PAN AFRICA CHRISTIAN UNIVERSITY

END OF SEMESTER EXAMINATION FOR THE DEGREE OF

MAY-AUGUST 2021

CAMPUS: ROYSAMBU

DEPARTMENT: BUSINESS

COURSE CODE: CFN 402

COURSE TITLE: FINANCIAL RISK MANAGEMENT

EXAM DATE:

TIME:

INSTRUCTIONS

- This examination script consists of **SIX (6)** questions.
- Answer question **ONE** and ANY other **THREE** Questions.
- Read all questions carefully before attempting.
- Write your **student number** on the answer booklet provided.

Question One (compulsory) : ANSWER ALL QUESTIONS (10 marks)

9. By entering into international business, a firm expects an improvement in

A. Marketing.

B. All spheres of marketing, operation and finance simultaneously.

C. Any or all spheres of marketing, operation and finance.

D. Finance only

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1. **An American put option allows the holder to**:
   a) buy the underlying asset at the strike price on or before the expiration date.
   b) sell the underlying asset at the strike price on or before the expiration date.

c) benefit from a stock price decrease with less risk than short selling the stock.
d) b and c.
e) a and c.

2. Buyers of put options anticipate the value of the underlying asset will __________ and sellers of call options anticipate the value of the underlying asset will:

a) increase; increase
b) decrease; increase
c) increase; decrease
d) decrease; decrease
e) cannot tell without further information

3. The type of SWAPS in which payment of interest are exchanged by two counter parties for floating payment of interest are called:

a) Float-fixed swaps
b) Interest rate swaps
c) Indexed swaps
d) Counter party swaps

4. Proper risk management involves a three stage process. Which one of the following is one of those stages:

a) Identify where the risk lies
b) Select the right tools to execute strategy
c) Design an appropriate strategy for managing risk
d) All of the above

5. Which of the following is true?

a) Both forward and futures contracts are traded on exchanges
b) Forward contracts are traded on exchanges but futures contract are not
c) Futures contracts are traded on exchanges but forwards contract are not
d) Nether futures nor forward contracts are traded on the exchanges

6. Which of the following is NOT true

a) Futures contracts nearly always last longer than forward contracts
b) Futures contracts are standardized; forward contracts are not.

c) Delivery for final cash settlement usually takes place with forward contracts; the same is not true of futures contracts.

d) Forward contracts usually have one specified delivery date; futures contract often have a range of delivery dates..

7. In a forward contract the party who commits to sell an asset at a specified date in the future takes a(n) position, and the party who commits to buy an asset at a specified date in the future takes a(n) position.

a) risk seeking; risk averse

b) open; closed

c) closed; open

d) short; long

e) long; short

8. **An investment strategy that requires no outlay of an investor's own money to generate positive riskless profits is:**

   a) Arbitrage

   b) risk seeking

   c) portfolio replicating

   d) beta adjusting

   e) minimum variance

9. **A call option is in-the-money if the**:

   a) strike price of the option is less than the current price of the underlying asset

   b) strike price of the option is greater than the current price of the underlying asset

   c) strike price of the option is equal to the price of the underlying asset

   d) intrinsic value of the option is zero

   e) settlement date is less than one month from the current date

10. An OTC forward contract is:

a) an option to call

b) a forward contract for which the payback is outside the contract period

c) a customised agreement that is not traded on an exchange

d) a standardised agreement that is traded on an exchange

ANSWER ANY THREE QUESTIONS

Question Two **(10 marks)**

Discuss the following types of currency risks giving suitable examples:

i. Economic risk (4 marks)

ii. Translation risk (3 marks)

iii. Transaction risk (3 marks)

Question Three **(10 marks)**

Discuss the following models in relation to purchasing power parity. Use suitable examples on each:

i. Asset Market Model (5 marks)

ii. Balance of payments model (5 marks)

Question Four **(10 marks)**

a) Using diagrams differentiate between:

i. Floating Exchange rate system (3 marks)

ii. Fixed Exchange rate system (3 marks)

b) Discuss using suitable examples:

i. **Two** advantages and (2 marks)

ii. **Two** disadvantages (2 marks)

of the fixed exchange rate system

Question Five **(10 marks)**

a) Assume that call currency option enable to buy of dollar for Shs. 50.00 while it is quoted at Shs. 50.70 in the spot market, and premium paid for call currency option is Shs. 1.00. Calculate the intrinsic value of the call? (5 marks)

b) Discuss the value of hedging to a firm. (5 marks)

Question Six **(10 marks)**

a) James prefers a fixed rate loan and has loans available at floating rate (LIBOR+0.5%) or at fixed rate (10.75%). Jane prefers a floating rate loan and has loans available at floating rate (LIBOR+0.25%) or at fixed rate (10%). Discuss how James and Jane can use swaps to their advantage. (5 marks)

b) XYZ is a multinational corporation based in the US. Its manufacturing facilities are located in Pittsburgh and hence its labor and manufacturing costs are incurred in US dollars (USD). A large fraction of its sales, however, are made to German customers who pay for the goods in Deutschemarks (GDM). There is a six-month lead time between the placement of a customer order and delivery of the product. XYZ's cost of production is 80% of the sale price. Suppose XYZ receives a $1MM GDM order and that the current USD/GDM exchange rate is 0.60 (i.e. 1 GDM = 0.60 USD). The cost of production of this order is $480,000 (0.60 x $1MM x 0.80). The exchange rate six months from now is, of course, uncertain in which case XYZ is exposed to exchange rate risk.

Required

Explain how the company can use forward contract for hedging purposes (5 marks)