Introduction to Banking and Finance
- Student Study Guide

Dr James Mallon
## Contents

1. Welcome to the module .......................... 1
2. Further Reading and Other Resources ....... 2
3. Assessment Criteria for the Module .......... 4
4. End of Unit Tutorial Questions .................. 11
5. Answers to Self-Assessment Questions ....... 26

Answers to Self Assessment Questions ........... 60

Prepared by: Dr James Mallon: Module Leader.
1. Welcome to the Module

I am pleased to welcome you to your introductory studies of Banking and Finance. As you study the Module text you will find references to a number of Self Assessment Questions (SAQ) corresponding to each of the Units. Attempt these questions at the appropriate point referred to in the Module text. The answers to the SAQs are listed at the end of the Study Guide.

Some of you may have experience of working in the financial sector and may already possess some knowledge of some of the material included in the Module text. It will be helpful to your fellow students and, of course, to yourself, if you share what knowledge and experience you already have with each other. Sharing knowledge and experience is a very effective way to learn and, indeed, develop friendships.

The aim of the module is enable you to learn the financial systemthe financial markets and institutions, and the main financial instruments, products and services provided by the financial services industry. Financial Markets and institutions are largely the same throughout the world and, although we shall study financial markets, institutions, products, instruments and services in a generic sense, the UK system, being well established as among the oldest and most sophisticated systems, provides us with an excellent example of a modern financial system.

I wish you every success in the Module and feel sure that you will find it to be a stimulating, challenging and rewarding experience.

Dr James Mallon

Module Leader
2. Further Reading and Other Resources

I have listed below some sources of further information which you might find useful in complementing your learning of the Module. However, it is not essential to purchase these.

Textbooks

**Recommended reading** (** = Good main text. ** = Good supplementary text)**


**Journals, Newspapers and Periodicals (some examples)**

Bank of England Quarterly Bulletin

People’s Bank of China Annual Reports

Financial Times [www.FT.com]; International Herald Tribune; China Daily.

Journal of the Institute of Fiscal Studies; Journal of Monetary Economics.
3. Assessment Criteria for the Module

The module is assessed by means of 2 assessments.

Module Assessment Guidance

Assessment will be by means of an essay of 2,500 words which will constitute 40% of the overall assessment, and a class test at the end which will constitute 60% of it.

Assessment 1: Coursework assignment

You are required to write an essay on the following topic:

Describe the process of financial intermediation and how the deposit-taking and non-deposit-taking financial intermediaries facilitate the transfer of liquidity from surplus to deficit units in the economy.

The marking scheme is as follows;

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Presentation</td>
<td>20%</td>
</tr>
<tr>
<td>Discussion and illustration</td>
<td>80%</td>
</tr>
<tr>
<td>Total marks</td>
<td>100%</td>
</tr>
</tbody>
</table>

The essay should be around 1500 words.

The assignment accounts for 40% of the overall assessment mark for the module.

There will be some flexibility in the marking of your essay to take into account the originality and quality of your answer. Your skills at identifying and explaining the points raised, as well as your ability to discuss these issues and illustrate your discussion with examples, will be assessed in this assignment.
Guidelines to completing your assignment

Presentation

Your essay should be easy to read, logical and well-structured. Although not essential, it would be preferable for it to be typed/word processed. However, if it is hand-written it will not lose marks unless it is illegible and/or untidy.

Your essay should include an introduction, a main section where the relevant points are explained and discussed, and a concluding section. Any illustrations can be included in the main section or in appendices.

Discussion and illustration

Draw on material from the relevant units in the module. You should not reproduce sections of text from the units or from the suggested further reading at the end of these units. Where specific information is reproduced its source should be acknowledged.

For a mark above a basic pass you should provide explanation, discussion and illustration which you have acquired from your own experience or from additional reading sources. You should include a bibliography of all references and reading sources. NB: Wikipedia is not an academic source.

There will be some flexibility in the marking of the essay in order to give credit for originality and quality of explanation, discussion and illustration.
ASSESSMENT 2: MULTIPLE CHOICE AND SHORT ANSWER CLASS TEST.

Some examples of short answers are shown below.

1.

