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GARP Financial Risk and Regulation (FRR) Series Sample Questions (Q328-Q333):

NEW QUESTION # 328

Which among the following are shortfalls of the static liquidity ladder model?

- I. The static model gives a liquidity estimate only after the bank faces the liquidity problem.
- II. The static model can only make projections over a few days.
- III. The static model does not incorporate uncertainty in the analysis.

- A. I, II, III
- B. I, II
- C. I, III
- **D. III**

Answer: D

NEW QUESTION # 329

Which one of the four following statements about Basis point values is correct?

Basis point value:

- A. Is a risk sensitivity measure used to measure the point spread risk in the banking book.
- B. Is a widely used statistical tool used to measure market risk.
- C. Provides a quick estimate of the sensitivity of the bank's banking book, to increasing volatility in interest rates.
- **D. Refers to the change in the value of a fixed income position for a very small change yields.**

Answer: D

Explanation:

Basis point value refers to the change in the value of a fixed income position for a very small change in yields. This measure is crucial in understanding the sensitivity of the position to changes in interest rates, which is a fundamental aspect of fixed income securities and interest rate risk management.

NEW QUESTION # 330

Which of the following statements depicts a difference between funding liquidity risks and trading liquidity risks?

- A. Funding liquidity risks are associated with how fast prices move in the market while trading liquidity risks originate out of bank trades.
- B. Funding liquidity risks are short term risks while trading liquidity risks are longer term risks.
- C. Funding liquidity risks are associated only with the bank assets while trading liquidity risks are associated with both assets and liabilities of the bank.
- **D. Funding liquidity risks are concerned with the ability of the bank to fund deposits withdrawals while trading liquidity risks are concerned with the change in bid-offer spreads of asset values.**

Answer: D

Explanation:

Funding liquidity risk and trading liquidity risk are two distinct types of liquidity risks faced by financial institutions, particularly banks.

* Funding Liquidity Risk: This type of risk pertains to a bank's ability to meet its financial obligations as they come due without incurring unacceptable losses. It primarily concerns the bank's ability to fund withdrawals, meet depositor demands, and other liabilities when they come due. If a bank cannot manage its funding liquidity, it may be forced to sell assets at fire sale prices, which can further deteriorate its financial condition.

* Trading Liquidity Risk: This risk, on the other hand, deals with the market liquidity of the bank's assets.

It involves the risk of being unable to buy or sell assets at or near their market value due to inadequate market depth or market disruptions. It is more concerned with the bid-offer spreads and the ability to execute trades without significantly impacting the market price of the asset.

References: Based on the information provided in "How Finance Works" document, funding liquidity risks are concerned with the ability of the bank to fund deposit withdrawals while trading liquidity risks are concerned with the change in bid-offer spreads of asset values.

NEW QUESTION # 331

After one year and spending USD 1.0 million, a bank finally succeeds in recovering USD 10 million on an exposure that, at the time of its default, was valued at USD 20 million. If the recovery discount rate is 10%, what is the estimate of the recovery rate?

- A. 36%
- **B. 41%**
- C. 46%
- D. 31%

Answer: B

Explanation:

Comprehensive and Detailed In-Depth Explanation:

The recovery rate is the percentage of the original exposure recovered, adjusted for the time value of money and recovery costs. Here, the exposure at default (EAD) is USD 20 million, the gross recovery after one year is USD 10 million, and the recovery cost is USD 1 million. The recovery discount rate is 10%, reflecting the time value of money over one year.

Step-by-step calculation:

* Net Recovery Amount: Gross recovery - Recovery costs = USD 10 million - USD 1 million = USD 9 million.

* Present Value of Recovery: Since the recovery occurs after one year, discount the net recovery at 10%:

$PV = \text{USD } 9 \text{ million} / (1 + 0.10) = \text{USD } 9 \text{ million} / 1.1 \# \text{USD } 8.1818 \text{ million.}$

* Recovery Rate: Divide the present value of the recovery by the original exposure: $\text{Recovery Rate} = (\text{USD } 8.1818 \text{ million} / \text{USD } 20 \text{ million}) \times 100 \# 40.91\%$, which rounds to 41%.

This aligns with Basel II/III definitions of Loss Given Default ($LGD = 1 - \text{Recovery Rate}$) and the discounting approach for recovery cash flows in credit risk models.

Reference: BCBS, "Basel II: International Convergence of Capital Measurement and Capital Standards," June 2006, para. 286-287; GARP FRR Study Notes, Credit Risk Section.

NEW QUESTION # 332

Banks duration match their assets and liabilities to manage their interest risk in their banking book. Currently, the bank's assets and liabilities both have a duration of 10. To hedge against the risk of decreasing interest rates, the bank should

- I. Increase the duration of the liabilities
- II. Increase the duration of the assets
- III. Decrease the duration of the liabilities
- IV. Decrease the duration of the assets

- A. I and II.
- B. II and III.
- C. I only.
- **D. I and IV**

Answer: D

Explanation:

To hedge against the risk of decreasing interest rates, a bank should look to reduce the duration of its assets or increase the duration of its liabilities. Decreasing the duration of assets makes them less sensitive to interest rate changes, while increasing the duration of liabilities does the same on the liability side. The bank currently has both assets and liabilities with a duration of 10, so it should decrease the duration of its assets and/or increase the duration of its liabilities to hedge against decreasing interest rates.

NEW QUESTION # 333

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