TECHNICAL UNIVERSITY OF MOMBASA

SCHOOL OF BUSINESS

DEPARTMENT OF MANAGEMENT SCIENCE

UNIVERSITY EXAMINATION FOR THE DEGREE OF

BACHELOR OF COMMERCE

B.COM SERIES: MAY 2016

BFI 4406: FINANCIAL RISK MANAGEMENT

SEMESTER EXAMINATION

2 HOURS

Instructions to candidates:

This paper consists of FIVE questions

Answer question ONE (compulsory) and any other TWO questions

TIME: 2 HOURS

Question 1

a) Risk management process has three generic approaches, namely hedging, diversification and insurance. Discuss (6 marks)

b) Discuss the Relationship between risk processes and generic risk management approaches (14 Marks)

c) Dawanox ltd is considering two mutually exclusive projects. The initial costs of both projects is Kshs 5000 and each has an expected life of five years. Under possible states of economy , their annual cash flows and associated probabilities are as follows:

		NCF(Kshs)	
Economic State	probability	Project A	Project B
Good	0.3	60,000.00	55,000.00
Normal	0.4	35,000.00	30,000.00
Bad	0.3	20,000.00	20,000.00

If the discount rate is 7%, which project should the company accept? (10 marks)

Question 2

a) Define Market Liquidity (4 marks)

b) Discuss the role of Financial Intermediaries (8 MARKS)

c) What is Credit Risk, discuss methods of mitigating credit risks. (8 marks)

Question 3

a) What is meant by foreign exchange risk (4 marks)

b) Define and illustrate transaction exposure, economic exposure and translation exposure in relation to foreign exchange. (12 marks)
c) In economic terms, what is the difference between risk and uncertainty? (4 marks)

Question 4

a) Interest rate risk is the risk arising from changes in the rate of interest of borrowed or invested (including lent) money: discuss the Sources of Interest Rate Risk? (8 Marks)

b) Discuss the following traditional Term Structure theories
   i. The Expectations Theory (3 Marks)
   ii. Liquidity Preference Theory (3 Marks)
   iii. The Market Segmentation Theory (3 Marks)

c) Discuss the qualitative methods of Risk Assessment (3 Marks)

Question 5

a) Define financial distress and responses to financial distress that a firm can make.
b) Briefly discuss THREE internal methods which could be used by a company to manage foreign currency transaction risk arising from its continuing business activities. (6 marks)
c) GXJ Co, whose home currency is the dollar, wishes to borrow €12 million for a period of six months in three months 'time. The lending bank will fix the interest rate for the loan period at its prevailing lending interest rate when the loan is taken out. The finance director of GXJ Co believes this lending interest rate could be a minimum of 3·5% per year or a maximum of 5·5% per year. The uncertainty regarding the future interest rate is caused by the volatile state of the economy and impending elections which could lead to a change in political leadership and direction. Interest on the euro loan would be payable at the end of the loan period. The finance director of GXJ Co would like to hedge the interest rate risk arising from the future loan and the company's bank has offered a 3–9, 4·5%–3·5% forward rate agreement. The finance director is also concerned about the foreign currency risk associated with the euro interest payment which would be due in nine months' time.

The following exchange rates are available:

Spot rate (euro per \$1)	1·7964–1·8306
Nine-month forward rate (euro per \$1)	1·7191–1·7505

Required:

(a) Evaluate the proposed forward rate agreement as a way of managing the interest rate risk anticipated by GXJ Co. (3 marks)

(b) Analyze the foreign currency risk associated with the future interest payment of GXJ Co and briefly discuss ways that this risk might be hedged. (4 marks)

(c) Explain the nature of four-way equivalence in the relationship between spot exchange rates, forward exchange rates and future (expected) spot rates.(3 marks)