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20 One-Liners | Value at Risk (VaR): Measuring Market Risk Explained for CAIIB

CAIIB - Revision - Value at Risk (VaR): Measuring Market Risk Explained for CAIIB

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20 One-Liners to Remember

Quick-fire facts for last-minute revision.

- 1 VaR estimates the maximum expected loss on a portfolio over a defined holding period at a given confidence level, under normal market conditions.**

This is the core statistical definition of Value at Risk used in market risk management.

- 2 A one-day 99% VaR of Rs 5 crore means there is only a 1% chance the portfolio loses more than Rs 5 crore in a single day.**

This example shows how a VaR figure is interpreted in plain English.

- 3 Every VaR figure is defined by three parameters: confidence level, holding period, and the base currency and portfolio.**

These three parameters must always be specified for a VaR number to be meaningful.

- 4 A higher confidence level, such as 99% versus 95%, produces a larger and more conservative VaR estimate.**

Raising the confidence level widens the loss threshold the model must cover.

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- 5 VaR indicates the threshold of loss, not the worst case, and says nothing about how bad losses can get beyond that threshold.**

This is a key limitation examiners frequently test in CAIIB Risk Management.

- 6 Expected Shortfall, also called Conditional VaR, measures the average loss in the tail beyond the VaR threshold.**

Expected Shortfall fills the gap that plain VaR leaves unmeasured.

- 7 The Variance-Covariance or Parametric method assumes normally distributed returns and uses volatility and correlations.**

This method is fast but relies on the normality assumption, which fails in market crises.

- 8 The Variance-Covariance method tends to understate tail risk and performs poorly for portfolios with options.**

Its normality assumption misses fat-tail events and option non-linearity.

- 9 Historical Simulation re-prices the portfolio using actual historical returns without assuming a return distribution.**

It naturally captures observed correlations because it uses real past data.

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- 10 Historical Simulation is only as reliable as the historical look-back window chosen for the analysis.**

A short or unrepresentative window can distort the resulting VaR estimate.

- 11 Monte Carlo Simulation generates many random scenarios from modelled distributions and handles non-linear instruments like options well.**

It is the most flexible of the three standard VaR methods.

- 12 Monte Carlo Simulation is computationally heavy and its accuracy depends on the model design chosen.**

Its flexibility comes at the cost of computing power and model risk.

- 13 The Basel framework historically used a 99% confidence level and a 10-day holding period for market risk capital.**

These parameters set the regulatory benchmark for market risk capital charges.

- 14 The square-root-of-time rule scales a 1-day VaR to a 10-day VaR by multiplying by approximately 3.16, the square root of 10.**

This shortcut lets banks convert daily VaR into the regulatory 10-day horizon.

- 15 The square-root-of-time scaling rule assumes portfolio returns are independent and identically distributed.**

This simplifying assumption is a known weakness banks and examiners should flag.

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- 16 A 99% VaR is typically breached on roughly 2-3 trading days a year, while a 95% VaR is breached far more often.**

The confidence level chosen directly affects how frequently actual losses exceed VaR.

- 17 Under the Basel III and FRTB evolution, regulatory focus has been shifting from VaR toward Expected Shortfall to better capture tail risk.**

Expected Shortfall addresses VaR's blindness to losses beyond its threshold.

- 18 Back-testing compares the daily VaR estimate against actual profit and loss to check whether the model is too optimistic.**

Frequent breaches of VaR by actual losses signal a model that understates risk.

- 19 Basel's traffic-light approach classifies VaR models into green, amber, or red zones based on exceptions over 250 trading days.**

More exceptions push a bank's model into stricter zones with higher capital multipliers.

- 20 Because VaR assumes normal markets, banks supplement it with stress testing and scenario analysis for extreme but plausible events.**

Stress testing covers the tail risk that standard VaR models are not designed to capture.

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