

**INSTITUTE OF BANKERS IN MALAWI**

**DIPLOMA IN BANKING EXAMINATION**

**SUBJECT: FINANCIAL MARKETS 1 (IOBM – D203)**

**Date: Thursday, 16th November 2017**

**Time Allocated: 3 hours (13:30 – 16:30 Hours)**

**INSTRUCTIONS TO CANDIDATES**

1 This paper consists of **TWO** Sections, A and B.

2 Section A consists of 4 questions, each question carries 15 marks.

Answer **ALL** questions.

3 Section B consists of 4 questions, each question carries 20 marks. Answer **ANY TWO** questions.

4 You will be allowed **10 minutes** to go through the paper before the start of the examination, you may write on this paper but not in the answer book.

5 Begin each answer on a new page.

6 **Please write your examination number on each answer book used. Answer books without examination numbers will not be marked.**

7 All persons writing examinations without payment will risk expulsion from the Institute.

8 If you are caught cheating, you will be automatically disqualified in all subjects seated this semester.

9 DO NOT open this question paper until instructed to do so.

**SECTION A (60 MARKS)**

**QUESTION 1**

1. Your organisation has just emerged from a very difficult economic environment. A new Chief Executive has been appointed and now most of the board is made up of new directors. The future looks more promising and the longer-term prospects look brighter, but the immediate future is expected to include losses as well as profits.

It has been proposed that the organisation needs refinancing and management have got two options at their disposal: either to raise debt or issue new or additional equity.

**Required:**

On the basis of your understanding of the risks involved in both debt and equity advise management of the best way to raise the required funds. *(5 marks)*

1. Make a detailed comparison of ordinary/common shares and preference/preferred shares. *(10 marks)*

**(Total 15 Marks)**

**QUESTION 2**

With regard to capital markets, what do you understand by the following:-

1. Capital gain and capital loss. (*3 marks)*
2. Private equity. *(3marks)*
3. Differentiate a financial liability from an equity instrument. *(6 marks)*
4. Give **three** examples of financial assets and **three** examples of financial liabilities. *(3 marks)*

**(Total 15 Marks)**

**QUESTION 3**

1. What is a foreign exchange rate?  *(1 mark)*
2. Compare and contrast currency depreciation and currency devaluation. Include examples in your explanation. *(8 marks)*
3. Explain the impact of depreciation or devaluation on:
   * 1. Property
     2. Investments and
     3. The economy

*(6 marks)*

(**Total 15 marks)**

**QUESTION 4**

1. You organisation has an opportunity to invest MWK (Malawi Kwacha) 25 million and USD (American Dollar) 25 Million.

**Required:**

Compare the redemption value for a Certificate of Deposit invested in MWK and USD which matures in 120 days, quoted in the market yield of 2.5%.

*Show your calculations* (*4 marks)*

1. Calculate the nominal annual yield for a money market deposit which matures in 150 days and which will return MWK 25.7 million. *Show your calculations* (3 *marks)*
2. Company Bold plans to pay a dividend of EUR 20 million in 90 days' time. The funds are available now and Bold's Treasurer is considering how best to invest these funds in the interim.

The Treasurer is considering investing in one or more of the following instruments:

* EUR 20 million in a 90-day money market deposit with Safe bank at interest of 4.7%.
* EUR 20.5 million nominal of a 180-day certificate of deposit to be issued by Secure bank at an issue price of EUR 20 million, (equivalent to a yield of 5%).

Secure Bank has a lower credit rating than Safe Bank.

**Required**

1. Explain why the certificate of deposit has a lower return than the money market deposit even though it had a higher yield when purchased. *(2 marks)*

1. Identify and briefly explain **three** factors, other than return, that are relevant to the treasurer's decision on whether to invest in the certificate of deposit or money market deposit under consideration. *(6 marks)*

**(Total 15 marks)**

**SECTION B (40 MARKS)**

Answer ANY **TWO** questions from this section

**QUESTION 5**

1. Explain the terms ‘Spot transactions’ and ‘spot date’ in a FX Transaction

*(2 marks)*

1. Compare a currency Forward Contract for foreign currencies with a forward rate agreement. *(5 marks)*
2. You are the Finance Manager for Tata Zambia with its head office in Lilongwe. You ask your bank for FX quotes and you receive the following table showing the quotes for the spot FX rate and the forward points for USD/MWK currency pair:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **SPOT** | **1-MONTH** | **3-MONTH** | **6-MONTH** | **1-YEAR** |
| 730/35 | 28/30 | 41/44 | 54/64 | 99/105 |

