

DP08

Retail Financial Services

10 MAY 2000

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**.

PART A

ANSWER ALL THREE (3) QUESTIONS

1. (a) Mr Tan Poh Lim, the Managing Director of Tan & Lim Sdn Bhd, a textile company, has approached your finance company to finance the company's proposed purchase of a computer equipment costing RM2.5million. Mr Tan Poh Lim however is undecided whether to opt for a hire-purchase facility or a leasing facility to finance the purchase of the computer equipment. You have been informed that the interest rate for leasing is 0.5% lower than that of a hire-purchase, while the period of financing is not more than **five** years for both types of facilities.
- (i) Why is the interest rate of leasing lower than that of a hire-purchase? [3]
- (ii) Giving reasons, recommend to Mr Tan Poh Lim the type of financing facility that would be appropriate for the purchase of the computer equipment. [3]
- (iii) If Mr Tan Poh Lim opts for the leasing facility, calculate the monthly instalment payable. Assume that the interest rate to be charged on leasing is 5.5% per annum flat and Mr Tan Poh Lim would like to have the maximum period of financing. [2]
- (b) (i) Fraud is a major risk in any financial institution and leasing companies are no exception. Criminals usually target to commit fraud in leasing companies that possess certain characteristics. Explain **three** of these characteristics. [3]
- (ii) Leasing frauds usually involve "multiple financing", "connected persons" and an "illusory lease". Describe how these **three** types of leasing frauds operate. [9]
- (Total:20 marks)
2. (a) Encik Latiff Hassan has secured a hire-purchase loan with your finance company. The principal sum is RM50,000 and Encik Latiff Hassan has to pay a monthly instalment of RM1,062.50 over a period of **five** years.
- Calculate the interest rate charged per annum on the hire-purchase loan. [4]
- (b) Mr Arul has decided to trade-in his car to a car dealer for a trade-in value of RM10,000 and in return, intends to purchase another car for RM80,000 which would serve his growing family needs. Mr Arul has approached your finance company for financing.
- How would you respond to his request? [4]
- (c) Mr Tan, the guarantor of a hire-purchase loan has been served with many default notices and has decided to settle the loan, which has constantly been in arrears.
- Upon settlement of the loan, what action can Mr Tan take in order to mitigate his losses? [6]
- (d) Your immediate superior has indicated that he intends to incorporate a clause in the hire-purchase agreement, in order to ensure smooth repossession in the event of default by hirers. The clause authorises the finance company to enter into any premises for the purpose of taking possession of goods and consequently, will be relieved from any liability on such entry.
- Will your finance company face any problems as a result of the incorporation of such a clause in the hire-purchase agreement? [4]
- (e) Your finance company has entered into a hire-purchase agreement with Encik Ismail for the purchase of a car. The interest rate is quoted at 11% per annum flat, while the interest on overdue instalment is quoted at 10% per annum daily rest.
- Is your finance company infringing any provisions of the Hire-Purchase Act 1967 as amended by the Hire-Purchase (Amendment) Act 1992 in quoting these rates? [4]
- (Total:20 marks)

3. (a) Mancon Development Sdn Bhd (MDSB) has approached your finance company to refinance its existing loan of RM1.8million granted by Telsa Finance Bhd. To date, RM600,000 of the loan has been drawn down for preliminary expenses relating to the project land.

The following information is provided:

Period of Refinancing	To part-finance the development of 30 units of luxurious apartments in Gasing Heights, Petaling Jaya.
Period of Loan	2½ years
Interest Rate Charged	10.45% [i.e. Base Lending Rate (BLR) 7.95% + 2.5%]
Borrower	MDSB is a small but experienced developer. It is a family-owned company.
Security	The project land is 10acres in size and has a market value of RM4million. It is registered in the name of Mancon Development Sdn Bhd and is charged to Telsa Finance Bhd.

- (i) Assuming your finance company has agreed to refinance the loan, calculate the redemption sum, which your finance company will have to pay Telsa Finance Bhd, if interest is outstanding for **26** days at the time of the redemption. [4]
- (ii) Before you disburse the redemption sum to Telsa Finance Bhd, you will require a letter of undertaking from Telsa Finance Bhd. In order to protect the interest of your finance company, state **two** clauses in the letter of undertaking, which you will require Telsa Finance Bhd to express. [4]
- (b) (i) The open market value of a piece of property may be defined as the best price at which the property might reasonably be expected to be sold by private treaty at the date of valuation on the assumption of several factors. State **four** of these factors. [4]
- (ii) Why should a lending officer take property pledged as security to the finance company for a bridging loan on an “as is where is” basis in the computation of security and not based on the expected development value? [2]
- (iii) In valuing a piece of development property, the valuer adopts either a “residual valuation basis” or a “comparative basis”. Explain the differences between the **two** valuation methods. [6]
- (Total:20 marks)

