BANKING INTRODUCTION

BARRINGTON
HIBBERT
ASSOCIATES

CONTENTS

I

DIFFERENT FORMS OF BANKING

3

1 INVESTMENT BANKING

Investment Banking is made up of three core functions:

A Corporate Finance

Financing – To assist companies, governments and individuals to raise capital in the Equity Capital Markets through the issue of shares and Debt Capital Markets (DCM) through the issue of bonds (**distribution**). Investment Bank also **underwrite** (guarantee a price); often the risk is shared across a number of banks through **syndication**.

Mergers and Acquisitions Advisory – Assisting clients in buying or selling a company, including identifying targets, performing due diligence, valuations, producing marketing materials.

B Research

This function analyses companies and provides traders with ideas for strategies and sales teams ideas to provide to clients. This is the area that produces **Buy**, **Sell** and **Hold** recommendations.

C Sales and Trading

Sales – Primary function is to face-off to the investment bank's clients (**the buy-side**) and create business (**order-flow**) through suggestions ideas from the Research team, if the clients decide to transact, the orders are passed to **Trading**

Trading – This is the process by which the requests for securities are fulfilled by transacting with the markets. In some instances traders are made on behalf of the bank (**proprietary trading**), in doing this they take on **principal risk**. There are some traders that will always be able to give you a firm bid and ask price on a stock no matter when you request it- they are known as **Market Markers.**

2 WHOLESALE BANKING

Wholesale Banking is generally concerned with accepting deposits and lending between banks (interbank) and lending between financial institutions. This is distance from the activity of taking 'retail' deposits from personal customer to fund lending activities.

3 RETAIL BANKING

This is where personal customers generally transact through a branch network, via internet or telephone banking. Key products include loans (including mortgages and overdrafts) and deposits, current accounts, pensions and insurance.

4 CORPORATE BANKING

Corporate Banking is always related to lending activity and would include secured or unsecured loans, cash management services, trade finance and structured finance.

GROUP FUNCTIONS

Group functions are established in organisations which have multiple business lines in order to provide support and ensure consistent governance and oversight. Group functions typically include:

Group Secretarial

Support the Chairman and Board. Activities include: managing the Annual General Meeting and ensuring transparent corporate governance.

Group Internal Audit

Provide independent and objective assurance around the effective of risk management, governance and control processes and ensure compliance with internal policies and procedures.

Investor Relations

Manage communications which ultimately effect the company's stock price. Typically these communications are with the stock market, institutional investors and the media.

Group Treasury

Ensure that liquidity and capital are managed across the Groups businesses as efficiently as possible.

Group Risk

Ensure that there are appropriate and consistent risk management frameworks across all of the banks businesses and geographies.

Group Legal

Manage major litigation across businesses or geographies and protect the Group's franchise as well as shaping company-wide policies and providing support for mergers and acquisitions.

Group Finance

Will typically include production of financial accounts on a timely basis in line with prevailing accounting standing.

Group Tax

Are responsible for all tax matters as they impact the bank's tax position e.g. Corporate taxes and VAT.

II KEY PRODUCTS

SECURITIES

These are tradable instruments split into two categories (**shares and bonds**), issued when an entity wants to raise capital in the **Equity or Debt Capital Markets**:

Equities

An equity represents ownership of a small part of the company hence they are referred to as **Shares**. Equities are traded on Stock Exchanges. For example, UK Equities are traded on the **LSE** (London Stock Exchange). There are different types of shares but the two most common are **Ordinary Shares** and **Preference Shares**:

Ordinary Shares are the most common type of share, they carry voting rights, a dividend (variable dependent on the company's performance) and are tradable.

Preference shares these do not carry voting rights, they carry a fixed rate of dividend (only payable if a dividend is declared) and are tradable.

Fixed Income

These instruments are known as **Bonds** and represent a proportion of a loan to a Company Government. The holders of these instruments are not owners of the company as with equities but are **creditors**. The major difference between bonds and other debt finance (such as bank loans) is that bonds are tradable in the **secondary markets**.

Bonds are released in **Issues** with a **Maturity Date** (at which point the investor is repaid their initial investment) and a promise to pay a defined rate of interest at specific points (hence **Fixed Income**). The interest is referred to as the **Coupon**.

