Exam : 2016-FRR

Title : Financial Risk and Regulation (FRR) Series

Version : DEMO

1.According to a Moody's study, the most important drivers of the loss given default historically have been all of the following EXCEPT:
I. Debt type and seniority
II. Macroeconomic environment
III. Obligor asset type
IV. Recourse
A. I
B. II
C. I, II
D. III, IV
Answer: D
Explanation:
Key Drivers of Loss Given Default: According to Moody's study, the most important drivers of loss given default (LGD) historically have been debt type and seniority, and the macroeconomic environment. These factors directly impact the severity of losses in the event of default by determining the priority of debt repayments and the overall economic conditions affecting the obligor's ability to recover.
Exclusions: The asset type of the obligor and recourse are not considered primary drivers of LGD in Moody's historical analysis. While they can influence the recovery process, they do not hold the same level of importance as the debt structure and economic conditions.

2.Alpha Bank determined that Delta Industrial Machinery Corporation has 2% change of default on a one-year no-payment of USD $1 million, including interest and principal repayment. The bank charges 3% interest rate spread to firms in the machinery industry, and the risk-free interest rate is 6%. Alpha Bank receives both interest and principal payments once at the end the year. Delta can only default at the end of the year. If Delta defaults, the bank expects to lose 50% of its promised payment.
What interest rate should Alpha Bank charge on the no-payment loan to Delta Industrial Machinery Corporation?
A. 8%
B. 9%
C. 10%
D. 12%
Answer: C
Explanation:
To determine the appropriate interest rate to charge, Alpha Bank needs to cover the risk-free rate, the spread, and the expected loss due to default. The formula used is: Risk-free rate + Spread + (Probability of Default x Loss Given Default). Substituting the given values: 6% (risk-free rate) + 3% (spread) + (0.02 x 0.50) = 6% + 3% + 1% = 10%.

3.Which one of the following four features is NOT a typical characteristic of futures contracts?
A. Fixed notional amount per contract
B. Fixed dates for delivery
C. Traded Over-the-counter only
D. Daily margin calls
Answer: C

Explanation:
Futures contracts have several key characteristics that differentiate them from other types of financial instruments. The features include a fixed notional amount per contract, fixed dates for delivery, and daily margin calls to manage credit risk. Futures are standardized contracts traded on exchanges, not over-the-counter (OTC). OTC trading typically refers to securities or derivatives that are not listed on formal exchanges and are traded directly between parties, which is not a feature of futures contracts.

4.A credit associate extending a loan to an obligor suspects that the obligor may change his behavior after the loan has been originated. The obligor in this case may use the loan proceeds for purposes not sanctioned by the lender, thereby increasing the risk of default. Hence, the credit associate must estimate the probability of default based on the assumptions about the applicability of the following tendency to this lending situation:
A. Speculation
B. Short bias
C. Moral hazard
D. Adverse selection
Answer: C
Explanation:
Moral hazard occurs when one party in a contractual relationship can take risks because the consequences of those risks will be borne by another party. In this scenario, the credit associate is concerned that the obligor might use the loan proceeds for purposes not sanctioned by the lender, thereby increasing the risk of default. This situation is a classic example of moral hazard, where the obligor's behavior after receiving the loan could change in a way that increases the lender's risk without the lender having control over those actions.

5.Which one of the following four statements about hedging is INCORRECT?
A. Traders can hedge their risks by taking an appropriate position in the underlying instrument.
B. Traders can hedge their portfolio risks by taking a position in a different instrument.
C. For a fully hedged portfolio, any changes in markets prices will typically produce significant changes in the market value of the portfolio.
D. A large number of hedge positions is generally required to match the underlying transaction completely.
Answer: C
Explanation:
A fully hedged portfolio is designed to minimize or eliminate the impact of market price changes on the portfolio’s value.
Here are the correct and incorrect statements about hedging:
Correct Statements:
Traders can hedge their risks by taking an appropriate position in the underlying instrument.
Traders can hedge their portfolio risks by taking a position in a different instrument.
A large number of hedge positions is generally required to match the underlying transaction completely.
Incorrect Statement:
For a fully hedged portfolio, any changes in market prices will typically produce significant changes in the market value of the portfolio.

This statement is incorrect because the purpose of hedging is to protect the portfolio from market price changes, hence reducing the impact of such changes on the portfolio's value.
References Source: How Finance Works?