

CF02

Operations of Financial Institutions

5 OCTOBER 2004

1. Time allowed : Three (3) hours
2. Total number of questions : Five (5) questions
3. Number of questions to be answered : Four (4) questions
Part A : Compulsory questions [40 marks]
Part B : Three (3) questions [20 marks each]
4. Show details of workings, where appropriate. Silent, non-programmable calculators may be used.
5. Begin each answer to a new question on a fresh page.
6. Answer **all** questions in **English**.

PART A

COMPULSORY QUESTION

1. (a) In relation to the banker-customer relationship, briefly elaborate on each of the following:
- (i) A customer's rights on:
 - (aa) repayment [2½]
 - (bb) drawing of cheques [2½]
 - (ii) A customer's duties on:
 - (aa) exercising reasonable care in drawing cheques [2½]
 - (bb) disclosing forgery [2½]
- (b) (i) What is a "bad" cheque? [1]
- (ii) Give **three** reasons under which a cheque is returned and is classified as a bad cheque. [3]
- (iii) In relation to Biro Maklumat Cek's definitions and rules on bad cheque offence, explain any **one** of the following:
- (aa) Prohibition period [6]
 - (bb) Probation period [6]
- (c) (i) When taking collateral as security for a loan, what are **four** characteristics that have to be taken into consideration? [4]
- (ii) Give an example for each of the characteristics mentioned above. [2]
- (d) Under the Association of Banks in Malaysia's rules governing bank guarantees, the period of bank guarantee issued must not exceed one year.
- State **four** exceptions to this rule. [4]
- (e) In order to hedge foreign exchange exposure, customers often enter into a forward exchange contract with their bankers.
- (i) What are **three** benefits of hedging? [3]
 - (ii) Give an example of a hedging transaction. [2]
- (f) Under the Islamic banking system, project financing is based on the Al-Musyarakah principle.
- Briefly outline how this principle works. [5]
- (Total:40 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

2. (a) One of the main functions of Bank Negara Malaysia is to regulate the liquidity in the financial markets to promote a stable monetary and financial structure. [5]
Elaborate on the above statement and give an example of how this function is carried out. [5]
- (b) State **five** ways how to handle customers' complaints. [5]
- (c) The law in Malaysia requires records to be kept for seven years. [5]
What are the records required to be kept by the banks? [5]
- (d) What does the term "jointly and severally" mean in a mandate form for opening an account? [5]
(Total:20 marks)
3. (a) Give **three** differences between a cheque and a bill of exchange. [6]
- (b) Name **four** alterations on a cheque which are considered as material alterations. [4]
- (c) Briefly explain how Electronic Data Interchange is useful for an importer. [5]
- (d) What are the documents requested by banks when opening an account for societies, clubs and associations? [5]
(Total:20 marks)
4. (a) A commitment fee is charged on the unutilised portion of an overdraft facility. [3]
Under what circumstances is this commitment fee exempted? [3]
- (b) What does a "back-to-back letter of credit" mean? [3]
- (c) Give **two** advantages of documentary collection for each of the following: [2]
(i) Seller [2]
(ii) Buyer [2]
- (d) Name **six** main problems faced by an owner in a hire-purchase agreement. [6]
- (e) Insurable interest is one of the four basic principles of insurance. [4]
Give **four** examples of how insurable interest could arise. [4]
(Total:20 marks)

5. (a) One of the principles of good lending is to determine the purpose of the loan. The following are three important considerations under this principle:
- (i) Is the loan reflective of the Government's policy?
 - (ii) Is the loan consistent with the present business activity?
 - (iii) Is the loan for working capital or for purchase of fixed assets?
- Briefly elaborate on **two** of these considerations and give an example for each consideration. [5]
- (b) Unit trust managers are required to maintain at least 10% of the net asset value of the funds in the form of liquid assets.
- Give **five** examples of such liquid assets other than cash. [5]
- (c) (i) State **five** types of International Offshore Financial Centres (IOFCs). [2½]
- (ii) Name **one** country where each type of IOFC identified in (c)(i) above can be found. [2½]
- (d) A bank accepts deposits from its customers who look for investment opportunities under the Al-Mudharabah principle.
- Briefly explain how this principle works. [5]
- (Total:20 marks)

- END OF QUESTION PAPER -

OUTLINE ANSWERS

The comments given in the boxes below indicate the areas of weaknesses the examiners have identified and their advice to future candidates.