(a) Compare the Gilt Repo Market and the Parallel Market. (5 Marks)

(b) Explain the difference between the money and the capital markets. (5 Marks)

(c) Describe the functions of a Bill of Exchange. (5 Marks)

(d) Distinguish between marketable and non-marketable investments. (5 Marks)

(e) Assume that you hold the following two securities:

   2000 Powergen ordinary shares at 450p, latest dividend 36p;
   £3,000 nominal of 7% Treasury, 2013 at £93.

   (i) Calculate the gross dividend yield of the shares.
   (ii) Calculate the gross redemption yield of the gilt. (5 Marks)

(f) Distinguish between primary banks and secondary banks. (5 Marks)

(g) Describe each of the following:

   - Treasury Bill
   - Commercial paper
   - Gilt-edged security
   - Debenture
Certificate of Deposit

(5 Marks)

2.

Describe the structure of the stock exchange. (8 Marks)

3.

Explain the relationship between risk, term and return. (4 Marks)

4.

Explain the process of financial intermediation. (8 Marks)
4. End of Unit Tutorial Tasks (Units 1 – 10)

TUTORIAL 1

Unit 1: Introduction to the UK Financial System

Key Areas:
- Financial institutions and financial markets
- Banking and non-banking financial intermediaries
- Explain what is meant by and provide examples of “financial claims”
- Marketable and non-marketable financial claims
- Deposit-taking and non-deposit-taking financial intermediaries
- The importance of liquidity in the markets for the operation of the economy
- The characteristics of the main financial instruments in the money markets
- The characteristics of the main financial instruments in the capital markets

Tutorial (Unit 1)

1. What do most financial claims represent to the owners of them?

2. Amongst the financial institutions and markets described in the workbook, distinguish between primary and secondary institutions.

3. What is the difference between a unit trust/mutual fund and an investment trust company?

4. What kinds of financial claims are dealt in on (a) the Money Markets and (b) the Capital Markets?

5. To what extent is it now valid or useful to distinguish between the discount and the parallel markets?
6. Assess the role of the 'parallel' sterling money markets.

7. Distinguish between a bond and a bill.

8. What is the significance of (a) the inter-bank market; and (b) Stock Exchange?

9. What is commercial paper?

10. Distinguish between a government bond and a corporate bond.

11. What are equities?

12. What are certificates of deposit (CDs) and who issues them?

13. Bills of Exchange don’t pay interest. How do holders of bills get a return on their investment?

14. What is the main function of financial institutions and markets?

Tutorial 1A

1. Distinguish between Traditional and Modern banking.

2. Describe the functions of the retail banks.

3. What are the current key issues in retail banking?

4. What is private banking?

5. Distinguish between corporate and business banking.

6. Describe the different forms of wholesale bank lending.

7. What is a eurocurrency?

8. How did the eurocurrency market arise?

9. Describe the range of Investment Banking activities.

10. What is meant by syndicate lending and why does it arise?

11. Describe the credit creation multiplier.

12. A bank has deposits of £100 million and a reserve ratio of 5%. What is the credit multiplier?

13. A bank has deposits of £100 million and a reserve ratio of 5%. Following an injection of £100 million into the system, at what amount will the process end?
TUTORIAL 2 Regulation of the financial Services System

Unit 2:

Key Areas:

- The reasons for regulation of the financial system
- The objectives of government intervention
- The types of regulation in the UK financial sector

Tutorial/Exercise/Task (Unit 2)

1. What are the arguments for and against regulation of the financial system?
2. What are the main objectives of government regulation of the financial system?
3. What general forms does government regulation of the financial system take?
4. Describe the various types of regulation that come within these classifications?
5. What is “insider dealing”?
6. Which body has overall responsibility for regulation of banks and building societies in the UK?
7. What are the main risks which necessitate bank supervision?
TUTORIAL 3
Unit 3:
Key Areas:
• appreciate the origins and history of money
• explain the functions and characteristics of money
• understand the circular flow of income, expenditure and production
• identify and explain the flow of funds between the sectors

Although we shall look at the functions and characteristics of money in this tutorial the emphasis will be on the sectoral funds' flows during the period from 1979 up to the present day. The Conservative government introduced a series of radical policy changes during the 1980s (most of which continued under the “New” Labour government) which have had a considerable effect upon sectoral funds’ flows since then. Try to find out the trend of the flows during the period in question.

