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Question 1

All else remaining the same, an increase in the joint probability of default between two obligors causes the default correlation between the two to:

Options:

A- Increase

B- Decrease

C- Stay the same

D- Cannot be determined from the given information

Answer:

A

Explanation:

The default correlation between two obligors goes up if the joint probability of default between them increases. This is intuitive. Also consider the formula for the default correlation between two obligors

Default correlation = [P(1,2) - P1 * P2] / P1*(1-P1)*P2*(1-P2); where P(1,2) is the joint probability of default between the two and P1 and P2 are their individual probabilities of default. Obviously, an increase in P(1,2) will cause the default correlation to increase.

Question 2

Question Type: **MultipleChoice**

For credit risk calculations, correlation between the asset values of two issuers is often proxied with:

Options:

A- Credit migration matrices

B- Transition probabilities

C- Equity correlations

D- Default correlations

Answer:

C

Explanation:

Asset returns are relevant for credit risk models where a default is related to the value of the assets of the firm falling below the default threshold. When assessing credit risk for portfolios with multiple credit assets, it becomes necessary to know the asset correlations of the different firms. Since this data is rarely available, it is very common to approximate asset correlations using equity prices. Equity correlations are used as proxies for asset correlation, therefore Choice 'c' is the correct answer.

Question 3

Question Type: MultipleChoice

If the full notional value of a debt portfolio is $100m, its expected value in a year is $85m, and the worst value of the portfolio in one year's time at 99% confidence level is $60m, then what is the credit VaR?

Options:

A- $40m

B- $25m

C- $60m

D- $15m

Answer:

B

Explanation:

Credit VaR is the difference between the expected value of the portfolio and the value of the portfolio at the given confidence level. Therefore the credit VaR is $85m - $ 60m = $25m. Choice 'b' is the correct answer.

Note that economic capital and credit VaR are identical at a risk horizon of one year. Therefore if the question asks for economic capital, the answer would be the same.

[Again, an alternative way to look at this is to consider the explanation given in III.B.6.2.2: Credit Var = Q(L) - EL where Q(L) is the total loss at a given confidence interval, and EL is the expected loss. In this case Q(L) - $100-$60 = $40, and EL = $100-$85=$15. Therefore Credit VaR = $40-$15=$25.]

Question 4

Under the internal ratings based approach for risk weighted assets, for which of the following parameters must each institution make internal estimates (as opposed to relying upon values determined by a national supervisor):

Options:

A- Probability of default

B- Effective maturity

C- Loss given default

D- Exposure at default

Answer:

A

Explanation:

Regardless of the approach being followed by a bank (ie, whether foundation IRB or advanced IRB), it must make its own estimates for the probability of default. Banks following the foundation IRB approach may use values set by the supervisor for the other three parameters, though those following the advanced IRB approach may use their own estimates for all four inputs. (This is also the difference between advanced IRB and the foundation IRB approaches.) Therefore Choice 'a' is the correct answer.

Also note the four difference elements that go as inputs to the internal ratings based approach in the choices provided.

Question 5

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

Options:

A- 150%

B- 12.5%

C- 100%

D- 8%

Answer:

D

Explanation:

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

Question 6

Question Type: MultipleChoice

Which of the following statements are true:

1. Credit VaR often assumes a one year time horizon, as opposed to a shorter time horizon for market risk as credit activities generally span a longer time period.

2. Credit losses in the banking book should be assessed on the basis of mark-to-market mode as opposed to the default-only mode.

3. The confidence level used in the calculation of credit capital is high when the objective is to maintain a high credit rating for the institution.

4. Credit capital calculations for securities with liquid markets and held for proprietary positions should be based on marking positions to market.

Options:

A- 1 and 3

B- 1, 3 and 4

C- 1 and 2

D- 2 and 3

Answer:

B

Explanation:

Statement I is correct as credit VaR calculations often use a one year time horizon. This is primarily because the cycle in respect of credit related activities, such as loan loss reviews, accounting cycles for borrowers etc last a year.

Statement II is false. There are two ways in which loss assessments in respect of credit risk can be made: default mode, where losses are considered only in respect of default, and no losses are recognized in respect of the deterioration of the creditworthiness of the borrower (which is often expressed through a credit rating transition matrix); and the mark-to-market mode, where losses due to both defaults and credit quality are considered. The default mode is used for the loan book where the institution has lent moneys and generally intends to hold the loan on its books till maturity. The mark to market mode is used for traded securities which are not held to maturity, or are held only for trading.

Statement III is correct. The confidence interval, or the quintile of losses used for maintaining credit ratings tends to be very high as the possibility of the institution's default needs to be remote.

Statement IV is correct too, for the reasons explained earlier.