PART A

Question 1

- Instead of explaining the repayment of loan by customers, candidates explained customers' demand for or withdrawal of their money deposited with the bank.
- Candidates' answers stated that customers with current accounts could withdraw funds from the bank but failed to elaborate that such customers had the right to draw cheques up to the credit balance they maintained.
- Candidates could not define a bad cheque.
- In relation to prohibition period, candidates' answers did not state the redesignation of an account to a "special account" and that withdrawals could be done through cash, cashier's orders, drafts or transfers.
- Candidates quoted the wrong probation period in relation to bad cheques offences.
- Candidates were unable to match the examples with the characteristics for collateral in credit evaluation.
- Instead of stating the benefits of hedging, candidates stated that hedging is to book forward so that customers could make profits.
- Candidates quoted the wrong Islamic principles.
- Application of the correct concepts/principles, reading and understanding what was required of the question would have improved the marks of the majority of the candidates. Candidates should also answer the questions according to the marks awarded.

1. (a) (i) (aa) Repayment

The banker is answerable to his customer for money deposited by the customer. The customer has an implied right to repayment, when he makes a demand for money he has deposited into his account.

(bb) Withdrawal of cheques

Arising from (i) (aa) above and the banker's duty to honour cheques, the customer has an implied right to draw cheques up to a certain amount. The amount will be the credit balance in the customer's account, or any amount up to the credit limit that the customer has arranged with his banker.

This right only extends to the customer's current account. It does not extend to other deposit accounts.

(ii) (aa) Exercising reasonable care in drawing cheques

In the case *London Joint Stock Bank Ltd v Macmillan and Arthur*, it was stated that "it is beyond dispute that the customer is bound to exercise reasonable care in drawing cheques to prevent the banker from being misled. If he draws the cheque in a manner which facilitates fraud, he is guilty of a breach of duty as between himself and the banker..."

In a another case of *E.A. Barbour Ltd v The Ho Hong Bank Ltd*, the learned judge stated that “if in fact was drawn in such manner as to render a dishonest alteration easy, then the drawer was guilty of breach of his positive duty to the bank and the banker ought not to be held responsible for any such alteration...”

(bb) Disclosing forgery

If a customer discovers that a cheque purportedly to be signed by him has been forged, he must inform his banker immediately. This is established in the case of *Greenwood v Martins Bank Ltd*. By not informing the bank immediately upon discovery of any forgery, the customer may be stopped from denying the genuineness of his signature.

Under normal circumstances, a banker is not entitled to debit his customer’s account if the signature is forged. In the case of *Young v Groupe*, it was stated that “a banker who pays a forged cheque, is in general bound to pay the amount again to his customer, because in the first instance, he pays without authority”.

(b) (i) A bad cheque is one that is returned unpaid due to insufficient funds in the account on which the cheque is drawn.

(ii) Reasons a bad cheque is returned

(Give any three of the following reasons:)

- Insufficient funds
- Effects not cleared
- Accounts closed
- Refer to drawer
- Not arranged for

(iii) (aa) Prohibition period

During the prohibition period, the bad cheque offender will not be allowed to open an account.

The prohibition period depends on the number of times the offender has been blacklisted.

Blacklisting	Prohibition Period
First	6 months
Second	12 months
Third	12 months
Fourth and subsequent offences	24 months

The prohibition period will commence from the date of the third bad cheque incident and will end at the end of the month stated in the Biro Maklumat Cek’s blacklist.

During this prohibition period, the bank may redesignate the affected account or open a “special account” for the blacklisted account holder. This is to enable the account holder to receive cheque payments. However, no cheque book is to be issued to the account holder who has to effect his/her payments through cash, cashier’s orders, bank drafts or transfers.

The redesignation or opening of the special account is at the discretion of the bank but subject to the following:

- Option is available to individuals with overdraft facilities.
- Option is available to first and second offenders.
- All unused cheques leaves belonging to the current account must be surrendered to the bank.

