CA FINAL

RISK MANAGEMENT

NOV 2020
PAPER ANALYSIS

CASE STUDY 2

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The Risk Management paper of CA Final Nov 2020 Exam was considered to be a challenging paper bymost studentswho appeared for the Exam. It was challenging in the sense that people could not find the answers from the mapping sheet in the ICAI Study Mat. It was challenging in the sense that most of the questions were applicative wherein:

- you know where the Risk Register topic is in the study mat, but you have to write something else
- you know where RCSA is in study mat, but you have to write about the **application** of RCSA in that particular case study
- you know what is strategic risk-you can pretty much find it in the study mat, but you have to talk about the **key drivers** of strategic risk.

So, it was applicative-applicative-applicative all through out. Even the MCQs were more-or-less related to the case study and not to be found from the institute'smat. All case studies required use of the exam taker's brain& judgement rather than just reproducing content from the mat. My question to you is---- isn't that what case studies actually mean and should be like???!
So, people were obviously surprised because they could not find the arbitrage opportunity that was there in the previous RM papers to date.

Was it different for other elective papers?

No, even the other elective paper have the same status. But RM is in the limelightmore because most people are doing RM these days and they have heard stories of people enjoying arbitrage in the past. As students of the RM paper, you will understand and acknowledge that markets are efficient and arbitrageitself leads to wiping out of the available opportunity. You, as budding CA's with RM as your elective (or specialization) have tonow upgrade your levels. You got to understand that ICAI'sstudy mat and mapping-sheet are now matters of the past and just a hoax now forth. Thesewouldn't help you on standalone basis now—that'sguaranteed. What's required of you now is that whatever topic you are doing-- alongwith in-depth knowledge of it,you got to keep an open mind about its concept—use your brain,general understanding &common sense involved in the topic--- be it regarding Risk Based Internal Audit, be it risk and control matrix(RCM), risk management strategies, reputation risk, governance risk, enterprise risk management, risk maturity of an organization or any other concept.

So this paper is causing a sea- change in the way in which Risk Management paper shall be set in future.

I have carried out a deep analysis of each & every Case Study-- provided multiple answers wherever there was a scope of ambiguity. It's a subjective paper and the answers are based on my judgement and are not provided by ICAI. As always, confusion arises (and will arise) when ICAI comes out with their suggested answers.

When they do, please look at them in detail and remember that ICAI's answers are supposed to be given more importance(even if it defies logic) than the answers that I have reproduced below.

Note:

- ✓ **For Jan 21 exam, I will be sharing a number of insights in the coming days.**
- ✓ **Also, I have already announced fresh batches in both English and Hindi for RM to begin from 4th Jan Live at Home on the Ulurn Portal. These are obviously for the May 21 exams and beyond.**

- **Sanjay Sir**

STAY TUNED ON SSEI QFORUM FOR ANALYSIS OF CASE STUDIES 3-5

CA FINAL RISK MANAGEMENT

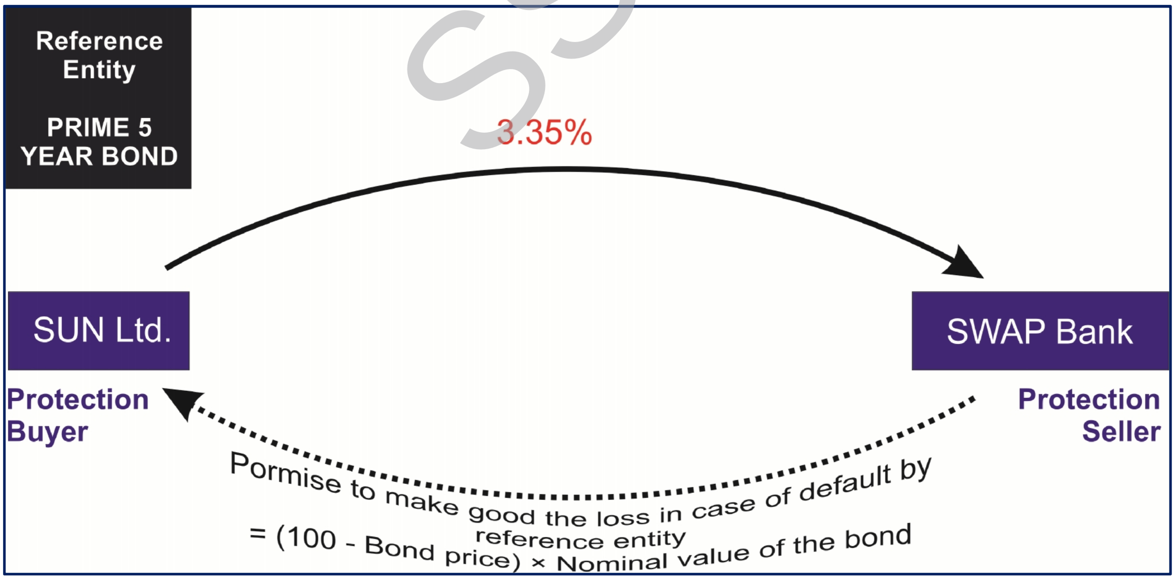
NOV 20 PAPER ANALYSIS

Case Study 2 : SUN Ltd.

