FRM Part I Exam

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Questions - Foundations of Risk Management

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Reading 1: The Building Blocks of Risk Management

Q.1 Which of the following liquidity definitions is most likely associated with market liquidity?

A. The risk that a bank will not be able to roll over a repo to finance their short-term cash flow needs.

B. The risk that depositors will flock into banks and withdraw their funds or that shareholders will redeem their shares en masse.

C. The risk that the collateral value of an asset will decline after a derivative position is established, resulting in an increase in the margin requirement.

D. The risk that an investor who lends out an asset will be forced to sell at a lower price once the asset is returned.

Q.2 Which of the following is NOT a type of market risk?

A. Interest rate risk

B. Foreign exchange risk

C. Equity price risk

D. Liquidity risk

Q.3 After the United Kingdom voted to leave the European Union in 2016, the British pound weakened against other currencies like the U.S dollar and the Chinese Yuan. Which one of the following risks best explains this observation?

A. Interest rate risk

B. Foreign exchange risk

C. Reputation risk

D. Equity risk

Q.4 Which of the following is not an example of operational risk?

A. Inadequate/malfunctioning computer systems

B. Circumvention of issued regulations and guidelines

C. Occurrence of a natural disaster, such as a tornado

D. An increase in the price of gas

Q.5 Which of the following best describes enterprise-wide risk management?

A. Applying risk management within individual departments on a piecemeal basis.

B. Risk management that includes all major departments in a company.

C. A structured and consistent set of principles or risk management that are applied across the whole of a company.

D. Risk management that encompasses all business units.

Q.6 Which of the following is the correct definition of risk management in the context of financial markets?

A. The practice of creating economic value by identifying and investing in risky projects that could earn a profit.

B. The practice of avoiding an extremely risky financial undertaking to prevent a loss.

C. The practice of creating economic value by identifying and measuring risks, and formulating robust plans to address and manage these risks.

D. Setting risk limits beyond which an entity should not operate.

Q.7 Tohonday, a motor vehicle production company, has historically channeled most of its earnings and spare cash into short-term government bonds maturing in less than a year. The board wishes to change its investment policy substantially and intends to tap the riskier but more profitable long-term bond market. Assuming you're the risk manager for the company, which of the following risks would be of utmost (immediate) concern from an operational point of view?

A. Trading liquidity risk

B. Funding liquidity risk

C. Interest rate risk

D. Market risk

Q.8 Distinguish between expected loss and unexpected loss.

A. Expected loss is the average credit loss we expect from an exposure while unexpected loss is the loss that occurs over and above the expected loss.

B. Unexpected loss is the average credit loss we expect from an exposure while expected loss is the loss that occurs over and above the unexpected loss.

C. Expected loss is the average credit loss that we would expect from an exposure while unexpected loss is the loss that would occur without a quantitative expression.

D. Expected loss is the average credit loss that we would expect from an exposure while unexpected loss is the sum of expected losses from several time periods.

Q.9 Which of the following statements best explains the relationship between investment risk and reward?

A. As the investment risk increases, the reward decreases.

B. As the investment risk decreases, the reward increases.

C. As the investment risk increases, the potential for reward increases.

D. The relation between investment risk and reward depends on the financial product.

Q.10 Which of the following risks does not fall under the larger category of credit risk?

A. Settlement risk

B. Downgrade risk

C. Upward risk

D. Default risk

Q.11 Which of the following combinations correctly matches a quantifiable risk with a non-quantifiable (qualitative) risk?

A. Quantifiable: Interest rate risk; Non-quantifiable: Default risk

B. Quantifiable: Civil war; Non-quantifiable: Liquidity risk

C. Quantifiable: Equity price risk; Non-quantifiable: Risk of terrorist attack

D. Quantifiable: Civil war; Non-quantifiable: Settlement risk

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Q.12 The following scenarios describe conflicts of interest in risk management. Which one does not?

A. The risk manager whose remuneration package includes stock options may overlook some risks inherent in a project with an eye on higher earnings when the stock price rises.

B. Lenders wish to see the company invest in less risky projects while shareholders support more risky ones.

C. The risk manager deliberately avoids riskier investments in favor of less risky ones to reduce chances of business failure and, therefore, safeguard their job security.

D. The risk manager sidelines environmentally harmful projects in order to safeguard the company's reputation and brand value.

Q.14 Distinguish between systemic and specific risks.

A. Systemic risk refers to the risks that affect the entire economy as a whole, while specific risks are risks that affect only a particular company or line of business.