(bb) Probation period

After the prohibition period, the offender may be allowed to open an account. However, he/she is still under probation. If he/she does not commit any bad cheque offences during the probation period, he/she will be given a clean record upon the expiry of the probation period.

The probation period depends on the offence and varies as follows:

Blacklisting	Probation Period
First	2 years
Second	2 years
Third	3 years
Fourth and subsequent offences	3 years

c) **Four characteristics** that need to be considered when taking collateral as security for a loan, and their respective **examples**, are

Characteristic	Example
(i) • How easy is it to place a charge/ownership claim on the asset?	(ii) • For landed property, this is quite easy. However, it may not be easy for items like furniture or stocks covered by debentures.
• Are the assets removable?	• Assets like motor vehicles, ships or machinery are movable and may not be easy to trace.
• How stable is the value of the assets?	• The value of some assets like shares may be volatile and need more monitoring than landed property, which is relatively more stable in value. Motor vehicles tend to depreciate rapidly and their resale value may be low.
• How easy is it to dispose of the collateral?	• Unlike quoted shares, unquoted shares will not be easy to dispose of.

(d) Exceptions to the requirement that the period of the bank guarantee issued must not exceed one year are:

- Guarantees in cover of government contracts where expiry of the guarantees must not be more than 12 months after the expiry of the original contract.
- Guarantees in respect of contracts for a specified period.
- Guarantees in respect of import and export of capital goods.
- Guarantees in lieu of earnest money/security deposits for licenses issued by the government for a specified period.

- (e) (i) Benefits of hedging or booking forward:
- Customer knows the exchange rate of a particular currency he is buying or selling sometime in the future, regardless of market fluctuations.
 - Customer is able to ascertain the amount of Ringgit needed for a payment or amount of Ringgit he will receive in advance.
 - Profits on exports or cost of imports are determined, thus allowing for better cash management.
- (ii) An importer needs foreign currency to pay for his imports. He knows when he needs to make payment to the exporter. If the exchange rate goes up, he will need more Ringgit to pay for his imports. If he has committed to sell the goods imported to a third party at a fixed price, he will want to minimise or totally negate his foreign exchange risk. He can do so by entering into a forward exchange contract to buy the foreign currency from the bank at a future date.
- (f) Under the Al-Musarakah principle, the bank/s together with the initiator/s of the project will both provide the financing for the project. The proportion that each party will provide will be agreed upon. All parties have the right to participate in the project's management. However, all the parties have the option to waive the right to participate in the project's management. The basis of distribution of profits to be generated from the project will be agreed upon by all parties. In the event of a loss, all parties will bear the loss in proportion to their share of the financing.

PART B

Question 2

- Candidates did not give an example on how Bank Negara Malaysia carries out the function.
- Candidates did not explain the liability of the signatories of the account.

2. (a) As the country's monetary authority, Bank Negara Malaysia (BNM) is responsible for promoting a stable and sound financial structure. BNM also has to regulate and 'influence' the credit situation in the country to help achieve the country's overall economic objectives. An example of this is the setting up of special funds to enable borrowers from certain sectors of the economy to obtain relatively cheaper financing. For example, under the Fund For Food scheme, borrowers in the food industry can obtain 'cheaper' loans.
- (b) Ways on how to handle customer complaints
- (Give any five of the following ways:)
- Do not react with anger. If a customer screams at you, you must never ever scream back! Restrain yourself. Get about changing that angry face to a happy one.
 - Do not question the customer's honesty. You will only make him angrier.
 - Do not find fault. Remember, "the customer is always right" even if he is wrong.
 - Do not stray from the specific problem. The customer is anxious that his problem be attended to.
 - Acknowledge that a mistake has occurred. However, do not admit liability for the mistake.

- Take responsibility for the problem. Make it known to the customer that helping him solve the problem is your top priority. When you take responsibility for the problem, you remain in control of the situation. You therefore have the opportunity to turn an initial failure into an ultimate success.
- Listen carefully to the customer.
- Ask questions to clarify details and make sure you have understood the problem correctly.
- When you have discovered the cause of the problem, explain it to the customer in calm, factual terms. Do not try to pin the fault on another person.
- Ask the customer what he feels should be done to correct the problem.
- Offer solutions to meet the customer's needs.
- If you cannot solve the problem or if the solution is beyond the limits of your ability, refer the matter immediately to your supervisor for assistance.

