

Update

Update for Licensing Examination for Securities and Futures Intermediaries Sample Questions - Paper 9: Derivatives

On pages 25 and 46 of the English version, Question 40 and its explanation are to be replaced by the following:

Question 40

Which of the following statements concerning caps and floors are **CORRECT**?

- I) A lender can buy a cap to hedge a fall in interest rates.
 - II) A borrower can sell a floor to hedge a rise in interest rates.
 - III) A collar eliminates both the upside and downside risks of interest rate movements outside the strike rates.
 - IV) A buy cap can be offset by selling a floor.
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- A I) and III) only.
 - B I) and IV) only.
 - C II), III) and IV) only.
 - D I), II) and III) only.

Question 40 The buyer of a cap will be compensated by the seller if the interest rate rises above the strike rate of the cap. Thus, a borrower can buy a cap to hedge a rise in interest rates. Conversely, the buyer of a floor will be compensated by the seller if the interest rate falls below the strike rate of the floor. Thus, a lender can buy a floor to hedge a fall in interest rates. Based on the nature of caps and floors:

- A lender may hedge a fall in interest rates by purchasing a floor or by selling a cap to gain a premium for funding the potential reduction in interest payments when the interest rate falls. Therefore, I) is incorrect.
- A borrower may hedge a rise in interest rates by purchasing a cap or by selling a floor to gain a premium for funding the potential increase in interest expense when the interest rate rises. Therefore, II) is correct.
- A collar is a combination of a cap and a floor. By combining a cap and a floor, both upside and downside risks can be hedged. Therefore, III) is correct.
- A buy cap premium can be offset by selling a floor premium. Therefore, IV) is correct.

The answer to the question remains to be C.

December 2007