

UNIVERSITY OF COLOMBO, SRI LANKA

FACULTY OF MANAGEMENT AND FINANCE

Bachelor of Business Administration (Level II - Semester VI) Examination

November 2018

FIN 2304 – Theory and Practice of Banking

Three (03) Hours

Instructions to candidates:

1. Answer ALL Questions.
 2. The use of calculators is permitted.
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1.

- i. Briefly explain the nature of commercial banking.

(05 Marks)

- ii. Describe the term 'borrowing short and lending long' with respect to banks.

(05 Marks)

- iii. The presence of transaction cost is one of the imperfections exists in the market. Suggest the strategies that a bank can use to overcome this market imperfection.

(10 Marks)

(Total Marks 20)

2.

- i. Briefly explain the basic expense management strategies a bank can use to improve its performance.

(06 (06 Marks)

- ii. During the recent past the banking sector has been attracted towards many emerging technologies (Central Bank of Sri Lanka, 2017). Explain any **four** such emerging technologies that have been attracted the attention of the banking sector in Sri Lanka.

(08 Marks)

- iii. A central bank borrows money at reverse repo rate to control an excess money supply situation of a country. Do you agree with this statement? Justify your answer.

(06 Marks)

(Total Marks 20)

3.

- i. Identify the main internal factors that a bank should consider in order to improve its performance.

(06 Marks)

- ii. Based on the surveys conducted by the Basel Committee, it has been identified different operational risks face by the banks. Briefly explain the key types of operational risk identified by the Basel Committee.

(06 Marks)

- iii. The recent financial statements of SMB Bank demonstrate that the bank's return on equity has declined continuously over the past five years. Further, the financial information reveals that SMB Bank is less geared compared to other banks in the industry. However, the chief executive officer (CEO) of the bank is not sure of how to use this information to improve the performance of the bank in the future. Advise the CEO of SMB Bank on how to use this information to improve the performance of the bank by using a suitable analytical technique.

(08 Marks)

(Total Marks 20)

4.

- i. One of the problems of duration gap analysis is the duration drift. Briefly explain the problem of duration drift.

(04 Marks)

- ii. The bonds which pay higher coupons effectively mature sooner compared to bonds which pay lower coupons even if the redemption dates are the same. Do you agree with this statement? Justify your answer with appropriate calculations.

(06 Marks)

- iii. TFC Bank which is having an interest sensitivity ratio of 2 expects to have a rupee gap of Rs. 15 million in one year's time for a period of another one year. Further, TFC Bank's yield curve has been calculated as:

Year	Yield curve (%)
1	2.50
2	3.75
3	4.25

Assume, two alternative choices are available for the bank to hedge the interest rate risk in order to maximize its net interest income. First alternative is to use a forward rate agreement (FRA) while the second alternative is to use an interest rate guarantee (IRG) for a premium of 0.2% of the size of the rupee gap amount.

- a. Calculate the forward rate/exercise rate applicable to the FRA.

(02 Marks)

- b. Assume in one year's time the interest rate is 4%. Evaluate the two alternatives based on the exercise rate calculated above (a) and recommend an appropriate alternative to hedge the interest rate risk based on the expectations on the interest rates. (Assume the exercise rate calculated above (a) is applicable to both FRA and IRG).

(08 Marks)

(Total Marks 20)

5.

i. Briefly explain the following terms by providing at least one example for each term,

- a. Islamic window
- b. Fully fledged Islamic Bank
- c. Dual banking system

(06 Marks)

ii. Describe the key features of a special purpose vehicle which operates as a shadow bank institution

(05 Marks)

iii. Duration gap analysis is considered to be a superior asset and liability management technique compared to rupee gap analysis. Do you agree with this statement? Explain your answer.

(09 Marks)

(Total Marks 20)

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