1. What are the problems of barter that are solved by money?
2. Outline and explain the functions of money.
3. What are the characteristics of money?
4. Which function and characteristic are necessary properties of money?
5. What ideological factors were influential in determining the sectoral flows of funds during the early 1980s?
6. List the factors which have had a major influence upon the financial balance of the personal sector since the 1980s and 1990s.
7. In 1986/87 what major shifts occurred in the financial balances of the different sectors?
8. When the personal sector is in deficit does this mean that no significant savings is taking place?
9. Explain why ICCs can be deeply in deficit while profits are buoyant.
10. How have ICCs reacted to the deficits in the late 1980s and more recently?
TUTORIAL 4
Unit 4: The Process of Financial Intermediation

Key Areas:
- Surplus and deficit units
- The contractual position involved in financial intermediation
- The problems and disparate needs of surplus and deficit units inherent in direct lending and how these are reconciled by financial intermediation
- The processes of maturity transformation, aggregation and risk transformation
- The advantages of economies of scale and diversification
- The problems of asymmetric information; particularly adverse selection and moral hazard.

Tutorial 4
1. Explain what is meant by surplus and deficit units in the economy.
2. What is the general problem inherent in direct lending?
3. What are the specific problems encountered in direct lending that are resolved by financial intermediation?
4. How does financial intermediation reconcile the problems inherent in direct lending?
5. What is disintermediation and why has it become more common?
6. What are the main classifications of financial intermediary?
7. Explain the contractual position of financial intermediation?
8. What transaction costs does financial intermediation help to alleviate?
9. What information problems does financial intermediation help to alleviate?
Unit 5: The Central Bank (Bank of England) and the UK Commercial Banks

Key Areas:

- The position and importance of the Bank of England as the Central Bank in the UK financial system
- How this has changed since 1997
- The range of retail banking services in the UK
- The services provided by the wholesale banks and the international banks
- The services provided by the investment banks

Tutorial 5

1. Outline the usual role of a Central Bank.
2. Compare this with the role of the Bank of England.
4. Explain the Central Bank’s use of open market operations.
5. Explain the Central Bank’s use of discount window/standing facilities.
6. Explain the Central Bank’s lender of last resort function.
Unit 6: The UK Money Markets

Key Areas:

- The role and nature of financial markets in general
- The meaning of market efficiency
- The role of the money market
- The different instruments traded in the money market and their characteristics
- Calculating the yields on various money market instruments.

Tutorial 6

1. Distinguish between primary and secondary markets.

2. Distinguish between batch (call) and continuous markets.

3. What are the 2 most important measures of the effectiveness of a trading system?

4. What is the meaning of “efficiency” in the context of financial markets?

5. What types of financial claims do the money markets deal in?

6. What is meant by the “secured” and “unsecured” markets?

7. Distinguish between money market deposits and other money market financial instruments.

8. Compare a Money Market Deposit and a CD?

9. Calculate the return on a MMD of £750,000 placed for 7 days at 8%.

10. Calculate the yield on a Treasury Bill with a par (nominal) value of £10,000, discounted at £9,700 for 91 days.

11. If market rates were to rise to 14%, what price would the Treasury Bill now sell at?

12. Calculate the return on a £500,000 CD after 120 days with an original maturity of 180 days at 12%. The current yield of similar CDs in the market is 8%.

13. Assume that the market rate on CDs falls to 10%. What then would be the price of the CD?
Unit 6: Extra examples.

1. Calculate the annual yield on a Treasury Bill with a par value of:
   - £12,000 issued at £11,790 for 91 days
   - £15,000 issued at £14,730 for 61 days
   - £24,000 issued at £22,400 for 183 days
   - £55,000 issued at £52,700 for 91 days.

2. Calculate the price on each of the above Treasury Bills after 20 days.

3. Assume that after 20 days market interest rates rose to 20%. What would be the price of each of the Treasury Bills?

4. Assume that after 20 days market interest rates fell to 5%. What would be the price of each of the Treasury Bills?

5. Calculate the price of a Certificate of Deposit after 115 days with an original maturity of 200 days. The current yield for such CDs in the secondary market is 10% and the nominal rate of interest is 12%. Nominal value is £100,000.
Unit 7: The Main Securities Traded on the UK Capital Markets

**Key Areas:**

- The difference between bonds and equities
- The distinctions between different types of long-term debt capital and risk capital
- Calculating the yields on various capital market securities
- Understand the presentation of relevant data on stocks and shares in the financial press.

