

2024 FRM[®]

Exam Prep

SchweserNotes[™]

Financial Markets and Products

PART I BOOK 3

KAPLAN SCHWESER

Book 3: Financial Markets and Products

SchweserNotes™ 2024

FRM Part I

KAPLAN  **SCHWESER**

SCHWESERNOTES™ 2024 FRM® PART I BOOK 3: FINANCIAL MARKETS AND PRODUCTS

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STUDY SESSION 8

27. Banks

Global Association of Risk Professionals. *Financial Markets and Products*. New York, NY: Pearson, 2023. Chapter 1.

After completing this reading, you should be able to:

- a. identify the major risks faced by banks and explain how these risks can arise.
- b. distinguish between economic capital and regulatory capital.
- c. summarize the Basel Committee regulations for regulatory capital and their motivations.
- d. explain how deposit insurance gives rise to a moral hazard problem.
- e. describe investment banking financing arrangements, including private placement, public offering, best efforts, firm commitment, and Dutch auction approaches.
- f. describe the potential conflicts of interest among commercial banking, securities services, and investment banking divisions of a bank, and recommend solutions to these conflict of interest problems.
- g. describe the distinctions between the banking book and the trading book of a bank.
- h. explain the originate-to-distribute banking model and discuss its benefits and drawbacks.

28. Insurance Companies and Pension Plans

Global Association of Risk Professionals. *Financial Markets and Products*. New York, NY: Pearson, 2023. Chapter 2.

After completing this reading, you should be able to:

- a. describe the key features of the various categories of insurance companies and identify the risks facing insurance companies.
- b. describe the use of mortality tables and calculate the premium payments for a policy holder.
- c. distinguish between mortality risk and longevity risk and describe how to hedge these risks.
- d. describe defined benefit plans and defined contribution plans and explain the differences between them.
- e. compare the various types of life insurance policies.
- f. calculate and interpret loss ratio, expense ratio, combined ratio, and operating ratio for a property-casualty insurance company.
- g. describe moral hazard and adverse selection risks facing insurance companies, provide examples of each, and describe how to overcome these risks.
- h. evaluate the capital requirements for life insurance and property-casualty insurance companies.
- i. compare the guaranty system and the regulatory requirements for insurance companies with those for banks.

29. Fund Management

Global Association of Risk Professionals. *Financial Markets and Products*. New York, NY: Pearson, 2023. Chapter 3.

After completing this reading, you should be able to:

- a. differentiate among open-end mutual funds, closed-end mutual funds, and exchange-traded funds (ETFs).
- b. identify and describe potential undesirable trading behaviors at mutual funds.
- c. explain the concept of net asset value (NAV) of an open-end mutual fund and how it relates to share price.
- d. explain the key differences between hedge funds and mutual funds.
- e. calculate the return on a hedge fund investment and explain the incentive fee structure of a hedge fund including the terms hurdle rate, high-water mark, and clawback.
- f. describe various hedge fund strategies including long-short equity, dedicated short, distressed securities, merger arbitrage, convertible arbitrage, fixed income arbitrage, emerging markets, global macro, and managed futures, and identify the risks faced by hedge funds.

- g. describe characteristics of mutual fund and hedge fund performance and explain the effect of measurement biases on performance measurement.

30. Introduction to Derivatives

Global Association of Risk Professionals. *Financial Markets and Products*. New York, NY: Pearson, 2023. Chapter 4.

After completing this reading, you should be able to:

- a. define derivatives, describe the features and uses of derivatives, and compare linear and non-linear derivatives.
- b. describe the specifics of exchange-traded and over-the-counter markets, and evaluate the advantages and disadvantages of each.
- c. differentiate between options, forwards, and futures contracts.
- d. identify and calculate option and forward contract payoffs.
- e. differentiate among the broad categories of traders: hedgers, speculators, and arbitrageurs.
- f. calculate and compare the payoffs from hedging strategies involving forward contracts and options.
- g. calculate and compare the payoffs from speculative strategies involving futures and options.
- h. describe arbitrageurs' strategy and calculate an arbitrage payoff.
- i. describe some of the risks that can arise from the use of derivatives.

31. Exchanges and OTC Markets

Global Association of Risk Professionals. *Financial Markets and Products*. New York, NY: Pearson, 2023. Chapter 5.

After completing this reading, you should be able to:

- a. describe how exchanges can be used to alleviate counterparty risk.
- b. explain the developments in clearing that reduce risk.
- c. define netting and describe a netting process.
- d. describe the implementation of a margining process, explain the determinants of and calculate initial and variation margin requirements.
- e. describe the process of buying stock on margin without using a CCP and calculate margin requirements.
- f. compare exchange-traded and OTC markets and describe their uses.
- g. identify risks associated with OTC markets and explain how these risks can be mitigated.
- h. describe the role of collateralization in the OTC market and compare it to the margining system.
- i. explain the use of special purpose vehicles (SPVs) in the OTC derivatives market.

32. Central Clearing

Global Association of Risk Professionals. *Financial Markets and Products*. New York, NY: Pearson, 2023. Chapter 6.

After completing this reading, you should be able to:

- a. provide examples of the mechanics of a central counterparty (CCP).
- b. describe the role of CCPs and distinguish between bilateral and centralized clearing.
- c. describe advantages and disadvantages of central clearing of OTC derivatives.
- d. explain regulatory initiatives for the OTC derivatives market and their impact on central clearing.
- e. compare margin requirements in centrally cleared and bilateral markets and explain how margin can mitigate risk.
- f. compare netting in bilateral markets vs centrally cleared markets.
- g. assess the impact of central clearing on the broader financial markets.
- h. identify and explain the types of risks faced by CCPs.
- i. identify and distinguish between the risks to clearing members and to non-members.

STUDY SESSION 9

33. Futures Markets

Global Association of Risk Professionals. *Financial Markets and Products*. New York, NY: