

UNIVERSITY OF ESWATINI  
DEPARTMENT OF ACCOUNTING  
RE-SIT EXAMINATION PAPER JANUARY 2019

DEGREE/ DIPLOMA AND

YEAR OF STUDY : B. COM IV

TITLE OF PAPER : RISK MANAGEMENT

COURSE CODE : ACF419 (RE-SIT) JANUARY 2019

TOTAL MARKS : 100 MARKS

TIME ALLOWED : THREE (3) HOURS

- INSTRUCTIONS
- 1 There are four (4) questions, answer all.
  - 2 Begin the solution to each question on a new page.
  - 3 The marks awarded for a question are indicated at the end of each question.
  - 4 Show all the necessary workings.
  - 5 Round off as you deem appropriate.

Note: You are reminded that in assessing your work, account will be taken of accuracy of the language and general quality of expression, together with layout and presentation of your answer.

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SPECIAL REQUIREMENTS: CALCULATOR.

**QUESTION 1**

Innovation and creating are driven by a wide diversity of factors. Underlying all these factors is the creation of value, and so most of the factors attempts to increase returns or to reduce risks. Discuss six (6) factors that have motivated financial innovation. (30 Marks)

**Total: (30 Marks)**

**QUESTION 2**

- a) Write short notes on the following:
- i. Forward contract (5 Marks)
  - ii. Futures (5 Marks)
  - iii. Swaps (5 Marks)
- b) Tonado Limited has just issued E1 million in five-year bonds with a variable annual interest rate defined as the London Interbank offered rate (LIBOR) plus 1.3% (130 basis points). LIBOR is at 1.7%, low for its historical range, so Tonado management is anxious about an interest rate rise. Tonado finds another company, Sabine Limited, which is willing to pay Tonado an annual rate of LIBOR plus 1.3% on a notional principal of E1 million for five years. In other words, Sabine Limited will fund Tonado's interest payments on its latest bond issue. In exchange, Tonado pays Sabine Limited a fixed annual rate of 6% on a notional value of E1 million for five years.
- With relevant calculations, consider the implications of the interest rate swap on the two companies if LIBOR rises by 0.75% per year. (5 Marks)
- c) What are two ways in which derivatives can be misused? (5 Marks)

**Total: (25 Marks)**

**QUESTION 3**

- a) Explain three operational advantages offered by derivative markets? (6 Marks)
- b) Compare and contrast options and forward contracts? (6 Marks)
- c) Give an example of an in the money call and put and an out of the money call and put. (8 Marks)
- d) What is the difference between an initial margin and a maintenance margin? (3 Marks)
- e) The crude oil futures contract on the Johannesburg Stock Exchange covers 1,000 barrels of crude oil. The contract is quoted in dollars and cents per barrel (e.g., E27.42), and the minimum price change is E0.01. The initial margin requirement is E2,500. Suppose you bought a contract at E27.42, putting up the initial margin. At what price would you get a margin call? (5 Marks).
- f) Explain the basic differences between open outcry and electronic trading systems? (2 Marks).

**Total: (30 Marks)**

**QUESTION 4**

- a) On 7 June 2017, an American watch dealer decided to import 100 000 swiss watches. Each watch costs SF225. The dealer would like to hedge against a change in the dollar/ Swiss franc exchange rate. The forward rate was \$0.3881. Determine the outcome from the hedge if it was closed on 16 August 2017, when the spot rate was \$0.4434. (5 Marks)
- b) On 2 January 2018, an American firm decided to close out its account at a Canadian Bank on 28 February 2018. The firm is expected to have 5 million Canadian dollars in the account at the time of the withdrawal. It would convert the funds to US dollars and transfer them to a New York bank. The relevant spot foreign exchange rate was \$0.7564. The March Canadian dollar futures contract was priced at \$0.7541.

**You are required to:**

Determine the outcome of a futures hedge if on 28 February 2018, the spot rate was \$0.7207 and the futures rate was \$0.7220. All prices are in U.S. dollars per Canadian dollar. The Canadian dollar futures contract covers CD100 000. (10 Marks)

**Total (15 Marks)**