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SUGGESTED SOLUTION

FINAL

SUBJECT- Elective (Capital Market)

Test Code – FNJ 7310

BRANCH - () (Date :)

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CASE STUDY -1

PART – A

1. B
2. B
3. B
4. B
5. C

PART – B

ANSWER -1

The CRAs can be monitored better to make them responsible for maintaining a rating. They can be made to function with common parameters so that what is stated by one CRA means the same across all CRAs. As of today, each CRA has a different system of rating, though, broadly, a 'high' rating by one also would mostly be high by another. However, standardization across agencies by adopting compulsory parameters and industry specific parameters should be made.

CRAs may be made to publish cumulative default rates.

CRAs may be made to publish the extent of risk in asset-liability mismatch by designing standard parameters for evaluation and reporting.

Data of default must flow immediately from the point of default to the CRAs so that they take the danger signal seriously and trigger better monitoring processes. Such triggers should also be standardized.

CRAs must be made to report a revised rating as on the date of default, within a reasonably short stipulated period. They may retain the earlier rating and not downgrade it due to a single lapse, but instead of the current passive concurrence to the earlier rating, they should actively publish the revised rating, be it same or different.

The CRAs should have a procedure to work out a probable default rate in the short, medium and long term. The high ratings especially should be intensely monitored since users assume almost no risk of default and are often surprised by bankruptcy. Ripples of such shocks a ffect even common man in the form of mutual fund investments.

The rating system and reporting should be revamped to capture individual instruments, the parent organization, subsidiary, prominent borrowers, associates, etc.in a fashion that enables a user find out readily the sensitivity of a particular organization to defaults of organization connected to it. Then, based on this sensitivity analysis, the most sensitive factors may be watched out more intensely.

CRAs must also be made to take cognizance of certain accounting ratios affecting liquidity and revalidate or revise their ratings if necessary. Thus instances of short term borrowings leaping up and not being noticed and reported will not happen (in this case, short term borrowings stepped up by 30 % and went unnoticed while yet being within law or regulation). Accountability will have to be fixed so that CRAs take note of these matters.

CRAs are being paid by the companies issuing debt for the rating done by them. Instead, there, there can be a central organization which charge companies for the rating and compensate the credit rating agencies for rating done by them.

Many financial institutions are capable of making their own research about the credit worthiness of the bond issuer. SEBI is also encouraging the asset managers to build their internal research capabilities. These parameters should be compared with those of the CRAs by a central organization so that points of variations can invite attention and if need be, revision in the ratings.

(5 MARKS)

ANSWER -2

The fundamental mess was created by the management (or rather mismanagement). CRAs and auditors come in as reporters and highlighters of the mess.

While infrastructure sector has an inherently long gestation period, a liquidity crisis in spite of institutional support (LIC/SBI) for the parent is clearly financial mismanagement.

The system under SEBI, RBI, CRAs, Companies Act, audits (both statutory and internal audits), are broadly in place to send out enough warning signals. Persons at the helm have decided to hide events and adopted unfair, unethical strategies to continue to raise money without accountability and have chosen to abandon the organisation in the wake of the impending crisis after unfairly enriching themselves.

Though the SFIO has not yet nailed fraudulent motives, the facts intentionally hidden from overseeing authorities which have led to the sudden crumble, affecting a large section of the ordinary people cannot be let go lightly.

According to me, the system is in place for early warning, like a burglar alarm. Fraud has covered it up like switching off the alarm before thieving.

Asset- liability mismatch and consequent mismanagement was an important reason.

Short term funds were used for long term investments, which is clearly against the rules of financial prudence. It was not corrected in time even after a 30% increase in short term borrowings. The debt trap was thus inevitable.

The allegation of the role of the corporate structure consisting of multiple layers of holding and subsidiary companies may have helped the management mask the pointed findings of an impending debt crisis. The structure may not have been faulty by itself, but it could have been used as an instrument to hide the insolvency crisis for some period till it surfaced.

