PROFESSIONAL LEVEL EXAMINATION

MONDAY 4 DECEMBER 2017

(2½ HOURS)

BUSINESS PLANNING: BANKING

This paper consists of **three** questions (100 marks).

1. Ensure your candidate details are on the front of your answer booklet. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on this question paper. You may not write anything else until the exam starts.

2. Answer each question in black ballpoint pen only.

3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.

4. The examiner will take account of the way in which answers are presented.

5. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

All references to IFRS are to International Financial Reporting Standards and International Accounting Standards.

IMPORTANT

Question papers contain confidential information and must **not** be removed from the examination hall.

DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK

You **must** enter your candidate number in this box.

1. You are Marina Ng, an ICAEW Chartered Accountant working in strategic planning within the finance department of Robinson Bank plc (Robinson).

   Robinson is a large, global bank with its headquarters in London. It is listed on the London Stock Exchange. Robinson's financial year end is 31 October. Its financial statements are expected to be authorised for issue in January 2018.

   Potential fines

   Prior to the Global Financial Crisis of 2007/08, Robinson sold large volumes of mortgage backed securities (MBS) to US investors. Robinson's draft statement of financial position at 31 October 2017 contains a provision of £1,200 million as the best estimate on that date of potential fines for mis-selling MBS.

   On 24 November 2017, the US Department of Justice (DOJ) initiated legal action against Robinson for mis-selling MBS, seeking fines equivalent to £10,600 million.

   Robinson's board is concerned about the impact that fines of this size would have on its capital adequacy. Robinson's financial information at 31 October 2017 is provided (**Exhibit 1**) and regulatory information at 31 October 2017 is also provided (**Exhibit 2**). The announcement of the action by the DOJ has caused Robinson's share price to fall by 27%.

   Commercial lending in Mediterranean countries

   In the last five years, Robinson's secured commercial lending has focused on those Mediterranean countries where high interest rates were available. In these markets, Robinson's policy was to lend only to highly rated borrowers. However, economic conditions have recently deteriorated in these countries. During November 2017, a number of borrowers owing money to Robinson had their credit ratings downgraded by credit rating agencies.

   Sovereign lending to Republic of Wakanda

   In addition, Robinson has a long-term holding of £2,000 million of sovereign debt issued by the Republic of Wakanda in Africa (Wakanda debt) which it purchased with the intention of holding to maturity. Since this purchase, economic conditions in Wakanda have deteriorated considerably. In November 2017, an unexpected change of government took place in Wakanda. The new Wakanda finance minister has just announced a temporary ban on the payment of interest and on capital repayments for all government debt held outside Wakanda. Consequently, the credit rating of Wakanda debt was downgraded on 1 December 2017 by credit rating agencies.

   Further information about credit ratings and risk weightings has been provided by Robinson's lending departments (**Exhibit 3**).

   Risk committee meeting

   Today's risk committee meeting generated three suggestions to strengthen Robinson's capital position and create greater resilience to unexpected events. Extracts from the minutes from the meeting are provided (**Exhibit 4**).

Requirements

1.1 Using the information in Exhibits 1 and 2 and ignoring any potential change in the DOJ fine:

(a) Calculate Robinson's total regulatory capital requirement and CET1 capital requirement at 31 October 2017; and

(b) Evaluate the adequacy of Robinson's total regulatory capital and CET1 capital.

1.2 Calculate the impact of the potential £10,600 million DOJ fine on Robinson's capital adequacy ratios. Explain the significance of your findings.

1.3 Describe the impact of the credit rating downgrades (Exhibit 3) on Robinson's credit risk. Calculate and explain how they may affect Robinson's capital adequacy.

1.4 Critically evaluate the risk committee's suggestions (Exhibit 4) to address the capital adequacy issues created by the potential £10,600 million DOJ fine and the credit rating downgrades.

1.5 Explain the correct financial reporting treatment of the potential DOJ fine and the credit rating downgrades and the impact on Robinson's financial statements for the year ended 31 October 2017.

