

Backtesting Value-at-Risk: A Duration-Based Approach

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Abstract

Financial risk model evaluation or backtesting is a key part of the internal model's approach to market risk management as laid out by the Basle Committee on Banking Supervision. However, existing backtesting methods have relatively low power in realistic small sample settings. Our contribution is the exploration of new tools for backtesting based on the duration of days between the violations of the Value-at-Risk. Our Monte Carlo results show that in realistic situations, the new duration-based tests have considerably better power properties than the previously suggested tests.

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