**Tutorial 7**

1. Calculate the following from the data provided below on Scotpic PLC:

<table>
<thead>
<tr>
<th>Share Price</th>
<th>52 wk high/low</th>
<th>Div Cov</th>
<th>Mkt cap £m</th>
<th>Div.Yld %</th>
<th>P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td>350 xd</td>
<td>356/260</td>
<td>1.5</td>
<td>£60.00</td>
<td>4.0</td>
<td>35</td>
</tr>
</tbody>
</table>

   a) Calculate the earnings per share of Scotpic PLC.
   b) How many ordinary shares has Scotpic?
   c) What does Scotpic’s Dividend cover indicate?
   d) What can you say about Scotpic’s share price?

2. You hold the following portfolio of stocks and shares:

   - £3,000 nominal of 8% Treasury 2016, at £110
   - £3,000 nominal of 4% Treasury 2014, at £84
   - 3000 Scottish and Newcastle ordinary shares at 215p: Net dividend per share, 8p.
   - 3000 Tesco ordinary shares at 320p: Net dividend per share, 16p.

   a) Calculate the value of the portfolio
   b) Calculate the gross income from the portfolio
   c) Calculate the gross redemption yields of the 2 gilt edged securities
   d) Calculate the net redemption yield of the 4% Treasury 2014
e) Calculate the gross dividend yield of the 2 shares.

3. a) List the characteristics of the following gilt edged securities:

£10,000 nominal of 3% Treasury, '66 Aft at £57
£10,000 nominal of 12% Treasury, '18 '22 at £164

b) Your client wishes to sell her holding of 3% Treasury and with the proceeds buy more 12% Treasury '18 '22.

i) How much nominal of the 12% Treasury will the client be able to buy?

ii) What will be the difference in income as a result of this transaction?

iii) What will be the capital gain/loss on the new stocks if held till maturity?

4. Calculate the price and the redemption yield of a government bond with a coupon of 6% and 5 more 6 monthly payments of interest to maturity, when the discount rate for similar bonds is currently 8%. 
### Extra question for tutorial 7

Assume that you hold the following investments:

<table>
<thead>
<tr>
<th></th>
<th>Price</th>
<th>Net div./ share</th>
</tr>
</thead>
<tbody>
<tr>
<td>£2,000 nominal 5% Treasury 2012</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td>£2,000 nominal 6% Treasury 2012</td>
<td>102</td>
<td></td>
</tr>
<tr>
<td>£2,000 nominal 7% Treasury 2016</td>
<td>82</td>
<td></td>
</tr>
<tr>
<td>3,000 Coates Vyella Ord. Shares</td>
<td>215p</td>
<td>7.0p</td>
</tr>
<tr>
<td>3,000 W H Smith Ordinary shares</td>
<td>507p</td>
<td>13.4p</td>
</tr>
<tr>
<td>3,000 Dixon’s Ordinary Shares</td>
<td>266p</td>
<td>6.0p</td>
</tr>
</tbody>
</table>

FROM THE INFORMATION CALCULATE:

(a) The value of the individual holdings;
(b) The overall value of the portfolio;
(c) The gross income from the portfolio;
(d) The gross redemption yield of the three gilts;
(e) The net redemption yield of the 5% Treasury, 2012;
(f) The gross and net dividend yields of the 3 shares.
Unit 8: The UK Capital Markets

*Key Areas:*

- The role and nature of the UK capital markets
- The structure of the UK capital markets
- The different methods of issue on the UK capital markets

**Tutorial 8**

1. What are the main role and functions of the capital markets?
2. What other specific functions does a stock market perform?
3. Describe the structure of the UK stock market.
Unit 9: The UK Derivatives’ Markets

**Key Areas:**
- The different types of derivative instruments: eg futures, options and swaps
- How, and on which markets, derivatives are traded
- The risk and return characteristics of derivatives
- Distinguish between speculation, hedging and arbitrage

**Tutorial 9**

1. What is the function of the derivatives’ market?
2. What is a financial derivative?
3. Distinguish between speculation, hedging and arbitrage
4. What is a forward contract?
5. What is a financial futures contract?
6. What is an options contract?
Unit 10: The UK Foreign Exchange Markets

Key Areas:

- The determinants of exchange rates
- Basic risk in relation to exchange rates

Tutorial 10

1. What are exchange rates?
2. Who are the buyers and sellers of foreign exchange?
3. What are the determinants of exchange rates?
5. Answers to self-assessment questions

Unit 1: Introduction to the UK Financial Markets

1.1

a) Marketable:  
- Treasury bills
- Commercial bills of exchange
- Government bonds (Gilts)
- Corporate bonds
- Local authority bonds
- Equities
- Unit trusts (mutual funds)
- Certificates of deposit (CDs)
- Commercial paper (CP)

b) Non-marketable:  
- Bank and Building society accounts
- NSCs and NS Bonds
- Life assurance policies

1.2

a) 1. Cash
   2. Treasury bills
   3. Government bonds
   4. Corporate bonds
   5. Equities

b) Bonds are long-term borrowing securities, bills are short-term borrowing securities at the time of issue.

