Session 7: Introduction to Value at Risk

1. A fund manager announces that the fund's 1-month 95% VaR is 6% of the size of the portfolio being managed. You have an investment of $100,000 in the fund. How do you interpret the portfolio manager's announcement?

2. Suppose that the change in the value of a portfolio over a 1-day time period is normal with a mean of zero and a standard deviation of $2 million, What is (a) the 1-day 97.5% VaR, (b) the 5-day 97.5% VaR, and (c) the 5-day 99% VaR?

3. What is *market risk?* How does this risk affect the operating performance of financial institutions? What actions can be taken by an FI's management to minimize the effects of this risk?

4. What is *credit risk?* Which types of FIs are more susceptible to this type of risk? Why?

5. What is the difference between *firm-specific credit risk* and *systematic credit risk?* How can an FI alleviate firm-specific credit risk?

6. What is the nature of an off-balance-sheet activity? How does an FI benefit from such activities? Identify the various risks that these activities generate for an FI, and explain how these risks can create varying degrees of financial stress for the FI at a later time.

7. What is the difference between technology risk and *operational risk?* How does internationalizing the payments system among banks increase operational risk?