

CF02

# Operations of Financial Institutions

11 OCTOBER 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) (i) State **five** main activities of merchant banks. [5]
- (ii) State **five** rights of a banker in a banker-customer relationship. [5]
- (b) (i) What is a partnership? [2]
- (ii) In a mandate, why is it necessary to get the partners to admit several liabilities? [3]
- (iii) In the event a partner retires or dies, explain the legal liability of the other partners and how a banker would handle the partnership account. [5]
- (c) (i) Explain how a banker's cheque can be encashed over the counter. [4]
- (ii) State **one** advantage of using telegraphic transfers. [2]
- (iii) Test Key is a system of authentication developed for use in the banking industry.
- Briefly explain the system of authentication. [4]

- (d) The following are ABC Sdn Bhd's (ABC) financial statements for the year ended 31 December 2004:

**BALANCE SHEET AS AT 31 DECEMBER 2004**

Item	RM'000
<b>Current assets</b>	
Cash at bank	390
Quoted investments	380
Accounts receivables	1,460
Stock	2,110
<b>Total current assets</b>	<b>4,340</b>
<b>Non-current assets</b>	
Long-term investments	400
Plant and equipment	2,600
Other assets	100
<b>Total non-current assets</b>	<b>3,100</b>
<b>Total assets</b>	<b>7,440</b>
<b>Current liabilities</b>	
Accounts payables	1,040
Other payables	620
Accrued expenses	100
<b>Total current liabilities</b>	<b>1,760</b>
<b>Non-current liabilities</b>	<b>1,900</b>
<b>Total liabilities</b>	<b>3,660</b>
<b>Net assets</b>	<b>3,780</b>
<b>Shareholders' equity</b>	
Paid-up capital	1,800
Share premium	502
Retained profits	1,478
<b>Total shareholders' equity</b>	<b>3,780</b>

**PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED  
31 DECEMBER 2004**

Item	RM'000
Sales	10,320
Cost of goods sold	(7,719)
Gross profit	2,601
Selling expenses	(1,030)
Administrative expenses	(567)
Financial expenses (interest)	(252)
Total expenses	(1,849)
Operating profit before tax	752
Income tax expense	(224)
<b>Net profit after tax</b>	<b>528</b>

Calculate the following ratios for ABC using the given information:

- (i) Net profit margin [2]
- (ii) Quick or acid test ratio [2]
- (iii) Debt ratio [2]
- (iv) Stock turnover ratio [2]
- (v) Average collection period [2]

(Total:40 marks)

## PART B

### ANSWER THREE (3) QUESTIONS ONLY

2. (a) How does a banker discover the needs of his customer? [6]
- (b) State any **four** principles under BNM/GP7 in relation to the code of conduct for bankers. [4]
- (c) Mr A placed a fixed deposit of RM350,000 with Bank ZZ on 25 January 2005 for 15 months at an interest rate of 4.5% per annum. Interest will be paid on 25 July 2005, 25 January 2006 and 25 April 2006.

Duration	No. of days
25 January 2005 to 25 July 2005	182 days
26 July 2005 to 25 January 2006	184 days
26 January 2006 to 25 April 2006	90 days

Calculate the interest payable for each of the three maturity dates. [6]

- (d) (i) How is a cheque crossed and what are the words to be written on it? [2]
- (ii) Name **two** persons authorised to cross a cheque. [2]  
(Total:20 marks)
3. (a) Name **five** facilities available in telephone or screenphone banking. [5]
- (b) One of the 5Cs in credit evaluation is "Character".  
Briefly describe **four** factors which contribute towards the character of a borrower. [8]
- (c) (i) State **three** general features of bank guarantees. [3]
- (ii) What are **two** salient features of a shipping guarantee? [4]  
(Total:20 marks)
4. (a) Briefly explain the negotiation of a Letter of Credit (LC), beginning from receipt of the LC by the supplier to payment by the buyer. [5]
- (b) Briefly describe the money market. [5]
- (c) Elaborate on the following forms of leasing:
- (i) Financial lease [2]
- (ii) Operational lease [3]

- (d) Mr YY intends to buy a car under hire-purchase based on the following terms:

Cost of the car	RM100,000
Deposit	RM20,000
Loan amount	RM80,000
Interest rate	6.0% per annum
Loan period	3 years

Calculate the monthly hire-purchase instalment. [2]