1.3

Retail banks' deposits and lending are relatively small, whereas wholesale banks deal in much fewer but much larger deposit and lending transactions. Retail banks operate the money transmission system and deal with personal and small business customers, among other things. Wholesale banks deal mainly with large corporate clients and provide finance for the facilitation of trade and investment, among other things.

1.4

Building societies differ from retail banks as follows, for example:

1. Most lending is for house purchase
2. Most lending is secured
3. Most lending is long-term
4. They do not have to hold deposits at the Bank of England
5. Their liquid assets include bank deposits.

1.5


b) General insurance: Home contents; Car; Pets.

Life assurance: Permanent health insurance; Mortgage protection.

1.6

Unit trusts: Open-ended fund; cannot be geared (cannot borrow); subject to trust law; fund traded in units.

OEICs: Open-ended fund; limited company; subject to company law; fund traded in shares; operate as umbrella funds, thereby allowing switching from one type of fund to another without incurring a chargeable event for tax purposes; fund traded in shares.

Investment trust: Closed-ended fund; limited company; subject to company law; can be geared (can borrow); fund traded in shares; can invest in property; issue a wide range of shares.

Unit 2: Regulation of the UK Financial System

2.1

a) Principal-agent problem
b) Moral hazard problem
c) Externalities problem
d) Asymmetric information problem

2.2

a) Moral hazard
b) Bingham Committee.

2.3

a) Prudential regulation; Liquidity
b) Investor protection; Licensing regulations
c) Prudential regulation; Exposure limits
d) Investor protection; Restriction on activities; licensing requirements; regulation of securities exchanges

e) Prudential regulations; Liquidity requirements; Restrictions on activities

f) Structural regulation; Restrictions on activities

g) Investor protection; Deposit insurance.

2.4

100% of up to a maximum of £50,000 deposited.

Unit 3: Money and the Flow of Funds in the Economy

3.1

a) Specialisation occurs where someone holds a comparative advantage over others in a particular activity. Exchange arises from the fact that man is not totally self-sufficient and has to acquire some needs from others in return for what he has to trade.

b) Barter is the direct exchange of one commodity for another. Indirect exchange arises when the transfer of one commodity can occur in exchange for any other generally acceptable medium of exchange, eg gold, money.

c) Precious metals came to be used as money because they were generally prized and only small quantities were required to settle transactions.

3.2

a) Medium of exchange

b) General acceptability

c) Store of value

d) Stability

e) Divisibility

f) Homogeneity.

3.3

1) £1m cash is not the same thing as £1m Treasury bills, although they add up to the same amount. Their maturities and liquidities are different.

2) £1m of Treasury bills is not the same as £1m of CDs due to different maturities and liquidities, although they add up to the same amount.
### 3.4

<table>
<thead>
<tr>
<th><strong>Overseas sector</strong></th>
<th>£bn</th>
<th><strong>Government sector</strong></th>
<th>£bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imports</td>
<td>30</td>
<td>Income tax</td>
<td>200</td>
</tr>
<tr>
<td>Exports</td>
<td>(25)</td>
<td>Expenditure tax</td>
<td>170</td>
</tr>
<tr>
<td><strong>Deficit</strong></td>
<td>(5)</td>
<td>Transfers</td>
<td>(150)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Government spending</td>
<td>(250)</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Deficit</strong></td>
<td>(30)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Personal sector</strong></th>
<th><strong>ICCs</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages and dividends</td>
<td>600</td>
</tr>
<tr>
<td>Transfers</td>
<td>150</td>
</tr>
<tr>
<td>Income tax</td>
<td>(200)</td>
</tr>
<tr>
<td>Disposable income</td>
<td>550</td>
</tr>
<tr>
<td>Spending on real assets</td>
<td>(40)</td>
</tr>
<tr>
<td>Consumption</td>
<td>(450)</td>
</tr>
<tr>
<td>Expenditure tax</td>
<td>(170)</td>
</tr>
<tr>
<td><strong>Deficit</strong></td>
<td>(110)</td>
</tr>
</tbody>
</table>

### Unit 4: The Process of Financial Intermediation

#### 4.1

a) Deficit  
b) Deficit  
c) Surplus  
d) Deficit  
e) Surplus

#### 4.2

Liquidity; safety; simplicity.

