

DP08

Retail Financial Services

6 OCTOBER 2004

1. Time allowed : Three (3) hours
2. Total number of questions : Six (6) questions
3. Number of questions to be answered : Five (5) questions
Part A : Three (3) questions [20 marks each]
Part B : Two (2) questions [20 marks each]
4. Show details of workings, where appropriate. Silent, non-programmable calculators may be used.
5. Begin each answer to a new question on a fresh page.
6. Answer **all** questions in **English**.
7. Blank pages are provided at the end of the question paper for rough work.

PART A

ANSWER ALL THREE (3) QUESTIONS

1. (a) En Ali purchased a house under construction costing RM100,000 from a developer. He approached a bank to apply for a housing loan with a 90% margin of finance.

After completing the necessary security documentation, the bank released the first 10% of the Sale and Purchase Agreement payment on 31 January 2004 for the completion of work done below ground level (including piling and foundation) based on the stage of completion in the architect progress certificate.

- (i) Calculate the interest charged for the month of January 2004, assuming that the interest rate was 5.0%. [3]

- (ii) The bank will make its final progressive release of 5% on 31 July 2005 when En Ali is expected to take possession of the vacant property.

Calculate the interest payable for the month of August 2005 assuming that the interest rate is 6.5%. [2]

- (b) A housing loan is a long-term loan that may go up to 30 years. Given the long duration of the loan, banks face significant risks in managing their housing loan portfolio.

- (i) Briefly explain **three** specific risks faced by banks. [6]

- (ii) State **three** actions that banks can take to mitigate the risks stated in (b)(i). [3]

- (c) En Ahmad has an overdraft (OD) facility with a bank. He was charged an interest of RM1,350 for the amount he utilised in January 2004, based on a 7.0% interest rate. If he had utilised his credit limit to the maximum, the bank would have charged him RM2,050 in interest.

Calculate the commitment fee levied for January 2004, assuming that the commitment fee for the unutilised portion of the OD facility was 1.0% and the base lending rate was unchanged. [4]

- (d) State any **two** measures set by the Securities Commission to safeguard the interests of unit trust investors who finance their investments using bank loans. [2]

(Total:20 marks)

2. Mike bought a car that cost RM60,000. The car dealer arranged for a hire-purchase financing from a finance company for a tenure of nine years at an interest rate of 3.3% per annum, and Mike paid a deposit of RM6,000.

- (a) Calculate the following:

- (i) Term charges [2]

- (ii) Monthly instalment [2]

- (iii) Annual percentage rate (APR), based on the following formula:

$$\text{APR} = \frac{2NF(300C + NF)}{2N^2F + 300C(N+1)}$$

Where:

N is the total number of instalments

C is the number of instalments that would be paid in 1 year if instalments continued to be paid at the same intervals

F is the amount, determined as:

$$F = \frac{100C \times T}{N \times A}$$

Where:

T is the total amount of predetermined term charges [4]

A is the amount financed

- (b) Assume that the hire-purchase agreement was signed on 2 January 2004. The finance company posted the hire-purchase agreement on 18 January 2004 (according to the post-marked date on the registered mail), and Mike received it on 30 January 2004.

Explain whether the hire-purchase agreement is still valid and enforceable. [3]

- (c) After several instalments, Mike was in financial difficulties and delayed the repayment of his monthly instalment.

Calculate the interest on overdue instalment, assuming that the number of days in arrears is 125 days and the maximum interest rate charged is 8.0% [2]

- (d) Finally, Mike decided that he was unable to continue repaying the monthly instalment. The finance company then served him the necessary notices to repossess the vehicle.

Outline the procedure that the finance company must observe in repossessing the vehicle, according to Rule 4 of the Hire-Purchase (Recovery of Possession and Maintenance of Records by Owner) Regulations 1976. [4]

- (e) Fortunately, Mike managed to find a close relative who is willing to assume the hire-purchase finance obligations through voluntary assignment under section 12(4) of the Hire-Purchase Act 1967.

