

**INSTITUTE OF BANKERS IN MALAWI**

**ADVANCED DIPLOMA IN BANKING EXAMINATION**

**SUBJECT: CREDIT RISK ASSESSMENT 2 (IOBM – AD303)**

**Date: Sunday, 13th May 2018**

**Time Allocated: 3 hours (08:00 – 11:00 Hours)**

**INSTRUCTIONS TO CANDIDATES**

1 This paper consists of **TWO** Sections, A and B.

2 Section A consists of 4 questions, each question carries 15 marks.

Answer **ALL** questions.

3 Section B consists of 4 questions, each question carries 20 marks. Answer **ANY TWO** questions.

4 You will be allowed **10 minutes** to go through the paper before the start of the examination, you may write on this paper but not in the answer book.

5 Begin each answer on a new page.

6 **Please write your examination number on each answer book used. Answer books without examination numbers will not be marked.**

7 All persons writing examinations without payment will risk expulsion from the Institute.

8 If you are caught cheating, you will be automatically disqualified in all subjects seated this semester.

9 DO NOT open this question paper until instructed to do so.

**SECTION A (60 MARKS)**

Answer **ALL** questions from this section

**QUESTION 1**

The balance sheet of Prudence Private Limited shows that the company has total shareholders’ funds of K150 million, long-term liabilities amounting to K100 million and total assets of K250 million. The asset base of the company comprises property, plant, equipment and some intangibles.

The company has been operating in tourism industry for 10 years. Despite the poor economic environment, the company has been relatively profitable. In the previous year it generated a profit before interest and tax of K110.5 million. The company pay interest on its long-term liabilities at a rate of 25%. According to its finance manager, the company’s current cost of share capital is 20%. The rate of corporate tax is 30%.

**Required:**

1. Estimate the current market value of Prudence Private Limited (using the net income method). *(5 marks)*
2. Explain how, you as a banker, are going to approach the valuation of the assets of the company.  *(7 marks)*
3. Discuss how your approach in (b) will impact financial leverage of the company.  *(3 marks)*

**(Total 15 marks)**

**QUESTION 2**

Dziko Holdings is a limited company which is considering acquiring an office block. The management of the company is faced with two choices for financing the purchase, namely: issuing preference shares and entering into a leasing agreement. It is forecasted that the net income from office block would be K1,000,000 per month. The expected return of Dziko Holdings is 20% per annum.

**Required:**

1. Estimate the value of the office block using capitalisation method. *(3 marks)*
2. Describe any **three** types of preference shares that the company can issue.

*(6 marks)*

1. Discuss why preference shares may be considered expensive source of finance.

*(3 marks)*

1. Explain what a leasing agreement is and differentiate between finance lease and operating lease. *(3 marks)*

**(Total 15 marks)**

**QUESTION 3**

A sole proprietor who is a steel merchant has presented a residential house as a collateral to a loan application of K40 million. The house is located within Blantyre but outside the city boundaries. The sole proprietor purchased it two years ago and currently it is occupied by a tenant. Alternative to this, the sole proprietor presented a pledge of stock of steel of the business and a cession of shares of an unlisted company.

**Required:**

1. Identify and briefly explain **four** attributes that you would consider in assessing collateral. *(8 marks)*
2. Explainthe difference between a cession and a pledge. *(3 marks)*
3. Listcredit risks (**two in each case**) associated with the pledge of stock and cession of the shares that have been provided. *(4 marks)*

**(Total 15 marks)**

**QUESTION 4**

You have been presented with the following table giving details of projects from four companies in different areas of the economy. Your bank’s policy is focused on promoting youth entrepreneurship and agricultural sector in line with the government’s growth and development strategy.



**Required:**

1. Explain how profitability index (PI) is interpreted when carrying out credit risk assessment of projects. *(2 marks)*
2. Rank projects of the companies using profitability index (PI). *(6 marks)*
3. Explain how profitability principle and desirability principle of lending will be applied in deciding which projects to finance. *(7 marks)*

**(Total 15 marks)**

**SECTION B (40 MARKS)**

Answer **ANY TWO** questions from this section

**QUESTION 5**

One of your big clients has threatened to take your institution to court. The issue has the potential to tarnish the image of the institution. Fortunately, the client is willing to negotiate.

**Required:**

1. Briefly explain the role of mental state of mind, rational behaviour and concept of fairness to negotiation process. *(6 marks)*
2. State the steps that you would take in planning for the negotiation with the client. *(14 marks)*

**(Total 20 marks)**

**QUESTION 6**

You have received a credit proposal from a partnership business that is operating in the city of Lilongwe. The business has been in existence for the past five years, in a highly competitive market and has managed to generate modest profit each year. The owners have decided to expand by opening a branch in the city of Blantyre. In light of the expansion drive the business seeks to borrow from you institution. This is the first time that the business is dealing with your institution in a loan related transaction.

**Required:**

1. Discuss **five** generic attributes that you will consider in assessing the goodness of the credit proposal. *(10 marks)*
2. Explain how you would ensure safety of the transaction. Give **five** points.

*(10 marks)*

**(Total 20 marks)**

**QUESTION 7**

A recent agriculture graduate approached your bank to borrow in order to boost capital for her cotton farming business which she started operating a year ago. She is yet to develop a business plan as she has no idea of what it is.

**Required:**

1. Advise her of the **ten** items that she should include in developing the business plan. *(10 marks)*
2. Discuss the **three** main types of individuals based on their risk preferences. *(6 marks*
3. Explain the relationship between risk and time. *(2 marks)*
4. Define hedging and list **four** common methods of hedging. *(2 marks)*

**(Total 20 marks)**

**QUESTION 8**

Write brief notes contrasting the following terms:

1. Risk and Uncertainty. *(4 marks)*
2. Future and Forward contract. *(4 marks)*
3. Factoring and Invoice Discounting. *(4 marks)*
4. Net present value and Profitability Index. *(4 marks)*
5. Safety principle and Profitability principle. *(4 marks)*

**(Total 20 marks)**

**END OF EXAMINATION PAPER**