Roll No……..……..

Membership No……

The Institute of Chartered Accountants of India
Forex & Treasury Management Certificate Course
Evaluation Test Booklet

Paper 2

9th NOV, 2014

Duration- 3 Hours **Total Marks- 100**

INSTRUCTIONS:

1. Please read the instructions carefully given in the question paper and solve it in the space provided.
2. The candidates are not allowed to carry the evaluation test booklet with them. This should be tied up with sheets provided to answer the question Paper.
3. Use Blue/Black pen only.
4. Do not write your Roll No. or Name or other identification other than in the space (perforated) provided on this sheet.
5. Please show Identity Card to the invigilator for verification of your identity, when asked.
6. The candidates may use the simple calculator.
7. In order to get full credit on the problems, the candidates must show all their rough work/ other workings.

(Participant Signature) (Invigilator Signature)

PLEASE RETURN THIS BOOKLET BEFORE LEAVING THE EXAMINATION HALL

Date : 9th Nov, 2014
Centre : Delhi/ Mumbai /Chennai/Kolkata/Bangalore/Ahmedabad/Baroda/Cochin & Pune.

(Do not write your Roll No. and Membership number anywhere in the answer sheet except as mentioned above)

Checked by **Verified by**

CERTIFICATION COURSE ON FOREX AND TREASURY MANAGEMENT

S. No.	Total Number of Questions	Questions to be answered	Total Marks	Marks Obtained
Multiple Choice - Section A	65	65	65	
Short Notes – Section B	7	5	25	
Case Study – Section C	2	1	10	
Total	74	71	100	

Section A

Number of questions: 65

Marks: 65

Multiple choices: There may be more than one correct answer. Please [✔] mark for the correct answer.

Part A: Answer all questions. 1 mark each

1. In a derivative transaction, the following is true of a market maker
   - **a. Market-maker provides bid & offer prices**
   - b. Market maker should have an underlying risk
   - c. Market maker provides only bid prices to users
   - d. Market maker provides only offer prices to users
2. In a Forward Rate Agreement,
   - a. There is an exchange of principal on the maturity date
   - b. The exchange of interest also takes place along with the principal
   - **c. Cash payment on the settlement date will be based on fixed and settlement rate**
   - d. The settlement rate is the reference rate prevailing on the date of contract
3. As per RBI definition, following is not a generic derivative product
   - a. Forex forward contract
   - **b. Swaption contract**
   - c. Interest rate swap
   - d. Cross currency swap
4. As per RBI guidelines, following is a structured derivative product
   - a. Instrument which is a combination of cash instrument & generic derivative product
   - b. Instrument which is combination of two or more generic derivative products
   - c. Instrument which is a combination of two or more cash instruments
   - **d. Choices a & b above**
5. Interest Rate Swap has the following feature
   - a. It is an exchange traded contract
   - **b. Involves exchanging streams of interest payment based on notional principal**
   - c. The swapping takes place once only
   - d. It is also known as Interest Rate Future
6. A settlement risk has the following features
   - **a. It generally arises when there is time zone difference**
   - b. It exists in transactions that involve delivery versus payment
   - c. It generally exists for a very long time i.e. much more than 24 hours
   - d. It is different from and more complicated than Herstatt risk
7. An interest rate cap has the following features

a. It is not a type of interest rate option
b. Payments are made when reference rate exceeds strike rate
c. Payments are made when strike rate exceeds reference rate
d. Payments are made when reference rate is equal to strike rate

