**GARISSA UNIVERSITY**

UNIVERSITY EXAMINATION 2020/2021 ACADEMIC YEAR **FOUR SECOND** SEMESTER EXAMINATION

SCHOOL OF BUSINESS AND ECONOMICS

FOR THE DEGREE OF BACHELOR OF BUSINESS MANAGEMENT

**COURSE CODE: BBM 415**

**COURSE TITLE: MANAGEMENT OF FINANCIAL INSTITUTIONS**

**EXAMINATION DURATION: 2HOURS**

**DATE: TIME:**

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**INSTRUCTION TO CANDIDATES**

* The examination has **FIVE (5**) questions
* Question **ONE (1)** is **COMPULSORY**
* Choose any other **TWO (2**) questions from the remaining **FOUR (4)** questions
* Use sketch diagrams to illustrate your answers where necessary
* Do not carry mobile phones or any other written materials in the examination room
* Do not write on this paper

**This paper consists of SIX (6) printed pages *Please turn over***

**QUESTION ONE (30MARKS)**

**CASE STUDY**

**KIMANI KERRETS & COMPANY**

**FINANCIAL MARKETS AND INSTITUTIONS**

Assume that you recently graduated with a degree in finance and have just reported to work as an investment adviser at the brokerage firm of Kimani Kerrets & Co. Your first assignment is to explain the nature of the Kenya’s financial markets to Michelle Paul, a professional tennis player who recently came to the Kenya from Morocco. Michelle is a highly ranked tennis player who expects to invest substantial amounts of money through Kimani Kerrets & Co. She is very bright; therefore, she would like to understand in general terms what will happen to her money. Your boss has developed the following questions that you must use to explain the Kenya’s financial system to Michelle.

**a)**. Discuss the three primary ways in which capital is transferred between savers and borrowers? Describe each one. **[3Marks]**

**b).**

1. Define the term market? **[1Mark]**
2. Differentiate between the following types of markets:
3. physical asset markets versus financial asset markets, **[2Marks]**
4. spot markets versus futures markets, **[2Marks]**
5. money markets versus capital markets, **[2Marks]**
6. primary markets versus secondary markets, and [**2Marks]**
7. Public markets versus private markets. **[2Marks]**

**c).** Why are financial markets essential for a healthy economy and economic growth?

**[2Marks]**

**d).** Discuss

1. Derivatives 2 Marks
2. Ways derivatives can be used to reduce risk  **2Marks**

**e).** Describe each of the following financial institutions:

1. Commercial banks, **[2Marks]**
2. Investment banks, **[2Marks]**
3. Mutual funds, **[2Marks]**
4. Hedge funds, and **[2Marks]**
5. Private equity companies. **[2Marks]**

**QUESTION TWO**

**(a).** Define Interest rate risk. **[1 Mark]**

A financial institution has the following market value balance sheet structure:

|  |  |  |  |
| --- | --- | --- | --- |
| **Assets** | | **Liabilities** | |
| Cash  Bond | **Ksh.**  1,000  10,000 | Certificate of deposit  Equity | **Ksh.**  10,000  1,000 |
| **Total assets** | **11,000** | **Total liabilities and equity** | **11,000** |

1. The bond has a 10-year maturity, a fixed-rate coupon of 10 percent paid at the end of each year and a par value of Ksh.10,000. The certificate of deposit has a 1-year maturity and a 6 percent Fixed rate of interest. The FI expects no additional asset growth.

**Required:**

Net interest income at the end of the first year **[5 Marks]**

1. If at the end of year 1, market interest rates have increased 100 basis points (1 percent), what will be the net interest income for the second year? Is this result caused by reinvestment risk or refinancing risk? [5 Marks]
2. Assuming that market interest rates increase 1 percent, the bond will have a value of Ksh.9, 446 at the end of year 1. What will be the market value of equity for the FI? Assume that all of the Net Interest Income (**NII**) in part **(a)** is used to cover operating expenses or dividends. **[5 Marks]**
3. If market interest rates had decreased 100 basis points by the end of year 1, would the market Value of equity be higher or lower than Ksh.1,000? Why? **[2 Marks]**
4. What factors have caused the changes in operating performance and market value for this firm? **[2 Marks]**

**QUESTION THREE**

**(a).** You are a consultant at **KK Securities** and a group of young investors ask you about Mutual Funds and Hedge funds.

