CHAPTER 11

# ANALYSIS OF FINANCIAL INSTITUTIONS

1. (A) **concern the co-movement of an institution's asset values with the overall market.**

**Explanation**

Systemic risk refers to the risk that impairment in one part of the financial system could spread throughout other parts of the financial system, and then negatively affect the entire economy. Note that systemic risk is distinct from systematic (beta) risk.

(Module 11.1, LOS 11.a)

**Related Material**

SchweserNotes - Book 2

2. (A) **The priority in the selection of assets should be liquidity.**

**Explanation**

Due to the uncertain nature of required payouts, liquidity is the key concern. High-risk, long term assets are therefore not appropriate. Level 1 valuations would suggest liquid assets, as they are priced using identical trading (and hence liquid) assets.

(Module 11.6, LOS 11.f)

**Related Material**

SchweserNotes - Book 2

3. (A) **To increase global opportunities for regulatory arbitrage.**

**Explanation**

One aim of establishing global regulatory bodies is to reduce, not increase, opportunities for regulatory arbitrage (multinational companies exploiting differences in regional regulations to avoid unfavorable rules).

(Module 11.1, LOS 11.b)

**Related Material**

SchweserNotes - Book 2

4. (C) **level 3 valuation**

**Explanation**

Neither the future cash flows or the discount rate in a PV calculation are directly observable, hence the valuation is level 3. Level 1 valuations are based on observed quoted prices for identical assets. Level 2 valuations are observable but are not quoted prices for identical assets, they may be prices for similar assets.

(Module 11.3, LOS 11.c)

**Related Material**

SchweserNotes - Book 2

5. (C) **due to their assets being predominantly tangible.**

**Explanation**

Lots of companies have predominantly tangible assets. Financial institutions differ in that their assets are predominantly financial assets. These are often measured at fair value, and financial institutions do give rise to systemic risk.

(Module 11.1, LOS 11.a)

**Related Material**

SchweserNotes - Book 2

6. (A) **incorrect, and statement 2 is most likely correct**

**Explanation**

Neither the mission nor the corporate culture are addressed in a typical CAMELS analysis, hence statement 1 is incorrect (stating that the mission is included) but statement 2 is correct (in stating that the corporate culture is not included.)

(Module 11.5, LOS 11.d)

**Related Material**

SchweserNotes - Book 2

7. (A) **competitive environment, mission, and support by government.**

**Explanation**

In addition to the CAMELS components, important attributes deserving analysts' attention include government support, the bank's mission, corporate culture and competitive environment, off-balance-sheet items, segment information, currency exposure, and risk disclosures. CAMELS itself focuses on a bank's: capital adequacy, asset quality, management capabilities, earnings sufficiency, liquidity position, and sensitivity to market risk.

(Module 11.5, LOS 11.d)

**Related Material**

SchweserNotes - Book 2

8. (A) **not be included in risk-weighted assets.**

**Explanation**

Cash has zero risk and hence is not included in risk-weighted assets (i.e. is weighted at zero).

(Module 11.2, LOS 11.c)

**Related Material**

SchweserNotes - Book 2

9. (A) **market risk, credit risk, liquidity risk, and interest rate risk.**

**Explanation**

Because the productive assets of financial institutions are primarily financial assets such as securities and loans, financial institutions are likely to have significant direct exposures to risks such as credit risk, liquidity risk, market risk, and interest rate risk.

(Module 11.1, LOS 11.a)

**Related Material**

SchweserNotes - Book 2

10. (B) **policies' final cost will typically be known within a year of an insured event.**

**Explanation**

P&C insurers' final cost will usually be known within a year of an insured event occurring. P&C insurers' policies are usually short term, and P&C claims are more variable and "lumpier" because they stem from unpredictable events such as accidents.

(Module 11.6, LOS 11.f)

**Related Material**

SchweserNotes - Book 2

11. (B) **has legal authority to enforce compliance with supervision and accountability standards.**

**Explanation**

The Basel Committee develops international regulatory framework for banks, and monitors adoption and implementation in member jurisdictions. However, the Basel Committee does not have legal authority (i.e., jurisdiction) to enforce compliance.

(Module 11.1, LOS 11.b)

**Related Material**

SchweserNotes - Book 2

12. (C) **Levels of government support**

**Explanation**

The level of government support or ownership is not part of the CAMELS process. The accuracy of accounting estimates and the valuation process used (level 1,2,3) would be considered within the earnings category.

(Module 11.5, LOS 11.d)

**Related Material**

SchweserNotes - Book 2

13. (B) **available stable funding ÷ required stable funding.**

**Explanation**

The Net Stable Funding Ratio (NSFR) is the percentage of a bank's required stable funding that must be sourced from available stable funding. The numerator (available stable funding) is a function of the composition and maturity of a bank's funding sources (i.e., capital and deposits and other liabilities), while the denominator (required stable funding) is a function of the composition and maturity of a bank's asset base.

