

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

Solutions

ANSWERS TO CASE STUDY: 1

Solution to Question no. 1

Note 1 Calculation of amount kept as reserve by factor

Factor will keep reserve equal to 20% of amount after adjusting commission and 10% of receivable.

$$\begin{aligned}\text{Average Receivable (in crores)} &= (\text{₹ } 4000 / 360) * 90 \\ &= \text{₹ } 1000 \text{ Crores}\end{aligned}$$

$$\begin{aligned}\text{Factoring Commission (in crores)} &= \text{₹ } 1000 * 1.50\% \\ &= \text{₹ } 15 \text{ Crores}\end{aligned}$$

$$\begin{aligned}10\% \text{ of receivable (in crores)} &= \text{₹ } 1000 * 10\% \\ &= \text{₹ } 100 \text{ crores}\end{aligned}$$

$$\begin{aligned}\text{Reserve kept by factor (in crores)} &= 15\% (\text{₹ } 1000 - \text{₹ } 15 - \text{₹ } 100) \\ &= \text{₹ } 132.75 \text{ crores}\end{aligned}$$

Note 2 Calculation of Interest amount charged by factor

The factor will provide advance after adjusting reserve, commission charges and interest amount.

$$\begin{aligned}\text{Amount available for advance before adjusting interest (in crores)} &= \text{₹ } 1000 - \text{₹ } 132.75 - \text{₹ } 15 \\ &= \text{₹ } 852.25 \text{ Crores}\end{aligned}$$

$$\begin{aligned}\text{Interest amount (in crores)} &= \text{₹ } 852.25 * 16\% * (90/360) \\ &= \text{₹ } 34.09 \text{ crores}\end{aligned}$$

Note 3 Amount paid as advance by factor

The factor will provide advance after adjusting reserve, commission charges and interest amount.

$$\begin{aligned}\text{Amount paid as advance by factor} &= \text{Amount available for advance before adjusting interest (in crores)} - \\ \text{Interest amount (in crores)} &= \text{₹ } 852.25 - \text{₹ } 34.09 \\ &= \text{₹ } 818.16 \text{ crores}\end{aligned}$$

Solution to Question no. 2

Note 1 Calculation of yearly factoring cost

Factoring cost for 90 days

$$\begin{aligned}(\text{in crores}) &= \text{Commission charges} + \text{Interest amount} \\ &= \text{₹ } 15 + \text{₹ } 34.09 \text{ crores} \\ &= \text{₹ } 49.09 \text{ crores}\end{aligned}$$

$$\begin{aligned}\text{Yearly factoring cost (in crores)} &= \text{₹ } 49.09 * (360/90) \\ &= \text{₹ } 196.36 \text{ crores}\end{aligned}$$

Note 2 Calculation of saving in cost due to factoring

Saving in administrative cost = ₹ 100 crores

Saving in bad debts = Nil*

*This factoring arrangement is on recourse basis. So bad debts will be borne by Saransh Garments.

Note 3 Calculation of effective factoring cost (%)

Particulars	₹ in crores	₹ in crores
Yearly factoring cost		₹ 196.36
Less: Cost Saved per year		
Bad debts	Nil	
Administrative cost	₹ 100	₹ 100
Net Factoring cost per year		₹ 96.36
Net Factoring cost per year (%)	$(₹ 96.36 / ₹ 818.16) * 100$	11.78%

Solution to Question no. 3

Increase in Turnover = $(₹1000 \text{ crores} / ₹4000 \text{ crores}) * 100 = 25\%$

Note 1 Calculation of amount kept as reserve by factor

Factor will keep reserve equal to 20% of amount after adjusting commission and 10% of receivable.

Average Receivable (in crores) = $(₹ 5000 / 360) * 90$
= ₹ 1250 Crores

Factoring Commission (in crores) = $₹ 1250 * 1.5\%$
= ₹ 18.75 Crores

10% of receivable (in crores) = $₹ 1250 * 10\%$
= ₹ 125 crores

Reserve kept by factor (in crores) = $20\% (₹ 1250 - ₹18.75 - ₹ 125)$
= ₹ 221.25 crores

Note 2 Calculation of Interest amount charged by factor

The factor will provide advance after adjusting reserve, commission charges and interest amount.

