Test Series: March, 2018

MOCK TEST PAPER
FINAL (NEW) COURSE: GROUP – II
PAPER – 6A: RISK MANAGEMENT

Attempt any two out of three case study based questions.
Each Case Study carries 50 Marks.

Time Allowed – 4 Hours
Maximum Marks – 100

Question 1

ZEO Payment Technology is one of the promising Financial Technology Start Up Company in India. ZEO is founded in 2015 and has emerged as one of the largest player in India’s Domestic Money Transfer (DMT) (Cash to Bank) segment. It is an award winning Online Transaction platform for DMT, Payments and Travel. ZEO has won several accolades and awards such as the prestigious National Payments Excellence Award 2016 organized by the National Payment Council of India for the largest number of transactions on the IMPS (non-Bank category). ZEO has one of the largest cash collection network agents in the country to work on cash collection and banking activities.

RA has founded ZEO and is now aspiring to apply for the Small Payment Bank License. The application has to be made to a Statutory Authority. As per the Statutory Authority’s guidelines, the payment bank applicant have to submit the top 10 risk scenarios that they would face while operating a Small Payment Bank in India.

The Board of ZEO would then evaluate the risk scenarios and prepare a formal report to adopt the risk scenarios with specific risk management actions. Post discussions at the Board and adoption of the risk scenarios, RA would make the application to the Statutory Authority for transforming ZEO into a Small Payment Bank.

Required:

1. Design risk scenarios in the following format out of the risk scenarios given in Exhibits.

<table>
<thead>
<tr>
<th>Risk Scenario Title</th>
<th>Scenario description</th>
<th>Impact of scenario</th>
<th>Current measures to manage risks</th>
</tr>
</thead>
</table>

(4 Marks for each scenario)

2. Prepare a report to the Board of ZEO including:

   (i) Bucketing of above identified risks
   (ii) Likelihood Scale of above identified risks (10 Marks)

3. Multiple Choice Questions (MCQs)

   (i) For .........., it is mandatory to have an Operational Risk Policy approved by the Board.
       (a) Banks
       (b) Insurance Companies
(c) Listed Companies
(d) Both banks and Listed Companies

(ii) The principles of Risk Appetite includes
(a) Risk appetite can be complex
(b) Risk appetite need not to be measurable
(c) Risk appetite is a single, fixed concept
(d) All of the above

(iii) ……… is the process of evaluating and defining the cost and benefits associated with risk consequences.
(a) Risk Assessment
(b) Risk Measurement
(c) Risk Quantification
(d) Risk Assessment

(iv) Risk Management techniques and options includes
(a) Tolerate
(b) Transfer
(c) Terminate
(d) Tackle

(v) Which is the most popular method of estimating volatility?
(a) GARCH Model
(b) EWMA Model
(c) Bayes Theorem
(d) Standard Deviation

(vi) The Key Characteristics, “Risk management and internal control fully embedded into operations”, comes under which heading of Risk Maturity.
(a) Risk Aware
(b) Risk Defined
(c) Risk Managed
(d) Risk Enabled

(vii) Risks can arise or change due to
(a) Changes in operating environment
(b) New or revamped information systems
(c) New business models, products, or activities
(d) All of the above

(viii) ……… is the risk of loss resulting from inadequate or failed processes, people and systems and from external events
(a) Enterprise Risk
(b) Operational Risk
(c) Strategic Risk
(d) Governance Risk

(ix) ........ is the credit score which depends upon consumer behaviour.

(a) FICO Score
(b) VANTAGE Score
(c) PLUS Score
(d) ENES Score

(x) Which among the following is the limitation of VaR?

(a) VaR uninformative of tail losses
(b) VaR can create perverse Incentives Structures
(c) VaR is sub-additive
(d) VaR can discourage diversification (10 x 2 = 20 Marks)

Exhibit 1

Cyber-attack on the website and systems

Recently, the systems of a PSU Bank have been hacked to create fake documents that may have been used to raise money outside India or help in dealing of prohibited items. The fake document may be letter of credit (LC) or guarantees. The bank later realised that their SWIFT (Society for World Wide Interbank Financial Telecommunication) system have been used to create fake documents. SWIFT is a financial messaging service which is used by banks to move millions of dollars and documents in various countries.