The financial mess could have been better addressed by:

Issuing long term instruments with roll-over facilities.

The fund flow planning for each project could have been done with care and calculations to match assets with liabilities.

The auditors should have been able to see and report the impending crisis while taking particular note of the debt non-servicing.

Fresh issues of CPs were in violation of RBI regulations. RBI should have taken action on fresh issue while older issues had defaulted.

The CRA should have used better market intelligence and surveillance and should have been able to gauge company's financial irregularities.

The company could have a proper Risk Management system so that the problem can be detected at an early stage.

Most importantly, the management should have been honest and not tried to resort to unfair self-enrichment using public money.

(5 MARKS)

ANSWER -3

CAMEL Stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the Rating Agencies deserves special attention; it focuses on the following aspects:

1) **Capital –**Composition of Retained Earnings and External Funds raised; Fixed dividend component for preference shares and fluctuating dividend component for equity shares and adequacy of long term funds adjusted to gearing levels; ability of issuer to raise further borrowings.
2) **Assets –** Revenue generating capacity of existing/proposed assets, fair values, technological/ physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues. Size, ageing and recoverability of monetary assets viz receivables and its linkage with turnover.
3) **Management –** Extent of involvement of management personnel, team-work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.
4) **Earnings –** Absolute levels, trends, stability, adaptability to cyclical fluctuations ability of the entity to service existing and additional debts proposed.

5) **Liquidity –** Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive/negative aspects under each of these five categories and these are factored in for making the overall rating decision.

The Camel Model is basically used in case of banking companies. Since, operations of banking companies are quite large and complicated; it seems that this model can also be used in case of large public offerings of debt securities.

(5 MARKS)

Alternative Solution

Camel stands for Capital, Assets, Management, Earnings, and Liquidity.

Capital signifies the shareholder's Equity and primarily is the long term funds available in an enterprise. The philosophy of accumulation of reserve and retained earnings for funding long term assets will be a noteworthy aspect.

(a) Evaluation of Assets should include fair values, physical/ technological obsolescence etc.

(b) Management – the quality of management personnel, the corporate goals, the authority matrix, effectiveness of decision making will all be considered and evaluated.

(c) Earnings – The level and trend of earnings, ability to service the existing and the proposed debts will all have to undergo due diligence.

(d) Liquidity – How well the working capital requirements and cash flow situations are managed and how well is ALM issues are addressed.

CAMEL is a basic due diligence model and works well for most Credit rating situations. However, for large public offerings of investment securities, CRAs must use market intelligence and also keep their eyes and ears open for any market, industry, company related information that may have a bearing on the company's ability to service the debts.

CASE STUDY -2

PART – A

1. **A**
2. **B**
3. **D**
4. **B**

5. D

PART – B

Ans. to Q (A)

Note on the rationalization of the scheme

It is desirable that different schemes launched by a Mutual Fund are clearly distinct in terms of asset allocation, investment strategy etc. Further, there is a need to bring in uniformity in the characteristics of similar type of schemes launched by different Mutual Funds. This would ensure that an investor of Mutual Funds is able to evaluate the different options available, before taking an informed decision to invest in a scheme.

Categories have been designed based on investment objectives (say equity schemes will invest predominantly in the equity shares of companies, debt schemes will invest in debt instruments, etc. Within the main category, sub cateogies are designed based on investment (say equity within mid cap or small cap or large cap), or sector, or income yield, (say dividend yield fund), or tax benefit scheme (ELSS). These categories are in relation to only open ended schemes.

Recently SEBI has come up with regulations for rationalization and categorization of mutual Fund schemes to bring uniformity in the functioning of the AMCs and standarzation of Mutual Fund schemes across specific categories. As per this regulation, the fund House has to define its schemes clearly. SEBI has specified 36 categories of mutual fund schemes in total spread over five broad categories. As per the new regulations, the AMCs will not be allowed to offer two different schemes with identical investment mandates.

