

PUBLIC FINANCE

Diploma stage examination
15 June 2005

From 2.00pm to 4.00pm
plus ten minutes reading time from 1.50pm to 2.00pm

Instructions to candidates

Answer **three** questions in total: **One** question from **Section A**, and **two** questions from **Section B**. The marks available for each question are shown in italics in the right-hand margin.

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.



SECTION A (Compulsory)

1

Chris Shepherd has recently been appointed head of the treasury management unit of the University of Camford, having previously been head of treasury management at Meath Common NHS Trust. Chris recognised that this move represented a very significant challenge for him and he spent a lot of time discussing it with his wife Eleanor before agreeing to it. Eleanor works for an investment bank in London and was concerned that Chris was attracted to his new job more by a desire to return to his old university than by any great enthusiasm for the wider range of treasury management responsibilities that he would inherit at Camford.

One month into his new job Chris is chairing a unit meeting. One of the items being discussed is the possible purchase of some UK treasury bills. The consensus of the meeting is that the purchase for £99,250 of some treasury bills with a redemption value of £100,000 in two months time should be sanctioned. The university's holding of government bonds is also discussed. The view is expressed that market expectations of interest rates falling over the next six months suggest that the university should consider selling at least some of its bonds during that period.

The final item on the meeting's agenda is the effective management of risk. Chris's deputy Miranda Thompson, who joined from a local authority shortly before Chris, contributes vociferously to the discussion. She feels that the unit does not have sufficiently robust risk management procedures in place and proposes that it voluntarily adopts the treasury management prudential indicators that are statutorily required for local authorities.

That night Chris confided to Eleanor that he was increasingly feeling out of his depth. "Sometimes," he said, "it's really hard to convince people that I know what they're on about. Today they were talking about the Debt Management Office; I didn't even know it existed; I thought it was all still done by the Bank of England." Normally Eleanor tries to steer conversations away from work as she's a little embarrassed by how much more quickly her career has progressed compared to Chris's. However, tonight she is concerned about whether she had been right to approve a large interest rate swap now that commentators are anticipating more significant interest rate reductions than she had expected and she shares those concerns with Chris.

• Requirement for question 1

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|-----|-------|--|----|
| (a) | (i) | Explain what a treasury bill is and identify its principal characteristics. | 5 |
| | (ii) | Calculate the percentage return that the university would earn on its proposed purchase of treasury bills. | 3 |
| | (iii) | Explain what an interest rate swap is. | 2 |
| (b) | | Describe in broad terms the treasury management indicators required of local authorities by the Prudential Code and explain how their adoption by Camford might improve the management of risks faced by its treasury management unit. | 11 |

- (c) Why exactly does it seem sensible for Camford to sell at least some of its holdings of government bonds during the next six months? 6
 - (d) In what ways did the creation of the Debt Management Office address conflicts of interest that had previously been faced by the Bank of England? 7
 - (e) Define the following types of treasury management risk and discuss broadly how each can be managed:
 - (i) Credit and counterparty risk. 3
 - (ii) Liquidity risk. 3
- (40)**
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SECTION B (Answer two questions from this section)

2

Phare is a mid-European industrial country with a newly elected right of centre government. It has a well-developed financial sector with sophisticated money and capital markets and has elected not to seek membership of the European Union. Partly as a result of this it has retained its own currency, the Peso. In anticipation of the new government, the civil servants at the Ministry of Finance have prepared a briefing paper for the incoming minister.

An excerpt from the paper reads as follows. "Indications exist that the economy is nearing a turning point in economic activity, which will lead to a sustained period of reduced economic growth. This downturn will require increased government borrowing in addition to the high levels that are already projected. In our view the growth in Phare public expenditure that has occurred for many years requires to be addressed if the economy is to avoid being damaged further by the consequences of high levels of borrowing and taxation. We believe that much of the public expenditure growth has been generated by supply rather than demand side factors and that the government will need to consider radical reforms in order to reverse this trend. Failure to do this could have dangerous consequences for the economy as a whole."

• Requirement for question 2

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|-----|--|-------------|
| (a) | Why is it that in Phare, as in other modern, western economies, economic downturns tend to lead to increased government borrowing? | 4 |
| (b) | Describe three supply side theories that have been put forward to explain the long-term tendency for government expenditure to increase over time. | 14 |
| (c) | What do economists believe to be the negative consequences of high levels of government borrowing? | 12 |
| | | (30) |

3

The senior finance managers of the Prison and Probation Agency are discussing options for the financing of a new combined prison and juvenile detention centre to be located in the inner city area of Felpool. The Agency's Finance Director is keen to pursue possible European Union grant funding for the project both because of its inner city location and because he believes that some of the more innovative features of the project would help secure such funding. The option of a Private Finance Initiative deal for the prison is also discussed at length with participants expressing significantly different views. Some participants highlight recent success stories in the construction of major capital projects under the initiative, while others are concerned as to whether the capacity exists within the Agency to manage successfully the complex long-term relationships with private sector partners. At the end of a largely inconclusive meeting the Finance Director arranges a further meeting for which he says he will draft a paper setting out and evaluating what he sees as the main options open to the Agency.

• **Requirement for question 3**

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|-----|--|-------------|
| (a) | What is the major purpose of the European Union structural funds and what are the three objectives set for the structural funds? | 7 |
| (b) | What are the problems and concerns that have been expressed about public sector organisations' ongoing management of PFI projects? | 9 |
| (c) | (i) Suggest a range of criteria by which sources of finance for public sector bodies might be evaluated. | 7 |
| | (ii) Briefly evaluate the Private Finance Initiative against these criteria. | 7 |
| | | (30) |
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4

The 'Balance of Funding' review commissioned by government and which reported in 2004 looked specifically at England. However, the issues it considered were relevant to all areas of the British Isles.

- **Requirement for question 4**

(a) Discuss and briefly evaluate the main criticisms that have been made of the current balance of funding of local authorities between central government grant and council tax proceeds. 15

(b) An alternative means of funding local authority expenditure is to extend the number of services for which users are required to pay a charge. Using examples as appropriate, present the arguments in favour of charging for the output of public sector organisations. 15

(30)
