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NEW QUESTION: 1

Which of the following statements is true:

- I. Recovery rate assumptions can be easily made fairly accurately given past data available from credit rating agencies.
- II. Recovery rate assumptions are difficult to make given the effect of the business cycle, nature of the industry and multiple other factors difficult to model.
- III. The standard deviation of observed recovery rates is generally very high, making any estimate likely to differ significantly from realized recovery rates.
- IV. Estimation errors for recovery rates are not a concern as they are not directionally biased and will cancel each other out over time.

- A. II and IV
- B. I, II and IV
- C. III and IV
- D. II and III

Answer: D (LEAVE A REPLY)

Explanation

Recovery rates vary a great deal from year to year, and are difficult to predict. Therefore statement III is true.

Similarly, any attempt to predict these is hamstrung by a high standard error, which can be as high as the historical mean itself. The error does not cancel itself out due to the effect of the business cycle making the error directionally biased. Thus statement IV is false.

Statement II is true as these are all factors that make forecasting recovery rates for any credit risk model rather difficult. Statement I is false because recovery rates are difficult to predict and assumptions are not easy to make.

NEW QUESTION: 2

If two bonds with identical credit ratings, coupon and maturity but from different issuers trade at different spreads to treasury rates, which of the following is a possible explanation:

- I. The bonds differ in liquidity
- II. Events have happened that have changed investor perceptions but these are not yet reflected in the ratings
- III. The bonds carry different market risk
- IV. The bonds differ in their convexity

A. I, II and IV

B. II and IV

C. I and II

D. III and IV

Answer: C (LEAVE A REPLY)

Explanation

When two bonds that appear identical in every respect trade at different prices, the difference is often due to differences in liquidity between the two bonds (the lessliquid bond will be cheaper and yield higher), and also due to the fact that ratings from the major rating agencies do not generally react to day to day changes in the market. The market's perception of the differences in the two credits will cause a divergence in the prices. This has been an extremely visible phenomenon during the credit crisis of 2007-2009, where fixed income security prices have changed sharply for many securities without any changes in external credit ratings.

Bonds carrying 'differentmarket risk' is meaningless, and so is the difference in convexity (because the calculated convexity would be identical for similar bonds).

Therefore Choice 'c' is the correct answer.

NEW QUESTION: 3

Under the KMV Moody's approach to calculating expectingdefault frequencies (EDF), firms' default on obligations is likely when:

A. expected asset values one year hence are below total liabilities

B. asset values reach a level below short term debt

C. asset values reach a level below totallabilities

D. asset values reach a level between short term debt and total liabilities

Answer: D (LEAVE A REPLY)

Explanation

An observed fact that the KMV approach relies upon is that firms do not default when their liabilities exceed assets, but when asset values are somewhere between short term liabilities and the total liabilities. In fact, the 'default point' in the KMV methodology is defined as the short term debt plus half of the long term debt. The difference between expected value of the assets in one year and this 'default point', when expressed in terms of standard deviation of the asset values, is called the 'distance-to-default'.

Therefore Choice 'd' is the correct answer. The other choices are incorrect.

NEW QUESTION: 4

According to the implied capital model, operational risk capital is estimated as:

- A. Operational risk capital held by similar firms, appropriately scaled
- B. Total capital less market risk capital less credit risk capital
- C. Capital implied from known risk premiums and the firm's earnings
- D. Total capital based on the capital asset pricing model

Answer: ([SHOW ANSWER](#))

Explanation

Operational risk capital estimated using the implied capital model is merely the capital that is not attributable to market or credit risk. Therefore Choice 'b' is the correct answer. All other responses are incorrect.

NEW QUESTION: 5

Which of the following situations are not suitable for applying parametric VaR:

- I. Where the portfolio's valuation is linearly dependent upon risk factors
- II. Where the portfolio consists of non-linear products such as options and large moves are involved
- III. Where the returns of risk factors are known to be not normally distributed

- A. I and II
- B. II and III
- C. I and III
- D. All of the above

Answer: ([SHOW ANSWER](#))

Explanation

Parametric VaR relies upon reducing a portfolio's positions to risk factors, and estimating the first order changes in portfolio values from each of the risk factors. This is called the delta approximation approach.

Risk factors include stock index values, or the PV01 for interest rate products, or volatility for options. This approach can be quite accurate and computationally efficient if the portfolio comprises products whose value behaves linearly to changes in risk factors. This includes long and short positions in equities, commodities and the like.

However, where non-linear products such as options are involved and large moves in the risk factors are anticipated, a delta approximation based valuation may not give accurate results, and the VaR may be misstated. Therefore in such situations parametric VaR is not advised (unless it is extended to include second and third level sensitivities which can bring its own share of problems).

Parametric VaR also assumes that the returns of risk factors are normally distributed - an assumption that is violated in times of market stress. So if it is known that the risk factor returns are not normally distributed, it is not advisable to use parametric VaR.

NEW QUESTION: 6

Which of the following are considered properties of a 'coherent' risk measure:

- I. Monotonicity
- II. Homogeneity
- III. Translation Invariance
- IV. Sub-additivity

- A. II and III
- B. II and IV
- C. I and III
- D. All of the above

Answer: (SHOW ANSWER)

Explanation

All of the properties described are the properties of a 'coherent' risk measure.

Monotonicity means that if a portfolio's future value is expected to be greater than that of another portfolio, its risk should be lower than that of the other portfolio. For example, if the expected return of an asset (or portfolio) is greater than that of another, the first asset must have a lower risk than the other. Another example:

between two options if the first has a strike price lower than the second, then the first option will always have a lower risk if all other parameters are the same. VaR satisfies this property.

Homogeneity is easiest explained by an example: if you double the size of a portfolio, the risk doubles. The linear scaling property of a risk measure is called homogeneity. VaR satisfies this property.

Translation invariance means adding riskless assets to a portfolio reduces total risk. So if cash (which has zero standard deviation and zero correlation with other assets) is added to a portfolio, the risk goes down. A risk measure should satisfy this property, and VaR does.

Sub-additivity means that the total risk for a portfolio should be less than the sum of its parts. This is a property that VaR satisfies most of the time, but not always. As an example, VaR may not be sub-additive for portfolios that have assets with discontinuous payoffs close to the VaR cutoff quantile.

NEW QUESTION: 7

When considering a request for a loan from a retail customer, which of the following factors is relevant for a bank to consider:

- A. The other retail loans in its portfolio
- B. The credit worthiness of the retail customer
- C. The contribution this new loan would bring to total portfolio risk
- D. All of the above

Answer: D (LEAVE A REPLY)

Explanation

The credit worthiness of the retail customer is certainly a factor for the bank to consider as it will need to price the loan to cover the expectation of default. At the same time, it will

need to look at other loans in its portfolio as to avoid unacceptable concentration risk. A corollary of the same theme is that the bank will need to take a portfolio view of the loan request and consider its contribution to total portfolio risk. Therefore all the choices are appropriate considerations for the bank and Choice 'd' is the correct answer.

NEW QUESTION: 8

The loss severity distribution for operational risk loss events is generally modeled by which of the following distributions:

- I. the lognormal distribution
- II. The gamma density function
- III. Generalized hyperbolic distributions
- IV. Lognormal mixtures

- A.** II and III
- B.** I, II and III
- C.** I, II, III and IV
- D.** I and III

Answer: C ([LEAVE A REPLY](#))

Explanation

All of the distributions referred to in the question can be used to model the loss severity distribution for op risk. Therefore Choice 'c' is the correct answer.

NEW QUESTION: 9

An investor enters into a 5-year total return swap with Bank A, with the investor paying a fixed rate of 6% annually on a notional value of \$100m to the bank and receiving the returns of the S&P500 index with an identical notional value. The swap is reset monthly, ie the payments are exchanged monthly. On Jan 1 of the fourth year, after settling the last month's payments, the bank enters bankruptcy. What is the legal claim that the hedge fund has against the bank in the bankruptcy court?

- A.** \$100m
- B.** \$6m
- C.** The replacement value of the swap
- D.** \$0, as all payments on the swap are current

Answer: C ([LEAVE A REPLY](#))

Explanation

According to ISDA standard definitions, the legal claim for OTC derivatives is the current replacement value of the contract. Therefore Choice 'c' is the correct answer. None of the other choices are correct.

NEW QUESTION: 10

Under the KMV Moody's approach to credit risk measurement, how is the distance to default converted to expected default frequencies?

- A. Using a proprietary database based on historical information
- B. Using migration matrices
- C. Using a normal distribution
- D. Using Monte Carlo simulations

Answer: [\(SHOW ANSWER\)](#)

Explanation

KMV Moody's uses a proprietary database to convert the distance to default to expected default probabilities.

NEW QUESTION: 11

Which of the following are valid approaches to leveraging external loss data for modeling operational risks:

- I. Both internal and external losses can be fitted with distributions, and a weighted average approach using these distributions is relied upon for capital calculations.
- II. External loss data is used to inform scenario modeling.
- III. External loss data is combined with internal loss data points, and distributions fitted to the combined data set.
- IV. External loss data is used to replace internal loss data points to create a higher quality data set to fit distributions.

- A. I, II and III
- B. I and III
- C. II and IV
- D. All of the above

Answer: [A \(LEAVE A REPLY\)](#)

Explanation

Internal loss data is generally the highest quality as it is relevant, and is 'real' as it has occurred to the organization. External loss data suffers from a significant limitation that the risk profiles of the banks to which the data relates is generally not known due to anonymization, and may likely may not be applicable to the bank performing the calculations. Therefore, replacing external loss data with external loss data is not a good idea. Statement IV is therefore incorrect.

All other approach described are valid approaches for the risk analyst to consider and implement. Therefore statements I, II and III are correct and IV is not.

NEW QUESTION: 12

Which of the following risks and reasons justify the use of scenario analysis in operational risk modeling:

- I. Risks for which no internal loss data is available
- II. Risks that are foreseeable but have no precedent, internally or externally
- III. Risks for which objective assessments can be made by experts
- IV. Risks that are known to exist, but for which no reliable external or internal losses can be analyzed

V. Reducing the complexity of having to fit statistical models to internal and external loss data VI. Managing the capital estimation process as to produce estimates in line with management's desired capital buffers.

