The Management University of Africa

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POST GRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

DEGREE OF MASTER OF BUSINESS ADMINISTRATION

BFO 503: FINANCIAL INSTITUTIONS STRATEGIC MANAGEMENT

DATE: 29TH NOVEMBER 2023

DURATION: 3 HOURS

MAXIMUM MARKS: 60

INSTRUCTIONS:

1. Write your registration number on the answer booklet.
2. **DO NOT** write on this question paper.
3. This paper contains **FOUR (4)** questions.
4. Question **ONE is compulsory.**
5. Answer any other **TWO** questions.
6. Question **ONE** carries **30 MARKS** and the rest carry **15 MARKS** each.
7. **Write all your answers in the Examination answer booklet provided**

QUESTION ONE

Read the Case Study below carefully and answer the questions that follow:

REFLECTIONS ON THE FUTURE OF INTERNATIONAL BANKING

The recent crisis highlighted deficiencies in the way many international banks conducted their business and managed financial risks. It also exposed gaps in the regulatory environment. The rapid transmission of shocks across the global financial system through internationally active banks, together with the concurrent macroeconomic problems, has prompted calls for improvements to these banks' business models that will strengthen their risk and liquidity management. These calls have led to a reassessment of the balance between the financial stability risks and the economic benefits associated with international banking.

From a long-term perspective, international banking has contributed to world economic progress. The internationalisation of banking has closely tracked the growth in international trade for long periods in the past, suggesting that real and financial globalization are closely intertwined. International banking has been an important driver of global integration and economic development, supporting the efficiency of multinational firms and helping to exploit the growth potential of both developed and emerging market economies. In addition, the establishment of local operations by foreign banks has often enhanced the effectiveness of emerging market financial systems. Against this backdrop, the long-term trend towards the internationalisation of banking can be expected to continue.

However, as its major drivers evolve, its overall pace and patterns are likely to differ from the past, posing challenges for authorities in their efforts to shape the future financial system. One development that is likely to affect international banking in the

future relates to international trade and multinational production. International banking should continue to expand alongside the expansion of trade and multinational production activity. The location of such activities could move more towards emerging market economies, especially areas exhibiting the most economic dynamism. This might spur further financial integration, both in the form of increased participation in these economies by foreign internationally active financial institutions and via an expanded international role for banks from emerging market countries. That role might be associated with more cross-border consolidation in the financial sector, both between institutions from emerging economies, and between those from industrialized and emerging economies.

Another important development relates to the balance between market- and bank-based international intermediation. According to a long-established "complementarity" view in the literature, economic growth is stronger and efficiency benefits are greater when both bank and market-based financial intermediation perform their respective functions. The main reason is that each type of intermediation has its comparative advantages, which depend on the stage of economic or financial development and manifest themselves in different economic sectors and industries. In addition, the complementarity of banks and markets is enhanced by the increasing interdependence of these two forms of intermediation.

Thus, the completeness of a financial system is essential (Levine (2002), Beck and Levine (2002), Arcalean et al (2007)). Lessons from the crisis have lent support to this view, underscoring the importance of resilience in both financial markets and the banking sector. The recently expanded role of international capital markets as a source of corporate financing has illustrated the greater flexibility of markets at a time of stress.

Large non-financial corporations, particularly in mature but also in emerging economies, resorted strongly to bond financing when faced with a sharp contraction in bank credit, resulting in record levels of issuance. At the same time, banks are a more

important source of external financing to households, as well as to small and medium-sized companies. These borrowers tend to be burdened by asymmetric information issues and, thus, have only limited and indirect access to capital markets.

These broad trends have a bearing on a third secular change, which is in the regulatory environment. Authorities envisage a new regulatory environment in which banks hold stronger capital and liquidity buffers and build balance sheets that are resilient to funding shocks. Many host country authorities are considering a strengthening of local oversight and regulation. Policy design faces the challenge of fixing the shortcomings of international banking while preserving its efficiency-enhancing functions. Effective policy should foster the development of liquid securities markets that complement bank-based intermediation, improve market infrastructures and ensure that entities performing similar financial functions receive similar regulatory treatment. Given its strong role in shaping international intermediation in the past, regulation has an important role to play in fostering cross-border knowledge transfer.

The end result, however, should not be the convergence to a single risk assessment or risk management framework, which would encourage herd behaviour and weaken financial stability. Since any given framework is inevitably imperfect, diversity of approaches would carry large benefits. Perhaps even more importantly, a new regulatory framework should aim at a level playing field. Competition is a major channel through which international banks promote growth. In addition, adhering to the level playing field principle goes hand in hand with the goals of enhancing oversight, transparency and supervision of systemically important activities.

Hence, the continuing financial integration of both developed and emerging market economies makes it even more important that regulation have a truly global reach. At the same time, competition may have contributed to the underpricing of risk and, thus, to a leverage-based expansion of balance sheets in the run-up to the crisis. There is scant evidence for economies of scale within large internationally active banks.

However, certain banks may have expanded, either domestically or internationally, with the aim of attaining a too-big-to-fail status. Such a status increases moral hazard and weakens market monitoring of risk-taking, which benefits individual firms but distorts economic incentives and renders the financial system more fragile. In turn, this underscores the importance of strong supervision and prudential buffers that restrain the build-up of risks. Effective, and therefore credible, bank resolution regimes that take into account the too-big-to-fail issue would be a welcome complement (BCBS (2010)).

Required

a) Explain five roles of International banking as a driver of global integration and economic development as identified in the above case study**(10 Marks)**

b) ''However, as international banking's major drivers evolve, its overall pace and patterns are likely to differ from the past, posing challenges for authorities in their efforts to shape the future financial system''. Evaluate five challenges of international banking to local banking sector regulators as raised in the above case study **(10 Marks).**

c) Assess the role of the central bank of Kenya in addressing the challenges raised in (b) above with respect to the case study. **(10 Marks)**

QUESTION TWO

a) ''Competition is a major channel through which international banks promote growth''. Illustrate the effects of multinational banks venturing into the Kenyan market with emphasis on banking industry competition **(10 Marks).**

b) ''International banking has had a favorable impact on economic growth and efficiency.'' Evaluate five international banking transmission channels in the Kenyan economy **(5 Marks).**

QUESTION THREE

a) "A key lesson of the 2008 global financial crisis is that deregulation allowed banks' balance sheets to expand beyond the level that could be justified by sound risk assessment''. Assess any five Factors that also contributed to the global financial crisis **(5 Marks).**

b) "The success with which a bank incorporates a host country's characteristics into its business model determines its comparative advantage vis-à-vis other internationally active banks." Analyze five sources of competitive advantage for local banks in the Kenyan market **(10 Marks).**

QUESTION FOUR

a) "As with any component of their business model, banks expand internationally in a way that allows them to find an optimal balance between return and risk". Briefly, Examine the strategies that can be used by Kenyan banks to venture abroad **(5 Marks).**

b) "Wealthy investors and financiers like banks and pension schemes are putting pressure on the Central Bank of Kenya (CBK) to increase the cost of government borrowing as global hikes in lending rates make local assets less attractive". Assess any five effects of the high cost of borrowing on the Kenyan government.

(10 Marks)