8. Which of the following is *not* a true statement?
    a. Interest rate futures is an exchange traded derivative product
    b. Interest rate swap is an OTC derivative product
    c. Forward rate agreement is an OTC derivative product
    d. Interest rate swap is an exchange traded derivative product
9. Banks which offer derivative products are required to conduct stress tests. Following is true in respect of these stress tests
    a. Stress tests indicate the level upto which exchange rate can be improved by banks without incurring loss
    b. Stress tests evaluate exposure under worst case scenario
    c. Stress tests estimate the extent of financial stress the system may undergo
    d. Stress tests need not cover factors which generate extraordinary losses
10. The 'position' held by a bank on account of derivatives is to be marked to market. As per RBI guidelines
    a. This is necessary to establish the current value of risk positions
    b. This is to enable the bank to book profits and increase earning
    c. This should not be done by the back office unit of the treasury
    d. Pricing factors used for revaluation are supplied by the front office
11. Continuous Linked Settlement is
    a. A process by which interbank settlements take place continuously
    b. A settlement process where there is a continuous linkage between consecutive deals
    c. A global initiative for addressing foreign exchange settlement risk
    d. A service offered by Clearing Corporation of India Ltd to banks
12. The following statement is true in respect of hedge accounting
    a. It expects the effects of the derivative and the risk being hedged at different periods to be reported
    b. Hedge accounting does not allow entities to override the normal accounting treatment for derivatives
    c. Hedge accounting does not allow entities to adjust the carrying value of assets and liabilities.
    d. Entities can only obtain the right to achieve hedge accounting if they meet the requirements set out in IAS 39
13. Hedge accounting is [mark the *incorrect* one]
    a. An exception to the usual accounting principles for financial instruments
    b. Compulsory for all transactions
    c. Optional
    d. Applicable only where hedge relationships meet defined criteria
14. Hedge accounting does not cease merely because the following occurs:

a. A hedge fails an effectiveness test
b. The hedged item is sold or settled
c. Management decides to revoke the designation
d. The forecast transaction is highly probable

15. If the current market rate is 6% and if you are a borrower and if there are two collars available viz.: Interest Rate Collar with
    i. a 4% Floor and a 7% Cap and
    ii. a 5% Floor and a 8.5% Cap

    then you will pay
    a. More premium for (i) above
    b. Less premium for (i) above
    c. The premium is same for (i) or (ii) above
    d. More or less premium depending on the terms of the collars
16. Which of the following statement is true?
    a. An Interest Rate Cap is simply a combination of an Interest Rate Collar and an Interest Rate Floor
    b. An interest rate Collar is a combination of a long Cap and short Floor, struck at different rates
    c. The premiums payable for an Interest Rate Collar are higher than the premium payable for an Interest Rate Cap
    d. Fixed interest rate borrowers are typical users of interest rate collars
17. Mark the correct statement among the following relating to option contracts
    a. Call option gives the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date
    b. Call option gives the buyer the right but not the obligation to sell a given quantity of the underlying asset, at a given price on or before a given future date
    c. Call option gives the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on a given future date
    d. Call option gives the writer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date
18. Option contract is different from an insurance contract in respect of the following:
    a. Options do not require one party to suffer actual loss for the payment to occur
    b. Owner of the option need not have an insurable interest
    c. The premium payable is independent of the amount of contract in case of options
    d. Both a & b above
19. The following equation is true in case of Original Issue Discount
    a. Book value = Face value – Original issue discount
    b. Face value = Book value – Original issue discount
    c. Book value = Original issue discount - Face value
    d. There is no term called Original Issue Discount
20. In the Indian banking context, the following can be considered to have an Original Issue Discount in it

a. Savings account with banks since interest is paid with no tax deduction
b. Fixed deposit accounts with interest paid half yearly
c. Fixed deposit accounts with cumulative interest option
d. Bridge loans with bullet payments

21. A company has made overseas investments and desires to hedge the exchange rate risk in respect of the market value of those investments. Do you think it is allowed and if yes to what extent?
    a. Allowed subject to RBI permission and to the extent allowed in that letter
    b. Is not allowed
    c. Allowed; but if the contract becomes naked due to shrinking of investment value, it should be immediately cancelled
    d. Allowed; but if the contract becomes naked due to shrinking of investment value, it may be allowed to continue at customer's request
22. Your company is exporting to Europe, always denominated in Euro. While there is not much movement in that currency, you see great opportunity in taking a bet on US dollar which is fluctuating rapidly. Is it possible to book forward contracts denominated in USD?
    a. No, the currency of the contract has to be the same as that of the underlying
    b. It is not advisable to book contracts in USD as it is a fluctuating currency
    c. Yes, provided the risk management policy of your company permits it
    d. Contract in USD can be booked subject to RBI permission
23. Canara Bank Mumbai has been approached by General Bank Singapore to open an Indian rupee account. Canara Bank
    a. Needs RBI permission for this
    b. Dealers have to decide whether to allow it or not
    c. Will call this as Vostro account, if opened
    d. Will call this as Nostro account, if opened
24. SBI Mumbai has opened an account denominated in HKD in SBI branch in Hong Kong.
    a. This affects the HKD 'position' of SBI Mumbai
    b. This does not affect the position since the account is in its own branch
    c. This affects the 'position' of SBI Hong Kong
    d. SBI Mumbai calls this as Vostro account
25. Where a bank in India maintains a nostro account abroad, the balance maintained there
    a. Is subject to ceiling advised by RBI
    b. Has to be repatriated to India periodically
    c. Affects the profitability since it does not earn any interest
    d. Is confidential and should not be revealed to the host Central Bank
26. For a bank, the net open position is arrived at for each currency separately and while aggregating it for each currency, the following is not included
    a. Net spot position
    b. Net forward position
    c. Net options position
    d. Net open position in gold

