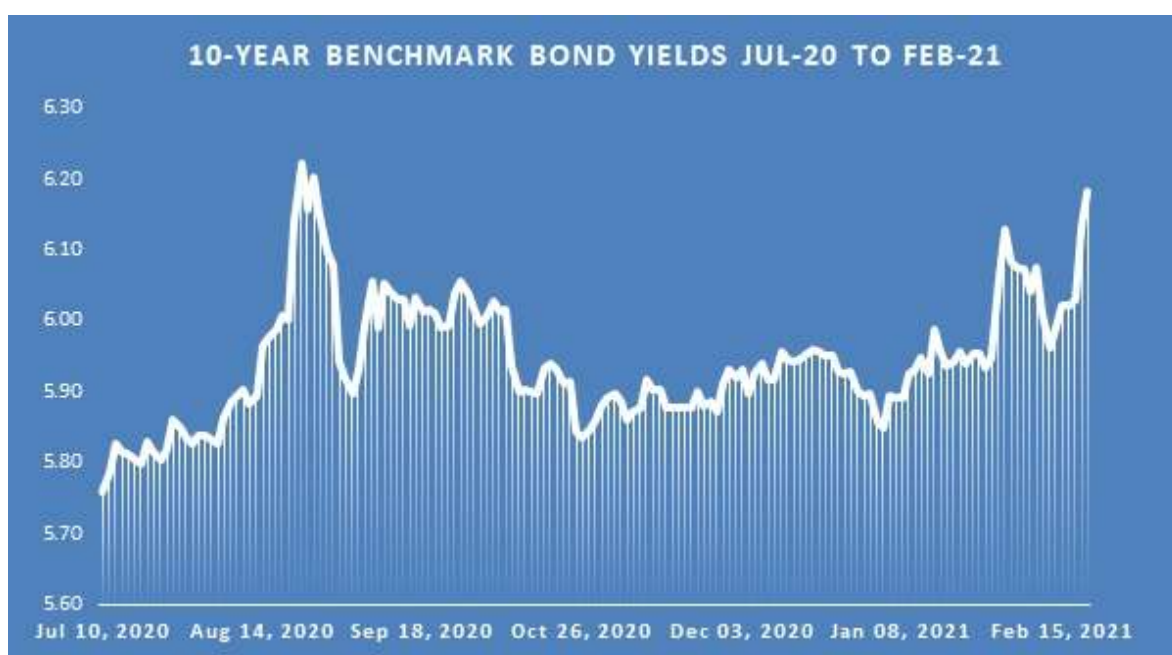


MOCK TEST PAPER
FINAL (NEW) COURSE: GROUP – II
PAPER – 6B: FINANCIAL SERVICES AND CAPITAL MARKETS

*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

In the year 2020, the stock markets suddenly start to slide down between the second and third weeks of February. It was found that the real reason for the stock market fall was the sharp increase in bond yields. The yield chart as given below shows the summary of this situation.



Date Source: RBI

If we take an 8-month perspective from July 2020 to February 2021, the bond yields have increased from 5.75% to above 6.18%. However, the sudden spurt in bond yields since January 2020, and especially after the announcement of the Union Budget is more relevant. The 40 basis points rise in 10-year bond yields since January 2021 can be clearly seen from the above chart, but what are the reasons for this quick soaring of bond yields?

Basically, there were two factors that triggered the sharp surge in bond yields and both came under the scanner recently.

- (a) Increase in fiscal deficit has been one of the important reasons for the rise in yields. The Union Budget set Financial Year 2021 fiscal deficit at 9.5% and Financial Year 2022 fiscal deficit at 6.8%. This indicates a huge borrowing spree from the government and it has fixed the total borrowing program at Rs 12,00,000 crore in Financial Year 2022. That is around the same level as Financial Year 2021. The recent bond cancellations are also an indication that markets expect higher yields as fund raising from the private sector is likely to be curtailed.
- (b) The second reason for the spurt in bond yields is inflation. It is true that inflation has come down to the 4% target in the last 2 months but nobody is taking the food price cycles very seriously. Crude prices

are still at yearly highs and core inflation at 5.7% is showing no signs of relenting. These make a case for higher bond yields.

The Federal Reserve System (Fed i.e. Central Bank of US) has already indicated at 3-4 rate hikes in the next 1 year and strong economic data has supported the view. Even the CME Fedwatch is indicating 3 rate hikes in the next 1 year.

