

EXAMINERS' REPORT

November 2025

Subject F107|B100 — Banking Fellowship Principles

INTRODUCTION

The attached report has been prepared by the subject's Principal Examiner. General comments are provided on the performance of candidates on each question. The solutions provided are an indication of the points sought by the examiners and should not be taken as model solutions.

General comments on the aims of this subject and how it is marked

The aim of the Banking Principles subject is to instil in successful candidates the key principles of banking and to introduce students to the different types of activities undertaken by banks, including their associated risks, and the quantification of these risks.

A mix of question styles is used, covering knowledge of the material set out in the core reading, application of this in calculations and case studies and higher order skills such as synthesis and collation of recommendations.

Candidates are awarded marks for all reasonable answers including different but still reasonable numerical solutions. Marks are awarded for working in the case of numerical answers. Successful candidates concentrate on answering the questions asked rather than repeating their knowledge without application.

Candidates who give well-reasoned points, not in the marking schedule, are awarded marks for doing so.

Comments on candidate performance in this diet of the examination

This was the eighth sitting of the Banking Principles subject.

The paper covered a range of syllabus objectives and included questions that required candidates to apply knowledge to the circumstances described. Candidates who were able to apply their knowledge to specific scenarios in the questions were successful, with better prepared candidates able to generate a number of valid points.

There was a mixed performance in the relevant bookwork related questions.

Many candidates did not provide sufficient breadth and depth in their responses and failed to generate a sufficient number of points for the marks on offer.

QUESTION 1

i. Define Value at Risk (VaR) and describe its key assumptions and limitations.

[4]

- Value at Risk (VaR) estimates the potential loss of a portfolio over a specified time period at a given confidence level.
- The model assumes that financial returns follow a selected distribution or historical sample, which may not always reflect future market conditions.
- There are a variety of different VaR approaches such as:
 - Parametric VaR assumes normally distributed returns and constant volatility, estimating risk using mean and standard deviation.
 - Historical simulation VaR calculates risk based on actual past returns without assuming any specific distribution.
 - Monte Carlo simulation VaR models thousands of possible future outcomes based on defined statistical processes.
 - Stressed VaR uses historical data from periods of financial stress to better capture extreme risk events.
 - Conditional VaR (or Tail VaR) measures the average loss in scenarios where losses exceed the VaR threshold.
- VaR calculations rely on a fixed confidence level, typically 95% or 99%, meaning extreme losses beyond this threshold are not considered.
- Parametric VaR assumes stable volatility and normally distributed returns, which can underestimate risk during market stress. To better capture extreme events, historical simulation or stressed VaR methods should be considered.
- The time horizon for VaR estimates is predetermined, often set at one day or ten days, which may not be appropriate for all risk scenarios.
- The model does not account for liquidity risk and assumes that all assets can be sold at their fair market value assumed.
- The different VaR calculation methods, can produce varying results, leading to different outcomes.

[Total 4]

A bank's trading portfolio experiences significant volatility due to uncertain market conditions.

ii. Explain how the bank can enhance its market risk management by using a range of risk measurement techniques and risk mitigation strategies alongside Value at Risk.

[6]

- Expected Shortfall estimates the average loss beyond the VaR threshold, providing a more complete picture of extreme risks.
- Stress testing evaluates how the portfolio would perform under severe but plausible market disruptions.

- Scenario analysis assesses the impact of specific market events such as interest rate hikes, currency devaluations, or geopolitical instability.
- Sensitivity analysis examines how small changes in key risk factors affect the value of assets in the portfolio.
- Historical simulation uses past market data to estimate potential losses based on actual observed fluctuations.
- Monte Carlo simulation generates thousands of potential market scenarios to assess the probability and magnitude of extreme losses.
- Risk factor decomposition involves breaking down market risk into components like interest rate, equity, and FX risk; first and second derivatives are used where applicable, for example delta hedging (managing sensitivity to small price changes) and gamma hedging (managing sensitivity to larger price movements).
- Hedging strategies using derivatives such as options, futures, and swaps help offset potential losses from adverse market movements.
- Diversification spreads exposure across different asset classes, reducing reliance on highly correlated risk factors.
- Dynamic portfolio rebalancing adjusts asset allocations based on changing market conditions to maintain an optimal risk-return profile.
- Regulatory capital buffers ensure that the bank holds sufficient capital to absorb potential trading losses during periods of heightened market stress as regulatory capital makes specific allowance for stress VaR.
- Risk management operates both at the desk level and floor-wide level: while individual desks monitor their specific exposures, floor-level risk management aggregates risks across the bank. Because VaR is not additive across desks, additional measures such as Expected Shortfall and stress testing are important to accurately capture aggregate risk.

[Total 6]

[Total 10]

This performance on this question was average, although it was expected to be better given that is was based on bookwork.

Part (i) performance on this question was fair. Most candidates did not capture sufficient detail in the response to have scored well. Few candidates considered the different available methods for calculating VaR, resulting in poor coverage of assumptions and limitations specific to certain methods.

Part (ii) performance was fair. Some candidates only answered part of the question or did not capture sufficient points for the marks allocated, scoring poorly as a result. Responses were typically weighted towards either measurement techniques or mitigation strategies, with few candidates providing good coverage across both angles. Many responses were generic and did not tie back to the trading portfolio.