27. A swap can be considered as equivalent of two or more
    a. Forward contracts
    b. Futures contracts
    c. Option contracts
    d. Interest rate swaps
28. In an option contract, the option [to buy or sell] is with
    a. Buyer
    b. Seller
    c. Both buyer and seller
    d. Exchange
29. A call option at a strike of Rs.75 is selling at a premium of Rs.16. At what price will it break even for the buyer of the option?
    a. Rs.59
    b. Rs.91
    c. Rs.94
    d. Rs.107
30. A European option
    a. can be exercised anytime during the life of the Option
    b. can be exercised only at maturity
    c. is traded only on European Exchange
    d. is one where the underlying currency is Euro
31. As per the accounting standard for financial instruments, following is a financial liability
    a. Forward contracts
    b. Own equity
    c. Warranty obligations
    d. Insurance contracts
32. If you have bought 1 lot (100 shares) of Wipro July Future @2000 it means
    a. You will buy 100 Wipro shares at Rs 2000 in July
    b. You will buy 100 Wipro shares in July in Futures market at Rs 2000 per share
    c. You have agreed to buy 100 Wipro **shares at Rs 2000 per share on 31.7.2014**
    d. You have a right to buy 100 Wipro shares in July at Rs 2000 per share
33. Which of the following statements is correct?
    a. A Call option is said to be in-the-money when the current price stands at a level lower than the strike price
    b. A put option is said to be in-the-money when the current price stands at a level higher than the strike price
    c. A Call option is said to be in-the-money when the current price stands at a level higher than the strike price
    d. A Call option is said to be in-the-money when the current price stands at a equal to the strike price
34. An investor buys one contract of Hind Expo Ltd [market lot 300] at Rs 260 and after 3 days sells at Rs 280. Ignoring the interest cost, the investor makes
    a. A profit of Rs 20

   b. A profit of Rs 6000
   c. A loss of Rs 20
   d. A loss of Rs 6000

35. Current Nifty is 3880. An investor buys one contract (lot size 50) of Nifty near month puts for Rs.17 each. The strike price is 3840. What is the break-even Nifty level?
   a. Rs 3863
   b. Rs 3857
   c. Rs 3840
   d. Rs 3823

36. An investor purchased 100 Nifty Futures @ Rs. 4200 on June 10. Expiry date is June 26. Initial Margin paid : Rs. 42,000. On June 26, Nifty index closes at 3,800. What is the loss or gain for the investor?
   a. Loss to the investor Rs 42000
   b. Gain to the investor Rs 42000
   c. Gain to the investor Rs 400
   d. No gain or loss

37. Among the various 'Greeks' used in relation to financial derivatives, the rate of change of the option's delta is called
   a. Alpha
   b. Beta
   c. Gamma
   d. Theta

38. The time value component of option tends to zero near the expiration date. Hence options are
   a. Called as wasting assets
   b. Considered as avoidable hedging instruments
   c. Preferably to be bought near the expiration date
   d. Valued only away from the expiration date

39. While booking forward contracts under 'contracted exposure' category, if customers are unable to produce underlying documents due to logistic reasons, maximum period available for producing such documents to the bank, as per RBI guidelines, is
   a. 7 days
   b. 15 days
   c. 30 days
   d. 90 days

40. Exporter can book forward contract based on past performance subject to RBI guidelines. One of the guidelines requires the exporter to submit quarterly declaration as per RBI format duly certified by
   a. Statutory auditor
   b. Any CA
   c. Concurrent auditor
   d. Internal auditor

