

Iqra National University



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Assignment : #1
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Question #1:

Part- A: How is risk management in banks different from other financial institutions?

Part – B: Define some of the ways through which banks can eliminate/avoid risk.

Answers:

Part A

1. Definition, identification and classification of risk exposure and the source of risk.
2. Analyzing and quantification of firm exposure to the risk.
3. Allocation of Capital to the business units and risks types that is commensurate with the risk taken.
4. Making decision whether to receive transactions from portfolio perspective and considering whether the risk taking is compensated appropriately from a risk-return perspective.
5. Limitation of risk taking to ensure a constant risk profile by “mitigating” risk.
6. Documenting and controlling of risk-management actions to ensure the achievement of the goals that have been set.
7. Evaluating the Performance and checking the results.

Part B:

Banks can eliminate or avoid risks by:

1. **Hedge/Sell:** Can use derivatives, such as futures, forwards, swaps etc.
2. **Diversification:** Bank has to invest in a diversified Portfolio i.e. investing in Different financial instruments.
3. **Insure:** Bank can avoid/eliminate risk by insuring it.
4. **Set Policy:** Banks can set policies for managing risk and bringing it to least level and implementing these policies.

Question #2: Iqra National University is in the middle of constructing a new building within its main campus. Let's suppose the management decides to give the contract to a contractor and fixes the construction cost in order to avoid the fluctuations in the overall cost in future. Which instruments should the management use to enter the above mentioned contract? What kind of risk will be avoided by INU by making the contract in this uncertain situation?

Answer. #2:

In this case INU will go for a **forward contract** with the contractor in order to avoid any fluctuation in the overall cost and it will avoid the risk of price hike, material shortage and other risks of the real estate industry specially steal price.

Because a forward contract is a customized contract between two parties to buy or sell an asset at a specified price on a future date. A forward contract can be used for hedging or speculation, although its non-standardized nature makes it particularly apt for hedging.

- A forward contract is a customizable derivative contract between two parties to buy or sell an asset at a specified price on a future date.
- Forward contracts can be tailored to a specific commodity, amount and delivery date.
- Forward contracts do not trade on a centralized exchange and are considered over-the-counter (OTC) instruments.

Example of a Forward Contract

Assume that an agricultural producer has two million bushels of corn to sell six months from now and is concerned about a potential decline in the price of corn. It thus enters into a forward contract with its financial institution to sell two million bushels of corn at a price of \$4.30 per bushel in six months, with settlement on a cash basis.

In six months, the spot price of corn has three possibilities:

1. It is exactly \$4.30 per bushel. In this case, no monies are owed by the producer or financial institution to each other and the contract is closed.
2. It is higher than the contract price, say \$5 per bushel. The producer owes the institution \$1.4 million, or the difference between the current spot price and the contracted rate of \$4.30.
3. It is lower than the contract price, say \$3.50 per bushel. The financial institution will pay the producer \$1.6 million, or the difference between the contracted rate of \$4.30 and the current spot price.

Question 3: A company knows that it will need to purchase 50,000 barrels of palm oil at some time in July or August. Palm oil futures contracts are currently traded for delivery every month and the contract size is 1,000 barrels. The company therefore decides to use the September contract for hedging and takes a long position in 50 September contracts. The futures price on January 10 is \$75.00 per barrel. The company finds that it is ready to purchase the crude oil on August 8. It therefore closes out its futures contract on that date. The spot price and futures price on August 8 are \$80.00 per barrel and \$78.15 per barrel.

What is the Basis when the contract is closed out?

Part A: Closed Out Basis = \$ 80.00 per Barrel - \$78.15 per Barrel

Closed Out Basis = \$1.85

What is the final effective price paid by the company for the oil purchased on November 10?

Part B: Effective Paid Price = Initial Price + Basis

Effective Paid Price = \$75 + \$1.85

Effective Paid Price = \$76.85

Will the company use commodity exchange or over-the-counter market to enter the above mentioned contract? And why?

Part C: The Company will use **commodity exchange** because, the contract is standardize having the followings:

- Specific units 1000 barrels per contract
- Maturity every month