





# COMMERCIAL BANK MANAGEMENT

(0503211)  
Part (1)

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First Semester 2013/2014

Department of Finance and Banking

Faculty of Finance and Business Administration

Al – al BAYT University

Part 1

## Key Notes

### ☞ Office Hours:

- Sun and Tue: 11:00 – 12:00.
- Wed: 11:30 – 12:30.

### ☞ 1<sup>st</sup> Exam: Wed, 30/10/2013, 02:00pm ☺

### ☞ 2<sup>nd</sup> Exam: Wed, 04/12/2013 , 02:00pm ☺

### ☞ Grading:

- 1<sup>st</sup> Exam: 20%.
- 2<sup>nd</sup> Exam: 20%.
- Positive Participation: 10%.
- Final Exam: 50%.

### ☞ No Makeup at al.

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Chapter

**1**

## An Overview of Intermediation

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*Part 1*

## The Financial System

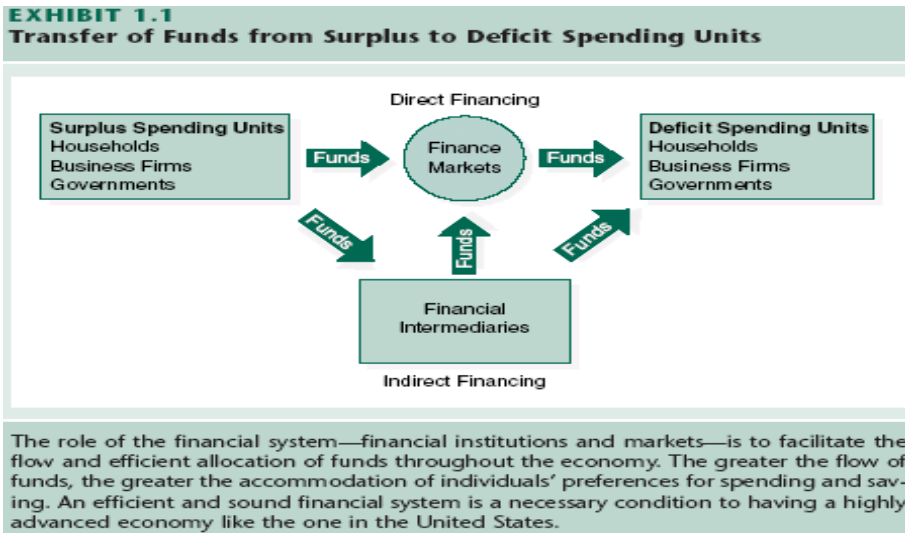
- ☞ Provides for efficient flow of funds from saving to investment by bringing savers and borrowers together via financial markets and financial institutions.

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## Exhibit 1.1 – Transfer of Funds



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### Basic components of the financial system: Markets and institutions.

- ☞ **Financial markets** are markets for financial instruments, also called financial claims or securities.
- ☞ **Financial institutions** (also called financial intermediaries) facilitate flows of funds from savers to borrowers.

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**Economic units with financial needs: Households,  
Businesses, Governments.**

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- ☞ **Households supply labor, demand products, and save for the future.**
- ☞ **Businesses demand labor, supply products, and invest in productive assets.**
- ☞ **Governments collect taxes and provide “public goods” (e.g. education, defense).**

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**Budget positions creating financial needs of economic  
units: Surplus or deficit.**

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- ☞ **Surplus units (SU's) have income for the period that exceeds spending, resulting in savings.**
  - **Other words for “SU” are *saver, lender, or investor*. Most SU's are households.**
- ☞ **Deficit units (DU's) have spending for the period that exceeds income.**
  - **Another word for “DU's” is “borrower”. Most DU's are businesses or governments.**

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## **Financial claims *arise as SU's lend to DU's.***

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- ☞ **SU's claim against DU's is liability to DU's and asset to SU's.**
- ☞ **One's liability is another's asset: What is payable by one is receivable by another.**
- ☞ **Assets arising this way are “financial assets.” The financial system “balances”-total financial assets equal total liabilities.**

