

DO NOT REMOVE THE QUESTION PAPER FROM THE EXAMINATION HALL

UNIVERSITY OF LONDON

CENTRE FOR FINANCIAL AND MANAGEMENT STUDIES

*MSc Examination*

*Postgraduate Diploma Examination*

for External Students

91DFMC338

FINANCE AND FINANCIAL LAW

**Introduction to Law and to Finance**

*Specimen Examination*

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*This is a specimen examination paper designed to show you the type of examination you will have at the end of the year for **Introduction to Law and to Finance**. The number of questions and the structure of the examination will be the same but the wording and the requirements of each question will be different. Best wishes for success in your final examination.*

The examination must be completed in **THREE** hours.

Answer **THREE** questions. Answer *at least ONE* question from **Section A** and *at least ONE* question from **Section B**.

The examiners give equal weight to each question; therefore, you are advised to distribute your time approximately equally between three questions.

**PLEASE TURN OVER**

Answer **THREE** questions. Answer *at least ONE* question from **EACH** section.

## **Section A**

*Answer at least ONE question from this Section.*

1. 'The essential difference between common law and civil law systems lies in their differing views of the significance of cases.'  
Discuss.
  
2. Edward agrees over the telephone to sell some shares in his company, Zephyr Limited, to Farouk. Edward is concerned about Farouk's ability to pay, so Farouk asks his friend, George, to guarantee payment. George rings up Edward, and says: "It's fine; if Farouk doesn't pay you, I will – no problem." Edward plans to use the money from the share-sale to go into supplying finance to consumers who wish to buy household goods. One of Edward's acquaintances, Harry, knows of these plans and asks Edward to lend him £1,000 to buy a car. Edward lends Harry the money, and they document the agreement by an exchange of letters. Fired with enthusiasm for his new activity, Edward leases an office from another acquaintance, Irene, who promises that in return for an increased rent, she will help him decorate the office to make it attractive to customers. The term of the lease is for six years. Again, the transaction is documented by an exchange of letters.  
  
Advise Edward as to the formal validity of the contracts involved and any liability that might arise.
  
3. Elle has asked Eastern Finance Ltd. for a loan of £300,000 to set up a new business. When asked for details of her current bank, she says that she has one bank account, with South Downs Bank plc, and signs an authorisation, allowing the bank to disclose details of her financial standing to Eastern Finance. In response to Eastern Finance's request for a bank reference, South Downs Bank sends a brief letter, stating that Elle has held a current account with them for 10 years and a savings account for 3 years and they are not aware of any

problems. In fact, although Elle does hold a savings account with the bank, the balance has, for the last 2 years never been above £100 and, over the same period, she has received 5 letters, warning her of exceeding the overdraft limit on her current account. Further, a company which she set up with her friend, Jared, went into insolvency 6 months ago.

On the basis of the bank reference, Eastern Finance grant the loan to Lucinda. Six months later, her business collapses. When her history is revealed, Eastern Finance complain to South Downs Bank, who inform them that the details they supplied of her accounts were true and that, on the date on which the request was received, her current account showed a balance of £500. Hence they believed in good faith that there was not a problem.

Advise Eastern Finance as to what remedies, if any, they may have against South Downs Bank.

4. Tia is interested in purchasing Tamara's house and has written to her asking, "If you were to sell your house, what is the lowest amount you would take for it?" Tamara has written back stating that if she were to sell the house, the least she would accept for it would be £100,000. Tia has now written back saying that she would accept Tamara's offer and buy the house from her for £100,000. Tamara says that she does not want to sell the house. Tia says that a contract is a contract and Tamara would have to sell the house to her.

Advise Tamara as to whether she would have to sell the house.

5. What is the impact of the Human Rights Act 1998 on English commercial and financial law?

**PLEASE TURN OVER**

## Section B

Answer at least **ONE** question from this Section.