(Module 11.5, LOS 11.e)

**Related Material**

SchweserNotes - Book 2

14. (A) **JJK's current tier 1 capital ratio meets Fonn's criteria even if the $85m of non-performing loans were reclassified**

| | | | | | |
|---|---|---|---|---|---|
| Common Equity Tier 1 Capital | 80,438 | | | | |
| Additional Tier 1 Capital | 14,294 | | | | |
| Tier 1 Capital | **94,732** | | | | |
| Pre Adjustment | | | | | |
| Cash | 165,754 | 0% | 0 | | |
| Performing loans | 235,631 | 100% | 235,631 | | |
| Non-performing loans | 158,654 | 150% | 237,981 | | |
| **Total** | | | **473,612** | **Tier 1 Ratio** | **94,732** |
| | | | | | **473,612** |
| Post Adjustment | | | | | |
| Cash | 165,754 | 0% | 0 | | 20% |
| Performing loans | 150,631 | 100% | 150,631 | | |
| Non-performing loans | 243,654 | 150% | 365,481 | | |
| **Total** | | | **516,112** | **Tier 1 Ratio** | **94,732** |
| | | | | | **516,112**<br>**18.4%** |

JJK's tier 1 ratio is 20% pre-adjustment and 18.4% post adjustment, both above 15%.

(Module 11.5, LOS 11.e)

**Related Material**

SchweserNotes - Book 2

15. (A) **The calculation of Property and Casualty insurers minimum capital requirements is more likely to factor in exposure to interest rate risk.**

**Explanation**

Property and Casualty insurers typically face more unpredictable claims and hence have higher capital requirements.

Life and Health insurers are more likely to sell products with material exposures to interest rate risk and hence they, not Property and Casualty insurers, are more likely to factor that risk into capital requirements.

(Module 11.6, LOS 11.f)

**Related Material**

SchweserNotes - Book 2

16. (B) **minimum capital requirement.**

**Explanation**

The minimum capital requirement specifies a ratio of assets to risk-weighted assets to ensure the balance sheet is robust enough to cope with loan losses. Stable funding requirements specify the amount of stable funding relative to liquidity needs over a one-year horizon. The minimum liquidity requirement specifies a minimum level of liquidity to cover a partial loss of funding sources or outflow due to off balance sheet commitments.

(Module 11.1, LOS 11.b)

**Related Material**

SchweserNotes - Book 2

17. (C) **corporate culture, exposure to currencies, and segment information.**

**Explanation**

In addition to the CAMELS components, important attributes deserving analysts' attention include government support, the bank's mission, corporate culture and competitive environment, off-balance-sheet items, segment information, currency exposure, and risk disclosures. CAMELS itself focuses on a bank's: capital adequacy, asset quality, management capabilities, earnings sufficiency, liquidity position, and sensitivity to market risk.

(Module 11.5, LOS 11.d)

**Related Material**

SchweserNotes - Book 2

18. (C) **indicate an underwriting loss when it is higher than 100%.**

**Explanation**

An underwriting loss is indicated by a combined ratio higher than 100% for a single insurance company. Low prices for premiums leads to a high combined ratio, indicating a soft market. The combined ratio equals the total insurance expenses divided by the net premiums earned.

(Module 11.6, LOS 11.f)

**Related Material**

SchweserNotes - Book 2

19. (C) **The net stable funding ratio was highest in 2017**

**Explanation**

| | | 2016 $m | 2017 $m | 2018 $m |
|---|---|---|---|---|
| Net Outflows | | 70,363 | 79,454 | 111,547 |
| Available Stable Funding | | 337,964 | 347,945 | 298,045 |
| Required Stable Funding | | 327,043 | 287,953 | 247,876 |
| High Quality Liquid Assets | | 82,334 | 87,677 | 109,654 |
| Liquidity coverage Ratio | High Quality Liquid Assets | **117%** | **110%** | **98%** |
| | Net Outflows | | | |
| Number of days of stress | | 30x1.17 | 30x1.10 | 30x0.98 |
| Level volume of cash outflows OWB can withstand | | **35.1** | **33.1** | **29.5** |
| Net Stable Funding Ratio | Available Stable Funding | **103%** | **121%** | **120%** |
| | Required Stable Funding | | | |

The answer "The net stable funding ratio was highest in 2017" is correct, the net stable funding ratio was highest in 2017. The number of days of stress level cash flows OWB can withstand has decreased over the period and is below the BASEL III requirement in 2018.

(Module 11.5, LOS 11.e)

**Related Material**

SchweserNotes - Book 2

20. (B) **capital adequacy, asset quality, management, earnings, liquidity, and sensitivity.**

**Explanation**

The CAMELS approach to analyzing a bank stands for: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity.

(Module 11.2, LOS 11.c)

**Related Material**

SchweserNotes - Book 2