



Free Questions for 8010

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Question 1

Question Type: MultipleChoice

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

Options:

- 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

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.

Question 2

Question Type: MultipleChoice

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

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

Options:

- A- 1 and 2
- B- 2 and 3
- C- 1 and 3
- D- All of the above

Answer:

B

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.

Question 3

Question Type: MultipleChoice

Random recovery rates in respect of credit risk can be modeled using:

Options:

- A- the beta distribution
- B- the omega distribution
- C- the normal distribution
- D- the binomial distribution

Answer:

A

Explanation:

The beta distribution is commonly used to model recovery rates. It is a distribution for variables whose values lie between 0 & 1, and the parameters of the distribution can be estimated using the mean and standard deviation of the data. Therefore Choice 'a' is correct and the others are wrong.

Refer to the tutorial on distributions for an Excel model of the beta distribution.

Question 4

Question Type: MultipleChoice

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?

Options:

- 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

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.

Question 5

Question Type: MultipleChoice

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

1. Ratings accuracy
2. Ratings stability
3. High accuracy ratio (AR)
4. Ranked ratings

Options:

- A- 2 and 3
- B- 3 and 4
- C- 1 and 2
- D- 1, 2 and 3

Answer:

C

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.

Question 6

Question Type: MultipleChoice

Which of the following best describes the concept of marginal VaR of an asset in a portfolio:

Options:

- A- Marginal VaR is the value of the expected losses on occasions where the VaR estimate is exceeded.
- B- Marginal VaR is the contribution of the asset to portfolio VaR in a way that the sum of such calculations for all the assets in the portfolio adds up to the portfolio VaR.
- C- Marginal VaR is the change in the VaR estimate for the portfolio as a result of including the asset in the portfolio.
- D- Marginal VaR describes the change in total VaR resulting from a \$1 change in the value of the asset in question.

Answer:

D

Explanation:

The correct answer is choice 'd'

Marginal VaR is just the change in total VaR from a \$1 change in the value of the asset in the portfolio. All other answers are incorrect. Mathematically, it is expressed as follows, where VaR_p is the VaR for the portfolio, and V_i is the value of the asset in question.

$$MVaR_i = \frac{\delta VaR_p}{\delta V_i}$$

Other answers describe other VaR related concepts such as incremental VaR, Component VaR and Conditional VaR.

Question 7

Question Type: MultipleChoice

Which of the following is not true about the ISDA master agreement (ISDA MA):

Options:

- A- All transactions under the ISDA MA are considered separate obligations
- B- The ISDA MA describes the close out process
- C- The CSA (Credit Support Annex) is one of the parts of the ISDA MA
- D- The ISDA MA describes events of default, and termination events

Answer:

A

Explanation:

The ISDA MA provides a template that can be used by market participants to document derivative transactions. It has a core section that applies always, and various schedules that can be agreed to by the parties. The ISDA MA considerably facilitates closing transactions once the ISDA MA has been negotiated, without requiring a renegotiation each time.

A key feature of the ISDA MA is that it binds all transactions into a single net obligation. The ISDA Master 2002 states that 'All transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties ... and the parties would not otherwise enter into any Transactions.' Therefore transactions under the ISDA MA are not considered separate obligations.

The ISDA MA does indeed define close out processes, default and termination events, and the CSA is one of the parts of the MA that describes the collateral related agreement.

Question 8

Question Type: MultipleChoice

Which of the following statements are true:

1. 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.
2. Pre-settlement risk can be partly mitigated by providing for early settlement in the agreements between the counterparties.
3. The current exposure from an OTC derivatives contract is equivalent to its current replacement value.
4. Loan equivalent exposures are calculated even for exposures that are not loans as a practical matter for calculating credit risk exposure.

Options:

- A- 2 and 4
- B- 3 and 4
- C- 1, 2, 3 and 4
- D- 2 and 3

Answer:

C

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.



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