- (e) XYZ Sdn Bhd obtained a leasing facility based on the following terms:

Asset cost	RM100,000
Lease financing	RM100,000
Lease period	4 years
Residual value	RM20,000
Interest rate	11% per annum on capital repayment and 13% per annum of the residual value

Calculate the monthly lease rental based on the residual value lease method. [3]  
(Total:20 marks)

5. (a) What are **five** main risks covered by life insurance policies? [5]
- (b) A unit trust is a trust established by a trust deed.
- (i) Who are **three** parties to a trust deed? [3]
- (ii) Briefly explain the role of each of the three parties stated in (b)(i) above. [3]
- (c) State **five** incentives offered to attract foreign companies to set-up businesses at the International Offshore Financial Centre in Labuan. [5]
- (d) Under the Islamic banking system, housing loans are granted under the Al-Bai Bithaman Ajil principle.

Briefly explain how this principle works. [4]  
(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 were not able to state the main activities of the merchant banks
- Candidates stated the banker's duties, instead of stating the banker's rights.
- Candidates had poor understanding of the concept of partnership and were unable to explain the legal liability of partners.
- They could not explain the ways a banker's cheque could be encashed over the counter.
- Poor elaboration on the advantage of using telegraphic transfers. They were unable to explain the system of authentication.
- Candidates were unable to apply the correct formula in the computation of financial ratios.
- Application of the correct concepts, reading carefully and understanding what was required of the questions would have improved the score of a number of candidates.

1. (a) (i) The main activities of merchant banks are:
- deposits taking and money market operations;
  - medium-term lending;
  - loan syndication and acting as loan managers;
  - corporate financial services, for example, advising corporate clients on such matters as listing on the Kuala Lumpur Stock Exchange, rights issues, mergers, acquisitions; and
  - fund management.
- (ii) The banker's rights are:
- to charge commission,
  - to charge interest,
  - to set-off,
  - to be repaid on demand, and
  - to be indemnified.
- (b) (i) A partnership is the relationship between two or more persons carrying on a business in common with a view of profit. Unlike a limited company, a partnership is not a separate legal entity distinct from the partners.
- (ii) A partnership can sue or be sued in the partnership's (firm's) name. Partners have unlimited liability for the debt of the partnership. However, the liabilities of the partners are joint. Hence, in the mandate, it is necessary to get the partners to admit several liabilities. The reasons for this are:
- Should the partnership become bankrupt, the bank can claim from the partnership and from the partners individually;
  - A credit balance in a partner's personal account can be set-off against a debt in the partnership account.

- (iii) When a partner retires or dies, and the partnership is to continue with the remaining partners, a new mandate form must be signed by all the remaining partners.

If the account is in credit, it may be allowed to continue. However, if the account is in debit, the retiring or deceased partner's estate remains liable for the debt. Hence, it is advisable to "freeze" the account and get the remaining partners to operate a new account.

This is because under the rule in Clayton's Case, any subsequent credits to the account will be used to set-off earlier debits.

The rule in Clayton's Case (*Devaynes v Noble*) states that in a current account, payments are appropriated to the debit items in date order, unless the customer (or the bank, if the customer does not take steps to appropriate particular credits against particular debits.

- (c) (i) Banker's cheques are presented over the counter for encashment. The banker's cheques will usually be crossed "Account Payee". Sometimes, the applicant will request that the crossing be cancelled. This request must come from the applicant, of the banker's cheque, who is the bank's customer. The beneficiary cannot request for the crossing to be cancelled.

Before payment is made to the beneficiary, he has to sign at the back of the cheque to indicate that he has received payment. It also, is the practice in Malaysia, to request the beneficiary to produce his identity card (IC) to identify himself. His IC number is then written at the back of the cheque.

- (ii) Telegraphic transfers provide the fastest mode for remitting funds to a beneficiary who may be residing in another town in the country or overseas. This is because messages are sent and received on the same day (with allowances for time difference in other parts of the world).
- (iii) Messages for the fund transfer will be sent by telex, fax, Society for Worldwide Interbank Financial Telecommunications (S.W.I.F.T.).

As messages are sent by telex or S.W.I.F.T., they must be authenticated as they would not carry with them signatures which can be verified. The system of authentication developed for use in the banking industry is the Test Key.

The Test Key is a secret coding system whereby banks can communicate with each other and add their "signature" to the message. This signature is a number (usually a numeric number with or without alphabetic letters. This number is made up of several secret numbers.