QUESTION 2

i. Define ICAAP and briefly outline how it contributes to the management of risks in banks.

[2]

- ICAAP is an internal assessment process that helps banks evaluate capital adequacy based on their unique risks and long-term plans.
- The process ensures banks hold enough capital to cover risks as outlined in Pillar 1 on the Basel minimum regulatory requirements.
- Both financial and non-financial risks are considered, incorporating capital forecasting, risk appetite, and scenario analysis.
- ICAAP requires banks to quantify capital needs under Pillar 1 (regulatory minimums) and Pillar 2 (additional risks not fully captured under Pillar 1, such as interest rate risk in the banking book and concentration risk).
- Stress testing is a key component of ICAAP, helping to determine additional capital buffers required under Pillar 2, above regulatory minimums.
- ICAAP supports internal risk governance and long-term strategic planning by aligning capital planning with the bank's specific risk profile and business model.
- ICAAP often involves calculating economic capital using internal models to better capture a bank's specific risk profile beyond regulatory minimums.

[Total 2]

ii. Describe how the ICAAP helps banks plan for future capital needs. Focus on how stress testing and scenario analysis can support capital management in uncertain conditions.

[7]

- The ICAAP ensures that a bank's capital planning aligns with its risk exposure and business strategy, helping prevent unexpected capital shortfalls.
- The process evaluates capital needs under normal and stressed conditions, allowing banks to adjust their strategies proactively rather than reactively.
- Forward-looking assessments help banks anticipate how economic downturns, interest rate fluctuations, and market volatility could impact their balance sheets.
- Scenario analysis within ICAAP tests multiple economic conditions, including recession scenarios, regulatory changes, and geopolitical risks.
- Stress testing allows banks to assess their resilience against extreme but plausible adverse events and determine whether they need additional capital buffers.
- ICAAP includes liquidity stress testing to ensure that the bank can meet its short-term and long-term funding needs under different conditions.
- ICAAP driven insights help banks refine their risk appetite, ensuring they do not take excessive risks that could lead to regulatory intervention or financial distress.

- The findings influence key decisions on capital allocation, dividend payouts, debt issuance, and funding strategies to maintain financial stability.
- ICAAP outcomes support discussions with regulators, providing evidence that the bank has a robust and sustainable approach to capital adequacy.
- Risk mitigation measures identified through ICAAP allow banks to implement adjustments such as adjusting their credit risk appetite, adjusting asset-liability mismatches, or restructuring portfolios.
- ICAAP enhances the ability to manage capital volatility, reducing the impact of economic cycles on the bank's financial health.
- The process helps banks identify potential gaps in risk management frameworks and improve risk-adjusted return strategies.
- Banks can use ICAAP results to set early warning indicators, ensuring they take pre-emptive action before capital adequacy issues arise.
- The flexibility of ICAAP allows banks to incorporate both internal and external risks into their capital planning, ensuring a more holistic risk management approach.
- By integrating ICAAP findings into strategic planning, banks can improve decision-making processes and maintain investor confidence.
- ICAAP supports resilience by ensuring banks are well-positioned to absorb shocks, adapt to regulatory changes, and sustain long-term growth.

[Total 7]

A bank's ICAAP process identifies that a large portion of its corporate lending is concentrated in a single industry.

- iii. Explain how this could affect capital requirements and outline actions the bank might take to reduce risk.

[7]

- High exposure to one industry increases the bank's vulnerability to sector-specific downturns, potentially leading to higher loan defaults and credit losses.
- Basel regulations and national supervisors may require additional capital buffers to offset the increased risk associated with concentrated lending.
- A downturn in the industry can raise the Probability of Default (PD) and Loss Given Default (LGD), increasing the bank's Risk-Weighted Assets (RWA) and overall capital requirements.
- Credit rating agencies may downgrade the bank's risk profile, leading to higher funding costs and a weaker market position.
- A decline in the industry's financial health can reduce cash flows from affected borrowers, impacting the bank's overall profitability and liquidity.
- A sector-wide crisis could result in systemic financial distress, requiring government or central bank intervention to stabilise the institution.

Potential actions

- The bank may need to rebalance its loan portfolio by diversifying lending across multiple industries and geographic regions to mitigate concentration risk.
- Pricing adjustments, such as increasing interest rates on loans in the high-risk industry, can help compensate for the additional risk exposure.
- Strengthening underwriting standards by requiring higher collateral coverage or stricter covenants can provide an added layer of protection.
- Conducting enhanced stress testing and scenario analysis focused on the concentrated industry can help quantify the potential capital impact.
- Implementing internal exposure limits prevents excessive lending to a single sector, ensuring more balanced risk distribution.
- Banks can engage in loan syndication or risk-sharing agreements with other financial institutions to reduce exposure to a single industry.
- Using credit risk transfer mechanisms, such as securitisation or credit derivatives, can help mitigate losses from sector-specific downturns.
- Monitoring of key risk indicators within the industry allows the bank to identify early warning signs and take corrective action.
- Establishing contingency plans for managing sector downturns, such as developing alternative lending strategies, can improve resilience.