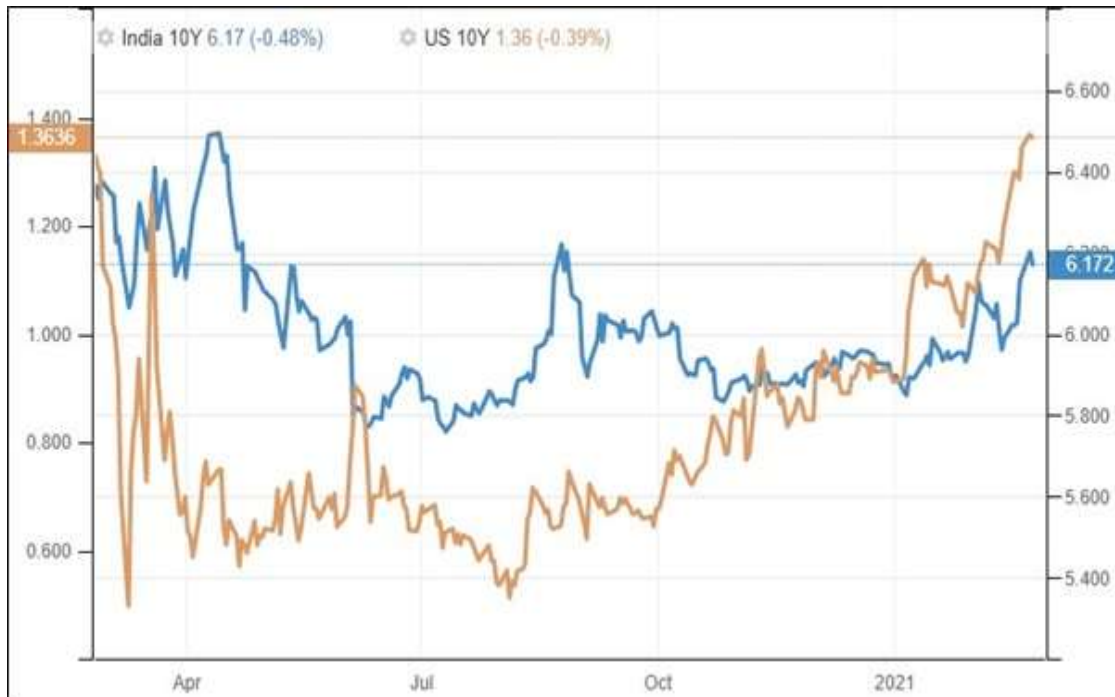


Chart Source: Trading Economics

The above chart shows that the US 10-year bond yields plummeted to 0.58% in August 2020 and has more than doubled to 1.36% since then. Comparatively, Indian bond yields are yet to catch up. There is a sense of worry in the bond markets that if the US chooses to increase rates then RBI may also be tempted to increase rates by 25-50 bps in 2021 to keep the yield differentials appealing to foreign investors. This is also a pertinent factor making Indian bond yields higher.

Higher bond yields could have unfavourable consequences for Indian corporates and Indian markets at multiple levels. The reasons are as follows:

- Rising bond yields can reduce bond portfolios of banks. The Indian Public Sector banks hold the majority of GOI bonds. Apart from the mandatory Statutory Liquidity Ratio (SLR) requirements, banks also hold government bonds as they are safe and offer good trading yields. However, bond prices are negatively correlated to bond yields and a fall in bond prices would result in losses for banks.
- Rising yields can impact the debt fund NAVs also. Debt funds in India manage close to Rs 14 trillion of short term and long-term bonds. The problem is more severe for funds holding long term government bonds as they are more exposed to rising bond yields. Fall in debt fund NAVs leads to negative wealth effect on investors.
- Furthermore, higher bond yields increase borrowing costs. Even before the spurt in bond yield, large scale borrowers have been borrowing at higher yields. Indeed, the borrowers with good credit rating will have more choices. The small and medium sized companies will obviously be badly hit.
- Another important point is that if the government has to reduce the fiscal deficit this year, it needs to respond strongly to its borrowing program. Higher bond yields mean that government has to

borrow at higher rates and that will sharply increase its borrowing cost. That will only increase the interest burden on the government.

- Finally, rising bond yields effect equities. Equity valuations are based on the Discounting Cash Flow (DCF) method, wherein future cash flows are discounted using cost of capital. If bond yields rise, cost of capital also increases thus impacting equity valuations. Moreover, higher bond yields improve the current yield on debt giving higher return to investors and making equity less attractive in comparison.

So, it can be concluded that current trend of rising bond yields can have consequences for Indian financial markets. And, a lot will depend on whether this is a temporary phase or a permanent trend.

To mitigate the situation, the Reserve Bank of India (RBI) has already undertaken steps to **TLTRO** to modify the yield spreads and cap the benchmark bond yields at around the 6% levels. But for that to succeed, the US bond yields will have to remain low in the future.

The RBI's 'On Tap TLTRO' scheme of Rs 1 trillion has been aimed to provide liquidity boost to various economic sectors and banks. The TLTRO scheme will operate for three years for a total amount of up to Rs 1 trillion at a floating rate linked to the policy repo rate for banks.

This initiative by the RBI can aid the construction, real estate, and the microfinance sectors. RBI will give these funds under **on-tap targeted long-term repo operations (TLTRO)** at a floating rate linked to the policy rate for up to three years. Currently, the repo rate is 4 percent.

