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Question No: 43 (Marks: 3)

What is the source of Trading risk, Credit risk and Liquidity risk?

Liquidity risk is the risk of a sudden demand for funds and it can come from both sides of a bank's balance sheet (deposit withdrawal on one side and the funds needed for its off-balance sheet activities on the liabilities side

If a bank cannot meet customers' requests for immediate funds it runs the risk of failure; even with a positive net worth, illiquidity can drive it out of business

Trading risk:

Banks today hire traders to actively buy and sell securities, loans, and derivatives using a portion of the bank's capital in the hope of making additional profits

However, trading such instruments is risky (the price may go down instead of up); this is called trading risk or market risk

Managing trading risk is a major concern for today's banks, and bank risk managers place limits on the amount of risk any individual trader is allowed to assume

Banks also need to hold more capital if there is more risk in their portfolio

Credit risk

This is the risk that loans will not be repaid and it can be managed through diversification and Credit-risk analysis

Credit-risk analysis produces information that is very similar to the bond-rating systems and is done using a combination of statistical models and information specific to the loan applicant

Question No: 44 (Marks: 3)

"Monetary policy can be used to stabilize economy" Discuss

Monetary policy Control over the money supply and interest rates by a central bank or monetary authority to stabilize business cycles, reduce unemployment and inflation, and promote economic growth.

Stability exists when fluctuations in prices, production, and employment have been eliminated. While stability for all aspects of the economy are important, monetary policy tends to be most concerned with price stability, that is, keeping the price level in check and eliminating inflation. Inflation erodes the purchasing power of financial wealth

Question No: 45 (Marks: 3)

Give an account of different components of aggregate demand?

Aggregate demand is divided into four components:

1. **Consumption:**

Consumption decisions often rely on borrowing, and the alternative to consumption is saving

(Higher rates mean more saving).

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2. **Investment:**

Investment is the most important of the components of aggregate demand that are sensitive to changes in the real interest rate

3. **Government purchases:**

While changes in real interest rate may have an impact on the government's budget by raising the cost of borrowing, the effect is likely to be small and ignorable

4. **Net exports:**

As for net exports, when the real interest rate in a country rises, her financial assets become attractive to foreigners, causing local currency to appreciate, which in turn means more imports and fewer exports (lower net exports)

Aggregate Govt.'s Net Demand = Consumption + Investment + Purchases + Exports

Question No: 46 (Marks: 5)

Differentiate between the Foreign exchange risk and the Sovereign risk.

Foreign exchange risk

(The risk from unfavorable moves in the exchange rate)

Banks manage their foreign exchange risk by attracting deposits denominated in the same currency as the loans and by using foreign exchange futures and swaps to hedge the risk

Sovereign risk

(The risk from a government prohibiting the repayment of loans)

Banks manage sovereign risk by diversification, by refusing to do business in a particular country or set of countries, and by using derivatives to hedge the risk

Question No: 47 (Marks: 5)

Central bank can control the size of the monetary base. What are central bank monetary policy tools? Name them.

Central bank controls the quantity of reserves that commercial banks hold. Besides the quantity of reserves, the central bank can control either the size of the monetary base or the price of its components.

The central bank has three monetary policy tools, or instruments:

The target federal funds rate:

What is it? Interest rate charged on overnight loans between banks

How is it controlled? Supply of reserves adjusted through open market operations to meet expected demand at the target rate

What is its impact? Changes interest rates throughout the economy

The discount rate:

What is it? Interest rate charged by the central bank on loans to commercial banks

How is it controlled? Set as a premium over the target federal funds rate

What is its impact? Provides short-term liquidity to bank in times of crisis and aids in controlling the federal funds rate

The reserve requirement:

What is it? Fraction of deposits that bank must keep either on deposit at the central bank or as cash in their vaults
How is it controlled? Set by the central bank within a liquidity imposed range
What is its impact? Stabilizes the demand for reserves

Question No: 43 (Marks: 3)

Write down the categories of assets in the balance sheet of commercial banks.

1. Cash Items

2. Reserves

Includes cash in the bank's vault and its deposits at the central bank
Cash items in the process of collections
Uncollected funds the bank expects to receive
The balances of accounts that banks hold at other banks (correspondent banking)
Because cash earns no interest, it has a high opportunity cost. So banks minimize the amount of cash holding

3. Cash items in process of collection

4. Vault cash

5. Securities

Stocks
T-Bills
Government and corporate bonds
Securities are sometimes called secondary reserves because they are highly liquid and can be sold quickly if the bank needs cash

6. Secondary reserves

7. Loans

The primary asset of modern commercial banks;
Business loans (commercial and industrial loans),
Real estate loans,
Consumer loans,
Inter-bank loans,
Loans for the purchase of other securities
The primary difference among the various types of depository institutions is in the composition of their loan portfolios
Commercial banks make loans primarily to business
Savings and loans provide mortgages to individuals
Credit unions specialize in consumer loans

Question No: 44 (Marks: 3)

How Central banks link tools to meet their objectives?