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## **Marketability**

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- ☞ **Ability to resell financial claims makes them more liquid by giving SU's choices:**
  - **Match maturity of claim to planned investment period;**
  - **Buy claim with longer maturity, but sell at end of period; or**
  - **Buy claim with shorter maturity, then reinvest.**

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## Direct Financing

- ☞ DU's and SU's find each other and bargain
- ☞ SU's transfers funds directly to DU's
- ☞ DU's issues claim directly to SU's
- ☞ Preferences of both must match as to-
  - Amount
  - Maturity
  - Risk
  - Liquidity

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## Finance and Intermediation Forms

- ☞ No-Intermediation (Direct Finance).
- ☞ Financial Intermediation (Indirect Finance through Investment Banks).
- ☞ Banking Intermediation (Indirect Finance through Commercial Banks).
- ☞ Disintermediation (Direct Finance).

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## ...Direct Financing

- ☞ **DU's and SU's “seize the day”**
  - **DU's fund desired projects immediately.**
  - **SU's earn timely returns on savings.**
- ☞ **Direct markets are “wholesale” markets.**
  - **Transactions typically \$1 million or more.**
  - **Institutional arrangements common.**

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## Institutional arrangements

- ☞ **Private placements are simplest.**
- ☞ **Investment bankers “underwrite” new issues of securities.**
- ☞ **Brokers and dealers bring buyers and sellers of direct claims together.**

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## Private placements are simplest.

- ☞ DU's sell whole security issue to one investor or investor group.
- ☞ Advantages include speed and low transactions costs.

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## Investment bankers

- ☞ Buy entire issues of securities from DU's
- ☞ Find SU's to buy securities at higher price
- ☞ Profit from difference - "*underwriting spread*"

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## Brokers and dealers

- ☞ Brokers buy or sell at best possible price for their clients.
- ☞ Dealers “make markets” by carrying inventories of securities.
  - buy at “bid price;” sell at “ask price”
  - “Bid-ask spread” is dealer’s gross profit

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## Problem with direct financing

- ☞ Not every SU’s can afford “wholesale” denominations of \$1 million or more.
- ☞ DU’s and SU’s often prefer different terms to maturity.

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## Indirect Financing

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☞ **Financial intermediaries “transform” claims:**

- raise funds by issuing claims to SU’s;
- use funds to buy claims issued by DU’s.

☞ **Claims can have unmatched characteristics:**

- SU’s has claim against intermediary;
- Intermediary has claim against DU’s.

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## Commercial Banks

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☞ **Take deposits and make loans -**

- Depositors are SU’s
- Borrowers are DU’s.

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## **Benefits of financial intermediation are a primary rationale for the financial system.**

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- ☞ **Financial intermediaries lower the cost of financial services as they pursue profit.**
- ☞ **Financial intermediaries perform 5 basic services as they transform claims.**

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## **Intermediaries lower the cost of financial services as they pursue profit.**

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- ☞ **3 sources of comparative advantage:**
  - **Economies of scale**
  - **Transaction cost control**
  - **Risk management expertise**
- ☞ **Competition pulls interest rates down**
  - **Financing less costly**
  - **Projects have higher NPVs**
  - **Investment in real assets boosts economy**

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**Intermediaries perform 5 basic services as they transform claims.**

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- ☞ **Denomination Divisibility** – pool savings of many small SU's into large investments.
- ☞ **Currency Transformation** – buy and sell financial claims denominated in various currencies.
- ☞ **Maturity Flexibility** – Offer different ranges of maturities to both DU's and SU's.

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**...Intermediation Services**

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- ☞ **Credit Risk Diversification** – Assume credit risks of DU's; spread risk over many different types of DU's.
- ☞ **Liquidity** – Give SU's and DU's different choices about when, to what extent, and for how long to commit to financial relationships.

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## Commercial Banks

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- ☞ Largest single class of financial institution
- ☞ Issue wide variety of deposit products - checking, savings, time deposits
- ☞ Carry widely diversified portfolios of loans, leases, government securities
- ☞ May offer trust or underwriting services

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Chapter

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## Bank Regulations in Jordan

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### NOTE!

- ☞ Please, Refer to Central Bank of Jordan (CBJ) REGULATIONS.
- Bank Law, Licensing Rules and Conditions (in Arabic).