Questions

Based on above, answer the following questions:

1. Why there is a rise in bond yields and why everyone is worried about it? **(5 Marks)**
2. How will the rising bond yield impact the banks and the government and what measures RBI can take to reduce the yield? **(5 Marks)**
3. PQR Ltd. had sold Rs. 10000 8% debentures 10 years ago. Interest rates have risen since then, so that debentures of this company are now selling at 10% yield basis. **(5 Marks)**
 - (i) Determine the expected market price of the debentures. Would you buy the debentures for Rs. 7000? What is the yield?
 - (ii) Assume that the debentures of the company are selling at Rs. 8250. If the debentures have 8 years to maturity, compute the approximate effective yield an investor would earn on his investment?
4. Multiple Choice Questions: **(10 Marks)**
 - (i) If the bonds already issued by the private sector are cancelled, it indicates that
 - (a) Markets expect higher yields as fund raising from the private sector is likely to be curtailed
 - (b) Markets expect lower yields as fund raising from the private sector is likely to be curtailed
 - (c) Markets expect lower yields as fund raising from the private sector is likely to be increased
 - (d) None of the above
 - (ii) If RBI decides to increase interest rates, the bond's price which is offering similar return as the current interest rates would because its coupon payment is less attractive now on a relative basis. Therefore, investors would look for new bonds with
 - (a) rise; higher risk-free return
 - (b) fall; lower risk-free return
 - (c) fall; higher risk-free return
 - (d) rise; lower risk-free return

- (iii) Which among the following is incorrect?
- (a) One of the reasons for spurt in bond yields is increase in inflation
 - (b) Fall in debt fund NAVs leads to negative wealth effect on investors
 - (c) Lower bond yield increases the government's borrowing cost
 - (d) If bond yields rise, cost of capital also increases thus impacting equity valuations
- (iv) The financial year currently followed by RBI is
- (a) July to June
 - (b) April to March
 - (c) March to February
 - (d) October to September
- (v) Surya purchased a bond for Rs. 8000 with a coupon payment of Rs. 900 per annum. He sold the bond for Rs. 9000 after one year. What is the holding period return?
- (a) 23.75%
 - (b) 21.11%
 - (c) 11.25%
 - (d) 12.50%

CASE STUDY: 2

Rihansh Food Truck Private Limited (RFTPL) was incorporated on July 1, 2015, by Sachin Mewal, Sonu Mewal and Ashok Mewal. On April 1, 2017, it was converted into a public limited company and a fresh certificate of incorporation was issued on July 1, 2017, under the name of RFTL. RFTL manufactures and exports processed and preserved food products like dry fruits, pickles, and jams and sells its products under the brand names, 'Rihansh' and 'Pop's Recipe' in India. In the Middle East, it sells pickles and tamarind through its premium brand 'family' and a popular segment brand 'Mast', and in the UK under the brand name 'Krish'. It has an installed capacity of 22,900 tonnes per annum (tpa) for canned and bottled processed vegetables/foods/fruits. RFTL completed the expansion and modernization of its existing plant at Gandhinagar, Gujarat, in the financial year 2019, thus increasing its capacity from 12,600 tpa to 19,900 tpa. A new project for manufacturing spices in Mumbai was also commissioned in FY20.

The Indian food industry is the second largest in the world after the Chinese. At present, the size of the Indian food industry is around US\$ 181 billion. It contributes to around two-third of the total Indian retail market. According to some experts, the industry will touch US\$ 258 billion by the end of FY22 and US\$ 318 billion by the end of FY25.

At a recent board meeting of RFTL, Sachin Mewal, Chairman of the company, apprised Ashok Mewal, Chief Executive Officer, and Sonu Mewal, Chief Financial Officer, for the dramatic change in return on equity, which increased substantially in FY20. However, Sonu Mewal, CFO of RFTL is disturbed about financial position of company.

To grow business, company has to acquire new clients and build their cash reserve. This reserve is required to meet variable cost as customer payment will take 90 days (Normal credit allowed to clients). Current financial position is not well to grow business and take on new clients.

After being denied a bank loan, RFTL is looking for finance company who are providing service of factoring. With factors help, RFTL will quickly gain access to cash equaling and will able to fund its operations; without having to wait for the customers to pay and without incurring any debt.

RFTL has invited proposals from various factors and also provided them extract of financial and operational data to evaluate and submit the proposal to company. The details are as follows:

Sr. No.	Particulars	Rs. in crore
1	Annual Turnover	3600
2	Variable Cost (60%) *	2160
3	Fixed Cost (Rent, Administrative expenses etc.)	450
4	Profit	990

*Also includes bad debts –Company experience indicates that bad debt losses are 2% of turnover)

Sonu Mewal has got a proposal from a factor that will provide factoring services on recourse basis. The proposal is as below:

- Factor will keep reserve equal to 20% of amount after adjusting commission and 10% of receivable
- Commission charges 1.80%
- Interest rate is 18% p.a.
- The factor will provide advance after adjusting reserve, commission charges and interest amount

The factoring is expected to save Rs. 75 crore as Administrative cost (Fixed Cost).

During this time, Mr. Sachin Mewal informed the management that they have received an order of Rs. 720 crore which is big enough in terms of contribution to the profits.