PART B

ANSWER TWO (2) QUESTIONS ONLY

4. (a) Leases can be broadly classified into **two** categories:
- operating lease; and
 - financial lease
- Explain and highlight the differences between these **two** types of leases. [6]
- (b) Describe briefly the following types of leases:
- (i) pure lease [2]
- (ii) direct lease [2]
- (iii) syndicated lease [2]
- (iv) leveraged lease [2]

- (c) Lexis Communications Sdn Bhd (LCSB), a manufacturer of electronic components for a leading public listed company in Malaysia, has proposed to purchase a new equipment from the United States of America to meet its customers' requirements. The cost of the equipment is USD700,000. The current exchange rate for USD against Malaysian Ringgit is fixed at USD1.00 = MYR3.80.

LCSB has approached your finance company for leasing facilities for the acquisition of the equipment. Your finance company provides leasing facilities on the following terms:

- Interest rate at 6% per annum
- Maximum tenure of **five** years

Assuming your finance company offers only 20% deposit lease, calculate the monthly rental payable. [3]

- (d) Explain **three** disadvantages of leasing to a lessee. [3]
(Total:20 marks)

5. (a) State and explain **two** benefits of factoring. [4]

- (b) Hovid Sdn Bhd (HSB) manufactures machine parts for two internationally renowned semi-conductor companies. Its monthly turnover is RM2million. The company extends a credit period of **120** days to its customers.

In view of the sharp increase in the demand for semi-conductors globally, HSB has received additional orders from its buyers. However, the long credit period of **120** days is making it difficult for HSB to take on the additional orders unless it has additional working capital.

HSB has approached your finance company for a factoring facility to finance its tight cash flow. Your finance company's base lending rate is 8% per annum and it is your company's policy to charge 2% above base lending rate per annum for factoring facilities. A factoring commission of 1% is also chargeable.

- (i) Assuming your finance company enters into a factoring agreement with HSB, calculate the cost of the factoring facility to HSB. [3]

- (ii) Would it be considered suitable for your finance company to enter into a factoring agreement with HSB? Give **two** reasons for your answer. [4]

- (c) Describe the following types of factoring:

- (i) confidential factoring [3]

- (ii) disclosed factoring [3]

- (iii) international factoring [3]

(Total:20 marks)

6. Your finance company has approved a block discounting facility to Lucy Credit Sdn Bhd (LCSB). The terms of the facility are as follows:

Limit	RM2million
Minimum block size	RM200,000
Margin of finance	Not exceeding 90% of the outstanding principal value of each block submitted
Interest rate	5% per annum
Tenure	Minimum of 24 months and maximum of 36 months

The unearned interest on the papers amounted to RM300,000. LCSB has submitted a batch of papers with an aggregate outstanding balance of RM1million. All the papers were for an original term of **60** months. **Six** months have elapsed since the original loans were financed by LCSB.

- (a) Assuming LCSB wants a repayment for as long as possible, calculate the amount to be released and the monthly instalment payable based on the following methods of computing interest:
- (i) add-on basis [3]
 - (ii) discounted basis [3]
- (b) Identify **three** areas of risk associated with block discounting and suggest steps that should be taken to minimise these **three** risks. [6]
- (c) When a batch of hire-purchase agreement is to be discounted under block discounting, the dealer will forward the original agreement to the finance company accompanied by **three** documents. What are these **three** documents? [3]
- (d) List **three** advantages and **two** disadvantages of block discounting. [5]
- (Total:20 marks)

OUTLINE ANSWERS

PART A

Question 1

Only a few candidates passed the compulsory question on leasing. Candidates did not perform well in the practical case study question because they failed to understand the benefits of leasing and were unable to calculate lease rentals and rate of return. Those who passed this question were able to obtain some marks from the theory questions on leasing frauds.

1. (a) (i) This is due to the fact that the finance company as the owner, is entitled to capital allowances which would translate to lower taxes for the finance company. Hence, the finance company is in a position to pass part of this tax benefit of the capital allowance to the lessee in the form of a lower rate.

(ii) Leasing will be more advantageous to Tan & Lim Sdn Bhd as the company can obtain 100% financing under the pure lease as compared to only 90% maximum financing under hire-purchase. Thus, the capital conserved can be used for other productive purposes.

In this particular case, there is no mention that the company has been accorded pioneer status, hence the company would not benefit by opting for hire-purchase financing from the tax perspective.