The target federal funds rate:

Central bank holds the capacity to force the market federal funds rate to equal the target rate all the time by participating directly in the market for overnight reserves, both as a

borrower and as a lender. As a lender, the central bank would need to make unsecured loans to commercial banks, and as a borrower, the central bank would in effect be paying interest on excess reserves.

Discount Lending:

Lending is the central bank's primary tool for ensuring short-term financial stability, for eliminating bank panics and preventing the sudden collapse of institutions that are experiencing financial difficulties.

The central bank is the lender of last resort, making loans to banks when no one else can or will, but a bank must show that it is sound to get a loan in a crisis

Reserve requirement:

By adjusting the reserve requirement the central bank can influence economic activity because changes in the requirement affect deposit expansion the reserve requirement exists primarily to stabilize the demand for reserves and help the

Central bank to maintain the market federal funds rate close to target; it is not used as a direct tool of monetary policy

Question No: 45 (Marks: 3)

Name the factors that affect the transaction demand for money.

The quantity of money people hold for transactions purposes depends on

Their nominal income

Nominal money demand raises with nominal income, as more income means more spending, which requires more money

The cost of holding money

Holding money allows people to make payments, but has cost of interest foregone.

The availability of substitutes

Question No: 46 (Marks: 5)

"Principal function of Commercial banks is to receive demand deposits and to make short-term loans". Discuss

Commercial banks:

They accept deposits and use the proceeds to make consumer, commercial and real estate loans. Banks obtain funds from individual depositors and business as well as by borrowing from other financial institutions and through the financial markets.

They use these funds to make loans, purchase marketable securities and hold cash

Receiving Deposits:

This is the main function of commercial banks to collect savings of individuals and firms. They offer different types of deposits for the facility of the customers.

i. Current Account or Demand Deposits:

Any amount can be withdrawn from this account any time without any notice. No interest is allowed on this type of account.

ii. Saving Account:

This type of deposit account which is usually held by the middle class group. The saving account carries lower rate of interest.

iii. Fixed Deposit:

Amount cannot be withdrawn before the fixed future date in this type of deposit. High interest is allowed in fixed deposit which is different according to period.

Types of loans granted by commercial banks

A **secured loan** is a loan in which the borrower pledges some asset as security for the loan

A **mortgage loan** is a very common type of debt instrument, used to purchase real estate

Unsecured loans are monetary loans that are not secured against the borrowers assets

Question No: 47 (Marks: 5)

Give brief explanation of the following.

What is reserve requirement?

How is it controlled?

What is its impact on economy?

Reserve requirement:

By adjusting the reserve requirement the central bank can influence economic activity because changes in the requirement affect deposit expansion the reserve requirement exists primarily to stabilize the demand for reserves and help the

Central bank to maintain the market federal funds rate close to target; it is not used as a direct tool of monetary policy

What is it? Fraction of deposits that bank must keep either on deposit at the central bank or as cash in their vaults

How is it controlled? Set by the central bank within a liquidity imposed range

What is its impact? Stabilizes the demand for reserves

Question No: 49 (Marks: 10)

Discuss the force of real interest rate on:

Monetary Policy and the Real Interest Rate

Central bankers control short-term nominal interest rates by controlling the market for reserves. But the economic decisions of households and firms depend on the real interest rate; To alter the course of the economy, central banks must influence the real interest rate as well

In the short run, because inflation is slow to respond, when monetary policymakers change the nominal interest rate they change the real interest rate.

The real interest rate, then, is the lever through which monetary policymakers influence the real economy.

In changing real interest rates, they influence aggregate demand.

Aggregate Demand and the Real Interest Rate

Investment is the most important of the components of aggregate demand that are sensitive to changes in the real interest rate.

Consumption and net exports also respond to the real interest rate; when the real interest

rate in a country rises, her financial assets become attractive to foreigners, causing local currency to appreciate, which in turn means more imports and fewer exports (lower net exports)
While changes in real interest rate may have an impact on the government's budget by raising the cost of borrowing, the effect is likely to be small and ignorable

Question No: 55 (Marks: 3)
Why banks are there in an economy?

