

CENTRE FOR FINANCIAL MANAGEMENT

CFM QUARTERLY IN FINANCE

JANUARY 2017

EDITOR: DR. PRASANNA CHANDRA

CONTENTS

PART A: ARTICLES/ CASES

- 1. TEN COMMANDMENTS FOR ASPIRING SUPER FORECASTERS**
- 2. REAL ESTATE (REGULATION & DEVELOPMENT) ACT, 2016**
- 3. P2P LENDING**

PART B: SNIPPETS

- 1. WHERE DO YOU FIND BARGAINS**
- 2. SYSTEMIC VS IDIOSYNCRATIC RISK**
- 3. CHECKING INTERNAL FRAUDS**
- 4. MANDATORY E- VOTING GIVES SHAREHOLDERS AN EDGE**

PART C: WIT AND WISDOM

- 1. HUMOUR**
- 2. WISE SAWS**

ARTICLES /CASES

1. TEN COMMANDMENTS FOR ASPIRING SUPER FORECASTERS*

Dr. Prasanna Chandra

According to Philip Tetlock and Dan Gardner there are ten commandments for improving forecasting abilities:

1. *Triage* Focus your questions on questions where your hard work is likely to be rewarding. As he says, 'Don't waste time either on easy "clocklike" questions (where simple rules of thumb can get you close to the right answer) or on impenetrable "cloud - like" questions. Concentrate on questions in the Goldilocks zone of difficulty, where effort pays off the most."
2. *Break seemingly intractable problems into tractable sub- problems* A seemingly intractable problem can become manageable if it is broken into a tractable problem. As Tetlock and Gardner say: "Decompose the problem into its knowable and unknowable parts. Flush ignorance into the open. Expose and examine your assumptions. Dare to be wrong by making your best guesses. Better to discover errors quickly than to hide them behind vague verbiage." They illustrate this commandment with an example. Peter Backus, a lonely guy in London guessestimated potential female partners in his vicinity as follows: Population of London (6 million) x Proportion of women in population (0.5) x Proportion of singles (0.5) x Proportion in the right age (0.2) x Proportion of university graduates (0.26) x Proportion he finds attractive (0.05) x Proportion likely to find him attractive (0.05) x Proportion likely to be compatible with him (0.10)= 19.5.

Often good estimates arise from a remarkably crude series of assumptions and guesstimates.

3. *Strike the right balance between inside and outside views* There are two ways to look at a problem, the inside view and the outside view. The inside view makes an estimate based on a plan and a reasonable progression according to the plan. The outside view calls for looking at the outcomes of similar projects or initiatives and using that evidence to inject greater objectivity in the forecasting exercise.

The advantage of the outside view is most pronounced for initiatives which have not been attempted earlier such as entering a new market or building a plant using a new technology. Ironically, the inside view is often preferred in such a case. As Dan Lovallo and Daniel Kahneman put it: "Managers feel that if

*Adapted from Philip Tetlock and Dan Gardner, Superforecasting: The Art and Science of Prediction, rh Books, 2016.

they don't fully account for the intricacies of the proposed project, they would be derelict in their duties. Indeed, the preference for the inside view over the outside view can feel almost like a moral imperative."

Superforecasters habitually pose the outside-view question: How often do things of this kind happen in situations of this kind? This helps them strike a balance between inside and outside views.