41. Private exchange houses are allowed to open rupee accounts with banks

a. Subject to Individual RBI permission
b. Subject to RBI guidelines, banks can open
c. Which can be used mainly for individual remittances
d. Choices b & c above

42. A Russian bank is maintaining a rupee account with United Bank Kolkatta. The reconciliation of the account
    a. Is to be checked by the auditors of United Bank
    b. Is the responsibility of the Russian bank
    c. Has to be done by United Bank
    d. Is automatically done in the automated system now
43. As per SEBI guidelines, the promoters' contribution in the public issue shall not be
    a. Zero
    b. Less than 10%
    c. Less than 20%
    d. Less than 50%
44. As per The Chit Funds Act, 1982, chit means a transaction
    a. In which subscribers get money as and when they want during the period when they have subscribed
    b. In which subscribers pool money to help each other during the period when they have subscribed
    c. In which subscribers earn high interest during the period when they have subscribed
    d. In which persons subscribe periodically during definite period and each by lot or auction is eligible for a prize amount
45. Foreign Direct Investment in chit funds in India is banned as per guidelines issued
    a. Under The Chit Funds Act 1982
    b. Under FEMA by RBI
    c. By SEBI
    d. By Government of India
46. RBI has issued guidelines for corporate debt restructuring. Under these, reorganization of the outstanding obligations does *not* include
    a. One time settlement
    b. Enhancing the repayment period of the loan
    c. Reducing the rate of interest
    d. Conversion of equity into debt
47. Under the RBI guidelines for corporate debt restructuring, the lenders' decision on restructuring proposal is arrived at by
    a. The borrower asking the lenders to agree
    b. Half the lenders agreeing
    c. 75% of the lenders by value agreeing
    d. Unanimous decision
48. The provision relating to service tax as applicable to amount charged as 'entry and exit load' by a mutual fund is as under:
    a. Exit load attracts service tax

b. Entry load attracts service tax
c. Both entry & exit loads attract service tax
d. Both entry & exit loads do not attract service tax

49. For the purpose of levying service tax, the following services are considered as Banking and Other Financial Services
    a. Merchant banking services
    b. foreign exchange broking
    c. Both a & b above
    d. Export of services
50. In the context of raising capital, book building means a process undertaken
    a. Build improved relationship with investors
    b. To clean up the books and to make the financial statements attractive
    c. To assess the price for determination of value of specified securities
    d. To improve the order position by a corporate resulting in better order books
51. As per Securities And Exchange Board Of India (Foreign Venture Capital Investors) Regulations, 2000, foreign venture capital investor
    a. Can maintain normal rupee account with any bank
    b. Includes foreign investor registered under these regulations
    c. Includes an investor incorporated and established in India
    d. Can make only nonrepatriable investments
52. Under PML Act, 2002, banks are required to maintain records connected with transactions covered under prevention of money laundering for a period of
    a. One year from the date of cessation of the transactions
    b. One year from the date of commencement of the transactions
    c. Five years from the date of the transaction
    d. Ten years from the date of cessation of the transactions
53. Who is the regulator for Chit funds?
    a. SEBI since chit is considered as a mutual fund
    b. RBI in view of large volume of funds involved
    c. Respective State Governments
    d. Ministry of Finance Government of India
54. According to SEBI guidelines, investment advice
    a. Includes advice given through newspapers
    b. Includes financial planning
    c. Does not include oral advice
    d. Does not include advice selling securities
55. In financial markets, Financial Market Infrastructure [FMI] refers to
    a. The infrastructure available for conducting financial transactions
    b. There is no term as FMI
    c. Multilateral system used for clearing, settling and recording transactions
    d. INFINET, the networking backbone
56. A customer walks into a bank branch, looks at the card rates and unhappily says that the rate is very low. He is likely to be
    a. An exporter

b. An importer
c. An unhappy customer
d. Either an importer or exporter depending on situation

