KNOWLEDGE CHECK

Risk profiles depend on individual borrowers, countries and situations but some types of exposure can be inherently more risky than others.

Assess the risk profile of different types of credit exposures by selecting low, medium and high (or a range) and give a rationale for your decision. One is done for you.

Borrower / Counterparty	Loan / Credit product or facility	Risk Profile: Low, medium or high	Rationale
Individual	Credit card		
Individual (prime borrower)	Residential mortgage		
SME (small and medium sized enterprise)	Overdraft to support working capital	**High**	SME's have relatively high default rates; overdrafts are usually unsecured and working capital is often a permanent revolving need.
BBB rated corporate	Term loan to support investment		
Property developer	Commercial mortgage		
Large corporate	Letter of credit to support import of goods		
Bank	Interbank deposit		

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KNOWLEDGE CHECK

Match the following regulatory limits to the risks they are trying to address.

- RWA floor for mortgages
- Loan to income cap for mortgages
- Loan to value cap stock margin finance
- Limit on FX lending
- Pillar II concentration limit
- Stress test on unemployment

High levels of unsecured lending to individuals

Aggressive growth in mortgage lending leading to asset price bubble

High exposures to commodity producers

Aggressive mortgage underwriting in a rising house price market.

High levels of loans to finance the purchase of equity securities.

Lending to corporates or individuals in foreign currency who do not have FX revenues

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KNOWLEDGE CHECK

1. An emerging market bank is growing its loan book at 20% whereas nominal economic growth is 7%. Other banks are growing at an even faster rate of 25%. The level of banking sector penetration (banking assets % GDP) in the economy is low at only 50%.

Which of the following is the best conclusion?

- This level of growth is acceptable as the level of banking sector penetration is low and the economy needs to catch up.
- This level of growth is acceptable as it is lower than peers.
- This level of growth is high risk as the bank is losing market share to competitors.
- This level of growth is high risk as it involves lending to borrowers who have not borrowed before and strains the bank's risk management capabilities.

2. Select the correct terms from the drop down box to fill the gaps:

When assessing loan growth, the analyst should compare a bank's growth against growth of the economy or growth plus inflation. Banks which grow much faster than the economy are exposed to increased credit risks. Problems in a loan portfolio usually take 1 or 2 years to emerge as impaired loans due to the of a loan portfolio. The lagged impaired loan ratio can be a good early warning signal of distress as it compares impaired loans with Gross loans

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TEST YOUR UNDERSTANDING

1. Which of the following is the best description of what happens if a bank increases its loan loss provisions due to expected increases in loss given default?

- ○ Net loans on the balance sheet decline; profits decline
- ○ Net loans on the balance sheet increase; profits decline
- ○ No impact on net loans; profits decline
- ○ No impact on net loans; profits increase

2. Which of the following is the best description of what happens if a bank accelerates the writing (charging) off of loans (assuming the bank has already provided for the loan)?

- ○ Impaired loan ratio goes down; no impact on profits and capital
- ○ Impaired loan ratio goes down; profits and capital fall
- ○ No impact on impaired loan ratio; profits and capital fall
- ○ Impaired loan ratio goes up; profits and capital fall

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KNOWLEDGE CHECK

1. Which of the following items are normally included in a bank's reported "impaired" or "non-performing" loans figure? Check all that apply.

☐	Restructured	Not usually included but should be monitored
☐	Special mention	Not usually included but should be monitored
☐	Sub-standard	Usually part of impaired loans
☐	Doubtful	Usually part of impaired loans
☐	Loss	Usually part of impaired loans
☐	Loans written off	No longer part of impaired loans as removed

2. High growth is one way that impaired loans can be obscured. Identify 3 other ways bad loans can be hidden.

Short term or non-amortising long term loans to distressed borrowers can be "rolled-over"
Restructured loans are excluded from impaired loan data
State owned enterprises may be excluded even though they are in distress and not guaranteed
Bad loans may be taken off balance sheet through a securitisation vehicle with continued recourse

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KNOWLEDGE CHECK

Please match these banks to their loan quality indicators. Citigroup is done for you.

Bank	Description of bank
A	A large Chinese state owned bank which is required by the regulator to build reserves against performing as well as non-performing loans.
B	A UK retail mortgage lender which has largely recovered from the acquisition of a distressed bank during the crisis and has an average loan to value of 46%.
C	The largest Italian bank after 3 years of recession.
D	The largest Indian State owned bank which is under pressure from weakening capital and profits and a growing burden of impaired and restructured loans.