[Total 7]

[Total 16]

This question was generally answered poorly

Part (i) was answered well as it was based on bookwork.

Part (ii) performance was poor. Many candidates failed to describe stress testing and scenario analysis and application of this related to the ICAAP.

Part (iii) performance was average. Many failed to explain how concentration risk could impact capital requirements. Surprisingly not many candidates explained how concentration risk could impact credit risk parameters such as PD. Some of the potential actions were vague and not explained in the required detail.

QUESTION 3

- i. Explain the relevance of Environmental, Social, and Governance (ESG) risks in banking, focusing on financial stability and reputational risks.

[6]

- Banks encounter ESG risk both from their own operations and through their counterparties, whose ESG related issues may impact loan repayment ability.
- Environmental risks include climate change-related issues, such as physical damage to bank assets (e.g., branches, ATMs) and increased credit risk from affected borrowers.
- Social risks relate to a bank's impact on communities, employees, and customers, including issues like fair lending practices and diversity policies.
- Governance risks arise from poor internal structures, weak compliance frameworks, or unethical leadership, which can lead to regulatory fines and loss of investor confidence.
- ESG considerations are increasingly integrated into risk management, as governance and social risks often contribute to reputational and conduct risk.
- A bank's credit risk assessment now includes ESG factors, as firms with poor governance or environmental practices are more likely to default on loans.
- Banks involved in high-emission industries face higher reputational risk due to public and investor scrutiny over funded emissions.
- Poor ESG practices can limit a bank's access to capital, as investors and lenders increasingly favour institutions with strong ESG credentials.
- Regulatory bodies are pushing for climate risk disclosures, requiring banks to assess their exposure to physical and transition risks.
- ESG-linked financial products, such as green bonds and sustainable loans, are becoming more common, impacting a bank's business model and lending strategies.
- Banks with poor ESG management may face litigation risks, such as lawsuits related to greenwashing or human rights violations.
- Reputational risk from ESG failures can result in customer attrition, damaging long-term profitability.
- Banks that actively manage ESG risks can improve stakeholder trust, which enhances financial stability and attracts sustainable investments.
- Institutions that fail to adapt to ESG expectations may experience higher borrowing costs and diminished investor confidence.
- Climate risk is now a key consideration in stress testing and scenario analysis, influencing capital planning and regulatory compliance.
- ESG risks can amplify market risk, as industries with poor environmental practices may experience sudden asset value declines.
- ESG integration supports long-term financial stability, as banks that proactively address sustainability concerns reduce credit, market, and operational risks.

- Investors, regulators, and customers are increasingly holding banks accountable for their ESG performance, making proactive management essential for sustained profitability.

[Total 6]

ii. Outline how banks can integrate climate factors into their credit risk models, incorporating climate-related financial risks.

[6]

- Climate-related financial risks are classified into physical risks (extreme weather events, rising sea levels) and transition risks (policy changes, carbon pricing, technological shifts).
- Physical risks impact credit risk by increasing default probability (PD) for borrowers exposed to extreme weather events, such as real estate in flood-prone area.
- Transition risks affect industries reliant on high-carbon outputs, as regulatory and market changes may lower profitability and increase borrower default risk.
- ESG factors are incorporated into PD and LGD models by adjusting credit scores based on a counterparty's exposure to climate-related risks.
- LGD models must consider how environmental risks affect collateral valuation, such as properties losing value due to climate change exposure.
- Scenario analysis allows banks to model future climate scenarios and adjust risk weightings for sectors sensitive to policy, legal, and reputational risks.
- Stranded asset risk assessment helps banks identify industries facing premature asset devaluation due to low-carbon transition policies (e.g., coal, oil & gas).
- Carbon footprint analysis is integrated into credit risk models to assess the emissions intensity of borrowers and anticipate regulatory penalties.
- Geospatial risk assessment evaluates borrower exposure to physical climate risks, mapping asset locations against climate hazard zones.
- Banks use stress testing to model extreme climate events and quantify their potential impact on capital requirements.
- Green lending policies encourage banks to offer favourable credit terms to borrowers with strong ESG credentials, reducing long-term risk exposure. However, the favourable terms need to be justified in terms of cost of risk.
- Sectoral ESG risk weightings adjust capital requirements for industries with higher exposure to environmental, social, or governance risks.
- Engagement with regulators ensures risk models align with evolving disclosure requirements, such as those under IFRS S2 Climate-Related Disclosures.
- Insurance-linked risk mitigation helps banks manage climate-induced credit risks, ensuring that insured borrowers can maintain loan repayments despite disasters.
- Supply chain risk assessment helps banks evaluate indirect exposure to high-risk industries through lending to companies with carbon-intensive suppliers.

- Reputational risk scoring is integrated into credit models, penalising borrowers with poor ESG records to mitigate financial fallout from public and investor backlash.
- Data quality improvements are critical, as ESG risk factors require standardised reporting and robust data sources for accurate credit risk modelling.
- The historic data required for comply with ESG reporting requirements might be a limiting factor if this is not been stored systematically over the years.
- Machine learning and AI models enhance ESG credit risk assessments by processing vast amounts of climate, emissions, and borrower financial data.

[Total 6]

iii. Briefly outline the different stakeholders involved in a model build process through the model lifecycle.