57. An inside/outside swap offered by CCIL
    a. Is an unofficial way of deviating the swap guidelines
    b. Helps in covering a position in breach of exposure limit with CCIL
    c. Changes the bank's forex position
    d. Is similar to a repo in money market
58. In the following case, the settlement is likely to take place earliest
    a. Cash deal
    b. Tom deal
    c. Spot deal
    d. Long forwards
59. A customer has not come forward to settle the forward contract booked by him. Such matured forward contracts
    a. Shall be automatically cancelled on the 15th day after maturity date
    b. Shall be automatically cancelled on the 30th day after maturity date
    c. Shall be reported to RBI for further action
    d. Will make the customers' accounts NPA
60. If there is a concept of discretionary portfolio manager as per SEBI Rules 1993, the following best describes such a person
    a. He is one who exercises any degree of discretion on management of the portfolio of securities of the client
    b. There is a concept of portfolio manager and not definitely Discretionary Portfolio Manager
    c. A wealth manager with enough discretion is considered as discretionary portfolio manager
    d. Discretionary Portfolio Manager is defined as a portfolio manager appointed at the discretion of the client
61. The ceiling on the amount of foreign exchange that can be drawn by any resident for business purposes at the bank is
    a. USD 25000 per year
    b. USD 25000 per visit
    c. USD 10000 per year
    d. USD 10000 per visit
62. While establishing a letter of credit by a bank on behalf of a customer, the following exchange rate is applied
    a. Bill selling rate
    b. TT selling rate
    c. No exchange rate is applied
    d. Depends on whether it is a sight LC or usance LC
63. Which of the following statement is correct in case of mutual funds business?
    a. While commencing mutual fund business, the sponsor's contribution should be atleast 40% of the networth of the Asset Management Company [AMC]

b. While commencing mutual fund business, the sponsor's contribution should be atleast 50% of the networth of the AMC
c. An AMC cannot route more than 10% or more of the aggregate purchases and sale of securities made in all its schemes through any broker
d. An AMC cannot route more than 25% or more of the aggregate purchases and sale of securities made in all its schemes through any broker

64. As per Foreign Exchange Management Act 1999,
    a. State Bank of India London branch is a resident entity whereas Indian staff who are deputed thereto are nonresident Indians
    b. State Bank of India London branch and also Indian staff who are deputed thereto are nonresident entity / Indians
    c. State Bank of India London branch and also Indian staff who are deputed thereto are resident entity / Indians
    d. State Bank of India London branch is a nonresident entity whereas Indian staff who are deputed thereto are resident Indians

65. The difference between Rate Sensitive Assets and Rate Sensitive Liabilities for each time bucket is known as the Gap and as Bank's ALM head, you have created a large Gap.
    a. The Bank is in a position to benefit from declining interest rates by having a negative Gap
    b. The Bank is in a position to benefit from rising interest rates by having a negative Gap
    c. The Bank is in a position to benefit from declining interest rates by having a positive Gap
    d. The Gap does not necessarily indicate the profit or loss due to movement in interest rate

Section B

Number of questions: 7

Marks: 25

Note: Answer any five questions. Each answer will carries 5 marks

[Unrelated answers & answers exceeding the brief will attract negative marks]

1. Write short notes not exceeding ten lines on each of the following
    a. Integrated treasury
    b. Debt vs equity

    a) The answer should cover what is meant by treasury, functions of treasury – it handling transactions both in Indian and overseas markets in INR & other currencies – and how beneficial if these are handled at the same place [to take advantage of interest arbitrage, to deploy surplus funds, to manage liquidity efficiently, to have overall control on credit exposure against counterparties etc]. Integrated treasury is this situation in banks where domestic and forex treasuries are handled at one place holistically.
    b) These terms are very familiar to a chartered accountant. However what is required here is a brief analysis of advantages & disadvantages of debt versus that of equity. In particular, the answer should cover issues of taxation, management control, cost and other financial issues.

2. Goodwill Ltd has an annual exports of around Rs 90 crores whereas its imports are nearly Rs 100 crores. Exports are mainly to Europe and invoiced in Euro. Most imports are in USD. Discuss whether the company has natural hedge and why?

    The answer should explain what is meant by natural hedge [i.e. a company having both buy and sell situations on a currency on account of internal causes]. Then it should analyse that natural hedge is possible only if
    - Receivables & payables are in the same currency
    - Receivables & payables are of matching amounts and
    - Receivables & payables occur at same point of time.

    The answer should then discuss whether apparently these conditions are met and if yes, there is a natural hedge to the extent of such congruence. Any cogent answer presuming data or info will fetch higher marks.