- (d) (i) Net profit margin

$$= \frac{\text{Net profit after tax}}{\text{Sales}} \times 100$$

$$= \frac{528}{10,320} \times 100$$

$$= 5.12\%$$

- (ii) Quick or acid test ratio
- $$= \frac{\text{Current assets} - \text{Stock}}{\text{Current liabilities}}$$
- $$= \frac{4,340 - 2,110}{1,760}$$
- $$= 1.27 \text{ times}$$
- (iii) Debt ratio
- $$= \frac{\text{Total liabilities}}{\text{Total assets}}$$
- $$= \frac{3,660}{7,440}$$
- $$= 0.49 \text{ times}$$
- (iv) Stock turnover ratio
- $$= \frac{\text{Cost of goods sold}}{\text{Inventory}}$$
- $$= \frac{7,719}{2,110}$$
- $$= 3.66 \text{ times}$$
- (v) Average collection period
- $$= \frac{\text{Accounts receivable} \times 365}{\text{Sales}}$$
- $$= \frac{1,460 \times 365}{10,320}$$
- $$= 52 \text{ days}$$

## PART B

### Question 2

- Candidates were unable to elaborate on the ways bankers discover customers' needs.

2. (a) - Questioning

During the interview process, get your customer to "open up" by asking him questions. Encourage him to talk to you so that you can discover his wants and needs.

- Listening

Give the customer a chance to talk and listen to what he is saying. Do not bombard him with questions without giving him a chance to answer. By asking him questions and then pausing to let him talk, you would give him the opportunity to tell you what he wants or needs.

It is always useful to paraphrase or summarise what the customer had said. This way you can get him to confirm what he has said.

- Observation

Observe the customer and the surroundings when talking to him. If you are at his place of work, you will be able to obtain clues to his character. Observe his facial expressions for non-verbal behaviour.

(b) Give any four of the following principles:

- Avoid conflict of interest
- Avoid misuse of position
- Prevent misuse of information gained through the financial institution's operations
- Ensure completeness and accuracy of relevant records
- Ensure confidentiality of communications and transactions between the financial institution and its customer
- Ensure fair and equitable treatment to all customers

(c) Interest on July 25, 2005

$$= \frac{\text{RM}350,000 \times 4.5 \times 182}{365 \times 100}$$

$$= \text{RM}7,853.42$$

Interest on January 25, 2006

$$= \frac{\text{RM}350,000 \times 4.5 \times 184}{365 \times 100}$$

$$= \text{RM}7,939.73$$

Interest on April 25, 2006

$$= \frac{\text{RM}350,000 \times 4.5 \times 90}{365 \times 100}$$

$$= \text{RM}3,883.56$$

- (d) (i) A cheque is said to be crossed when it bears across its face two parallel transverse lines with or without the following:
- The words “AND COMPANY” or “& CO”;
  - The words “Not Negotiable”; or
  - The name of the banker with or without the words “Not Negotiable”.
- (ii) Name any two of the following persons:
- The drawer of the cheque;
  - The holder of the cheque, either general or specific. (If the cheque is crossed generally, the holder may cross it specifically);
  - The banker may cross it specifically to another banker for collection; or
  - Where the cheque is crossed generally, the banker may cross it specifically to himself.

### Question 3

- Candidates wrote on Automated Teller Machine services instead of telephone and screenphone banking.
- They were not able to describe the factors contributing towards the borrower’s character; instead candidates related their answers to the borrowers’ capability.
- Candidates stated the types of bank guarantees, instead of giving answers in relation to the question.
- Answers given by candidates were brief and not proportionate to the allocated marks.
- Many candidates lacked an understanding of the concepts. The majority of them did not know how to write the answers appropriate to the number of marks given for the question and as such were not able to score better marks.

3. (a) Name any five of the following facilities:

- (i) Account inquiry
- (ii) Pay bills
- (iii) Managing funds
- (iv) Message service
- (v) Monitoring usage
- (vi) Funds transfer

- (b) Give any four of the following factors that contribute towards the character of a borrower:

- (i) Honesty

When a person is honest, he will try his best to pay his debt and will not try to run away from his responsibility.

- (ii) Reasonableness

When a reasonable person is faced with having to pay his debt, he will be reasonable in meeting his responsibility and not be unreasonable as to avoid doing so, or claim that he is not liable to pay.

