

QFI – Quantitative Finance Exam

Spring 2021/Fall 2021

Important Exam Information:

[Exam Registration](#)

Candidates may register online or with an application.

[Order Study Notes](#)

Study notes are part of the required syllabus and are not available electronically but may be purchased through the online store.

Syllabus Readings

Readings listed in this syllabus may include study notes, online readings and textbooks. Candidates are responsible for all readings in their entirety, including sections such as Appendices, unless it is stated otherwise in the syllabus.

[Introductory Study Note](#)

The Introductory Study Note has a complete listing of all study notes as well as errata and other important information.

Case Study

A case study will not be used for this examination.

[Past Exams](#)

Past Exams from 2000-present are available on SOA website.

[Updates](#)

Candidates should be sure to check the Updates page on the exam home page periodically for additional corrections or notices.

[Formula Package](#)

A Formula Package will be provided with the exam. Please see the Introductory Study Note for more information.

[Table](#)

A Cumulative normal distribution table will be provided with the exam.

1. Topic: Stochastic Calculus

Learning Objectives

The candidate will understand the foundations of quantitative finance.

Learning Outcomes

The Candidate will be able to:

- a) Understand and apply concepts of probability and statistics important in mathematical finance
- b) Understand the importance of the no-arbitrage condition in asset pricing
- c) Understand the Ito integral and stochastic differential equations
- d) Understand and apply Ito's Lemma
- e) Understand the Black-Scholes-Merton PDE (partial differential equation)
- f) Understand and apply Jensen's Inequality
- g) Understand the distinction between complete and incomplete markets
- h) Define and apply the concepts of martingale, market price of risk, and measures in single and multiple state variable contexts
- i) Demonstrate understanding of the differences and implications of real-world versus risk-neutral probability measures, and when the use of each is appropriate
- j) Understand and apply Girsanov's theorem in changing measures
- k) Understand the importance of the Feynman-Kac Theorem

Resources

- *An Introduction to the Mathematics of Financial Derivatives*, Hirta, Ali and Neftci, Salih N., 3rd Edition 2nd Printing, 2014
 - Ch. 1-15 (excluding section 8.2.4)

Note: Candidates should verify that their copy of the Hirta & Neftci textbook is the 3rd edition, second printing by checking that page iv, *Notices* section, begins with "Knowledge and best practice in this field...". If the *Notices* section begins "No responsibility is assumed..." it is the first printing and should be replaced.
- QFIQ-113-17 *Frequently Asked Questions in Quantitative Finance*, Wilmott, Paul, 2nd Edition, 2009, Ch. 2, pp. 103-105, 109-115, 155-161 and 248-249
- *Problems and Solutions in Mathematical Finance: Stochastic Calculus*, Chin, Eric, Nel, Dian and Olafsson, Sverrir, 2014

Note: Candidates should study the following problems in Chin, Nel, and Ólafsson alongside the matching chapters of *An Introduction to the Mathematics of Financial Derivatives*, Hirta and Neftci to reinforce the standard techniques used in stochastic calculus. Please note that formulas from Chin, Nel, and Ólafsson are not included in the formula package.

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Chin et al. Chapter	Pages	Item	Corresponding Hirta & Neftci Chapter sections
1	1 to 3	Definitions 1.1 to 1.7 (Note that statement (b) of Definition 1.7 involves integration using a measure-theoretic approach. An equally valid statement can be made using a Riemann-Stieltjes integral for continuous distributions or a sum for discrete distributions.)	5.2
	4 to 5	Q3 to Q7	5.2
	18 to 19	Q7	15.4.1
	43 to 44	Q4	14.2.2
	43 to 44	Q5	Pg. 245 paragraph containing equations from (14.91) - (14.93)
2	52	Definitions 2.1, 2.2	8.2.1
	52	Theorems 2.3 and 2.4	5.8
	52	Definitions 2.5 and 2.6	2.2.9, 6.2
	55 to 57	Q1 to Q3	6.4.1
	57 to 68	Q4 to Q13, except Q11	8.2.1
	68 to 71	Q1, Q2, Q3	***
	71	Q1	6.6.1
	72	Q2	6.6.2
3	96 to 97	Theorem 3.2	10.4
	97 to 98	Theorem 3.3	21.4
	99 to 100	Definition 3.6	10.4
	112	Q13	First part is different approach to part of question #12 in pg. 64
	123 to 149	Q1 to Q20 In Q13 the variance should be $t/(1-t)$	10.5
	155 to 158	Q1 to Q3	10.7
	175 to 178	Q10	10.7
4	186 to 187	Definitions 4.1(a) - (f)	H&N Introduces self-financing portfolios in 6.11.3 and goes into detail in 12.3
	189	Theorem 4.6	14.3
	192 to 194	Q1	6.11 and exercise 1 in pg. 109
	192 to 194	Q2	6.11 and exercise 4 in pg. 110
	194 to 197	Q1 to Q3	14.3
	221 to 242	Q1 to Q17	15
5	262 to 264	Q9 to Q11	5.5.5, 8.2.2
	281 to 285	Q1, Q2	Chapter 11: section on pure jump framework