Total: 42 marks

Exhibit 1 – Robinson's financial information at 31 October 2017

Statement of financial position at 31 October 2017

	£m
Cash and balances with central banks	49,837
Trading assets	165,432
Derivative financial assets	243,909
Loans and advances to banks	47,543
Loans and advances to customers	316,545
Investment securities	230,354
Property and equipment	5,342
Goodwill and intangible assets	16,329
Other assets	24,007
Total assets	**1,099,298**
Trading liabilities	120,000
Derivative financial liabilities	140,061
Deposits from banks	31,901
Deposits from customers	681,775
Debt securities issued	55,616
Provisions	3,882
Other liabilities	23,432
Total liabilities	**1,056,667**
Ordinary share capital	4,355
Share premium	4,888
Other equity instruments	3,505
Retained earnings	29,883
Total equity	**42,631**
Total liabilities and equity	**1,099,298**

Notes to the statement of financial position

- Other equity instruments comprise contingent convertible bonds (coco bonds). The terms of the coco bonds state that they convert into equity if the carrying amount of CET1 falls below 7% of risk weighted assets. The coco bonds were issued by Robinson as they fulfil the criteria for additional tier 1 capital.
- Robinson has no tier 2 capital in issue.
- Other assets include a deferred tax asset of £6,342 million dependent upon future profitability.
- Impairment allowances in relation to the proportion of the banking book subject to the internal ratings based approach for credit risk are £11,234 million.
- Provisions include £1,200 million in respect of DOJ fines for mis-selling.
- Investment securities include £2,345 million in relation to a holding of 8% of the share capital in Steel Bank plc.

Exhibit 2 – Regulatory information at 31 October 2017

Robinson is classified by the Prudential Regulation Authority (PRA) as a global systemically important bank (GSIB) and is subject to a GSIB buffer of 1.5%. The capital conservation buffer is 1.25% and the countercyclical buffer is 0.5%. The PRA has informed Robinson that its individual capital guidance is 9.5%.

Robinson uses the basic indicator approach to establish its capital requirement for operational risk. Average gross income of the bank over the last three years is £14,244 million.

Robinson calculates the capital requirement for market risk using the internal models approach and has arrived at a capital requirement of £898 million.

Robinson uses both the internal ratings based approach and the standardised approach for calculating the capital requirement for credit risk. The following methods are used for different elements of the banking book.

- For the part of the banking book assessed using the internal rating based approach, the exposure at default amounts to £170,582 million and the risk weight function applied is 2.6%. The expected loss for this portion of the banking book was calculated as £14,430 million.

- The remainder of credit exposures are subject to the standardised approach under which risk weighted assets have been calculated as £22,341 million.

Exhibit 3 – Information from Robinson's lending departments

Robinson's commercial lending in Mediterranean countries – credit ratings

Amount of loans £m	Ratings at 31 October 2017	Ratings at 4 December 2017
22,307	AA-	A+
30,102	A-	BBB+
9,239	BB-	CCC
61,648		

Robinson's sovereign lending to Republic of Wakanda – credit ratings

The Wakanda debt has an individual impairment allowance equivalent to 30% of the value recognised at 31 October 2017. On 1 December 2017, external credit rating agencies downgraded its rating from BBB to CCC.

Standardised model risk weightings

Rating	Corporate risk weight	Sovereign risk weight
AAA to AA-	20%	0%
A+ to A-	50%	20%
BBB+ to BBB-	100%	50%
BB+ to B-	100%	100%
Below B-	150%	150%

Exhibit 4 – Extracts of minutes from risk committee meeting

Summary of suggested proposals to strengthen capital

(1) A substantial issue by Robinson of coco bonds. Under the terms of issue, conversion into Robinson's ordinary shares would be triggered if the carrying amount of its CET1 falls below 7% of risk weighted assets.

(2) A substantial rights issue of Robinson's ordinary shares.

(3) A private placement of Robinson's subordinated debt to a large Middle-East sovereign investment fund.

2. You are an audit senior working for Snook LLP (Snook), a firm of ICAEW Chartered Accountants. Snook is performing the final audit for the year ended 30 November 2017, of the UK-based subsidiary of a large Japanese bank, Umami Bank (Umami). The UK-based subsidiary, Mariko plc (Mariko), accepts current account and savings account deposits in pound sterling from retail and business customers in the UK and offers residential mortgages to UK customers. Mariko is material to the group financial statements.

