Question 1 of 3

P1.T1.20.7.1

The Acme Investment Trading Company perceives the credit risk of a certain public retailer is mispriced by the market. Acme is considering buying or selling a credit default swap (CDS) for the purpose of speculating on this view with respect to the retailer's credit profile. In comparison to buying or shorting the retailer's cash bond, Acme has already identified an advantage to the CDS: it has better liquidity. On the other hand, which of the following is a **disadvantage** of the CDS?

- **A.** The CDS will introduce a new counterparty risk and legal risk
- **B.** The CDS will introduce basis risk because Acme, who cannot be naked, will need to also purchase the retailer's bond(s) that are referenced by the CDS
- **C.** Although the CDS is a good vehicle for expressing Acme's view on the retailer's default risk, it will not adjust for mere credit deterioration
- **D.** Unlike credit ratings which are frequently updated, Acme will need to wait until it sells the CDS in order to obtain price discovery with respect to a change in retailer's credit risk

Explanation

A is CORRECT.

In regard to (B), (C), and (D), each is FALSE. Instead:

- Acme does NOT need to own the (underlying) referenced bond. Importantly, credit default swaps (CDS) are technically NOT insurance because they do not require an "insurable interest" in the reference instrument.
- The CDS does not hedge market risk, but it DOES hedge credit risk, including deterioration.
- As long as the CDS is marked-to-market, its spread will dynamically re-price credit risk.

Question 2 of 3

P1.T1.20.7.2

Securitization is a trend that is over fifty years old: The Housing and Urban Development Act of 1968 gave birth to Ginnie Mae (https://www.ginniemae.gov/) in an effort to promote homeownership by way of guaranteeing residential mortgage-backed securities (MBS). As GARP explains (see Figure 4.2 of Chapter 4), there have been several milestones along the way. Each of the following statements about securitization is true **EXCEPT** which is false?

- **A.** Securitization offers at least some diversification of credit risk
- **B.** Securitization transfers a substantial amount of risk, including but not limited to credit risk, from the originator's balance sheet to investors
- **C.** The 2007-2009 global financial crisis (GFC) discredited the principles of securitization as evidenced by the subsequent evaporation of asset-backed securities (ABS)
- **D.** Securitization enables originate-to-distribute (OTD), but the 2007-2009 crisis witnessed poor securitization risk management that allowed too much systemic concentration of risk

Explanation

C is CORRECT.

The crisis neither discredited securitization nor saw the evaporation of asset-backed securities.

In regard to (A), (B), and (D), each is TRUE. The first two true statements (i.e., A and B) capture the two essential features of classical securitization: 1. By **pooling** credit-sensitive assets, it provides diversification; and 2. By issuing liabilities (notes) to investors, it **transfers credit risk**.

Question 3 of 3

P1.T1.20.7.3

Any history of the 2007-2009 global financial crisis (GFC) probably needs to include the role of credit derivatives and changes in the credit derivative market that occurred as a result of the crisis. According to some (not all) authors, the build-ups (e.g. imbalances, risks) to the GFC can be traced back decades before the crisis actually materialized. According to GARP, "starting in the 1980s, certain banking activities shifted from the traditional buy-and-hold strategy to a new originate-to-distribute (OTD) business model. Credit risk that would have once been retained by banks on their balance sheets was sold, along with the associated cash flows, to investors in the form of ABSs and similar investment products." About the lessons of the role of credit derivatives in the GFC, each of the following statements is true **EXCEPT** which is false?

- **A.** Originate-and-distribute created moral hazards
- **B.** CLO issuance has grown significantly since the 2007-2009 crisis and has surpassed pre-crisis levels
- **C.** Although the notional amount of CDS is significantly down from its 2008 peak, CDS markets operated smoothly during the crisis, and CDS contracts now account for about half of all contracts cleared by central counterparties (CCPs)
- **D.** The crisis might have been averted if investors in the securitization chain understood the definitions of structured (securitized) product ratings by credit rating agencies

Explanation

D is CORRECT.

While many investors surely did not understand the difference between traditional and structured finance ratings by credit rating agencies (CRA), there is a widespread belief that the ratings were inaccurate.

In the self-reinforcing securitization chain (GARP's Figure 4.3 in Chapter 4), step three in the chain is Credit Rating Agencies: "3. Credit Rating Agencies: Some securitized products were awarded higher ratings than fundamentals suggested, and correlations were underestimated; "Ratings shopping" may have resulted in upwardly biased ratings."

Additionally, GARP writes in regard to this self-reinforcing securitization chain, "There was an overreliance on the accuracy and transparency of credit ratings. This was problematic because rating agencies failed to adequately review the granular data underlying securitized transactions and underestimated the risks of sub-prime CDO structuring [footnote: See M. Crouhy, R. Jarrow, and S. Turnbull, The Subprime Credit Crisis of 2007, Journal of Derivatives, Fall 2008, pp. 84–86.]." -- 2020 FRM Part I: Foundations of Risk Management, 10th Edition. Pearson Learning Solutions

In regard to (A), (B) and (C), each is TRUE.