Therefore, the person who hacked into the system to create a fake LC may put it before a foreign bank for finance. However, the Indian Bank, whose system has been used to create a fake L.C., may face a claim for money when a foreign bank tries to recover its money released against an LC.

Some measures have been taken to prevent such reoccurrences in future. Firstly, physical access to the system must be controlled. Secondly, strong password and multi-layer authentication policy should be there. And, lastly, identity and token management policies are needed to control who has access to data.

SWIFT customers should have in place a system of detecting any unusual activity and how the staff shall respond when such an untoward event happens.

(Extract from an article)

Exhibit 2

Bank Fraud

In a leading multinational bank, a banking fraud of Rs. 400 has been taken place. The fraud has happened because of the mastermind of an employee named Lalit. The modus operandi of Lalit was to sell investment products to high net worth individuals (HNIs). He falsely projected to the HNIs that these financial products are authorised by the bank’s investment product committee.

So, he lured them by convincing them that their investments would be invested in lucrative schemes giving good returns. Then, he transferred the funds accumulated from HNIs to some fictitious accounts. Funds amounting to Rs. 400 crore belonging to about 20 customers were transferred to such accounts. He, then, used the money to invest it into the stock market.
Modus operandi was simple. He lured customers with a fake circular by SEBI promising 2-3% returns per month. The fake circular also mentioned a custodian that route investor funds. Lalit also use some blank cheques and he used this to transfer money out of their accounts directly to the brokerages to be invested in the stock market.

The RBI has issued master circular advising banks to set up internal control system to combat frauds and to take pro-active fraud control and enforcement measures.

(Source : Extract from a leading financial daily)

Exhibit 3

Natural Calamity impacting continuity of business operations

Small businesses are personally affected by a storm, earthquake or extreme weather. Since ZEO payment technology is a small financial technology company, it can feel the pinch of a natural disaster, in case it happens.

When a natural calamity took place, it affects the supply chain of an organisation severely. When the devastating flood took place in Thailand in 2011, the impact was felt the world over, affecting almost every industry from electronics to automobile. It leads to break down of supply of many crucial components. This prompted many companies to outsource their supply chain to a few low cost countries. However, the business of a fintech company may also be impacted if the physical office from which it conducts its business is also being affected by the natural disaster.

(Source : Extract from a leading Financial Daily)

Exhibit 4

Corporate Governance Issues

ZEO Payment Technology is a small unlisted company willing to venture into the field of Small Payment Bank. ZEO has 6 directors out of which one is independent director. The paid up share capital of the company is Rs. 12 crore. However, the company is yet to draft a suitable policy for training and performance evaluation of directors.

Some of the provisions of the Companies Act, 2013 relating to Corporate Governance have been given in the following sentences. Every company having a paid up share capital of Rs. 10 crore or more has to constitute an audit committee and shall have atleast two independent directors. Further, it is required to appoint a Nomination and Remuneration Committee and draft a suitable policy for training and performance evaluation of directors. Also, a company having a paid share capital of Rs. 50 crore or more OR a turnover of Rs. 200 crore or more has to appoint an internal auditor to conduct internal audit of the functions and activities of the company.

The new Companies Act has given powers to Serious Fraud Investigation Office (SFIO) to carry out arrests, raids and seizure in respect of certain offences of the act which attract the punishment for fraud. Further, as per the section 212, on the intimation of special resolution passed by the company, SFIO can investigate into the affairs of the company or on the receipt of a report of the Registrar or inspector or in the public interest or on request from any Department of the Central Government or a State Government.

Moreover, the Companies Act, 2013 do not contain any compulsory provision for constitution of a Risk Management Committee. However, it requires its Board to develop and implement a risk management policy and identify risks which may threaten the existence of the company.

Exhibit 5
From: Lee Port
To: Mr. Z (CEO of ZBO Payment Bank)
Dated:……………………………………
Subject: Pitch Presentation for financing of proposed small payment bank under the FDI Scheme of Govt. of India

Hi Z,

This has reference to your last week’s Pitch Presentation at Singapore for making investment in your proposed Small Payment bank in India. While the idea of this type of banking is naïve in India but the most catchy feature of the same is to reach consumers through mobile phones rather than traditional system of bank branches as it is quite uneconomical affair for the banks to open branch in each and every village of India. This is a good initiate by Govt. of India as a major step towards financial inclusion in India where a major part of population is living in villages.