4. *Strike the right balance between under- and overreacting to evidence* Skillful updating of beliefs calls for picking up subtle clues before everyone else and avoiding being suckered by misleading clues: savvy forecasters know how to revise their probability estimates quickly in response to diagnostic signals. As Tetlock and Gardner put it, "Superforecasters are not perfect Bayesian updaters but they are better than most of us. And that is largely because they value this skill and work hard at cultivating it."
5. *Look for the clashing causal forces at work in each problem* For every good policy argument there is often a counterargument that cannot be easily dismissed. Super forecasters are skillful in synthesizing divergent views. As Tetlock and Gardner put it, "Synthesis is an art that requires reconciling irreducibly subjective judgments. If you do it well engaging in this process of synthesizing should transform you from a cookie-cutter dove or hawk into an odd hybrid creature a dove-hawk, with a nuanced view of when tougher or softer policies are likelier to work."
6. *Strive to distinguish as many degrees of doubt as the problem permits but no more* Things are rarely certain or impossible. And "may be" not very informative. Since nuance matters, you need more than three settings on your uncertainty dial. As Tetlock and Gardner put it, "The more degrees of uncertainty you can distinguish, the better a forecaster you are likely to be. As in poker, you have an advantage if you are better than your competitors at separating 60/40 bets from 40/60- or 55/45 from 45/55." It may feel unnatural at first to translate vague verbal hunches into numeric probabilities. But it can be done with patience and practice. We can learn quite quickly to think about uncertainty in a more granular fashion.
7. *Strike the right balance between under- and overconfidence, between prudence and decisiveness* There is a risk in making a hasty judgment as well as in waffling too long. Aware of these risks, super forecasters strike the right balance between the need to take decisive stands and the need to qualify their stands. As Tetlock and Gardner put it, "It is not enough just to avoid the most recent mistake. They have to find creative ways to tamp down both types of

forecasting errors- misses and false alarms- to the degree a fickle world permits such uncontroversial improvements in accuracy.”

8. *Look for the errors behind your mistakes but beware of rearview- mirror hindsight biases* Own your mistakes. Don't try to rationalize them. Conduct objective postmortems of your failures. Remember that while it is common to learn too little from failure, there is also a possibility of learning too much.

Do a post-mortem of your successes as well. As Tetlock and Gardner put it, “Not all successes imply that your reasoning was right. You may have just lucked out by making offsetting errors. And if you keep confidently reasoning along the same lines, you are setting yourself up for a nasty surprise.”

9. *Bring out the best in others and let others bring out the best in you* Inter alia, skillful team management involves perspective taking (understanding well the arguments of the other side), precision questioning (helping others to clarify their arguments so that there is no scope for misunderstanding), and constructive confrontation (disagreeing without offending). Wise leaders know the subtle difference between making a helpful suggestion and micromanagerial meddling. As Tommy Lasorda put it, “Managing is like holding a dove in your hand. If you hold it too tightly you kill it, but if you hold it too loosely, you lose it.”
10. *Master the error- balancing cycle* As is clear from the preceding discussion, implementing each commandment calls for balancing opposing errors. Learning the art of error- balancing requires practice. As Tetlock and Gardner put it, “Just as you can't learn to ride a bicycle by reading a physics textbook, you can't become a super forecaster. Learning requires doing, with good feedback that leaves no ambiguity about whether you are succeeding.”
11. *Don't treat commandments as commandments* As no two cases will never be the same, it is not possible to lay down binding rules. In a world where nothing is certain or exactly repeatable, discretion is required in following guidelines. As Tetlock and Gardner put it, “Superforecasting requires constant mindfulness, even when- perhaps especially when- you are dutifully trying to follow these commandments.”

2. REAL ESTATE (REGULATION & DEVELOPMENT) ACT, 2016

Venugopal Unni

The real estate sector in India is well known to be riddled with all sorts of problems and the Consumer Protection Act, 1986 has failed to be of much help to the common man. It is in this context that Parliament passed the Real Estate (Regulation & Development) Act, 2016 ("Act") which has become effective from May 1, 2016.

As land is a state subject, the Act has to be necessarily implemented by the states. Under the Act every state(except J & K) and Union Territory has to notify the rules within six months of passing the Act They need to establish a state level regulatory authority called Real Estate Regulatory Authority("RERA") within one year for regulation and promotion of the real estate sector. A RERA will have one Chairman and at least 2 whole time members. Questions before it have to be disposed of within sixty days. Every state also has to establish a Real Estate Appellate Authority ("REAT") to hear appeals against the decisions of RERA. A REAT also will have one Chairman and at least 2 members. An appeal to REAT has to be made within 60 days. REAT has to dispose of a complaint within 60 days. An appeal against REAT decision is with High Court and the same has to be made within 60 days.

