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RISK MANAGEMENT

IN-HOUSE

CASE STUDY SERIES

-By Sanjay Saraf Sir

Case Study 7 Answers

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CASE STUDY

Multiple Choice Questions

1. B is correct.

VaR measures the frequency of losses of a given minimum magnitude. Here the VaR indicates that on 5% of trading days, the portfolio will experience a loss of at least $6.5 million. (Although C may appear to say the same thing as B, it actually implies that the portfolio will experience a loss on 95% of trading days.) The correct interpretation is that returns will be equal to or greater than −$6.5 million on 95% of trading days; those returns include gains as well as losses.

2. A is correct.

The bank policy requires the addition of forward-looking risk assessments, and management is focused on tail risk. Conditional VaR measures tail risk, and stress tests and scenario analysis subject current portfolio holdings to historical or hypothetical stress events.

3. A is correct.

VaR measures do not capture liquidity risk. "If some assets in a portfolio are relatively illiquid, VaR could be understated, even under normal market conditions. Additionally, liquidity squeezes are frequently associated with tail events and major market downturns, thereby exacerbating the risk.

4. A is correct.

VaR measures the expected amount of capital one can expect to lose within a given confidence level over a given period of time. One of the problems with VaR is that it does not provide information about the expected size of the loss beyond the VaR. VaR is often complemented by the expected shortfall, which measures the expected loss conditional on the loss exceeding the VaR. Note that since expected shortfall is based on VaR, changing the confidence level may change both measures. key difference between the two measures is that VaR is not sub-additive, meaning that the risk of two funds separately may be lower than the risk of a portfolio where the two funds are combined. Violation of the sub-additivity assumption is a problem with VaR that does not exist with expected shortfall.

5. B is correct.

The VaR of this investment can be interpreted as either (1) there is 95% probability that the portfolio will lose no more than $18 million on a given day or (2) there is a 5% probability that the portfolio will lose more than $18 million on a given day.

6. D is correct.

Separate testing creates organizational barriers, making it difficult to integrate insights and perspectives obtained on a bank-wide basis. The other items clearly help to promote the success of stress testing.