(iii) Equipment cost = RM2,500,000
Amount financed = RM2,500,000
Lease Period = 5 years
Interest rate = 5.5% per annum

Monthly lease instalment:

$$\frac{RM2,500,000 + (RM2,500,000 \times 5.5\% \times 5)}{60}$$

$$= \underline{RM53,125}$$

(b) (i) Select any 3 characteristics:

- Poorly trained or inexperienced management or staff.
- Strategies which are excessively sales driven and where credit is subjugated to the pressure on the staff to achieve business targets or quotas.
- Inadequate or poorly documented procedures for handling new business.
- Where there is no effective supervision, or audit team to ensure that the company's policies and procedures are followed.

(ii) **Multiple Financing**

Multiple financing of the same equipment is more common where the lessee is a company controlled by the supplier or there is a pattern of subleases. Assets originally financed can be more easily sold without informing the lessor.

Connected Persons

Where the supplier has connection with someone (in a position of responsibility) within a lessee's organisation, or there is collusion between the parties. It will be even difficult to detect the fraud, if it involves a staff.

Illusory Lease

In such situations, the supplier of the equipment with a good collateral value will form another company with a name which when abbreviated to its initials may be mistakenly identified as a major well-known company. The address, telephone

number, delivery notes and other documentation are all designed to delude the lessor into thinking that he is dealing with the major company. If the lessor relaxes its normal credit and new business checks, such a company may unwittingly be treated as the lessee although no equipment is actually delivered.

Question 2

This question featured various areas in retail financial services such as interest rates, hire-purchase financing and hire-purchase agreements. Candidates managed to perform well in these areas.

2. (a) Total amount payable:
= RM1,062.50 x 60
= RM63,750
- Interest portion:
= RM63,750 - RM50,000
= RM13,750
- Interest rate charged for 5 years:
= $\frac{\text{Interest (5 years)} \times 100}{\text{RM50,000}}$
- = $\frac{13,750 \times 100}{50,000}$
- = 27.5 %
- Interest rate per annum = $\frac{27.5\%}{5}$
= 5.5% per annum flat
- (b) Section 31 of the Hire-Purchase Act 1967 as amended by the Hire-Purchase (Amendment) Act 1992 forbids the granting of hire-purchase loans exceeding a margin of finance of 90% of the cash price of goods. Hence the finance company can therefore finance Mr Arul's loan for up to a maximum of RM72,000 – RM10,000 (trade-in value) = RM62,000.
- (c) Under Section 23 and 24 of the Hire-Purchase Act 1967 the guarantor upon paying the amount to the owner by the hirer is entitled to:
- sue the hirer in the name of the owner for any breach of the hirer's obligations under the said Hire-Purchase Agreement;
 - insist upon the transfer to himself of all securities taken by the owner from the hirer to secure the performance of the hirer's obligations; and
 - be indemnified by the hirer against any claim by the owner on the guarantee.
- (d) Such a clause is void under Section 34(e) of the Hire-Purchase Act.
- (e) 11% interest rate per annum flat will infringe Section 30(1) of the Hire-Purchase Act and the Hire-Purchase (Terms Charges) Regulations 1968, wherein the maximum interest rate charged is at 10% per annum.
- 10% overdue interest will infringe Section 34(1) of the Hire-Purchase Act, wherein the maximum interest rate on overdue instalments is fixed at 8% per annum daily rest.

Question 3

The question calculating redemption sum and valuation methods were the weakest attempted question. Only a few candidates passed this question. Majority of the candidates had very little knowledge on property loans.

3. (a) (i) Redemption Sum

Principal Outstanding	= RM600,000.00
Add : Interest Outstanding	
(RM600,000 x $\frac{10.45}{100}$ x $\frac{26}{365}$)	= RM 4,466.30

	RM604,466.30

- (ii) Telsa Finance Bhd will be required to:
- undertake that upon receipt of the redemption sum it will deliver to the finance company:
 - valid and registrable discharge of title duly executed by Telsa Finance Bhd;
 - duplicate charge; and
 - title document
 - refund redemption sum if the discharge of charge cannot be registered for any reason whatsoever.

(b) (i) *Select any four points.*

1. A willing buyer and a willing seller, both dealing at arm's length.
2. A reasonable period within which to negotiate the sale, taking into consideration the nature of the property and state of the market.
3. Values will remain static throughout the period of sale.
4. The property is freely exposed to the market.
5. No account to be taken of any additional bid by a special purchaser.