**Required:**

1. Compute the forward rates for 1month to 1 year. *(4 marks)*
2. Calculate the appropriate 6-month forward rate for Tata Zambia to purchase USD.  *(1 mark)*
3. You are attending a job interview at an Investment Bank in town and one of the panellist has asked you to explain the various types of options to showcase your knowledge. Explain the following types of options:
   1. American Style Options *(2 Marks)*
   2. European Style Options *(2 marks)*
   3. Bermudan Style Options *(2 marks)*
   4. Asian Style Options or Average Option *(2 marks)*

**(Total 20 Marks)**

**QUESTION 6**

1. You have a new colleague in your treasury department. They are currently learning the basic aspects of his new role. They have heard you mention in the office the terms arbitrage and interest rate parity but they have told you that they do not understand what these terms mean.

Also, whilst the new colleague is familiar with spot and forward exchange rates, they are confused because they have compared today’s spot rate to the rate set 3 months ago for a forward transaction due to settle today . They do not understand why the rates do not match.

They have asked you for help to increase his level of understanding.

1. Explain the relationship between arbitrage and interest rate parity. *(4 marks)*

1. Explain why forward rates are unlikely to be an accurate indicator of future spot rates. *(6 marks)*
2. An investment is expected to pay out in perpetuity, with the first payment of EUR 5,150 in one year’s time, and subsequent payments growing at a forecast inflation rate of 3% *per annum*. The annual effective cost of capital is 10%.

**Required:**

Calculate a ‘real terms’ adjusted cost of capital, stripping out the inflation growth rate of 3% *per annum* from the money cost of capital of 10% annual effective rate.

(*4 marks)*

1. Briefly explain **three** factors that should be taken into account by a company when considering whether or not to set up a commercial paper programme. *(6 marks)*

**(Total 20 Marks)**

**QUESTION 7**

1. A company has just paid a dividend of MWK 10 tambala per share. Dividend growth is anticipated to be 5% ongoing and the cost of equity is 8%. Calculate an estimate of the current share price. Show your workings. *(3 marks)*
2. Calculate the value of the bond that matures in five years with a coupon of 7% and a maturity value of MWK 1,000. The bond pays an annual coupon and the discount rate is 5%. *(4 marks)*
3. Calculate how the value to the bond change when the discount rate is 10%.

*(4 marks)*

1. Explain what happens when the discount rates changes from 5% to 10%.

*(1 mark)*

1. When determining the cost of equity:
2. Explain the difference between diversifiable risk and systematic risk. Illustrate your answer with examples. *(4 marks)*
3. Discuss how these risks may influence the actions of investment portfolio managers. *(4 marks)*

**(Total 20 marks)**

**QUESTION 8**

Tawina was given a sum of MK2, 000,000.00 by her uncle who stays in England. She decided to invest part of the money in shares on 27th September 2010. She bought the following counters listed on MSE:

|  |  |  |  |
| --- | --- | --- | --- |
| **COUNTER** | **NO. OF SHARES** | **PRICE/SHARE** | **DIVIDEND DECLARED** |
| FMB | 100,000 | K6.00/share | 20t / share |
| MPICO | 280,000 | K2.00/share | 25t / share |
| NICO | 100,000 | K5.00/share | 50t / share |
| STANDARD | 1,200 | K50.00/share | K2.20 / share |

On March 27, 2011 the price per share for the above counters were as follows:

MPICO MK4.00

FMB MK4.75

NICO MK8.20

STANDARD MK55.00

By this date all dividends declared were all received.

**Required:**

1. Calculate how much was received in dividends from all the listed companies.

*(3 marks)*

1. You have been approached by Tawina for a clarification on how her portfolio is performing and she seeks your advice if it is worthy holding on to all counters.

**Note:** your advice should be supported by calculations. *(12 marks)*

1. If Tawina opted for Treasury Bill investment for all the funds so received at the rate/yield of 22% for a tenor of 182 days rather than investing in shares. Was this going to be a better option for her? *(5 marks)*

**(Total 20 marks**)

**END OF EXAMINATION PAPER**