fund may be able to buy policies against particular kinds of disasters, for particular areas. Also, the assets under management by pension funds and insurance companies are now over ₹55 lakh crore. However, what is required is the systematic allocation of resources to insure extreme events in an efficient manner.

Questions

Based on above, answer the following questions:

1. On 1st April 2019 Good Return Mutual Fund has the following assets and prices at 3.00 p.m.

Shares	No. of Shares	Market Price Per Share (₹)
A Ltd.	20000	22.70

B Ltd.	100000	502.60
C Ltd.	20000	294.40
D Ltd.	200000	696.90
E Ltd.	60000	35.90
No. of units of funds		10,00,000

Please calculate:

- (a) NAV of the Fund on 1st April 2019.
- (b) Assuming that on 1st April 2019, Mr. X, an HNI, send a cheque of ₹ 60,00,000 to the Fund and Fund Manager immediately purchases 20000 shares of C Ltd. and balance is held in bank. Then what will be position of fund.
- (c) Now suppose on 2 April 2019 at 3.00 p.m. the market price of shares is as follows:

Shares	₹
A Ltd.	25.30
B Ltd.	533.70
C Ltd.	310.80
D Ltd.	707.90
E Ltd.	54.20

Then what will be new NAV.

(5 Marks)

2. The insurance regulator has allowed insurance companies to invest in debt securities issued by InvITs and REITs. However, this brings certain risks related to interest rate, exchange rate and credit default. How these risks can be mitigated? **(5 Marks)**
3. Explain catastrophic bonds. How do they work? **(5 Marks)**
4. Multiple Choice Questions **(10 Marks)**
 - (i) In case of, mandatory sponsor holding is 15%.
 - (a) Mutual Fund
 - (b) Exchange Traded Fund
 - (c) InvIT
 - (d) REIT
 - (ii) The ratio measures excess return generated per unit of risk in the portfolio i.e. excess return earned above the risk-free investment.
 - (a) Sharpe
 - (b) Treynor
 - (c) Sortino
 - (d) Jensen Alpha
 - (iii) Which among the following is false with relation to the granting of certificate of registration for the mutual fund?
 - (a) be carrying on business in financial services for a period of not less than five years
 - (b) ensure that the networth is positive in all the immediately preceding five years
 - (c) the sponsor has shown profits in three out of five immediately preceding years

- (d) the sponsor has contributed or contributes at least 50% to the net worth of the asset management company
- (iv) Which among the following in case of Money Market Mutual Fund is not true?
 - (a) The minimum investments would be ₹ one lakh
 - (b) The re-purchase would be subject to a minimum lock-in-period of 6 months.
 - (c) Minimum of 20 per cent of funds will be invested in 182 days treasury bills.
 - (d) Maximum of 20 per cent of funds will be diverted to call money markets.
- (v) InvITs are set up as a and registered with
 - (a) Company; SEBI
 - (b) Trust; SEBI
 - (c) Company; RBI
 - (d) Trust; RBI

CASE STUDY: 5

- (A) Mr. Sumesh, a senior executive of a private bank was told by his financial advisor, C.A. Tarun about the new fixed deposit scheme launched by Equitas Small Finance Bank (SFB) through Google Pay. He explained the entire thing (in the paragraphs to follow) to Sumesh so that he could discuss the matter with his seniors on a proper strategy to be adopted in this matter.

Recently, Equitas SFB started a unique fixed deposit scheme that can be booked through the Google Pay app instantly. It is just like buying a T-Shirt or Jeans from an online marketplace. It is another welcome move towards easy availability of financial products. However, it sends some jitters to the banking regulator.

Equitas Small Finance Bank declared that any Google Pay user can open a fixed deposit account with it by using Google's Unified Payment Interface (UPI). Equitas has been provided a 'Spot' in the Google Pay business section. Actually, the spot is a visual code just like a QR code which is available only for Google. So, when a spot is scanned for a particular business, it navigates the customer to the website of that business. However, Google cannot see whatever the customer is selecting on the website of the dealer which is Equitas in this particular case.

Once the deposit amount is selected and the amount is finalized, the payment is made through UPI. So, what Google does is – debits the account of that person linked with UPI ID and credit the account of Equitas. But, before that Equitas will also ask for the Know-your-customer documents to open an account. Now, Google's task is completed with the payment transfer and a relationship exists only between Equitas and the customer.

