PAN AFRICA CHRISTIAN UNIVERSITY

END OF SEMESTER EXAMINATION FOR THE DEGREE OF

JANUARY- APRIL 2022

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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a) Donald prefers a fixed rate loan and has loans available at floating rate (LIBOR+0.5%) or at fixed rate (10.75%). June 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) MAZE 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)

ANSWER ANY THREE QUESTIONS

Question Two **(10 marks)**

Discuss the following using suitable examples:

i.	Hedgers	(2 marks)
ii.	Speculators	(2 marks)
iii.	Arbitraguers	(2 marks)
iv.	Exchange traded derivatives	(2 marks)
v.	Over the counter derivatives	(2 marks)

Question Three **(10 marks)**

Derivative contracts also have the ability to create artificial wealth and this creates additional risk. The artificial wealth skews the values of underlying assets considerably.

Using suitable examples, discuss any **five** types of derivative risks. (10 marks)

Question Four **(10 marks)**

a) "Forward contracts are zero-sum games". Explain (2 marks)

b) Discuss the difference between the delivery price and the forward price in the following periods:

i.	At the beginning of the contract	(2 marks)
ii.	During the life of the contract	(3 marks)
iii.	When the contract matures	(3 marks)

Question Five **(10 marks)**

a) Using suitable examples differentiate between a call option and a put option (4 marks)

b) Explain three principles of call option pricing using suitable examples. (6 marks)

Question Six **(10 marks)**

Using examples, critically discuss the effects of derivatives on a firms' financial performance. (10 marks)