[4]

- Model owner – the persons responsible for model outputs and their application in business.
- The model owner may also fulfil a project management function for such a large project, or this could be through a dedicated project management team. This duty may also reside with the model developer.
- The model owner may also be responsible for model monitoring. Monitoring the model performance, parameters and trends.
- Business owners – where a model spans across different business units/areas of a bank, there could be multiple users of the output.
- Business owners could also be experts to give guidance on model parametrisation, or for qualitative component oversight as well as feedback on the performance of current models that could be incorporated into any new models.
- Model developer – responsible for model choice, parameter specification and parameter estimation.
- The model development team could also need the assistance of a data team to consolidate data, for example loss severity and frequency data.
- Model validators – responsible for independent replication of results, methods and assumptions as applied by model developer.
- Model approvers – the individuals(s) or committees responsible for the final approval of the model.
- Regulator – the regulator will usually approve any large regulatory capital model changes of a bank. Regulatory approval is not always required.
- Internal audit – will monitor overall model governance process including adherence to policies and regulations.
- External audit/assurance – could give external assurance on model parametrisation and impact.
- Model implementer – responsible for deploying models according to design specifications and standards, ensuring the model is used within its intended scope.

[Total 4]

[Total 16]

This question was answered very poorly.

Part (i) was answered poorly. Candidates did not explain the ESG risks impacts broadly. Stronger candidates focused on each element and how these could impact the bank and its various stakeholders.

Part (ii) performance was exceptionally poor. Many struggled to generate a sufficient number of distinct ideas. A key missed opportunity was the failure to distinguish between transition and physical risks, which would have naturally supported a broader and more structured response. Instead of focusing on how these risks could be incorporated into credit risk models, candidates frequently diverted into governance, policy, or underwriting considerations - none of which were asked. Critically, very few candidates managed to link their ideas back to actual model integration, which was central to the question.

Part (iii) performance was generally strong. However, several candidates anchored their responses too narrowly to specific model types - such as PD models - introducing stakeholders like credit bureaus or economics teams that may not be universally applicable. Many overlooked the instruction to briefly outline stakeholders, instead elaborating on responsibilities, which was not required and detracted from the clarity and relevance of their answers.

QUESTION 4

- i. Explain the key revisions made under “Basel IV” as part of the finalisation of Basel III, including how these changes aim to improve the credibility and comparability of capital requirements.

[5]

- The Basel IV refers to the finalisation of Basel III reforms, with implementation timelines varying, and some requirements postponed to 2025.
- Under Basel II and early Basel III, banks’ internal models led to inconsistent and sometimes underestimated risk-weighted assets.
- This undermined the credibility and comparability of banks’ reported capital ratios across the industry
- Basel IV introduced stricter rules, standardised approaches, and output floors to restore trust and improve comparability.
- The standardised approach for credit risk was enhanced with increased granularity and risk sensitivity.
- Risk weights were refined for various asset classes, including a more detailed treatment for exposures to banks, corporates, and retail customers.
- The use of the internal ratings-based approach was restricted for certain exposures, such as large and mid-sized corporates.
- New parameter floors were introduced in IRB models to prevent excessive variations in capital requirements.
- The Credit Valuation Adjustment framework was revised by removing the internally modelled approach and introducing standardised and basic approaches.
- The advanced measurement approach for operational risk was removed and replaced with a single, risk-sensitive standardised approach.
- The market risk framework was refined with the introduction of new sensitivities-based calculations and a shift from Value at Risk to Expected Shortfall.
- A revised boundary was introduced between the banking and trading books to limit regulatory arbitrage.
- A leverage ratio buffer was introduced for Global Systemically Important Banks to provide a capital backstop against excessive leverage.
- The Basel II output floor was replaced with a more robust, risk-sensitive capital floor based on standardised approaches.
- The revisions aimed to balance the complexity of modelled outputs with overall risk sensitivity.
- These changes also sought to reduce the level of national discretion in capital calculations.
- The final framework improves capital adequacy and enhances financial stability by reducing inconsistencies across banks.
- The credit risk RWA scalar of 1.06 was removed.

[Total 5]

A bank has total exposures of L\$500 million, consisting of the following asset classes:

- Corporate loans: L\$300 million (previous risk weight: 50%, revised risk weight: 60%)
- Retail mortgages: L\$150 million (previous risk weight: 40%, revised risk weight: 50%)
- Sovereign bonds: L\$50 million

Under Basel IV, the standardised approach introduces higher risk weights for certain asset classes.

- ii. Calculate the increase in risk-weighted assets (RWA) under the revised framework and determine the additional capital required if the minimum capital ratio remains at 8%.

[3]

Assume a sovereign risk weight of 0%.

Current RWA:

- Corporate loans: $300\text{m} \times 50\% = 150\text{m}$
- Retail mortgages: $150\text{m} \times 40\% = 60\text{m}$
- Sovereign bonds: $50\text{m} \times 0\% = 0\text{m}$
- Total Current RWA = 210m

Revised RWA:

- Corporate loans: $300\text{m} \times 60\% = 180\text{m}$
 - Retail mortgages: $150\text{m} \times 50\% = 75\text{m}$
 - Sovereign bonds: $50\text{m} \times 0\% = 0\text{m}$
 - Total Revised RWA = 255m
-
- Increase in RWA = $255\text{m} - 210\text{m} = 45\text{m}$
 - Minimum capital requirement = 8% of RWA
 - Increase in capital required: $= 45\text{m} \times 8\% = 3.6\text{m}$

[Total 3]

- iii. Discuss the broader implications of these changes on bank capital adequacy and lending practices.