- A. I, II and III
- B. I, II, III and IV
- C. V
- D. All of the above

Answer: B ([LEAVE A REPLY](#))

Explanation

All the reasons and risks presented above are valid reasons for using scenario analysis, except V and VI - ie, the need to reduce the complexity of calculations is not a valid reason for using scenario analysis. Similarly, making operational risk capital estimates match management's desired capital allocation targets is also not a valid reason. Capital calculations are intended to provide adequate capital for managing the risk from operations, regardless of what management may desire them to be.

NEW QUESTION: 13

According to Basel II's definition of operational loss event types, losses due to acts by third parties intended to defraud, misappropriate property or circumvent the law are classified as:

- A. Internal fraud
- B. Execution delivery and system failure
- C. External fraud
- D. Third party fraud

Answer: ([SHOW ANSWER](#))

Explanation

Choice 'c' is the correct answer. Refer to the detailed loss event type classification under Basel II (see Annex 9 of the accord). You should know the exact names of all loss event types, and examples of each.

NEW QUESTION: 14

An error by a third party service provider results in a loss to a client that the bank has to make up. Such a loss would be categorized per Basel II operational risk categories as:

- A. Execution delivery and process management
- B. Outsourcing loss
- C. Business disruption and process failure
- D. Abnormal loss

Answer: ([SHOW ANSWER](#))

Explanation

Choice 'a' is the correct answer. Refer to the detailed loss event type classification under Basel II (see Annex 9 of the accord). You should know the exact names of all loss event types, and examples of each.

NEW QUESTION: 15

Which of the following losses can be attributed to credit risk:

- I. Losses in a bond's value from a credit downgrade
- II. Losses in a bond's value from an increase in bond yields
- III. Losses arising from a bond issuer's default
- IV. Losses from an increase in corporate bond spreads

- A. I, III and IV
- B. II and IV
- C. I and II
- D. I and III

Answer: D ([LEAVE A REPLY](#))

Explanation

Losses due to credit risk include the loss of value from credit migration and default events (which can be considered a migration to the 'default' category). Therefore Choice 'd' is the correct answer. Changes in spreads or interest rates are examples of market risk events. [Discussion: It may be argued that losses from spreads changing could be categorized as credit risk and not market risk. The distinction between credit and market risk is never really watertight.

The reason I have called it market risk in this question is because spreads can change due to two reasons: first, due to the individual issuer going down in their credit rating (whether issued or perceived, as we have witnessed in Europe sovereign debt), and second due to the spread for the overall category changing due to macro fundamentals with nothing changing for the individual issuer. For example the spread between municipal bonds and treasuries may be small during boom times and may expand during recessions - regardless of how the individual issuer has been doing. Clearly, the first case is credit risk and the second is probably market risk.

A change in overall corporate bond spreads is something I would consider akin to a rate change - which is why I have called it as not a part of credit risk. But an alternative perspective may not be incorrect either.]

NEW QUESTION: 16

Under the CreditPortfolio View model of credit risk, the conditional probability of default will be:

- A. lower than the unconditional probability of default in an economic expansion
- B. higher than the unconditional probability of default in an economic expansion
- C. lower than the unconditional probability of default in an economic contraction
- D. the same as the unconditional probability of default in an economic expansion

Answer: (SHOW ANSWER)

Explanation

When the economy is expanding, firms are less likely to default. Therefore the conditional probability of default, given an economic expansion, is likely to be lower than the unconditional probability of default.

Therefore Choice 'a' is the correct answer and the other statements are incorrect.

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NEW QUESTION: 17

Which of the following is a cause of model risk in risk management?

- A. Programming errors
- B. Misspecification of the model
- C. Incorrect parameter estimation
- D. All of the above

Answer: D (LEAVE A REPLY)

Explanation

Model risk is the risk that a model built for estimating a variable will produce erroneous estimates. Model risk is caused by a number of factors, including:

- a) Misspecifying the model: For example, using a normal distribution when it is not justified.
 - b) Model misuse: For example, using a model built to estimate bond prices to estimate equity prices
 - c) Parameter estimation errors: In particular, parameters that are subjectively determined can be subject to significant parameter estimation errors
 - d) Programming errors: Errors in coding the model as part of computer implementation may not be detected by end users
 - e) Data errors: Errors in data used for building the model may also introduce model risk
- Therefore the correct answer is d, as all the choices are a source of model risk.

NEW QUESTION: 18

Which of the following are valid approaches to calculating potential future exposure (PFE) for counterparty risk:

- I. Add a percentage of the notional to the mark-to-market value
- II. Monte Carlo simulation
- III. Maximum Likelihood Estimation
- IV. Parametric Estimation

- A. III and IV
- B. I, III and IV
- C. I and II
- D. All of the able

Answer: C ([LEAVE A REPLY](#))

Explanation

When a derivative position is entered into, its mark-to-market value is generally close to zero (though the notional may be high). With the passage of time, the derivative's value fluctuates in an unpredictable way, creating a counterparty exposure that may be difficult to estimate and risk manage. Counterparty risk in such cases is estimated based on Potential Future Exposure, which may be calculated using either:

- a) Take the mark-to-market at present, and add a certain percentage of the notional, or b) Perform a Monte Carlo simulation, capturing the stochastic nature of the PFE.

Therefore I and II are valid choices. MLE and parametric estimation are not methods for calculating PFE.

NEW QUESTION: 19

Which of the following statements are true:

- I. Top down approaches help focus management attention on the frequency and severity of loss events, while bottom up approaches do not.
- II. Top down approaches rely upon high level data while bottom up approaches need firm specific risk data to estimate risk.
- III. Scenario analysis can help capture both qualitative and quantitative dimensions of operational risk.

- A. III only
- B. II and III
- C. I only
- D. II only

Answer: ([SHOW ANSWER](#))

Explanation

Top down approaches do not consider event frequency and severity, on the otherhand they focus on high level available data such as total capital, income volatility, peer group information on risk capital etc. Bottom up approaches focus on severity and frequency distributions for events. Statement I is therefore not correct.

Top down approaches do indeed rely upon high level aggregate data and tend to infer operational risk capital requirements from these. Bottom up approaches look at more detailed firm specific information. Statement II is correct.

Scenario analysis requires estimating losses from risk scenarios, and allows incorporating the judgment and views of managers in addition to any data that might be available from internal or external loss databases.

Statement III is correct. Therefore Choice 'b' is the correct answer.

NEW QUESTION: 20

Under the standardized approach to calculating operational risk capital under Basel II, negative regulatory capital charges for any of the business units:

- A. Should be ignored completely
- B. Should be offset against positive capital charges from other business units
- C. Should be included after ignoring the negative sign
- D. Should be excluded from capital calculations

Answer: B ([LEAVE A REPLY](#))

Explanation

According to Basel II, in any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit. Therefore Choice 'b' is the correct answer.

NEW QUESTION: 21

Which of the following statements is true in respect of a non financial manufacturing firm?

I. Market risk is not relevant to the manufacturing firm as it does not take proprietary positions
II. The firm faces market risks as an externality which it must bear and has no control over
III. Market risks can make a comparative assessment of profitability over time difficult
IV. Market risks for a manufacturing firm are not directionally biased and do not increase the overall risk of the firm as they net to zero over a long term time horizon

- A. III only
- B. IV only
- C. I and II
- D. III and IV

Answer: (SHOW ANSWER)

Explanation

A non-financial firm such as a manufacturing company faces market risks similar to those faced by financial firms, except perhaps for not being exposed to risks from the equity markets. Non financial firms commonly face interest rate risks in respect of their debts, commodity price risks in respect of their inputs and products, and foreign currency risks in respect of their overseas operations. It is therefore not correct to say that the manufacturing firm does not face market risk because it does not take proprietary positions. While decisions on positions may not be actively taken, positions in foreign exchange (eg, through overseas debtors owing foreign currency, or liabilities in foreign currencies to overseas suppliers), commodities (through exposure to the need for raw material and inventory of finished goods) and interest rates (through debt financed, whether at fixed or floating rates) exist and create market risk much in the same way as they would for a proprietary position. Therefore statement I is incorrect.

While the firm faces market risks as an externality (as do financial firms for that matter, though often they seek such exposure to profit from their view on which way the externality

will express itself), it is incorrect to say that these risks must be borne. They can be measured and hedged. Therefore statement II is incorrect.

The results of a manufacturing firm will include gains and losses arising from exposure to market risk, and will cloud the true profitability of the business. A firm with significant unhedged overseas sales may show vastly different results across time periods due to the FX gains and losses, making comparative assessment of profitability difficult. Therefore statement III is correct.

Market risks for a manufacturing firm may be directionally biased in terms of exposure, ie there may be a consistent 'long' position in a particular commodity that the firm produces, and a consistent 'short' position in the commodities consumed. In the same way, directional biases may exist in FX or interest rate exposures too.

Regardless of the bias, the existence of market risk exposures increase the volatility of the income stream and make the firm more risky, even though the long term expected returns from such exposures is zero (ie, returns may be zero but standard deviation is not).

Therefore statement IV is not correct as market risks for non financial firms do increase the overall risk of the firm.

NEW QUESTION: 22

Which of the following statements is NOT true in relation to the recent financial crisis of 2007-08?

- A.** An intention to diversify from their core activities led all market participants to the same activities, which though appearing diversified at the bank's level, created a concentration risk at the systemic level
- B.** The existence of central counterparties could have limited the damage caused by the financial crisis
- C.** Central banks had data on the interconnections between institutions, but poor understanding and analysis meant this data was never analyzed
- D.** Counterparty risk was difficult to gauge as it was impossible to know who the counterparty's counterparties were

Answer: C (LEAVE A REPLY)

Explanation

Counterparty risk was difficult to gauge as it was impossible to know who the counterparty's counterparties were - this is true as the chain of financial transactions became excessively long with no central transparency of who owed who what. Bank A's credit depended upon the health of its counterparties, whose health in turn depended upon other counterparties. Thus Choice 'd' is a correct statement.

In an attempt to diversify, banks became more like each other - chasing yield, they piled into securitized products, and chasing diversification, they piled into different types of securitized products. The system as a whole became susceptible to small shocks in the assets underlying this vast edifice of structured products.