The two key types of bonds are **Government Bonds** and **Corporate Bonds**. Governments raise finance through taxation. Another way in which it can raise finance is through the issue of bonds. Similarly, corporates may wish to raise finance in the bond markets as an alternative to equity finance.

TREASURY PRODUCTS

A treasury department in any organisation is primarily responsible for asset/liability management and the related activities of capital and liquidity management. This will include managing Interest rate and Foreign Exchange Risks. Treasury products include:

Money Markets

These are short term lending/borrowing products (maturities of **less than 1 year**). In contrast, the bond markets are concerned with longer term borrowing. Typical Money Markets products include:

Treasury Bills (T-Bills) **–** These are issued when a government has a short term requirement. They are very similar in structure to bonds and typically have a maturity of 3 months, 6 months or a year. It may not make sense for these to have a coupon payment. Therefore, these instruments are sold at a discount to face value (so that the coupon payment is effectively made at maturity when the instrument is redeemed).

Call Money – This is money which is lent or put on deposit for a short period of time (from overnight to serveral weeks) in the Interbank (**wholesale**) market which is where banks lend to each other, for example where their deposit balances do not provide sufficient capital to support their lending activities. These loans are re-payable at short notive (callable).

Foreign Exchange

Another important product for Treasury Management is Foreign Exchange (the sale of one currency in exchange for another). Two key products are:

Spot FX – This is the price at which 1 currency can be bought in exchange for another at prevailing exchange rates settling two days later. FX dealers quote prices at which they will buy and sell currency the difference between the two is the **spread**.

Forward FX – This allows the investor to buy or sell currency at a future date at a price agreed today. When used for Treasury Management purposes, FX Forwards are typically used to 'hedge' currency exposure.

Say a UK company needs to pay a US company that supplies it with raw materials in 6 months time and it is worried about the dollar strengthening against the pound (or the pound weakening) then it may lock-in its USD:GBP exchange rate today.

DERIVATIVES

These are instruments whose value depends on the price of the other underlying assets e.g. Equities, Fixed Income or Foreign Exchange.

Listed Derivatives

Listed Derivatives (also known as **Exchange Traded Derivatives**) can be traded on exchanged such as **LIFFE** (London International Financial Futures and Options Exchange). The two most common listed derivatives are **Futures** and **Options**.

Futures – This is a legal **obligation** to buy or sell the underlying asset at a pre-agreed price at a pre-agreed future date.

Options – This is a **right** (not obligation) to buy or sell the underlying asset at a specified price at (or before) a specified date.

Warrants – These instruments are very similar to options and give the holder the right to purchase shares at a specified price. They are similar to long call options but:

- The purchase of the new shares is made from the issuing company
- They are often used as a sweetener with a new bond issue
- The period to expiry is typical longer at issue

OTC Derivatives

Over the Counter derivatives are contracts that are negotiated directly between the two parties (counterparties) involved (there is no exchange or intermediary involved). In fact, the OTC Derivatives market is much larger than the Exchange Traded Derivatives market.

Some of the key differences between listed derivatives and OTC derivatives are laid out below:

OTC	LISTED
Terms negotiated	Terms set by the exchange
No active market	Highly liquid market
Pricing complex (as all products are different)	Market pricing continuously available
Credit Risk	No Credit Risk

Swaps – Swaps are one of the most common OTC instruments. They commit the two parties to the transaction (**counterparties**) to swap cash flows. This is normally the swap of a fixed cash flow for a variable cash flow. The two most common forms of swap are **Interest Rate Swaps** and **Currency Swaps**.

III KEY FUNCTIONS

FRONT OFFICE

OPERATIONS

- Clearing and Settlement
- Trade Support
- Client Support
- Collateral Management
- Reconciliations and Investigations
- Corporate Actions

FINANCE

Product Control

- PV & Risk Validation
- Independent Price Validation (IPV)
- P&L Reconciliation and Validation

Financial Control

- Ledger Processing
- Capital Allocation
- Balance Sheet Allocation
- Budgeting and Forecasting
- Statutory Reporting
- Regulatory Reporting

RISK

Credit Risk

- Sanctioning and Quality Assurance
- Methodology and Models
- Policy and Framework
- Control, Reporting and Data

Market Risk

- Market Risk Management
- Market Risk Analytics and Model Validation
- Control, Reporting and Data

Operational Risk

- Policy, Framework and Reporting
- Fraud
- Product
- Information
- Business Continuity Management

Legal

Compliance

Tax

Marketing

HR

Technology

OPERATIONS

Clearing and Settlement
Clearing is the process of ensuring that trades are confirmed and agreed with the counterparty. Settlement is the process of ensuring that the seller gets paid and the buyer takes ownership of security.