Synopsis:

1. Sun Ltd. produces Nylon fibres that are used to weave colourful clothes for making sarees.

2. Sun Ltd. has robust treasury desk and huge exposure to AA and BB rated debt. To hedge against the default risk of 10 year BB rated debt, it buys a 5 year CDS at a Swap premium of 3.35%.



3. Issues of Reputation Risk and Static Business Strategy since inception resulting in demand & revenue losses compared to competitors.

4. Silo approach to Risk management with RM framework missing and no Risk Register. Also firm currently operates with separate and independent RM, compliance and audit functions.

5. Company recently set up a small factory in South Africa - hence, concern towards Country risk.

6. Recent developments - Company recently adopted INDAS and is in the process of establishing a robust system of Expected Credit Loss (ECL).

Objective Questions

2.1. Assuming now that during the life of the swap, there is a technical default on the Prime 5-year bond, such that its price now stands at 58. Under the terms of the swap, the protection buyer delivers the bond to the seller who pays to the protection buyer INR

A. INR 4.2 million

B. INR 42 million

C. INR 5 million

D. INR 4 million

Answer : A is correct.

Explanation :

The protection seller will pay the loss suffered by the protection buyer = (100-58)% of 10m = 4.2m

Sanjay Sir's Comment :

This is an incorrect questions because we know that in CDS there are two type of settlement

1. Cash Settlement
2. Physical Settlement .

In case of Cash Settlement the protection buyer does not deliver the bond. He keeps the bond with himself and claims the loss amount from the protection seller. In this case 10 million was the face value of bond and the price has fallen to 58%. So, accordingly the loss is 42% . So, 42% of 10 million is 4.2 million and therefore **option A** has to be ticked as the right answer but that is wrong because the question is saying that the protection by delivers the bond to the seller. If the protection buyer is delivering the bond to the seller in that case he should get the entire 10 million. The entire 10 million option should have say 10 million that goes to show the degree of depth of the CA institute when it comes to setting questions and when I used the word "chomu" to refer to this lack of depth then student say that sir was saying "dekho CA Institute chomu hai" . Please understand that either I will keep my bond and get the loss amount which is 4.2 million or deliver the bond and take the entire 10 million. So, the answer should have been 10 million given the language of the question.

One of the major Strategic risk faced by SUN is that of obsolete technology. It started with new technology when it was founded in 2002- perhaps the reason for its initial success. But not upgrading tech in todays fast moving dynamic business/industry environment is a key component.

We had done CDS in excrutiating details in our classroom. Future examinations may throw up questions testing such details. Average performance would have been good.

It is surprising that certain students had messaged me that some YouTuber told them that CDS is not a part of RM but is a part of SFM. This is sheer stupidity and CA Final Students have to be matured enough to allocate the most precious resource on this universe i.e. time into positive NPV content.

2.2. In order to assess ECL, Loss Given Default (LGD) is required? Which of the following is correct definition of Loss Given Default (LGD) ?

A. It measures the remaining economic maturity of the exposure.

B. It is estimated amount outstanding in a loan commitment if default occurs.

C. It measures the proportion of the exposure that will be lost if Default occurs.

D. It measures the likelihood that the borrower will default over a given time horizon.

Answer : C is correct.

Explanation :

Option A is refering to the time dimension how much time is left totally relevant.

Option B is taking about EAD (Exposure at default).

Option D is taking about probability of default.

Option C is telling us that if the default occurs what will be the loss percentage i.e., LGD.

So, answer is Option C.

Sanjay Sir's Comment :

We know that there are 3 components of Credit Risk

- PD, LGD and EAD. All the 3 are clearly defined in Chapter 6. Average Performance of the students would have been Excellent.

2.3. **A recently hired junior in a risk management department is wondering how a pure risk differs from a speculative risk . Which of the following statement is correct in this respect ?**

A. A pure risk always has an environmental cause whereas a speculative risk always involves human error.

B. A pure risk can be measured in probability terms whereas a speculative risk cannot.

C. A pure risk is not subject to regulatory control but a speculative risk always is.

D. Pure risks are associated with uncertainties that can lead to the possibility of a loss, whereas a speculative risk may lead to a gain.

Answer : D is correct.

Explanation :

Page 1.16 - clearly given - Pure Risk refers to scope of loss only, whereas, speculative risk may result in a gain or loss

Sanjay Sir's Comment :

Easiest question in the entire paper - one requires great caliber to do it wrong.