Therefore Choice 'a' represents a correct statement.

Choice 'c' does not represent a correct statement. Central banks had little data on the interconnections between institutions. They were aware of the large volumes of OTC transactions, but had no data to figure out who was connected to who, and who had what kind of exposures.

Choice 'b' represents a correct statement. Most transactions, other than exchange cleared futures trades (which were a tiny fraction of all trades) were cleared on a bilateral basis. The existence of central counterparties (CCPs) could have limited the impact of the crisis significantly as market participants would not have lost trust in each other, and the 'collateral damage' that was witnessed from a fall in housing prices, and thereby mortgage assets, would have been more contained.

NEW QUESTION: 23

Which of the following statements are true:

- I. Credit risk and counterparty risk are synonymous
- II. Counterparty risk is the contingent risk from a counterparty's default in derivative transactions
- III. Counterparty risk is the risk of a loan default or the risk from moneys lent directly
- IV. The exposure at default is difficult to estimate for credit risk as it depends upon market movements

- A.** II and III
- B.** I and II
- C.** II
- D.** III and IV

Answer: (SHOW ANSWER)

Explanation

Credit risk is the risk from a borrower defaulting on moneys lent. Counterparty risk, on the other hand, is the risk that a counterparty to a derivative transaction will be unable to pay at the time the transaction is in-the-money.

Credit risk therefore relates more to the banking book, counterparty risk relates more to the trading book.

Credit risk and counterparty risk differ in that for counterparty risk, the amount at risk fluctuates for counterparty risk depending upon the value of the underlying derivative. Counterparty risk generally starts at zero, for most swaps and other derivatives are near zero value at inception. Over time, as the prices of the underlying instruments move, one party ends up owing money to the other. A deterioration in the financial situation of the party owing moneys may lead to a loss to the other party, resulting in counterparty risk. Counterparty risk can also arise from stock lending operations and repo trades. Credit risk on the other hand is the traditional risk of default by a borrower, or a bank's customer who has taken a loan or has an overdraft or other credit facility. Statement I is therefore incorrect as credit risk and counterparty risks are different.

Statement II is correct as counterparty risk is 'contingent' in the sense it arises only if the transaction with the counterparty ends up being in-the-money, and the counterparty defaults.

Statement III is incorrect. The statement describes credit risk.

Statement IV is incorrect, as the exposure is known for moneys lent. Derivative exposures for the future are difficult to estimate, they can even turn from moneys owed to moneys due as the value of the underlying changes.

NEW QUESTION: 24

If the marginal probabilities of default for a corporate bond for years 1, 2 and 3 are 2%, 3% and 4% respectively, what is the cumulative probability of default at the end of year 3?

- A. 8.74%
- B. 9.58%
- C. 9.00%
- D. 91.26%

Answer: ([SHOW ANSWER](#))

Explanation

Marginal probabilities of default are the probabilities for default for a given period, conditional on survival till the end of the previous period. Cumulative probabilities of default are probabilities of default by a point in time, regardless of when the default occurs. If the marginal probabilities of default for periods 1, 2... n are $p_1, p_2 \dots p_n$, then cumulative probability of default can be calculated as $C_n = 1 - (1 - p_1)(1 - p_2) \dots (1 - p_n)$. For this question, we can calculate the probability of default for year 3 as $= 1 - (1 - 2\%)(1 - 3\%)(1 - 4\%) = 8.74\%$

NEW QUESTION: 25

A zero coupon corporate bond maturing in an year has a probability of default of 5% and yields 12%. The recovery rate is zero. What is the risk free rate?

- A. 5.26%
- B. 7.00%
- C. 5.00%
- D. 6.40%

Answer: ([SHOW ANSWER](#))

Explanation

The probability of default would make the expected value of the future cash flows from both the corporate bond and the risk free bond identical. If p be the probability of default, the cash flows from the risky corporate bond would be
 $= (\text{cash flows in the event of default} \times \text{probability of default}) + (\text{cash flows without default} \times (1 - \text{probability of default}))$
 $=> 5\% \times 0 + (1 - 5\%)(1 + 12\%) = (1 + R_f)$
therefore $R_f = 6.4\%$

(In reality investors would demand a 'credit risk premium' over and above the expected default loss rate. They are unlikely to be happy with just being compensated with exactly the expected default loss rate plus the risk-free rate because the expected default loss rate itself is uncertain. They would demand some premium over and above what the default rate alone might mathematically imply above the risk free rate. In this question, this credit risk premium is ignored.)

NEW QUESTION: 26

Which of the following statements is true

- I. If no loss data is available, good quality scenarios can be used to model operational risk
- II. Scenario data can be mixed with observed loss data for modeling severity and frequency estimates
- III. Severity estimates should not be created by fitting models to scenario generated loss data points alone
- IV. Scenario assessments should only be used as modifiers to ILD or ELD severity models.

A. I

B. I and II

C. III and IV

D. All statements are true

Answer: B (LEAVE A REPLY)

Explanation

There are multiple ways to incorporate scenario analysis for modeling operational risk capital - and the exact approach used depends upon the quantity of loss data available, and the quality of scenario assessments.

Generally:

- If there is no past loss data available, scenarios are the only practical means to model operational risk loss distributions. Both frequency and severity estimates can be modeled based on scenario data.
- If there is plenty of past data available, scenarios can be used as a modifier for estimates that are based solely on data (for example, consider the MAX of the loss estimates at the desired quantile as provided by the data, and as indicated by scenarios)
- If high quality scenario data is available, and there is sufficient past data, one could mix scenario assessments with the loss data and fit the combined data set to create the loss distribution. Alternatively, both could be fitted with severity estimates and then the two severities could be parametrically combined.

In short, there is considerable flexibility in how scenarios can be used.

Statement I is therefore correct, and so is statement II as both indicate valid uses of scenarios.

Statement III is not correct because it may be okay to create severity estimates based on scenario data alone.

Statement IV is not correct because while using scenarios as modifiers to other means of estimation is acceptable, that is not the only use of scenarios.

NEW QUESTION: 27

Which of the following was not a policy response introduced by Basel 2.5 in response to the global financial crisis:

- A. Comprehensive Risk Model (CRM)
- B. Comprehensive Capital Analysis and Review (CCAR)
- C. Stressed VaR (SVaR)
- D. Incremental Risk Charge (IRC)

Answer: B (LEAVE A REPLY)

Explanation

The CCAR is a supervisory mechanism adopted by the US Federal Reserve Bank to assess capital adequacy for bank holding companies it supervises. It was not a concept introduced by the international Basel framework.

The other three were indeed rules introduced by Basel 2.5, which was ultimately subsumed into Basel III.

Stressed VaR is just the standard 99%/10 day VaR, calculated with the assumption that relevant market factors are under stress.

The Incremental Risk Charge (IRC) is an estimate of default and migration risk of unsecuritized credit products in the trading book. (Though this may sound like a credit risk term, it relates to market risk - for example, a bond rated A being downgraded to BBB. In the old days, the banking book where loans to customers are held was the primary source of credit risk, but with OTC trading and complex products the trading book also now holds a good deal of credit risk. Both IRC and CRM account for these.) While IRC considers only non-securitized products, the CRM (Comprehensive Risk Model) considers securitized products such as tranches, CDOs, and correlation based instruments.

The IRC, SVaR and CRM complement standard VaR by covering risks that are not included in a standard VaR model. Their results are therefore added to the VaR for capital adequacy determination.

NEW QUESTION: 28

Which of the following is NOT true in respect of bilateral close out netting:

- A. The net amount due is immediately receivable or payable
- B. All transactions are immediately closed out upon the occurrence of a credit event for either of the counterparties
- C. All transactions are netted against each other
- D. Transactions are separated by transaction type and immediately settled separately at each's replacement value

Answer: D (LEAVE A REPLY)

Explanation

Choice 'b', Choice 'c' and Choice 'a' correctly describe a bilateral close out netting as recommended by the ISDA. However Choice 'd' is not correct as it suggests individual

settlement of transactions without netting which is the whole point of bilateral close out netting.

NEW QUESTION: 29

Which of the following is closest to the description of a 'risk functional'?

- A. A risk functional is the distribution that models the severity of a risk
- B. A risk functional is a model distribution that is an approximation of the true loss distribution of a risk
- C. Risk functional refers to the Kolmogorov-Smirnov distance
- D. A risk functional assigns a penalty value for the difference between a model distribution and a risk's severity distribution

Answer: D (LEAVE A REPLY)

Explanation

For operational risk modeling, both frequency and severity distributions need to be modeled. Modeling severity involves finding an analytical distribution, such as log-normal or other that approximates the distribution best represented by known data - whether from the internal loss database, the external loss database or scenario data. A 'risk functional' is a measure of the deviation of the model distribution from the risk's actual severity distribution. It assigns a penalty value for the deviation, using a statistical measure, such as the KS distance (Kolmogorov-Smirnov distance).

The problem of finding the right distribution then becomes the problem of optimizing the risk functional. For example, if F is the model distribution, and G is the actual, or empirical severity distribution, and we are using the KS test, then the Risk Functional R is defined as follows:

The diagram shows the formula $R_{KS}(F, G) = \sup_x |F(x) - G(x)|$ with several annotations. An arrow points from 'F is the model distribution' to F . Another arrow points from 'G is the severity distribution' to G . A third arrow points from 'Absolute of the KS distance' to the absolute value part of the formula. A fourth arrow points from 'For our purposes, sup means the max value' to the $\sup_x$ term. The PRMIA logo is visible in the background.

Note that $\sup_x$ stands for 'supremum', which is a more technical way of saying 'maximum'. In other words, we are calculating the maximum absolute KS distance between the two distributions. (Note that the KS distance is the max of the distance between identical percentiles of the two distributions using the CDFs of the two.) Once the risk functional is identified, we can minimize it to determine the best fitting distribution for severity.

NEW QUESTION: 30

Which of the following describes rating transition matrices published by credit rating firms:

- A.** Expected ex-ante frequencies of migration from one credit rating to another over a one year period
- B.** Probabilities of default for each credit rating class
- C.** Probabilities of ratings transition from one rating to another for a given set of issuers
- D.** Realized frequencies of migration from one credit rating to another over a one year period

Answer: ([SHOW ANSWER](#))

Explanation

Transition matrices are used for building distributions of the value of credit portfolios, and are the realized frequencies of migration from one credit rating to another over a period, generally one year. Therefore Choice 'd' is the correct answer.

