

CF02

Operations of Financial Institutions

12 APRIL 2005

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) Elaborate on the following functions of Bank Negara Malaysia:
- (i) Acts as the Government's banker and advisor [5]
 - (ii) Acts as the banker to all banks [5]
- (b) Why is an introducer necessary when opening a current account with a bank? [5]
- (c) (i) The Bills of Exchange Act 1949 states that "a bill is not invalid by reason only that it is ante-dated or post-dated, or that it bears a date on a Sunday".
- What do the following terminologies mean? Give an example for each terminology.
- (aa) Ante-dated [3]
 - (bb) Post-dated [3]
- (ii) In relation to the cheque clearing system, explain what a "hold day" means. Give an example for your answer. [4]
- (d) In relation to the principles of good lending, elaborate on the following:
- (i) Duration of a loan [4]
 - (ii) Source of repayment of a loan [6]
- (e) Unit trust funds are categorised according to the level of risks they take. The higher the risk, the greater the potential return.
- State **five** types of unit trusts according to the risk level, beginning from the lowest risk to the highest risk. [5]
- (Total:40 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

2. (a) List **four** prohibitions/restrictions that are stated in the Memorandum and Articles of Association of a private company. [4]
- (b) (i) Define "customer". [1]
(ii) State **four** basic factors of good customer service. [4]
- (c) (i) One of the principles under BNM/GP7 is preventing the misuse of information gained through the financial institution's operations.
Briefly explain this principle. [2]
(ii) Give **two** examples of how information can be misused. [3]
- (d) Under The Association of Banks in Malaysia rules, a bank may proceed to close a savings account which has been dormant for one year or more and has a balance of RM5 or less.
Describe the steps that a bank should take before closing a savings account. [6]
(Total:20 marks)
3. (a) (i) What is a banker's cheque? [3]
(ii) What are **four** main features of a banker's cheque? [2]
- (b) State **two** advantages of Electronic Funds Transfer Point of Sale to the following:
(i) Customer [2]
(ii) Business [2]
- (c) (i) Name **six** parties to a letter of credit. [6]
(ii) What is an irrevocable letter of credit? [5]
(Total:20 marks)
4. (a) Under trust receipt financing, state **three** risks that a bank is exposed to. [3]
- (b) Under what circumstances would a bank not accept a banker's acceptance that is drawn to finance a trade transaction between two parties? [7]
- (c) Article 13 of ICC Uniform Customs and Practice for Documentary Credits (UCP500) states that "banks must examine all documents stipulated in the credit with reasonable care, to ascertain whether or not they appear, on their face, to be in compliance with the terms and conditions of the credit..."
What are the options available to a beneficiary in the event that the documents submitted contain discrepancies and do not comply with the requirements as stipulated in the credit? [4]
- (d) Name **six** instruments that are traded in the interbank money market. [6]
(Total:20 marks)

5. (a) Under Section 16(1) of the Hire-Purchase Act 1967, state **four** conditions where an owner has the right to repossess goods. [4]
- (b) (i) State **three** advantages of a term life insurance. [3]
(ii) State **three** disadvantages of a term life insurance. [3]
- (c) (i) What is "offshore banking business" as defined in the Offshore Companies Act 1990? [2]
(ii) Name **three** categories of products or services offered by the offshore banks. [3]
- (d) Outline **five** mechanisms of letter of credit under the Al-Musyarakah principle. [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

- Candidates explained other functions of Bank Negara Malaysia (BNM), instead of explaining the given BNM functions required by the question.
- Candidates were confused between an introducer and a guarantor. They did not state that an introducer has to be an existing account holder and should be known to the bank.
- Candidates could not elaborate on the factors that determine the tenor of a loan. They were also unable to state the source of repayment of a loan.
- Candidates stated the risks of investing in unit trusts, instead of stating the types of unit trusts.
- Application of the correct concepts, reading carefully and understanding what was required in the questions would have improved the score of the majority of the candidates.