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(5 MARKS)

Ans. to Q (B)

The Schemes would be broadly classified in the following groups:

a. Equity Schemes
b. Debt Schemes
c. Hybrid Schemes
d. Solution Oriented Schemes
e. Other Schemes

(5 MARKS)

Ans. to Q (C)

The sub-categorization within the broad categorization is as follows (restricted to 5 in each broad category):

1. **Equity Schemes**
   (i) Multi Cap Fund
   (ii) Large Cap Fund
   (iii) Large & Mid Cap Fund
   (iv) Mid Cap Fund
   (v) Small cap Fund
   (vi) Dividend Yield Fund
   (vii) Value Fund/Contra Fund
   (viii) Focused Fund
   (ix) Sectoral/ Thematic Fund
   (x) ELSS (Equity Linked Saving Scheme)
2. **Debt Schemes**
   (i) Overnight Fund
   (ii) Liquid Fund
   (iii) Ultra Short Duration Fund
   (iv) Low Duration Fund
   (v) Money Market Fund
   (vi) Short Duration Fund
   (vii) Medium Duration Fund
   (viii) Medium to Long Duration Fund
   (ix) Long Duration Fund
   (x) Dynamic Bond Fund
   (xi) Corporate Bond Fund
   (xii) Credit Risk Fund
   (xiii) Banking and PSU Fund
   (xiv) Gilt Fund
   (xv) Gilt Fund with 10 years constant duration
   (xvi) Floater Fund
3. **Hybrid Schemes**
   (i) Conservative Hybrid Fund

(ii) Balanced Hybrid Fund

(iii) Aggressive Hybrid Fund

(iv) Dynamic Asset Allocation or Balanced Advantage

(v) Arbitrage Fund

(vi) Multi Asset Allocation

(vii) Equity Savings

(Note: Foreign securities will not be treated as a separate class)

4. Solution Oriented Schemes

(i) Retirement Fund

(ii) Children's Fund

5. Other Schemes

(i) Index Funds/ ETFs or Exchange Traded Funds

(ii) FoFs or Fund of Funds (Overseas/ Domestic)

(5 MARKS)

CASE STUDY -3

Note: Please note these solutions are for guidance purpose only.

XYZ Consulting

Dated:

Mr. Zahir

Sub: Report on the various issues raised during our meeting dated…….

The point-wise reply on the various issues raised by you is as follows:

(A) Although in WhatsApp, it is not easy due to end-to-end encryption to monitor the messages but it is possible, to set up specialised units to track and monitor such a medium. It is also possible for Sebi to set up an email id, for example, where such messages can be anonymously forwarded for analysis. That would give the regulator some idea about the scale of problem and an opportunity to judge which messages are credible and actionable and worth following up.

(2 MARKS)

(B) As per SEBI Guidelines the meaning of the term 'insider' means any person who is:

(i) a connected person; or

(ii) in possession of or having access to unpublished price sensitive information;

and 'unpublished price sensitive information' is:

any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the price of the securities and shall, ordinarily including but not restricted to, information relating to the following: –

(i) financial results;

(ii) dividends;

(iii) change in capital structure;

(iv) mergers, de-mergers, acquisitions, delistings, disposals and expansion of business and such other transactions;

(v) changes in key managerial personnel; and

(vi) material events in accordance with the listing agreement.

To curb the practice of Insider Trading the law expanded the scope of who constitutes an "insider" to include "anyone in possession of or having access to unpublished price-sensitive information" regardless of how they came "in possession of or had access to such information".

Further circulating "unpublished price-sensitive information" can result in penalties of up to 250 million rupees and a jail term of up to 10 years. The monetary amount can be higher if it can be proven that an individual traded on such information.

