CF02

Operations of Financial Institutions

7 OCTOBER 2003

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 question [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) Ahmad and Ishak decided to form a partnership firm to undertake renovation contracts for residential houses. They went to a bank to open a current account in the name of the partnership. Among the documents that the bank requested them to sign was a document to admit several liabilities.

Why did the bank request for this document to be executed? [6]

(b) Banking has become a very competitive industry. Therefore, it is important that the banker gives his customers good service. To do so, the banker must know the needs of his customers.

How does a banker discover the needs of his customers? [6]

(c) What are the **three** conditions that must be met before an instrument is deemed "negotiable"? [6]

(d) What are **four** advantages of credit cards to the card holders? [8]

(e) In Malaysia, we have two banking systems, that is, the conventional banking system and the Islamic banking system.

What are **two** differences between these two systems? [6]

(f) State **eight** permitted investments of a unit trust. [8]

(Total:40 marks)

PART B

ANSWER THREE (3) QUESTIONS ONLY

2. "Character", "Condition" and "Collateral" are three important Cs under the 5Cs of credit.

(a) Define what these three Cs are. [6]

(b) What are the factors to consider when evaluating these three Cs? [14]

(Total:20 marks)

3. (a) What are the responsibilities of both the exporter and importer in any **two** of the following Incoterms?

(i) Ex Works, Sejingkat Warehouse (EXW) [4]

(ii) Free on Board, Port Klang (FOB) [4]

(iii) Delivered Ex Quay (Duty Paid), Bintulu Port (DEQ) [4]

(iv) Cost and Freight, Kinabalu Port (CFR) [4]

(b) Briefly elaborate on any **three** basic principles of insurance. [12]

(Total:20 marks)

4. (a) What are the main functions of Bank Negara Malaysia as the central bank of Malaysia? [6]

(b) In relation to the currency futures market, explain the following:

(i) A call option [2]

(ii) A put option [2]

(iii) A premium [2]

(c) One of your customers bought a demand draft for RM3,000 from you on 2 June 2002. The draft was presented through the clearing on 3 January 2003.

(i) Would you honour the draft? Explain why. [4]

(ii) Would your action be different, if the draft had been presented on 23 December 2002 before you closed your books? Explain why. [4]

(Total:20 marks)

5. (a) Briefly explain **four** types of negotiable instruments in the Malaysian money market. [8]

(b) (i) State **six** principles that broadly govern the ethical behaviour of a banker. [9]

(ii) Give **two** examples of unethical behaviour by bankers or financial institutions. [3]

(Total:20 marks)

- END OF QUESTION PAPER -

OUTLINE ANSWERS

PART A

Question 1

Most candidates performed poorly, particularly in parts (a), (c) and (f). For part (f), instead of stating the permitted investments of a unit trust, some candidates wrote on the benefits, purpose and advantages of investing in a unit trust.

Candidates are advised to answer the questions accordingly.

As this exam paper has a compulsory question, candidates are advised to study all the topics in the syllabus.

1. (a) The bank requested for the document to be executed because:

- Partners in a partnership have unlimited liability.
- Liabilities are joint.
- It is necessary to get partners to admit several liabilities so that bank can claim from both the partnership and from the individual partners.
- A credit balance in a partner's account can be set-off against a debt in the partnership account.

(b) A banker can discover his customers' needs by:

- Questioning – encouraging the customer to talk to discover his wants and needs
- Listening – listen to what the customer is saying
- Observation – observe the customer, his surroundings and his facial expression for non verbal behaviour

(c) The three conditions that must be met before an instrument is deemed "negotiable" are:

- Transfer of title by mere delivery or by indorsement
- The holder of the instrument can acquire absolute legal title by taking the instrument:
  - ❑ in good faith
  - ❑ for value
  - ❑ without notice of defect in title
- The transferee gains full title and can sue in his own name.

(d) Four advantages of credit cards:

- A means of obtaining credit
- Interest free credit is given from a week to 4 weeks
- Easier to use to make payment than cheques
- Can withdraw cash over the counter or through Automated Teller Machines (ATMs)

(e) The differences between Islamic banking and conventional banking are:

- With regard to lending of funds (term loans and bills discounted), banks under the conventional banking system charge their customers interest. However, under the Islamic banking system, banks finance their customers through equity participation, that is, the bank will purchase and then resell the assets to the customer. Therefore, an Islamic bank's income is from the share of profits generated. If a loss is incurred, the bank will bear the full loss.