#### 4.3

a) Aggregation  
b) Maturity transformation  
c) Risk transformation

#### 4.4

a) Moral hazard  
b) Adverse selection  
c) The general problem is asymmetric information
Unit 5: The Bank of England and the UK Commercial Banks

5.1

The theory applicable to the laws of supply and demand. As public sector borrowing increases, there is a shift of the demand for money curve to the right, which, ceteris paribus, will lead to a rise in the interest rate, the price of money.

5.2

A repo operation is a secured lending situation because the borrowing is allowed for an agreed period in return for gilt-edged securities (or TBs, CDs, etc). The securities are returned in exchange for the agreed sum being paid on the agreed date.

5.3

Declining use of cheques since 1990, projected to continue. Increased use of plastic cards since 1985, projected to increase by 6-fold by 2008. Increased use of automated facilities since 1985, projected to increase by 7-fold by 2008.

5.4

Automation; telebanking; merger; branch closures; redundancies; diversifying, selling traditionally non-banking products.

5.5

a) Liquidity risk
b) Asset risk.

5.6

a) Retail banking relates mainly to large amounts of relatively small-scale saving and borrowing by personal clients and small business enterprises. It is involved in the provision of the main money transmission service, and interbank clearing. The wholesale banks operate on the wholesale money and capital markets arranging large-scale borrowing for, and accepting large deposits from, corporate clients. Larger borrowing involves syndication of the loan.

b) NIFS are Note Issuance Facilities, short-term syndicated loan facilities introduced following the lesser developed countries’ crisis in order to reduce default risk. RUFs were Revolving Underwriting Facilities by which wholesale banking syndicates agreed to support fund raising note issues (Euronotes) by corporates. Typically of 1, 3, or 6 months’ maturity. These Euronotes would be issued and bought on a revolving basis. MOFs were Multiple Option Facilities, and comprised a considerable degree of flexibility, and could involve multi-currency bank loans; acceptances; commercial paper and Eurocommercial paper.
c) Standby credit is an amount of credit that is made available to the borrower which can be drawn down in tranches. Once it has been repaid it cannot be reborrowed. Revolving credit is similar, but unlike standby credit, if repayments have been made, borrowing can be continued up to the limit allowed.

d) Bilateral lending occurs when one bank lends to a client. Syndicated lending occurs when the risk is spread among a series of banks.

5.7

a) Committed lending occurs where the wholesale bank has committed itself under a formal contract with an agreed fee structure, to provide credit for a client. It takes the form of term loan, standby credit, revolving credit or project finance.

Uncommitted lending involves little by way of formal documentation and no arrangement fees. The agreement is usually for short-term finance, with no commitment to renewing the loan. Involves overdraft, line of credit and banker’s acceptance.

b) Securitisation involves transforming previously illiquid, non-marketable financial instruments, such as mortgages, into liquid marketable instruments by changing their liquidity, risk, term and return characteristics. This is also known as asset backed securitisation (ABS), and it has the advantage of removing the assets from the balance sheet and frees up capital for other uses.

5.8

a) Retail banks deal in large numbers of small deposits and arrange relatively small loans for personal and business clients. Wholesale banks deal in large deposits and loans, usually of at least £500,000. Retail banks’ business tends to be with personal and small business clients; whereas wholesale banks’ business tends to be with corporate and sovereign clients.

b) Syndicated lending occurs because a single bank might be unable to take the exposure inherent in a major loan request, and to avoid losing the business, and to spread the risk, it arranges with other banks to share in the loan arrangement.

5.9

A “White Knight” is a rival bidder in a takeover situation who is more desirable to the target company. A “White Squire” arises when one or two bidders can be found to take a substantial minority holding which is sufficient to block the predator. A “Trojan Horse” arises when a “White Squire” takes sufficient control and can oust the board and replace it with his own people. The “poison pill” is designed to deter a hostile bid by making it prohibitively expensive to mount one. It applies to a shareholder on acquiring a holding of around 20% of the company's shares. It usually requires the company to offer all shareholders, other
than the 20% holder, the right to buy new shares in the company at a large discount, often 50%.