[5]

- The bank must raise an additional L\$3.6 million in capital to meet the new regulatory requirements.
- Higher capital requirements reduce the bank's return on equity (ROE), as more capital is needed for the same level of risk-weighted assets.
- Increased capital requirements may lead to higher borrowing costs for customers as banks adjust pricing to maintain profitability.
- The bank may become more selective in lending, focusing on lower-risk borrowers to reduce its capital burden.
- There is a possibility of reduced credit availability, particularly for riskier corporate and retail borrowers who now attract higher risk weights.

- The bank may shift towards lower-risk asset classes, such as government bonds, which have lower or zero risk weights.
- Greater capital allocation towards lower-risk assets could result in lower interest margins, affecting overall profitability.
- Basel IV's capital requirements may encourage banks to increase securitisation activities to move assets off their balance sheets.
- The changes may lead to increased regulatory compliance costs, requiring more resources for risk assessment and capital planning.
- Capital-constrained banks may explore alternative funding sources, such as issuing subordinated debt or hybrid capital instruments.
- If capital shortfalls persist, banks might reduce dividend payouts or share buybacks to preserve regulatory capital.
- Banks with weaker capital positions may experience higher funding costs, as investors demand greater risk premiums.
- More stringent risk weightings could increase competition among banks, particularly favouring those with stronger capital buffers.
- Large banks may absorb the changes more easily, whereas smaller banks with lower capital reserves may face greater challenges.
- The shift in risk weightings may encourage banks to improve credit risk models, leading to more refined risk assessments.
- Banks may consider adjusting loan pricing models to account for the increased cost of capital.
- The regulatory changes could lead to procyclical effects, where banks restrict lending during economic downturns, potentially exacerbating recessions.
- Higher risk weights for corporate loans may disincentivise lending to SMEs, which often lack external credit ratings.
- Investors and analysts may need to reassess bank valuation metrics, as changes in capital requirements affect profitability and growth potential.
- Banks that fail to adapt efficiently to these regulatory changes may lose market competitiveness to institutions with stronger capital management strategies.
- The overall impact will also largely be driven by the current jurisdiction of the bank and the current level of Basel III adoption.

[Total 5]

In the country of Actuarialia instead of a constant (flat) risk weight for retail mortgages, the regulator has confirmed the following risk weight approach based on LTV (Loan to Value):

LTV	$LTV < 25\%$	$25\% \leq LTV < 40\%$	$40\% \leq LTV < 70\%$	$LTV \geq 70\%$
Risk Weight	10%	50%	60%	80%

iv. Outline the possible reasons for the approach and compare this method to a single risk weight approach.

[3]

- The retail mortgages portfolio is highly sensitive to Loan to Value.
- The lower the LTV, the greater the amount that could be recovered if a loan has to default.
- It gives more risk-based differentiation than compared to a single risk weight.
- It may be a measure to prevent high risk lending as banks could potentially bring in higher risk deals at the same risk weight.
- It gives banks with greater diversification a benefit for capital requirements.
- Banks could price these risks more accurately.
- This could be a way to encourage more competition in the industry.
- There may have been some pushback from the industry on the single risk weight approach.
- Using these grouped risk weights instead of a function formula also introduces some discreet jumps in capital which will potentially have unintended credit policy or product design implications.

[Total 3]

The current retail mortgage book distribution is shown below.

LTV	$LTV < 25\%$	$25\% \leq LTV < 40\%$	$40\% \leq LTV < 70\%$	$LTV \geq 70\%$
Retail Mortgage book – distribution (L\$150m)	50m	30m	20m	50m

The acquisitions team are looking to purchase a retail mortgage loan portfolio with $LTV \geq 70\%$.

v. Calculate the size of the portfolio that could be purchased to ensure that the overall risk weight of the portfolio is the same as the revised standardised risk weight.

[2]

Assume y is the purchased portfolio:

$$50 * 0.1 + 30 * 0.5 + 20 * 0.6 + 50 * 0.8 + y * 0.8 = 0.5 * (150 + y)$$

$$\Rightarrow 72 + 0.8y = 75 + 0.5y$$

$$\Rightarrow y = 10$$

[Total 2]

[Total 18]

This question performance was generally average.

Part (i) performance on this bookwork question was generally strong, with the cohort demonstrating solid foundational knowledge. However, many responses focused too heavily on listing the additional changes without explaining how these changes were designed to enhance credibility and comparability - an essential aspect of the question.

Part (ii) virtually all candidates scored full marks, reassuring given the simplicity of the question.

Part (iii) performance was mixed. Stronger candidates demonstrated a clear understanding of both capital adequacy and lending practices, often linking each observation to its dual impact across these dimensions. In contrast, weaker responses tended to default to general Basel IV commentary, missing the question's specific focus on credit and lending-related changes. A recurring challenge was the limited number of distinct, relevant ideas presented, which hindered candidates from achieving full marks despite the breadth of material available.