- With regard to deposits, under the conventional banking system, deposits are paid interest. Under the Islamic system, deposits are not entitled to any income. However, at their discretion, Islamic banks may give the depositors a share of the profits generated.

(f) The following are permitted trust fund investments:

- Securities of companies listed on the Kuala Lumpur Stock Exchange (KLSE).
- Units of unrelated property trust funds listed on the KLSE.
- Securities listed on a foreign stock exchange (up to 10% of the net asset value of the fund. Prior approval of the Securities Commission needed).
- Unlisted securities that have been approved by the Securities Commission for listing and quotation on the KLSE.
- Malaysian Government Securities, Bank Negara Malaysia Certificates and Government Investment Certificates.
- Malaysian currency holdings, Ringgit deposits (including NCDs) in commercial banks, finance companies, merchant banks and Bank Islam.
- Cagamas bonds, bankers' acceptances, unlisted loan stocks and corporate bonds traded in the money market and/either bank-guaranteed or carrying at least BBB rating by Rating Agency of Malaysia Berhad (RAM) and private debt securities that have an equivalent rating by RAM.
- Other investments as may be approved by the Securities Commission.

PART B

Question 2

Most candidates could define "Character" and "Collateral" but failed to define "Condition".

Candidates also failed to elaborate part (b) of question.

The answers the candidates give should commensurate with the marks allotted.

2. (a)

- Character – the quality in a borrower that makes him want to pay or intend to pay when a debt is due.
- Condition – the environment under which the borrower is operating.
- Collateral – assets that may be charged or pledged as security for loans.

(b) Factors to consider:

- Character – honesty, reasonableness, responsibility, correct attitude, virtuous
- Condition – economic condition, industry outlook, government policy
- Collateral – How easy is it to place a charge/ownership claim on the asset? Is the asset removable? How stable is the asset's value? How easy is it to dispose of the collateral?

Question 3
Very few candidates attempted this question. Part (b) of the question was generally well answered.

3. (a) Choose any **three** of the following:

	Exporter	**Importer**
(i) Ex Works	Makes the goods available at Sejingkat Warehouse suitably packed for pickup by importer. An invoice will be also given.	Takes delivery of goods from Sejingkat Warehouse. Has to make arrangements for transport, insurance, import/export licences at own cost.
(ii) Free on Board, Port Klang	Delivers goods to quayside on nominated shipping line at Port Klang. Advises importer of delivery and supplies invoice and proof of delivery. Liability ceases once goods have crossed ship's rail and loaded on board. Must make arrangement for export licence, complete customs formalities and pay cost including duties and taxes.	Makes arrangements with shipping company to transport goods to destination. Does not arrange for export licence. Pays taxes, duties and insurance. Not responsible until the goods have crossed the ship's rail at the port.
(iii) Delivery Ex Quay (Duty Paid) Bintulu Port	Delivers goods on the quay at Bintulu Port. Arranges for export and import licences, customs formalities and pays cost including duties and taxes.	Accepts delivery of goods at Bintulu Port. Liability for goods commences from the time goods are placed at his disposal at the quay.
(iv) Cost & Freight, Kinabalu Port	Arranges and pays for transportation of goods to Kinabalu Port. Arranges and pays for export licence, duties and taxes. Advises importer of details of voyage, supplies commercial invoices and proof of delivery. Liability ceases when goods have crossed the ship's rail.	Arranges for import licence, duties and taxes. Arranges and pays for insurance when goods have crossed ship's rail.

(b) To elaborate on any **three** of the principles:

- Insurable interest:
  - ❑ person taking out the insurance policy must have insurable interest in the subject matter of insurance.
  - ❑ arises when a person benefits from the safety or suffers a loss in the subject matter.
  - ❑ examples are: owners of property, a person on his own life, his spouse's life, his children's lives, a corporate on the life of its officer.
- Utmost Good Faith:
  - ❑ the person proposing to take up the insurance must provide the insurer with all material facts that may affect the insurer's decision to accept or decline the proposal.
  - ❑ a material fact is a fact that may influence a prudent insurer in deciding whether or not to accept a risk.
  - ❑ it is the duty of the proposer to fully disclose all material facts, whether asked or not.
  - ❑ When the insured fails to disclose a material fact, the breach of utmost good faith renders the policy violable.