**Required:**

Discuss Mutual Funds and Hedge Funds and clearly differentiate the two in terms of how they are regulated in Financial Services Industry. **[6 Marks]**

**(b). Discuss the following terms:**

1. Equity funds **[1 Mark]**
2. Bond funds **[1 Mark]**
3. Hybrid funds **[1 Mark]**
4. Load fund **[1 Mark]**
5. No-load fund **[1 Mark]**

**(c).**

**(i).** A Mutual Fund owns 1,000 shares of **Bamburi Cement** currently trading at Ksh.37.75, 2,000 shares of **Nation Media Group** currently trading at Ksh.43.70, and 1,500 shares of **Bank of Africa** currently trading at Ksh.46.67. The mutual fund currently has 15,000 shares outstanding held by investors.

**Required:**

Net Asset Value **(NAV)** of the fund **[3 Marks]**

**(ii).** If investors expect the price of **Bamburi Cement** shares to increase to Ksh.45, **Nation Media Group** shares increase to Ksh.48, and **Bank of Africa** shares increase to Ksh.50. Assuming the same number of shares outstanding.

**Required:**

What is the expected **NAV** at the end of the year? **[3 Marks]**

**(iii).** Consider the mutual fund in **question (i) above**, but suppose that today 1,000 additional investors buy into the mutual fund at the current **NAV** of Ksh.13.01. This means that the fund manager now has Ksh.13,010 in additional funds to invest. Suppose the fund manager decides to use these additional funds to buy additional shares in **Bamburi Cement**. At today’s market price he or she can buy Ksh.13,010÷Ksh.37.75 = 344 additional shares of **Bamburi Cement**. Thus, the mutual fund’s new portfolio of shares would be 1,344 in **Bamburi Cement**, 2,000 in **Nation Media Group**, and 1,500 in **Bank of Africa**.

**Required:**

**Net Asset Value** of the portfolio at the end of the month and explain your answer. **[3 Marks]**

**QUESTION FOUR [20Marks]**

(a). A NOW account requires a minimum balance of Ksh.750 for interest to be earned at an annual rate of 4 percent. An account holder has maintained an average balance of Ksh.500 for the first six months and Ksh.1,000 for the remaining six months. The account holder writes an average of 60 cheques per month and pays Ksh.0.02 per cheque, although it costs the bank Ksh.0.05 to clear a cheque.

1. What average return does the account holder earn on the account?  **[5 Marks]**
2. What is the average return if the bank lowers the minimum balance to Ksh.400?

**[5 Marks]**

1. What is the average return if the bank pays interest only on the amount in excess of Ksh.400? Assume that the minimum required balance is Ksh.400.  **[5 Marks]**

How much should the bank increase its cheque fee to the account holder to ensure that the average interest it pays on this account is 5 percent? Assume that the minimum required balance is Ksh.750. **[5 Marks]**

**QUESTION FIVE [20MARKS]**

**(a).** Explain how securities firms differ from investment banks. In what ways are they financial intermediaries?  **[2Marks]**

**(b).**

1. What are the risk implications to an investment bank from underwriting on **a** **best-efforts**

**basis** versus **a** firm commitment basis? **[2Marks]**

1. If you operated a company issuing stock for the first time, which type of underwriting would you prefer and why?  **[2Marks]**
2. What factors may cause you to choose the alternative? **[2Marks]**

**(c).**

(i).Define the term venture capital? **[2Marks]**

(ii). Discuss the advantages and disadvantages to a new or small firm of getting capital funding from a venture capital firm?  **[4Marks]**

**(d**).

1. How do the operating activities, and thus the balance sheet structures, of securities firms differ from the operating activities of depository institutions? **[3Marks]**
2. How are the balance sheet structures of securities firms similar to depository institutions?  **[3Marks]**