

BFC 5914 Bank Lending: Tutorial of Topic 10

Q.1 Explain how the asset swap arbitrage works and provide an example using the following instruments/rates:

5- year fixed bond rate of 6%

5-year FRN yield of LIBOR +35bps

5-year swap rate of LIBOR +50bps

Q.2 Describe how a bank or investor can obtain default protection by using as asset swap switch.

Q.3 In what way is a CDS different to a conventional OTC swap contract? Describe a more appropriate analogy from the financial markets.

Q.4 Name three factors that drive the price of a CDS and describe how each one influences prices levels.

Q.5 Explain why an unfunded TRS is similar to a synthetic financing

Q.6 If an investor buys a 12-month credit spread call option on Company ABC's bond with a strike spread of 100bps for a premium of 35 bps, what is the appropriate course of action if ABC's spread tightens to 50bps? Widens to 150bps? What is the breakeven level of the trade?

Q.7 Assume the following reference credit portfolio:

Credit 1: \$10 million notional, post-default price 40

Credit 2: \$10 million notional, post-default price 30

Credit 3: \$10 million notional, post-default price 50

Given a \$30 million structure, how much will an investor receive?

- (a) If credit 2 defaults in a standard default?
- (b) If credit 2 defaults in a first-to-default basket?
- (c) If credit 1 and 2 default in a first-to-default basket (in that order)?
- (d) If credit 3 defaults in a senior basket with a \$5 mn first-loss limit?
- (e) If credit 1 defaults in a senior basket with a \$5 mn first-loss limit?