Trade Support
Trade capture and enrichment, trade matching and confirmations.

Client Support
Direct contact with clients to resolve processing and confirmation issues.

Collateral Management
Process of receiving, delivering and perfecting collateral and dealing with margin calls.

Reconciliations and Investigations
Reconcile trade and position details and investigate reasons for reconciliation 'breaks'.

Corporate Actions
Deal with actions by the security issuer that impact the investor e.g. dividends, coupon payments and stock splits.

Product Control

PV & Risk Validation
Direct liaison with the Front Office to determine the accuracy of profit and loss figures or risk exposures initially provided by the front office.

Independent Price Validation
Price verification of all products using appropriate market data.

P&L Reconciliation & Validation
Daily reconciliation of P&L to traders estimated and attribution.

Financial Control

Ledger Processing
Posting of P&L to the General Ledger.

Capital Allocation
Monitoring the use of capital and minimising the capital needed (e.g. for Capital Adequacy Requirements).

Balance Sheet Allocation
Where individual businesses have balance sheet targets which are monitored by product line, as they will use a portion of the capital base on the balance sheet.

Budgeting and Forecasting
Creating and reviewing plans and budgets for future operating activity.

Statutory Reporting
Ensuring that external returns and group financial statements are prepared and disclosed in accordance with the relevant GAAP (Generally Accepted Accounting Principles), SSAP (Statements of Standard Accounting Principles) and FRS (Financial Reporting Standards).

Regulatory Reporting
Informing the banks regulators of trading activity, positions, liquidity etc.

Credit Risk

Sanctioning and Quality Assurance
Assessing counterparty data and deal data in order to determine whether credit should be extended.

Methodology and Models
Developing and refining Credit Methodology and Models i.e. Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD).

Policy and Framework
The codification of how the firm will establish to whom and to what extent they are prepared to lend.

Control, Reporting and Data
Limits monitoring, watch-lists, management information e.g. Size and quality of book, deteriorating positions, losses, provisions, margin calls.

Market Risk

Market Risk Management
Development of a market risk management policy, process, system and organisational framework. Interact with Front Office to put market risk as a result of specific transactions into a portfolio/enterprise context.

Market Risk Analytics and Model Validation
Measuring the maximum amount that could be lost in a trading portfolio through market volatility or through interest rate risk over a specific time period with a given probability. VAR reports, scenario analysis and back-testing for business control and regulatory purposes.

Control, Reporting and Data
Establish and monitor limits and ensure the bank's market risk profile is transparent to management.

Operational Risk

Policy, Framework and Reporting
Define operational risk policy and framework. Run a risk event reporting process.

Fraud
Mitigation and investigation of attempted (or perpetrated) internal or external attempts to defraud, misappropriate property or circumvent regulations, the law or company policy.

Product
Ensure that risks created by the introduction of new products or services are understood and mitigated.

Information
Mitigate risks associated with failure of systems or security of data.

Business Continuity Management
Identify and prioritise critical processes and ensure a plan is in place for timely resumption.

Legal

- Litigation
- Shaping policies
- Working with external lawyers

Compliance

'Primary concern is to ensure compliance with the handbook (FSA Code of Conduct)

- Maintain the relationship with the regulator
- Ensure training, competence and maintenance of the approved persons regime
- Anti-money laundering, sanctions and anti-bribery and corruption

Tax

- Coprorate taxes and VAT
- Tax consequences of Mergers and Acquisition activity
- Tax implications of new products or services