2.4. **Many companies are taking a broad view of strategic risk that doesn't just focus on challenges that might cause a particular strategy to fail, but on any major risks that could affect a company's long-term positioning and performance. Which one of the following is correct with respect to strategic risks ?**

A. Strategic risk are those that arise from fundamental decisions that Board takes concerning an organisation's objectives.

B. Strategic risks are subdivided into business and non-business risks.

C. CEO, board or risk management committee of the board has the oversight of strategic risk and hence the composition of the Board should be balanced in skills, knowledge and experience.

D. All listed in (A), (B) & (C).

Answer : A is correct.

Explanation :

Option B is incorrect because, Business Risk is the superset or umbrella which covers strategic risk and not the other way round.

Option C is wrong as the board and CEO have oversight of strategic risk - not the RM committee. Hence,

Option A is correct - strategic has to deal with firm's Long term objectives and hence, fundamental decisions come into play.

Sanjay Sir's Comment :

Good Question - Average performance would have been Average

2.5. **SUN operates with separate and independent risk management, compliance and audit functions. The SUN's Board should be aware that**

A. all costs will be reduced and more risks will be eliminated.

B. holistic risk management processes will be more effective across the company.

C. this is likely to create a more robust approach to managing risk.

D. work will often be duplicated and costs will usually be increased.

Answer : B is correct.

Explanation :

If a firm has separate and independent RM, compliance and auditing functions, it will lead to duplication and costs will increase. Therefore, even Option D seems to be correct. However, Option B which talks about holistic RM process is like a Bhagwat Gita statement and has to be correct. Obviously, Option A and C are incorrect.

Sanjay Sir's Comment :

Good Question, but wrong Option Designing as both B and D are correct. An earnest advise to ICAI that if they find it so difficult to frame 4 options to the extent that they frame incorrect options, why don't they start having 3 Options per questions like the CFA institute has. Believe me, it doesn't make things easy and is a time tested brilliant evaluation padagogy.

DESCRIPTIVE QUESTIONS

2.6. Briefly explain the strategic risks SUN is facing and what broad key risk drivers you would like to consider assessing that risk ?

Answer :

Strategic Risk - The current and prospective impact on earnings, capital, reputation or good standing of an organization arising from its poor business decisions, improper implementation of decisions or lack of response to industry, economic or technological changes. Failure of strategies will adversely impact the business objectives and attainment of the goals.

Strategic risks are those that arise from the fundamental decisions made by the management concerning an organisation's objectives. Essentially, strategic risks are the risks of failing to achieve these business objectives.

- One of the major Strategic risk faced by SUN is that of obsolete technology. It started with new technology when it was founded in 2002- perhaps the reason for its initial success. But not upgrading tech in todays fast moving dynamic business/industry environment is a key component.
- Another concern here is the fact that SUN boasts of a robust treasury management and holds AA and BB rated debts in its portfolio while on the other hand as far as it's non Treasury i.e. Core Operations are concerned, it is characterized by Silo approach to Risk management with RM framework missing and no Risk Registerand suffers from business risk in form of operational issues, revenue loss etc. SUN needs to shift its focus on Core business function that is its speciality- that is manufacturing and supply of synthetic fibres and yarns.
- SUN has not reviewed its business model since inception, which is a matter of concern. With stiff competition and ever-changing industry dynamics, proper team (not comprising of just the CEO/Promoter) needs to be set up to come up with ideas (after proper assessment of course) and implementing the same to tackle stiff competition and to be responsive to industry changes.

- Managing the relationship with suppliers, customers etc is instrumental in maintaining a good standing of the organisation in the industry as brand image today plays a major role in success/failure of any organisation- big or small. SUN needs to assess the same.

Sanjay Sir's Comment :

The ICAI study mat just gives a definition of Strategic Risk and does not elaborate on the same. So unless somebody has a strong understanding of strategic risk, it is difficult to draft a good answer. Even I will admit that I had not covered strategic risk in details in my lectures, because, nobody was ready to take any detail which is outside ICAI mat. Now that such questions are coming, students would be ready to take classes in an elaborate manner without casting doubts on why the teacher is teaching so much elaborate stuff.

Average performance would be poor

2.7. **What is reputational risk ? You are hired by the SUN to assess reputational risk. What are the steps needed to assess reputational risks ?**

Answer :

Any event, activity or practices that affects the name or brand image of an entity in the eye of the public and stakeholders constitute Reputational Risk. It is a threat or danger to the good name or standing of a business or entity and may occur directly (as the result of the actions of the company itself) or indirectly (due to the actions of an employee or employees) or tangentially through connected parties (including **joint venture**, partners or suppliers)

In addition to having good governance practices and transparency, companies need to be socially responsible and environmentally conscious to avoid or minimize reputational risk.