The Act has defined 44 key terms like promoter, consumer, real estate developer, project, intermediary, unit, person, carpet area, common area, advertisement, agreement for sale, etc. All builders, agents and promoters will be required to register with RERA. Any aggrieved person can file a complaint with RERA or the adjudicating officer for any violations of the provisions of the Act against any promoter, allottee or real estate agent.

The Act requires all promoters of residential and commercial projects with areas in excess of 500 sq.mtrs or 8 apartments to upload all project details on the RERA website before making any advertisement, marketing or sale. These to include the details of all projects launched by the promoter in the previous five years and their current status, authenticated copies of all approvals and commencement certificate of the proposed project, sanctioned plan, layout plan and specifications, the number and types of apartments or plots, payment schedules, completion schedules, list of approvals taken and pending, proforma of the allotment letter, agreement for sale, and the conveyance deed proposed to be signed with the allottees, quarterly updates on projects etc. RERA will maintain comprehensive publicly accessible record of every project along with details of defaulter promoters with names and photographs, of registered agents and a list of agents whose registrations have been cancelled or revoked. For a project with different phases, each phase will be treated as a standalone one needing separate registration. If a project is neither registered nor rejected by RERA within 30 days the same would be deemed to have been registered. A promoter failing to register a project will be required to pay a penalty

which could extend upto 10% of the estimated project cost (“EPC”) and failure to register despite RERA orders, would attract imprisonment and an additional 10% fine. No registration is required for projects relating to renovation or redevelopment without new allotment or marketing.

A promoter is required to deposit 70 % of the money collected from buyers in a separate bank account earmarked for each project, including the land cost. Withdrawal from the account is allowed only in proportion to the percentage of completion of the project. He (or she or it) cannot collect more than 10% of the cost from a buyer without entering into a written agreement for sale. After sale he cannot make any additions and alterations (except very minor ones) in the sanctioned plans, layout plans and specifications and the nature of fixtures, fittings and amenities, without the consent of at least 2/3 of the buyers. Nor can he transfer project rights and liabilities to a third party without the prior written permission of at least two thirds of the allottees or RERA. It is obligatory for him to obtain insurance on title of the land and buildings and construction of every project. He is required to get the project accounts audited within 6 months of the end of every FY with the auditor also certifying the end use of funds. He has to obtain completion certificate from the relevant authority and in case no possession is given return the money to the buyer. For any delay in giving possession he has to pay penal interest at the same rate the buyer is required to pay for any delay in making payments. He has to provide a warranty period of 5 years to fix defects in structure/quality/provision of services after transfer of the property to buyer and also help in providing essential services till association of buyers takes over. Violation of any of these provisions can attract a penalty of upto 5% of EPC/cancellation of the registration/imprisonment. Real estate agents will have to pay a fine of Rs.10, 000 for each day of violation of the provisions of the Act.

The Act has the following provisions for a buyer. He has to make payment only for the carpet area. He can withdraw if he suffers loss due to any false representation and is entitled to receive back the amount paid with interest. In case of delay in getting possession, he can either withdraw from the project in which case he is entitled to receive the entire money back with interest or receive monthly interest at a prescribed rate till possession. If the developer reneges on any commitment, he can approach RERA for redressal. Every allottee has to take possession of the apartment/building within a period of 2 months of the issue of occupancy certificate and has to participate in the formation of an association or society. He can claim compensation for any defective title on land and such claim will not be subject to any law in force on limitation. Contravention of any of the RERA decision/direction by an allottee will make him liable to pay penalty upto 5 % of the cost for the defaulting period and contravention of a REAT order entails imprisonment upto 1 year or fine for every day of the defaulting period totaling upto 10% of the cost.

Inadequacies of the Act arise mainly on account of land being a state subject. RERAs will not have any powers to approve projects or their pricing and can only advise a state government on such matters. State governments can also prescribe lower limits for various exemptions. The Act is applicable only to new projects where completion certificates have not been issued. The Act does not cover rental arrangements/agreements. All issues of competition will have to be referred to the Competition Commission by RERAs.