Note:

Year represents 360 days

Questions:

Based on above, answer the following:

1. Compute amount paid as advance by factor considering RFTL has accepted the proposal of factor. **(4 Marks)**
2. Compute Net Factoring cost (%). **(4 Marks)**
3. RFTL has opportunity to accept new orders of Rs.720 crore. Company has to accept current proposal from factor if they wish to grab this opportunity. Suggest RFTL whether they should accept new orders. **(7 Marks)**
4. Multiple Choice Questions (MCQs) **(10 Marks)**
 - (i) Which form of factoring is known as "Old Line Factoring"?
 - (a) Recourse Factoring
 - (b) Non-Recourse Factoring
 - (c) Full Factoring
 - (d) Cross Border Factoring
 - (ii) Identify the incorrect statement.
 - (a) A forfaiter discounts the entire value of the note/bill. In a factoring arrangement, the extent of financing available is 75%-80%.
 - (b) The forfaiter's decision to provide financing depends upon the financing standing of the availing bank. On the other hand, in factoring deal the export factor bases his credit decision on the credit standard of the exporter.

- (c) Factoring is a pure financial arrangement while forfaiting includes ledger administration as well as collections.
- (d) Factoring is a short-term financial deal. Forfaiting spreads over 3-5 years.
- (iii) Which form of factoring is known as “Two Factor System”?
 - (a) Recourse Factoring
 - (b) Non-Recourse Factoring
 - (c) Full Factoring
 - (d) Cross Border Factoring
- (iv) In a factoring transaction, who purchases the goods and services on credit?
 - (a) Factor
 - (b) Client
 - (c) Customer
 - (d) Both (b) and (c)
- (v) Every company seeking registration as NBFC-factor shall have a minimum NOF of Rs. _____.
 - (a) 1 crore
 - (b) 2 crores
 - (c) 5 crores
 - (d) 10 crores

CASE STUDY: 3

Fisker, a maker of high-end electric vehicles (EVs) that is yet to deliver a single car has become a public traded company by merging with a Special Purpose Acquisition Company (SPAC) **Spartan Energy Acquisition Corp.** to reach a valuation of \$4.8 billion. It can be recalled that in 2013, it had filed for bankruptcy.

Similarly, Lucid Motors entered into a SPAC deal at a \$24 billion valuation with Churchill Capital Corp, a special-purpose acquisition company. It was almost about to close its operations a few years ago for lack of investors.

Nikola, yet another Elective Vehicle maker which was summoned for using questionable technology by a short seller had also gone ahead with its business combination with VectoIQ Acquisition Corp. a publicly-traded special purpose acquisition company. Also, hedge fund billionaire Bill Ackman raised \$5 billion in a SPAC aiming to acquire a new internet economy giant.

So, what these examples as quoted above depicts. It shows that SPAC deals have surged in the United States in the year 2020.

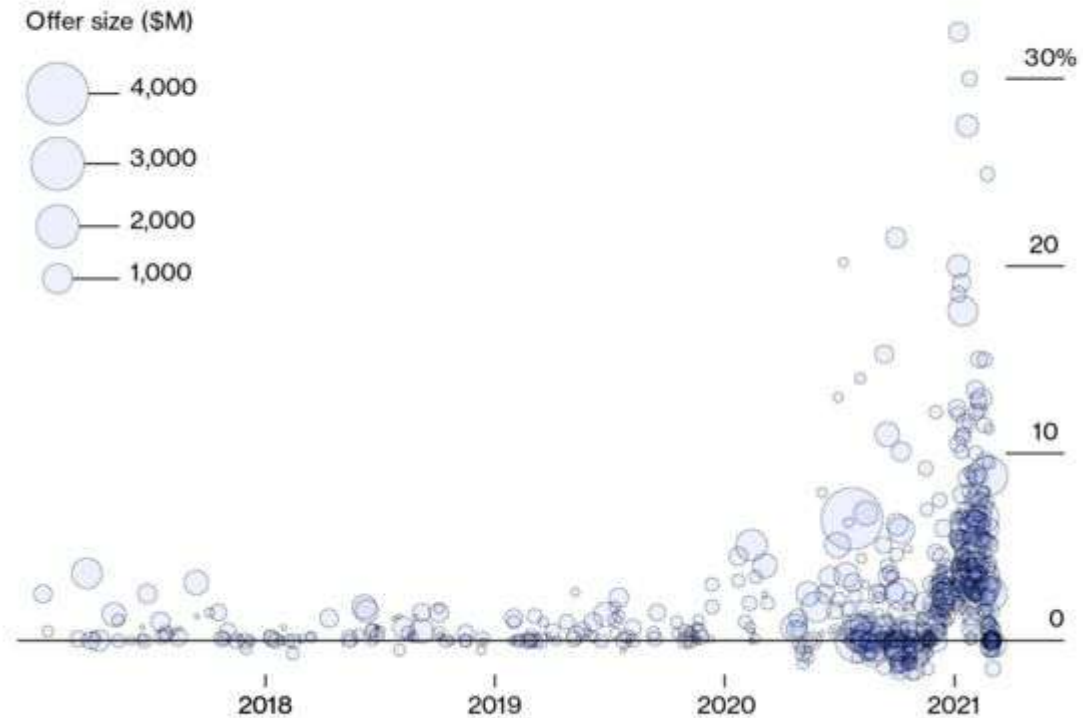
Basically, Special Purpose Acquisition Companies (SPACs) are listed shell companies formed with the intention to acquire unlisted or private companies and then merge with them. SPACs do not pursue any business operations. Neither do they have any revenue of their own but are formed to raise capital through an initial public offering, or IPO, to purchase private companies on a later date. This is executed by selling shares to the general public as it is done in the case of a regular IPO. The choice is also given to the investors to purchase a warrant that provides them an opportunity to buy more shares at a later stage at a fixed price.