6. Answer **BOTH** parts of the question.

- a) Consider the daily value at risk (VaR) for an investor with a 10 million index portfolio in British pounds (£). The investor is about to invest in a UK stock index fund which exactly follows the UK stock index. Suppose that (i) the standard deviation of the daily changes of the UK stock index is 0.6%, (ii) the average daily change is 0, and (iii) the returns are normally distributed. Draw a diagram and explain how the investor might calculate the daily VaR of her portfolio. You may use the following table. (15 marks)

**Normal distribution cumulative probabilities for commonly used VaR percentiles**

| Probability<br>( $X < z$ ) | 0.1%   | 0.5%   | 1.0%   | 2.5%   | 5.0%   | 10%    |
|----------------------------|--------|--------|--------|--------|--------|--------|
| Z Score                    | -3.090 | -2.576 | -2.326 | -1.960 | -1.645 | -1.282 |

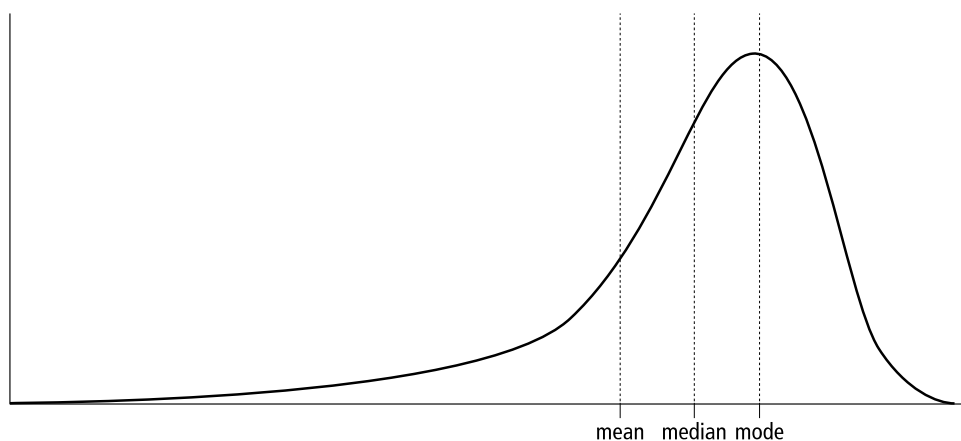
- b) Financial models have been widely blamed for underestimating and mispricing of the risk prior to the financial crisis. One of the reasons has been that the financial models are based on the assumption of a normal bell-shaped curve whereas the reality has been that the bell-shaped curve is negatively skewed as in the diagram below.

Explain why financial models underestimated the risks.

(85 marks)

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### Negatively skewed distribution

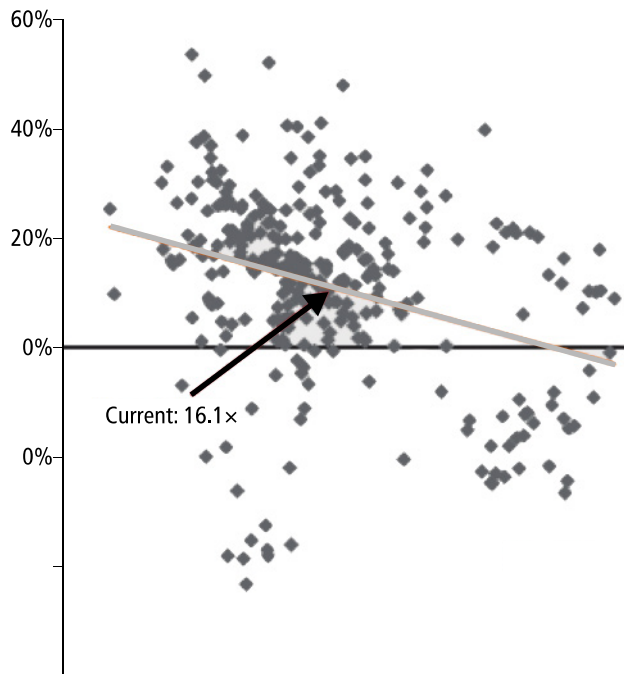


7. The most important thing to understand about picking stocks is this: If you are buying a share, someone else is selling it. Whatever analysis you have done to tell you that this stock is a good deal at today's price, be aware that there is someone else on the other side of the trade who has run the numbers and decided that the smart move is to get out now. Stock picking is a battle of wits against other investors, most of whom, you should assume, are at least as informed and rational as you are.
- a) Discuss how you might evaluate whether a share is good value or not. *(70 marks)*
- b) Demonstrate whether the price of a bond is higher or lower than its face/par value if the bonds' yield to maturity is greater than the coupon rate. *(30 marks)*
8. Refer to the graphs below and answer the following questions:
- a) Explain why there is an inverse relationship between the required return and the share price. *(30 marks)*
- b) From your evaluation of the graphs discuss what essential statistical concepts underpin the extent to which two or more variables fluctuate together. *(30 marks)*

