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**Assignment of: Financial Risk Management**

**Submitted to: Maam Maryam Saleem**

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**Question 1**

**Answer:**

Ali will bear interest rate risk. He will lose money if interest rate rise. I suggest to him for hedging this risk that Ali should use short hedge method. He should sell 2 months Treasury bond future contract because with rise in interest rates, the price of mortgage as well as T. Bonds will fall. His loss on mortgage is offset by the profit on short hedge of T. Bonds.

But in this way it may not hedge the risk properly. So the long hedge is perfect for hedging this kind of risk. He should buy future contract to reduce the risk when interest rates fall. Because the value of his future contract will be increase if interest rates fall. Conversely he will gain in the cash market when in interest rates rise. When interest rates will fall, he will get loss in mortgage and profit in future market. And when interest rate will rise, he will get profit in mortgage and loss in future market. So this method is good for Ali. Doing this he will get profit and will not face losses.

**Question 2:**

**Answer:**

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| --- |
| Interest rate One year pure Discount Bond Five years pure Discount Bond |
| 6% 1,018.86 =    1,097.98 = |
| 8% 1,000 =  1,000.01 = |
| 10% 981.81 =  912.33 = |