Risk Management

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Contents

CHAPTER 1

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Risk management is a fundamental aspect of financial decision-making, encompassing various methodologies and measures aimed at quantifying and mitigating the uncertainty inherent in financial markets. Among the diverse array of risk measures employed by market participants, Value at Risk (VaR), credit risk, and counterparty risk hold particular significance. VaR, a widely used metric, provides an estimate of the maximum potential loss that a portfolio or investment may incur over a specified time horizon, at a given confidence level. Credit risk, on the other hand, pertains to the likelihood of default by a borrower or issuer of debt securities, presenting a significant concern for lenders and investors alike. Similarly, counterparty risk arises from the possibility of financial loss resulting from the failure of a counterparty to fulfill its contractual obligations. In this introduction, we explore the key concepts and methodologies associated with VaR, credit risk, counterparty risk, and other risk measures, shedding light on their role in financial risk management and their implications for portfolio optimization and investment decision-making. Understanding these risk measures is crucial for effectively managing risk exposures and safeguarding against adverse market outcomes in the dynamic landscape of modern finance.

1.1. Value at Risk (VaR)

Value at Risk (VaR) is a widely used measure of financial risk. It quantifies the maximum potential loss that a portfolio or investment may suffer over a specified time horizon at a given confidence level.

1.1.1. Calculation Methods.

(i). **Historical Method:** Based on historical returns data, VaR is calculated as a percentile of the historical return distribution.

(ii). **Parametric Method:** Assumes a parametric distribution for asset returns (e.g., normal distribution) and estimates VaR using statistical properties.

(iii). **Monte Carlo Simulation:** Generates multiple scenarios of future asset returns and computes VaR based on the simulated distribution.

Example 1.1 (Interpretation). For example, a VaR of $1 million at the 95% confidence level means that there is a 5% chance that the portfolio will lose more than $1 million over the specified time horizon.

Definition 1.2 (Credit Risk). Credit risk refers to the risk of loss arising from the failure of a borrower to fulfill its contractual obligations. It is prevalent in lending and fixed income investments.

Definition 1.3 (Credit Rating). Credit rating agencies assign credit ratings to issuers of debt securities based on their creditworthiness. Common rating agencies include Standard & Poor's, Moody's, and Fitch Ratings.

1.1.2. Credit Risk Metrics.

(i). **Credit Spread:** The difference in yield between a risky asset and a risk-free asset of similar maturity.

(ii). **Probability of Default (PD):** The likelihood that a borrower will default within a given time frame.

(iii). **Loss Given Default (LGD):** The proportion of a loan's value that is lost if the borrower defaults.

1.2. Counterparty Risk

Counterparty risk, also known as default risk, arises from the possibility that a counterparty in a financial transaction will default on its obligations.

1.2.1. Measuring Counterparty Risk.

(i). **Credit Exposure:** The potential loss that a party to a transaction would incur if the counterparty defaults.

(ii). **Credit Valuation Adjustment (CVA):** The adjustment made to the value of a financial contract to account for counterparty credit risk.

(iii). **Expected Positive Exposure (EPE):** The expected value of future credit exposures over a given period.

1.3. Other Risk Measures

Definition 1.4 (Sharpe Ratio). The Sharpe ratio measures the risk-adjusted return of an investment or portfolio. It is calculated as the excess return of the investment over the risk-free rate divided by the standard deviation of returns.

Definition 1.5 (Beta). Beta measures the sensitivity of an investment's returns to changes in the market return. A beta of 1 indicates that the investment moves in line with the market, while a beta greater than 1 implies higher volatility than the market.

Definition 1.6 (Tracking Error). Tracking error measures the deviation of a portfolio's returns from its benchmark index. It quantifies the risk that an active manager takes in deviating from the benchmark.

Remark 1.7. Various risk measures, such as VaR, credit risk, counterparty risk, Sharpe ratio, beta, and tracking error, help investors and financial institutions assess and manage risks associated with investments and transactions.

1.4. Exercises

(1) Calculate the historical VaR at the 95% confidence level for a portfolio with the following daily returns over the past year:

Date	Daily Return (%)
Day 1	-0.5
Day 2	1.2
Day 3	-0.8
⋮	⋮
Day 250	0.9

(2) Using the same data as above, calculate the 1-day, 5-day, and 10-day historical VaR at the 99% confidence level.

(3) (a). Suppose the returns of a portfolio are normally distributed with a mean return of 0.8% and a standard deviation of 1.5%. Calculate the 1-day parametric VaR at the 95% confidence level.

(b). For the same portfolio, calculate the 1-day parametric VaR at the 99% confidence level.

(4) (a). Given a corporate bond with a yield of 6% and a similar maturity risk-free rate of 3%, calculate the credit spread.

(b). If the credit spread of a bond widens from 2% to 3%, what impact does this have on the bond's price?

(5) (a). Calculate the probability of default (PD) over the next year for a borrower with the following characteristics:

(I). Current credit rating: BBB

(II). Historical default rate for BBB-rated borrowers: 2%

(b). If the borrower in the previous question undergoes a credit rating downgrade to BB, how does this affect their probability of default?

(6) (a). Calculate the credit exposure for a derivative contract with a notional value of $1,000,000 and a current replacement cost of $50,000.

(b). If the potential future exposure (PFE) of the contract is estimated to be $100,000, what is the total credit exposure?

(7) Calculate the credit valuation adjustment (CVA) for a portfolio of derivative contracts with a total notional value of $10 million, a default probability of 1%, and an LGD of 40%.

(8) Calculate the Sharpe ratio for a portfolio with an average annual return of 10% and a standard deviation of returns of 15%. The risk-free rate is 3%.

(9) Calculate the beta of a stock with an average return of 12% and a standard deviation of returns of 18%. The average return of the market is 8%, and its standard deviation of returns is 12%.

(10) Calculate the tracking error of a portfolio with an annualized standard deviation of returns of 12% compared to its benchmark index, which has an annualized standard deviation of returns of 10%.

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