	Citigroup				
Loan growth prior year	(4)	(6)	13	12	(7)
Impaired loans % gross loans	1.7	2.1	4.3	1.5	15
Reserves % impaired loans	124	32	49	287	61
Reserves % gross loans	2.1	0.7	2.1	4.4	9
Net impaired loans % equity	negative	16	23	negative	57
Provisions % average loans	1.1	0.1	1.5	0.8	0.9
Write offs (charge offs) % average loans	2.6	0.7	1.5	0.4	2.4

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TEST YOUR UNDERSTANDING

HABU BANK

Trading securities

Trading securities include debt securities, equity securities and other kinds of securities that the Bank and/or its subsidiary fully purchased and intended to sell in short term in order to gain profits from price fluctuation.

Trading securities are initially recognized at cost and subsequently carried at cost.

Interest received while holding trading securities is recorded in the consolidated income statement on cash basis.

Trading securities are subsequently subject to review for value diminution as at balance sheet date. Provision for diminution is made when carrying value of the securities is higher than their market value determined in accordance with Circular No. 228/2009/TT-BTC dated 7 December 2009. If the market value of securities is undeterminable, there is no provision created. Provision for decline in value is recorded in "Net gain/loss from trading securities" in the consolidated income statement.

Source: Habu Bank Annual Report 2011

1. How does the accounting policy of this Vietnamese bank differ from internationally accepted norms?

Trading assets are stated at cost rather than fair value through the profit and loss. An impairment provision is only created if the market value is less than the carrying value and the market value is determinable. Under IFRS and US GAAP, if a security held at amortised cost is deemed to be impaired, a bank is required to make an impairment provision based on the estimated loss even if there is not an available market valuation.

2. Which of the following items would be affected by a bank failing to value trading securities in the normal way? Note: tick all that apply.

- ☐ Net income
- ☐ Equity capital
- ☐ Cash

Note: cash is not impacted by unrealised gains and losses.

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TEST YOUR UNDERSTANDING

DEUTSCHE BANK

Level 3 Financial Assets

in € millions.	Dec 31, 2008
Financial assets held at fair value:	
Trading securities:	
Sovereign and quasi-sovereign obligations	602
Mortgage and other asset-backed securities	5,870
Corporate debt securities and other debt obligations	10,669
Equity securities	127
Total trading securities	**17,268**
Positive market values from derivative financial instruments	48,792
Other trading assets	**13,560**
Financial assets designated at fair value through profit or loss:	
Loans	5,531
Other financial assets designated at fair value through profit or loss	274
Total financial assets designated at fair value through profit or loss	**5,805**
Financial assets available for sale	1,450
Other financial assets at fair value	788
Total financial assets held at fair value	**87,663**
Total Assets	**€2,202 bn**
Tangible Equity	**€20.8 bn**

Extracted from Deutsche Bank Annual Report 2008

1. *How significant were exposures to level 3 assets for Deutsche Bank? Consider exposures as a % of assets and tangible equity.*

- ◯ Very significant
- ◯ Moderately significant
- ◯ Insignificant

2. *Why are analysts concerned about level 3 assets in a bank? Tick all which apply.*

- ☐ Level 3 assets are illiquid and if the bank needs to sell them it could take a loss
- ☐ The valuation of level 3 assets is subjective and the bank may be over-stating profits and equity
- ☐ Level 3 assets are intangible
- ☐ Level 3 assets are not permitted in a bank

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KNOWLEDGE CHECK

1. Banks face many risks on their derivative exposures. Check all of the following which are true.

- [ ] Market risk tends to be high as banks make leveraged unmatched bets on price movements.
- [ ] Counterparty default risk tends to be low as derivative counterparties are high quality and exposures are mitigated through netting and collateral.
- [ ] Counterparty migration risk can be significant in times of price volatility and is measured using credit valuation adjustments.
- [ ] Liquidity risk is not significant on derivatives as derivatives are unfunded positions.

Market risk is normally kept low on derivatives but liquidity risk can be high as banks often have to fund collateral payments and these can be significant in volatile times.

2. Derivative accounting can be complex and lead to misleading conclusions. Answer true or false to the following statements:

A bank has substantial trading derivatives but low levels of hedge derivatives. This means that most derivatives are for proprietary trading purposes.	True	False
Centrally cleared derivatives are moved off the balance sheet in both US GAAP and IFRS but only US GAAP permits banks to deduct close out netting and cash collateral from the balance sheet amount.	True	False
A funding valuation adjustment is a charge to cover the cost of funding collateral on a derivative liability when the bank is not receiving collateral on the in the money side of the derivative.	True	False

Many trading derivatives are client market making transactions or risk management transactions which do not meet strict hedge accounting criteria.

FVA is an accounting charge and a pricing mechanism to cover the cost of funding collateral when it is not received on the other side.

Check Answers

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