1. (a) (i) Acts as the Government's banker and advisor

Bank Negara Malaysia (BNM) acts as banker, fiscal agent and financial advisor to the Government. It is also banker to a number of statutory authorities and state governments. As the Government's banker and fiscal agent, BNM is responsible for managing the issue of Government securities. Funds from the collection of tax and dividend payments are also placed with BNM. This enables BNM to manage the country's liquidity condition.

As financial advisor to the Government, BNM manages the operations of Government accounts, public debt and is also responsible for the floatation of Government loans, both locally and overseas. It advises the Government on its loan programme, including the terms, timing and issuance of new types of securities.

- (ii) Acts as the banker of all banks

BNM maintains special accounts with banks, inspecting them regularly and when necessary, performing the function as a lender of last resort.

Under the Banking and Financial Institutions Act 1989 (BAFIA), banking institutions are required to hold licenses to carry out business. These licenses are issued by BNM. BNM must ensure that the minimum requirements under BAFIA are met.

Some of these requirements are:

- limit on individual ownership,
- maintenance of minimum capital funds, and
- maintenance of minimum risk-weighted capital ratio.

Banking institutions are also required to maintain a statutory reserve account with BNM. The amount in this account is determined mainly by the amount of deposits that the institution has collected from its customers and the amount it has borrowed from the money market.

BNM is also empowered to inspect licensed institutions and conduct investigations into their affairs to ensure sound and prudent conduct of operations to safeguard their depositors.

BNM stands ready to provide lender of last resort facilities to licensed institutions to help meet depositors' demands. This is a normal function of a central bank and is essential for the proper and smooth working of the financial system.

- (b) An introducer or referee is normally required for the opening of a current account. He or she would be someone known to the bank. This is to ensure that an undesirable or unscrupulous party who may use the account to carry out illegal or fraudulent activities does not open the account. Under the Code of Good Banking Practice, introduced by The Association of Banks in Malaysia, financial institutions have a duty to ensure that undesirable characters do not use their facilities to perpetuate fraud or to conduct criminal activities. Should the account be referred to court, the bank would have to show that due care had been taken to verify and check on the customer before allowing him/her to open the account.

- (c) (i) (aa) An ante-dated cheque is one that bears a date before the date of issue.

Example:

The cheque was issued on September 9, 2004 but dated August 15, 2004. Such a cheque, if presented would be honoured. However, we have to be careful that the cheque is not dated more than six months before as it would then be considered as stale. A stale cheque will not be honoured.

- (bb) A post-dated cheque is one, which bears a future date.

Example:

Ai Lyn draws a cheque on January 27, 2005 but dates the cheque February 18, 2005. Such a cheque, if presented before due date would not be honoured. It will be returned, and the payee is requested to represent the cheque on the aforesaid date. The Association of Banks in Malaysia has advised all banks not to accept post-dated cheques from customers, even if by the time the cheques are cleared they would no longer be post-dated.

- (ii) Hold day is the number of working days from the time the cheque is collected from the customer and sent for clearing until the time when funds are made available to the customer.

Give any one of the following examples:

- A customer deposits a local cheque on Monday, January 10, 2005. The hold day for local cheques is two working days. This cheque will be credited to the customer's account on Monday (the same day) but proceeds from this cheque will not be available to the customer to withdraw. The customer will only be allowed to use the funds from this cheque on Wednesday, January 12, 2005.
- A customer deposits an outstation cheque on Monday, January 10, 2005. The customer's account will not be credited on Monday. The cheque will be sent for collection through the clearing system. If the hold day on this cheque is eight working days, the cheque will be credited to the customer's account on Wednesday, January 19, 2005.

- (d) (i) Duration of a loan

The duration of a loan is important. The duration of the loan should commensurate with the nature of the proposal. The banker cannot realistically expect the loan to be repaid within a short period of time if the project undertaken is not going to generate enough income in the short term.

For example, financing an oil palm estate. There would be an initial two to three years' gestation period, during which there would be no production of palm oil kernels. Also, during the first few years income from production would have to be used to repay other more pressing commitments. The banker would have to be realistic and work within the limitations of that particular industry.