Before we forward your proposal of investing the funds in your start-up to the Board please confirm the following unique features of the proposed Small Payment Banks:

- Payment bank will reduce the dependency on Cash and will increase m-commerce as mobile wallet will be used as payment option.
- Payment Bank will invest 75% of its demand deposits in Government Securities and Treasury Bills and balance 25% can be held as fixed deposits with other Scheduled Commercial Banks.
- Payment bank can also provide Forex Cards to the travellers.
- Payment Bank will get a big chunk of deposit comparing to commercial banks due to reason of providing higher interest rates.

In case there is any deviation in above points please let us know immediately.

Thanks,
Lee Port
Question 2

ABC Ltd. is a Delhi based company. It was established in 2009 and deals in the manufacturing business of high-end electronics distributed through retail superstore. The company is currently going through a rapid growth phase. Its products are receiving good response from the market. The company is experiencing the challenges of retaining good sales employees and developing an efficient financial system. Ravi Narain is the CFO of the company.

ABC Ltd. has an outdated computerized accounting system which does not lock out the changes made after the month end.

ABC is looking to develop a more effective and efficient financial system and considering implementing an incentive plan for sales employees who are currently paid a flat salary.

ABC Ltd has a turnover of ₹ 800 crores in 2016-17 and was listed on Indian Stock exchange in 2014. Ajay and Pawan are the newly appointed directors of Finance and Human Resource divisions respectively.

Ajay is a street smart finance professional and he played a critical role in the areas of budgeting and forecasting, finance and asset management. He has a team of 25 people including Jatin and Mohit who directly reports to Ajay.

In spite of a limited salary, Ajay maintains a lavish style of living. Jatin maintains the journal entries according to Ajay’s directions. One day HSBC bank notified Ravi Narain that Ajay’s personal credit card balances were being paid off by ABC’s account. Since, Ravi Narain was busy for Board Meeting confirmed that this might be reimbursement of his Travelling Expenses.

Jatin records the internet sales from the company’s retail outlet as well as carries out following functions:

1. Reconciliation of accounts receivable sub-ledger to general ledger
2. Mailing checks to vendors
3. Coding and recording of checks received for deposit

Ravi normally never reviews financial details as he trusts Ajay.

On the Human Resource front, to overcome the problem of retaining the sales employees, the company has recently hired Pawan as the HR director who is known for developing good HR policies to manage people effectively and motivate them to perform well.

Pawan advised the management to implement a compensation plan of base salary and bonus instead of fixed monthly salary. Sales incentive compensation is based on the performance of sales employees. The performance can be measured by looking at the revenue they generate for the employees. The management liked the proposal advised by Pawan and the compensation plan is finalized which was as follows.

Base Salary: 35,000/month

Commission: 5% of Sales exceeding 10,00,000/month + 5% extra commission on sales made over and above 20,00,000/-

Consequently, the present organization structure comes out as follows:
After passing some time, the Board of Directors started realizing that the company is facing liquidity crunch. Also, the introduction of new compensation plan resulted in unhealthy competition among employees.

Some employees were less willing to provide assistance to struggling co-workers and would prefer to improve their own productivity. It also promoted an environment of excessive risk—taken by the sales employees for pursuing short term profits.

The company has a system of identification of risk but only at the functional level and not for processes. Further these Risks are not communicated among various organization levels.