Mariko is regulated by the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). In the year ended 30 November 2017, Mariko's board has concentrated on growing its mortgage book to improve profitability. There has also been a focus on expanding digital communications with customers to reduce the branch network and its associated costs. This investment in online and mobile banking has increased costs in the current year.

Mariko is financed by its deposit base and by funding provided by Umami. This funding from Umami is provided in the form of renewable variable rate Japanese Yen loans with a maturity of one year. The Japanese base rate has fallen during the financial year ended 30 November 2017 to zero percent. The UK base rate has remained stable. Debt securities totalling £500 million were issued on 1 September 2017 to mature six months later.

The audit manager, Lee Haines, provided you with Mariko's individual company draft financial statements for the year ended 30 November 2017 (**Exhibit 1**) and outstanding issues from audit planning (**Exhibit 2**). Lee sends you the following message:

"There may be some issues in respect of financial interests in our client, Mariko. I have my personal mortgage with Mariko, but that's irrelevant. More importantly, in February 2017, Snook moved the mortgage in respect of its head office to Mariko. This needs to be dealt with before the group reporting pack is finalised."

Requirements

2.1 Identify and explain the key audit risks arising for the audit of Mariko for the year ended 30 November 2017. Include analytical procedures to identify risks using Exhibit 1 and use the information in Exhibit 2.

2.2 Explain the correct financial reporting treatment of the two outstanding issues in Exhibit 2. Set out the relevant audit procedures that Snook should undertake to address each of these outstanding issues.

2.3 Identify any ethical issues arising for Lee and Snook from the audit of Mariko. Explain what actions Lee and Snook should take to address these issues.

Total: 33 marks

Exhibit 1 - Mariko's individual company draft financial statements

Statement of profit or loss for the year ended 30 November

	Draft 2017 £m	Audited 2016 £m
Interest income	300	273
Interest expense	(61)	(63)
Net interest income	**239**	**210**
Net income from financial instruments at fair value through profit or loss	8	12
Revenue	**247**	**222**
Administrative expenses	(101)	(80)
Depreciation and amortisation	(13)	(14)
Net impairment charge on financial assets	(10)	(8)
Conduct provision charge	(45)	(33)
Profit before tax	**78**	**87**
Tax	(18)	(22)
Profit for the year	**60**	**65**

Statement of financial position at 30 November

	Draft 2017 £m	Audited 2016 £m
Cash and balances with central banks	1,500	1,630
Derivative financial assets	630	690
Loans and advances to banks	254	310
Loans and advances to customers	8,230	6,120
Non-current assets	37	39
Total assets	**10,651**	**8,789**
Derivative financial liabilities	595	454
Due to related entities	2,000	1,400
Deposits from banks	330	350
Deposits from customers	3,400	2,800
Debt securities issued	1,200	700
Provisions	100	90
Total liabilities	**7,625**	**5,794**
Share capital and share premium	24	24
Retained earnings	3,002	2,971
Total equity	**3,026**	**2,995**
Total equity and liabilities	**10,651**	**8,789**

PLEASE TURN OVER FOR EXHIBIT 2

Exhibit 2 - Outstanding issues from audit planning - provided by Lee Haines

1. Loans and advances to customers analysed by loan to value

Mariko has provided an analysis of LTVs which will be included in the annual report.

Loan to value (LTV) percentage	**Draft 2017 £m**	**Audited 2016 £m**
Less than or equal to 50%	500	780
Greater than 50% and less than or equal to 75%	1,800	2,150
Greater than 75% and less than or equal to 90%	2,800	1,950
Greater than 90%	3,130	1,240
Total	**8,230**	**6,120**

There has been a slowdown in the buy-to-let mortgage market in large areas of the UK. These mortgages are used by investors buying properties to rent (let) out rather than to live in. Buy-to-let mortgages typically have lower loan-to-value (LTV) percentages than residential mortgages. This fall in buy-to-let demand has been offset by high national employment levels and higher house prices increasing demand for residential mortgages at higher LTVs. UK base rates are currently low, but are expected to increase in the medium term.

Mariko has not identified any individual loans with evidence of impairment. A collective impairment allowance has been recognised against these loans and advances based on historical default rates.