However, the banker should also bear in mind that the longer the duration of the loan, the greater the risk, or the chance of unforeseen circumstances occurring. There is always the chance that when production finally comes online, the product may be obsolete or that a better substitute has been found.

(ii) Source of repayment of a loan

Repayment is often considered as the first line of defence. The banker needs to know the source of income for the repayment.

- Present income

Is the present income adequate to service the loan repayment? For loans to individuals, this is important.

For example, housing loans are mainly serviced by salary income. Is the salary adequate to meet the monthly instalment? How steady is the borrower's income? Is the borrower dependent on overtime to service the loan? If so, how steady or regular is the income from the overtime?

- Future income

For business loans, repayment is usually from revenue to be generated by the 'project to be financed'. Is this revenue flow to be generated sufficient? Are the assumptions regarding revenue flow realistic? Are they achievable or too optimistic?

- Sale of assets

For speculative loans, repayment is usually from the sale of assets.

For example, share margin accounts. In this case, the banker has to be certain that the borrower will sell the assets and that the sale proceeds will be sufficient to repay the loan. That is why if the borrower will not sell, the banker would then exercise its right to sell before prices drop further, resulting in the proceeds being insufficient to settle the loan.

(e) Give any five types of unit trusts according to the risks arranged in the sequence from the lowest risk to the highest risk.

- Money market funds – investing in money market instruments
- Bonds funds – investing in Government stocks and bills.
- Balanced funds – investing in a mixture of bonds and stocks
- Income funds – investing in high dividend stocks
- Growth and income funds – investing in index-linked stocks
- Growth funds – investing in stocks of companies with better than average prospects for growth
- Aggressive growth funds – investing in companies or industries that are risky but with great potential to yield good returns.

PART B

Question 2

- Candidates explained the features of a private exempt company – what an M & A is, forms 24 and 49, Board Resolution and mandate – instead of listing the prohibitions/restrictions.
- Candidates could not define the term “customer” and they also stated the sub-factors instead of the basic factors of good customer service.
- Candidates wrote on conflict of interest and misuse of position, instead of explaining the prevention of misuse of information.
- Candidates were unable to state the steps a bank should take before closing a savings account.

2. (a) The four prohibitions/restrictions are:

- restricts the right to transfer its shares
- limits the number of members to not more than fifty
- prohibits any invitation to the public to subscribe for any shares in or debentures of the company
- prohibits any invitation to the public to deposit money with the company for fixed periods or payable at call, whether bearing or not bearing interest.

(b) (i) A customer is someone who brings his needs to you and it is for you to handle these needs profitably, both to him and to your bank.

The four basic factors of good customer service:

- Project a positive sales image
- Know your company and your competitors
- Know your products
- Understand your customer

(c) (i) Misuse of Information

In the course of his work, a bank staff may come across private and confidential information. This information may relate to the bank, banking industry or the bank's customers.

Bank staff are not allowed to make use of, copy or remove any information obtained in the course of business that would directly or indirectly benefit themselves or any other person.

The prohibition relating to the misuse of information obtained in the course of work applies not only while the staff is in employment with the bank, but also when the staff has resigned.

(ii) Examples:

- To take advantage of information received to trade in the stock market – one of your customers may be about to declare dividend and asks the bank to print special dividend warrants. With this knowledge, you buy shares in the company. Bank staff are reminded of the existing laws governing insider trading and must comply with them at all times.
- To leak information so that a third party may benefit – one of your customers has arranged for a loan with the bank to buy a piece of land for development. You leak this information to the seller of the land, who with this knowledge may refuse to negotiate on the price of the land.

- (d) A bank can give notice to its savings account holder of its intention to close the account, which has been dormant for one year or more and which has a balance of RM5 or less. Thereafter, the bank can close the account with a service charge of RM5 or with the outstanding balance in the account (whichever is lower).

Notice shall be given in the following manner:

- Banks shall enquire whether the account holder has any objection to the closure of the account.
- A second reminder is to be sent three months after the first reminder.
- If there is no response after the two reminders, the bank concerned may proceed to close the account with a service charge levy of RM5 or the outstanding balance in the account (whichever is lower).
- Should the account holder object to the closure of the account at any stage before the account is closed, the bank may at its discretion either:
 - Close the account and return the balance outstanding in the account deducting any related expenses such as postage charges, or
 - Allow the account to continue, upon such terms as it may impose.