A. Questions

The Board of Directors approaches you and requests you to submit a report on the following aspects:

(i) Identify the Risks that may be possible and their nature. (5 Marks)
(ii) Scaling of these identified risks based on ICAI Guide on Risk Based Internal Audit. (5 Marks)
(iii) Any three to four approaches to identify and assess the risk. (5 Marks)
(iv) Course of action to be followed to treat these risks. (5 Marks)
(v) Matters on which Risk Governance Framework can define a policy statement. (5 Marks)
(vi) Risk Maturity Level and reasons for the same. (5 Marks)
B. Multiple Choice Questions

1. As per the ……… risk has been defined as resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
   (a) Basel II
   (b) ICAI - SA 315
   (c) CIMA
   (d) None of these

2. Which of the following is not the classification of risk as stated by Enterprise Risk Management?
   (a) Knowledge risk
   (b) Operational risk
   (c) Financial risk
   (d) Residual risk

3. Which of the following is not the benefit of the risk management plan?
   (a) Saving Valuable resources: time, income, assets, people and property can be saved if fewer claims occur.
   (b) Creating a safe and secure environment for staff, visitors and customers
   (c) Reducing legal liability and increasing the stability of your operations
   (d) Provide an absolute assurance that risks will be mitigated.

4. In which of the following techniques to assess and evaluate risks, a panel of experts are appointed and each of them gives his/her opinion in a written and independent manner:
   (a) Judgment and intuition
   (b) The Delphi approach
   (c) Scoring
   (d) Quantitative techniques

5. Which of the following is not the risk type that often overlaps or is caused by operational failure?
   (a) Regulatory Risk
   (b) Financial Risk
   (c) Credit Risk
   (d) Legal Risk

6. Technique involving acceleration of payments of hard currency and delaying payments of soft currency payables to hedge forex exposure is called
   (a) Netting
   (b) Managing Blocked Funds
   (c) Leading and Lagging
(d) None of these

7. Which of the following option gives the effect of it purchases into a floating rate of interest that is bounded on both high side and the low side?
   (a) Cap Option
   (b) Floor Option
   (c) Collar Option
   (d) Swaption

8. Which of the following exposure measures the effect of fluctuations in foreign exchange rate on the value of the firm?
   (a) Transaction Exposure
   (b) Translation Exposure
   (c) Economic Exposure
   (d) Industry Exposure

9. More risk in a project can be incorporated by decreasing
   (a) Estimated future cash inflows from the project
   (b) Initial investment in the project
   (c) Required rate of return of the project
   (d) Internal rate of return of the project

10. Which of the following action is called hedging?
    (a) Protection of a profit already made from having undertaken a risky position
    (b) Making profit by accepting risk
    (c) Reducing or eliminating exposure to risk
    (d) None of these

(10 x 2 = 20 Marks)
Question 3

Sunshine Ltd. is a software company specialized in the software development for their clients. In the last decade it has earned a good name and fame. For example, a super critical boiler in a thermal power plant takes 10-12 days to be fine-tuned or synchronized. It means system is shut for power generation and lead to loss of millions of dollars. Sunshine Ltd. came up with a solution that cuts the time taken to synchronize a boiler from 10-12 days to 3-4 days through the use of software and services of IT Professionals. The main strength of Sunshine is the IT professional they employed with it.

It captured data through sensors on the boilers, use the algorithm built in house to check nearly 240 parameters and over 10,000 combinations to tune the boiler.

It also helped a global heating, ventilation and air conditioning firm to bring down the time taken to design an AC solution in a building or office from 9 days to just 2 hours now.

However, traditional outsourcing business of Sunshine Ltd is dying a slow death as clients cutting their budgets on such services and shifting their focus on newer areas such as digital and cloud.

Three-fourth of the revenue of Sunshine Ltd is from traditional services. However, half of its revenue still comes from fixed price projects which allow it the flexibility to determine the resources it deploys and use software tools to deliver services. Now, the aim is to increase that goal by reducing the dependency on people and more on software led services which coincide with it’s goal of IT Modernization.

Sunshine Ltd. derives a major portion of its revenues from customers discretionary spending which is linked to their business outlook. It’s major revenues are from UK, USA and other European countries.

Some draft legislations in USA has been made to restrict the availability of work visas. Such protectionist policies threaten the prospect of global mobility of people which may also affect the work of Sunshine Ltd. as distributed software development requires free movement of people.

Appreciation of the rupee against any major currency results in the revenue denominated in that currency to appear lesser in reported terms. Then, there may be different exchange rate when sale took place and when invoice is collected.