(c) The records to be kept by banks are:

- ledger books, vouchers, documents and bank statements,
- computer tapes and diskettes (this will require special storage facilities as the tapes and diskettes are sensitive to heat, dust and magnetic fields),
- computer programs,
- microfiches films, and
- computer print-outs and reports.

(d) The term "jointly and severally" in a mandate form for account opening means that:

All the account holders are responsible for the account on a joint basis.

In the event that the bank needs to recover the amount owing in the account, the bank can demand for payment from the account holders jointly.

All the account holders are responsible for the account on an individual basis.

As an example, where there are three account holders, A, B and C, each one of them will be held responsible for any amount owing in the account.

In the event that the bank needs to recover the amount owing in the account, it can demand for payment from one or more of the account holders, that is, it can demand payment from A only; or from A and B; or from B and C; or from A and C.

Question 3

- Candidates quoted “unconditional order in writing” which is the common similarity between a cheque and bill of exchange.
- Candidates failed to explain what an EDI is. Instead they explained that it is an exchange where sellers and buyers pay into and where buyers expect to receive their sales proceeds.
- Instead of stating the documents required for opening an account for societies, clubs and associations, candidates related their answers to opening an account for a “Sdn Bhd”.
- It is important that candidates understand the question’s requirement before giving their answers.

3. (a) Distinctions between cheques and bills of exchange.

(Give any three of the following distinctions)

	Cheques	Bills of Exchange
1	Must be drawn on a banker.	May be drawn on anyone.
2	Payable on demand, and should be presented at a reasonable time for payment.	May be drawn at any tenor and must be presented within (a) a reasonable time for demand bills, and (b) on the due date for usance bills.
3	No need for acceptance.	Until accepted, the drawer is primarily liable.
4	Drawer of a cheque is not discharged by the holder failing to present it for payment within a reasonable time.	Drawer is discharged if a demand bill is not presented for payment within a reasonable time and other bills on the due date.
5	The bank is protected by the Bills of Exchange Act when paying a cheque bearing a forged indorsement.	No protection for the bank when paying a domiciled bill bearing a forged indorsement.
6	The Cheques Act covers a bank paying or collecting cheques or other instruments.	The Cheques Act does not cover payment or collection of bills of exchange.
7	Crossing of cheques is provided for in the Bills of Exchange Act.	No statutory provision for crossing bills of exchange.
8	“Not Negotiable” on a cheque restricts title but not transfer.	“Not Negotiable” on a bill of exchange prevents its transferability.

(b) Material alterations of a cheque.

(Choose any 4 material alterations:)

- Date
- The amount payable in words
- Crossing
- Alterations from order to bearer
- Payee’s name

- (c) The importer, upon receipt of import documents (from the banks) delivers the documents to the customs even before the goods arrive at the port. The importer's details in the Custom's Information File are linked to the Electronic Data Interchange (EDI).

The importer permits the customs to debit his bank account for the necessary customs duty or tax.

The EDI clearing centre electronically communicates with the importer's bank to debit the charges.

The funds are remitted to the customs' bank account under advice to the customs.

Upon the goods' arrival at the port, the importer is informed through EDI. The goods are cleared speedily.

- (d) The documents required for opening an account for Societies, Clubs and Associations are:

- A certified copy of the rules and regulations;
- A certified copy of the license or certificate issued by the Registrar of Societies;
- A certified copy of an extract of the resolution passed by the committee or any other governing body;
- Identity cards of the office bearers/signatories.

The Bank will also ask the applicant to fill in a Mandate Form stating clearly the condition of the signatory(ies) for operation purposes.

Question 4

- Candidates had a poor knowledge of commitment fees.
- Candidates confused documentary collection with documentary credit.
- Instead of stating examples of insurable interest, candidates quoted irrelevant insurance principles.

