The CAS is providing this advanced copy of the draft syllabus for this exam so that candidates and educators will have a sense of the learning objectives and readings. Please note that the final edition of the 2011 Syllabus of Basic Education will be released in November 2010 and that the 2011 Study Kits will be available in early December 2010. The final version of this syllabus may contain wording clarifications and revised readings based on newer editions of study materials that may be produced or identified between now and then.

Before commencing study for this three-hour examination, candidates should read the “Introduction” to “Materials for Study” in the current Syllabus for important information about learning objectives, knowledge statements, readings, and the range of weights.

Exam 9 focuses on a broad array of finance, investment, and financial risk management topics. This examination assumes a working knowledge of basic ratemaking, finance, probability and statistical modeling, liability and reserve risk, and insurance underwriting. The ability to apply this knowledge and experience may be tested through questions dealing with problems for which there are no generally recognized solutions.

READINGS
There are two main texts: Investments (2009) by Bodie, Kane, and Marcus and Options, Futures and Other Derivatives (2009) by Hull. Investments contains references to various Web sites. Candidates are not responsible for the identity of the Web sites or the actual content of the Web sites except to the extent the content is reproduced in the text. Candidates are also not responsible for any aspect of the Excel applications or the boxes entitled “E-Investments” that are usually placed at or towards the end of a chapter.

While, in general, it is suggested that the candidate cover the learning objectives in the order listed, some references to later chapters in texts may occur before references to earlier chapters. In these cases, the candidate may need to review the earlier chapters first and then return to the learning objectives that reference the later chapters.

For the Financial Risk and Rate of Return exam, the appendices are part of the material covered unless specifically excluded.

There are various numeric tables scattered throughout the readings, illustrating actual observations or hypothetical examples. Candidates are not responsible for the actual numeric values.

BACKGROUND – FINANCIAL MARKETS AND INSTRUMENTS
Candidates may find it helpful to review Chapters 1-5 of Investments for background in financial markets and instruments.
A. Portfolio Theory and Equilibrium in Capital Markets

Range of weight for Section A: 13-17 percent

The portfolio theory portion of this section discusses the relationship between the risk and return for different combinations of risky and risk-free investments and discusses the effect of diversification on this relationship. Candidates are introduced to the manner in which investors might select a particular portfolio, from those available, that best suits their individual preferences for risk and return. In the portion of this section on equilibrium in capital markets, various equilibrium models are presented, including the Capital Asset Pricing Model (CAPM) and Arbitrage Pricing Theory (APT). The concept of market efficiency is presented to help candidates understand the factors that move market prices towards and away from the theoretical prices presented in these models.

<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Explain key concepts of risk:</td>
<td>a. Utility functions, utility scores, and utility maximization</td>
</tr>
<tr>
<td>• Appetite</td>
<td>b. Risk aversion</td>
</tr>
<tr>
<td>• Tolerance</td>
<td>c. Mean-variance criterion</td>
</tr>
<tr>
<td>• Aversion</td>
<td>d. Capital allocation line</td>
</tr>
<tr>
<td>• Measurement</td>
<td>e. Complete portfolio</td>
</tr>
<tr>
<td>• Portfolio construction</td>
<td>f. Reward to variability ratio (Sharpe ratio)</td>
</tr>
<tr>
<td>• Strategies for monitoring</td>
<td></td>
</tr>
<tr>
<td>Range of weight: 0-5 percent</td>
<td></td>
</tr>
</tbody>
</table>

READINGS

BKM, Chapter 6

<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Calculate the expected value, variance, and covariance of returns of asset portfolios in a multi-dimensional setting.</td>
<td>a. Expected return and standard deviation for portfolios of risky and risk-free assets</td>
</tr>
<tr>
<td>Range of weight: 3-7 percent</td>
<td>b. Optimal risky portfolio</td>
</tr>
<tr>
<td></td>
<td>c. Optimal complete portfolio</td>
</tr>
<tr>
<td>3. Explain and demonstrate the efficient frontier (Markowitz) and diversification principles in asset construction.</td>
<td>a. Passive vs. active strategies: costs of active strategy and free-rider benefit</td>
</tr>
<tr>
<td>Range of weight: 3-7 percent</td>
<td>b. Minimum variance frontier</td>
</tr>
<tr>
<td></td>
<td>c. Efficient frontier of risky assets</td>
</tr>
<tr>
<td></td>
<td>d. Optimal capital allocation line</td>
</tr>
<tr>
<td></td>
<td>e. Separation property</td>
</tr>
<tr>
<td></td>
<td>f. Asset allocation vs. security selection</td>
</tr>
<tr>
<td>4. Explain and demonstrate effects of various strategies.</td>
<td>a. Systematic risk</td>
</tr>
<tr>
<td>Range of weight: 0-5 percent</td>
<td>b. Risk pooling</td>
</tr>
<tr>
<td></td>
<td>c. Risk sharing</td>
</tr>
<tr>
<td></td>
<td>d. Insurance principle</td>
</tr>
</tbody>
</table>