Part (iv) performance on this part was mixed. While some demonstrated a basic grasp of the topic, many failed to frame their responses as potential reasons explaining why the approach may have emerged, instead presenting statements without sufficient analytical depth. A common issue was brevity—answers were often too short and lacked the breadth of distinct ideas needed to secure full marks.

Part (v) performance on this question was disappointingly poor with some showing no understanding of RWAs. A significant number misinterpreted the core requirement, assuming the question implied no change in RWAs, rather than correctly focusing on the stated risk weight of the portfolio. Additionally, many candidates struggled with basic mathematical translation, failing to convert a straightforward word problem into a solvable single-variable equation.

QUESTION 5

Personal loan products usually have a term up to 5 years. A colleague has suggested personal loans should be extended up to 10 years as this could improve customer retention and revenue to the bank.

- i. Discuss the merits of this proposal and highlight any risks to the bank.

[6]

Proposal

- A longer term could introduce higher revenues (NII and fees) as the customer is locked in for a longer period.
- This may also encourage customers to be bank customers for longer, improving retentions.
- Customers who stay longer may also take up further products of the bank across credit, transactional, savings, etc.
- It may improve competitiveness and market share for the bank. The bank would need to review if this product is offered in the market to understand if they are matching a product or bringing some differentiation of our product range to market

Risks

- The longer the loan term, the greater the likelihood of changes in the borrower's financial situation (and macro environment) and possibility of default.
- For example, in 10 years economic conditions may fluctuate creating pressure on the customers' repayment ability.
- Various life events such as job loss or illness become more likely to occur over a longer period.
- Expected credit losses for a 10-year loan may be higher than a 5-year loan, and there may be a higher credit risk capital demand for these products.
- If these loans are fixed rate and interest rates rise, the bank's funding costs may increase, while the interest income from the fixed-rate personal loans remains constant (higher impact on the 10-year loan).
- Longer-term personal loans tie up the bank's funds for an extended period, reducing its liquidity.
- Credit life insurance products may not be available for such a long term. If these are not available then the bank may be exposed to more risks.
- The longer period may not be allowed by the local credit regulations.

[Total 6]

Doge Bank currently operates a reward programme where customers earn points for using banking services such as utilising their credit cards, maintaining a minimum balance in their savings accounts, and using the banking application (mobile app).

The reward programme offers various tiers (reward levels), based on customers' banking activities and products.

Tier	Activity required
1	▪ Have an active credit card account.
2	▪ Have an active credit card account. ▪ Perform 5 transactions on the banking app.
3	▪ Have an active credit card account. ▪ Perform 5 transactions on the banking app. ▪ Have an active personal loan product.
4	▪ Have an active credit card account and spend at least L\$1 000 per month. ▪ Perform 10 transactions on the banking app. ▪ Have an active personal loan. ▪ Have an active savings product.
5	▪ Have an active credit card account and spend at least L\$1 000 per month. ▪ Perform 10 transactions on the banking app. ▪ Have an active personal loan. ▪ Have an active savings product and grow it by L\$500 per month.

ii. Comment on the potential effectiveness of the reward programme structure. Focus on elements of customer retention and profitability.

[4]

- The reward programme encourages the use of more products and greater activity for higher reward levels. It does not consider the profitability of each product nor the retention capacity.
- The greater activity and engagement allow customers to be tied in to the bank. Therefore, at the core one would expect a transactional account and/or credit card.
- Holding more products could encourage greater retention of customers.
- If customers enjoy the benefits of higher tiers, then this would encourage more customers to utilise more banking products in order to achieve a higher tier status.
- A reward programme could make this bank more attractive compared to other banks who may not have a programme.
- Obtaining rewards for banking make customers feel appreciated hence adding to loyalty. However, lending products' ROE vary greatly and close inspection of the products is required to decide whether to incentivise such products.
- Setting up of a reward programme, running the programme would be a cost to the bank reducing profitability.
- Giving out rewards (e.g., discounts, or partnerships) would be an expense and would also reduce profitability. However, the bank could charge a reward membership and give supplier discounts for marketing to the bank's customers.
- The programme could also increase revenue generation and profitability by some of the following:

- Customers utilising a wider range of products which would increase both interest income and non-interest income. This should be considered based on the profitability of each product.
- Higher transaction activities could also boost fee income, for example, utilising the credit card or banking app more frequently.
- Cross-selling of banking products and services would boost income.
- The utilisation of savings products could also reduce funding costs and improve net interest margin.
- Data insights from product usage such as credit card transactions would allow for more opportunities to tailor products for the customers.
- The bank could use the app to market strategic partners to its customer base.

[Total 4]

Doge Bank is looking to enhance its reward programme over the next year. The team have suggested the inclusion of a financial literacy module completion as a reward activity.

- iii. Analyse the potential benefits and risks of adding financial literacy module completion as a reward activity to Doge Bank's existing programme.

