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K. J. Somaiya Institute of Management Studies and Research

24 Dec 2012

NEW RESPONSIBLE COMPANIES BILL & BANKING BILL

The Companies Bill, 2012 was passed by the Lok Sabha which requires earmarking 2% of net profits (for companies having Rs.500 Crores net worth or Rs.1000 Crores of turnover) for 'Corporate Social Responsibility Policy' purposes in addition to various other amendments. The Banking Bill lays the groundwork for the issuance of new bank licenses and gives the RBI the power to supersede the board of a bank in case of fraud, was too, successfully passed in the Parliament.

NO CUT IN POLICY RATES BY THE RBI

The Wholesale Price Index (WPI)-based inflation decreased to 7.24% in November but the RBI stuck to the status quo, maintaining repo rate at 8%, reverse repo at 7% and Cash reserve ratio (CRR) at 4.25%. Some analysts were anticipating a reduction in CRR for easing of liquidity situation. A cut in the interest rate is expected next month, when the central bank meets for the third-quarter review of its policy on January 29.

BHARTI INFRATEL IPO GETS WEAK RESPONSE FROM RETAIL INVESTORS

The Rs.4,500 crore initial public offer (IPO) of Bharti Infratel Ltd, the country's first telecom tower firm to go public, received demand for 1.3 times the shares on offer, thanks to institutional buyers. Analysts said problems looming over the troubled telecom sector in which profits are under pressure and erratic regulations were responsible for the weak individual investor demand.

UBS ADMITS FRAUD IN $1.5 BILLION LIBOR RIGGING

Swiss bank UBS was hit with a $1.5 billion fine, admitting to fraud, paying bribes to brokers and manipulation of the global benchmark interest rates, LIBOR by dozens of its staff in a deal with international authorities and other banks. A week earlier, Britain's HSBC was penalized $1.92 billion to settle a probe in the United States into laundering money for drug cartels.

FDI INFLOWS UP BY 67% FROM OCTOBER 2011

FDI inflows touched $1.94 billion in October 2012, a 67% increase from the previous year, the major players being Mauritius, Japan, Singapore, Netherlands and the UK. However, FDI inflows have declined by about 27% to $14.78 billion, from $20.29 billion in the previous fiscal year.

The little things

- **Forex reserves:** $296.63 billion as on Dec 21
- **Brent Crude:** 109.10 USD / bbl as on Dec 22
- **Sensex:** 19242 as on Dec 21
- **Gold (10 gm)**: Rs. 30640 (as on Dec 22 in Mumbai)
- **Exchange rate (Rupee)**: USD/INR 55.0860 as on Dec 23

Did you know?

- In the United States of America, amount of Monopoly money printed is more as compared to the Real Money, every year.
- GM sold slightly more cars in China than in the U.S. in 2011 -- 2.55 million to 2.50 million.

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Did you know?

- **The Bombay Stock Exchange (BSE)** is the oldest stock exchange in Asia and with 4900 listings, it has the third largest number of listed companies in the world. Its first name was 'The Native Share & Stock Brokers Association'.

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Financial Risks and Risk Management

Authored by: Sohil Mehta, MMS-B

Risk is inherent in all businesses. However it is a particularly complex phenomenon in finance sector. Controlling them is even more difficult and the whole process of identification, analysis and either acceptance or mitigation of uncertainty in investment decision-making is risk management. Essentially, risk management occurs anytime an investor or fund manager analyzes and attempts to quantify the potential for losses in an investment and then takes appropriate action given their investment objectives and risk tolerance. Inadequate risk management can result in severe consequences for companies as well as individuals. For example, the near collapse of General Motors in 2007 or the recession that began in 2008 was largely caused by the loose credit risk management of financial firms.

Financial intermediaries encounter five general risk types:

1. Interest rate risk
2. Price risk
3. Prepayment risk
4. Credit risk
5. Exchange-rate risk

1) Interest rate risk:

Interest rate risk is the risk which exists in an interest-bearing asset, such as a loan or a bond, due to the possibility of a change in the asset's value resulting from the variability of interest rates. Companies have paid hefty prices and even gone bankrupt in the wake of ignoring the interest rate risks.

2) Price risk:

It is the risk of a decline in the value of a security or a portfolio and is the biggest risk faced by all investors. Although price risk specific to a stock can be minimized through diversification, market risk cannot be diversified away.

3) Prepayment risk:

It is the risk associated with the early unscheduled return of principal on a fixed-income security. Some fixed-income securities, such as mortgage-backed securities, have embedded call options which may be exercised by the issuer. For example when principal is returned early, future interest payments will not be paid on that part of the principal.

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Financial Risks and Risk Management

4) **Credit risk:**

The risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation is termed as credit risk. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt.

5) **Foreign exchange risks**

When companies conduct business across borders, they deal in foreign currencies. Companies exchange foreign currencies for home currencies when dealing with receivables, and vice versa for payables. This is done at the current exchange rate between the two countries. Foreign exchange risk is the risk that the exchange rate will change unfavorably before the currency is exchanged.

A risk management plan includes strategies and techniques for recognizing and confronting these threats. It is a two-step process - determining what risks exist in an investment and then handling those risks in a way best-suited to your investment objectives. Financial products help transfer risk from one party to another in a manner similar to how wheat derivatives allow a farmer to transfer to another party the risk of receiving a low price for his wheat crop next year. Financial products allow firms to reshape the risk profile inherent in their underlying business.