Since they represent an actually observed set of values, they are not probabilities nor are they forward looking ex-ante estimates, though they are often used as proxies for probabilities. Choice 'a' and Choice 'c' are not correct. They include more than information on just defaults, therefore Choice 'b' is not correct.

NEW QUESTION: 31

A financial institution is considering shedding a business unit to reduce its economic capital requirements.

Which of the following is an appropriate measure of the resulting reduction in capital requirements?

- A.** Incremental capital for the business unit in consideration
- B.** Proportionate capital for the business unit in consideration
- C.** Percentage of total gross income contributed by the business unit in question
- D.** Marginal capital for the business unit in consideration

Answer: ([SHOW ANSWER](#))

Explanation

Incremental capital (or incremental VaR, depending upon the context), is a measure of the change in the capital (or VaR) requirements if a certain change is made to a portfolio. It uses the 'before' and 'after' approach, ie find out what the capital requirement or VaR will be without the change, and what it will be after the change. The difference is the incremental capital or incremental VaR. It helps measure the change in risk as a result of a particular action, eg a change in a position.

Marginal capital or VaR on the other hand is a method to break down the capital requirement or the VaR so that it can be assigned to individual positions within the portfolio. The total of marginal capital or marginal VaR for all the positions in a portfolio adds up to the total capital requirements or total VaR. Note that marginal VaR is also called component VaR.

Therefore incremental capital is the correct answer to this question. The other choices are incorrect. In the exam, the question may be phrased differently, so try to keep in mind the

different between incremental and marginal capital, which can be a bit confusing given what these terms mean in plain English.

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NEW QUESTION: 32

An assumption regarding the absence of ratings momentum is referred to as:

- A. Ratings stability
- B. Time invariance
- C. Markov property
- D. Herstatt risk

Answer: C (LEAVE A REPLY)

Explanation

Choice 'c' is the correct answer. The Markov property is the assumption that there is no ratings momentum, and that transition probabilities are dependent only upon where the rating currently is and where it is going to.

Where it has come from, or what the past changes in ratings have been, have no effect on the transition probabilities. ('Herstatt risk' refers to settlement risk, and is irrelevant.)

NEW QUESTION: 33

A portfolio has two loans, A and B, each worth \$1m. The probability of default of loan A is 10% and that of loan B is 15%. The probability of both loans defaulting together is 1%.

Calculate the expected loss on the portfolio.

- A. 500000
- B. 250000
- C. 1000000
- D. 240000

Answer: B (LEAVE A REPLY)

Explanation

The easiest way to answer this question is to ignore the joint probability of default as that is irrelevant to expected losses. The joint probability of default impacts the volatility of the losses, but not the expected amount. One way to think about it is to think of asset portfolios, where diversification reduces risk (ie standard deviation) but the expected returns are nothing but the average of the expected returns in the portfolio. Just as the

expected returns of the portfolio are not affected by the volatility or correlations (these affect standard deviation), in the same way the joint probability of default does not affect the expected losses. Therefore the expected losses for this portfolio are simply $\$1\text{m} \times 10\% + \$1\text{m} \times 15\% = \$250,000$.

This can also be seen from the lens of a joint probability distribution as follows:

	Loan A defaults	Loan A survives	
Loan B defaults	1%	14%	15%
Loan B survives	9%	76%	85%
	10%	90%	

There are four possibilities for this portfolio:

- Only loan A defaults: loss of \$1m: 9% probability
- Only loan B defaults: loss of \$1m: 14% probability
- Both loan A and B default: loss of \$2m: 1% probability
- Neither A nor B default: loss of \$0m: 76% probability

Therefore the expected losses on the portfolio are $(\$1\text{m} \times 9\%) + (\$1\text{m} \times 14\%) + (\$2\text{m} \times 1\%) + (\$0\text{m} \times 76\%) = \$250,000$.

(Notes: How is the above table calculated? The totals (10%, 90%, 15% and 85%) are filled in first. The top left cell (both A & B default) is given as 1%. We can now calculate the rest of the cells as the totals are known.)

NEW QUESTION: 34

A bullet bond and an amortizing loan are issued at the same time with the same maturity and with the same principal. Which of these would have a greater credit exposure halfway through their life?

- A. Indeterminate with the given information
- B. They would have identical exposure half way through their lives
- C. The amortizing loan
- D. The bullet bond

Answer: D (LEAVE A REPLY)

Explanation

A bullet bond is a bond that pays coupons covering interest during the life of the bond and the principal at maturity. An amortizing loan pays the interest as well as a part of the principal with every payment. Therefore, the exposure of the amortizing loan continually reduces, and approaches zero towards the end of its life. The bullet bond will always have a higher exposure at any time during its life when compared to an equivalent amortizing loan. Hence Choice 'd' is the correct answer.

NEW QUESTION: 35

Pick underlying risk factors for a position in an equity index option:

- I. Spot value for the index
- II. Risk free interest rate
- III. Volatility of the underlying
- IV. Strike price for the option

- A. I and IV
- B. I, II and III
- C. II and II
- D. All of the above

Answer: B (LEAVE A REPLY)

Explanation

The index option is affected by the spot value for the underlying index, as also the risk free interest rate, or the zero rate for the duration of the option. It is also affected by the volatility of the underlying. The 'strike price' is set and is fixed at the time the option is purchased, and therefore is not a risk factor.

Therefore other than IV, all other choices are valid risk factors that underlie an equity index option.

Other instruments may have other risk factors - for example, a long forex position will have the spot exchange rate as the only risk factor.

NEW QUESTION: 36

The CDS rate on a defaultable bond is approximated by which of the following expressions:

- A. Hazard rate / (1 - Recovery rate)
- B. Loss given default x Default hazard rate
- C. Credit spread x Loss given default
- D. Hazard rate x Recovery rate

Answer: B (LEAVE A REPLY)

Explanation

The CDS rate is approximated by the [Loss given default x Default hazard rate]. Thus Choice 'b' is the correct answer.

Note that this is also equal to the credit spread on the reference bond over the risk free rate. Therefore credit spreads and CDS rates are generally the same. Also, 'loss given default' is nothing but (1 - Recovery rate). This can be substituted in the formula for the credit spread to get an alternative expression that directly refers to the recovery rate. Therefore all other choices are incorrect.

NEW QUESTION: 37

Which of the following statements are true:

I. Pre-settlement risk is the risk that one of the parties to a contract might default prior to the maturity date or expiry of the contract.

II. Pre-settlement risk can be partly mitigated by providing for early settlement in the agreements between the counterparties.

III. The current exposure from an OTC derivatives contract is equivalent to its current replacement value.

IV. Loan equivalent exposures are calculated even for exposures that are not loans as a practical matter for calculating credit risk exposure.

A. II and IV

B. III and IV

C. I, II, III and IV

D. II and III

Answer: C (LEAVE A REPLY)

Explanation

Pre-settlement risk is the risk that one of the counterparties defaults prior to the date for the maturity of the transaction in question. This may be an unrelated default, in fact there may have been no default on that particular contract, but the party may have defaulted on its other obligations, or filed for bankruptcy. To deal with such cases and to protect the interests of both the parties, it is common to provide for immediate termination of positions and settlement based on the current replacement value of the contracts. Therefore statements I and II are correct.

Statement III is correct as well - the exposure from an OTC derivative contract derives from its current replacement value, and not the notional. If the current replacement value is negative, then the credit exposure is considered equal to zero.

Statement IV is correct as it is quite common to restate all exposures - those from credit lines, OTC derivatives etc - in loan equivalent terms prior to estimating credit risk.

NEW QUESTION: 38

The capital adequacy ratio applied to risk weighted assets for the calculation of capital requirements for credit risk per Basel II is:

A. 150%

B. 12.5%

C. 100%

D. 8%

Answer: D (LEAVE A REPLY)

Explanation

The capital adequacy ratio, also called the minimum capital requirement for credit risk per Basel II is 8% of riskweighted assets. The other choices are incorrect.

NEW QUESTION: 39

A cumulative accuracy plot:

- A. is a measure of the correctness of VaR calculations
- B. measures the accuracy of credit risk estimates
- C. measures accuracy of default probabilities observed empirically
- D. measures rating accuracy

Answer: D ([LEAVE A REPLY](#))

Explanation

A cumulative accuracy plot measures the accuracy of credit ratings assigned by rating agencies by considering the relative rankings of obligors according to the ratings given. Choice 'd' is the correct answer.

NEW QUESTION: 40

If the cumulative default probabilities of default for years 1 and 2 for a portfolio of credit risky assets is 5% and 15% respectively, what is the marginal probability of default in year 2 alone?

- A. 15.79%
- B. 10.53%
- C. 10.00%
- D. 11.76%

Answer: B ([LEAVE A REPLY](#))

Explanation

One way to think about this question is this: we are provided with two pieces of information: if the portfolio is worth \$100 to start with, it will be worth \$95 at the end of year 1 and \$85 at the end of year 2. What it is asking for is the probability of default in year 2, for the debts that have survived year 1. This probability is $\$10/\$95 = 10.53\%$. Choice 'b' is the correct answer.

Note that marginal probabilities of default are the probabilities for default for a given period, conditional on survival till the end of the previous period. Cumulative probabilities of default are probabilities of default by a point in time, regardless of when the default occurs. If the marginal probabilities of default for periods 1, 2... n are $p_1, p_2...p_n$, then cumulative probability of default can be calculated as $C_n = 1 - (1 - p_1)(1 - p_2)...(1 - p_n)$. For this question, we can calculate the probability of default for year 2 as $[1 - (1 - 5\%)(1 - 10.53\%)] = 15\%$.

NEW QUESTION: 41

A Bank Holding Company (BHC) is invested in an investment bank and a retail bank. The BHC defaults for certain if either the investment bank or the retail bank defaults. However, the BHC can also default on its own without either the investment bank or the retail bank defaulting. The investment bank and the retail bank's defaults are independent of each other, with a probability of default of 0.05 each. The BHC's probability of default is 0.11. What is the probability of default of both the BHC and the investment bank? What is the probability of the BHC's default provided both the investment bank and the retail bank survive?