[6]

Benefits

- Overall benefit of greater customer literacy would ensure customers make better decisions.
- Great financial literacy could mean less riskier customers/portfolios.
- Greater engagements encourage more usage on the app, which could lead to more transactions.
- Financial literacy learning could introduce more products to the customer which could generate sales and income.
- Modules could be tailored to challenges faced by different types of customers.
- This could improve brand image of the bank as it is seen as doing a social good and improving TCF.
- Investors and regulators may look positively on such a change.
- Creating such an innovation could improve publicity through the industry thereby potentially bringing in new customers.

Risks

- Cost of development and maintenance of the modules might be substantial.
- There could be some incorrect information or outdated information in the modules.
- Possibility of reduced engagement and customers finding it burdensome.
- Customers could find ways to bypass actually completing the module defeating the underlying purpose.

- The modules become out to the public and may be easily copied by other banks.
- It may not be easy to track any benefits or changes in customer behaviour after taking the modules.
- Debt could be paid of sooner than usual causing the portfolio to run-off sooner than planned with lower revenue as a result - not a bad thing for client but could be challenge for shareholders if something to replace this missed revenue is not added.

[Total 6]

- iv. Describe the key factors Doge Bank should consider when designing the financial literacy modules and determining the reward criteria or rewards.

[4]

- Ensure that the content is accurate and up to date and the important and relevant regulations and laws are covered.
- The topics need to be relatable to the customer type and demographics.
- The language of the modules and the customers need to be considered, given that the module could be attempted by a variety of people.
- The type of module design format should be interactive: e.g., videos, or simulations.
- The modules should be easily accessible on a mobile phone – with various operating systems, and hardware specifications.
- Modules should be able to be tracked and progress saved.
- Design should consider the overall time taken per module as people may not want to spend too much of time on the modules if it is not worth the effort.
- There should be an element of assessment to ensure the content is not skipped over. This could be in the form of quizzes.
- The number of modules completed could allow a 1 or 2 Tier boost.
- Completed modules could also unlock more rewards or discounts independently of the Tier level.
- The bank could look at similar reward programmes (local or international) to assess the right level of reward.

[Total 4]

[Total 20]

This question was answered generally well.

Part (i) had a mixed performance from the cohort. Candidates focused on considerations on how the product could be launched, failing to translate such considerations to the actual underlying/associated risk. Candidates failed to realise that 10 years is expected to easily cover a full economic cycle, usually just focusing their answer on the current position in the cycle and changes in the near future. Candidates often introduced direct contradictions in the merits/risks, failing to sufficiently differentiate the points such that both answers would be acceptable (providing context, examples, etc.). The bank already offers unsecured credit up to 5 years, and candidates wasted effort focusing on the drawbacks of unsecured credit where the question specifically asks to focus on the increase in term (where both scenarios would be unsecured).

Part (ii) performance on this part was generally strong, with most candidates able to generate relevant points based on the information provided. Better candidates included higher-level insights in their responses, such as differences in profitability between savings, transactions and lending.

Part (iii) performance on this part was fair. Candidates managed to capture relevant points, but many did not include sufficient content to have scored well. Stronger candidates mentioned that the bank could end up generating less revenue as individuals become more financially savvy.

Part (iv) performance was generally fair, although better performance was expected given the number of points available in the solutions. A few candidates did not complete this question, and some misinterpreted the question. Many candidates did not follow the 'describe' instruction of the question and ended up listing points.

QUESTION 6

- i. Explain the importance of considering price elasticity and the marginal cost of extra deposits for a bank looking to increase its retail deposit base to fund additional lending.

[4]

- In managing their books of deposits, retail banks typically make use of price elasticity, which measures how changes in interest rates affect the volume of deposits.
- There will be a trade-off between the volume of deposits attracted and the rate offered on the deposits that will impact the margin made.
- By considering price elasticity, banks can make informed decisions that balance attracting new deposits with maintaining profitability.
- Raising interest rates could attract more deposits which could be used to fund additional lending but would reduce profit margins due to higher interest payouts.
- If the bank is increasing their lending aggressively, they should pay close attention to the increased costs of deposits necessary to fund the additional lending and the overall impact on net interest margins.
- Using an average cost of deposits may be misleading. Banks need to calculate the marginal cost of extra deposits, because this represents the true cost of extra deposits.
- The marginal cost of extra deposits is calculated as the ratio between the increase in interest paid and the volume of extra deposits generated.
- If the marginal cost of extra deposits exceeds the rate that would be earned on new lending, the bank can lose money if it reprices across its entire deposit book in order to attract additional deposits.

[Total 4]

Gestalt Bank is a large, full-service retail bank. The following table contains a summary of the savings products that the bank currently offers and their key features:

Product	Minimum Deposit (L\$)	Term	Access	Rates (nominal per annum)
EntrySave	0	N/A	Immediate	6.00% - 7.25%
EntryInvest	100	N/A	24 Hours	6.25% - 7.50%
32Day Notice	100	N/A	32 days	6.75% - 8.00%
Access Deposit	2 500	12 months	Two 24-hour notice withdrawals allowed during term	6.00% - 7.25%
Fixed Deposit	10 000	1 – 60 months	End of term	7.50% - 9.00%

- ii. Discuss the product offering summarised above, considering:

- The range of available products and their benefits both to the bank and to customers.
- The rates offered on the different products.