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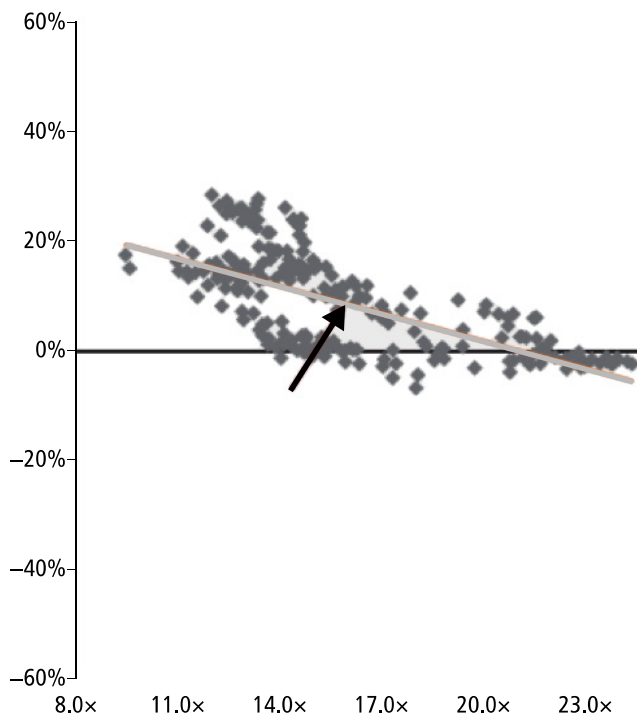
- c) Critically discuss the significance of the coefficient of determination ( $R^2$ ) on the graphs. (40 marks)

**Graph (a) Forward P/E and subsequent 1-year returns**  
S&P 500 total return index  
 $R^2 = 10\%$

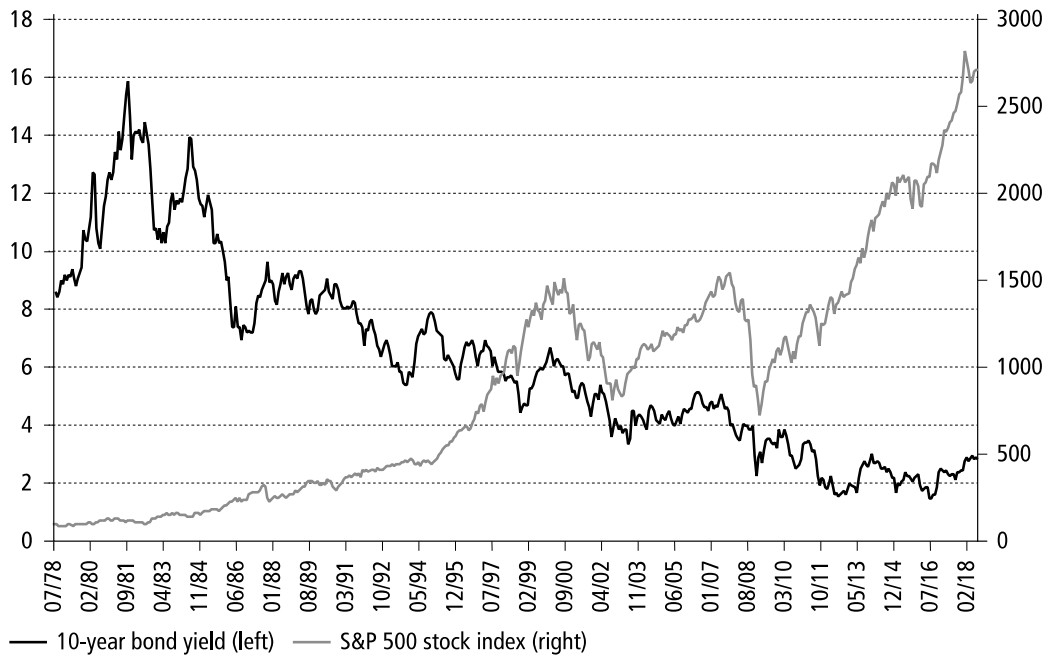


Source: JP Morgan Asset Management

**Graph (b) Forward P/E and subsequent 5-year annualised returns**  
S&P 500 total return index  
 $R^2 = 44\%$



**Graph (c) Correlation between stocks (S&P500 index) and bonds (The US Government 10-year bond yield)**



**[END OF EXAMINATION]**