- (ii) Although the security cover may improve over time due to enhancement of the property based on progressive construction thereon; nevertheless, it must be realised that every ringgit invested into the project does not necessarily mean that upon foreclosure of the property before the whole project is completed, the lender can recover the amount in full that has been disbursed, i.e. ringgit for ringgit. Hence it would be prudent to adopt 'as is where is' basis in the computation of security which is more realistic and reflective of the current value of the property.

- (iii) On "residual valuation basis", the valuer assumes the following:

- Project will be developed according to plan.
- The selling price is already pre-determined.
- Total construction costs involved for the project.
- Profit element for the project.

If there is any variance in the above assumptions, the value of the land may be grossly overstated or understated.

On "comparative basis", the valuer compares transaction of similar properties around the vicinity or within similar locations.

PART B

Question 4

Only a few candidates passed this question. Candidates were required to briefly describe various leases and the disadvantages of leasing. It is disappointing to note that most candidates were unable to answer these straightforward questions on leases despite the fact that most of these answers can easily be obtained from the study manual (Chapter 4, Pages 94, 95, 97, 102 and 104).

4. (a) **Operating Lease**

An operating lease is essentially a rental agreement wherein the lessor is normally responsible for maintaining and servicing the equipment.

Normally an operating lease is confined to those types of equipment with an established second-hand market value. The equipment user does not plan to continue to use the equipment for the whole of its working life, possibly expecting obsolescence or technological enhancement.

The risks of ownership under such a lease are for the accounts of the lessor and the lessee can with due notice withdraw from the agreement as it is usually of a short-term nature and is substantially less than the economic life of the asset. In this type of lease, the lessor does not expect the asset to be wholly amortised during the lease period.

An operating lease covers a wide range of commercial activities. Two examples of an operating lease arrangement is a short-term car hire business and a computer lease facility.

Financial Lease

A financial lease is a contract involving payments over an obligatory period of specified sums sufficient in total to amortise the capital outlay of the lessor and provide him some profit on the finance provided.

As such a lease of this type is non-cancellable or cancellable only under certain conditions and the lessee enjoys substantially all the rewards associated with the ownership of an asset, other than the legal title.

(b) (i) **Pure Lease**

A pure lease is one where the cost of the equipment is fully funded by the lessor. It normally contains options for the lessee to purchase the equipment at the end of the lease term for its fair market value and to renew the lease for a further period or periods at a rental which reflects that fair market value.

(ii) **Direct Lease**

In a direct lease the lessor finances the whole of the purchase price for the leased equipment from its own resources including any borrowing for which the lessor is principally liable.

(iii) **Syndicated Lease**

This is similar to direct lease except that there is more than one lessor participating in the leasing of various equipment to either a single lease or lessees who are within a group of companies. In view of the existence of more than one lessor, one of the lessors will be appointed as agent and manager to manage the leases for all the lessors.

(iv) **The Leveraged Lease**

This form of lease requires large capital outlay for investment projects or the purchase of equipment of a capital nature by companies of the highest credit standing.

Under a leveraged lease, a lessor provides only a proportion of the capital cost from its own funds to purchase the equipment for leasing. This proportion ranges from 20% to 40% of the purchase price, which emanates from equity funds. The balance of the funds required to meet the purchase price, known as the debt portion or debt funds, is often provided by one or a consortium of institutional investors.

(c) Cost of Equipment:
 $= \text{USD}700,000 \times 3.8 = \text{RM}2,660,000$

20% security deposit:
 $= \text{RM}2,660,000 \times 0.2 = \text{RM}532,000$

Monthly rental:
 $= \frac{(\text{RM}2,660,000 - \text{RM}532,000) + [(\text{RM}2,660,000 - \text{RM}532,000) \times 6\% \times 5]}{60}$
 $= \frac{\text{RM}2,128,000 + \text{RM}638,400}{60}$
 $= \frac{\text{RM}2,766,400}{60}$
 $= \underline{\text{RM}46,106.67}$

- (d) Disadvantages of leasing to lessee
- Leasing requires immediate repayment – there is no grace period on principal repayment pending commissioning of an equipment which may take some time.
 - High stamp duty on agreement – lease agreement attracts *ad valorem* stamp duty unlike hire-purchase agreement where stamp duty is nominal.
 - The lease is non-cancellable – the lessee is irrevocably committed to future payments of rentals.

Question 5

The question on factoring was a popular question among the candidates. It was generally well-attempted by most candidates.

5. (a) Select any **two** benefits:

More Competitive

The supplier can compete more effectively by giving longer credit to its valued customers especially those with first class credit ratings.