[10]

Overall comments

- Gestalt Bank's savings and investment product offering represents a diverse range of products that will meet a broad range of customer needs and preferences.
- Overall, the range of products caters to both conservative savers seeking higher returns and those who require some level of access to their funds whilst still receiving generous interest.
- Offering a range of products with different characteristics benefits the bank by attracting deposits from a broad customer base.
- These products also benefit the bank by providing a stable and predictable source of funding, which can be used to support lending activities.
- The varying rates reflect the flexibility and commitment associated with each product, aligning customer benefits with the bank's need for stable funding.
- Each product has a range of rates offered. It is likely that higher rates are offered on larger deposit amounts as customers with larger amounts to invest are generally more price sensitive. Higher rates are also likely offered to customers that are willing to commit funds for longer timeframes.
- The Access Deposit product offers the same rate as the Entry Save product but has a higher minimum deposit and less access flexibility. This could result in cannibalisation.

Comments on specific products

- The EntrySave product, with no minimum deposit and immediate access to funds, will be attractive to customers that do not have significant funds to invest and require flexibility in accessing their savings.
- This product provides the greatest degree of flexibility but offers the lowest interest rates.
- The rate for immediate access appears to be high in comparison to the other products.
- As this is an instant access deposit account, high-quality liquid assets would need to be held to ensure liquidity in times of stress.
- This reduces the attractiveness of instant access deposits to the bank as a source of funding.
- The EntryInvest product, which has a low minimum deposit amount and 24-hour notice period, provides slightly less flexibility to customers, but offers higher interest rates than the EntrySave product.
- The higher rates offered on this product reflect the increased stability of funding that results from the withdrawal notice period.
- The 32Day Notice product similarly offers greater returns than the EntryInvest product in return for reduced flexibility and increased funding stability resulting from the longer withdrawal notice period.
- This product would likely appeal to customers that are able to make a greater commitment to saving, but would like the ability to access funds to cover expected large expenditures.
- Since this is a notice deposit product, Gestalt bank would not be required to hold a percentage of deposits in HQLA, enabling better rates to be offered.

- The Access Deposit product, available with a minimum deposit of 2,500 for a 12-month term, allows for two 24-hour notice withdrawals during the term.
- This product would appeal to customers that have a lump sum that they are able to save for a fixed term, but would still like access to funds for emergencies without penalties.
- The Fixed Deposit product, with end-of-term rates ranging from 7.50% to 9.00%, offers attractive returns for customers willing to commit their funds for a specific period.
- This product provides stable deposits that benefit the bank from a liquidity management perspective.
- As for other products, a range of rates is offer on Fixed deposits. The actual rate paid will likely vary depending on both the amount invested and the term of the deposit, with the largest and longest term deposits offering the highest rates.

[Total 10]

Gestalt Bank is considering launching a new savings product with the aim of attracting additional deposits to fund further lending. This product would offer preferential rates on fixed deposits to customers over the age of 55.

- iii. Outline factors that Gestalt Bank should consider in developing and launching this new product.

[6]

- The financial needs of the target market for the product should be understood.
- The product offers preferential rates to customers over the age of 55. These customers are likely to be close to retirement, and would find a stable, low risk savings option to boost their pension attractive.
- Market demand and competition should be considered.
- The bank should conduct market research to understand the demand for fixed deposit products among customers over the age of 55.
- The bank should also analyse the competitive landscape to determine what rates and features are being offered by other banks and financial institutions.
- The interest rates to be offered should be considered, and should be determined through consideration of interest rate trends and economic indicators to ensure that they are competitive yet sustainable
- The marginal cost of the extra deposits should be considered to ensure that the preferential rates offered do not exceed the rate earned on new lending.
- The bank should ensure that the new product complies with all relevant banking regulations and consumer protection laws.
- Ways in which the new product would be marketed and promoted should also be considered.
- Targeted marketing strategies should be developed to effectively reach and attract customers over the age of 55.

- Various marketing channels, such as digital marketing, community outreach and partnerships with organisations that work with senior citizens, should be made use of.
- Customer experience and service requirements should be considered, and should be tailored to the customer group that this new product targets.
- Sales and call centre staff should be appropriately trained on the features and benefits of this new product.
- Any technology and infrastructure changes required to support the new product should be considered, and should be implemented and tested before the new product is rolled out.

[Total 6]

[Total 20]

This question was answered generally well.

Part (i) performance was fair and a few candidates managed to score well. A large proportion of candidates were familiar with the underlying concepts, but failed to link them to pricing on the loan book. Some candidates did not have sufficient knowledge of the theory.

Part (ii) performance was generally strong. Most candidates were able to link the differences in rates offered to differences in product term and flexibility, and to suitably comment on the impact on deposit stability. Most candidates also identified the pricing anomaly on one of the products and commented accordingly. Candidates that considered and contrasted each product in turn rather than responding in general were able to generate more relevant points and scored better.

Part (iii) performance was fair. Some candidates did not attempt the question. Better candidates included considerations such as size of market, systems implications and marketing approach in addition to considering the needs of the targeted customers and the determination of the preferential rate to offer. Some candidates dedicated a large portion of their responses to TCF considerations at the expense of covering other relevant points.

[Paper Total 100]

END OF EXAMINERS' REPORT