- A. 0.0475 and 0.10
- B. 0.11 and 0
- C. 0.08 and 0.0475
- D. 0.05 and 0.0125

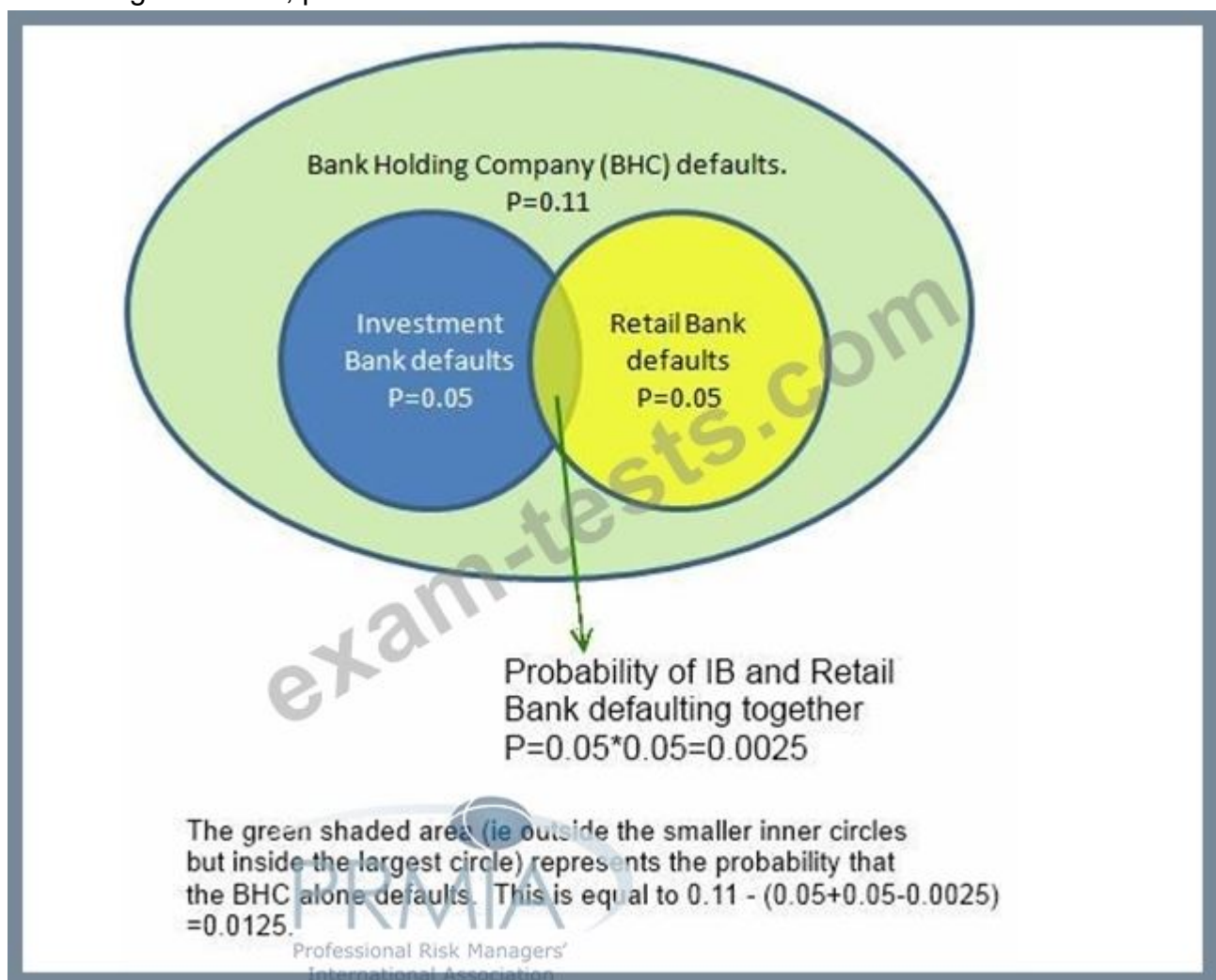
Answer: D ([LEAVE A REPLY](#))

Explanation

Since the BHC always fails when the investment bank fails, the joint probability of default of the two is merely the probability of the investment bank failing, ie 0.05.

The probability of just the BHC failing, given that both the investment bank and the retail bank have survived will be equal to $0.11 - (0.05 + 0.05 - 0.05 \times 0.05) = 0.0125$. (The easiest way to understand this would be to consider a venn diagram, where the area under the largest circle is 0.11, and there are two intersecting circles inside this larger circle, each with an area of 0.05 and their intersection accounting for 0.05×0.05 . We need to calculate the area outside of the two smaller circles, but within the larger circle representing the BHC).

Refer diagram below, please excuse the awful colors.



NEW QUESTION: 42

Which of the following statements are true:

- I. A transition matrix is the probability of a security migrating from one rating class to another during its lifetime.
- II. Marginal default probabilities refer to probabilities of default in a particular period, given survival at the beginning of that period.
- III. Marginal default probabilities will always be greater than the corresponding cumulative default probability.
- IV. Loss given default is generally greater when recovery rates are low.

- A. I and III
- B. I, III and IV
- C. II and IV
- D. I and IV

Answer: C (LEAVE A REPLY)

Explanation

Statement I is incorrect. A transition matrix expresses the probabilities of moving to a given set of ratings at the end of a period (usually one year) conditional upon a given rating at the beginning of the period. It does not make a reference to an individual security and certainly not to the probability of migrating to other ratings during its entire lifetime.

Statement II is correct. Marginal default probabilities are the probability of default in a given year, conditional upon survival at the beginning of that year.

Statement III is incorrect. Cumulative probabilities of default will always be greater than the marginal probabilities of default - except in year 1 when they will be equal.

Statement IV is correct. $LGD = 1 - \text{Recovery Rate}$, therefore a low recovery rate implies higher LGD.

NEW QUESTION: 43

Which of the following statements are correct?

- I. A reliance upon conditional probabilities and a-priori views of probabilities is called the 'frequentist' view
- II. Knightian uncertainty refers to things that might happen but for which probabilities cannot be evaluated
- III. Risk mitigation and risk elimination are approaches to reacting to identified risks
- IV. Confidence accounting is a reference to the accounting frauds that were seen in the past decade as a reflection of failed governance processes

- A. II, III and IV
- B. II and III
- C. I and IV
- D. All of the above

Answer: B (LEAVE A REPLY)

Explanation

In statistics, which is relevant to risk management, a distinction is often drawn between 'frequentists' and

'Bayesians'. Frequentists rely upon data to draw conclusions as to probabilities. Bayesians consider conditional probabilities, ie, take into account what things are already known, and

inject sometimes subjective a-priori probabilities into the calculations. Statement I describes Bayesians, and not frequentists. In reality however, the difference is merely academic. Risk managers use whichever technique best applies to the given situation without making it about ideology.

The difference between 'Knightian uncertainty' and 'Risk' is similarly academic. Knightian uncertainty refers to risk that cannot be measured or calculated. 'Risk' on the other hand refers to things for which past data exists and calculations of exposure can be made. To give an example in the context of the financial world, the risk from a pandemic creating systemic failures from a failure of payment and settlement systems and the like is 'Knightian uncertainty', but the market risk from equity price movements can be modeled (albeit with limitations) and is calculable. Statement II is therefore correct.

Once a risk is identified, it can be mitigated, accepted, avoided or eliminated, or transferred by way of insurance. Therefore statement III is correct.

Confidence accounting is a conceptual idea that suggests that accounting statements make reference to ranges as opposed to point estimates in financial statements. For example, instead of saying that the pension obligation is \$xx million, the company should say the pension obligation is in a range of \$xxm - \$yy m with a certain confidence level. Statement IV is therefore inaccurate.

NEW QUESTION: 44

The Altman credit risk score considers:

- A.** A historical database of the firms that have defaulted
- B.** A quadratic approximation of the credit risk based on underlying risk factors
- C.** A combination of accounting measures and market values
- D.** A historical database of the firms that have survived

Answer: C (LEAVE A REPLY)

Explanation

A computation of Altman's Z-score considers the following ratios:

- Working capital to total assets
- Retained earnings to total assets
- EBIT to total assets
- Market cap to debt
- Sales to total assets

Nearly all the numbers above are accounting measures derived straight from the balance sheet or the income statement. Market capitalization is a market driven number. Therefore Choice 'c' is the correct answer as the Altman credit risk score considers both accounting and market based measures.

Altman's score, though computationally straightforward and intuitively easy to understand, was introduced in the late sixties and has been very accurate in predicting corporate bankruptcies, which is why it continues to be used extensively.

NEW QUESTION: 45

The Basel framework does not permit which of the following Units of Measure (UoM) for operational risk modeling:

- I. UoM based on legal entity
- II. UoM based on event type
- III. UoM based on geography
- IV. UoM based on line of business

- A. I and IV
- B. III only
- C. II only
- D. None of the above

Answer: D ([LEAVE A REPLY](#))

Explanation

Units of Measure for operational risk are homogenous groupings of risks to allow sensible modeling decisions to be made. For example, some risks may be fat-tailed, for example the risk of regulatory fines. Other risks may have finite tails - for example damage to physical assets risk (DPA) may be limited to the value of the asset in the question. Additionally, risk reporting may need to be done at the line of business, legal entity or regional basis, and in order to be able to do, so the right level of granularity needs to be captured in the risk modeling exercise. The level of granularity applied is called the 'unit of measurement' (UoM), and it is okay to adopt all of the choices listed above as the dimensions that describe the unit of measure.

Note that it is entirely possible, even likely, to use legal entity, risk type, region, business and other dimensions simultaneously, though doing so is likely to result in an extremely large number of UoM combinations. That can be addressed by then subsequently grouping the more granular UoMs into larger UoMs, which may ultimately be used for frequency and severity estimation.