Improved Credit Standing

Credit standing can improve in two ways. Firstly, when the improved cash flow is utilised to pay to creditors promptly which in turn improves its credit standing. Secondly, utilisation of funds obtained through factoring improves liquidity and cash flow position. A higher credit standing assures a more reliable flow of merchandise from suppliers, facilitates bank and other financing and lowers interest rates on borrowed funds.

Increased Sales

With factoring the client can get immediate advances of up to 80% of the credit sales. It is almost like selling for cash. The cash flow is accelerated and the working capital is released from receivables, thus resulting in increased sales.

Better Credit Control

With the factor's credit experience and pool of credit information, the factor can help the client to achieve better credit controls and therefore minimise customer risks.

- (b) (i) Factoring commission
 = RM2,000,000 x 1%
 = RM20,000

Factoring interest
 = $RM2,000,000 - [RM2,000,000 \times (1 + \frac{0.10}{12})^{-4}]$
 = RM2,000,000 - RM1,934,726
 = 65,274

Factoring cost: RM20,000 + RM65,274 = RM85,274

- (ii) Hovid Sdn Bhd may be considered suitable for factoring based on:
- the value of the invoices which is significant; and
 - the customers appear to be of sound credit standing.

(c) (i) **Confidential Factoring**

It refers to an arrangement where the supplier enters into a factoring arrangement, either on a with-recourse or without-recourse basis with the factor without the knowledge of the customer. Usually, the arrangement is with-recourse as the risk to the factor is very high.

(ii) **Disclosed Factoring**

Just as the case of confidential factoring the supplier enters with the factoring arrangement either with-recourse or without-recourse with the factor. The factor then discloses this financial arrangement to the customer. Since the customer is notified, he is required to pay the amount due under the invoices direct to the factor. Additionally, the factor also acts as an administrator of the debts for the supplier.

(iii) **International Factoring**

This is a relationship between an exporter of goods (supplier), the supplier's factor (export factor), a foreign importer (customer) and a foreign factor who is usually located in the customer's own country (import factor). The export factor purchases the factor's invoices and payments made by the customers are not due to the supplier but to the import factor.

Question 6

The least attempted question was on block discounting. The candidates who did not perform well, failed to explain the areas of risk associated with block discounting and the advantages and disadvantages of block discounting.

6.	(a)	(i)		RM
			Outstanding balance	1,000,000
			Less unearned interest	<u>300,000</u>
			Net collection value	<u>700,000</u>
			Margin of financing = 90% x RM700,000 = RM630,000	
			<u>Add-on basis</u>	
				RM
			Loan to be granted	630,000
			Add interest (after interest) RM630,000 x 3 years x 5%	<u>94,500</u>
				724,500
			Amount to be released = RM630,000	

$$\text{Monthly instalment} = \frac{\text{RM}724,500}{36}$$

$$= \text{RM}20,125$$

(ii) **Discounted basis**

	RM
Loan to be granted	630,000
Less interest (after interest) RM630,000 x 3 years x 5%	<u>94,500</u>
	535,500

Amount to be released = RM535,500

$$\text{Monthly instalment} = \frac{\text{RM}630,000}{36}$$

$$= \text{RM}17,500$$

(b) **Fictitious Agreements/Papers**

Agreements submitted for discounting are fictitious, i.e. non-existence of hirers and/or goods.

The risk is minimised by verifying the existence of the hirer. This can be achieved by confirmation over the telephone or through visits. At the same time, inspect the goods – the subject matter of agreement.

Multiple Financing of Goods

This occurs when the goods under an agreement to be discounted with a finance company is already under financing agreement with another institution.

To reduce the risk, the central computer database maintained by financial institutions must be accessed at the time the agreement is submitted for acceptance to reduce or avoid the incidence of multiple financing.

Account settled in dealer's books

In this case the hirer has settled his account with the dealer but the dealer does not make immediate settlement with the finance company. The ownership to the goods would have been passed to the hirers but the agreement held by the finance company is without security.

Hence to minimise the risk it is imperative that the audit of the dealer's books must be carried out by the finance company as frequently as possible, so that such deviation can be revealed and remedied at an early stage.

(c) The relevant documents are:

- An offer for sale or request to purchase.
- A schedule or schedules listing the agreements and showing the balance outstanding under each agreement and the unexpired period remaining.
- A sales letter and declaration.

(c) **Advantages of Block Discounting**

- Requires little overhead.
- Regular repayment received by a finance company, or the dealer is under obligation to pay the lender on due date every month.
- Enables finance company to underwrite large volume of business, with less physical number of accounts to monitor.

Disadvantages of Block Discounting

- Less remunerative for finance company than direct collection.
- Finance company has little or no control over the handling of the hirer's accounts.