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BACHELOR OF FINANCIAL SERVICES

END OF SEMESTER EXAMINATION

BFS 1101: INTRODUCTION TO FINANCIAL SERVICES

Date: Thursday, 9th December 2021   **Time:** 2 Hours

Instructions:
1.   This examination consists of **FIVE** questions.
2.   Answer **Question ONE (COMPULSORY)** and any other **TWO** questions.

QUESTION 1   30 Marks

a. Explain the difference between the following terms:
   i.   Long term mutual fund and short-term mutual fund   (2 Marks)
   ii.   Bearish market and bullish market   (2 Marks)
b. Discuss the return that an investor of a mutual fund will get by investing in a mutual fund
                                                                           (3 Marks)
c. Explain the following types of life insurance:
   i.   Group life   (2 Marks)
   ii.   Credit life   (2 Marks)
   iii.   Endowment life   (2 Marks)
d. State and explain three services that are provided by securities firms and investment banks   (6 Marks).
e. A company want to raise money by issuing shares. It has approached an investment banker who has agreed to underwrite the issue on a commitment basis. The investment bank pays the company Sh. 25 per share for 200 million shares. The investment banker then sells the shares to the public for Sh. 24 per share.

   Required: answer the following questions:
   1.   How much does the company receive? What is the price of the share? (2 marks)
   2.   What is the profit/loss to the investment banker?   (1 mark)
   3.   If the investment bank can sell the shares for Sh. 27, how much money does the company receive?   (1 mark)
   4 .   What is the profit of the investment banker?   (1 mark)
f. Explain the meaning of the following terms as used in the banking industry:
   i.   Cash reserve ratio   (2 Marks)
   ii.   Discount windows operations   (2 Marks)
g. Discuss two challenges faced by commercial banks (2 Marks)

QUESTION 2   **20 Marks**

a. Explain the difference between the following terms:
    i.   Primary market and secondary market   (2 Marks)
    ii.   Money market and capital market   (2 Marks)
b. Explain the term marked-to-market as used in mutual funds (2 Marks)
c. Explain the difference between open ended mutual fund and a close-ended mutual fund
                                                                            (2 Marks)
d. Mutual funds are required by law to issue investors with prospectus. Explain the purpose
    of a prospectus to investors   (2 Marks)
e. A mutual fund contains 200,000 shares of Britam, currently trading at Sh. 30; 400,000
    shares of shares of Equity bank, currently trading at Sh. 40 and 300,000 shares of Kakuzi
    currently trading at a price of Sh. 20. The mutual fund currently has 200,000 share
    outstanding held by investors.

    Required:
    i.   Calculate the NAV of the mutual fund   (3 Marks).
    ii.   Assume that the mutual fund sells 10,000 additional shares at their current NAV.
            Suppose the additional shares are used to purchase shares of Kakuzi. Calculate the
            Net asset value of the mutual fund.   (4 Marks)
f. An investor has purchased a mutual fund with a front-end cost of 8%. The fund also has a
    fund operating ratio of 2% per annum. Calculate the annualized cost if the investor is
    going to maintain the mutual fund for a period of 2 years.   (3 Marks)

QUESTION 3   **20 Marks**

a. With the aid of an example, explain how a hedge fund manager can make profit by
    taking:
    i.   A short position   (2 Marks)
    ii.   A long position   (2 Marks)
b. A hedge fund manager is managing a fund whose value is Sh. 2.5 billion. The fund has
    generated a return of 12% for the year 2020. The fund uses a fee structure of 2 and 20
    compensation structure.

    Required:
    Calculate the fees for this fund (what the fund manager will get).   (3 Marks)
c. Give a criticism for the expense ratio (management fee)   (2 marks)
d. Explain how a hedge fund manager can employ the following strategies   (8 Marks)
    i.   Long/short equity
    ii.   Merger arbitrage
    iii.   Global macro
    iv.   Convertible bond arbitrage

e. Assume the current price of Centum shares is Sh. 20 which is underpriced. The price of NSE share is Sh. 5 which is overpriced. Further to this assume that a fund manager wants to benefit by long/short equity strategy.

If the fund manager buys 1000 shares of Centum at Sh. 20, the fund manager should short sell 4000 shares of NSE at a price of Sh. 5 per share.

In the ideal situation when the price of Centum rises to their actual value of Sh. 25 and for NSE reduces to Sh. 4.

Required: Calculate the gain of this strategy. (3 Marks)

QUESTION 4   20 Marks

a. James operating a hardware shop in Nairobi. He imports, the products that he sells from China whereby he is required to pay for the products using the Chinese currency. James is required to pay for the imports on cash basis but his customers pay him on credit basis. Moreover he would like to expand his business but does not have the amount of money that would be required for this.

Required:
Explain to James some of the bank services that are offered that can help his business
(6 marks)

b. Jane wants to expand her business and she has therefore taken a loan of Sh. 600,000 from a bank that charges interest at a rate of 15% per annum. She is required to pay for this loan in the next five months.

Required:
i.   Calculate the monthly amount that she will paying (2 Marks)
ii.   Prepare a loan amortization schedule for this loan for the five months (4 Marks)

c. Discuss 4 ways that financial cooperatives make return (4 Marks)
d. Explain two agency functions of a bank (4 Marks)

QUESTION 5   20 Marks

a. Explain three challenges that are currently facing the insurance industry (6 Marks)
b. Differentiate the term adverse selection and moral hazard as used in the insurance industry (4 Marks)
c. With the aid of an example, explain the meaning of the term black swan in insurance
(2 Marks)
d. Peter wants to safeguard his financial interest when he grows up. Explain to him how he can benefit from annuities (3 Marks).
e. Explain the meaning of the following terms used in the balance sheet of an insurance company:
i.   Policy reserves   (1 Mark)
ii.   Surrender values   (1 Mark)
iii.   Capital reserves   (1 Mark)

f. Differentiate between third party insurance and comprehensive car insurance as used in motor insurance. (2 Marks)