Banks monitor Stabilizes the Economy
Control the availability of money and credit in so it can keep low inflation, high growth, and stability of the financial system
A stable economy grows faster than an unstable one so bank plays vital role
Banks mitigate risk by taking deposits from a large number of clients and make numerous of loans, thus giving each depositor a small stake in each of the loans. So it provide economic of scale.

Question No: 56 (Marks: 5)
Discuss the impact of inflation shock on output and inflation.

Inflation shock is a change in the cost of producing output which causes the short run aggregate supply curve to shift.
It can be the result of change in the cost of raw materials or change in price of energy.
A positive inflation shock causes the short run aggregate supply curve to shift upward, and cause the inflation to rise

Question No: 57 (Marks: 5)
Discuss different types of insurance companies in detail.

Insurance companies:
Accept premiums, which they invest in securities and real estate in return for promise to compensate the policy holder incase of any events occurs like fire, accident, death etc.
There are two type of in Insurance companies
Life insurance
Property and casualty insurance
Term life insurance
Makes a payment to the insured's beneficiaries upon the death of the insured
Group insurance is obtained through employers
Whole life insurance
Combination of term life insurance and a savings account
A payment of a fixed premium over lifetime in return for a fixed benefit in case of death of policy holder
The cash value can be refunded if the policyholder decides to discontinue the policy

Over the years, the emphasis shifts from insurance to savings

Property and casualty Insurance

Auto insurance is a combination of property insurance on the car and casualty insurance on the driver

Question No: 58 (Marks: 10)

Discuss adjustments in short run equilibrium if aggregate demand increases.

Short-run equilibrium is determined by the intersection of the aggregate demand curve with the short-run aggregate supply curve.

At point output is greater the potential output SARS start to move shift up and output start falling down. Inflation will rise. If no action will be taken by policy maker at this stage then

Economy will move to point 3, where Current inflation will be greater then Target inflation

Aggregate demand curve shifts to the right and inflation will rise if policymakers committed to their original inflation target then they will do something to get the economy back to the point where it started government purchases will raise the real interest rate increasing the real interest rate at every level of inflation will be achieved by compensating the shifting of monetary reaction curve to the left.

When the monetary policy reaction curve shifts, the aggregate demand curve also shifts with it.

The aggregate demand curve will shift to the left, and economy will be back to long-run equilibrium.

Question No: 59 (Marks: 10)

a) Distinguish between illiquidity and insolvency. Why is it difficult for a lender of last resort to tell insolvency from illiquidity?

Does the distinction matter?

Insolvent mean bankrupt or someone who has insufficient assets to cover their debts

Insolvent is not in position to pay its due bills

Illiquidity

In such a position where assets are not immediately or easily be converted into cash.

Illiquid assets can be converted into cash, but usually only after a time or at lower value.

Insolvent is in hard time or not a position to revive its working condition compared to insolvency illiquidity is position where business has enough assets only thing is not immediately available. Lender of last resort can take those assets as security to provide the funds.

b) A government is considering changing its deposit insurance system from one in which deposits are implicitly guaranteed
(That is, if a bank fails, people trust the government to put enough resources into the bank so that depositors will lose nothing) to one with an explicit ceiling. What would be the impact of such a change on depositors? On banker

Bank will be having less money to business as they have to keep money as deposit.

Due to keeping more money as required reserve banks will not be in position to lend more loans.
It will reduce their business activity. Same time it will increase the liquidity of bank.

People will trust then banks more, due to guaranty form govt.

Due to shortage of lending more money to public bank might charge more keeping demand and supply rule in mind.

Cost of borrow from bank can increase.

Question No: 43 (Marks: 3)

Give a single line definition of the following.

Answer:
1) Credit risk: This is a risk which arises when loans are not repaid. It is avoided by diversification and checking credit worthiness.

2) Interest-rate risk: The assets and liabilities of a bank are sensitive to interest rate but liabilities are of short term and assets of long term so by an increase in interest rate banks have the risk that value of assets fall more than that of liabilities affecting the net worth or capital of bank.

3) Liquidity risk: It is a risk associated with a sudden increase in demand of funds. If bank can not meet the withdrawal requirement of all its customers, bank is considered illiquid and it may fail.

Question No: 44 (Marks: 3)

Describe the role of Central bank as "The Bankers Bank".

Answer: The central Bank works as a Banker's Bank. The role which it plays is Lender of last resort. If banks go illiquid or during financial stress central bank provide discount loans to banks.