NEW QUESTION: 46

Which of the following objectives are targeted by rating agencies when assigning ratings:

- I. Ratings accuracy
- II. Ratings stability
- III. High accuracy ratio (AR)
- IV. Ranked ratings

- A. II and III
- B. III and IV
- C. I and II
- D. I, II and III

Answer: C ([LEAVE A REPLY](#))

Explanation

Rating agencies target both accuracy and stability when they assign ratings. These two objectives can sometimes conflict, so a balance needs to be struck between the two. Rating agencies do not target any particular 'accuracy ratio' or rankings. Therefore Choice 'c' is the correct answer.

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NEW QUESTION: 47

For a back office function processing 15,000 transactions a day with an error rate of 10 basis points, what is the annual expected loss frequency (assume 250 days in a year)

- A. 3750
- B. 0.06
- C. 37500
- D. 375

Answer: A (LEAVE A REPLY)

Explanation

An error rate of 10 basis points means the number of errors expected in a day will be 15 (recall that 100 basis points = 1%). Therefore the total number of errors expected in a year will be $15 \times 250 = 3750$. Choice 'a' is the correct answer.

NEW QUESTION: 48

A corporate bond has a cumulative probability of default equal to 20% in the first year, and 45% in the second year. What is the monthly marginal probability of default for the bond in the second year, conditional on there being no default in the first year?

- A. 3.07%
- B. 2.60%
- C. 15.00%
- D. 31.25%

Answer: A (LEAVE A REPLY)

Explanation

Note that marginal probabilities of default are the probabilities for default for a given period, conditional on survival till the end of the previous period. Cumulative probabilities of default are probabilities of default by a point in time, regardless of when the default occurs. If the

marginal probabilities of default for periods 1, 2... n are $p_1, p_2 \dots p_n$, then cumulative probability of default can be calculated as $C_n = 1 - (1 - p_1)(1 - p_2) \dots (1 - p_n)$.

For this question, we can calculate the marginal probability of default for year 2 by solving the equation $[1 - (1$

$- 20\%)(1 - P_2) = 45\%]$ for P_2 . Solving, we get the marginal probability of default during year 2 as 31.25%.

Since this is the annual marginal probability of default, we will need to convert it to a monthly number, which we can do by solving the following equation where M_1 is the monthly marginal probability of default.

$$1 - 31.25\% = (1 - M_1)^{12}, \text{ implying } M_1 = 3.07\%$$

NEW QUESTION: 49

Which of the following statements are true:

- I. The three pillars under Basel II are market risk, credit risk and operational risk.
- II. Basel II is an improvement over Basel I by increasing the risk sensitivity of the minimum capital requirements.
- III. Basel II encourages disclosure of capital levels and risks

- A. III only
- B. I only
- C. I and II
- D. II and III

Answer: D (LEAVE A REPLY)

Explanation

The three pillars under Basel II are minimum capital requirements, supervisory review process and market discipline. Therefore statement I is false. The other two statements are accurate. Therefore Choice 'd' is the correct answer.

NEW QUESTION: 50

Financial institutions need to take volatility clustering into account:

- I. To avoid taking on an undesirable level of risk
- II. To know the right level of capital they need to hold
- III. To meet regulatory requirements
- IV. To account for mean reversion in returns

- A. II, III and IV
- B. I & II
- C. I, II and III
- D. I, II and IV

Answer: (SHOW ANSWER)

Explanation

Volatility clustering leads to levels of current volatility that can be significantly different from long run averages. When volatility is running high, institutions need to shed risk, and when

it is running low, they can afford to increase returns by taking on more risk for a given amount of capital. An institution's response to changes in volatility can be either to adjust risk, or capital, or both. Accounting for volatility clustering helps institutions manage their risk and capital and therefore statements I and II are correct.

Regulatory requirements do not require volatility clustering to be taken into account (at least not yet).

Therefore statement III is not correct, and neither is IV which is completely unrelated to volatility clustering.

NEW QUESTION: 51

Which of the following is not an event of default covered in the ISDA Master Agreement?

- I. failure to pay or deliver
- II. credit support default
- III. merger without assumption
- IV. Bankruptcy

A. All are considered events of default

B. II and III

C. I

D. IV

Answer: C ([LEAVE A REPLY](#))

Explanation

Note that events of default under the ISDA MA are caused by one of the parties that is considered 'atfault'. In contrast, "termination events" are events for which no one is at fault, for example changes in legislation, illegality etc that still justify termination of the transactions under the contract.

The ISDA MA describes the following 8 types of events of default:

1. failure of pay or deliver
2. breach of agreement
- credit support default
4. misrepresentation
5. default under specified transaction
6. cross default
7. bankruptcy
8. merger without assumption

All of the options presented in the question are events of default.

NEW QUESTION: 52

Which of the following data sources are expected to influence operational risk capital under the AMA:

- I. Internal Loss Data (ILD)
- II. External Loss Data (ELD)

III. Scenario Data (SD)

IV. Business Environment and Internal Control Factors (BEICF)

A. I and II

B. I, II and III only

C. III only

D. All of the above

Answer: D (LEAVE A REPLY)

Explanation

All four data sources are expected to be utilized as inputs as appropriate for operational risk calculations under the advanced measurement approach. Of these, the last one, BEICF, is slightly different from the rest as it does not yield data points that become the basis of curve fitting or other statistical computations underlying capital calculations. It includes items such as KRIs, risk assessments etc and allow the risk manager to assess the qualitative aspects of loss data.

NEW QUESTION: 53

Which of the following are ordered correctly in the order of debt seniority in a bankruptcy situation?

I. Equity, Subordinate debt, Senior debt

II. Senior debt, Preferred stock, Equity

III. Secured debt, Accounts payable, Preferred stock

IV. Secured debt, DIP financing, Equity

A. II and III

B. I and IV

C. I

D. II, III and IV

Answer: A (LEAVE A REPLY)

Explanation

In a bankruptcy, equity ranks last. Preferred equity is one level above equity. Senior debt gets paid out first compared to junior debt, and secured debt is paid out first to the extent of the asset securing it (after which it counts as unsecured debt). Accounts payable and other short term liabilities are treated like unsecured creditors. Debtor-in-possession (DIP) financing ranks higher than any other asset as it is financing secured after the bankruptcy to continue the business.

Based on the above, statement I does not represent a correct ordering of seniority as equity is paid last.

Similarly, DIP financing receives higher priority than even secured debt, and therefore statement IV is incorrect. Therefore the only correct statements are II and III and Choice 'a' is the correct answer.

NEW QUESTION: 54

Which of the following is true in relation to the application of Extreme Value Theory when applied to operational risk measurement?

I. EVT focuses on extreme losses that are generally not covered by standard distribution assumptions II. EVT considers the distribution of losses in the tails III. The Peaks-over-thresholds (POT) and the generalized Pareto distributions are used to model extreme value distributions IV. EVT is concerned with average losses beyond a given level of confidence

A. I and IV

B. II and III

C. I, II and III

D. I, II and IV

Answer: C ([LEAVE A REPLY](#))

Explanation

EVT, when used in the context of operational risk measurement, focuses on tail events and attempts to build a distribution of losses beyond what is covered by VaR. Statements I, II and III are correct. Statement IV describes conditional VaR (CVAR) and not EVT.

Choice 'c' is the correct answer.

NEW QUESTION: 55

A derivative contract has a negative current replacement value. Which of the following statements is true about its loan equivalent value for credit risk calculations over a 2-year horizon?

A. Since the derivatives contract has a negative current replacement value, exposure will be zero.

B. The credit exposure will be a given quintile of the expected distribution of the value of the derivatives contract in the future.

C. The notional value of the derivatives contract should be used for loan equivalence calculations.

D. The current exposure can be used for loan equivalence calculations as that is an unbiased proxy for the future value.

Answer: (SHOW ANSWER)

Explanation

The current exposure is negative, so there is no immediate credit exposure. However, since the price of the derivative is volatile, we can reasonably expect the value to be greater than zero sometime in the future. This is a stochastic variable which will have a distribution, and not just a unique value, in the future that will represent the credit exposure. Since there is no unique value, a conservative approach is to pick a quintile of the distribution, and use that as the future value of the derivative contract, with the assurance that the probability of the credit exposure exceeding that quintile is known and has been consciously selected. This number can then be converted to a loan equivalent

amount for credit risk purposes. Therefore Choice 'b' is the correct answer. Choice 'a', Choice 'd' and Choice 'c' are incorrect for these reasons.

NEW QUESTION: 56

For a bank using the advanced measurement approach to measuring operational risk, which of the following brings the greatest 'model risk' to its estimates:

- A.** Choice of an incorrect distribution for loss event frequencies
- B.** Insufficient number of simulations when building the loss distribution
- C.** Choice of incorrect parameters for loss severity distributions
- D.** Aggregation risk, from selecting an incorrect value of estimated correlations between different operational risk estimates

Answer: D ([LEAVE A REPLY](#))

Explanation

The greatest model risk when calculating operational risk capital comes from incorrect assumptions about correlations between different operational risks for which standalone risk calculations have been made.

Generally, the correlation can be expected to be positive, and would therefore vary between 0 and 1. These two values determine the 'bounds' between which the total operational risk capital would lie, and these bounds are generally quite far apart. Therefore the total value of the operational risk capital is very sensitive to the value chosen for the correlation, and this is the source of the biggest model risk under the AMA.

NEW QUESTION: 57

The probability of default of a security over a 1 year period is 3%. What is the probability that it would not have defaulted at the end of four years from now?

- A.** 11.47%
- B.** 88.53%
- C.** 12.00%
- D.** 88.00%

Answer: B ([LEAVE A REPLY](#))

Explanation

The probability that the security would not default in the next 4 years is equal to the probability of survival raised to the power four. In other words, $= (1 - 3\%)^4 = 88.53\%$. Choice 'b' is the correct answer.

NEW QUESTION: 58

When compared to a low severity high frequency risk, the operational risk capital requirement for a medium severity medium frequency risk is likely to be:

- A.** Zero
- B.** Lower
- C.** Higher

D. Unaffected by differences in frequency or severity

Answer: C (LEAVE A REPLY)

Explanation

High frequency and low severity risks, for example the risks of fraud losses for a credit card issuer, may have high expected losses, but low unexpected losses. In other words, we can generally expect these losses to stay within a small expected and known range. The capital requirement will be the worst case losses at a given confidence level less expected losses, and in such cases this can be expected to be low.

