**MODEL ANSWERS - INTRODUCTION TO BANKING MAY 2013**

**MODEL ANSWERS**

**Section A**

1. a
2. b
3. c
4. d
5. a
6. a
7. c
8. b
9. c
10. b
11. a
12. d
13. b
14. a
15. b
16. c
17. b
18. a
19. c
20. d

**Section B**

1. Paper to new recruits of fiscal police

Title : Money supply and demand

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1. Money supply and Money demand. Money supply is the aggregate of notes and coins in circulation and totak bank deposits in an economy. Money demand is the total quantity of money required in an economy.
2. Why people hold money

* Transaction motive – so that they can use it for day to day transactions such as buying of groceries and other necessities.
* Precautionary motive – to protect themselves against unknown future eventualities or emergencies.
* Speculative motive – anticipating that money as an asset is likely to gain value in the near future hence make a revaluation gain.

1. the three classes of money supply

* M1 – notes and coins in circulation, including private sector demand sight deposits.
* M2 – M1 plus all public sector sight and time deposits
* M3 – M2 plus all deposits of all nationals in foreign currencies.

1. three problems of monetary instability

* Changes in the value of money are not of equal importance to all sections of the community. Some people are likely to gain while others to lose.
* Business contracts are expressed in terms of money and if the value changes, the foundations on which business decisions are based are undermined.
* Not all prices rise and fall in the same proportion and the working of the price system may be disturbed.

2. A commercial bank – a legally licensed bank which is authorized to carry out banking business in a country after meeting all the requirements as defined by the central bank.
3. the three main sources of revenue for commercial banks

* Revenue from loans – the provision of loans and overdrafts generate revenue in a form of interest earnings and fees.
* Revenue from fees and charges – payments on various services offered such as provision of statements, production of bank cheques, special clearances, etc.
* Returns on investments and securities – banks use part of customers’ deposits to purchase securities such as treasury bills that have yields or interest earnings on top of the purchase price.

1. Four reasons for great transformation in the banking and financial sector of late

* Changes in real sector of the economy – leading to demand for new types of financial services, such as growth of multinationals that has made banks to be outward focused, than concentrating in their primary economy.
* Improvements in technology – the growth of electronic funds transfer systems and plastic card-using devices have been the most obvious effect of computers revolution and the need for banks to embrace more radical changes as well as enhanced security measures.
* Financial liberalization or deregulation – the relaxing down of the controls over banks by respective governments in terms of rules and regulations with which banks are supposed to comply or making it easier for new entrants into the banking sector to commence business.
* Internal innovations – the ever growing competition within the banking and financial services sector has forced banks to change internally to embrace a more effective and innovative work force in a bid to be more competitive.

1. Credit creation - Credit creation is the multiple expansions of banks demand deposits. For example, if A deposits K100, the bank can create a loan of K80 given to B. If withdraws K20, the bank can create another loan of K40 on the K60 deposit in B’s account.
2. (a) Barter trade – a type of transaction system in which goods and services are directly exchanged for other goods and services without the employment of money as a medium of exchange.

(b) Problems associated with barter trade;

* Deciding the relative values – determination of the value of one product in terms of the other.
* Double coincidence of wants – finding someone who wants the commodity that you want, and you also in need of the commodity the other person has.
* Divisibility problem – exchanging a large and indivisible commodity like a goat, for a small commodity such as bread.
* Acceptability – a challenge to be widely accepted as a medium of exchange
* Divisibility – divisible and that when divided the value of the parts is equal to the value of the whole
* Homogeneity – one piece should be as good as the other
* Indestructibility – must be very durable and not lose value regardless of the duration it is kept.
* Portability – must have large value compared with its weight and size
* Cognisability – must possess unique qualities and characteristics that readily distinguish it from other substances.
* Stability of value – must be stable in value and this must be maintained over time.

1. KYC
2. KYC – means ‘Know Your Customer’. It is a principle that intends to assist financial institutions to systematically address challenges surrounding money laundering. Every financial institution shall, before entering into a business relationship with a customer, ascertain the identity of the customer or beneficial owner, and shall verify the identity on the basis of reliable and independent source documents.
3. Circumstances one would be proven to have committed an offence of money laundering

* Converts or transfers property knowing or having reason to believe that the property is a proceed of crime, with the aim of concealing or disguising the origin of the property or aiding any person involved in the commission of an offence to evade legal consequences thereof.
* Conceals or disguises the true nature, origin, location, disposition, movement or ownership of that property knowing or having knowledge that it is a proceed of crime.
* Acquires, possess or uses that property knowing or having reason to believe that it is derived, directly or indirectly from proceeds of crime.
* Participates in, associates with or conspires to commit, attempts to commit and aids, abets and facilitates the commission of any act that lead to crime.

1. Any three risks that can affect business of financial institution as a result of lack of sound KYC principles.

* Reputation risk – adverse publicity that will cause loss of confidence in the integrity of the financial institution.
* Operational risk – direct or indirect losses from inadequate or failed internal processes, people and systems, or from external events that lead to financial losses.
* Legal risk – the possibility of lawsuits, adverse judgments or contracts that turn out to be unenforceable, can disrupt or adversely affect operations or conditions of a financial institution.
* Concentration risk - Probability of loss arising from heavily lopsided exposure to a particular group of counterparties, i.e. depositors or borrowers.

1. No need to have a central bank in a liberalized economy where all forces are controlled by the market players.
2. The statement is not correct.
3. The economy still needs the central bank for the following:

* To issue legal tender and managing money supply – issuing banknotes and coins and control the growth of money.
* Lender of last resort – provide funds to banks when in dire need of funding.
* Management of the bank rate/discount rate – as a way of controlling commercial banks’ borrowing.
* Government’s bank – as an agent for the government.
* Supervising commercial banks – so that they conform to the stipulated standards set by the central bank and conditions of their banking license.
* Clearing and settlement services – facilitate settlement of obligations among the commercial banks

1. Role of the central bank that is greatly affected by liberalization

* Managing of exchange rates – as this is determined by the forces of the market that include demand and supply, as well as financial institutions profit margin policies.

1. Monetary policy operations instruments that are still going to be used in a liberalized economy and how.

* Open market operations – involves going direct into the market to buy and sell securities. The central bank buys securities to inject liquidity and sells securities to mop liquidity in the economy.
* Discount rate – by changing the discount rate upward or downward, the central bank can attain its desire to reduce or increase money supply.
* Liquidity reserve requirement – imposition of a certain percentage of deposits collected by commercial banks to be kept by central bank. This has an impact on the credit creation of the economy.
* Moral suasion – the ability of the central bank to cordially persuade commercial banks to follow certain policies or strategies to effect desired results in an economy.