These are also called “blank cheque companies” as SPAC investors have no idea about where and how their capital will be utilized. Once the capital is raised, it is kept in a trust till a target company is found and acquired. If a SPAC fails to find a right acquisition within two years, investors get their capital back. As SPACs don’t

pursue any business operations, or a track record to talk about, they are largely sponsored by high profile investors or CEOs who have the ability to attract investors in an IPO.

Out of The Gate

U.S. SPACs in 2021 closed on average 5% higher in their first day of trading



Source: Bloomberg

Bloomberg

The sponsors reward themselves by buying up to a fifth of the SPAC's total shares or capital at a huge discount to the issue price. For example, if a regular investor pays Rs. 100 per share, sponsor get the same at Re. 1 or even less. This reward for the promoters is called "Promote" in industry circles which leads to stake dilution of ordinary shareholders that upset their long-term returns.

SPAC sponsors are the founders of a SPAC. They make the initial investment in the blank cheque company before going out to sell their idea to other investors so they can put more money in the project. Sponsors often retain 20 percent stake after the SPAC IPO, which also means they end up with significant holding in the private company with which the blank cheque company will eventually merge. SPAC sponsors are generally very experienced business executives or fund managers. Prominent among them are Michael Klein, Chamath Paliapitiya and Bill Foley. They have been known as serial sponsors, having started several blank cheque companies.

Furthermore, once SPACs get listed on the bourses, they use the capital raised during their IPOs to acquire a private company and merge with it. Post – merger, the SPAC changes its name and identity to reflect the business operation of the merged entity.

SPAC sponsors assert that they can use their skill and experience to purchase a promising private company at a valuation lower than had it listed through a traditional IPO. This highly improves the post-listing/merger profits for SPAC investors.

For example, in 2019, Richard Branson promoted space company Virgin Galactic listed on the bourses through merger with a SPAC sponsored by venture capitalist Chamath Palihapitiya. Virgin Galactic share price has tripled since its listing compared to a 50% rise in S&P 500 index during the period. The success of Virgin Galactic had led to an explosion in new SPACs, especially in the United States. According to a financial daily, SPACs have raised more than \$100 billion since the start of the calendar year 2020.

However, some experts view SPAC as a launchpad for the rich and famous to evade regulatory probe and make unfair gains at the expense of hapless shareholders who have sold shares at par or full value.

Traditionally, a private company gets listed through IPO, which is a four-to-six-month long process and required it to make an exhaustive list of disclosures about its finances, business operations, future prospects and promoter's background. This results in a close scrutiny of the company by the media, financial analyst and the market regulator.

SPACs avoid this entire mechanism and offer private companies the opportunity to list directly. This saves companies time, besides the financial cost involved in hiring several experts in the IPO process.

The fast route to listing is the biggest advantage of SPACs, especially in the post pandemic period that has seen a big boom in IPOs and valuation of tech companies is at an all-time high.

Many view SPAC as a tool for rich and famous bankers and CEOs to take advantage of their popularity and reputation without risking any of their own capital. For instance, Palihapitiya had purchased shares in his SPAC at 0.002 cents per share. On the other hand, ordinary shareholders had paid \$10 for the same shares.

This incident has put SPAC in a debatable position on income and wealth inequality that is now a burning political material in the United States and several other countries.

Moreover, according to a study by Goldman Sachs, companies that acquired by SPACs have tended to underperform the S&P 500 within three, six and twelve months after the merger and listing.

Recently, Reuters reported that IPOX SPAC Index that tracks the performance of listed SPACs is down 12.5% in the last two months compared to the 2.4% decline in the broader US market during the period.

Analyst attribute SPACs poor performance to a large equity dilution inherent in their IPO pricing. According to a Bloomberg study, ordinary investors typically pay \$10 for shares worth \$7 net of the Promote cost. This imposes a stiff financial cost on the ordinary shareholders suppressing their returns for a long time.

Further, shell companies, or SPACs are currently not allowed to raise capital through IPO in India. But this could change as many Indian start-ups are willing to use SPACs to get listed in the US. This has led many to urge SEBI to allow SPACs or similar investment vehicles to raise capital through IPO. And, SEBI and the International Financial Services Centers Authority are willing to prepare the way for SPACS in India.