READINGS

BKM, Chapter 7
<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
</table>
| 5. Explain the single factor models and compare/contrast with the Markowitz model. Range of weight: 3-7 percent | a. Markowitz model  
b. Single factor model  
c. Single index model  
d. Systematic risk  
e. Alpha, Beta estimating and forecasting  
f. Covariance and correlation estimates for single index model  
g. Risk premiums due to market and non-market factors  
h. Parameter estimation risk  
i. Macroeconomic factors |

**READINGS**

BKM, Chapter 8

<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
</table>
| 6. Explain the assumptions and construction of CAPM and use CAPM to calculate expected returns for risky securities. Range of weight: 3-7 percent | a. CAPM assumptions  
b. Market price of risk  
c. Capital market line  
d. Security market line  
e. Extensions of CAPM  
  • Zero Beta CAPM  
  • CAPM with non-traded assets and labor income  
  • ICAPM  
  • CAPM with liquidity adjustments |

7. Compare/contrast CAPM and single index model and explain the assumptions that are modified under various extensions of CAPM. Range of weight: 0-5 percent | a. CAPM  
b. Single index model  
c. Expected vs. actual returns  
d. Market portfolio vs. market index |

**READINGS**

BKM, Chapter 9

<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
</table>
| 8. Use APT to determine the expected return for a security and compare/contrast with CAPM and factor models. Range of weight: 0-5 percent | a. Arbitrage and the Law of One Price  
b. APT and its comparison to CAPM  
c. Factor betas  
d. Factor portfolios and factor risk premiums  
e. Alternative factors in multifactor models |

**READINGS**

BKM, Chapter 10
LEARNING OBJECTIVES | KNOWLEDGE STATEMENTS
--- | ---
9. Explain market efficiency and its implications for portfolio management, and describe the various tests and studies of market efficiency. | a. Efficient market hypothesis  
b. Random walk  
c. Technical analysis  
d. Fundamental analysis  
e. Passive investment strategy  
f. Portfolio management  

Range of weight: 3-7 percent

READINGS
BKM, Chapter 11

LEARNING OBJECTIVES | KNOWLEDGE STATEMENTS
--- | ---
10. Explain the effect of behavioral finance on market efficiency. | a. Information processing errors  
b. Behavioral biases  
c. Limits to arbitrage  
d. Violations of Law of One Price  
e. Behavioral critique  
f. Technical analysis  

Range of weight: 0-5 percent

READINGS
BKM, Chapter 12

---

**B. Asset-Liability Management**

Range of weight for Section B: 13-17 percent

This section exposes the candidate to factors that influence the price sensitivity of fixed income securities and presents various ways in which a portfolio manager might manage the interest rate and cash flow risk in a portfolio of these instruments. The same concepts are also applied to the interest rate risk associated with a firm’s liabilities and the interest rate risk associated with a firm’s total market value, inclusive of their franchise value.

LEARNING OBJECTIVES | KNOWLEDGE STATEMENTS
--- | ---
1. Explain the different Term Structure Theories. | a. Expectations hypothesis  
b. Liquidity preference theory  
c. Segmentation theory  
d. Forward rate versus expected spot rate  

Range of weight: 0-5 percent

2. Determine U.S. Treasury zero rates at different maturities | a. Bootstrap method for determining zero rates from coupon bonds using both continuous and semi-annual compounding  
b. Determining forward rates from spot rates (zero rates)  
c. Spot rates  
d. Short rates  
e. LIBOR zero rates  
f. Forward Rate Agreements  

Range of weight: 3-7 percent

READINGS
BKM, Chapter 15  
Hull, Chapter 4
LEARNING OBJECTIVES

3. Utilize various strategies to manage interest rate risk and cash flow risk in a bond portfolio.
Range of weight: 3-7 percent