*** means there is no direct correspondence

2. Topic: Fixed Income Markets
Learning Objectives
The candidate will understand the fundamentals of fixed income markets and traded securities.
Learning Outcomes
The Candidate will be able to: <ul style="list-style-type: none">a) Understand the characteristics of fixed rate, floating rate, and zero-coupon bondsb) Bootstrap a yield curvec) Understand measures of interest rate risk including duration, convexity, slope, and curvatured) Understand the characteristics and uses of interest rate forwards, swaps, futures, and options
Resources
<ul style="list-style-type: none">• <i>Fixed Income Securities: Valuation, Risk, and Risk Management</i>, Veronesi, Pietro, 2010<ul style="list-style-type: none">○ Ch. 1○ Ch. 2○ Ch. 3 (excluding Appendix)○ Ch. 4○ Ch. 5 (excluding Case Study)○ Ch. 6• QFIQ-121-20: A Guide to Duration, DV01, and Yield Curve Risk Transformations, pp. 1-28

3. Topic: Interest Rate Models and Hedging

Learning Objectives

The candidate will understand:

- The quantitative tools and techniques for modeling the term structure of interest rates.
- The standard yield curve models.
- The tools and techniques for managing interest rate risk.

Learning Outcomes

The Candidate will be able to:

- a) Understand and apply the concepts of risk-neutral measure, forward measure, normalization, and the market price of risk, in the pricing of interest rate derivatives
- b) Understand and apply various one-factor interest rate models
- c) Calibrate a model to observed prices of traded securities
- d) Describe the practical issues related to calibration, including yield curve fitting
- e) Demonstrate understanding of option pricing theory and techniques for interest rate derivatives
- f) Apply the models to price common interest sensitive instruments including: callable bonds, bond options, caps, floors and swaptions
- g) Understand and apply the techniques of interest rate risk hedging
- h) Understand the application of Monte Carlo simulation to risk neutral pricing of interest rate securities
- i) Understand the implications of replacing LIBOR with alternative reference rates
- j) Understand and apply the Heath-Jarrow-Morton approach including the LIBOR Market model
- k) Understand and apply multifactor interest rate models
- l) Demonstrate an understanding of the issues and approaches to building models that admit negative interest rates

Resources

- *An Introduction to the Mathematics of Financial Derivatives*, Hirta, Ali and Neftci, Salih N., 3rd Edition 2nd Printing, 2014
 - Ch. 16-21
- *Fixed Income Securities: Valuation, Risk, and Risk Management*, Veronesi, Pietro, 2010
 - Ch. 14
 - Ch. 15 (excluding Appendix)
 - Ch. 16 (including Case Study, excluding Appendix)
 - Ch. 17
 - Ch. 18 (excluding Appendix)
 - Ch. 19 (excluding Appendix)

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- Ch. 20
- Ch. 21 (excluding Appendix)
- Ch. 22.1-22.4
- QFIQ-116-17: Low Yield Curves and Absolute/Normal Volatilities
- QFIQ-129-21: Negative Interest Rates and Their Technical Consequences, AAE, 12/2016
- QFIQ-130-21: Interest Rate Models – Theory and Practice, Second Edition, Brigo, Damiano and Mercurio, Fabio, 2006, sections 4.2.1, 4.2.2, and 4.2.5 only
- QFIQ-131-21: Beyond LIBOR: A Primer on the New Reference Rates, BIS, March 2019

4. Topic: Equity Option Pricing and Hedging

Learning Objectives

The candidate will understand:

- How to apply the standard models for pricing financial derivatives.
- The implications for option pricing when markets do not satisfy the common assumptions used in option pricing theory.
- How to evaluate risk exposures and the issues in hedging them.