(5 MARKS)

(C) Since Joseph was in possession of unpublished price sensitive information and he has circulated the data also, he can be called as 'insider'. **(1 MARK)**

(D) Insider Trading Management System (ITMS) serves as a central repository of insider related information for reporting and analytics.

ITMS helps organizations easily capture details about "Insiders" and their relatives as per the policy definition. A workflow enabled pre-dealing approval as well as post trade update mechanism brings efficiency to request handling.

A configurable "Trading Window" and automated alerts & notifications add flexibility to the system.

(2 MARKS)

(E) Since the difference between the actual information compiled and the information as per the message is almost minuscule there is a clear cut case of insider trading. Further following course of action can be followed by such insiders on receiving such information.

Company	**Course of action might have been followed by Insider**
DR WADES	Since there is a prediction of loss. The insider will sell the shares he/ she own before the information is made public as price will fall after the announcement of results. (Insider can take short position in the shares)
CFDC BANK	Insider shall acquire the shares as bank is likely to post profit and very less GNPA. (Insider can take long position in the shares)
SIXES BANK	Since the results likely to be announced are not good e.g. rising GNPA etc. it is likely that the price of shares will fall. Hence insider shall sell his/ her shares. (Insider can take short position in the shares)
ABCD STEEL	Since there is likely announcement of losses, the share prices of the company shall fall. Accordingly, the insider shall sell the share before such announcement. (Insider can take short position in the shares)
RAJENDRA HOLIDAYS	Since after the announcement of bonus issue there is likely to be a rise in the prices of the shares, the insider shall purchase the shares. (Insider can take long position in the shares)

Thanks, ABC

(Signature)

(5 MARKS)

Answers to Multi Choice Questions (MCQs)

1. **D**
2. **D**
3. **C**
4. **A**
5. **B**

CASE STUDY -4

(i) The total number of subscribed shares of ABC Ltd. in November 2014 is 57,42,36,166 fully paid equity shares.

(1 MARK)

(ii) After the bonus announcement, the investors have not reacted positively. The shares are down by about Rs. 120 to Rs. 2001 levels now. The reasons for this may be because the company has pile up excess cash and it has not enough investment opportunities.

(1 MARK)

(iii) After the bonus issue, EPS will reduce. The reason is that after the bonus issue, the number of shares will increase leading to increase in denominator while numerator i.e. Profit after tax is same. This leads to fall in the value of EPS.

(1 MARK)

(iv) (a) As per regulation 95 of SEBI (ICDR) Regulation, 2009, if an issuer after the approval of its board of directors which does not require the shareholders' approval for bonus issue shall implement the bonus issue within fifteen days from the date of approval of the issue by its board of directors.

However, where the issuer is required to seek shareholders' approval for bonus issue, the bonus issue shall be implemented within two months from the date of the meeting of its board of directors wherein the decision to announce the bonus issue was taken subject to shareholders' approval.

(2 MARKS)

(b) While calculating basic earnings per share, profit after tax after preference dividend is divided by the total number of equity shares outstanding. On the other hand, in the computation of diluted earnings per share, debt which can be converted into equity in the future is also taken into account. Since, ABC Ltd. is a debt free company; there is no convertible debt on its part. Therefore, basis earning per share and diluted earnings per share are equal.

Further, as per Regulation 93 of SEBI (ICDR) Regulation, 2009 no company shall make a bonus issue of equity shares unless it has made reservation for holders of convertible debt instruments.

However, since ABC Ltd. is a debt free company, the above provision is not applicable to it.

(2 MARKS)

(c) It is clearly provided in the SEBI Regulations that once the decision to make a bonus issue is announced, the issue cannot be withdrawn.

(1 MARK)

(v) Prices of ABC Ltd. on the Ex-Bonus date has been reduced drastically. The basic reason is that after the bonus issue, the prices of shares come down in the immediate period. For instance, if the share price before bonus issue is Rs. 1000 and the company issues bonus shares in the ratio of 1:1, the share price after the bonus issue will be Rs. 500. However, it also means that the total market value (2 shares x Rs. 500 = 1000) remains the same.

