**BCOM 430: MANAGEMENT OF FINANCIAL INSTITUTIONS**

**EXAM FOR AUGUST 2011**

**INSTRUCTIONS: ATTEMPT QUESTION ONE AND CHOOSE TWO OTHER QUESTIONS.**

**SECTION A: COMPULSORY**

* 1. Discuss the provisions of the Basel III accord, and the implications to the management of financial institutions. (6 mks).

***The Basel Committee on Banking Supervision (the “Basel Committee”) released a near final version of its new bank capital and liquidity standards, referred to as “Basel III”, in December 2010 (The DAVOS Summit). Subsequent guidance was issued in January 2011 regarding minimum requirements for regulatory capital instruments. Basel III is a series of amendments to the existing Basel II framework. It highlights on:***

* ***Capital ratios.***
* ***Liquidity ratios.***
  1. What do you understand by the term net regulatory burden? (2mks)

***Regulation has a cost to those being regulated, for example the opportunity cost of additional capital required, and the cost of producing information required by regulators. Regulation also has benefits, in the form of lower risk of insolvency, for example. The difference between the private benefits of being regulated and the costs is the net regulatory burden.***

* 1. Regulators place emphasis on the need for financial institutions to have adequate capital. Consequently, most financial institutions must meet certain minimum capital requirements set by the regulators. Give three reasons why you think financial institutions should have adequate capital (6 mks).
     + - ***To absorb unanticipated losses with enough margin to inspire confidence and enable the financial institution to continue as a going concern.***
       - ***To protect depositors in the case of insolvency and liquidation.***
       - ***To protect the insurance funds (in the form of deposits protection fund) and taxpayers who may intervene to protect claimants.***
       - ***To protect the industry from increased insurance premiums due to increased riskiness of insolvency caused by a perception that the financial institutions are undercapitalized.***
       - ***To fund new assets and business expansion.***
  2. Distinguish between core capital and supplementary capital as applied to commercial banks in Kenya (4 mks).

***Is as defined in Section 2(1) of the Kenya of the Banking Act and includes permanent shareholders equity (issued and fully paid-up ordinary shares and perpetual non-cumulative preference shares) plus disclosed reserves (additional share premium plus retained earnings plus 50% of profits after tax plus minority interest in consolidated subsidiaries) less intangible assets (goodwill and equity funded through revaluation reserves). In arriving at the applicable figure, any proposed or interim dividends have to be taken into account. Tier one capital (Core capital) is the capital in the bank's balance sheet that can absorb losses without a bank being required to cease trading.***

***Is as defined in Section 2(1) of the Kenya Banking Act and includes 25% of asset revaluation reserves which have received prior Central Bank’s approval, subordinated debt, hybrid (debt equity) capital instruments or any other capital instrument approved by Central Bank. Supplementary capital must not exceed core capital. Tier two capital (Supplementary capital) can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.***

* 1. When an investor chooses to invest through a mutual fund, he/she should be aware that there are costs to be incurred. In reference to mutual funds, discuss:

***Front-End Load***

***A front-end load is a commission or sales charge paid when you purchase the shares. These charges are used primarily to pay the brokers who sell the funds. There exist low load funds with a front end load of around 3%. An ordinary fund will charge around 6%.***

***Back-End Load***

***A back-end load is a redemption, or “exit,” fee incurred when you sell your shares.***

***Operating Expenses***

***Operating expenses are the costs incurred by the mutual fund in operating the portfolio, including administrative expenses and advisory fees paid to the investment manager. These expenses are usually expressed as a percentage of total assets under management. Shareholders do not receive an explicit bill for these operating expenses; however, the expenses periodically are deducted from the assets of the fund. Shareholders pay for these expenses through the reduced value of the portfolio.***

* 1. Differentiate between defined contribution and defined benefits pension funds. Which one do you think most employees would prefer and why. (3 mks)

***A defined contribution (DC) scheme is a scheme in which member' and employer' contributions are fixed either as a percentage of pensionable earnings or as a shilling amount, and a member's retirement benefits has a value equal to those contributions, net of expenses including premiums paid for insurance of death or disability risks, accumulated in an individual account with investment return and any surpluses or deficits as determined by the trustees of the scheme.***

***A defined benefit (DB) Scheme is an arrangement where the benefit, which is ordinarily determined by the scheme rules, is defined in advance. Benefits are often related to the final salary and/or years of service of the employee. The main risk for beneficiaries is the solvency of the employer so as to be in a position to meet the promised benefits.***

***Employees would prefer defined benefit due to the certainty of the amount to be received.***

* + 1. Pension versus provident fund.(3 mks)

***Provident fund means a scheme for the payment of lump sums and other similar benefits to employees when they leave employment or to the dependants of employees on the death of those employees.  
  
In the case of a pension fund at the point of retiring a proportion of the retirement fund is commuted as lump sum with the remainder paid out as periodical payments***

**SECTION B (CHOOSE TWO QUESTIONS)**

* 1. Highlight and briefly explain two reasons why financial institutions face liquidity problems (4 mks).