On the other hand, medium severity medium frequency risks, such as the risks of unexpected legal claims,

'fat-finger' trading errors, will have low expected losses but a high level of unexpected losses. Thus the capital requirement for such risks will be high.

It is also worthwhile mentioning high severity and low frequency risks - for example a rogue trader circumventing all controls and bringing the bank down, or a terrorist strike or natural disaster creating other losses - will probably have zero expected losses & high unexpected losses but only at very high levels of confidence. In other words, operational risk capital is unlikely to provide for such events and these would lie in the part of the tail that is not covered by most levels of confidence when calculating operational risk capital.

Note that risk capital is required for only unexpected losses as expected losses are to be borne by P&L reserves. Therefore the operational risk capital requirements for a low severity high frequency risk is likely to be low when compared to other risks that are lower frequency but higher severity.

Thus Choice 'c' is the correct answer.

NEW QUESTION: 59

Which of the following is the best description of the spread premium puzzle:

A. The spread premium puzzle refers to observed default rates being much less than implied default rates, leading to lower credit bonds being relatively cheap when compared to their actual default probabilities

B. The spread premium puzzle refers to dollar denominated non-US sovereign bonds being priced at a significant discount to other similar USD denominated assets

C. The spread premium puzzle refers to AAA corporate bonds being priced at almost the same prices as equivalent treasury bonds without offering the same liquidity or guarantee as treasury bonds

D. The spread premium puzzle refers to the moral hazard implicit in the monoline insurance market

Answer: A (LEAVE A REPLY)

Explanation

Choice 'a' is the correct answer. The other choices represent non-sensical statements.

NEW QUESTION: 60

Concentration risk in a credit portfolio arises due to:

- A.** A high degree of correlation between the default probabilities of the credit securities in the portfolio
- B.** A low degree of correlation between the default probabilities of the credit securities in the portfolio
- C.** Issuers of the securities in the portfolio being located in the same country
- D.** Independence of individual default losses for the assets in the portfolio

Answer: C ([LEAVE A REPLY](#))

Explanation

Concentration risk in a credit portfolio arises due to a high degree of correlation between the default probabilities of the issuers of securities in the portfolio. For example, the fortunes of the issuers in the same industry may be highly correlated, and an investor exposed to multiple such borrowers may face 'concentration risk'.

A low degree of correlation, or independence of individual defaults in the portfolio actually reduces or even eliminates concentration risk.

The fact that issuers are from the same country may not necessarily give rise to concentration risk - for example, a bank with all US based borrowers in different industries or with different retail exposure types may not face practically any concentration risk. What really matters is the default correlations between the borrowers, for example a lender exposed to cement producers across the globe may face a high degree of concentration risk.

NEW QUESTION: 61

Which of the following techniques is used to generate multivariate normal random numbers that are correlated?

- A.** Simulation
- B.** Markov process
- C.** Cholesky decomposition of the correlation matrix
- D.** Pseudo random number generator

Answer: ([SHOW ANSWER](#))

Explanation

A PRNG (pseudorandom number generators of the kind included in statistical packages and Excel) is used to generate random numbers that are not correlated with each other, ie they are random. A Markov process is a stochastic model that depends only upon its current state. Simulation underlies many financial calculations.

None of these directly relate to generating correlated multivariate normal random numbers. That job is done utilizing a Cholesky decomposition of the correlation matrix.

Specifically, a Cholesky decomposition involves the factorization of the correlation matrix into a lower triangular matrix (a square matrix all of whose entries above the diagonal are zero) and its transpose. This can then be combined with random numbers to generate a

set of correlated normal random numbers. This technique is used for calculating Monte Carlo VaR.

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NEW QUESTION: 62

There are three bonds in a diversified bond portfolio, whose default probabilities are independent of each other and equal to 1%, 2% and 3% respectively over a 1 year time horizon. Calculate the probability that none of the three bonds will default.

- A. 94%
- B. 0.11%
- C. 0.0006%
- D. 2%

Answer: A ([LEAVE A REPLY](#))

Explanation

The probability that only none of the three bonds will default is equal to the probability of all surviving. Since default correlation is zero, we can simply multiply the probabilities of survival. Therefore the correct answer is

$$94\% = (1 - 1\%) * (1 - 2\%) * (1 - 3\%)$$

NEW QUESTION: 63

Which of the following statements are true ?

I. Risk governance structures distribute rights and responsibilities among stakeholders in the corporation II. Cybernetics is the multidisciplinary study of cyber risk and control systems underlying information systems in an organization III. Corporate governance is a subset of the larger subject of risk governance IV. The Cadbury report was issued in the early 90s and was one of the early frameworks for corporate governance

- A. I, II and IV
- B. I and IV
- C. II and III
- D. All of the above

Answer: B ([LEAVE A REPLY](#))

Explanation

Governance structures specify the policies, principles and procedures for making decisions about corporate direction. They distribute rights and responsibilities among stakeholders that typically include executive management, employees, the board etc. Statement I is therefore correct.

"Cybernetics is a transdisciplinary approach for exploring regulatory systems, their structures, constraints, and possibilities. In the 21st century, the term is often used in a rather loose way to imply "control of any system using technology" (Wikipedia).

Governance literature has been affected by cybernetics, which is not the same thing as information security or cyber security. Statement II is incorrect.

Corporate governance includes risk governance, and not the other way round. Therefore statement III is incorrect.

The Cadbury Report, titled Financial Aspects of Corporate Governance, was a report issued in the UK in December 1992 by "The Committee on the Financial Aspects of Corporate Governance". The report is eponymous with the chair of the committee, and set out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures. Statement IV is therefore correct.

NEW QUESTION: 64

There are two bonds in a portfolio, each with a market value of \$50m. The probability of default of the two bonds are 0.03 and 0.08 respectively, over a one year horizon. If the probability of the two bonds defaulting simultaneously is 1.4%, what is the default correlation between the two?

- A. 0%
- B. 100%
- C. 40%
- D. 25%

Answer: D (LEAVE A REPLY)

Explanation

Probability of the joint default of both A and B =

Probability of the joint default of both A and B =

$P(A \text{ defaults} \cap B \text{ defaults}) =$

$$(\text{Default Correlation of A\&B}) * \sqrt{(P(A)(1 - P(A))) (P(B)(1 - P(B)))} + P(A)P(B)$$

We know all the numbers except default correlation, and we can solve for it.

$\text{DefaultCorrelation} * \text{SQRT}(0.03 * (1 - 0.03) * 0.08 * (1 - 0.08)) + 0.03 * 0.08 = 0.014.$

Solving, we get default correlation = 25%

NEW QUESTION: 65

Credit exposure for derivatives is measured using

- A. Current replacement value
- B. Notional value of the derivative
- C. Forward looking exposure profile of the derivative

D. Standard normal distribution

Answer: C (LEAVE A REPLY)

Explanation

Current replacement values are a very poor measure of the credit exposure from a derivative contract, because the future value of these instruments is unpredictable, ie is stochastic, and the range of values it can take increases the further ahead in the future we look. Therefore it is common for credit exposures for derivatives to be measured using forward looking exposure profiles, which are distributions of the expected value of the derivative at the time horizon for which credit risk is being measured. To be conservative, a high enough quintile of this distribution is taken as the 'loan equivalent value' of the derivative as the exposure. Choice 'c' is the correct answer.

The notional value of derivative contracts generally tends to be quite high and unrelated to their economic value or the counterparty exposure. Therefore notional value is irrelevant.

NEW QUESTION: 66

The principle underlying the contingent claims approach to measuring credit risk equates the cost of eliminating credit risk for a firm to be equal to:

- A.** the cost of a call on the firm's assets with a strike equal to the value of the debt
- B.** the value of a put on the firm's assets with a strike equal to the value of the debt
- C.** the probability of the firm's assets falling below the critical value for default
- D.** the market valuation of the firm's equity less the value of its liabilities

Answer: B (LEAVE A REPLY)

Explanation

Under the contingent claims approach, a firm will default on its debt when the value of its assets fall to less than the face value of the debt. Debt holders can protect themselves against such an event by buying a put on the assets of the firm, where the strike price is equal to the value of the debt. In other words, Risky Debt + Put on the firm's assets = Risk free debt. This is because if the value of the assets is greater than the value of the debt, they will be paid in full. If the value of the assets is lower than the value of the debt, they will exercise the put and be paid in full.

Therefore the value of the put on the firm's assets with a strike equal to the value of the debt represents the cost of eliminating credit risk. Choice 'b' is the correct answer.

Note that it is improbable that a put on the firm's assets is available in real life to debt holders. However, the same effect can be synthetically achieved by using the shares of the firm as a proxy for its assets, and shorting an appropriate number of shares. Such a synthetic put will require frequent readjustments.

NEW QUESTION: 67

The generalized Pareto distribution, when used in the context of operational risk, is used to model:

- A.** Tail events

- B. Average losses
- C. Unexpected losses
- D. Expected losses

Answer: ([SHOW ANSWER](#))

Explanation

Some risk experts have suggested the use of extreme value theory to model tail risk or extreme events for operational risk. The generalized Pareto model or the Peaks-over-Threshold (POT) model are often used to model extreme value distributions, and therefore Choice 'a' is the correct answer.

NEW QUESTION: 68

The risk that a counterparty fails to deliver its obligation upon settlement while having received the leg owed to it is called:

- A. Pre-settlement risk
- B. Credit risk
- C. Replacement risk
- D. Settlement risk

Answer: D ([LEAVE A REPLY](#))

Explanation

Choice 'd' is the correct answer. Settlement risk, as the name suggests, arises upon settlement when one of the parties delivers its obligation under the transaction and the other does not. Consider a EUR/USD FX forward contract maturing in a month. At maturity, one of the parties will deliver EURs and the other USDs. If one party fails to deliver, then it constitutes a very large risk to the other party. This risk is much larger than pre-settlement risk, because the amount at risk is the entire notional and not just the replacement value. Of course, settlement risk exists for a very short period of time, no more than a number of hours or a day.

There is no such thing as 'replacement risk', and credit risk is a larger category of which settlement risks is one component. Settlement risk is the most appropriate answer.