(2 MARKS)

(vi) It is generally considered prudent to pay dividend consistently even after the bonus issue. Higher dividend payout on the part of ABC Ltd. indicates that existing shareholders will get more dividend after the bonus issue.

For example, in the given case, the company issues bonus shares in the ratio of 1: 1. It declared dividend of 10% which will be Rs. 1 on the face value of Rs. 10 in the previous year. In the current year, it decides to maintain the dividend at 10%. Now, a shareholder with one share will get an additional share. His total shares will be 2. And, he is eligible for total dividend of Rs. 2 (Rs. 1 x 2 shares). So, his dividend income will be doubled due to issue of bonus shares.

Therefore, higher dividend payout on the part of ABC Ltd indicates willingness on the part of company to keep the shareholders happy and increase their wealth. Also, the company can utilize it’s excess cash reserves in this way.

(3 MARKS)

(vii) The company is debt free as it can be observed from the Balance Sheet of the company. The reason for such non debt element in the capital structure of the company may be due to the fact company has large cash reserved which can be utilized for short term working capital requirements of the company. Further, the exclusion of debt in the capital structure reduces the periodic interest cost on the part of the company. Also, there is the possibility of default risk which may arise due to non-payment of interest and principal amount of loan.

(2 MARKS)

Answers to Multi Choice Questions (MCQs)

1.A

2.B

3.D

4.B

5.C

CASE STUDY – 5

(i) The mutual fund discussed in the Case Study is a debt oriented scheme. The reason is that it's investments include Listed Debentures and Bonds and Government securities.

(ii) Although not specifically mentioned in the Case Study, it seems that the scheme is open ended scheme because of following reasons:

- The number of units issued and redeemed during the year has been given in the Case Study.
- The high amount of redemption (about 25% of units outstanding at the beginning of the year) indicates that the scheme is an open ended one.
- No fixed maturity period has been given.
- Lots of changes are happening in the current scheme.

(iii) Only close ended schemes are required to be listed. Since, the present mutual fund scheme is an open ended scheme; it cannot be listed and traded in the stock exchange.

(iv) Yes, plans are permitted as lateral shift receivable and lateral shift payable is given in the Case Study itself, an indication that switching between plans is permitted in this mutual fund product.

(v) Only liquid fund schemes need to hold substantial amounts as deposits with scheduled banks. This is not a liquid fund. It is a Bond Fund. It needs liquidity to the extent of repurchase of units, being open ended. This is available in the current account balances, probably on an estimated basis, depending on the usual redemption demands by investors. Value of units pending allotment should be deposited in a scheduled commercial bank.

(vi) The scheme cannot be said to have negligible risk since although almost half the investments are in government securities, there is the other half in listed debentures and bonds. If the listed securities are risky, that risk will directly affect the riskiness and exposure of this scheme. Government bonds yields low interest and high safety. Similarly, the other investments are also listed debentures/bonds which give less than equity investment returns. Hence the overall risk of the scheme can be said to be moderate.

Collateralized lending and receivables are high. Since the fund is a bond fund scheme, it may be presumed that the lending is against similarly secured collaterals.

(vii)

Average purchase price

$$= \frac{100000}{1+0.0876x\frac{85}{365}} = \frac{100000}{1.0204} = 98000$$

Alternative Answer

Yield = (FV – Price)/Price x 365/85

$$8.76\% = \frac{(100000 - Price)}{Price} x \frac{365}{85}$$

$$\text{Price} = \frac{429412}{4.381712} = 98000.9640$$

Alternatively, if 360 days assumed in a year, then average purchase price

$$= \frac{100000}{1+0.0876x\frac{85}{360}} = \frac{100000}{1.0207} = 97972$$

Answers to Multiple Choice Questions

1. **C**
2. **B**
3. **A**
4. **D**
5. **B**