3. Explain with example what is a repo transaction and how it helps banks in managing liquidity and meeting statutory ratios

   This is a typical text book question. The answer should explain what is meant by repo [and reverse repo, if logically follows] and how the two legs happen simultaneously. Thereafter the answer should give an example e.g. a bank having surplus securities [beyond SLR requirement] but has less than cash required to be kept with RBI in the form of CRR. If there is another bank with exactly opposite situation, the two banks enter into a repo [bank with excess securities selling it with reverse purchase after say 2 working days], thereby both banks being able to comply with SLR & CRR requirements.

4. Describe the various items that appear on the balance sheet of a bank and explain their interest rate sensitivity

   The CA candidate should find this very easy to explain. The answer should explain why interest sensitive rather than mere stating sensitive or not.

   Types of assets

Cash & bank balances	no
Investments	yes
Loans and advances	mostly yes
Bills	mostly yes
Fixed assets	no
Intangible assets	no

   Types of liabilities

Capital & reserves	no
Deposits	some parts like CA are not; others yes
Borrowings	yes
Provisions	no

5. If you are the official in charge of the treasury of a bank, what are the various limits you expect to be in force and explain the significance of each

   Some of the important limits to be covered in the answer are:
   Overnight limit: the exposure to which the position can be kept open at the end of the day. This decides the currencywise exposure and has a direct bearing on the profit or loss treasury makes.
   Intra day limit [also called daylight limit]: the limit upto which dealers can take exposure currencywise. This will be generally higher than overnight limit because there is time to bring down the exposure if market rate movement requires.
   Gap limit: The limit on the gap monthwise and the aggregate gap limit [AGL] for all months together. Here gap represents net of inflows and outflows in that currency during that month. This helps in understanding the interest rate arbitrage opportunities.

Counter party limits: against each counterparty bank depending on the financial position of that bank. The amount of outstandings against each bank has to be within this.
VaR limit: gives an estimate of possible loss & an overall ceiling on the results of the exposure
There are also other limits fixed by some banks like limit on the balances that can be maintained in nostro accounts, size of deal etc.

6. Explain the terms statutory cap and sectoral cap in FDI policy with examples

Answer:
Statutory cap means the ceiling on the foreign direct investment in the equity of companies as prescribed in the respective statutes. E.g. in SME units, the ceiling cannot be more than 24%, in insurance sector it is 26%, 20% in banking. Sectoral cap means depending on the type of industry there are ceilings upto which FDI can take place. E.g. in petroleum it is 49%, defence industry it is 26% and so on. Depending on the sensitivity of the industry, social causes, domestic issues etc, Government has specified in around 19 types of industries and even if it is 100%, the conditions attached. A good answer should explain why there are such caps besides the numbers.

7. Discuss the salient features of supplier credit for imports as permitted under FEMA provisions.

The answer should explain what is meant by trade credit [i.e. buyer or supplier credit], what is meant by buyer credit or supplier credit. Then the answer should explain the features as advised by RBI [available in RBI master circular of 1st July 2014] such as amount [USD 20 m], credit support [bank guarantee, LC or acceptance allowed], ceiling on interest rate [could vary from time to time – now LIBOR + 3.5% pa], maximum period [6 months] etc.

Section C

Number of questions: 2

Marks: 10

Note : Case Studies. Answer any one. Max 10 marks

1. Sri Project exports ltd is in the business of project exports viz.: executing turnkey projects in different parts of the world but mainly in developing world. The projects include building simple housing colonies to constructing & delivering complex airports. It has been bidding successfully for these projects from time to time. The projects are of large value [typical size varying from USD 50 to 500 million] and generally payments receivable over a period of 3 to 5 years. If the bid is successful, there is a large forex exposure. While bidding, naturally, it has to estimate the expected exchange rate and arrive at the profitability and bid. However, it cannot hedge because of the uncertainty. Considering the political set up in most target countries, the decision is always slow and hence the exchange risk to Sri higher. Banks are also hesitant to support bid bond guarantee in view of large amount and the cost of credit insurance appeared to be high. As the newly joined treasury head, what suggestions you have on these?