NEW QUESTION: 69

Which of the following statements is true:

I. Basel II requires banks to conduct stress testing in respect of their credit exposures in addition to stress testing for market risk exposures II. Basel II requires pooled probabilities of default (and not individual PDs for each exposure) to be used for credit risk capital calculations

- A. I
- B. I & II
- C. II
- D. Neither statement is true

Answer: ([SHOW ANSWER](#))

Explanation

The correct answer is choice 'b'

Both statements are accurate. Basel II requires pooled probabilities of default to be applied to risk buckets that contain similar exposures. Also, stress testing is mandatory for both market and credit risk.

NEW QUESTION: 70

Which of the following is not a limitation of the univariate Gaussian model to capture the codependence structure between risk factors used for VaR calculations?

- A.** The univariate Gaussian model fails to fit to the empirical distributions of risk factors, notably their fat tails and skewness.
- B.** Determining the covariance matrix becomes an extremely difficult task as the number of risk factors increases.
- C.** It cannot capture linear relationships between risk factors.
- D.** A single covariance matrix is insufficient to describe the fine codependence structure among risk factors as non-linear dependencies or tail correlations are not captured.

Answer: ([SHOW ANSWER](#))

Explanation

In the univariate Gaussian model, each risk factor is modeled separately independent of the others, and the dependence between the risk factors is captured by the covariance matrix (or its equivalent combination of the correlation matrix and the variance matrix). Risk factors could include interest rates of different tenors, different equity market levels etc.

While this is a simple enough model, it has a number of limitations.

First, it fails to fit to the empirical distributions of risk factors, notably their fat tails and skewness. Second, a single covariance matrix is insufficient to describe the fine codependence structure among risk factors as non-linear dependencies or tail correlations are not captured. Third, determining the covariance matrix becomes an extremely difficult task as the number of risk factors increases. The number of covariances increases by the square of the number of variables.

But an inability to capture linear relationships between the factors is not one of the limitations of the univariate Gaussian approach - in fact it is able to do that quite nicely with covariances.

A way to address these limitations is to consider joint distributions of the risk factors that capture the dynamic relationships between the risk factors, and that correlation is not a static number across an entire range of outcomes, but the risk factors can behave differently with each other at different intersection points.

NEW QUESTION: 71

A bank extends a loan of \$1m to a home buyer to buy a house currently worth \$1.5m, with the house serving as the collateral. The volatility of returns (assumed normally distributed)

on house prices in that neighborhood is assessed at 10% annually. The expected probability of default of the home buyer is 5%.

What is the probability that the bank will recover less than the principal advanced on this loan; assuming the probability of the home buyer's default is independent of the value of the house?

- A. More than 1%
- B. Less than 1%
- C. More than 5%
- D. 0

Answer: B (LEAVE A REPLY)

Explanation

The bank will not be able to recover the principal advanced on this loan if both the home buyer defaults, and the house value falls to less than \$1m, ie the price moves adversely by more than \$500k, which is

$\$500k/\$150k = -3.33$. (Note that 150k is the 1 year volatility in dollars, ie $\$1.5m * 10\%$).

The probability of both these things happening together is just the product of the two probabilities, one of which we know to be 5%. The other is also certainly a small number, and intuitively it is clear that the probability of both the things happening together will be less than 1%.

For a more precise answer, we can calculate the probability of the house price falling by 3.33 standard deviations by calculating the area under the standard normal curve to the left of -3.33. This indeed is a very small number (actually equal to $NORMSINV(-3.33)=0.00043$), which when multiplied by the probability of default of the home buyer at 5% is certainly going to be less than 1%. Therefore Choice 'b' is the correct answer.

NEW QUESTION: 72

Which of the following credit risk models relies upon the analysis of credit rating migrations to assess credit risk?

- A. KMV's EDF based approach
- B. The CreditMetrics approach
- C. The actuarial approach
- D. The contingent claims approach

Answer: B (LEAVE A REPLY)

Explanation

The correct answer is Choice 'b'. The following is a brief description of the major approaches available to model credit risk, and the analysis that underlies them:

1. CreditMetrics: based on the credit migration framework. Considers the probability of migration to other credit ratings and the impact of such migrations on portfolio value.
2. CreditPortfolio View: similar to CreditMetrics, but adds the impact of the business cycle to the evaluation.

3. The contingent claims approach: uses option theory by considering a debt as a put option on the assets of the firm.
4. KMV's EDF (expected default frequency) based approach: relies on EDFs and distance to default as a measure of credit risk.
5. CreditRisk+: Also called the 'actuarial approach', considers default as a binary event that either happens or does not happen. This approach does not consider the loss of value from deterioration in credit quality (unless the deterioration implies default).

NEW QUESTION: 73

The largest 10 losses over a 250 day observation period are as follows. Calculate the expected shortfall at a 98% confidence level:

20m

19m

19m

17m

16m

13m

11m

10m

9m

9m

A. 19.5

B. 14.3

C. 18.2

D. 16

Answer: C ([LEAVE A REPLY](#))

Explanation

For a dataset with 250 observations, the top 2% of the losses will be the top 5 observations. Expected shortfall is the average of the losses beyond the VaR threshold. Therefore the correct answer is $(20 + 19 + 19 + 17 + 16)/5 = 18.2\text{m}$.

Note that Expected Shortfall is also called conditional VaR (cVaR), Expected Tail Loss and Tail average.

NEW QUESTION: 74

Which loss event type is the loss of personally identifiable client information classified as under the Basel II framework?

A. Technology risk

B. Clients, products and business practices

C. Information security

D. External fraud

Answer: B (LEAVE A REPLY)

Explanation

Choice 'b' is the correct answer. All other answers are incorrect.

Refer to the detailed loss event type classification under Basel II (see Annex 9 of the accord). You should know the exact names of all loss event types, and examples of each.

NEW QUESTION: 75

Which of the following is not a risk faced by a bank from holding a portfolio of residential mortgages?

A. The risk that mortgage interest rates will rise in the future

B. The risk that the homeowners will pay the mortgage off before they are due

C. The risk that the homeowners will not be able to pay their mortgage when they are due

D. The risk that CDS spreads on the bank's debt will rise making funding more expensive

Answer: D (LEAVE A REPLY)

Explanation

Choice 'd' represents a risk that does not arise from its holdings of mortgages. Therefore Choice 'd' is the correct answer.

All the other risks identified are correct - the bank faces interest rate, default and prepayment risks on its mortgages.

NEW QUESTION: 76

For a loan portfolio, unexpected losses are charged against:

A. Credit reserves

B. Economic credit capital

C. Economic capital

D. Regulatory capital

Answer: B (LEAVE A REPLY)

Explanation

Credit reserves are created in respect of expected losses, which are considered the cost of doing business.

Unexpected losses are borne by economic credit capital, which is a part of economic capital. This question is a bit nuanced - and 'economic capital' would generally be a good answer as well. However, taking a rather beady eyed view of the terminology and distinguishing between 'economic credit capital' which is a subset of 'economic capital', we can say that 'economic credit capital' is a more appropriate Choice 'a's the question relates to credit losses.

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NEW QUESTION: 77

Which of the following is not a tool available to financial institutions for managing credit risk:

- A. Collateral
- B. Cumulative accuracy plot
- C. Third party guarantees
- D. Credit derivatives

Answer: B (LEAVE A REPLY)

Explanation

Collateral, limits to avoid credit exposure concentrations, termination rights based upon credit ratings, third party guarantees and credit derivatives are all tools or instruments that financial institutions use to manage their credit risk. A cumulative accuracy plot measures the accuracy of ratings, and is not a tool for managing credit risk. Therefore Choice 'b' represents the correct answer.

NEW QUESTION: 78

Which of the following statements is true:

I. Confidence levels for economic capital calculations are driven by desired credit ratings II. Loss distributions for operational risk are affected more by the severity distribution than the frequency distribution III. The Advanced Measurement Approach (AMA) referred to in the Basel II standard is a type of a Loss Distribution Approach (LDA) IV. The loss distribution for operational risk under the LDA (Loss Distribution Approach) is estimated by separately estimating the frequency and severity distributions.

- A. I and II
- B. I, III and IV
- C. I, II and IV
- D. III and IV

Answer: (SHOW ANSWER)

Explanation

Statement I is correct. Economic capital is the capital available to absorb unexpected losses, and credit ratings are also based upon a certain probability of default. Economic capital is often calculated at a level equal to the confidence required for the desired credit rating. For example, if the probability of default for a AA rating is

0.02%, then economic capital maintained at a 99.98% would allow for such a rating.

Economic capital set at a

99.8% level can be thought of as the level of losses that would not be exceeded with a 99.8% probability.

Loss distributions are the product of the severity and frequency distributions, each of which are estimated separately. The total loss distribution is affected far more by the severity distribution than by the frequency distribution, therefore statement II is correct.

The Loss Distribution Approach (LDA) is one of the ways in which the requirements of the AMA can be satisfied, and not the other way round. Therefore statement III is incorrect.

Statement IV is correct as the total loss distribution is estimated using separate estimates of loss frequency and distributions.

NEW QUESTION: 79

When fitting a distribution in excess of a threshold as part of the body-tail distribution method described by the equation below, how is the parameter 'p' calculated.

$$F_T(x) = \begin{cases} p + (1 - p)F_{Tail}(x) & x > T \\ pF_{Body}(x) & x < T \end{cases}$$

Here, $F(x)$ is the severity distribution. $F(Tail)$ and $F(Body)$ are the parametric distributions selected for the tail and the body, and T is the threshold in excess of which the tail is considered to begin.

- A. p is a function of the reporting threshold and determined by the log-likelihood functional
- B. If there are K observations up to the tail threshold, then $p = k/n$
- C. p is a parameter estimated using either the sum of least squares or maximum likelihood estimation
- D. If there are N observations, of which K are up to T , then $p = k/N$

Answer: (SHOW ANSWER)

Explanation

$p = k/N$. If there are N observations of which K are up to T , then $p = k/N$ allows us to have a continuous unbroken curve which gets increasingly weighted towards the distribution selected for the tail as we move towards the 'right', ie the higher values of losses.

The other choices are incorrect and mostly nonsensical.

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