4. (a) Below are the circumstances under which the commitment fee charged on the unutilised portion of an overdraft facility is exempted:
- Overdraft facilities for which the interest rate is prescribed by Bank Negara Malaysia, such as those under the Credit Guarantee Scheme and loans to small scale enterprises and the Bumiputera Community for business purposes; and
 - Personal overdraft facilities with a limit of up to RM250,000 in total.
- (b) A back-to-back letter of credit is a transaction involving two separate letters of credit. Initially, the applicant will request his banker to issue a letter of credit in favour of his seller. The seller will, in turn, request his banker to issue another letter of credit to a second beneficiary. This is also sometimes called counter credit.
- (c) (i) Advantages to the seller:
- The seller has control over the title to the goods until payment is received.
 - As the seller knows the buyer, he can expect to receive payment soon or on due date.

- (ii) Advantages to the buyer:
- He saves on not having to establish a documentary credit.
 - He can negotiate with the seller to give him credit.

- (d) Main problems faced by an owner in a hire-purchase agreement

(Give any six of the following problems:)

- Fictitious hirers/goods
- Financing of fixtures
- Locked premises
- Used/reconditioned equipment
- Stolen goods
- Insurance
- Repossessor
- Death of hirer

- (e) Examples of how insurable interest can arise.

(Give any four of the following examples:)

- Owners of property
- Trustees in respect of property held in trust for others
- Mortgagees in respect of property held as security for a loan
- Tenants who have covenanted to insure a property
- A person has unlimited insurable interest on his own life and limbs, his spouse's life and limbs and his children's lives and limbs
- A corporation on the life of an officer or employee
- Anyone who has potential legal liability (including legal costs and associated expenses) can effect liability insurance

Question 5

- Instead of stating the types of International Offshore Financial Centres (IOFC), candidates stated the incentives offered by the IOFC and inadvertently stated "Labuan" as the country where the IOFC can be found.

5. (a) Elaborate on any two of the following:

- (i) Reflects government policy.

For example, if the government is against the use of radioactive materials, a proposal to set up a nuclear plant should not be considered.

Similarly, if it is the government's decision not to allow the building of high-rise buildings on hill slopes, banks should not consider financing proposals to construct multi-storey condominiums on hill slopes.

- (ii) Be consistent with present business activity.

A loan could be for the purpose of expanding the present business, for example, to set up branches or to expand to a new market. However, credit officers must exercise caution if the loan is to enable the borrower to embark on a new venture in another industry. The borrower may not have sufficient know-how in the new industry. Success in a particular industry does not guarantee success in another industry, for example, a poultry farmer going into shipping.

(iii) Is the loan for working capital or for purchase of fixed assets? Is it speculative?

Generally, most banks will consider an application if the loan is for expanding the borrower's business or to buy fixed assets to expand or improve the business.

However, if the request is for speculative purposes, most banks will exercise caution when considering such an application. An example is the purchase of landed property for resale at a later date.

(b) Five examples of liquid assets which unit trust managers maintain to meet the 10% of the net asset value requirement:

- Deposits with commercial banks, finance companies, merchant banks, discount houses and Bank Islam.
- Malaysian Government Securities, treasury bills, Bank Negara Malaysia certificates and Government investment certificates.
- Cagamas bonds.
- Bankers' acceptances and negotiable certificates of deposits.
- Any other forms of investment as may be approved by the Securities Commission.

(c) Five basic types of International Offshore Financial Centre (IOFC) and their respective examples:

Type of International Offshore Financial Centre (IOFC)	Example
(i) • IOFCs that offer no income tax or grant extensive tax exemptions	(ii) • Bahamas, Bahrain and the Cayman Islands
• IOFCs that do not tax income from foreign sources	• Costa Rica, Hong Kong and Panama
• IOFCs that offer low tax rates and other incentives	• Cyprus, the Netherlands and Switzerland
• IOFCs that offer low tax rates, other incentives and special privileges	• British Virgin Islands, Channel Islands and the Isle of Man
• Special incentives and privileges are offered to offshore companies	• Luxembourg, Singapore, the Netherlands and Antilles

(d) Al-Mudharabah principle

Under the Al-Mudharabah principle, the bank provides the "entrepreneurship" and depositors the capital. Both parties will agree on the distribution of profits, if any. Depositors do not participate in the management of the investment. In the event of a loss, depositors shall bear the whole loss.