Amount available for advance before adjusting interest (in crores) = $₹1250 - ₹221.25 - ₹18.75$
= ₹1010 Crores

Interest amount (in crores) = $₹ 1010 * 16\% * (90/360)$
= ₹ 40.40 crores

Note 3 Calculation of yearly factoring cost

Factoring cost for 90 days

(in crores) = Commission charges + Interest amount
= ₹ 18.75 + ₹ 40.40
= ₹ 59.15 crores

Yearly factoring cost (in crores) = $₹ 59.15 * (360/90)$
= ₹ 236.6 crores

Note 4 Calculation on effect of Profit after accepting new orders and factoring proposal

Particulars	₹ in crores	₹ in crores
Annual Turnover		₹ 5000
Less:		
Variable Cost		
= ₹ 2400 + 20% of ₹ 2400	₹ 3000	
Less: Saving in Bad debts	Nil*	₹ 2000
Fixed Cost	₹ 500	
Less: Saving in Fixed Cost	₹ 100	₹ 400
Factoring Cost		₹ 236.6
Profit		₹ 1363.4

* This factoring arrangement is on recourse basis. So bad debts will be borne by Saransh Garments.

Increase in Profit (in crores) = ₹ 1363.4 – ₹ 1100

= ₹ 263.4 crores

It is worthwhile for Saransh Garments to accept new order worth ₹1000 crores as it will result in increase in profits.

Solution to Question no. 4

(i) (d)

(ii) (c)

(iii) (b)

(iv) (b)

(v) (a)

ANSWERS TO CASE STUDY: 2**Solution to Question no. 1**

Credit Rating means an assessment made from credit-risk evaluation, translated into a current opinion as on a specific date on the quality of a specific debt security issued or on obligation undertaken by an enterprise in terms of the ability and willingness of the obligator to meet principal and interest payments on the rated debt instrument in a timely manner.

Thus Credit Rating is:

- (1) An expression of opinion of a rating agency.
- (2) The opinion is in regard to a debt instrument.
- (3) The opinion is as on a specific date.
- (4) The opinion is dependent on risk evaluation.
- (5) The opinion depends on the probability of interest and principal obligations being met timely.

The importance of credit rating agencies have been discussed as follows:

- (i) Credit rating agencies rate the debt obligations of companies which helps the investors to take an

informed decision as to investment in debt securities.

- (ii) They guide the investors regarding the risk of investment in a debt security as to timely repayment of interest obligations and principle amount.
- (iii) They create awareness of the concept of credit rating amongst corporations, merchant bankers, brokers and regulatory authorities.
- (iv) They help in the creation of environment that facilitates debt rating.
- (v) Rating agencies inculcate a positive environment regarding investment in debt securities.
- (vi) They help in creating confidence in the minds of investors.
- (vii) The credit rating agencies also enable the companies to be quality conscious regarding their securities and creating a positive pressure on them to fulfill their debt obligations.

Solution to Question no. 2

Credit rating agencies are criticized recently due to various reasons which are discussed as below:

- (i) According to the industry analysts, CRAs still lack an evaluation tool for identifying new business risks. The credit rating agencies ignored the rising debt levels at IL&FS, and continued rating it AAA, indicating the highest level of creditworthiness.
- (ii) Rating firms have also been facing certain regulatory challenges, particularly real-time information on bank defaults.
- (iii) CRAs may lack the appropriate evaluation models to recognise new business risks, which could have an impact on the rating action they take. As a result, the ratings do not always reflect the company's or instruments' financial soundness.
- (iv) Evaluating liquidity risk which was a problem during the global financial crisis is still a problem for them today.
- (v) CRAs believe that the varied disclosure rules for bond and bank loan defaults could lead to information asymmetry and render the rating process vulnerable to manipulation. In the case of bonds, any interest or principal repayment default is currently disclosed promptly. In the case of bonds, any interest or principal repayment default is currently disclosed promptly. Companies are given a 30-day grace period before the disclosure requirements apply to bank loans.