In order to minimize these risks companies engage in corporate hedging with derivatives. A hedge is an investment position intended to offset potential losses/gains that may be incurred by a companion investment. In simple language, a hedge is used to reduce any substantial losses/gains suffered by an individual or an organization. It can be constructed from many types of financial instruments, including stocks, exchange-traded funds, insurance, forward contracts, swaps, options, many types of over the counter and derivative products, and futures contracts.

Hence, Risk management ensures that an organization identifies and understands the risks to which it is exposed and guarantees that the organization creates and implements an effective plan to prevent losses or reduce the impact if a loss occurs.

In this way, transactions between different parties can be carried out over the SWIFT network with the use of Nostro/Vostro accounts. It is important to note that the entities holding Nostro/Vostro accounts are almost always, but need not be, banks.

Terminologies:

Slippage -
The difference between the price at which you set your order for execution and the price at which you are actually filled. This often occurs when traders enter a market order or a stop/limit order is filled at a time of strong market volatility. It can also happen when a trader sets a very large order and it cannot be executed at the desired price because there aren't enough shares available.

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Terminologies:

Market maker – A market maker is responsible for providing a constant bid and ask for the particular share they are designated to. It is possible for them to use a computer network to match buyers and sellers almost instantaneously. Market makers must provide a quote within a pre-determined spread. The difference between the bid and ask is determined by share volume, price and liquidity amongst other things.

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SWIFT

Authored by: Sahil Kulkarni, PGDM-A

SWIFT stands for the 'Society for Worldwide Interbank Financial Telecommunication'. It is a member-owned co-operative, i.e. a non-profit organization of member banks, and is headquartered in Belgium. It operates a worldwide financial messaging network. Over this network, 'Financial Messages' are exchanged between banks, other financial institutions and non-financial institutions (example- corporate). More than 10,000 financial institutions and corporations in 212 countries exchange millions of standardized financial messages through SWIFT's network. The exchange involves secure transmission of proprietary data and maintaining the confidentiality and integrity of messages. On an average, the SWIFT processes over 2.4 millions of messages every day, concerning total transactions worth $2 trillion.

Prior to SWIFT, all communications between banks were done by telephone, telex, courier or mail. But all these channels were low on security and reliability. Therefore, a need was felt by the bankers, to have a communication channel which was reliable, efficient and secure, and thus, SWIFT was founded in 1973. The SWIFT network is an IP based network. Network partners such as AT&T and Info-net provide connectivity. Usually the following network connections are available - Broadband Internet (VPN secured), through a third party or Shared Internet (SSL secured). Messages were originally secured with keys exchanged with the messaging parties (also known as Bilateral Key Exchange BKE). Nowadays a public-key infrastructure (PKI) is used.

Any bank wanting to become a SWIFT member needs to apply to the society and obtain an ID. This ID is called BIC, which stands for Bank Identifier Code. Once a bank obtains BIC, it can send and receive messages on this network. A BIC code comprises eight or eleven characters that throw light on details regarding the bank code, country code, location code and the branch code. The first four characters represent the bank code, another two digits represent the country code, next two letters help identify the location. The last three letters are optional, and they tell us more about the branch related to the financial institution.

Example:

BOFA- 4 letters: Institution Code or bank code (Bank of America).

US- 2 letters: country code

3M- 2 letters or digits: location code

A SWIFT message consists of five blocks of data including three headers, message content, and a trailer. Message types are crucial to identifying content SWIFT messages include the literal "MT" (Message Type). This is followed by a 3-digit number that denotes the message type, category, and group. There are several hundred message types across the categories.

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Terminologies:

Michigan Sentiment - Very similar to consumer confidence, it measures consumers' perception of current and future economic conditions. Conducted by the University of Michigan, once monthly, it is a 500-person survey.

SWIFT

Example: Consider an order to buy or sell via a third party:

MT304-
The first digit (3) represents the category which is Treasury Markets
The second digit (0) represents a group of related parts in a transaction life cycle, which is Financial Institution Transfer
The last digit (4) is the type that denotes the specific message, which is notification

SWIFT messages have many advantages over the traditional communication system, some of them are:

- Messages are standardized, and are accepted across banks, financial institutions
- The messaging system is efficient and secure
- The system handles heavy volume of message transfer
- The cost of the system is low
- Improvement in Funds Visibility and Liquidity Management over the traditional system

SWIFT does not facilitate funds transfer, rather, it sends payment orders, which must be settled via correspondent accounts that the institutions have with each other. To facilitate this, there should be an accounting arrangement between two correspondent banks to maintain a local currency account for one another. This arrangement is often termed as Nostro/Vostro/Loro accounts. The system of Nostro and Vostro accounts facilitates foreign exchange dealings and settlements and allows the settlement of currency transactions between the Country's Local Bank and foreign banks. Nostro bank, correspondent bank, agent bank, and clearing bank are used interchangeably.

For example, suppose that Punjab National Bank holds an account with Bank of America in US dollar currency. This account is Nostro Account from PNB's point of view, where as it is Vostro account from BosfA's point of view. Moreover, from the point of view of Barclays Bank based out of the UK, this account is Loro account.

Now suppose that a buyer in India holds an account with PNB, and wants to purchase goods worth $5000 from a seller in the USA, who holds an account with BofA. The buyer deposits the cash in Rupees equivalent to $5000 in PNB. PNB sends a SWIFT message to BofA, where PNB holds a Nostro account, requesting BofA to make the payment to the seller in US Dollars. BofA makes the payment of $5000 to the seller by debiting PNB's US Dollar account with BofA and crediting the seller's account. From accounting point of view, PNB's asset on Nostro account in PNB book is reduced by $5000, and in Bank of America's book liability due to PNB's Vostro Account with them is also reduced by $5000.

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