***Mismatch in maturity of loans and deposits***

***Financial institutions, especially banks borrow large amounts of short term deposits and reserves from individuals, then turn around and make long term credit (loans). This mismatch in maturities is a cause of liquidity problems.***

***Sensitivity to changes in interest rates***

***When interest rates rise, some depositors will withdraw their cash in search of higher returns elsewhere. Customers will also postpone loan requests, or prefer to borrow in credit lines that attract lower interest.***

* 1. Discuss in detail (with examples) three methods a liquidity manager may use to estimate liquidity needs for a financial institution. (12 mks). ***Discuss***
* ***The sources and uses of funds approach.***
* ***The structure of funds approach.***
* ***The liquidity indicator approach.***
  1. List, in order of priority, how funds for a financial institution should be employed. (4 mks)

***Liquidity***

***Since public confidence is essential for the survival of a financial institution, it has to lay an overiding emphasis on liquidity. With that end in view, it must provide itself with andequate cash. There are also legal requirements – every commercial bank, for example is required by law to keep with the central bank some cash reserves against its deposits. The cash reserve held by the bank for legal and operational purposes is designated in banking circles as primary reserve. Excess reserves act as an insurance against costs associated with deposit outflows.***

***Secondary reserves***

***Since cash is a barren asset, it forms only a small proportion of banks total assets. Secondary reserves- liquid but earning assets occupy the second priority. These assets can be converted to cash with little or no delay or loss of principal.***

***Customers needs for loans and advances***

***The third priority is to consider its customer needs for funds- and it will extend credit to customers whose operations and needs are intimately understood and known by the institution- hence the need for guarantors and collateral.***

***Purchase of investment securities in the open market***

***If the first three priorities have not exhausted income, the financial institution may purchase earning assets in the open market.***

* 1. In your own words, provide a definition of capital for financial institutions. Explain the role of capital in the support of growth and public confidence for an institution. (3 mks)(pp 17-1)

***Capital is the total of a financial institutions long term sources of funds. It provides cash necessary for a business to begin operations, and also support subsequent growth. Capital also serves to absorb losses and thereby promote public confidence.***

* 1. Explain why capital in depository institutions serves to reduce **moral hazards** and to provide protection for deposits. (3 mks) 17-1)

***Capital reduces moral hazards because it means that owners of a financial institution have placed some of their personal resources at risk. The more the capital, the more the owners have to loose if excessive risks are taken and the more likely that the owners will monitor managers actions. Capital thus tends to reduce risk of failure and protect deposit insurance funds.***

* 1. Explain why market value (Economic capital) is theoretically a better measure than book value (book capital) for measuring the ability of capital to perfom functions of providing protection and supporting growth. (6 mks) (17-3).

***Market value captures the true economic difference between the value of an institutions asset and its liabilities. For capital to serve as a cushion between the value of a firms assets and the value of its outstanding liabilities, it must have significant economic value.***

* 1. Explain the potential advantages and disadvantages to regulators and to managers of financial institutions of the risk adjusted capital measures. How do they differ from the traditional measures of capital? (8 mks) (17-5)

***The risk adjusted capital requirements consider the individual differences in the riskiness of an institutions operations including activities that may not be show cased in traditional financial statements (off balance sheet events). In addition the approach recognizes that not all balance sheet items are equally risky. The measures incorporate the belief that the required ratio of capital should be based on a risk adjusted total reflecting these factors.***

* 1. Explain the risk transferred to investment bankers when they underwrite new securities issued by corporations. (4 mks)

***Investment bankers assume the risk associated with underwriting new securities. They guarantee a stated amount of capital to the issuing firm and they must accept uncertainty about whether the securities will actually bring that price in the market.***

* 1. How does the formation of a syndicate limit the risk exposure to underwriting? (2 mks)

***A syndicate is formed when the lead investment banker invites other investment banking firms to participate in the new issue. Members of the syndicate contribute a portion of the capital guaranteed to the issuing corporation, and thus share the risk with the lead firm.***

* 1. Discuss three types of underwriting contracts that an investment bank may enter into. (6 mks) (26-1)
* ***Best efforts.***
* ***Firm commitment***
  1. What FOUR benefits do investment funds (including mutual funds) offer to shareholders that are not offered by direct investment initiatives? (8mks) (25-8)
* ***Greater diversification.***
* ***Higher liquidity***
* ***Lower transactions costs***
* ***Better portfolio management.***
  1. Explain the important elements of policies concerning default risk in the loan portfolio. (4 mks)

***These are:***

* ***The thoroughness with which the financial position of a borrower is analyzed.***
* ***The standards set for accepting or rejecting loan applicants.***

***The assessment of an applicant’s loan default risk depends on the size of the firm and the risk aversion of the owners. The credit standards affect the volume of lending and the variability in earnings.***

* 1. How are credit risk policies affected by regulatory standards? (4mks) 14-2

***Regulatory standards limit the amount of risk that a financial institution is allowed to accept. For example a financial institution cannot lend more than 25% of its core capital to one borrower.***

* 1. Describe four different areas of depository activities that can be analyzed through financial ratios. What difficulties may be encountered when using financial information to make performance comparisons of different institutions?(12 mks) 22-1

The main areas are:

* ***Liquidity management.***
* ***Securities portfolio management.***
* ***Loan portfolio management.***
* ***Liability and capital management.***
* ***Asset liability management.***
* ***Effect of international operations.***