State **three** conditions that the finance company can impose before consenting to the voluntary assignment. [3]

(Total:20 marks)

3. (a) The following are the Balance Sheet and Profit and Loss Account of Viva Berhad as at 31 December 2003:

BALANCE SHEET AS AT 31 DECEMBER

Item	2003 (RM'000)	2002 (RM'000)
Property, plant & equipment	2,895	2,013
Development expenditure	9,889	6,988
Current assets		
Inventories	2,083	938
Trade debtors	20,029	19,915
Other debtors, deposits & prepayments	4,341	769
Fixed deposits	3,614	3,483
Cash & bank balances	235	151
	30,302	25,256
Current liabilities		
Trade creditors	13,676	8,207
Other creditors & accruals	2,077	3,045
Hire-purchase creditor	56	73
Amount due to director	100	2,650
Bankers acceptance	2,057	1,225
Bank overdrafts	1,984	2,008
Term loan	4,505	-
Provision for taxation	2	2
	24,457	17,210
Net current assets	5,845	8,046
	18,629	17,047
<i>Financed by:</i>		
Share capital	16,880	8,227
Share premium	-	3,397
Unappropriated profits	1,022	5,267
Shareholders' funds	17,902	16,891
Long-term liabilities		
Hire-purchase creditor	36	156
Term loan	691	-
	18,629	17,047

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER

Item	2003 (RM'000)	2002 (RM'000)
Revenue	22,706	21,988
Cost of sales	(16,970)	(15,793)
Gross profit	5,736	6,195
Other operating income	131	111
Administration expenses	(2,024)	(2,293)
Other operating expenses	(2,380)	(2,331)
Profit from operations	1,463	1,682
Finance costs	(416)	(335)
Profit before taxation	1,047	1,347
Taxation	(35)	(76)
Net profit for the year	1,012	1,271
Earnings per RM0.10 share		
Basic (sen)	0.60	0.75

Based on the financial statements provided, calculate the following financial ratios for Viva Berhad for the year 2003:

- | | | |
|--------|-------------------------|------|
| (i) | Working capital | [1] |
| (ii) | Gearing ratio | [1] |
| (iii) | Current ratio | [1] |
| (iv) | Quick ratio | [1] |
| (v) | Gross margin ratio | [1] |
| (vi) | Net profit margin ratio | [1] |
| (vii) | Stock turnover days | [1] |
| (viii) | Debtors' days | [1½] |
| (ix) | Creditors' days | [1½] |
- (b) You are a credit officer-in-charge of the financing of Small- and Medium-sized Enterprises (SMEs) in your bank. An SME customer submitted a loan application to finance his working capital and new equipment acquisition.

Briefly explain the key factors that you need to consider before recommending the loan application for approval from your Management or Credit Committee.

[10]
(Total:20 marks)

PART B

ANSWER TWO (2) QUESTIONS ONLY

4. (a) (i) Company A intends to purchase a machine costing RM200,000. To finance the acquisition, the company is considering a lease financing facility where the lease period is five years and the interest rate is 5% per annum.
- Calculate the monthly lease rental based on the following:
- (aa) Full payout lease [2]
- (bb) Non-full payout lease, if the residual value at the end of the fifth year is RM20,000 and the interest rate on the residual value is 8% per annum [2]
- (ii) Financiers face many types of risks in leasing transactions.
- Briefly explain **three** common types of risks (other than credit risk) in leasing transactions. [3]
- (iii) Briefly explain **three** common frauds associated with leasing. [3]
- (b) Identify and describe any **five** key factors that credit officers need to consider when undertaking the evaluation of agricultural project financing. [10]
(Total:20 marks)
5. (a) (i) Briefly explain **four** major factors that contribute to the growth in Internet banking transactions. [4]
- (ii) Briefly explain **four** major risks in Internet banking that are of greatest concern for financial institutions. [6]
- (b) Identify and describe **five** main problems in hire-purchase financing faced by the banking and finance industry. [10]
(Total:20 marks)
6. (a) About 92% of business establishments in the manufacturing sector in Malaysia comprises Small- and Medium-sized Enterprises (SMEs). They create about 33% of employment opportunities but only contribute to 6% of the Gross Domestic Product.
- Identify **seven** major problems faced by SMEs in Malaysia. [7]
- (b) List **four** advantages and **three** disadvantages of a financial lease from the lessee's viewpoint. [7]
- (c) Share financing is the lending of funds for the purchase of or investment in shares listed on Bursa Malaysia Berhad (formerly known as Kuala Lumpur Stock Exchange).
- State **four** advantages and **two** disadvantages of accepting quoted shares as security from the financiers' perspective. [6]
(Total:20 marks)

OUTLINE ANSWERS

The comments given in the boxes below indicate the areas of weaknesses the examiners have identified and their advice to future candidates.