Questions

Based on above, answer the following questions:

1. How are SPACs different from traditional IPOs? Do you agree that SPACs are preferable to Private Equity? Discuss with reasonable explanation. **(5 Marks)**
2. Discuss the risks which are generally inherent when the investors want to invest their money in a blank cheque company. **(5 Marks)**
3. How such risks can be mitigated and whether SEBI should allow such companies in India? **(5 Marks)**
4. Multiple Choice Questions: **(10 Marks)**
 - (i) SPACs are also called blank cheque companies because
 - (a) investors are required to issue blank cheques to companies in which they invest

- (b) investors are not aware of the acquisition targets
- (c) investors are fully aware of the acquisition targets
- (d) investors are partially aware of the acquisition targets
- (ii) For startups companies, in which place they can separately list their shares?
 - (a) Innovators Growth Platform
 - (b) Institutional Trading Platform
 - (c) SME Exchange
 - (d) None of the above
- (iii) Which among the following statements is correct?
 - (a) A shell company has a reasonable track record of profitability
 - (b) India's mergers and acquisitions have an edge in comparison to that of developed nations
 - (c) The sponsor should be able to identify an acquisition target within two years and buy it up
 - (d) SPAC is only an American phenomenon
- (iv) Which among the following is a benefit of SPAC?
 - (a) Improves risk sharing
 - (b) Broadening investors access to investment opportunities
 - (c) Access to capital
 - (d) All of the above
- (v) The sponsors reward themselves through a fee which is called
 - (a) Promote
 - (b) Promotion
 - (c) Dividend
 - (d) Capital Gain

CASE STUDY: 4

An investment trust, ABC incorporation owns Rs.1 crore corporate bond issued by a private housing firm – 'Housing for All (HSA)'. ABC was circumspect that HSA may default on repayments. Therefore, it purchases a credit default swap (CDS) from another company which is a Hedge Fund. The investment trust will pay interest on this credit default swap at the rate of 3%. This could involve payments of Rs. 3,00,000 a year for the duration of the contract. If the private housing firm doesn't default, the hedge fund gains the interest from the investment bank and pays nothing. It is a simple profit. If the private housing firm does default, then the hedge fund has to pay compensation to the investment bank of Rs. 1 crore i.e., the value of the credit default swap. Therefore, the hedge fund takes on a larger risk and could end up paying Rs. 1 crore. So, the higher the perceived risk of the bond, the higher the interest rate the hedge fund will require.

When it is established that a credit default has taken place, the amount paid by the CDS seller to the buyer is calculated using the following formula:

$$\text{Payout Amount} = \text{Payout Ratio} = A \times (1 - \% \text{ of bond amount recovered})$$

Where A is the actual amount invested into a bond and payout ratio is the loss suffered by a holder of the bond as a percentage of the bond's face value. It equals 1 minus the percentage of amount owed which is received by a bondholder during the bankruptcy proceedings. So, the percentage of amount not recovered is multiplied by the actual amount invested into a bond to arrive at the payout amount.

Therefore, during the period of the CDS, the profit or loss that accrues to the buyer/seller of the CDS can be computed as follows:

Profit to buyer = basis point change in credit spread x actual amount invested into a bond x duration of the bond

It can be understood from the above formula that if the default spread increases over the life of the CDS, the buyer gains and if the spread decreases the seller gains.

The above paragraphs highlighted some of the nuances of credit default swap. The first credit default swap was introduced in 1995 by JP Morgan. By 2007, their total value has increased from an estimated \$45 trillion to \$62 trillion. Although since only 0.2% of investment companies default, the cash flow is much lower than this actual amount.

In USA, the size of the credit default market is very big in comparison to the stock market and the bond market they represent. So, it is evident from the above fact that credit default swaps are generally used for speculation and not to insure against actual bonds.

Credit Default Swaps are unregulated and since they get traded so often there is an uncertainty over who owns them and whether the holders can actually be able to pay in the event of a credit default.

In India, the CDS is almost non-existent. The only CDS instrument sold by the country's largest lender, the State Bank of India, is no longer exist in the market.

CDS is also viewed as a major culprit for the 2008 global crisis, and therefore, Indians are still afraid to initiate it. In case of RBI, which think of regulation ahead of innovation, CDS took a back seat for a very long time.

In its original form CDS was a bilateral instrument, and, when a former RBI governor tried to introduce it, the central bank proposed to make it strictly a hedging instrument by attaching several conditions. At that time, bond dealers and banks were not interested in it.

The last draft guidelines on CDS were introduced in 2013. The new draft norms replace those. In 2010, too, there was an attempt to introduce CDS, but it didn't get enough assistance. The reason behind that is - 90% of the corporate debt market is dependent on private placement. All the risks are concluded in the pricing negotiation and buyers know what they are getting into. CDS is not needed in this type of surrounding when there is no corporate paper to deal with in the secondary market.

CDS is required only for corporate bonds. Government bonds are sovereign instruments, the safest form of investment possibly in India. In case of government bonds, there is no need for CDS as it covers primarily the default risk. However, there are other instruments for government securities to hedge the interest risk and even currency risk for global investors.

The Reserve Bank of India (RBI) recently came out with the draft guidelines to allow derivatives trading in the credit default swaps (CDS) in over-the-counter (OTC) markets and on recognised stock exchanges in the country.

As per the draft guidelines, the debt instruments eligible to be a reference or deliverable obligation in a CDS contract will include commercial papers, certificates of deposit and non-convertible debentures of original maturity up to one year, rated corporate bonds (listed and unlisted) and unrated rupee bonds issued by the special purpose vehicles set up by infrastructure companies.