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Chapter

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## Bank's Sources and Uses of Funds

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### Chapter Outline

- ☞ **The bank balance sheet**
  - Money
  - How do banks get funds and use funds.
- ☞ **T-accounts**
  - business
  - How do banks operate?
- ☞ **Bank management**
  - risk
  - Manage risk to be within proper limits.

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## The bank balance sheet

☞ **Balance sheet** of a bank is a listing of its assets, its liabilities and owners equity.

☞ **Assets:**

➤ what the bank owns, uses of funds

☞ **Liabilities**

➤ what the bank owes to others, sources of funds

☞ **Bank Owners Equity**

➤ Bank's net worth, defined to be the difference between its assets and its liabilities

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**Assets = Liabilities + Owners Equity**

TABLE 1 Balance Sheet of All Commercial Banks (items as a percentage of the total, January 2006)

Assets (Uses of Funds)*		Liabilities (Sources of Funds)	
Reserves and cash items	4%	Checkable deposits	7%
Securities		Nontransaction deposits	
U.S. government and agency	13	Small-denomination time deposits	
State and local government and		(< \$100,000) + savings deposits	43
other securities	10	Large-denomination time deposits	16
Loans		Borrowings	26
Commercial and industrial	12	Bank capital	8
Real estate	34		
Consumer	8		
Interbank	3		
Other	9		
Other assets (for example,			
physical capital)	7		
Total	100	Total	100

\*In order of decreasing liquidity.  
Source: [www.federalreserve.gov/releases/h8/current/](http://www.federalreserve.gov/releases/h8/current/).

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## Liabilities

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☞ **Liabilities** are a bank's sources of funds, it specifies what the bank owes to others .

1. **Checkable Deposits:**

- checking accounts, etc.
- liquid, payable on demand, decline in importance

2. **Nontransaction Deposits:**

- interest-bearing savings accounts and time deposits (e.g. CDs).
- the primary source of bank funds.

3. **Borrowings:**

- loans obtained from the Fed (**discount loans**), other banks (in overnight Fed funds market), corporations, etc.
- an increasingly important source of bank funds.

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## Bank Owners Equity

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☞ net worth

☞ raised by selling new equity (stocks) or from retained earnings

☞ a cushion from insolvency

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## Sources of Funds in Banks of Jordan

	2012	2011	
<b>Demand Deposit</b>	<b>6284.8</b>	<b>5807.1</b>	<b>ودائع تحت الطلب</b>
Public Non-Financial Institutions	39.0	29.7	مؤسسات عامة غير مالية
Municipalities and Village Councils	3.4	3.4	البلديات والمجالس القروية
Non-Banking Financial Institutions	69.4	88.0	المؤسسات المالية
Social Security Corporation	59.0	43.5	مؤسسة الضمان الاجتماعي
Private Sector (Resident)	6114.0	5642.5	القطاع الخاص (مقيم)
<b>Saving and Time Deposit</b>	<b>15426.4</b>	<b>15272.2</b>	<b>ودائع التوفير ولأجل</b>
Public Non-Financial Institutions	275.9	299.0	مؤسسات عامة غير مالية
Municipalities and Village Councils	15.7	13.0	البلديات والمجالس القروية
Non-Banking Financial Institutions	205.5	189.0	المؤسسات المالية
Social Security Corporation	656.3	507.9	مؤسسة الضمان الاجتماعي
Private Sector (Resident)	14273.0	14263.3	القطاع الخاص (مقيم)
<b>Foreign Liabilities</b>	<b>5827.2</b>	<b>6164.0</b>	<b>المطلوبات الاجنبية</b>
Central Government Deposits	646.7	637.4	ودائع الحكومة المركزية
Credit From CBJ	998.3	449.0	الاقتراض من البنك المركزي
Capital Accounts & Allowances	5848.2	5397.2	رأس المال والاحتياطيات والمخصصات
<b>Unclassified Liabilities</b>	<b>4243.8</b>	<b>3959.5</b>	<b>المطلوبات الاخرى</b>

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## Assets

☞ **Bank assets indicate use of bank funds.**

### 1. Reserves:

- **vault cash + deposits in an account at the Fed**
- **required reserves + excess reserves**

