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Question 1

Question Type: MultipleChoice

If X represents a matrix with ratings transition probabilities for one year, the transition probabilities for 3 years are given by the matrix:

Options:

A- P ^ (-3)

B- P x P x P

C- 3 [P ^ (-1)]

D- 3 [P]

Answer:

B

Explanation:

Assuming time invariance and the Markov property, it is easy to calculate the transition matrix for any time period as P^n, where P is the given transition matrix for one period and n the number of time periods that we need to compute the new transition matrix for. Thus Choice 'b' is the correct answer.

Question 2

Question Type: MultipleChoice

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

Options:

A- Ratings stability

B- Time invariance

C- Markov property

D- Herstatt risk

Answer:

C

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.)

Question 3

Question Type: **MultipleChoice**

Which of the following need to be assumed to convert a transition probability matrix for a given time period to the transition probability matrix for another length of time:

1. Time invariance

2. Markov property

3. Normal distribution

4. Zero skewness

Options:

A- 1, 2 and 4

B- 3 and 4

C- 1 and 2

D- 2 and 3

Answer:

C

Explanation:

Time invariance refers to all time intervals being similar and identical, regardless of the effects of business cycles or other external events. 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.

Rating agencies generally provide transition probability matrices for a given period of time, say a year. The risk analyst may need to convert these into matrices for say 6 months, 2 years or whatever time horizon he or she is interested in. Simplifying assumptions that allow him to do so using simple matrix multiplication include these two assumptions - time invariance and the Markov property. Thus Choice 'c' is the correct answer. The other choices (normal distribution and zero skewness) are non-sensical in this context.

Question 4

Question Type: MultipleChoice

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

Options:

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:

D

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.

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

A cumulative accuracy plot:

Options:

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

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.

Question 7

Question Type: MultipleChoice

Which of the following statements are true:

1. A transition matrix is the probability of a security migrating from one rating class to another during its lifetime.

2. Marginal default probabilities refer to probabilities of default in a particular period, given survival at the beginning of that period.

3. Marginal default probabilities will always be greater than the corresponding cumulative default probability.

4. Loss given default is generally greater when recovery rates are low.

Options:

A- 1 and 3

B- 1, 3 and 4

C- 2 and 4

D- 1 and 4

Answer:

C

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 - Recovery Rate, therefore a low recovery rate implies higher LGD.