Moreover, nearly a fourth of borrowers who defaulted to banks carried an investment grade credit rating up to a quarter before they defaulted according to a report published Reserve Bank of India bulletin in the year 2020.

What this means is that ratings of companies have plunged from at least BBB (investment grade) to D (default) in three months. The study has concluded that ratings do not always reflect the asset quality of borrowers in a timely manner and there are concerns over delayed reporting of ratings by banks. But despite the limitations, the report says the use of external ratings in regulations is inevitable and ways to improve agency performance should be explored.

The study covered 560 large borrowers, accounting for about 21% of NPA borrowers and as high as 40% of NPAs as of end-March 2018. About 24% of the sampled NPA exposure from Central Repository of Information on Large Credits (CRILC) carried an investment grade rating just a quarter before becoming non-performing.

Since 2014, the RBI has been maintaining a database of large accounts that have defaulted on the CRILC. These are companies where banks have an exposure of ₹ 5 crore and above. According to the authors, an earlier study concerning accredited credit rating agencies (CRAs) shows that the cumulative default rates (CDRs) for the CRAs in India are much higher than those prescribed under the Basel framework (an international standard for banks).

Solution to Question no. 3

Efficiency of credit rating agencies have definitely been increased after the IL&FS fiasco. In this respect, the example of credit rating agency CARE can be taken.

As stated by the spokesperson of CARE rating, its board of directors is brand new, and it has been working hard to improve its rating systems and governance. External hires have also been recruited to supplement the existing team of specialists and ensure that modifications can be made as needed. In response to a media inquiry, the CARE ratings spokeswoman also mentioned that the firm has a new MD and CEO, a chief rating officer (CRO), chief financial officer, head legal, compliance and secretarial, and a chief culture officer at the leadership."

It also stated that ratings oversight and governance had been enhanced, with the CRO reporting to the board's risk sub-committee.

CARE Ratings also has an external risk supervisory committee made up of senior and independent professionals who assess and provide ideas on its ratings on a regular basis.

Solution to Question 4:

- (i) (b)
- (ii) (b)
- (iii) (c)
- (iv) (d)
- (v) (c)

ANSWERS TO CASE STUDY: 3

Solution to Question 1:

Some of the important steps SEBI has taken to tackle the menace of insider trading in India have been discussed as follows:

- (i) No insider shall communicate any unpublished price sensitive information to any person except where it is required for legal purposes.
- (ii) No insider shall trade in securities that are listed or proposed to be listed on a stock exchange when in possession of unpublished price sensitive information. However, there are certain situations in which the insider can prove his innocence in this respect.
- (iii) If an insider is continuously in possession of unpublished price sensitive information, he can trade provided he prepares a trading plan and submit it to the compliance officer of the company for approval and public disclosure.
- (iv) The board of directors of every company, whose securities are listed on a stock exchange, shall formulate and publish on its official website, a code of practices and procedures for fair disclosure of unpublished price sensitive information.
- (v) The Chief Executive Officer, Managing Director or such other analogous person of a listed company, intermediary or fiduciary shall put in place adequate and effective system of internal controls to ensure compliance with the requirements given in these regulations to prevent insider trading.

Solution to Question 2:

There are certain situations in which insider trading is not considered bad. If an insider has traded in any unpublished price sensitive information, he can prove his innocence in the following situations:

- (i) The Chief Executive Officer, Managing Director or such other analogous person of a listed company, intermediary or fiduciary shall put in place adequate and effective system of internal controls to ensure compliance with the requirements given in these regulations to prevent insider trading.