Learning Outcomes

The Candidate will be able to:

- a) Demonstrate an understanding of option pricing techniques and theory for equity derivatives
- b) Identify limitations of the Black-Scholes-Merton pricing formula
- c) Demonstrate an understanding of the different approaches to hedging – static and dynamic
- d) Demonstrate an understanding of how to delta hedge, and the interplay between hedging assumptions and hedging outcomes
- e) Analyze the Greeks of common option strategies
- f) Appreciate how hedge strategies may go awry
- g) Describe and explain some approaches for relaxing the assumptions used in the Black-Scholes-Merton formula
- h) Compare and contrast the various kinds of volatility, e.g., actual, realized, implied and forward, etc.
- i) Define and explain the concept of volatility smile and some arguments for its existence
- j) Compare and contrast “floating” and “sticky” smiles
- k) Describe and contrast several approaches for modeling smiles, including stochastic volatility, local-volatility, jump-diffusions, variance-gamma, and mixture models
- l) Explain various issues and approaches for fitting a volatility surface

Resources

- *The Volatility Smile*, Derman, Emanuel and Miller, Michael B., 2016
 - Ch. 1 (background)
 - Ch. 2-11
 - Ch. 14
 - Ch. 17-19
- QFIQ-114-17: Chapter 2, pp. 162-173 and 223-225, of *Frequently Asked Questions in Quantitative Finance*, Wilmott, Paul, 2nd Edition, 2009
- QFIQ-115-17: Which Free Lunch Would You Like Today, Sir?: Delta Hedging, Volatility Arbitrage and Optimal Portfolios

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- QFIQ-120-19: Chapters 6 and 7 of *Pricing and Hedging Financial Derivatives*, Marroni, Leonardo and Perdomo, Irene, 2014

5. Topic: Applications
Learning Objectives
The candidate will learn how to apply the techniques of quantitative finance to applied business contexts.
Learning Outcomes
The Candidate will be able to: <ol style="list-style-type: none">Identify and evaluate embedded options in liabilities, specifically indexed annuity and variable annuity guarantee riders (GMAB, GMDB, GMWB, and GMIB)Demonstrate an understanding of embedded guarantee risk including market, insurance, policyholder behavior, and basis riskDemonstrate an understanding of dynamic and static hedging for embedded guarantees, including:<ol style="list-style-type: none">Risks that can be hedged, including equity, interest rate, volatility and cross GreeksRisks that can only be partially hedged or cannot be hedged including policyholder behavior, mortality and lapse, basis risk, counterparty exposure, foreign bonds and equities, correlation and operational failuresDemonstrate an understanding of target volatility funds and their effect on guarantee cost and risk controlDemonstrate an understanding of how differences between modeled and actual outcomes for guarantees affect financial results over time
Resources
<ul style="list-style-type: none">QFIQ-122-20: Equity Indexed Annuities: Downside Protection, But at What Cost?QFIQ-124-20: Variable Annuity Volatility Management: An Era of Risk-ControlQFIQ-132-21: Investment Instruments with Volatility Target Mechanism, Albeverio, Steblovskaya, and Wallbaum, 2013QFIQ-126-20: Malcolm Life Enhances its Variable AnnuitiesQFIQ-128-20: Mitigating Interest Rate Risk in Variable Annuities: An Analysis of Hedging Effectiveness under Model RiskQFIQ-133-21: IAA, Stochastic Modeling, Theory and Reality from an Actuarial Perspective, Section IV.A.1-8On the Importance of Hedging Dynamic Lapses in Variable Annuities, Risk and Rewards, Aug 2015Hedging Variable Annuities: How Often Should the Hedging Portfolio be Rebalanced?, Risks and Rewards, Feb 2018