Sun Fiber is unable to improve their reputation in the industry to a level enjoyed by the competitor:

- Sun Fiber should study the payment terms and related policies being followed by its competitors. It could be so that Sun is not paying its suppliers on time or there is a variation in its offered terms relative to industry standard.
- Assess the terms being offered to its customers- that is small, local textile weavers who act as its franchise. Offering better payment terms, introducing incentives etc might help in popularising and uplifting its image amongst the local weavers.
- Using latest technology will also help in improving brand image and reducing reputational risk.
- The company practices and strategies- as mentioned, are age-old and no upgradation has been made to keep up with the competition. The management needs to take drastic steps to change this immediately as industry landscape is dynamic and staying static poses a clear cut threat to company reputation.

Sanjay Sir's Comment :

The ICAI study mat just gives a definition of Reputation Risk and does not elaborate on the same. So unless somebody has a strong understanding of reputation risk, it is difficult to draft a good answer. Even I will admit that I had not covered reputation risk in details in my lectures, because, nobody was ready to take any detail which is outside ICAI mat. Now that such questions are coming, students would be ready to take classes in an elaborate manner without casting doubts on why the teacher is teaching so much elaborate stuff.

Average performance would be poor

2.8. What is the purpose of risk management framework ? What could be the steps in developing risk management framework ?

Answer :

A Risk Management Framework(RMF) sets the foundations and organizational arrangements for designing, implementing, monitoring, reviewing and continuously improving RM capabilities.

There are at least five crucial components that must be considered when creating a risk management framework. They include:

- Risk identification
- Risk measurement and assessment
- Risk mitigation
- Risk reporting and monitoring
- Risk governance

Sanjay Sir's Comment :

Since ICAI study mat is basically a random copy paste from n number of places, the exact steps of RMF are present in different languages in chapter 1,2,3 and 4. Exactly which one will the suggested answer provide is nothing better than a guess work. This is a problem that is faced by teachers as well as students and nobody
likes it.

Average Performance would be poor

2.9. In your opinion what should be done to establish in-house process to analyze country risk of SUN?

Answer :

Country Risk is a major issue of concern in overall management of business. Broadly speaking the country risk management process involves the following steps:

i. **Identification of Risk**: First and foremost, step in country risk management is identification of risk. The various quantitative and qualitative techniques can be used to identify the risks.

ii. **Analysis of Risk**: Once the risk is identified the next step is analyse the same from various angles.

iii. **Evaluation of Risk Management Techniques**: Evaluation of various techniques to manage the risk is carried out.

iv. **Selection of suitable techniques**: Once various techniques have been evaluated next steps comes of selection of most suitable technique to manage the risk.

v. **Implementation of Techniques**: The techniques to manage the risk are implemented.

vi. **Control**: Once the selected techniques are implemented they need to be reviewed on periodic and if required they are revised.

Broadly Country Risk Assessment tools can be divided into following two categories:

1. Qualitative Tools
2. Quantitative Tools

Sanjay Sir's Comment :

This is a straight forward question from Pg 5.16. Of course, you should be smart enough to show that your answer pertains to SUN ltd.
Average performance would have been Good.

2.10. While you were in the board room one member remarked as under.

"Having too much on the risk register runs the risk of diluting the focus on the key risks"

What would be your response to the above and why ?

Answer :

This is an incorrect and immature statement. Risk Register incorporates ranking risks i.e. scoring them based on the product of likelihood and impact. Accordingly, risks which have higher scores are given more importance as compared to risks with lower score. So, all risks must be present in the risk register. This will not dilute the focus on Key Risks.

The following Diagram shows the categorization of risks in the Risk Register.

Impact			
	Grid I High impact & low probability; may be reviewed every quarter	**Grid II** High impact & medium probability; needs quarterly review with real time monitoring	**Grid III** High impact & high probability; needs quarterly review with online monitoring
	Grid IV Medium impact & low probability; may be reviewed every six months	**Grid V** Medium impact & medium probability; may be reviewed every six months	**Grid VI** Medium impact & high probability; may be reviewed every quarter
	Grid VII Low impact & low probability; may be reviewed annually	**Grid VIII** Low impact & medium probability; may be reviewed annually	**Grid IX** Low impact & high probability; may be reviewed every six months

Likelihood (probability)

So, management can easily focus on the key risks in Grid no. 2&3.

Sanjay Sir's Comment :

This is a straight forward question. It would be wrong if students face a difficulty in answering the same as you have to write it in your own words. What he is saying - "saara ka saara risk agar risk register me likhenge, to important risks pe dhyaan nahi jaayega." He is totally wrong. "Saare risks jo Risk register me hay, unka scoring kiya gaya hay and heat map banaya jaata hay. To jahir hay, dhyaan waha chala jayega jaha aag lagi hui hay."

I hope you don't mind the frustrated use of hindi above.