- (ii) The transaction was carried out through the block deal window mechanism between persons who were in possession of the unpublished price sensitive information without being in breach of regulation 3 of the insider trading regulations and both parties had made a conscious and informed trade decision.
- (iii) The transaction in question was carried out pursuant to a statutory or regulatory obligation to carry out a bona fide transaction.
- (iv) The transaction in question was undertaken pursuant to the exercise of stock options in respect of which the exercise price was pre-determined in compliance with applicable regulations.
- (v) The transaction in question was undertaken pursuant to the exercise of stock options in respect of which the exercise price was pre-determined in compliance with applicable regulations.

Further, if an insider is in possession of unpublished price sensitive information, he can still trade in the shares of the company by preparing a trading plan by getting it approved by the compliance officer and disclosed it publicly.

Solution to Question 3:

The institutional mechanism to be mandatorily executed by the companies to prevent insider trading is given under Regulation 9A of SEBI (Prohibition of Insider Trading) Regulations, 2015 which has been discussed as follows:

- (1) The Chief Executive Officer, Managing Director or such other analogous person of a listed company, intermediary or fiduciary shall put in place adequate and effective system of internal controls to ensure compliance with the requirements given in these regulations to prevent insider trading.
- (2) The internal controls shall include the following:
 - (a) all employees who have access to unpublished price sensitive information are identified as designated person;
 - (b) all the unpublished price sensitive information shall be identified and its confidentiality shall be maintained as per the requirements of these regulations;
 - (c) adequate restrictions shall be placed on communication or procurement of unpublished price sensitive information as required by these regulations;
 - (d) lists of all employees and other persons with whom unpublished price sensitive information is shared shall be maintained and confidentiality agreements shall be signed or notice shall be served to all such employees and persons;
 - (e) all other relevant requirements specified under these regulations shall be complied with;
 - (f) periodic process review to evaluate effectiveness of such internal controls.
- (3) The board of directors of every listed company and the board of directors or head(s) of the organization of intermediaries and fiduciaries shall ensure that the Chief Executive Officer or the Managing Director or such other analogous person ensures compliance with regulation 9 and sub-regulations (1) and (2) of this regulation.
- (4) The Audit Committee of a listed company or other analogous body for intermediary or fiduciary shall review compliance with the provisions of these regulations at least once in a financial year and shall verify that the systems for internal control are adequate and are operating effectively.
- (5) Every listed company shall formulate written policies and procedures for inquiry in case of leak of unpublished price sensitive information or suspected leak of unpublished price sensitive information, which shall be approved by board of directors of the company and accordingly initiate appropriate inquiries on becoming aware of leak of unpublished price sensitive information or suspected leak of unpublished price sensitive information and inform the Board promptly of such leaks, inquiries and results of such inquiries.

- (6) The listed company shall have a whistle-blower policy and make employees aware of such policy to enable employees to report instances of leak of unpublished price sensitive information.
- (7) If an inquiry has been initiated by a listed company in case of leak of unpublished price sensitive information or suspected leak of unpublished price sensitive information, the relevant intermediaries and fiduciaries shall co-operate with the listed company in connection with such inquiry conducted by listed company.

Solution to Question 4:

- (i) (c)
- (ii) (d)
- (iii) (c)
- (iv) (a)
- (v) (a)

ANSWERS TO CASE STUDY: 4

Solution to Question 1:

The NSE is facing allegations that some brokers got preferential access through the co-location facility at the stock exchange, early login, and 'dark fiber', which can allow a trader a split-second faster access to the data feed of an exchange. Even this infinitesimally sooner access is considered to result in huge gains for a trader.

In January 2015, a whistleblower wrote to SEBI alleging that a few brokers were able to log into the NSE systems with better hardware specifications while engaged in algorithmic trading, which allowed them unfair access and advantage.

The unfair access issue pertains to 2012-14 when NSE used to disseminate price information through a unicast system. In such a system information is disseminated to one member after another.

The whistleblower's letter to SEBI alleged that sophisticated market manipulation has been taking place for several years at the NSE co-location centre. It also said that NSE had allowed non-empanelled Internet Service Provider (ISP) to lay fibre cables on its premises for few stock brokers.