KNOWLEDGE STATEMENTS

a. Duration (Macaulay, modified, and effective)
b. Convexity
c. The effect of interest changes on bond prices
d. Immunization
e. Cash flow matching and dedication
f. Contingent immunization
g. Rebalancing
h. Use of interest rate swaps, mortgage-backed securities, and other derivative securities to alter the interest rate risk for a bond portfolio

READINGS

BKM, Chapter 16
Hull, Sections 4.8 and 4.9, Chapter 7

LEARNING OBJECTIVES

4. Calculate the Macaulay duration of loss reserves and the Macaulay duration of the surplus of a property and casualty (P&C) insurance company.
Range of weight: 0-5 percent

KNOWLEDGE STATEMENTS

a. Macaulay duration
b. Relationship between surplus, asset, and liability durations

READINGS

Feldblum Asset
Noris (excluding Sections I, II, V, and VI)

LEARNING OBJECTIVES

5. Quantify franchise value and demonstrate how it can be effectively managed.
Range of weight: 0-5 percent

KNOWLEDGE STATEMENTS

a. Total economic value
b. Franchise value – magnitude and exposure to interest rate risk (duration)
c. Pricing strategy
d. Advantages of managing the interest rate sensitivity of the firm’s total economic value through pricing strategy

READINGS

Panning

C. Financial Risk Management

Range of weight for Section C: 25-30 percent

This section addresses financial risks as well as risks related to the insurance industry from the financial economics perspective. The concepts and techniques presented in this section are important components in the field of enterprise risk management.
<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Estimate the credit risk due to default and default correlation associated with fixed income securities. Range of weight: 3-7 percent</td>
<td></td>
</tr>
<tr>
<td>a. Default intensity or hazard rate</td>
<td></td>
</tr>
<tr>
<td>b. Unconditional default probability</td>
<td></td>
</tr>
<tr>
<td>c. Expected loss from default</td>
<td></td>
</tr>
<tr>
<td>d. Yield spread</td>
<td></td>
</tr>
<tr>
<td>e. Recovery rate</td>
<td></td>
</tr>
<tr>
<td>f. Relationship between asset volatility and equity volatility.</td>
<td></td>
</tr>
<tr>
<td>g. Merton’s model</td>
<td></td>
</tr>
<tr>
<td>h. Credit ratings transition matrix</td>
<td></td>
</tr>
<tr>
<td>i. Use of Gaussian copula to simulate correlated ratings transitions for two bonds</td>
<td></td>
</tr>
<tr>
<td>j. CreditMetrics approach to estimating credit value at risk</td>
<td></td>
</tr>
<tr>
<td>2. Describe the credit risk in derivatives transactions and various mechanisms to manage the risk. Range of weight: 0-5 percent</td>
<td></td>
</tr>
<tr>
<td>a. Counterparty default risk</td>
<td></td>
</tr>
<tr>
<td>b. Netting</td>
<td></td>
</tr>
<tr>
<td>c. Collateralization</td>
<td></td>
</tr>
<tr>
<td>d. Downgrade triggers</td>
<td></td>
</tr>
</tbody>
</table>

READINGS
Hull, Chapter 22

<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Describe the reasons for the development of credit derivatives market, the valuation of credit derivative contracts, and the complexity of trading credit risks. Range of weight: 3-7 percent</td>
<td></td>
</tr>
<tr>
<td>a. Credit default swaps (CDS)</td>
<td></td>
</tr>
<tr>
<td>b. Mark-to-market</td>
<td></td>
</tr>
<tr>
<td>c. Asset-backed securities (ABS)</td>
<td></td>
</tr>
<tr>
<td>d. Collateralized debt obligation (CDO) and synthetic CDO</td>
<td></td>
</tr>
<tr>
<td>e. The role CDS played in the 2008 financial crisis</td>
<td></td>
</tr>
</tbody>
</table>

READINGS
TBD

<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>4. Describe liquidity risk and various mechanisms to manage the risk. Range of weight: 3-7 percent</td>
<td></td>
</tr>
<tr>
<td>a. Liquidity Risk</td>
<td></td>
</tr>
</tbody>
</table>