The Internal Financial Control System

The internal Financial Control System of Sunshine Ltd. has been laid down as below:

- Recording and providing reliable financial and operation information.
- Safeguarding assets.
- Ensuring compliance with corporate policies.
- Well defined delegation of power.
- Efficient ERP system.
- Internal audit by one of the big audit firm.
- Periodic audit by specialized third party consultants.
- Audit Committee found internal financial control adequate.

A. Questions

(1) Discuss the SWOT analysis of Sunshine Ltd. (5 Marks)

(2) Briefly explain the political risk to be encountered by Sunshine Ltd. (3 Marks)
Elucidate the types of exposures risks to be encountered by the company. (6 Marks)

How can the company tackle the exposure of difference in exchange rates when sale took place and when invoice is collected. (12 Marks)

Discuss the efficacy of the Internal Financial Control System of Sunshine Ltd. (4 Marks)

B. Multiple Choice Questions

1. Risk Adjusted Discount Rate Method is based on the concept that........
   (a) investors demand higher returns from more risky projects
   (b) investors demand lower returns from more risky projects
   (c) investors demand higher returns from less risky projects
   (d) None of these

2. A project has a cost of capital of 10% and a payback period of 2 years with annual cash inflows commencing from year end 2 to 4 of Rs. 60 crore. The initial investment outlay at the beginning of year 1 shall be
   (a) Rs. 67.80 crore
   (b) Rs. 74.58 crore
   (c) Rs. 60.00 crore
   (d) Rs. 95.07 crore

3. If interest rates are 3.4% and 1.4% per annum in USA and UK respectively and spot exchange rate is $1.40/£ then 90-days forward rate shall be
   (a) Rs. 1.346976
   (b) Rs. 1.347976
   (c) Rs. 1.406976
   (d) Rs. 1.407976

4. Which of the following risk will not affect foreign exchange rate?
   (a) Investment Risk
   (b) Inflation Risk
   (c) Interest Rate Risk
   (d) Sovereign Risk

5. The purpose of Financial Swap is to reduce ________.
   (a) Interest Rate Risk
   (b) Exchange Rate Risk
   (c) Credit Risk
   (d) Both (a) and (b)

6. In case if principal or interest payment overdue between 61-180 days then as per RBI’s framework for Revisiting Distressed Assets in Economy they are classified in category ________.
   (a) SMA – 0
   (b) SMA – 1
   (c) SMA – 2
7. _______________ as a formal discipline for risk and capital management was born out of financial crises.
   (a) Substantive procedures
   (b) Test of Controls
   (c) Corporate Governance
   (d) Stress Testing

8. Which of the following is not a type of country risk?
   (a) Political Risk
   (b) Financial and Economic Risk
   (c) Credit Risk
   (d) None of the above

9. Which of the following risk action describe:
   Reducing the risk likelihood or impact by transferring or, otherwise, sharing a portion of the risk. Common techniques include purchasing insurance cover, outsourcing activities, engaging in hedging transactions.
   (a) Avoid
   (b) Reduce/Manage
   (c) Transfer/Share
   (d) Accept

10. Speech Recognition, Handwriting Recognition and Intelligent Robots uses _______.
    (a) Block Chain Technology
    (b) Distributed Ledger Technology
    (c) Artificial Intelligence
    (d) None of these

    (10 x 2 = 20 Marks)

Exhibit 1

Domestic ratings agency ICRA said that the appreciation in the rupee is aggravating the troubles of the Indian IT sector, which is already hit by a change in the market landscape and compressing revenue growth.

It said the industry is already reeling under pressures like uncertain macroeconomic environment, lower deal sizes in digital technologies, cloud adoption and high competitive intensity.

The agency said despite a 8.1 per cent growth in USD revenue, IT players have registered a growth of only three per cent in the second quarter of the current fiscal, due to the rupee appreciation of four per cent during the quarter.

Due to the difficulties on the currency front, the agency said the $160-billion industry will be able to notch a mid-to-high single digit growth till FY20.

On margins, it said the industry should brace for an impact on margins as price led competition is likely to intensify and will negatively impact the spreads.
"IT Services players profitability also remains sensitive to rupee depreciation vis-a-vis major currencies such as USD, GBP and Euro and the same too will have an impact," it said.