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Manage interbank payment system
Monitors the working of banks and stabilizing financial system

Question No: 45 (Marks: 3)

What is the effect of an increase in potential output on inflation and output?

Answer: Increase in potential output shifts long run aggregate supply curve to right, this shift has no impact on short run aggregate supply curve so inflation and output remains unchanged. But in long run now as potential output is increased so current output will be below potential output creating recessionary output gap causing inflation to fall and output begins to rise.

Question No: 46 (Marks: 5)

Which relationship is shown by the monetary policy reaction curve?
What will be the change in monetary policy reaction curve if the given factors change?
An increase in the Central Bank's Inflation Target
An increase in the Long-run real interest rate

Answer: Monetary policy reaction curve gives a relationship between inflation and real interest rate. It is set so that when current inflation equals target inflation, real interest rate equals long run real interest rate.
a. Increase in central bank's inflation target shifts the monetary policy reaction curve to right
b. Increase in long run real interest rate shifts the curve to left.

Question No: 47 (Marks: 5)

Fill the table below:

Financial intermediary	Primary Sources of Funds (Liabilities)	Primary Uses of funds (Assess)	Services provided
Depository institutions (Bank)	Checkable deposits, savings and time deposits Borrowing from other sources	Cash reserves, Market securities, loans	Pool savings, access to payment system, Diversification, liquidity
Insurance company	Expected claims	Corporate and government bonds, stocks	Pooling of risk

Question No: 48 (Marks: 10)

Discuss the factors that cause an increase or decrease in the transaction and

portfolio demand for money.
Answer:
Transaction Demand for money: The quantity of money people hold for transaction purposes is called transaction demand for money. It depend on following factors
Nominal income of people: As the nominal income increases spending increases which causes an increase in the demand for money holding.
Cost of holding money: The cost of money holding is the interest foregone in holding the money in hand. So if the nominal interest rate is higher people will prefer keeping money in banks etc so demand for money holding decreases.
Availability of substitutes: If people have cheaper alternative means of payment they will hold less money.

Portfolio Demand for Money: Money is one instrument that people can hold in their investment portfolio. The demand for holding money in portfolio is dependent on following factors:
Wealth: An increase in wealth increases the demand for money
Return on alternative investments: As the return on alternative investments fall people hold more money.
Expected future interest rate: An increase in expected future interest rate increases holding demand for money
Riskiness of alternatives: Riskier the alternative investments greater the demand for money.
Liquidity: If alternative investments become more liquid demand for money decreases

Question No: 49 (Marks: 10)

If Excess reserves are not available how a bank manages Liquidity risk?
Answer: One way of managing liquidity risk is to keep excess reserves but this is not profitable as reserve is interest free.
There are two other ways through which a bank can manage liquidity risk.
Adjusting other assets of balance sheet
Adjusting liability side

In adjusting assets banks can instead of paying through reserves, fulfill withdrawal requirements by adjusting other assets. Banks can either
Sell their securities
Sell their loans
Refuse a loan renewal

The second option banks have is to adjust their liabilities.
Borrow from other banks or central bank

Attracting more deposits

Question No: 55 (Marks: 3)
Why the aggregate demand curve slopes down?

There are two reasons why the aggregate demand curve slopes down:
- First, because higher inflation reduces real money balances (thus reducing purchases),
- Second, because higher inflation induces policymakers to raise the real interest rate, depressing various components of aggregate demand
- rising inflation also reduces wealth, which lowers consumption and drives down aggregate demand.

Question No: 56 (Marks: 5)
What will be the effect of following factors on bond demand curve?
1- Expected inflation
2- Expected return on stocks and other assets
3- Risk relative to alternatives

The **bond demand curve** is the relationship between the price and quantity of bonds that investors demand, all other things being equal.
Expected inflation
A fall in expected inflation shifts the bond demand curve to the right, increasing demand at each price and lowering the yield and increasing the Bond's price.
Expected return on stocks and other assets
If the return on bonds rises relative to the return on alternative investments, the demand for bonds will rise. This will increase bond prices and lower yields.
Risk relative to alternatives
If a bond becomes less risky relative to alternative investments, the demand for the bond shifts to the right.