### 2. Cash in the process of collection

### 3. Deposits at other banks

1 - 3 are cash items only 4%

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## ...Assets

### 4. Securities:

- not allowed to hold stocks, they hold debt instruments (bonds)
- short-term U.S. government bonds are "secondary reserves"

### 5. Loans:

- relatively illiquid, greater default risk
- primary profit source for banks

### 6. Other Assets: physical assets, etc.

4 - 5 are income-earning assets

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## Uses of Funds in Banks of Jordan

Assets	2012	2011	
<b>Foreign Assets</b>	<b>6353.1</b>	<b>6285.9</b>	<b>الموجودات الاجنبية</b>
Cash in Vaults (In Foreign Currencies)	289.6	135.3	نقد في الصناديق (بالعملات الاجنبية)
Balances with Foreign Banks	4437.5	4298.6	ارصدة لدى بنوك في الخارج
Portfolio (Non-Resident)	483.9	637.5	محفظة الاوراق المالية (غير مقيم)
Credit Facilities to Private Sector (Non-Resident)	853.4	974.0	التسهيلات الائتمانية للقطاع الخاص (غير مقيم)
Other Foreign Assets	288.7	240.5	موجودات اجنبية أخرى
<b>Domestic Assets</b>	<b>32922.3</b>	<b>31400.5</b>	<b>الموجودات المحلية</b>
Claims on Public Sector	9023.8	7402.7	الديون على القطاع العام
Claims on Central Government	8540.3	6888.9	الديون على الحكومة المركزية
Claims on Public Entities	483.5	513.8	الديون على المؤسسات العامة
Claims on Private Sector (Resident)	15933.5	14905.2	الديون على القطاع الخاص (مقيم)
Claims on Financial Institutions	122.5	128.1	الديون على المؤسسات المالية
Reserves	3976.2	5639.0	الاحتياطيات
Currency	343.0	347.6	النقد في الصناديق
Deposits with CBJ in Jordan Dinar	3633.2	5291.4	ارصدة لدى البنك المركزي (بالدينار)
Deposits with CBJ in Foreign Currencies	865.8	527.4	ارصدة لدى البنك المركزي (بالعملات الاجنبية)
Unclassified Assets	3000.5	2798.1	موجودات اخرى
<b>Assets = Liabilities</b>	<b>39275.4</b>	<b>37686.4</b>	<b>الموجودات = المطلوبات</b>

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## T - account

- ☞ Bank performs asset transformations.
- ☞ ‘borrows short and lends long’
- ☞ Use T-account to keep track of bank’s business.
- ☞ T-account is a simplified balance sheet, that lists only the changes that occur in balance sheet items starting from some initial balance sheet position.

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### Example 1 - cash deposit

First National Bank	
Assets	Liabilities
Vault +\$100	Checkable +\$100
Cash	deposits

☞ Opening of a checking account leads to an increase in the bank’s reserves equal to the increase in checkable deposits.

First National Bank	
Assets	Liabilities
Reserves +\$10	Checkable +\$100
0	deposits

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## Example 2 - check deposit

First National Bank	
Assets	Liabilities
Cash items +\$100 in process of collection	Checkable +\$10 deposits 0

When a bank receives additional deposits, it gains an equal amount of reserves; when it loses deposits, it loses an equal amount of reserves

First National Bank	
Assets	Liabilities
Reserves +\$100	Checkable +\$100 deposits

Second National Bank	
Assets	Liabilities
Reserves -\$100	Checkable -\$100 deposits

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## Example 3 - making a profit

First National Bank	
Assets	Liabilities
Required reserves +\$10	Checkable +\$100 deposits
Loans +\$90	

- ☞ **Asset transformation: selling liabilities (e.g. checkable deposits) with one set of characteristics and using the proceeds to buy assets (e.g. loans) with a different set of characteristics**
- ☞ **The bank borrows short (e.g. checkable deposits) and lends long (e.g. loans)**

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## Bank Management

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### 1. Liquidity Management

- enough cash and liquidity assets to pay depositors

### 2. Asset Management

- diversifying investment

### 3. Liability Management

- low cost of getting funds

### 4. Capital Adequacy Management

- get enough bank capital as required by regulators

### 5. manage credit risk

### 6. manage interest-rate risk

### 7. manage risks in off-balance-sheet activities

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## Liquidity management

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☞ Banks need to have sufficient reserves or liquid asset to meet obligations to depositors – satisfy their withdrawals.