Question 1

Candidates could not state the risk mitigation measures for housing loans, and also measures set by the Securities Commission to safeguard investors engaged in unit trust financing

1. (a) (i) Interest payable in January 2004
= Principal x Time x Interest rate
= (10% x 100,000) x 1/365 x 5% = **RM1.37**
- (ii) Interest payable in August 2005
= 90,000 x 1/12 x 6.5% = **RM487.50**
- (b) (i) Specific risk faced by banks in managing housing loan portfolios:
- Default risk – borrowers unable to fulfil loan repayment obligations.
 - Interest rate risk – rising interest rate causes banks to pay for long-term relatively low interest rate loans with more costly short-term deposits.
 - Liquidity risk – a lack of liquidity could result in a failure to meet withdrawal demands.
- (ii) Risk mitigation measures:
- Third-party guarantee (for those with inadequate income)
 - Periodic credit review of accounts
 - Maintain constant and adequate liquidity levels through the development of a well-structured asset/liability portfolio
- (c) Commitment fee in January 2004
=
$$\frac{\left[\begin{array}{l} \text{Interest payable at full} \\ \text{utilisation of overdraft} \end{array} - \begin{array}{l} \text{Actual interest} \\ \text{paid for the month} \end{array} \right] * \left[\begin{array}{l} \text{Commitment fee for unutilised} \\ \text{portion of overdraft facility (\%)} \end{array} \right]}{\text{Interest rate charged for the overdraft facility (\%)}}$$

= (RM2,050 – RM1,350) * 1.0% / 7%
= **RM100**
- (d) Securities Commission's safeguard measure for unit trust fund borrowers (any **two**):
- Maximum margin of finance for unit trust purchases is fixed at 67% so that investor can only obtain a loan up to twice the value of his initial deposit or investment in a unit trust fund.
 - All loan plan sales materials must be disassociated from unit trust sales, e.g. promotion materials with projected returns based on a loan scheme is not allowed.
 - Investors need to sign a Risk Disclosure Statement to the effect that the risks involved has been explained to them by the unit trust agents and that they understand the content of the loan.

Question 2

- Candidates did not know that repossession can be carried out by the owner personally or if carried out by another person, this person must show his identity and authority cards.
- In detailing steps for repossession, candidates need to differentiate between repossession undertaken by the owner personally or through an agent.
- Candidates were unable to provide the three conditions required for consent on voluntary assignment.

2. (a) (i) Term charges = $\frac{54,000 \times 9 \times 3.3}{100} = \mathbf{RM16,038}$
- (ii) Monthly instalment = $\frac{54,000 + (54,000 \times 9 \times 3.3\%)}{9 \times 12} = \mathbf{RM648.50}$
- (iii) $F = \frac{100 \times 12 \times 16,038}{9 \times 12 \times 54,000} = 3.3$
- APR = $\frac{2 \times 108 \times 3.3 (300 \times 12 + 108 \times 3.3)}{2 \times 108 \times 108 \times 3.3 + 300 \times 12 (109)} = \mathbf{6.008}$
- (b) Under Section 5(1) of the HPA, the HP agreement must be served within 14 days (i.e. by 16 January 2004). Since it was served on 18 January 2004 (2 days late), the HP agreement is unenforceable.
- (c) Interest on overdue instalment = $\frac{648.5 \times 8\% \times 125}{365} = \mathbf{RM17.77}$
- (d) Procedure to be observed when repossessing a vehicle:
- If the repossession is being carried out by the owner personally, he must produce and show his identity card and provide the name and address of the company to which he belongs, to the hirer, his servant or agent, or occupant or person who is in possession of the goods.
 - If the repossession is being carried out by the owner's agent or servant, such agent and servant must produce and show his identity card and an authority card to the hirer or his servants or agents or occupant or the person who is in possession of the goods.
- (e) Consent for voluntary assignment:
- Hirer must first make settlement of all amount defaulted/in arrears
 - Both hirer and assignee execute and deliver to the owner a deed of assignment without prejudice to the continuing liabilities of hirer
 - Hirer pays cost of stamping and registration of assignment of deed of assignment.

