FINANCIAL INSTITUTIONS AND MARKETS

ATTEMPT QUESTION ONE AND TWO OTHER QUESTIONS

TIME: 2 HRS

**QUESTION ONE**

a. “In a world without information and transaction costs, financial intermediaries would not exist”. Is this statement true or false? Explain. (6 mks)

b. How does risk sharing benefit both financial intermediaries’ and private investors? (4 mks)

c. Discuss some of the manifestations of the globalization of world capital markets. (6 mks)

d. calculate the value of a Ksh. 100 zero coupon bond with 5 years to maturity if the yield to maturity is 6%. (3 mks).

e. Discuss the pros and cons of financial innovation. (6 mks)

1. Although real assets comprise the true productive capacity of an economy, it is hard to conceive of a modern economy without well-developed financial markets and security types. How would the productive capacity of the Kenyan economy be affected if there were no markets in which one could trade financial assets? (15 mks)
   1. "A country is always worse off when its currency weakens (falls in value)." Is this statement true, false, or uncertain? Explain your answer (4 mks).
   2. Short-term interest rates are 2% in Kenya and 4% in the United States. The current exchange rate is 102 shillings per dollar. What is the expected forward exchange rate? (4 mks).
   3. Discuss the following terminology:
      1. The law of one price.
      2. Purchasing power parity.
      3. Local arbitrage.
      4. Triangular arbitrage (8 mks).
   4. Short-term interest rates are 2% in UK and 4% in Kenya. The current exchange rate is Ksh. 150 per sterling pound. If you can enter into a forward exchange rate of Ksh. 135 per sterling pound, how can you arbitrage the situation? (4 mks).
   5. Discuss the pros and cons of the regulation of financial markets. (9 mks).
   6. To what extent is self regulation applicable in the financial sector? (3 mks)
   7. Under what circumstances might regulation decrease rather than increase the stability of an industry? (4 mks)
   8. How important is moral hazard as a determinant of people’s behavior? Provide examples of moral hazard related to the financial services industry. (4 mks).

“The existing regulatory framework for the financial sector in Kenya consists of a number of independent regulators each charged with the supervision of their particular sub sectors”.

Discuss the structure of financial sector regulation in Kenya and highlight 4 GAPs and 2 OVERLAPS (Use diagrams where appropriate) (20 marks)