Its vice president Gaurav Jain said future growth will be supported by higher spend on digital technologies, continued cost benefit offered through outsourcing model and market share gains for the Indian IT sector.

"While companies have increased spending on digital technologies and awarding new contracts, the overall IT budgets have moderated leading to lower incremental spends," he said.

He, however, warned that an increase in the global IT market, which moved up to 67 per cent in 2016 from 60 per cent in 2012, will be limited as Indian IT Services companies, which are in the midst of re-orienting their business models focusing more on higher-end services such as IT consulting and digital, are lagging behind the competition.

"We expect large Indian IT companies to grab a higher share of the digital services space over the next three years," he said.

From a vertical standpoint, manufacturing is outperforming with a 5.8 per cent growth but the largest revenue contributor of banking and financial services has shown a muted trend over the last few quarters on macroeconomic conditions including factors like Brexit.

Over the next decade, the agency expects consolidation in the sector due to the margin pressures.

The rating agency, however, said that despite the pressures on growth and profitability, credit profile for the sector will remain stable.

(Extract from Economic Times)

Exhibit 2

The U.S. government is toughening up the process for renewing a popular foreign work visa.

This week, U.S. Citizenship and Immigration Services advised its officers to "apply the same level of scrutiny" to extension requests for the H-1B visa, among other sought after visas.

In other words, officers are instructed to review requests for renewal as thoroughly as they would initial visa applications.

The H-1B is a common visa pathway for high-skilled foreigners to work at companies in the U.S. It's valid for three years, and can be renewed for another three years. It's a program that's particularly near and dear to the tech community, with many talented engineers vying for one of the program's 85,000 visas each year.

The directive rescinds the previous guidance, which gave "deference" to previously approved visas "as long as the key elements were unchanged and there was no evidence of a material error or fraud related to the prior determination."

"This updated guidance provides clear direction to help advance policies that protect the interests of U.S. workers," said new USCIS Director L. Francis Cissna, who was sworn in this month. President Donald Trump announced his intent to nominate Cissna last spring.

In April, Trump directed federal agencies to implement a "Buy American, Hire American" strategy, which included proposing new rules and guidance for preventing fraud and abuse of work visas. The H-1B program, in particular, is one that President Trump has eyed for reform, criticizing abusers of the program who use the visa to replace American workers.
Other visas impacted by the new guidance include L-1, for intracompany transfers, TN for Canadian and Mexican citizens, and O-1, for those with "extraordinary abilities."

Some say the new policy will be unnecessarily burdensome and is aimed at limiting foreign workers.

Betsy Lawrence, the director of government relations for the American Immigration Lawyers Association, told CNN Tech that the previous guidance made it efficient to review cases. Even then, USCIS had the authority to question prior decisions and request additional information in reviewing extensions.

"We are going to much greater scrutiny of these cases, and thus delays, even when the underlying facts have not changed," Lawrence told CNNMoney.

Immigration attorney Chris Wright of The Wright Law Firm told CNNMoney that it fits a broader pattern: "It seems clear that USCIS have been instructed to push back wherever they can..." he said, noting that "the prevailing attitude seems to be, 'How might we be able to deny this petition?'"


**Effect on IT sector due to Brexit**

The Indian IT sector, faced with multiple challenges, is already bracing itself for a tough ride with US tightening its visa norms. Brexit only adds to the growing uncertainty in the business environment for the IT companies. Of the $108-billion of the IT industry's estimated exports in 2015-16, 17 per cent was to the UK and about 11.4 per cent to other nations within the EU. For large Indian IT companies, over a fourth of their revenues come from Europe, in particular from the UK.

Currency has always been a wild card for the IT sector. Wild swings in the pound vis-à-vis dollar and the rupee, will also impact revenues and profits for Indian IT companies. The British pound revenues make for 10-15 per cent of the overall revenues in the case of TCS, Tech Mahindra and Wipro. For Infosys, GBP revenue makes for 6.7 per cent of the overall revenue.

With pound depreciating sharply over the past year, dollar revenues of Indian IT companies have been under pressure. The pound has also depreciated over 20 per cent against the rupee. This can reduce cost arbitrage for companies outsourcing to the UK.

*(Extract from Hindu Business Line)*