Solution to Question 2:

The Securities and Exchange Board of India has formed a committee to investigate the causes of the lapses at multiple levels, including the board, the regulator, and the government, and to recommend checkpoints and tighter controls to ensure that such problems do not occur again.

The committee is expected to delve into five key areas to restore investor trust and confidence and bring ethical efficiency in the working of Market Infrastructure Institutions (MIIs) such as National Stock Exchange. They are as follows:

- (1) **Commercial:** The commercial side is important since an institution like the NSE needs to be profitable to operate efficiently and enhance its trading and security systems, as well as offer new products.
- (2) **Technology:** MIIs should be well-equipped to deal with the intricacies of business on a day-to-day basis. It must do so by investing in technology, which will help it deliver regulatory requirements more efficiently and effectively, as well as support supervision in terms of proactive risk and compliance monitoring at financial institutions.
- (3) **Measures for evaluation:** The group will work to develop comprehensive metrics for evaluating MIIs and holding officials accountable.
- (4) **Omissions and commissions:** Omissions and commissions must be eliminated at all costs. The committee's focus will most likely be on eliminating omission errors.

- (5) **Framework:** The committee may look into a governance structure that will allow for tighter compliance and better scrutiny, preventing shortcuts and protecting the system from being duped.

Solution to Question 3:

The recent strengthening of rules relating to Market Infrastructure Institutions will boost up the capital market in India. The reasons are discussed as follows:

- (i) Fixing the tenure of Managing Director (MD) of the company will improve the governance of MIs as the MD will be under pressure to sustain the efficiency of its organization.
- (ii) The expansion of KMP to anyone who reports directly to the CEO or is two rungs below the CEO and the revelation of information regarding the ratio of remuneration provided to KMPs vs. the median of all employees' compensation will act as a check against arbitrary payment of remuneration to certain persons and urging the KMPs to work more efficiently towards the organization.
- (iii) The check on public interest directors (PIDs) such as extension of their tenure after proper performance evaluation and disclosure of any potential conflict of interest will bring the required transparency in the governance of MIs which in turn will boost up the capital market.
- (iv) Internal committees were consolidated and reduced from fifteen to seven in order to improve efficiency and eliminate overlap. At least an equal number of PIDs and shareholder directors must serve on MI governing bodies and regulatory committees. In the event of a tie, the chairperson (who is also a PID) allowed for a second vote.

Subramanian's nomination and remuneration in NSE are said to have been approved improperly by the Nomination and Remuneration Committee (NRC). Having a greater or equal number of PIDs will help to diminish management's influence in internal committees like the NRC.

- (v) MIs have been required to reveal the amount of money they have set aside for regulatory functions. It will help in the separation of an MI's commercial and regulatory obligations.

Solution to Question 4:

- (i) (b)
- (ii) (a)
- (iii) (a)
- (iv) (b)
- (v) (d)

CASE STUDY 5

Solution to Question No. 1

To further simplify and provide greater clarity, capital market regulator SEBI has come out with a new format for disclosures in abridged prospectus, whereby critical information will be provided in the front page of the offer document.

It is mandated that every application form for the purchase of any securities of a company needs to be accompanied by an abridged prospectus.

After reviewing the disclosure requirement, it was felt that due to the multitude of information which is required to be disclosed, the look and text on the front page appears to be crowded, SEBI had said in a circular.

Under the revised format, a company will have to disclose about name of the promoter, details of offer to public -- types of issue, fresh issue and offer for sale (OFS) component, total issue size -- and share reservations details on the front page of the abridged prospectus (DRHP or RHP).

Also, the company is required to make disclosure about details of OFS by promoter, promoter group and other shareholders.

In the abridged prospectus containing salient features of the Red Herring Prospectus (RHP), the company will have to disclose about price band and minimum bid lot under the revised format.

Also, the issuer company has to disclose about indicative timelines for opening and closing of the issue, initiation of refunds, credit of equity shares to demat accounts of allottees and commencement of trading of equity shares among others.

The new format is part of SEBI's effort to further simplify, provide greater clarity and consistency in the disclosures across various documents and to provide additional but critical information in the abridged prospectus.