- Indemnity means the insurer will be compensated for losses suffered. He cannot benefit from his suffering.

  The two subsidiary principles are:

  - Contribution – when a person has two or more policies covering the same subject matter, he cannot claim from both policies and thus make a profit. Each insurer will bear a rateable share of the loss.

  - Subrogation – the insurer, when he has indemnified the insured, can exercise the insured's right to claim from a third party in respect of the loss.

- Proximate Cause means that the loss must be caused by the insured peril. When a loss is attributed to two or more causes, the insured must prove that the loss is caused by the insured and not by the uninsured peril.

  - Insured perils are expressly covered by a policy.
  - Uninsured perils are not mentioned in the policy.
  - Excluded perils are expressly excluded in the policy.

Question 4

Most candidates stated only 1 or 2 functions of Bank Negara Malaysia, which is inadequate, for the marks allotted for the question. Some candidates lost marks because they used wrong terms in their explanation.

Many candidates failed to answer part (b) of the question. Some candidates gave wrong answers and some of them did not elaborate their answers.

Many candidates gave wrong answers for part (c) because they failed to notice the expiry date of the demand draft.

4. (a) As the central bank, Bank Negara Malaysia:

- issues and manages the local currency to safeguard its value
- acts as the Government's banker and advisor
- regulates liquidity in the financial markets so as to promote a stable monetary and financial structure
- acts as the banker to all banks

(b) (i) A call option gives the owner the right, but no obligation to buy a particular currency or commodity at a specified price during a fixed period of time.

(ii) A put option gives the owner the right, but no obligation, to sell a particular currency or commodity at a specified price during a fixed period of time.

(iii) The premium is the price of the option. In order to have the right to buy or sell the currency or commodity, the holder of the option must pay a price, called the premium, to the party that sells (writes) the option.

(c) (i) I would not honour the demand draft because it has been presented more than six months after the date of the draft was issued. A demand draft becomes stale six months after the date of issue.

(ii) No, my action would not be different if the draft had been presented on 23 December 2002 instead of 3 January 2003. On 23 December 2002, the draft would still have been presented more than six months after the date of issue and is therefore considered stale. The closing of the bank's books at the end of the year has nothing to do with the fact that the draft is stale.

Question 5

Many candidates lost marks because they only listed the four types of negotiable instruments, whereas the question required them to give a brief explanation.

Part (b) was generally well answered except that some candidates were confused between "unethical" behaviour and "unlawful" behaviour.

5. (a)

- Short-term Negotiable Certificate of Deposits (SNCDs)

  SNCDs have maturity dates of between 90-364 days from the date of issue. Upon maturity, the issuer will pay interest at the fixed coupon rate.

- Long-term Negotiable Certificate of Deposits (LNCDs)

  The maturity dates are not earlier than 12 calendar months and not later than 60 calendar months from the date of issue. The issuer is required to pay interest on two interest dates in a year. The two interest dates are 6 months apart. The interest periods shall be 6 calendar months with the exception of the first interest period, which can have a duration of less than 6 calendar months.

- Zero-coupon Negotiable Certificate of Deposits (ZNCDs)

  The maturity date is not earlier than 3 calendar months and not later than 60 calendar months from the date of issue. There is no coupon interest rate.

- Floating Rate Negotiable Certificate of Deposits (FRNCDs)

  The maturity date is not less than 12 months if the interest rate is determined every 3 months or not less than 24 months if the interest rate is determined every 6 months and in multiple of 3 months up to a maximum of 60 months. The interest rate is determined at 3- or 6-month intervals after the issue date, on the basis of a determined coupon rate in percent per annum in accordance with variations of the relevant Kuala Lumpur Inter-Bank Offer Rate (KLIBOR).

(b) (i) The six principles that broadly govern the ethical behaviour of a banker are:

- to avoid conflict of interest
- to avoid misuse of position
- to prevent misuse of information gained through the financial institution's operations
- to ensure completeness and accuracy of records
- to ensure confidentiality of communications and transactions between the financial institution and its customers
- to ensure fair and equitable treatment of all customers

(ii) Choose any **two** of the following examples of unethical behaviour:

- Errors in statement not corrected unless questioned
- Changes in products and services which reduce their value are not revealed unless questioned
- Defaulters punished with minimal possible warning
- Unnecessarily heavy use of jargon to mislead the customer
- High usage of 'small print' for important matters