Apart from its regulatory duties a RERA has to also advise the state government on achieving single window system of clearances, grading projects and promoters and ensuring digitalisation of land records etc. Apart from RERAs the Act also provides for establishment of a Central Advisory Council to advise and recommend to the central government on all matters concerning implementation of the Act, major questions of policy, consumer protection and development of the real estate sector. The Act is expected to go a long way in making real estate promoters more accountable and transparent and pave the way for considerably higher investment in the sector.

3. P2P LENDING

Savita Shrimal

Lending between individuals has been around since the beginning of human civilisation. It may be the world's oldest profession. Peer to Peer Lending, also known as P2P lending is a financial innovation which connects verified borrowers seeking loans with investors/lenders who are looking to earn returns on their investments. It is a new and unique concept making its rounds in the financial circles. It works on the principle of creating a virtual marketplace of lenders and borrowers. Investors can see all the details about the borrowers before lending money. They have the option to lend small amounts to multiple borrowers to diversify their investments.

P2P lending is a hugely successful model for alternate financing across the globe. In India, it is gaining popularity at a rapid pace as an attractive investment option. According to the reports, close to 20 new online P2P lending companies have been launched in the last one year. Presently, there are around 30 P2P lending platforms operational in India.

RBI has already come up with a consultation paper to regulate this sector. Some of the key highlights of the proposed regulations by RBI are as under :

- P2P companies must act only as intermediaries without taking on the functions of a bank.
- The funds must move directly from the lender's account to the borrower's account to prevent risk of money laundering.
- The companies must have a minimum capital of Rs.2 crore.
- Promoters, directors and chief executive officers of P2P platforms will have to meet a so-called "fit and proper" criteria with a proportion of board members having a background in finance.
- They are required to have a "brick-and-mortar" presence in India.
- Platforms need to submit regular reports on their financial position, loans arranged each quarter, complaints, and so on to RBI.
- Since RBI can only regulate companies and co-operative societies, all P2P platforms may have to be structured as companies.
- They will have to guarantee confidentiality of customer data and need to adhere to existing guidelines for loan recovery practices.

Most P2P platforms offer the following services :

- They provide an online platform wherein a borrower can get his requirements funded at a viable rate and the lender can get the best possible return on his investment.

- They undertake complete verification process based on the personal, professional and financial data collected from each potential member and authenticate it. The information, is however safeguarded for client confidentiality.
- They perform borrower credit checks and filter out the unqualified ones.
- Most of these companies have developed a proprietary Credit Score Model which incorporates various parameters such as credit history, financial and behaviour pattern of the borrower etc. Based on the detailed analysis, the underwriting team assigns a risk category along with the recommended interest rates for each of these loans which hence acts as a benchmark.
- They help in processing the payments which includes collection and recovery of loans.
- They keep a full track of the loan repayment schedule and report any delay of default at the earliest.

Some of the well known P2P portals are Faircent, Rupaiya Exchange, LoanKuber etc. One can start investing from as low as Rs.10,000 onwards with an upper cap of Rs.5 lakhs for personal loans and 15 lakhs for business loans. The time period ranges between 6 – 36 months while the return on investment could vary between 12% to 30%. Initially, the loan funding were available only to individual borrowers as consumer loans. However, this has rapidly changed as small businesses and start-ups can now access these type of loans to finance their business. Swajal, a solar based water purifier and Baxi, India's 1st on-demand motorcycle taxi are examples of some of the start-ups which got funded through the P2P lending platform Faircent. Countries such as U.K and US have led the growth of P2P lending. According to a recent Financial Express article, China is currently the largest P2P lending market in the world. India is just opening up to this new phenomenon. By 2020, the size of peer to peer lending in India is expected to be at Rs. 30,000 crores. P2P lending is gaining traction and over a period of time these portals may soon emerge as a supplementary mechanism to the traditional banking system.

B.SNIPPETS

1. Where Do You Find Bargains

Where should you look for bargains? According to Howard Marks: "A good place to start is among things that are:

- little known and not fully understood;
- fundamentally questionable on the surface;
- controversial, unseemly or scary;

- deemed inappropriate for ‘respectable’ portfolios;
- unappreciated, unpopular and unloved;
- trailing a record of poor returns; and
- recently the subject of disinvestment, not accumulation.”

In essence, a bargain exists when the perception is worse than reality.