SEBI said that the abridged prospectus will be made available on the website of Issuer Company, lead managers, registrar to an issuers and a link for downloading the prospectus will have to be provided in price band advertisement.

The Issuer Company and merchant bankers (MBs) will have to ensure that the disclosures in the abridged prospectus are adequate, accurate and does not contain any misleading or mis-statement.

Furthermore, the issuer company/MBs will have to ensure that the qualitative statements in the abridged prospectus will be substantiated with Key Performance Indicators (KPIs) and other quantitative factors.

Also, no qualitative statement will be made which cannot be substantiated with KPIs.

Further, they will have to insert a Quick Response (QR) code on the front page of the documents such as front outside cover page, abridged prospectus, price band advertisement, etc. as deemed fit by them.

The scan of QR code will lead to downloading of prospectus, abridged prospectus and price band advertisement as applicable.

Thus, the new format is part of SEBI's effort to further simplify, provide greater clarity and consistency in the disclosures across various documents and to provide additional but critical information in the abridged prospectus.

Solution to Question No. 2

Key disclosures required to be made in an offer document i.e. in a prospectus are given as below:

- (i) names and addresses of the registered office of the company, company secretary, Chief Financial Officer, auditors, legal advisers, bankers, trustees, if any, underwriters etc.;
- (ii) dates of the opening and closing of the issue, and declaration about the issue of allotment letters and refunds within the prescribed time;
- (iii) a statement by the Board of Directors about the separate bank account where all monies received out of the issue are to be transferred and disclosure of details of all monies including utilized and unutilized monies out of the previous issue;
- (iv) details about underwriting of the issue;
- (v) the authority for the issue and the details of the resolution passed therefor;
- (vi) procedure and time schedule for allotment and issue of securities;
- (vii) capital structure of the company;
- (viii) main objects of public offer and terms of the present issue;
- (ix) main objects and present business of the company and its location, schedule of implementation of the project;
- (x) particulars relating to management perception of risk factors specific to the project, gestation period of the project, extent of progress made in the project and deadlines for completion of the project;

- (xi) minimum subscription, amount payable by way of premium, issue of shares otherwise than on cash;
- (xii) details of directors including their appointments and remuneration,
- (xiii) sources of promoter's contribution.

Solution to Question No. 3

RBI's rebalancing of liquidity management started in February 2020, as the central bank shifted its liquidity absorption tool out of the fixed-rate overnight reverse repo window into VRRR auctions of longer maturity.

In order to absorb additional liquidity in the system, the RBI announced conducting a VRRR program because it has higher yield prospects as compared to the fixed rate overnight reverse repo.

The Reserve Bank of India (RBI) has increased the amount of variable rate reverse repo (VRRR) auctions, as it is shifting out of the fixed-rate overnight reverse repo auction and re-establishing VRRR as the main liquidity management operations

Market participants expect the heavy liquidity withdrawal from the system will pull overnight rates near to repo rate, this would mean that accrual returns on a very short-term, low market risk products like overnight and liquid funds could rise in the coming months.

The reverse repo rate is the rate at which the RBI borrows money from commercial banks. Since RBI is deemed as lender of the last resort and it would hardly need money from other sources, VRRR seems to be a way to absorb excess liquidity from the market which is in turn helped to reduce inflation in the country.

Furthermore, through VRRR auctions, the RBI absorbs the excess liquidity from the market. RBI goes for 1 day, 3 day, 14 day and 28 day auctions and the banks participate in this auction. RBI chooses to store the money of a particular bank which accepts the quote for a particular amount of money with the least VRRR. The bank which quotes the minimum interest which is over and above the Reverse Repo Rate is deemed to be the winner of the VRRR auction. From banks point of view, it is a good way to store the money as it receives a higher rate than the Reverse Repo Rate and from RBI's perspective too, it would be able to control the money supply and lessen inflation risk in the economy.

Solution to Question No. 4

- (i) (d)
- (ii) (c)
- (iii) (a)
- (iv) (d)
- (v) (b)