Question 3

- Lack of understanding of the concepts tested. Candidates did not give detailed enough answers to warrant them being awarded higher marks.
- Candidates could not define a banker's cheque but instead gave the definition of a bill of exchange and requisites of a cheque. Candidates stated the components of a cheque, such as date and bearer, instead of stating the features of a banker's cheque.
- Candidates explained Automated Teller Machines and electronic banking, instead of explaining Electronic Funds Transfer Point of Sale. They also wrote on the types of letters of credit (LC), such as red clause LC, revolving LC and transferable LC, instead of giving the definition of an irrevocable LC.

3. (a) (i) A banker's cheque (or often referred to as a cashier's order) is a form of cheque drawn on a bank, bearing the authorised signature(s) of the bank's officer(s). It is therefore a cheque issued by the bank and is considered to be better than a cheque drawn by an ordinary customer.

Banker's cheques are only issued in Ringgit Malaysia for the remitting of funds to beneficiaries residing in the same town or area where the issuing bank is in operation.

A banker's cheque must not be drawn payable to bearer as such an instrument would be tantamount to issuing of bank notes, which is prohibited under the law.

- (ii) The four main features of a banker's cheque:
- Name of beneficiary
 - Amount
 - Crossing
 - Signatory

- (b) (i) Customer – Give any two of the following advantages:
- **Convenience and speed**
Convenience of not carrying cash and speed in transactions as compared to credit cards.
 - **Redundancy**
There is no need to carry or write cheques.
 - **Reduced transaction cost**
Banks encourage the use of debit cards, as it reduces the cost of processing large volume of cheques. However, there is a minimal transaction cost.
 - **Transaction trail**
The statement provides the time, location and amount of purchase, which is not possible with a cheque statement.
- (ii) Business – Give any two of the following advantages:
- **Speed**
This is the fastest transaction available to the retailer.
 - **Lower bank transaction charge**
Banks will charge the retailer a lower transaction cost as the retailer helps to reduce the banks' cost of processing cheques.
 - **Reduction in administration costs**
There will be lower cost in processing cash and cheques.
 - **Reduce/eliminate bad debts**
With real-time debits, the retailer will be able to reduce/eliminate bad debts.
- (c) (i) Give any six of the following parties:
- Applicant
 - Issuing bank
 - Advising bank
 - Beneficiary
 - Confirming bank
 - Negotiating bank
 - Reimbursing bank
- (ii) An irrevocable letter of credit (LC) is a definite undertaking by the issuing bank to pay a certain sum of money to the beneficiary provided he complies with the terms and conditions of the credit. This undertaking cannot be amended or cancelled unless with the consent of all parties concerned.
- An irrevocable LC may or may not be confirmed. A confirmed LC is one where the advising bank, at the request of the issuing bank, adds its confirmation. By adding its confirmation, the confirming bank gives an undertaking similar to that of the issuing bank. Any cancellation or amendments to a confirmed LC needs the additional consent of the confirming bank.

Question 4

- Candidates had poor knowledge of trust receipt financing.
- Candidates were unable to state the circumstances in which a bank would not accept a banker's acceptance (BA) drawn to finance a trade transaction between two parties.

4. (a) Risks to the bank under trust receipt financing:

- Although trust receipts provide a certain degree of protection to the bank, it cannot be considered a security.
- The bank will not be able to monitor the goods taken by the customer.
- The bank may not be able to identify the goods taken by the customer. For small articles or articles with no identification numbers or marks to differentiate the goods from others, the bank will not be able to prove its ownership. For bigger items, like motor vehicles or computers, the bank will be able to depend on the serial numbers to positively identify the goods.

(b) A bank will not accept a banker's acceptance (BA) that is drawn to finance a transaction where the two parties are either one of the following:

- Part of a legal entity

Example:

Between branches of the same organisations, or between the production department and sales department, sole proprietorships operated or owned by the same individual or where the proprietors are different individuals related to each other (parent/child or spouse).