READINGS
TBD
<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
</table>
| 5. Discuss the development and the complexity of financial engineering products such as mortgage-backed securities and other forms of securitization. Range of weight: 0-5 percent | a. Effect of securitization on sources of funds for mortgage holders and on interest rate risk retained by the mortgage originators  
b. Mortgage pass-throughs and the effect of mortgage prepayment on cash flows to investors  
c. Collateralized mortgage obligations (CMOs) and the effect of prepayments on cash flows to investors in particular tranches  
d. Market liquidity and credit rating  
e. Lessons from the recent subprime crisis |
| 6. Describe the market for securitizing catastrophe risk in the insurance industry and explain the reasons for its growth. Range of weight: 0-5 percent | a. Products on the market:  
  • Risk-linked securities  
  • CAT bonds  
  • Sidecars  
  • Cat-E-puts  
  • Catastrophe risk swaps  
  • Industry loss warranties  
b. Factors influencing interest in insurance securitization in relation to traditional reinsurance  
c. Factors impeding the growth of the market:  
  • Regulatory  
  • Accounting  
  • Tax  
  • Rating issues |

**READINGS**

BKM, Chapter 1 (pp. 16-17), Chapter 2 (pp. 37-38), and Chapter 16 (Section 16.2)  
Cummins CAT Bond  
TBD
<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
</table>
| 7. Describe various risk measures and the need for practicing sound financial risk management. Range of weight: 3-7 percent | a. Capital structure and risk taking incentives  
 b. Regulation and rating agency  
 c. Limitations of VaR  
 d. Cash flow at risk  
 e. Shortfall risk  
 f. Risk-based capital  
 g. Expected policyholder deficit (EPD)  
 h. Capital associated with a constant EPD ratio  
 i. Risk-adjusted return on capital (RAROC), including alternative measures of income and alternative measures of risk-adjusted capital  
 j. EVA |
| 8. Benefits of Risk Management Range of weight: 0-5 percent | a. Friction Costs, including agency costs and double taxation  
 b. Lessons from past failures due to poor financial risk management |

**READINGS**

- Butsic
- Culp, Miller and Neves (excluding Appendix)
- Cummins Capital
- Goldfarb
- Stulz

<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
</table>
| 9. Describe the concept of economic capital (or risk capital) in the insurance industry and various methods of allocating the risk capital to business units or lines of business. Range of weight: 3-7 percent | a. Financial and insurance risks  
 b. Economical capital or risk capital  
 c. Risk aggregation  
 d. Strengths and weaknesses of the various allocation methods using risk measures such as:  
   - Percentile (VaR)  
   - CTE  
   - EPD Ratio  
   - Merton-Perold method  
   - Insolvency Put/EPD ratio risk measure  
   - Myers-Read method  
   - Co-Measures  
   - Co-CTE |
| 10. Apply the RAROC framework to risk management in the insurance industry. Range of weight: 3-7 percent | a. Economic profit as income measure  
 b. Cost of capital  
 c. RAROC  
 d. Additional risk margin in price  
 e. Multi-period capital commitment |
11. Assess the performance of business units and set prices for insurance policies on a risk-adjusted basis.
   Range of weight: 3-7 percent
   a. Economic profit as income measure
   b. Cost of capital
   c. RAROC
   d. Additional risk margin in price
   e. Multi-period capital commitment

D. Rate of Return, Risk Loads, and Contingency Provision

Range of weight for Section D: 35-40 percent

This section explores the relationship between insurance concepts (such as underwriting profits, premium-to-surplus ratios, and investment income) and financial concepts (such as interest rates, inflation rates, cost of capital, and risk premiums). The readings build on a background of finance as related to the insurance business, and deal with specific techniques used by actuaries to develop an appropriate profit loading in insurance prices.

Because insurance claims are fortuitous, the expected profit loaded in rates may not be realized. The models discussed in Learning Objectives 1 and 2 assume that insured events are predictable in time and amount. Learning Objective 3 addresses the consideration required when insured events are uncertain, particularly where capacity is limited and/or sufficient diversification of exposure is impossible.