Unit 6: The UK money markets

6.1

Order driven systems involve matching markets - deal takes place when one public order crosses another, quote driven systems involve dealer markets - recognised dealers in particular stocks must decide the price (and quote it publicly) that they are ready to buy or sell out of their own inventories. The trade takes place whenever a trader accepts that price.

A batch (call) market can be either *verbal and iterative* where traders bid for shares, or *written and non-iterative* where the auctioneer gathers orders submitted previously, as in a tendering arrangement.

Continuous markets allow trading to occur whenever *buy* and *sell* orders cross, and are either matching or dealer markets.

6.2

1. a) Strong
   b) Random Walk
   c) Semi-strong
   d) Weak

2. Weak

6.3

1. CDs are issued by banks and building societies. CP is issued by companies.
2. Commercial paper has a maturity of from 7 days to one year. MTNs have a maturity of over one year up to 5 years.

6.4 \[ r = P \times \frac{I(n/365)}{365} = 800,000 \times 0.09(10/365) = £1,972.56p \]

6.5 \[ \frac{N - P \times 365 \times 100}{P} = r = 9.86\% \quad \text{ie} \quad 5,000 - 4,880 \times 365 \times 100 = 9.86\% \]

6.6 \[ 250,000 \times \frac{(365 \times 100) + (10 \times 300)}{(365 \times 100) + (8 \times 180)} = 250,000 \times \frac{39,500}{37,940} = £260,279.37 \]
Unit 7: Securities traded in the UK capital Markets

7.1

a) The coupon on a bond is the rate of interest quoted on it.

b) i) Medium-dated
   ii) Short-dated
   iii) Long-dated

7.2

a) Preference shares usually have a fixed rate of dividend attached. They have preference in dividend payments over ordinary shares, and the dividend is usually cumulative, in that if it is not paid out one year, then all of the arrears have to be paid before an ordinary dividend can be paid. Ordinary shares rank last in the earnings’ distribution process. However, the ordinary dividend does not have a fixed rate attached; the dividend is variable. Both preference and ordinary share dividends are paid out of after-tax profits (earnings). Bond holders are paid interest out of pre-tax profits.

b) A corporate bond is a bond issued by a company. It pays interest usually at a fixed rate until redemption. Their prices have to vary, therefore, in order for the yield to vary in line with market interest rates. They rank ahead of preference and ordinary shares for payment of income, and for repayment in the event of a liquidation. The interest is paid out of pre-tax profits. Preference shares are fixed income (dividend) securities issued by companies. The dividend is paid out of after-tax profits, and is normally cumulative. Preference shares rank after corporate bonds but ahead of ordinary shares.

c) A bonus issue (or scrip, or capitalisation issue) is simply a book-keeping exercise which moves funds from reserves into share capital. It raises no additional income for the company. A rights issue, however, does raise new capital for the company, therefore increasing both assets and liabilities.

7.3

\[ GDY = \frac{27 \times 100 \times 100}{400 \times 90} = 7.5\% \]

7.4

a) £200m = 62,500,000 Shares.  
b) = £18,000,000

£3.2
7.5

Mikado’s EPS = 5

(Price/EPS = 30, Therefore, if price equals 150p, EPS = 5; ie 150/5 = 30)

7.6

Evaluation of Scottish and Newcastle shares.

<table>
<thead>
<tr>
<th></th>
<th>23 - 6 - 99</th>
<th>23 - 6 - 00</th>
<th>Percentage change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>500p</td>
<td>488p</td>
<td>( \frac{488 - 500}{500} = -\frac{12}{500} = -2.40% )</td>
</tr>
<tr>
<td>Sector Index</td>
<td>3954.95</td>
<td>3385.82</td>
<td>( \frac{3385.82 - 3954.95}{3954.95} = -14.39% )</td>
</tr>
<tr>
<td>FTSE 100</td>
<td>6496.50</td>
<td>6413.80</td>
<td>( \frac{6413.80 - 6496.50}{6496.50} = -1.27% )</td>
</tr>
</tbody>
</table>