Asset-backed securities and mortgage-backed securities and structured obligations, such as credit enhanced and guaranteed bonds, convertible bonds, and bonds with call-put options, will not be permitted as reference or deliverable obligations.

According to the draft guidelines, at least one of the parties to a CDS transaction will be a market-maker or a central counterparty authorised by the RBI.

The market makers for CDS will include scheduled commercial banks, NBFCs and primary dealers with a minimum net worth of Rs 500 crore, Exim Bank, NABARD, National Housing Bank and SIDBI.

The user of the credit derivatives contract can be retail as well as non-retail. The non-retail users include insurance companies, pension funds, mutual funds, alternate investment funds, and foreign portfolio investors.

The guidelines further said the retail users will be allowed to undertake transactions in permitted credit derivatives for hedging their underlying credit risk, while the non-retail users may undertake transactions for hedging and other purposes.

The draft guidelines also mentioned that exchanges may offer standardized single-name CDS contracts with guaranteed cash settlement. Any change in the structure of an exchange traded CDS will need to be approved by the RBI. Further, retail users can only enter into transactions in exchange-traded CDS for hedging their underlying credit risk.

The RBI has directed that market-makers shall arrange appropriate and robust mechanism for marking to market the credit derivative contracts. A daily CDS curve published by Fixed Income Money Market and Derivatives Association of India (FIMMDA) or a benchmark administrator or a proprietary model can be used to value CDS positions. Also, proprietary models must be disclosed.

The RBI has also asked the market participants to follow the applicable prudential norms and capital adequacy requirements for credit derivatives issued by their respective regulators.

Questions

Based on above, answer the following questions:

1. What is a credit default swap? What is the status of the CDS market in India? Also discuss why India doesn't trade in CDS? **(5 Marks)**
2. What is the recent effort of RBI push to credit default swap market in India? Does this include for speculative purposes? Discuss with reference to the case study and recent instances in this area. **(5 Marks)**

3. ABC bank has loaned \$50 million to a company for 6 years requiring periodic interest payments equal to LIBOR + 2.4%. The bank's policy requires all loans to be backed by a credit default swap on the principal amount of loans made. In this case, the bank can buy a CDS with a notional amount of \$50 million. The CDS costs 3%.

What is the annual premium bank must pay to the CDS seller? Also calculate the amount which the CDS seller must pay to ABC Bank in case the borrower defaulted on the final principal payment and bank was able to collect only 60% of its principal amount. **(5 Marks)**

4. Multiple Choice Questions **(10 Marks)**
 - (i) The financial products are subject to mainly
 - (a) market risk
 - (b) credit risk
 - (c) both (a) and (b)
 - (d) default risk

- (ii) Synthetic CDOs are structured in such a manner that credit risk is transferred by the without actual transfer of assets.
 - (a) sponsor
 - (b) originator
 - (c) portfolio manager
 - (d) special purpose vehicle
- (iii) If any investor buys a CDS without being exposed to credit risk of the underlying bond issuer, it is called
 - (a) Cash CDOs
 - (b) Synthetic CDOs
 - (c) Arbitrage CDOs
 - (d) Naked CDOs
- (iv) Which among the following is not a market maker in CDS?
 - (a) Commercial Banks
 - (b) Insurance Companies
 - (c) Non-Banking Financial Companies
 - (d) National Housing Bank
- (v) CDS is not required in which of the following financial instruments?
 - (a) Private Placement of Bonds
 - (b) Government Bonds
 - (c) Both (a) and (b)
 - (d) Mortgage-Backed Securities

CASE STUDY: 5

ABC Mutual Fund has been founded on November 25, 2019 as a trust in accordance with the provisions of the Indian Trusts Act, 1882 sponsored by ABC Bank Ltd. (liability restricted to Rs. 1 lakh). The Deed of Trust has been registered under the Indian Registration Act, 1908. The Mutual Fund was registered with SEBI on January 18, 2020.

The other statutory details are as follows:

Trustee – ABC Mutual Fund Trustee Ltd.

Investment Manager – ABC Asset Management Company Ltd. (the AMC)

Risk Factors – ABC Bank Ltd. is not liable or responsible for any loss or shortfall resulting from the operation of the scheme.

The ABC Bank Ltd. has been holding 15% voting rights in asset management company of the mutual fund.

The mutual fund shall appoint a Custodian to carry out the custodial services for the schemes of the fund and sent intimation of the same to SEBI within ten days of the appointment of the custodian. The mutual fund has entered into a custodian agreement with the custodian, which contains the clauses which are necessary for the efficient and orderly conduct of the affairs of the custodian.

ABC Mutual Fund is a professionally managed investment fund that pools money from many investors to purchase securities. Within a short span of time, it becomes very popular amongst various investors. It provides comprehensive suite of savings and investment products across asset classes, which provide income and wealth creation opportunities to large retail and institutional customer.

All the directors of the ABC asset management company have been duly appointed. Suresh, one of the technical directors was appointed by taking the approval of the trustees after his appointment.