2. Systemic vs Idiosyncratic Risk

When thinking about risk, one must distinguish between “idiosyncratic risk” and “systemic risk.” Although it is conceptually related to the distinction between idiosyncratic and systematic (beta or market wide) risk in the capital asset pricing model, this distinction is different. For example, Baring Bank’s 1995 failure was specific to Barings whereas the failure of Lehman Brothers and AIG in 2008 was related to a systemic crisis in the housing market and wider credit markets.

The distinction between idiosyncratic and systemic risk is significant for the following reasons:

- First, the sources of these risks are different. While idiosyncratic risk arises from within a firm and is generally amenable to control by its managers, systemic risk is shared across firms and often stems from misdirected government intervention, inappropriate economic policies, or exogenous events (like natural disasters).
- Second, the consequences of these risks are quite different. A firm- specific disaster has repercussions which are generally limited to the firm and its stakeholders (owners, debtors, employees, customers, and so on). A systemic risk disaster, however often have serious repercussions for the macro economy and larger society. For example, the Great Depression of the 1930s, the Russian default of 1998, the various Asian crises of the later 1990s, and the worldwide financial crisis of 2008 entailed huge direct costs like bailout costs and indirect costs such as loss of output.

3. Checking Internal Frauds

A major corruption risk that companies face is not that they will have to pay bribes or speed money to government officials, but that their own employees may commit fraud in various ways such as accepting kickbacks from vendors and advertising agencies, commissions on machinery purchases, real estate deals, and acquisition and divestiture transactions:

To protect itself against employee frauds, a company must (a) have a formal code of conduct with mandatory training for every employee along with annual re-certification, (b) communicate the code to all customers, dealers, and vendors, (c)

institute a strong internal audit system and a competent fraud investigation team, (d) carry out investigations speedily and punish decisively and fairly, (e) pay attention to small things such as use of corporate resources for personal convenience, and (f) pursue a zero tolerance policy.

When it comes to ethics and compliance, culture and leadership matter a great deal. An open culture and committed leadership helps. As Ravi Venkatesan put it, "The CEO has to ensure that every employee in every part of the world is utterly clear about what conduct is acceptable and what is not ... Dealing with corruption is a new core competency that no global company can afford to do without."

4. Mandatory E- Voting Gives Shareholders An Edge

E- Voting has been made mandatory by the Ministry of Company Affairs from June 2014, enabling shareholders to vote from the comfort of their home or office. This will facilitate greater participation by public and institutional shareholders.

Thanks to e-voting, any special resolution that needs the approval of 75% of shareholders present will be put through litmus test. A case in point is the surprise defeat of Tata Motors' resolutions to ratify the salary of three top executives in July 2014. As Anil Singhvi, founder and director, Institutional Investor Advisory Services (IIAS), a proxy shareholder advisory firm, says. "This is a wakeup call for corporate India. There is need for shareholders to engage proactively with shareholders and not treat any proposal as a procedural issue."

PART C: WIT AND WISDOM

1. HUMOUR

- At an international conference, three scientists, a Russian, an American, and an Indian, were discussing about their technological achievements. The Russian scientist said, "We have mastered the art of sending a rocket to a specific point on Venus." The American scientist asked, "Is it really so?" The Russian scientist clarified, "Within a few miles of a target point." The American scientist claimed, "We can send ICBM (Intercontinental Ballistic Missile) to hit any given building." The Indian scientist asked, "Really?" The American scientist clarified, "Within a few yards." The Indian scientist boasted, "We have mastered the art of eating through the nose." Both the Russian and American scientists said, "Is that really true." The Indian scientist said, "Within an inch or two."
- Commenting on his performance in the 1999 Annual Report of Berkshire Hathaway, Warren Buffett wrote, "My performance reminds me of the quarterback whose report card showed four Fs and one D but who

nonetheless had an understanding coach. 'Son,' he drawled, 'I think you're spending too much time on one subject.'

2. WISE SAWS

- Happiness consists of making a bouquet of flowers within your reach
- Man, unlike the animals, has never learnt that the sole purpose of life is to enjoy it Samuel Butter