7.7

a) GIY = 11/90 x 100 = 12.2%; NIY = 12.2 – (0.2 x 12.2) = 12.2 – 2.44 = 9.76%
b) GIY = 6/108 x 100 = 5.55%; NIY = 5.55 – (0.2 x 5.55) = 5.55 – 1.11 = 4.44%
c) GIY = 7/100 x 100 = 7%; NIY = 7.00 – (0.2 x 7.00) = 7.00 – 1.40 = 5.60%

7.8

a) £5,000 x 0.9 = £4,500
b) £5,000 x 1.08 = £5,400
c) £5,000 x 1.0 = £5,000

7.9

a) GIY = 5/96 x 100 = 5.2%; GRY = 5.2 + \frac{4}{4} = 5.2%
b) GIY = 9/115 x 100 = 7.8%; GRY = 7.8 – \frac{15}{10} = 6.3%

7.10

£7,000 nominal of 6% Treasury 2013 @ £104 : £7,280.00
Add 161 days Accrued interest : 154.38
£7,434.38
Less commission @ 0.9% x 7,280 \[= 65.52\]  
\[\text{£7,369.06}\]

7.11

Sold contract note

\[
egin{align*}
1,000 \text{ CMG ordinary shares} & @ \ £12 : \ £12,000 \\
\text{Less Contract levy} & \ £2.00 \\
\text{Less Commission} & \ £180.00 : \ (182) \\
& \ £11,818
\end{align*}
\]

Bought contract note

\[
egin{align*}
1,000 \text{ ICI ordinary shares} & @ \ £5 : \ £5,000 \\
\text{Stamp duty @ 0.5\% x 5,000} & : \ 25 \\
\text{Commission} & : \ 75 \\
& \ £5,100
\end{align*}
\]

Unit 8: The UK Capital Markets

8.1

a) False  
b) False  
c) True  
d) True

8.2

Rights issue.

8.3

a) Below 513p only 13,837,566 shares are subscribed for. At that price all 15 million can be taken up. The issue is in fact over-subscribed at 20,247,036.

b) Either all of the applicants or just those at 513p will be balloted.

8.4

a) An introduction is appropriate when a company already listed on the AIM or on another exchange seeks a full listing on the LSE.
b) When it is a fixed interest issue.

8.5

Dematerialisation means that paper securities are not used, such as in the CREST settlement system.

Unit 9: The Derivatives Market

9.1

<table>
<thead>
<tr>
<th>Series</th>
<th>Option price</th>
<th>Intrinsic value</th>
<th>Time value</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 330p 00;</td>
<td>23.5p</td>
<td>13.0p (343-330)</td>
<td>9.5p</td>
</tr>
<tr>
<td>Oct. 330p 00;</td>
<td>38.5p</td>
<td>13.0p</td>
<td>25.5p</td>
</tr>
<tr>
<td>Jan. 330p 01;</td>
<td>54.0p</td>
<td>13.0p</td>
<td>41.0p</td>
</tr>
<tr>
<td>July 360p 00;</td>
<td>9.0p</td>
<td>0</td>
<td>9.0p</td>
</tr>
<tr>
<td>Oct. 360p 00;</td>
<td>24.5p</td>
<td>0</td>
<td>24.5p</td>
</tr>
<tr>
<td>Jan. 360p 01;</td>
<td>40.0p</td>
<td>0</td>
<td>40.0p</td>
</tr>
</tbody>
</table>

9.2

A call option is an option to buy a particular security at some predetermined date in the future.
A put option is an option to sell a particular security at some predetermined date in the future.

9.3

Number of contracts required = \( \frac{40,000,000}{50,000} = 800 \)

The manager sells these 800 contracts for next expiry period. One month later the index is down 5%, at 4750 and the manager sells. For the same quantity that might have been sold a month earlier for £40 million, £38 million is received, a loss of £2 million.

The position now is:
• Sell futures at : 5000
• Buy contracts at : 4750
• Gain per contract: 250 points

250 x £10 = £2,500. £2,500 x 800 = £2 million.

The loss is offset by the “gain” on the futures contracts.

**Unit 10: The Foreign Exchange Market**

10.1

1/1.58 = £0.63

10.2

The relative prices of international assets
expectations of inflation
expectations of exchange rate stability or volatility
actual exchange rates
psychological factors.

Purchasing Power Parity theory is used by economists to explain exchange rates but, contrary to economic theory, international trade is not the prime determinant, accounting for only 3% of