Answer:

- The company can take bid bond guarantee from the banks and ECGC supports the banks by issuing Export Performance Guarantees [EPGs]. Export Performance Guarantee is an insurance cover for banks. The insurance is provided by ECGC with the objective of enabling exporters to obtain the required guarantee facility from banks on easy terms. The Guarantee, which is in nature of a counter guarantee to the bank, is issued to protect the bank against losses that it may suffer on account of guarantees given by it on behalf of export purposes. In order to reduce the cost of participating in global tenders for Projects, EPGs to cover the related Bid Bond Guarantees are issued on payment of 25% of the premium due. No further premium is payable if the exporter is not declared successful in the bid. The balance amount of the premium will have to be paid only if the exporter succeeds in the bid.
- Sri cannot book forward contracts for the receivables over the next 3 to 5 years because it is not sure of securing the project under the tender. Moreover, FCs for long term may not be offered by banks. However, option contract is ideal for this type of situation. Sri should buy put option contracts for amounts and maturities matching with its expected down and subsequent milestone payments. The cost to the company is the premium paid, which it has to lose and hence could build into the quote. If Sri is successful, it can

exercise the option contracts and get the USD converted to INR at those rates, provided the contract is in the money i.e. it is worth exercising the option contract.

2. Suraj imports is a regular timber importer based in Bangalore. It imports from Malaysia from limited number of known suppliers. The imported timber is sold in the domestic market for which there is good demand but due to current market situation, there is always delay in collections. Suraj has a collection team for this purpose. Suraj enjoys cash credit limit on the imported timber stock and receivables from SBI at an interest rate of 13% pa. It is fully used and bank is happy with the track record of Suraj. The suppliers in Malaysia offer competitive rates, if payment is made on sight basis and otherwise, the quote is quite unattractive. Since there are a large number of such importers, Suraj's profit margin is low. Suggest alternatives to Suraj to reduce the interest cost.

Answer

Suraj could avail trade credit where the interest will be in LIBOR terms and forward contract can be booked to avoid exchange risk. The effective cost to Suraj will be the LIBOR linked interest rate + forward margin + bank guarantee commission [if there is no LC]. Generally, this will be still lower than 13% pa, presently Suraj is paying.

Since the suppliers are not ready to extend usance terms [unattractive terms and hence not an option], suppliers' credit is not feasible. What Suraj has to do is to ask SBI to arrange for a buyers' credit say from SBI Singapore branch. When the buyers' credit is arranged by foreign branch of an Indian bank, there is no withholding tax applicable since the lender will be a 'resident entity' in such cases, as per FEMA definition. This will substantially reduce the cost of borrowing. Since it is SBI's own branch and since Suraj has good track record, it could even seek concession in guarantee / LC commission. The LC opened will be for six months and restricted to SBI Singapore. Forward contract will also be booked. Thereafter, Suraj has to inform the supplier that though the LC is apparently of usance terms, as soon as the supplier submits the credit complying documents, its bank can send the documents to SBI Singapore who will make sight payment and hence the supplier can quote rates as applicable to sight payments. SBI Singapore will create a loan in the name of Suraj supported by LC of SBI India which will carry a margin over LIBOR. Thus the supplier gets sight payment, Suraj gets sight rates and pays LIBOR linked hedged lower interest rates, SBI Singapore gives loan against SBI LC and SBI India gets LC commission. Apparently a win-win situation to all!

Company Venky's functional currency is euro. It has a US subsidiary Clars, whose functional currency is US dollar. This subsidiary has highly probable forecast sales denominated in Japanese yen. Company Venky has hedged its subsidiary's forecast Japanese yen inflows using external foreign currency forward contracts (Japanese yen/EUR) to hedge the exposure back into euros. Venky's management intends to designate, in the consolidated financial statements, the forward contracts as hedging instruments in a cash flow hedge of the forecast transactions denominated in Japanese yen. Do you think it is allowed? Examine from the foreign exchange risk management angle as seen through hedge accounting.

Answer:

No. The Japanese yen/EUR forward contracts taken out by Venky do not qualify for cash flow hedge accounting on consolidation. There is no Japanese yen/EUR cash flow exposure in the consolidated income statement. The income statement will be exposed to Japanese yen/USD movements, as the subsidiary will translate its Japanese yen sales into its own functional currency (USD). The exposure to movements in USD/EUR constitutes a translation risk rather than a cash flow exposure and therefore cannot be the subject of a cash flow hedge. It is possible for the subsidiary to use a yen/USD forward contract to designate a cash flow hedge of its yen/USD transaction exposure. Parent Company can designate the net investment

[http://www.pwc.com/gx/en/ifrs-reporting/pdf/ias39hedging.pdf]