

# CA FINAL

## RISK MANAGEMENT

### IN-HOUSE

## CASE STUDY SERIES

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### **Case Study 21 Questions**

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# Case Study

The world of credit risk management has altered considerably in the last few years and significant changes are still to come. The International Swaps and Derivatives Association (ISDA) released its first survey of the global credit derivatives market last month showing a total notional outstanding volume of \$631.5 bn as of year-end 2001.

According to a Goldman Sachs report, global revenue from credit derivatives might grow to an annual US \$9 bn in the next few years due to an increasing need for protection against bankruptcies and a decline in high yield and emerging market bonds. Credit derivatives account for only one percent of the global derivatives market, but it is the fastest growing sector. As they tend to provide better margins than the cash market for corporate bonds the instruments are popular in the United States. Hedge Funds typically use credit derivatives as structured products, which can be customized to improve pricing and efficiency distribution.

Credit derivatives have been around for a number of years but the market is still relatively small. This is because, the discipline of credit risk is not as well understood or mature as market risk, and so the field of credit risk still has some way to go before properly establishing itself.

The growth in credit derivatives has been driven by financial institutions needing to quantify their credit risk and highlight credit risk concentrations. At the same time, analytic models are more accepted and provide a consensus on how to price credit risk. As these two factors permeate the market, volumes are increasing and a growth pattern similar to the market for interest rate derivatives is expected. ISDA standards for these contracts will also lead to greater acceptance and trading volumes.

The new Basel capital adequacy rules affect the credit derivatives markets. Basel II has developed regulatory rules that give freedom for banks to more efficiently allocate capital via the use of internal capital allocation models. The regulatory environment has lagged, and the Bank for International Settlements requirements for credit capital as they currently stand, remains fairly crude by comparison. As a result, a divergence exists between economic capital and regulatory capital. The draft Capital Accord will bring these closer and permit banks to use more sophisticated tools to meet regulatory requirements.

However, the new accords will still not allow simulation methodologies to be used to evaluate the time dependence of credit exposures. Part of the Basel Committee's new proposals are calling for increased transparency and the disclosure of more information by banks about what is held in their books. But credit derivatives allow banks to hedge the credit exposures they may have without actually trading any assets, allowing banks to subtly change their balance sheets. Effectively this should spur growth in the credit derivatives market.

The new Basel proposal will provide a more direct relationship between credit risk and capital reserves that must be held. Credit derivatives will not only facilitate management of credit risk but also management of capital reserves levels. As a result, additional trading volume in credit derivatives can be anticipated as the revised accord nears adoption.

## Multiple Choice Questions

**(2 × 5 = 10 Marks)**

1. What is the primary source of worry for banks regarding their customers?
  - A. Non-banks are getting access to their customer information through third-party applications.
  - B. Deficiencies in the sale of the third-party investment products by the lenders
  - C. Cashback facilities offered by the e-wallet companies
  - D. Non-adherence to the RBI instructions about mobile or electronic banking services
  
2. Credit insurance is an investment policy offered for sale to a person in the market & is a type of
  - A. Reinsurance
  - B. Property & casualty insurance
  - C. Life insurance
  - D. Health insurance
  
3. Within what time, market makers have to report their CDS trades with both users and other market makers on the reporting platform of CDS trade repository as per RBI guidelines?
  - A. 6 hours
  - B. 5 working days
  - C. 1 hour
  - D. 30 minutes
  
4. ....can be calculated for a single obligor or group of an obligor with similar credit risk features
  - A. Credit insurance
  - B. PDC
  - C. EADD
  - D. LGD

5. Which among the following are rating outlooks assigned by the various credit rating agencies?
- A. Stable
  - B. Positive
  - C. Negative
  - D. All of the above

## Descriptive Questions

6. Discuss the significance of credit derivatives in credit risk management.

**( 5 Marks)**

7. Credit risk is a function of other risks or the combined outcome of other risks, such as, default risk, recovery risk etc. Explain the constituents of credit risks.

**(10 Marks)**