

# EXAMINATION

3 April 2006 (am)

## Subject SA5 — Finance Specialist Applications

*Time allowed: Three hours*

### **INSTRUCTIONS TO THE CANDIDATE**

1. *Enter all the candidate and examination details as requested on the front of your answer booklet.*
2. *You have 15 minutes at the start of the examination in which to read the questions. You are strongly encouraged to use this time for reading only, but notes may be made. You then have three hours to complete the paper.*
3. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*
4. *Mark allocations are shown in brackets.*
5. *Attempt both questions, beginning your answer to each question on a separate sheet.*
6. *Candidates should show calculations where this is appropriate.*

### **AT THE END OF THE EXAMINATION**

*Hand in BOTH your answer booklet, with any additional sheets firmly attached, and this question paper.*

*In addition to this paper you should have available the 2002 edition of the Formulae and Tables and your own electronic calculator.*

**1** Firefly Plc is a small private wealth management company. It manages the diverse business interests of Mr. Hope, a wealthy celebrity. Firefly has told Mr. Hope that he should start up a consumer loan company provisionally named Money-Now Finance Ltd (MNF). MNF would be based in the UK and would offer personal consumer credit loans to UK resident individuals with a relatively poor credit history.

Firefly's research suggests that the market segment is currently dominated by three apparently well run loan companies. However, Firefly believes that MNF can grow quickly in the early years by utilizing Mr Hope's popularity and through product differentiation otherwise known as unique selling points. In particular Firefly has suggested that MNF:

1. Offers loans at reduced interest rates in return for specified security but, unlike the other loan companies, MNF should advertise that it will consider accepting a wide range of different securities; and
2. Makes a bonus payment at the end of the loan term to any borrowers who have paid their loan principal and interest instalments on time throughout the loan term.

Mr. Hope has expressed interest in the proposal.

You work for Firefly. Draft a proposal to Mr. Hope describing:

- (i) (a) the key steps which need to be taken prior to MNF commencing to trade; and
- (b) the parties involved in this process [9]
- (ii) The features and parameters of the financial model to be used for business planning purposes including:
  - (a) projecting future profits; and
  - (b) planning future new business growth, future capital needs and future operational needs [9]
- (iii) Your proposed optimal capital structure. [7]
- (iv) Your proposals for administering, managing and advertising the business. [4]
- (v) The proposed loan underwriting procedures. [4]
- (vi) The advantages and disadvantages of Firefly's proposed unique selling points including any loan underwriting/pricing issues arising from the unique selling points. [6]
- (vii) (a) the real investment options available to Mr. Hope with respect to investing in Firefly; and
- (b) your proposed method for including these options in the financial model described in part (ii) above [4]

[2 marks for drafting]

[Total 45]

- 2 As a prelude to its stated intention of entering the European Monetary Union the UK Government announced yesterday that it had instructed the Bank of England to set the short term interest rate to be equal to the European Central Bank's equivalent short term interest rate now and in the future. Accordingly the Bank of England has **increased** the Bank Base Rate from 2.5% p.a. to 4.5% p.a. with immediate effect and has announced that the Monetary Policy Committee will be disbanded.

The relevant UK short term interest rate is often referred to as the Bank Base Rate. The equivalent European Central Bank rate is the overnight rate for lending to banks and is known as the Marginal Lending Facility rate.

Headlines in today's financial press include "Markets in Turmoil", "Chaotic Trading in the wake of an unprecedented Government Policy Switch" and "The FSA recalls all employees from annual leave".

- (i) Outline the inter-relationships between UK companies, The Bank of England and the UK Government. Include a description of the effects that the policy change might be expected to have on the inter-relationships. [14]
- (ii) Describe the likely short term and long term impact of the policy change on:
  - (a) the Bank of England
  - (b) the Financial Services Authority (FSA) [10]
- (iii) Using example cash flows describe the workings of a typical:
  - (a) interest rate swap (also known as a basis swap)
  - (b) currency swap: and
  - (c) credit default swap [15]

You work for a major international bank. The bank's activities in the UK include deposit taking, lending, cash management, investment fund management and derivative trading.

- (iv) Describe with reasons your bank's trading activities in the UK in the 24 hours following the announcement. [14]
- (v) Describe two ways in which your bank might measure its exposure to interest rate changes. [2]

[Total 55]

**END OF PAPER**