On hearing this, Mr. Sumesh asked that this can be done even by visiting the bank websites. So, what is the need for taking Google's help? CA Tarun replied that actually, Google's help is not required for opening a fixed deposit account. The basic purpose of Equitas is to utilize the Google's distribution channel as a means to reach out to new customers. Indeed, the customers can always go to the nearest bank branch or visit the website of the bank to open an account digitally.

But, if the same deposit process can be done instantly by using Google Pay without going through the botheration of visiting the website, creating passwords, etc, which may take a little bit of extra time – the customer is most likely to go through this new system. And Equitas SFB is definitely counting on that.

Furthermore, it is true that there are so many financial services players like CashE, Groww, 5paisa, Zest Money, etc. which are using Google Pay to expand their businesses, the fixed deposit initiative was taken by Equitas through Google Pay is the first of its kind in India. For this, Google charges a commercial fee from all the dealers using Spot on Google Pay.

However, ultimately, it is the responsibility of Equitas SFB for the safety of the deposits because the banking regulator RBI ensures that the bank fulfill its obligations to the deposit holders. And it is also true that deposits are an important part of the banking business and the very core of RBI's existence. Also, the banking regulations of RBI have two main purposes – the safety of deposit holders' money; and the financial stability of the system.

- (B) The board of directors of the Securities and Exchange Board of India (SEBI) on August 2021 gave its permission to begin the process of changing the concept of 'promoters' to 'person in control or 'controlling shareholders' and urged the regulator to prepare a detailed plan by consulting their peers. SEBI opined that in the last few years, a number of businesses and new companies with diversified shareholding and professional management that are being ventured into a listed company is not family-owned and their promoter group is not separately identifiable.

For example, in the recently listed Zomato, the NSE data showed that promoters cannot be identified separately. The early investors like Info Edge and Alipay (an arm of Alibaba of China), Deepinder Goyal, the founder, are all listed as public shareholders. However, traditionally, most of the bluechip companies like Reliance Industries, TCS, HDFC Bank, and several others have promoters. Indeed, the exceptions are HDFC, ICICI Bank, ITC, and L&T.

SEBI noted that now the situation is different from the past, the concentration of ownership and control rights does not vest completely in the hands of the promoters or promoter group. There has been a substantial enhancement in the number of private equity and institutional investors who invest in companies and take up substantial shareholding and in some situations control also. Such investors invest in unlisted firms and extend to hold shares even after the listing. Most of the times, they are the largest public shareholders, drawing special rights, such as the right to nominate directors.

However, it is important to clarify that the shift from 'promoter' to 'person(s) in control' will not bear fruits if no corresponding change is done to the definition and utilization of the term 'control' as presently defined in various legislations. It would be viable to differentiate between a person running the business and a person assisting or financially supporting it. So, only the former can be said to be a 'person in control of a business'.

Questions

Based on above, answer the following questions:

1. What is the main concern with RBI and other banks with this deposit arrangement between Equitas SFB and Google Pay? Discuss with examples. **(6 Marks)**
2. Explain briefly the risks as well as the opportunities to Mr. Sumesh for an Indian Bank which are inherent in this Equitas SFB and Google Pay deal. **(4 Marks)**
3. Discuss the reasons for SEBI's inclination towards changing the concept of "promoters" and move towards "person in control". **(5 marks)**
4. Multiple Choice Questions **(10 Marks)**
 - (i) Spot is just like a which is available only for Google
 - (a) QR Code
 - (b) Visual Code
 - (c) Secret Code
 - (d) Both (a) and (b)
 - (ii) The basic advantage of the deal between Equitas and Google is to
 - (a) Reducing the botheration of visiting a physical branch of a bank
 - (b) Utilize the Google's distribution channel as a means to reach out to new customers
 - (c) Reducing the need to visit websites

- (d) All of the above
- (iii) A listed entity shall appoint a qualified as a compliance officer.
 - (a) Chartered Accountant
 - (b) Cost Accountant
 - (c) Company Secretary
 - (d) Lawyer
- (iv) A listed entity has to file a statement of investor complaints on a quarterly basis within from the end of each quarter.
 - (a) 7 days
 - (b) 14 days
 - (c) 21 days
 - (d) 30 days
- (v) The prescribed quorum for every meeting of the board of directors of the top 2000 listed entities since April 1, 2020 has been
 - (a) one-third of its total strength or three directors, whichever is higher, including at least one independent director.
 - (b) one-third of its total strength or three directors, whichever is higher, including at least one non-executive director.
 - (c) one-third of its total strength or two directors, whichever is higher, including at least one independent director.
 - (d) one-third of its total strength or two directors, whichever is higher, including at least one non-executive director.