Marketing

- Brand Management
- Marketing communications
- Customer research

HR

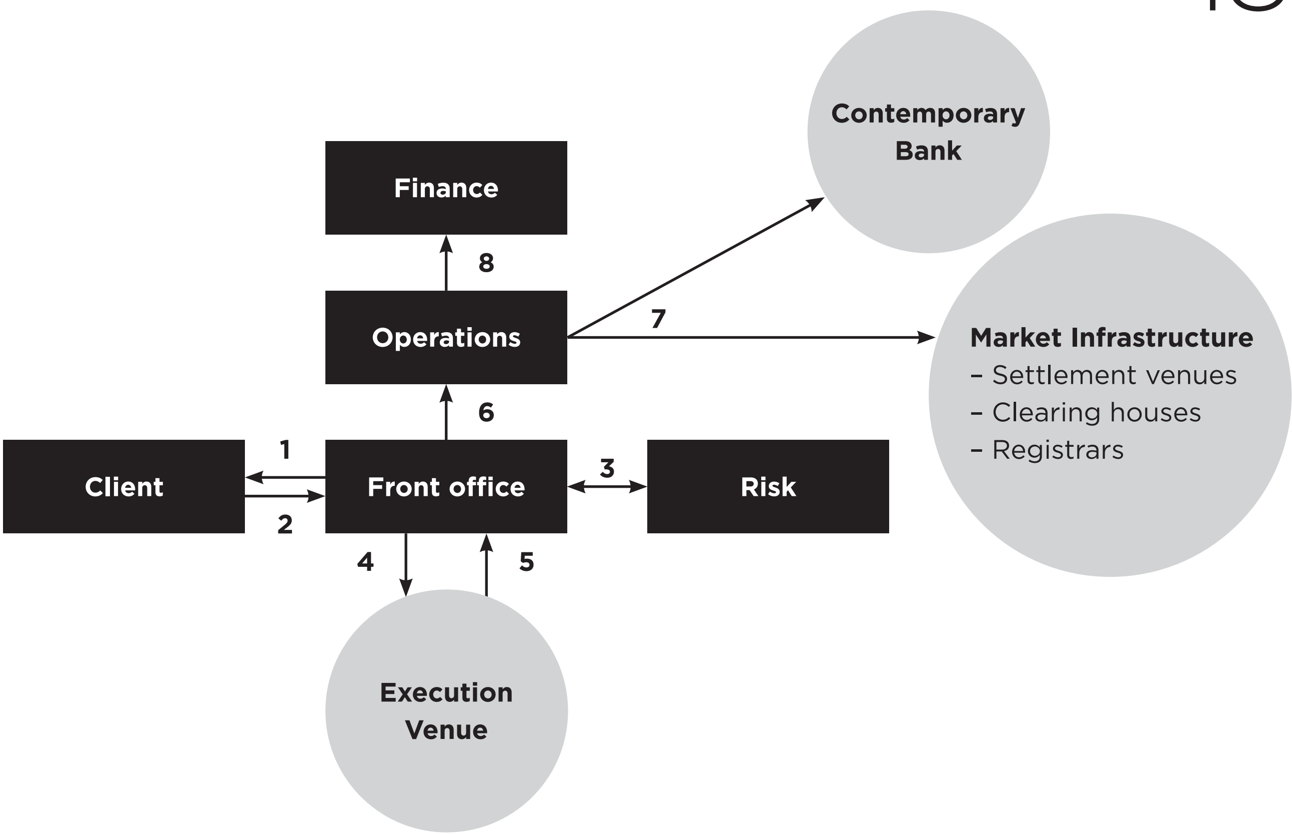
- Recruitment
- Employee Relations
- Compensation and Benefits
- Talent Management
- Learning and Development

Technology

- Application Development and Maintenance
- Infrastructure development and Maintenance (Networks, Servers and Storage)

IV LIFECYCLE OF A TRADE

The schematic below is a high level simplified representation of how a bank processes a trade.



Front Office

1 Front Office (Sales Team) share research with a client

2 Client submits an order to the Front Office (Trading Team)

4 The order is routed to the execution venue (Stock Exchange / ECN / Broker) where it is 'filled'

5 Front Office is notified that the orders have been 'filled' and that the trade is therefore complete

Risk

3 Limits Checking

6 Trade details sent to Operations

Operations

7 Operations interacts with the counterparty bank and market infrastructure to Clear and Settle the trade

Finance

8 Trade Settlement triggers accounting activity

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