Question 3

- Candidates could not compute the more complicated ratios, although all formulas/computations could be found in the study manual.
- Candidates did not take into consideration the nature of the business and purpose of the loan in credit revaluation of a SME loan.

3. (a) (i) Working capital
= Current assets – Current liabilities
= 30,302 – 24,457
= **5,845**

- (ii) Gearing ratio
 = Total liabilities / Networth
 = 25,184 / 17,902
 = **1.41**
- (iii) Current ratio
 = Current assets / Current liabilities
 = 30,302 / 24,457
 = **1.24**
- (iv) Quick ratio
 = (Current assets – Inventory) / Current liabilities
 = (30,302 – 2,083) / 24,457
 = **1.15**
- (v) Gross profit margin
 = Gross profit / Net sales x 100%
 = (5,736 / 22,706) x 100%
 = **25.3%**
- (vi) Net profit margin
 = (Net profit after tax / Net sales) x 100%
 = (1,012 / 22,706) x 100%
 = **4.5%**
- (vii) Stock turnover days
 = (Inventory / Cost of goods sold) x 365
 = (2,083 / 16,970) x 365
 = **45**
- (viii) Debtors days
 = (Trade debtors / Net sales) x 365
 = (20,029 / 22,706) x 365
 = **322**
- (ix) Creditors days
 = (Trade creditors / Net sales) x 365
 = (13,676 / 22,706) x 365
 = **220**
- (b) Key factors for consideration:
- Nature of business and purpose of loans
 - 5Cs of credit:
 - Character ~ willingness and determination to repay
 - Capital ~ owners fund and commitment to operate the business
 - Capacity ~ capability and ability to run the business
 - Conditions ~ external operating environment especially economy
 - Collateral ~ security and personal assets pledged for the loan

Question 4

- Candidates could not calculate the monthly lease rental of a non-full payout lease or identify the common risks in leasing transactions and common frauds associated with leasing.
- Candidates wrongly evaluated the risks involved in agriculture, instead of providing viability factors as required by the question.

4. (a) (i) (aa) Full payout lease
$$= \frac{200,000 + (200,000 \times 5.0\% \times 5)}{60}$$
= RM4,166.67
- (bb) Non-full payout lease
$$= \frac{180,000 + (20,000 \times 8\% \times 5) + (180,000 \times 5\% \times 5)}{60}$$
= RM3,883.33
- (ii) **Three** common types of risks:
- Title and security:
 - If the equipment is not fully paid for by the vendor and if the vendor subsequently goes into receivership, the lessor may have to pay for the equipment that he has no legal title to and the equipment may be subjected to repossession by the original owner.
 - Fixtures: equipment fixed to a building may have its title automatically transferred to the landlord unless a waiver is obtained.
 - Supplier risk: depends on the credit standing of the supplier, quality of product and maintenance support
 - Fraud: ingenuity of perpetrators/criminals
- (iii) **Three** common frauds in leasing:
- Illusory lease: a lessee passing off itself as a subsidiary of an established company.
 - Multiple financing of the same equipment usually happens where the lessee is a company controlled by the supplier or the equipment has been subleased. The lessee can sell off the asset without informing the lessor.
 - “Connected” persons is when the supplier has a connection with someone in a position of responsibility within a lessee organisation, or a collusion happens between two parties, or if it involves a member of the lessor’s staff.
- (b) Factors to consider when undertaking agricultural project evaluation (any 5):
- *Technical viability* – location, infrastructure, layout and design, technical system and technology, technical assistance, project cost and implementation schedule
 - *Financial viability* – project plan, costing and profitability, cashflow and debt service ability, risk and sensitivity analysis, owner capital commitment and financial management ability
 - *Commercial viability* – efficient procurement and marketing processes. Efficient business operations – production, marketing, finance, compliance with regulation and law
 - *Sociological/environmental viability* – social objectives to alleviate rural poverty and creation of employment and business opportunities (spin-off effects).
 - *Economic viability* – the appropriate use of resources and whether the project is consistent with and contributes to the agricultural policies of the government.
 - *Managerial capability* – Experience and track records in managing business functions such as production, finance, marketing and HR profitably.

