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# CCP PART III SECTION 6

# CREDIT PRACTICE

**FRIDAY: 3 September 2021.** **Time Allowed: 3 hours.**

**Answer ALL questions. Marks allocated to each question are shown at the end of the question.**

## QUESTION ONE

### TOTAL CAPITAL MANAGEMENT (TCM)

Total capital management (TCM), under the leadership of James Mine faced tremendous default and credit risks as a result of failing to properly manage the hedge fund's credit risk exposure. The professional credibility and reputation of the managing partners was shattered in August 2008, after TCM came dangerously close to collapse when the market shifted against an aggregate of Sh.1.3 trillion derivative position that was backed by only Sh.4 billion in hedge fund equity assets.

Former National Reserve Bank CEO J. William speaking to parliament's Banking and Financial Services Committee in March 2009 blamed TCM's failure on three factors; insufficient knowledge on counterparties, exposure assessment and stress testing.

Mr. William went on to explain that lack of financial information on respective counterparties resulted from the lender's inability to engage in through credit analysis for the types of risks to which TCM was exposed, especially regarding their leveraged trading positions with credit extensions to their banking counterparties. TCM on the other hand was discovered to be highly leveraged with Sh.1 trillion in off-balance sheet derivatives contracts and liabilities that were not reflected in the Sh.125 billion in balance sheet assets and Sh.4 billion capital base.

Credit risk arose as a result of counterparty trading positions with TCM held by some of the largest multinational banks in the world, who were unaware of the firm's true financial and leverage status. Having been exempted from regulatory standards that are required by most financial institutions, TCM had not been frank about disclosing its financial condition to bank financial counterparties. Major banks such as Universal credit bank, Bear systems, Main lynch, UBS and SB Bank among others, had no mechanisms in place to determine the operations of TCM and as a result, they lost a total of Sh.2.2 billion in aggregate exposure. They were also unaware of TCM's leverage status and other counterparty exposures. TCM also lacked adequate collateral in relation to credit exposure that it held in the various forms of trading activities that it was engaged in. Had these banks conducted a more straightforward credit evaluation on TCM, they would have discovered that the collateral retained was insufficient for the leverage and counter party exposure and that their values had deteriorated over several weeks.

Furthermore, there was failure to conduct stress testing in order to predict or assess the consequences of "worst case" scenarios especially as they related to the Asian Region counterparties' respective market conditions. If TCM would have been aware of its increased concentration exposure in relation to highly leveraged institutions, most likely it would have used different trading and investment strategies and credit decisions relative to market and credit risks that were embedded in the trading books.

"According to TCM executives, their stress checks entailed looking at the 12 biggest deals with each of their 30 counterparties". As a result, this only produced a worst-case loss of around Sh.3 billion against the mark-to-market loses that were estimated. In addition to the aforementioned flaws, the hedge fund's management had also failed to establish and enforce comprehensive credit policies and procedures which could have helped in either avoiding or minimising their losses.

**Required:**

(a) With reference to the above case, discuss the 5 Cs of bad credit. (10 marks)

(b) Analyse three factors in the business and capital structure of Total Capital Management (TCM) that might have contributed to credit loss given default (LGD). (6 marks)

(c) Assess six major elements of a sound credit risk management system that TCM have put in place to minimise the credit risk exposure. (12 marks)

(d) Examine four techniques of managing credit risk that TCM could consider. (8 marks)

(e) (i) Explain the term "stress testing" as a risk management tool. (2 marks)

(ii) State two advantages of stress testing that would have reduced the credit exposure to TCM if it had been undertaken. (2 marks)

**(Total: 40 marks)**

**QUESTION TWO**

(a) Suggest five alternative collection strategies that should be considered when terminating delinquent loans. (5 marks)

(b) Evaluate three advantages and two disadvantages of short-term financing as a source of corporate finance. (5 marks)

(c) Enumerate five advantages of managing cash flow from a credit manager's point of view. (5 marks)

**(Total: 15 marks)**

**QUESTION THREE**

(a) Using an example in each case, highlight the purpose of the following categories of ratios as used in credit risk assessment:

(i) Liquidity ratios. (2 marks)

(ii) Efficiency ratios. (2 marks)

(iii) Gearing ratios. (2 marks)

(b) Distinguish between "adverse selection" and "moral hazard" with reference to management of delinquency in lending institutions. (4 marks)

(c) With reference to regulatory requirements on minimum capital requirements:

Enumerate five capital requirements under Basel III. (5 marks)

**(Total: 15 marks)**

**QUESTION FOUR**

(a) Explain four internal factors which could influence a firm's corporate decisions relating to the optimal level of current assets and current liabilities. (4 marks)

(b) (i) Analyse three causes of credit risk concentrations in commercial banks. (6 marks)

(i) Managing risk concentrations has greatly increased in the recent years. Highlight five factors which have led to this increase. (5 marks)

**(Total: 15 marks)**

**QUESTION FIVE**

(a) Examine four benefits of a computerised credit management system. (4 marks)

(b) In relation to bank risks explain the following terms:

(i) Bank run. (2 marks)

(ii) Bank panic. (2 marks)

(iii) Contagion. (2 marks)

(c) Discuss five challenges facing small and medium sized enterprises (SMEs) in your country. (5 marks)

**(Total: 15 marks)**

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