<table>
<thead>
<tr>
<th>LEARNING OBJECTIVES</th>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
</table>
| 1. Analyze rate of return. | a. Composition of surplus  
Range of weight: 10-15 percent | b. Measures of return including ROE, underwriting profit, Internal Rate of Return (IRR)  
• Advantages  
• Disadvantages  
• Perspectives of users  
c. Sources and types of data used for analysis including calendar year versus accident year |
| 2. Estimate a rate in order to achieve a target rate of return. | a. Composition of surplus  
Range of weight: 10-15 percent | b. Measures of return (including ROE, underwriting profit, and IRR)  
c. Sources and types of data used for analysis including calendar year versus accident year |

READINGS

Feldblum Financial  
Ferrari  
McClenahan  
Robbin  
Roth
LEARNING OBJECTIVES

<table>
<thead>
<tr>
<th>KNOWLEDGE STATEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Theory underlying the risk load</td>
</tr>
<tr>
<td>b. Purpose of a risk load</td>
</tr>
<tr>
<td>c. Relationship between risk load and variability</td>
</tr>
</tbody>
</table>

3. Determine risk load and contingency provision to be included in insurance rates.
   Range of weight: 10-15 percent

READINGS

Bault
Feldblum Financial
Ferrari
Kreps
Mango
Roth

Complete Text References for Exam 9

Text references are alphabetized by the citation column.

<table>
<thead>
<tr>
<th>Citations</th>
<th>Abbreviation</th>
<th>Learning Objective</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bodie, Z.; Kane, A.; and Marcus, A.J., <em>Investments</em> (Eighth Edition), McGraw-Hill/Irwin, 2009. Chapter or section citations are listed under the appropriate learning objective, and include Chapters 1 (p.16-17), 2 (p.37-38), 6-12, 15, 16, and 18.</td>
<td>BKM</td>
<td>A1-15, B1-3, 5-6</td>
<td>L</td>
</tr>
<tr>
<td>Citations</td>
<td>Abbreviation</td>
<td>Learning Objective</td>
<td>Source</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>--------------</td>
<td>-------------------</td>
<td>--------</td>
</tr>
<tr>
<td>Feldblum, S., “Pricing Insurance Policies: The Internal Rate of Return Model,” CAS Study Note, May 1992. Only Sections 1, 3, and 6 will be directly tested, but the other sections may provide useful background.</td>
<td>Feldblum Financial</td>
<td>D1-3</td>
<td>W</td>
</tr>
<tr>
<td>Hull, J.C., <em>Options, Futures, and Other Derivatives</em> (Seventh Edition), Prentice Hall, 2009. Chapter or section citations are listed under the appropriate learning objective, and include Chapters 2-5, 7-13, 16, and 22.</td>
<td>Hull</td>
<td>B1-3, C1-3</td>
<td>L</td>
</tr>
</tbody>
</table>
Source Key

L May be purchased from the publisher or bookstore or borrowed from the CAS Library.

SK Represents material included in the 2011 CAS Study Kit.

W Represents material in the 2011 Web Notes that is available at no charge from the “Study Tools” section of the CAS Web Site. A printed version may be purchased from the CAS Online Store.

Publishers and Distributors

Contact information is furnished for those who wish to purchase the text references cited for Exam 9. Publishers and distributors are independent and listed for the convenience of candidates; inclusion does not constitute endorsement by the CAS.

ACTEX Publications (Mad River Books), 107 Groppo Drive, Suite A, P.O. Box 974, Winsted, CT 06098; telephone: (800) 282-2839 or (860) 379-5470; fax: (860) 738-3152; e-mail: retail@actexmadriver.com; Web site: www.actexmadriver.com.

Actuarial Bookstore, P.O. Box 69, Greenland, NH 03840; telephone: (800) 582-9672 (U.S. only) or (603) 430-1252; fax: (603) 430-1258; Web site: www.actuarialbookstore.com.

American Risk and Insurance Association, 716 Providence Road, Malvern, PA 19355; telephone: (610) 640-1997; Web site: aria@cpcuia.org.


Casualty Actuarial Society E-Forum, Forum, PCAS, and Discussion Paper Program, Casualty Actuarial Society, 4350 N. Fairfax Drive, Suite 250, Arlington, VA 22203; telephone: (703) 276-3100; fax: (703) 276-3108; e-mail: office@casact.org; Web site: www.casact.org.


Journal of Risk and Insurance, The, American Risk and Insurance Association, 716 Providence Road, P.O. Box 3028, Malvern, PA 19355; telephone: (610) 640-1997; fax: (610) 725-1007; Web site: www.aria.org.

McGraw-Hill/Irwin, 860 Taylor Station Road, Blacklick, OH 43004; telephone: (800) 262-4729.

SlideRule Books, P.O. Box 69, Greenland, NH 03840; telephone: (877) 407-5433 or (603) 373-6140; fax: (877) 417-5433 or (603) 430-1258; Web site: www.sliderulebooks.com.