- (iii) Virtuous

If a person possess these virtues, namely, humbleness, fairness, patience and temperance, he is most likely to value his character and try to uphold his name by paying his debts.

(iv) Responsibility

A responsible person will face up to his responsibility and not run away from it.

(v) Correct attitude

A person with the correct attitude towards his debts will try his best to honour them when they are due.

(c) (i) All guarantees should specifically state the following three general features:

- The sum guaranteed,
- The period of the guarantee, and
- The name of the beneficiary.

(ii) The two salient features of a shipping guarantee are:

- It does not specify the total liability of the bank.

There is no amount stated in the guarantee as in the normal guarantee. Legally, there is, therefore, no limit to the amount that the bank would be liable.

- It does not specify an expiry date.

Unlike the normal bank guarantee, there is no expiry date in the shipping guarantee. The bank's liability is therefore indefinite or until such time the bill of lading is presented and the shipping guarantee returned for cancellation.

**Question 4**

- Candidates showed poor understanding of letter of credits.
- They were unable to describe the money market and forms of leasing. They were also unable to apply the correct formula in the computation of lease rental.

4. (a) Negotiation of Letter of Credit (LC), from receipt of LC by the supplier to payment by buyer:

- Upon receipt of the LC, the supplier will make arrangements to ship the machine to the buyer.
- He has to ensure that all the terms stipulated in the LC are complied with.
- Once, he has shipped the machine to the buyer, he will present all the necessary documents to his banker.
- His banker will forward all the documents to the buyer's banker and claim reimbursement from the reimbursing bank.
- The buyer's banker will present the documents to the buyer and get payment from the buyer.

- (b) The money market is the inter-bank money market where banks and other financial institutions lend or borrow funds from each other.
- These lendings and borrowings are not restricted to Ringgit deposits but can also be in other foreign currencies.
  - The borrowers and lenders are also not restricted to banks or institutions resident in Malaysia.
  - They may be in other locations such as Singapore, Tokyo or London.
- (c) (i) Financial lease
- In a financial lease, the lessor acts as the financier. Payments by the lessee over the lease period cover the full cost of the asset plus interest to the lessor for his investment.
- (ii) Operational lease
- An operational lease is usually for a short period of time and does not cover the useful life of the asset. The rental payments by the lessee do not provide for the lessor to fully recover the cost of the asset. There is usually a “residual value” at the end of the lease period.
- (d) Monthly hire-purchase instalment
- $$= \frac{\text{RM}80,000 + (\text{RM}80,000 \times 6\% \times 3)}{3 \times 12}$$
- $$= \frac{\text{RM}80,000 + \text{RM}14,400}{36}$$
- $$= \text{RM } 2,622.22$$
- (e) Monthly lease rental
- $$= \frac{\text{RM}80,000 + (\text{RM}80,000 \times 11\% \times 4) + (\text{RM}20,000 \times 13\% \times 4)}{48}$$
- $$= \text{RM } 2,616.67$$

#### Question 5

- Candidates wrote on general insurance, instead of life insurance.
- They were unable to state the roles of the parties to a trust deed.
- Generally, failure to understand the concepts and principles were the major factors that prevented the candidates from doing well.

5. (a) The five main risks covered by life insurance policies are as follows:
- Premature death,
  - Permanent disability,
  - Temporary disability,
  - Financial guarantee, and
  - Retirement benefits.

- (b) (i) The three parties to a trust deed are as follows:
- The managers,
  - The trustees, and
  - The beneficiaries.
- (ii) The role of the three parties to a trust deed are as follows:
- The managers  
They are the promoters of the fund and undertake certain obligations in the trust deed.
  - The trustees  
They are responsible for holding the trust assets.
  - The beneficiaries  
They are the unit holders who “own” the trust assets.
- (c) Give any five of the following incentives:
- Minimum tax
  - Abatement of tax for professional services
  - Abatement of tax for business relating to or letting of a qualified asset
  - Abatement of tax for employment
  - Tax exemption
  - Exemption from stamp duty
  - Secrecy and confidentiality
  - Exchange control
  - Competitive pricing
  - World-class teleport
- (d) Under the Al-Bai Bithaman Ajil principle:
- The customer will identify the house he wants to buy;
  - The bank will purchase the house that the customer wants to buy;
  - The bank will sell the house at an “agreed price”; and
  - The customer will pay the “agreed price” by instalment.