Question No: 57 (Marks: 5)

What is the source of a credit risk and how this risk could be managed?
Credit risk
This is the risk that loans will not be repaid and it can be managed through diversification and credit-risk analysis
Diversification can be difficult for banks, especially those that focus on certain kinds of lending
Credit-risk analysis produces information that is very similar to the bond-rating systems and is done using a combination of statistical models and information specific to the loan applicant

 Lending is plagued by adverse selection and moral hazard, and financial institutions use a variety of methods to mitigate these problems
 Screen loan application
 Monitor borrowers after they have received loan
 Collateral or high net-worth demand
 Developing long term relationships

Question No: 58 (Marks: 10)
a. Assume that:
Monetary Base (MB) = $350 billion
Required Deposit Reserve Ratio (r_D) = 10%
Excess Reserve Ratio (ER/D) = 5%
Currency Ratio (C/D) = 25%
Calculate the total money supply (M) from this information.
Answer:
M= (C/D +1)/(C/D+RD + ER/D) *MB
M= 25%+1/ (25% + 10%+ 5%)*350
=1.25/1.25+.1+.05*350
=.893*350 = 312.5
=31250%
b) Under the condition that the monetary base is $350 billion but the required deposit reserve ratio (r_D) changes from 10% to 20%, while the excess reserve ratio (ER/D) remained at 5% and the currency ratio (C/D) remained at 25%, what is the total money supply (M) now?
M= (C/D +1)/(C/D+RD + ER/D) *MB
M= 25%+1/ (25% + 20%+ 5%)*350
=1.25/1.25+.2+.05*350
=1.875 * 350 = 656.25
=65625%
c. What is the change in total money supply?

Question No: 59 (Marks: 10)
Explain in detail the tools of monetary policy in your own words.

The central bank has three monetary policy tools, or instruments:
The target federal funds rate:
Central bank holds the capacity to force the market federal funds rate to equal the target rate all the time by participating directly in the market for overnight reserves, both as a borrower and as a lender. As a lender, the central bank would need to make unsecured loans to commercial banks, and as a borrower, the central bank would in effect be paying interest on excess reserves
What is it? Interest rate charged on overnight loans between banks

How is it controlled? Supply of reserves adjusted through open market operations to meet expected demand at the target rate
What is its impact? Changes interest rates throughout the economy
The discount rate:
Lending is the central bank's primary tool for ensuring short-term financial stability, for eliminating bank panics and preventing the sudden collapse of institutions that are experiencing financial difficulties.
The central bank is the lender of last resort, making loans to banks when no one else can or will, but a bank must show that it is sound to get a loan in a crisis
What is it? Interest rate charged by the central bank on loans to commercial banks
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Central bank to maintain the market federal funds rate close to target; it is not used as a direct tool of monetary policy
What is it? Fraction of deposits that bank must keep either on deposit at the central bank or as cash in their vaults
How is it controlled? Set by the central bank within a liquidity imposed range
What is its impact? Stabilizes the demand for reserves

Question No: 55 (Marks: 3)
What is term life insurance?
Term life insurance or **term assurance** is life insurance which provides coverage at a fixed rate of payments for a limited period of time, the relevant term. After that period expires coverage at the previous rate of premiums is no longer guaranteed and the client must either forgo coverage or potentially obtain further coverage with different payments and/or conditions. If the insured dies during the term, the death benefit will be paid to the beneficiary. Term insurance is the most inexpensive way to purchase a substantial death benefit on a coverage amount per premium dollar basis.

Question No: 56 (Marks: 5)
What is the difference between corporate banking and Enterprise banking?
Corporate Banking means Financing to corporate institutions which have been declared as corporate entity. Corporate entity means if more than one company falls in the same line of business, financing terms will be same to all the corporate institution as whole.
Enterprise banking means each individual business units will be covered separate, according to the specific requirements for financing. Though more than one company falls in the same group, the financing terms will differ according to each enterprise

demands and needs

Question No: 57 (Marks: 5)
In what ways monetary and fiscal policy differs? Discuss.

The fiscal policy of a country is chiefly related to the economic state of affairs of that very nation. It refers to the strategy that the government of a country incorporates to tax its citizens and to make optimum use of that money. These decisions are not consistent for various periods and change with the passage of every year concentrating mainly on what exactly are the needs of the nation during a particular period and what amount of money is required to cater to those needs.

As for **monetary policy**, it differs from the fiscal policy in the way that monetary policy clearly and exclusively focuses on the strategy of the bank to regulate money and circulate it in an effective manner. This policy is also not the same for every year and changes in accordance with the demand and supply cycle of funds while in cohesive accordance the interest rate on which loans are offered also change. The main body that acts as the chief regulator in the monetary policy is the Central Bank of a country. (For example for Pakistan, it is the State Bank of Pakistan; for the United States, it is the Federal Reserve System)