2. Renegotiated mortgages

Mariko informed us that a number of residential mortgages in parts of the north east of England have been subject to renegotiation following the closure of a large manufacturing plant in the area which triggered job losses. The collective renegotiation allows for mortgage repayment holidays for a period of up to 18 months at the discretion of credit department managers.

These mortgages have not been individually impaired, but are part of the collective impairment allowance calculation.

3. On 1 January 2015, Peel Bank Ltd (Peel) incorporated as a new bank. It undertakes core banking operations such as accepting deposits and offers loans for retail and business customers globally. It also offers private banking services to customers in the UK. Peel's revenue arises from interest margins and fee income from private banking.

Throughout the financial years ended 31 December 2015 and 31 December 2016, currency exposure on international deposits and loans was monitored, but was not hedged due to the costs involved.

You work in Peel's internal audit department. Due to concerns from private investors about Peel's volatile profits, you are reviewing Peel's unhedged currency exposure for the three years ending 31 December 2017. Peel's statement of profit or loss for each of the three years ending 31 December 2017 and analysis of net interest income is provided in **Exhibit 1**.

You discussed the issues with the risk management division which provided an example of a hedge strategy (**Exhibit 2**). The Peel board is concerned about the impact of the implementation of IFRS 9 on the hedge strategy because the statement of financial position at 31 December 2017 will provide the opening balances for IFRS 9 implementation.

Requirements

3.1 Analyse the available data to identify the drivers of Peel's profitability since its incorporation. Provide supporting explanations.

3.2 Describe the correct financial reporting treatment under IAS 39 of the proposed hedge strategy in Exhibit 2. Address the concerns of the risk committee chairman.

3.3 Outline any changes to the financial reporting treatment of the hedge strategy described in requirement 3.2 when IFRS 9 is adopted for the year ended 31 December 2018.

3.4 Internal audit has been asked to recommend a system of internal controls to monitor the effectiveness of the hedge strategy from a risk management perspective. Describe the internal controls that Peel should implement.

Total: 25 marks

Exhibit 1 - Peel's statement of profit or loss and analysis of net interest income

Statement of profit or loss for the years to 31 December

	Forecast 2017 £m	Audited 2016 £m	Audited 2015 £m
Net interest income	**332**	**369**	**353**
Fees and commissions income	290	266	238
Fees and commissions expense	(56)	(48)	(44)
Net fees and commissions income	**234**	**218**	**194**
Revenue	**566**	**587**	**547**
Administrative expenses	(141)	(143)	(135)
Depreciation and amortisation	(17)	(17)	(18)
Net impairment charge in respect of financial assets	(165)	(178)	(202)
Conduct provision charge	(41)	(37)	(54)
Profit before tax	**202**	**212**	**138**
Tax	(50)	(53)	(34)
Profit for the year	**152**	**159**	**104**

Analysis of net interest income for the years ended 31 December

	Forecast 2017 £m	Audited 2016 £m	Audited 2015 £m
Interest income			
Underlying interest income	481	520	477
Currency (losses)/gains	(11)	14	3
Total interest income	**470**	**534**	**480**
Interest expense			
Underlying interest expense	(133)	(169)	(129)
Currency (losses)/gains	(5)	4	2
Total interest expense	**(138)**	**(165)**	**(127)**
Net interest income	**332**	**369**	**353**
Average loans and advances	10,670	10,130	9,860

Exhibit 2 - Hedge strategy provided by risk management division

One example of Peel's currency exposure is euro denominated loans and advances. The total exposure to euro denominated loans is €4,521 million with the following maturities:

Maturity	**Loans and advances €m**
6-12 months	23
1-2 years	140
2-3 years	650
3-4 years	856
4-5 years	905
Greater than 5 years	1,947
Total exposure	**4,521**

A risk committee member proposed that Peel trades currency swaps over-the-counter with counterparties to swap interest and principal payments in euro against sterling ie receive sterling, pay euro. These currency swaps tend to have a maturity of less than one year, but the proposal is to hedge the full exposure of €4,521 million with these swaps.

The risk committee chairman, who is not an accountant, believes that the effectiveness of hedge accounting could be justified for only the loans and advances maturing within two years. He is concerned, however, that there will be an accounting mismatch in relation to currency swaps relating to loans and advances maturing after two years.