

INTRODUCTORY BANKING



Tutorial 12/13 – Case study

Institute of Economic Studies, Faculty of Social Sciences,
Charles University in Prague, Czech Republic

6 May 2021

Key terms of Lecture 12

Governance issues

Organizational structure

Segregation of conflicting duties

Bank regulation

Bank supervision

Case study

Background

- ABC financial institution („ABC“) is situated in a small country in Asia. The country is politically and economically stable, the economy is growing at a steady state of 3 % per year, unemployment is around 5 %, the general perspectives of the country are dependent on the crude oil prices.
- ABC is a middle-size institution concentrating on the retail market. The retail portfolio consists of non-collateralized consumer loans financing small electronic and kitchen equipment devices. The average Probability of Default (PD) of this non-collateralized portfolio is 8 %. ABC also provides retail collateralized real estate financing, the PD of this portfolio is 7 %. ABC is provisioned accordingly. Also, ABC also provides (as they say „for yield enhancement“) an investment into foreign bonds.
- ABC is funded by a revolving loan from a Concordia Bank and deposits collected locally. It has also recently issued bonds.
- The business has grown rapidly over the past 5 years, with profits trebling in that time and is viewed as a ‘national champion’.
- While its main business is Asia focussed, it does have a small UK subsidiary and a new branch in a neighbouring country.
- ABC reports growing assets reaching 6,7 bn as of 31.12.2020. The capital levels have stagnated over the last 5 years as all profit were distributed as dividends. All of the capital comprises of CET1 capital. For more financial information see Part Financials.

Case study

Strategy

- Given how successful the business has been, the CEO plans to grow the business aggressively over the next 3 years, expanding across Southern Asia and growing the European business (via its UK subsidiary) as well. In Asia, it will grow its current business lines of deposits, loans and introduce Trade Finance products in the near future.
- Over a longer-term horizon Joe Bloggs as Group CEO and the UK CEO have discussed opening a US branch office in New York.

Case study

Management and Governance

- ABC is convinced it meets all requirements on the financial institution, it has a Board of Directors consisting of 6 members, 3 of them executive and 3 non-executive. The CEO is responsible for the whole business of the ABC, both for business and the risk, the other BoD members are responsible for finance (CFO) and operations (COO). ABC in Asia has not recruited a new internal auditor yet (after the only one was redeployed to London subsidiary), hence it plans to do so when the number of staff of ABC increases above 500 employees (see also Part Risk and control). ABC currently has circa 320 employees.
- ABC's CEO Joe Bloggs (JB) has been CEO for 20 years and owns 60% of the issued shares. He has grown the business from nothing and is well known in the country. Jim Smith (JS) is Independent Chairman of the Board and has been for 15 years. He owns 30% of the shares, with the final 10% being owned by wider management. JB and JS are close friends. There are two additional Independent Non Executive Directors (NEDs) on the Board. They have been in role for 14 and 12 years respectively. JB, as owner, makes all of the decisions on the Bank and is known not to accept any challenge to those decisions. He is a dominant individual and believes ABC's past success will continue into the future.
- In addition to the Board, there is a Risk and Audit Committee. This reports into the Board. There are no other Committees in any location throughout the Group. The NEDs only sit on the Board and not on any other Committees. All Committees are chaired by JB as CEO, he approves all Management Information that is provided to the Board.

Case study

Risk and control

- ABC has been reducing its key control functions to save costs. It has redeployed the one Internal Auditor it did have in place to its sub in London. It has reduced the number of risk officers from 5 to 3 and within its credit risk department from 2 to 1. JB as Group CEO views this as a success, having saved ABC a lot of money.
- There are no specific news in media about ABC, only recently a TV news spot challenged AML processes in the institution, as three of the clients were convicted of money laundering practices.
- The ICT systems are satisfactory, there haven't been any disruption or failure of ICT systems so far. ICT is provided by solid and experienced external provider, but ABC itself has no IT department. ABC has never delivered any Outsourcing and SLA agreements although has been asked several times by the third party (i.e. supervisor).

Case study Financials

	31.12.2020	31.12.2019	31.12.2018
Assets, total	6 790	6 281	5 813
1. Cash, cash balances at central banks and other demand deposits	100	101	95
2. Financial assets held for trading	40	45	51
3. + 4. Other assets at fair value through profit and loss	20	25	22
5. Financial assets at fair value through other comprehensive income	720	550	495
5.1. Equity instruments	-	-	-
5.2. Debt securities	720	550	495
--- Investment in Government bond - Russian Federation, in RUB	380	200	150
--- Portfolio of Chinese corporate bonds, in CNY	340	350	345
6. Financial assets at amortised cost	5 310	4 960	4 550
6.1. Debt securities	450	450	450
--- US Corporate bonds, USD	450	450	450
	-	-	-
6.2. Loans and advances (net values)	4 860	4 510	4 100
--- portfolio of retail loans with average maturity of 4 years, 12 M repricing	1 700	1 400	950
--- portfolio of retail collateralized real estate loans with average maturity of 8 years, 2 years repricing	2 000	1 700	1 550
--- LOAN A (principal amount of 1 000), 5 Y, fixed rate loan, amortized	360	430	500
--- LOAN B (principal amount of 600), 3 Y, fixed rate loan, amortized	300	480	600
--- LOAN C (principal amount of 500), 4 Y, 12 M repricing, bullet repayment	500	500	500
9. Investments in subsidiaries, joint ventures and associates	300	300	300
All other assets	300	300	300
TOTAL	6 790	6 281	5 813

Case study Financials

	31.12.2020	31.12.2019	31.12.2018
Liabilities and equity, total	6 790	6 281	5 813
1. Liabilities, total	6 260	5 741	5 293
1.1. Financial liabilities held for trading	-	20	10
1.2. Financial liabilities designated at fair value through profit or loss	-	21	13
1.3. Financial liabilities measured at amortised cost	6 260	5 700	5 270
1.3.1. Deposits, notice period 1 week, repriced monthly	2 360	500	20
1.3.1. Bank revolving loan, repriced monthly (Concordia Bank)	3 300	5 100	5 250
1.3.3. Debt securities issued, 5 Y, fixed rate	600	100	-
2. Equity, total	530	540	520
Capital	380	380	380
Other capital items	20	7	12
Retained earnings from previous years	-	-	-
Profit of the current year	130	153	128
Leverage ratio (European style)	7,81%	8,60%	8,95%
Leverage ratio (US style)	12,81	11,63	11,18
Credit risk (risk weighted exposure)	3 990	3 670	3 375
<i>Credit risk capital requirement</i>	<i>319</i>	<i>294</i>	<i>270</i>
Market risk (risk weighted exposure)	180	180	180
<i>Market risk capital requirement</i>	<i>14</i>	<i>14</i>	<i>14</i>
Operational risk (risk weighted exposure), not a risk sensitive item	500	500	500
<i>Operational risk capital requirement</i>	<i>40</i>	<i>40</i>	<i>40</i>
Total capital requirement	374	348	324
Capital	530	540	520
Regulatory Capital Adequacy	11,35%	12,41%	12,82%
ROE	24,5%	28,3%	24,6%
ROA	1,9%	2,4%	2,2%

Case study – questions for discussion

Show and analyse the risks ABC is exposed to. Where do you see weak points of the institution ? In terms of

- Business model
- Corporate governance
- Risks (Credit, Concentration, IRRBB, FX risk, Operational, Liquidity risks), (Strategic, Reputational risks)

Any recommendations to

- decrease the inherent risk
- improve the internal controls ?