



MURANGA UNIVERSITY COLLEGE

(A constituent College of Jomo Kenyatta University of Agriculture & Technology)

MAIN CAMPUS

ORDINARY UNIVERSITY EXAMINATIONS

2015/2016 ACADEMIC YEAR

FOURTH YEAR SECOND SEMESTER EXAMINATIONS

**FOR THE DEGREE
OF
BACHELOR OF COMMERCE**

COURSE CODE: HBB 2403

COURSE TITLE: FINANCIAL RISK MANAGEMENT

DATE: 18TH APRIL 2016

TIME: 2 HOURS

INSTRUCTIONS TO CANDIDATES

Question ONE (1) is COMPULSORY

Answer ANY OTHER TWO (2) questions

MRUC observes ZERO tolerance to examination irregularities

This Paper Consists of 3 Printed Pages. Please Turn Over. ►

QUESTION ONE (COMPULSORY)

- a. The goal of risk management is not to eliminate risk but to ensure that risk remains at a certain level of acceptability. Explain the various risk management approaches available to risk managers (12 marks)
- b. Using a well labelled diagram, explain the relationship between risk and diversification (4 marks)
- c. In the context of risk, explain the effects of debt financing on the owners of a business (6 marks)
- d. Differentiate between actuarial and financial risk (2 marks)
- e. A market has an expected return of 20% and a standard deviation of 12%. The risk free rate in the market is 17%. An investor in the market wants to assume a risk of 3.96 percent by holding a market portfolio along with the risk free asset. Using the concept of Capital Market Line (CML), calculate;
- i. The proportion of the Market portfolio in his portfolio (2 marks)
 - ii. The reward to variability ratio (2 marks)
 - iii. The return of the portfolio using (ii) above (2 marks)

QUESTION TWO

- a. The problem of credit risk in the management of financial institutions is compounded by the challenges of adverse selection and moral hazards. Explain the various methods used by financial institutions to manage these challenges and by extension credit risk (15 marks)
- b. A key emerging issue in institutional financial risk management is the use of Management Information and Reporting Systems in reporting risk related information. Highlight the features of an effective Management Information and Reporting System (5 marks)

QUESTION THREE

- a. i. What is systematic risk (2 marks)
- ii. Describe the components that constitute systematic risk (9 marks)

- a. A portfolio consists of three securities A, B and C with the following parameters

Security (weight)	A (0.4)	B (0.35)	C (0.25)	Correlation Coefficient
Expected Returns (%)	15	12	8	
Standard deviation (%)	11	8	6	
$\rho_{A,B}$				-0.9
$\rho_{B,C}$				-0.6
$\rho_{A,C}$				0.2

- i. Calculate the risk of return of the portfolio formed by the three securities (3 marks)
- ii. Determine the risk of the optimum portfolio consisting of A and B only (6 marks)

QUESTION FOUR

- a. Explain the benefits that accrue to a firm adopting an active risk management approach (9 marks)
- b. Under what circumstances is it possible to diversify virtually all systematic risk in a portfolio? (1 marks)
- c. What are off-balance sheet risks in financial institutions (2 marks)
- d. How can liquidity risk be resolved in financial institutions (4 marks)
- e. The payback period method is one of the oldest methods used in recognizing and allowing for risks of time nature;
- i. How does it recognize and allow for these risks? (3 marks)
- ii. This method falls short in allowing for these risks. Why is this so? (1 marks)