ISQ Examination (Summer-2012)
Advance Risk Management – Associateship

Q. A) Define Risk. What are the major sources of risk?

Q. B) What is the main difference between LC Sight and LC Usance?

Q. A) What are the three categories of adverse classification as advised by SBP Prudential Regulations?

Q. B) During mid 2011, cotton prices in Pakistan witnessed a reduction. If a spinner had entered into forward contracts for purchasing raw material early in 2011 for the whole year, what impact would this have on his profitability during 2011 assuming that the spinner operates in a highly competitive market with marginal market share? Provide reason for your answer.

Q. A) A Pakistani textile exporter to the US fears a devaluation of the US Dollar in the foreseeable future. What FX Risk mitigating strategies can the exporter apply?

Q. B) Human resources have two roles in risk management. Define each role.

Q. A) What is the difference between Export Finance Scheme Part I and Part II?

Q. B) Can a bank/DFI allow lending to the borrowers with CIB showing default?

Q.

ABC Bank Ltd is leading bank in Pakistan. Credit related activities of the bank are governed by the Board approved Credit Policy and procedural guidelines (which includes steps from credit initiation, collateral verification to credit performance monitoring) are provided in Credit Manual. Credit policy defines the roles of respective stakeholders, significant of which are as follows:

- **Business Units (Corporate/ Retail): Loan origination and approvals**
- **Credit Administration: Collateral/ security management**
- **Operations: Loan booking**
- **Special Assets Management/ Legal: Loan recovery/ legal actions**

Salman, a Corporate Relationship manager, brought in a high net-worth but new entrant as a client to the bank. Post initial screening and approval, the underlying collateral/ security documents were forwarded to Credit Administration for detailed scrutiny/ verification (with respect to legality enforceability, existence, ownership, valuation etc.). Post documents verification the loan was disbursed to the client by Operations. Two & half years later, the client defaulted. The bank sought legal action against the defaulted client, where it was discovered that the verification conducted

intently overstated the value of the collateral/ security. Furthermore the collateral could not be liquidated to recover losses as the same was not in the name of client that was erroneously overlooked at the time of verifications. As a result the bank lost the law suit against defaulted customer and had to book an operational loss by writing off the loan amount.

Operational risks are categorized as follows:

a. **Process:** Losses that have been incurred due to a deficiency in an existing procedure, or the absence of a procedure.
b. **People:** Losses associated with intentional/ unintentional violation of internal policies by current or past employees.
c. **Systems:** Losses that are caused by breakdowns in existing systems or technology.
d. **External Events:** Losses occurring as a result of natural or man-made forces or the direct result of a third party's action.

Questions:

A) Identify the segregation of duties issues, if any, in the credit process with respect to the responsibilities mentioned above and classify the risk into operational risk category.

B) Categorize the identified lapses in the verification process into the operational risk categories.

Q.

TRAILBLAZER

Trailblazer has been in the business of manufacturing and exporting high-end fashion garment products to Europe. The company was established in 2000 and has enjoyed a significant growth in its exports volume over the years because of its strict quality control and strong relationship with one key customer, Pioneer International that serves the European market. Trail blazer is proud to supply 100% of its goods to Pioneer International and this has enabled the former to increase sales phenomenally over the years. Because of this relationship, Trailblazer extends a lenient credit period of 120 days to Pioneer International.

The ownership structure of the company is as follows:

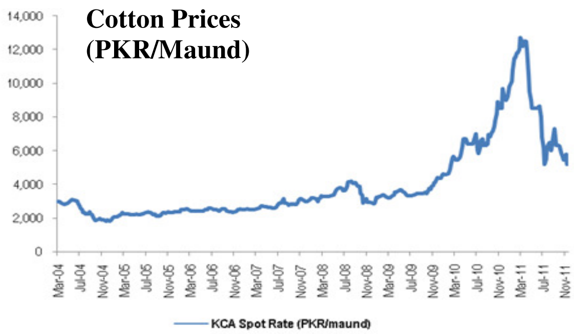
Shareholder	Shareholding %
Mr. Charles (England)	60%
Mr. Kamran (Pakistan)	40%

During the riots in late December 2007, Trailblazer suffered damage and was not operational for a couple of months. All physical damages were recoverable via insurance claim; however, the qualitative damage because of delay in sales order was not quantifiable.

Even though, Pioneer International, doesn't rely extensively on the purchases from Trailblazer, however, due to a slump in the European market and a credit squeeze witnessed by them from other suppliers, they had to meet their procurement requirements from Trailblazer that resulted in significant built-up of receivables b latter.

The financial and economic crisis since 2008 brought Pioneer International into financial distress, resulting in write-off of inventories and receivables enough to erode the equity of the company. Trailblazer had to face a setback because of this crisis with stuck up receivables. However, Trailblazer is confident that Pioneer International would pay back its receivables in due time and has sought bank financing to bridge the working capital gap.

Trailblazer used Foreign Currency Financing (FCY) in order to lower the interest cost of bank financing as the base rate (LIBOR) was hovering in the range of 1-2% whereas local currency base (KIBOR) was in the band of 14-15% in the last three years.



Provided below is the financial snapshot of Trailblazer:

PKR Million	June 2006	June 2007	June 2008	June 2009	June 2010	June 2011
Sales	2 140	3 057	2 765	2 149	1 883	1 870
Net Profit/(Loss)	263	316	47	32	(398)	(200)
Current Assets	1 511	2 079	2 811	3 190	3 242	2 719
Current Liabilities	1 504	1 915	2 577	2 804	3 309	2 786
Fixed Assets	1 023	1 484	2 602	2 956	2 892	2 625
Total Assets	2 582	3 588	5 416	6 151	6 136	5 344
Total Bank Debt	1 131	1 956	2 872	3 458	3 719	3 504
Total Liabilities	1 684	2 215	3 197	3 900	4 283	3 691
Net Worth	898	1 374	2 219	2 251	1 853	1 653

Receivables aging as at June 30, 2011 are provided below:

	Not Overdue (<120 days)	120-180 days	180-360 days	Over 360 days	Total
PKR Million	100	50	150	1 900	2 200

Below is the current facility-wise Bank Outstanding of Trailblazer as at June 30, 20

PKR Million	Long Term Loan	FCY (equivalent in PKR)	Export Refinance Facility	Running Finance	Total
All Banks	1 300	1 000	700	504	3 504

Questions:

a) **Highlight and elaborate on the main risks inherent in the business model of Trailblazer that has resulted in decline in its profitability?**

b) **Would Trailblazer be in a position to service its existing loans? Explain your answer?**

c) **What restructuring package can be designed for the company in order for it to get back on track? (Keep in mind the existing business model and the bank loan outstanding).**

Q. Your Bank has received a Swift message from one of your correspondents to pay USD 1,000,000 to M/s 'Y' one of your clients and claim reimbursements from the nostro account specified therein. What type of risk is being faced by your bank and how would you secure under such situation?

Q. Briefly discuss the status of circular debt in Pakistan and how they are affecting both the individual consumers and industry?

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