☞ Too much?

☞ Too little?

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## Ample excess reserves

Bank			
Assets		Liabilities	
Reserves	\$20M	Deposits	\$100M
Loans	\$80M	Bank	\$10M
Securities	\$10M	Capital	

☞ Suppose required reserve ratio is 10%, for \$100 deposit, how much required reserve should the bank have?

Bank			
Assets		Liabilities	
		Deposits	\$90M
Loans	\$80M	Bank	\$10M
Securities	\$10M	Capital	

☞ ample excess reserves  
☞ deposit outflow (e.g. \$10M)  
☞ bank doesn't need to take actions.

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## No excess reserves

Bank			
Assets		Liabilities	
Reserves	\$10M	Deposits	\$100M
Loans	\$90M	Bank	\$10M
Securities	\$10M	Capital	

Bank			
Assets		Liabilities	
Reserves	\$0	Deposits	\$90M
Loans	\$90M	Bank	\$10M
Securities	\$10M	Capital	

- ☞ Reserves are a legal requirement and the shortfall must be eliminated (bank needs to take actions – it has 4 options – all costly).
- ☞ Excess reserves are insurance against the costs associated with deposit outflows

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## Option 1: borrow from the Fed

Bank			
Assets		Liabilities	
Reserves	\$9M	Deposits	\$90M
Loans	\$90M	Borrow from Fed	\$9M
Securities	\$10M	Bank Capital	\$10M

- ☞ **Borrowing from the Fed incurs cost of interest payments based on the discount rate.**

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## Option 2: borrow from other banks

Bank			
Assets		Liabilities	
Reserves	\$9M	Deposits	\$90M
Loans	\$90M	Borrowing	\$9M
Securities	\$10M	Bank Capital	\$10M

- ☞ **If borrow temporarily (overnight), cost incurred is the interest rate (the fed funds market rate) paid on the borrowed funds.**
- ☞ **Long-term loans cost much more.**

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## Option 3: sell securities

Bank			
Assets		Liabilities	
Reserves	\$9M	Deposits	\$90M
Loans	\$90M	Bank Capital	\$10M
Securities	\$1M		

- ☞ The cost of selling securities is the brokerage and other transaction costs, and may incur capital loss.

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## Option 4: Call in or sell off loans

Bank			
Assets		Liabilities	
Reserves	\$9M	Deposits	\$90M
Loans	\$81M	Bank Capital	\$10M
Securities	\$10M		

- ☞ Reduction of loans is the most costly way of acquiring reserves.
- ☞ Calling in loans antagonizes customers.
- ☞ Other banks may only agree to purchase loans at a substantial discount.

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## Liquidity management

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### Conclusion:

- ☞ Excess reserves are ‘insurance’ against the costs associated with deposit outflows.
- ☞ Another ‘insurance’ is holding liquid assets, mainly the ‘secondary reserves’ - short-term U.S. government securities.

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## Key Notes

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- ☞ **Office Hours:**
  - Sun and Tue: 11:00 – 12:00.
  - Wed: 11:30 – 12:30.
- ☞ **1<sup>st</sup> Exam:** Wed, 30/10/2013, 02:00pm ☺
- ☞ **2<sup>nd</sup> Exam:** Wed, 04/12/2013, 02:00pm ☺
- ☞ **Grading:**
  - 1<sup>st</sup> Exam: 20%.
  - 2<sup>nd</sup> Exam: 20%.
  - Positive Participation: 10%.
  - Final Exam: 50%.
- ☞ **No Makeup at al.**

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# ***COMMERCIAL BANK MANAGEMENT***

**(0503211)  
Part (1)**

***Sufian I. HRAZE, Lecturer***

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First Semester 2013/2014

Department of Finance and Banking

Faculty of Finance and Business Administration

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***Part 1***