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KIRIRI WOMEN'S UNIVERSITY OF SCIENCE AND TECHNOLOGY
UNIVERSITY EXAMINATION, 2024/2025 ACADEMIC YEAR
FIRST YEAR, FIRST SEMESTER EXAMINATION
FOR THE BACHELOR OF ECONOMICS AND FINANCE

Date: 14th August, 2024
Time: 2.30pm –4.30pm

KEF 2101 FUNDAMENTALS OF INSURANCE & MANAGEMENT

INSTRUCTIONS TO CANDIDATES

ANSWER **QUESTION ONE (COMPULSORY)** AND **ANY OTHER TWO** QUESTIONS

QUESTION ONE (30 MARKS)

Investment Bank Abuses: Case Study of Goldman Sachs and Deutsche Bank

The Report cites investment banks as a major player in the lead up to the crisis, and uses a case study of two leading participants in the U.S. mortgage market, Goldman Sachs and Deutsche Bank. The case study found that from 2004 to 2008, banks focused their efforts heavily on RMBS and CDO securities, complex and high risk financial products that they could bundle and sell to investors who did not necessarily know the composition of the product. Financial institutions issued $2.5 trillion in RMBS and $1.4 trillion in CDO securities. They created large trading desks that dealt strictly in RMBS and CDO securities. More alarmingly, their trading desks began to take out insurance policies against the RMBS and CDO securities, allowing them to wager on the fall in value of their own asset. They acted in many instances as an intermediary between two opposing parties who wished to bet on either side of the future value of a security. This practice led to a blatant conflict of interest in the securities market, as the banks used "net short" positions, in which they wagered on the fall of a security, to profit off the failure of a security they had sold to their own client.

The case study of Goldman Sachs exemplifies this conflict of interest. They underwrote about $100 billion in RMBS and CDO securities in 2006 and 2007. They saw their securities were defaulting, and instead of warning investors to stay away from those products, they began developing a short position that would allow them to profit off of the inevitable collapse of the mortgage market. They amassed a $13.9 billion net short, and made $3.7 billion in profit in 2007 from the decline of the mortgage market. They sold RMBS and CDO securities to their own clients without notifying them of their conflict, that they had a multibillion-dollar short against that same product. The case study further examines four CDOs sold by Goldman known as Hudson 1, Anderson, Timberwolf, and Abacus 2007-AC1. The study found that Goldman would sometimes take risky assets they held in their inventory and dump them into these CDOs. They knowingly included low-value and poor quality assets in them, and in three of the CDOs, they had taken a short position against the CDO. Goldman sold their own toxic assets to their clients, then proceeded to bet against them, without ever notifying anyone about their conflict of interest. In the case of Hudson 1, Goldman took a 100% short against the $2 billion CDO, and then sold the CDO to their clients. The security soon lost value, and while their clients lost their investments, Goldman made $1.7 billion. In the Timberwolf CDO, Goldman sold the securities above book value to their clients, then soon dropped the price after the sale, causing their clients to incur quick losses. The Timberwolf security lost 80% of its value within 5 months and is worthless today. In the case of the Abacus CDO, Goldman did not take a short position, but allowed Paulson & Co. Inc., a hedge fund with relations to former Treasury Secretary and Goldman executive Henry Paulson, although the two are not related, to select the assets included in the CDO.

Goldman marketed and sold the security to their clients, never disclosing the role of Paulson & Co. Inc. in the asset selection process or the fact that the CDO was designed to lose value in the first place. Today, the Abacus securities are worthless, while the Paulson hedge fund made about $3 billion.
In the Deutsche Bank case study, the Report focuses on the bank's top CDO trader, Greg Lippmann. He warned colleagues that the RMBS and CDO securities were "crap" and "pigs" and could make money taking shorts against them. He predicted the securities would lose value and called the financial industry's CDO operation as a "ponzi scheme."Deutsche Bank took out a $5 billion short position against the RMBS market from 2005 to 2007, earning a profit of $1.5 billion. The case studies of these two investment firms also show that even as mortgage delinquencies increased in 2008, the banks continued to heavily market CDOs and RMBS securities to their clients. The banks knew that if they were to stop their "CDO machine" that was churning out record profits and record executive bonuses, the firms would have to cut back on their excesses and close their CDO desks. The studies show how the credit default swaps that allowed investors and banks themselves to place bets on either side of the performance of a security further intensified market risk. Finally, they show that the unscrupulous trading techniques at the banks led to "dramatic losses in the case of Deutsche Bank and undisclosed conflicts of interest in the case of Goldman Sachs." The Report found that the investment banks were "the driving force behind the risk-laden CDO and RMBS market's expansion in the U.S. financial system, and the banks were a major cause of the crisis itself.

a) Explain Four method Goldman Sachs and Deutsche Bank could have used to handle risk. (5 Marks)

b) Explain five challenges faced by Goldman Sachs and Deutsche Bank (5 Marks)

c) Discuss five steps Goldman Sachs and Deutsche Bank could use to reduce unscrupulous trading techniques at the banks (5 Marks)

d) Explain five benefits Goldman Sachs and Deutsche Bank get by taking insurance policy. (5 Marks)

e) Discuss five roles the risk manager of Goldman Sachs and Deutsche Bank failed (5 Marks)

f) Explain five Factors that Goldman Sachs and Deutsche Bank should have considered in deciding whether to do risk Retention and Transfer of risk (5 Marks)

<u>QUESTION TWO (20 MARKS)</u>

a) Explain four types of hazard that could be facing business enterprises (8 Marks)

b) Discuss four classification of insurance companies (8 Marks)

c) Highlight four broad categories of loss likelihood under Prouty Approach (4 Marks)

QUESTION THREE (20 MARKS)

a) Explain four Techniques and Tools for Risk Identification (8 Marks)

b) Discuss the procedure on how to conduct an inspection in a business firm (8 Marks)

c) Explain the following terms as used in HAZOP analysis: (4 Marks)

i) Study Nodes

ii) Intention.

iii) Deviations

iv) *Causes*

QUESTION FOUR (20 MARKS)

a) Discuss four Post loss objectives of risk Management (8 Marks)

b) Explain four roles of government in handling Risk (8 Marks)

c) Explain five Nature of insurable risks (4 Marks)

QUESTION FIVE (20 MARKS)

a) Explain four principles / doctrines that are followed in insurance (8 Marks)

b) Discuss four different classes of insurance (8 Marks)

c) Highlight four benefits and economics reasons to form a captive in an organization (4 Marks)