Question 5

Candidates were unable to describe the problems in hire-purchase financing faced by banks.

5. (a) (i) **Four** major factors accounting for the growth of internet banking:
- The Internet is available everywhere and all the time. The Internet is becoming widespread and global, providing cheap and convenient communication.
 - Low entry and start-up costs to reach customer targets. Requires only a PC, telephone/lease line and an Internet Service Provider subscription. Most required softwares come free.
 - Ease of use. The World Wide Web can be accessed with the web browser application, which has a user-friendly interface.
 - Real world constraints such as physical premises and established branding not required. No need for brick-and-mortar presence – only a website.
- (ii) **Four** major types of risk in Internet banking:
- Transaction risk (security)
 - Unauthorised access, disclosure of confidential information, denial of services and repudiation of transactions.
 - Detection and recovery of security breaches requires substantial expertise and resources
 - Legal risk
 - Inadequate legal infrastructure
 - Legality and enforceability of contracts especially foreign transactions.
 - Inadequate disclosure of information to customer, failure to protect customer privacy.
 - Reputation risk – public trust and confidence
 - Negative publicity and image can affect business and customer confidence.
 - Strategic risk
 - Significant resources are required to implement Internet banking infrastructure especially capital and skill (HR).
 - Internet must fit into overall business strategy (strategic fit) to be effective.
- (b) The main problems in HP financing (any **five**):
- Fictitious hirers and goods
 - Fixtures (immovable assets that formed part of “land”) are financed without the waiver from the landowner/landlord
 - Used and reconditioned vehicle/equipment
 - Lack of knowledge on valuation, year of manufacture and conditions of vehicle/equipment.
 - Improper documentation especially import condition, custom declaration and clearance.
 - Stolen goods – no good titles and cannot transfer ownership.
 - Locked premises – difficult to repossess – no authorisation to enter. Court order is required to enter premises for repossession (risk offence of housebreaking and trespassing).
 - Insurance cover after first year and subsequent years – inadequate coverage – third party only instead of comprehensive.
 - Repossessor’s behaviours and ethics – high-handedness and strong arm tactics.
 - Syndicate workshops – exorbitant repairs, service and storage charges especially at unauthorised workshops – retained at workshops under lien.

Question 6

- Candidates were confused between a lessee and a lessor.
- Candidates have difficulties differentiating between operating and financial leases.
- Candidates' answers should be given in point form to improve clarity and presentation.

6. (a) Major problems faced by SMEs (choose any **seven**):
- Small in size, with informal management style
 - Poor accounting record-keeping and limited information available
 - Inefficient production due to use of old and outdated machines, old technology
 - Poor quality control and products
 - Lack of managerial and technical skills
 - Lack of updated market knowledge
 - Located outside industrial estates and parks – lack of facilities
 - Lack of capital – problems obtaining financing and limited collateral
- (b) The advantages and disadvantages of a financial lease for lessee:
- Advantages (any four):*
- 100 % financing and off-balance sheet
 - Certainty of fixed monthly lease payment improve cash forecasting
 - Hedge against higher prices and technology obsolescence
 - Simple and minimal cost on documentation
 - Fully tax deductible
- Disadvantages (any three):*
- Non-cancellable over fixed tenor.
 - Fixed irrevocable expense commitment
 - No ownership and capital tax allowance
 - High stamp duty at ad valorem rate
- (c) The advantages and disadvantages of accepting quoted share as a security:
- Advantages (any four):*
- Market price readily available and easily ascertained
 - Low stamp duty on transfer, low cost
 - Ready liquid secondary market facilitate easy disposal/realisation
 - Easy to share transfer through CDS accounts
- Disadvantages (any two):*
- Uncertainty (fluctuation) in share prices (due mainly to speculation)
 - Collateral subject to daily valuation (mark-to-market) and in some instances
 - Resulted in margin calls/ top-up which borrowers are unable to fulfil.