- Partnerships in which the partners are the same individuals, or the majority of the partners are common, or one or more common partners own majority shares of the partnerships.

(c) Options available to the beneficiary:

- He can rectify the errors.
- The beneficiary can ask his buyer to accept the discrepancies and amend the credit accordingly.
- He can ask his banker to accept the documents and send them on a collection basis to the issuing bank.
- He can ask his bank to negotiate the documents "under reserve" or "against indemnity".

(d) Six instruments traded in the interbank money market:

- Negotiable instruments of deposits
- Banker's acceptance
- Malaysian Government securities
- Bank Negara Malaysia Certificates
- Cagamas Bonds
- Private Debt Securities

Question 5

- Candidates were unable to state the conditions but instead related their answers to Section 16(1A) and the Fifth Schedule.
- Candidates could not state the advantages and disadvantages of a term life insurance, as they were unable to differentiate between the various types of life insurance. Some candidates gave answers related to “whole life” and “endowment” insurance.
- Candidates were unable to define the term “offshore banking business”.
- Candidates had poor knowledge of Islamic banking especially on issues relating to Islamic LCs. Instead of stating the mechanisms of an LC under the Al-Musyarakah principle, candidates gave answers related to the Al-Wakalah and Al-Murabahah principles.

5. (a) Four conditions where an owner has the right to repossess goods:
- There have been two successive defaults of payment or default in respect of the last payment.
 - The owner has served, on the hirer, the form set out in the fourth schedule.
 - The period fixed by the notice has not expired (The period shall not be less than 21 days.)
 - The owner must serve the hirer a “Notice of Intention to Take Possession”, not earlier than 14 days after the service of the fourth schedule. A copy of this notice must be sent to the Controller of Hire Purchase.
- (b) (i) The benefits of term life insurance are:
- Premiums are generally lower than permanent insurance.
 - It allows you to buy a higher coverage especially at a younger age when the need for protection is greatest.
 - It is good for covering certain financial obligations/liabilities that will disappear in time, for example, a bank loan.
- (ii) The disadvantages of term life insurance:
- The policy provides no benefits, if the assured survives the protection period.
 - The policy has no cash value.
 - The premium becomes prohibitively expensive, as the assured gets older.
- (c) (i) Offshore banking business is defined as:
“The business of receiving deposits on current account, deposit account, savings account or any other account as may be specified by the Central Bank, and the provision of credit facilities, in any currency other than the Malaysian currency.”
- (ii) Give any three of the following categories of products or services:
- Deposit-taking
Current accounts, savings accounts, term deposits, negotiable certificates of deposits.

- Foreign exchange
Buying and selling of foreign exchange both on spot and forward basis.
- Swaps
Both interest rates and currency swaps.
- Syndicated loans
Both participating in syndicated loans and managing of such loans.
- Fund management
Managing of funds or providing fund management advisory services to high net worth individuals.
- Stock broking
Handles the sales and purchase of stocks and shares in exchanges world-wide. Also provides the related nominee services.
- Bonds
Trading in bonds and other financial instruments.
- Credit facilities
Providing credit facilities to both residents and non-residents.
- Providing factoring facilities.
- Providing hire-purchase facilities.
- Providing leasing facilities.
- Trustee services
Providing trustee services to high net worth individuals.
- Safe custody
Provides safe custody services either directly or at other centres through its network.

(d) Five mechanisms of letter of credit under Al-Musyarakah principle:

- The customer informs the bank of his letter of credit requirement and negotiates the terms of Al-Musyarakah financing.
- The customer deposits his share of the financing with the bank. The bank accepts the deposit under the Al-Wadiah Yad Dhamanah principle.
- When the letter of credit is negotiated, the bank pays the negotiating bank from the customer's deposit and the bank's share of financing. The documents are then released to the customer.
- The customer takes possession of the goods and disposes of them in the manner agreed upon.
- The bank and the customer share in the profit from the venture as provided for in their agreement.