

UNIVERSITY OF PORTSMOUTH

Portsmouth Business School

Economics of Banking and Money U04833B

Level M Semester 1
January/February 2008

Candidates must attempt to answer **TWO** questions. All questions carry equal marks.

Time Allowed: 2 Hours

Calculators that are *capable* of holding text are not permitted in examinations

(for the purposes of identification calculators capable of holding text will have an alpha-numeric keypad, ie a-z letters)

Unit Co-ordinator: Yaseen Ghulam

Department: Economics

1.

- i. Critically explain both the Structure-Conduct-Performance (SCP) and the Relative Efficiency models in relation to the banking. Support your answer by detailing the conclusions from a range of relevant empirical studies.

[50% of question marks]

- ii. *'It is established fact that customers are better off when banking sectors are contestable. A lack of contestability is a recipe for high interest rate differentials and a lack of innovation in financial products and services'.*

Explain what is meant by the concept of a 'contestable' banking market and discuss the extent to which contestability has been measured by academic studies in any one banking sector of your choice.

[50% of question marks]

2.

The regulatory environments in the UK and the USA have evolved over time to meet the needs of their respective modern banking sectors. Critically assess this evolution for both countries by highlighting the similarities and differences between the two cases.

3.

- i) Credit risk management techniques are probably among the best-developed tools that can be used by banks to mitigate exposure to risk. Critically evaluate the approaches to the management of credit risk employed in the modern banking industry.

[40% of question marks]

- ii) In explaining risk management in banking, Rose (2002) presents the following case. Read the case carefully and answer the questions that follow.

Casio Merchants and Trust Bank, N.A. has a portfolio of loans and securities expected to generate cash inflows for the bank as follows:

Expected cash receipts	Period in which receipts are expected
£1,385,421	Current year
746,872	2 years from today
341,555	3 years from today
62,482	4 years from today
9,871	5 years from today

Deposits and money market borrowings are expected to require the following cash outflows:

Expected cash payments	Period in which payments will be made
£1,427,886	Current year
831,454	2 years from today
123,897	3 years from today
1,005	4 years from today
-----	5 years from today

Assume that the discount rate applicable to the above cash flows is 8 percent.

- a) What is the duration of the bank's portfolio of earning assets and of its deposits and money market borrowings?
- b) Assuming all other factors are held constant what will happen to the bank's total returns, if interest rates rise? If interest rates fall?
- c) Given the size of the duration gap you have calculated, what type of hedging should the bank engage in?
- d) If interest rates drop from 8 percent to 7 percent, what happens to Casio's net worth in this case and by how much in pounds does it change by?

[60% of question marks]

4.

Banks fail for a variety of reasons. Some of these reasons are involvement in derivative markets, ambitious expansionary strategies, the adoption of less stringent internal risk management procedures, negligence by external auditors, inefficiency on the part of regulators and, in some cases, fraud by top level managers or employees.

Explain in detail each of the above factors and the role they played in the failure of the following banks:

- i. Barings
- ii. Banco Ambrosiano
- iii. Continental Illinois and Pen Square
- iv. Johnson Matthey Bankers
- v. Bank of Credit and Commerce International (BCCI)