The single most important factor that drives ABC Mutual Fund is its belief to give the investors the chance to profitably invest in the financial market, without constantly worrying about the market swings. To realize this belief, ABC Mutual Fund has set up the infrastructure required to conduct all the fundamental research and back it up with effective analysis. Their robust significance on managing and controlling portfolio risk avoids chasing the latest mechanisms.

ABC Ltd. has entrusted a sum of ` 10 Lakh as the initial contribution towards the corpus of the Mutual Fund. PQR limited looks after the operation and investment of Mutual Fund. PQR limited may undertake any other business activities including activities in the nature of management and advisory services to offshore funds, financial consultancy and exchange of research on commercial basis etc., subject to receipt of necessary regulatory approvals. In accordance with SEBI (Mutual Funds) Regulations, 1996, activities of PQR Ltd. are reviewed by CID Ltd. The Board of Directors of the PQR Ltd. and CID Ltd. comprises eminent personalities with varied experience.

ABC Ltd. has launched its new scheme recently. All the advertisements have been in conformity with the Advertisement Code as specified in the Sixth Schedule of the Mutual Fund Regulations and has been submitted to the SEBI within 7 days from the date of issue. The offer document and advertisement materials has not been misleading or contain any statement or opinion which are incorrect or false.

All transactions done by the trustees or the employees or directors of the asset management company or the trustee company in real estate assets has been disclosed by them to the compliance officer within one month of the transaction.

XYZ mutual fund is willing to buy back ("redeem") their shares from their investor at the net asset value (NAV) computed that day based upon the prices of the securities owned by the fund. The cut-off timing for the redemption is 3:00 PM. The average expenses ratio (including management fees) amounted to 2.65% which also included GST.

The market regulator, SEBI, has recently announced various measures for the mutual funds industry. SEBI has made modification to certain mutual funds rules to make them more affable to the investors. The recently announced 'flexi cap category' under equity schemes has boosted the morale of the investors who were sceptical about their investments in multi cap funds due to the change in portfolio allocation rules announced by SEBI in September, 2020.

SEBI has declared a 'flexi-cap category' for mutual funds. The basic task of this category is to invest at least 65% of the funds in equity but there is complete freedom as whether to invest in large, mid or small-cap company stocks.

Some time back in September 2020, SEBI announced to change the asset allocation rules for multi cap funds. According to the circular, a multi cap fund must invest a minimum of 75% in equity and equity related instruments and should have a minimum allocation of 25% to large, mid and small-cap stocks each.

Further, the existing equity schemes by just changing the scheme's name will be able to reclassify themselves under the new category and continue to run their multi cap funds in the same way without any alteration in portfolio allocation or investment process.

Questions

Based on above, answer the following questions:

1. SEBI has introduced a 'Flexi Cap Category' recently. Discuss the benefit of this category to both the investor as well as the mutual fund. Also discuss whether it is preferable to 'Multi Cap Category'.

(5 Marks)

2. The ABC Mutual Fund has defaulted in compliance with some of the provisions of the SEBI (Mutual Fund) Regulations, 1996. You are required to highlight those.

(3 Marks)

3. (i) A mutual fund has NAV in the beginning and at the end of the period, of Rs. 12.50 and 12.80 respectively. During the year, cash dividend of Rs. 2.20 has been distributed. The capital gain of Rs. 1.50 has also been distributed during the year. Calculate the return of the mutual fund.

(3 Marks)

- (ii) A Mutual Fund made an issue of 15,00,000 units of Rs. 10 each on January 1, 2019. It made the following investments:

60,000 equity shares of Rs. 100 each @ 150	Rs. 90,00,000
8% Government Securities	16,00,000
9% Debentures (unlisted)	12,00,000
10% Debentures (listed)	<u>12,00,000</u>
	<u>1,30,00,000</u>

During the year, dividends of Rs. 15,00,000 were received on equity shares. Interest on all types of debt securities was received as and when due. At the end of the year, the equity shares and 10% debentures are quoted at 150% and 90% respectively. Find out the NAV per unit given that operating expense paid during the year amounted to Rs. 8,00,000.

(4 marks)

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

- (i) Of unit holders can terminate the appointment of an asset management company.

- (a) 50%
- (b) 75%
- (c) simple majority
- (d) 100%

- (ii) No scheme shall be launched by the asset management company unless such scheme is approved by the and a copy of the offer document has been filed with the

- (a) AMC; SEBI
- (b) trustees; SEBI
- (c) sponsors; stock exchange
- (d) trustees; stock exchange

- (iii) A mutual fund shall not invest money under any of its schemes in

- (a) money market instruments
- (b) gold or gold related instruments

- (c) real estate assets
 - (d) futures and options
- (iv) For which of the following purposes a mutual fund shall not borrow to meet its temporary liquidity needs?
- (a) Repurchase
 - (b) Launching a new scheme
 - (c) Redemption of Units
 - (d) payment of dividend
- (v) The Net Asset Value of the scheme shall be calculated on a basis and disclosed in the manner specified by the Board.
- (a) daily
 - (b) weekly
 - (c) monthly
 - (d) yearly