B. Systemic risks are risks borne by a single entity while specific risks are borne by the economy as a whole.

C. Systemic risks are quantifiable while specific risks are non-quantifiable.

D. Systemic risk can be minimized with diversification.

Q.15 At the center of every financial institution's focus lies the need to instill confidence in all stakeholders, including customers, lenders, shareholders, and others. Each party should feel that its interests are safeguarded. Which type of risk do companies face in this regard?

A. Legal and regulatory risk

B. Reputation risk

C. Specific risk

D. Operational risk

Q.31 During a job interview for the position of risk analyst, Lee Yung was asked to define the risk management process in two points. Having an intermediate knowledge of risk management, Lee Yung mentioned the following points:
I. The risk management process starts with the very first step of identifying the correct risk.
II. The last step of the risk management process is to analyze the risk .

Identify which of the above-mentioned point(s) is/are correct?

A. Point I

B. Point II

C. Both I and II

D. None of the above

Q.33 The purpose of economic capital is to absorb:

A. economic losses

B. expected loss

C. unexpected loss

D. tail loss

Q.34 Which of the following is NOT the definition of risk measurement tools and procedures used by a firm to measure and manage risk?

A. VAR is the maximum loss over a target horizon such that there is a low, prespecified probability that the actual loss will be larger.

B. Scenario Testing is a quantitative risk measurement that takes into consideration potential risk factors such as interest rate, payroll data, etc. that are often quantifiable and focussed on frequency.

C. Stress Testing is both a qualitative and quantitative risk measurement tool that analyses the financial outcome of a firm based on a given stress

D. Enterprise Risk Management (ERM) is an integrative risk measure approach that considers entity-wide risk factors and integrates all the risk factors in entity-wide decisions

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Q.35 The relationship between risk and return is simple for some assets and complex for others. The public perception of risk and return trade-off is that higher risk will lead to higher returns. However, in some asset classes like fixed-income securities, a large number of factors such as market risk, inflation, interest rate risk, and risk tolerance are considered. Which of the following options is most appropriate for a market with investors having a high risk tolerance?

A. As the risk tolerance of investors is high, more investors will choose corporate bonds over government bonds

B. As the risk tolerance of investors is high, more investors will choose government bonds over corporate bonds

C. As the risk tolerance of investors is high, all investors will choose a good mix of corporate and government bonds

D. As the risk tolerance of investors is high, all investors will choose not to buy corporate bonds

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Q.36 Equity price risk is the type of market risk that refers to the variability in the prices of equity or stocks. Equity price risk is further subdivided into specific risk and systematic risk. Which of the following is most likely a type of specific risk?

A. The risk of changes in the consumer price index (CPI).

B. The risk of change in the aggregate demand of a specific sector.

C. The risk of strategic weaknesses in a business.

D. The risk of changes in tax rates.

Q.37 BT Motors and New Atlas bank are two parties of a derivative contract to hedge exchange rate risk. At the end of the contract, BT Motors has a net loss position of $6.9 million but refused to pay the entire amount. Which of the following sub-types of credit risk best describes this situation?

A. Bankruptcy risk.

B. General market Risk.

C. Settlement risk.

D. Default risk.

Reading 2: How Do Firms Manage Financial Risk?

Q.16 In the modern world, it's common to find companies using derivatives for risk management. The following are theoretical arguments against the use of derivatives to manage risks. Which one is not a direct objection to their use?

A. Hedging using derivatives requires specialized skills, knowledge and infrastructure, besides involving massive data acquisition and processing.

B. Aggressive hedging may distract a company's management from its core business leading to low productivity.

C. Risk managers may prioritize personal interests at the expense of the shareholders.

D. Trading in derivatives comes with compliance costs, strict accounting regulations and compulsory financial disclosures that can reveal key business strategies to competitors.

Q.18 Which of the following statements best describes the concept of hedging in risk management?

A. Buying an asset to offset a decline in value of another asset.

B. Holding an asset that appreciates in value to offset the decrease in the value of another asset.

C. Selling a loss-making asset and replacing it with a profitable one.

D. Holding an offsetting position in an asset or portfolio whose value we expect to move in line with market changes.

Q.19 An international construction company places a bid for a major construction project. Top management is convinced the company will secure the contract but are also wary of currency fluctuations during the bids evaluation process, which would make the project more costly and reduce the profit margin. Which of the following actions do you think can reduce this risk?

A. Negotiating the price of construction materials with sellers in advance

B. Purchasing construction materials in advance with the option to sell them if the bid turns out unsuccessful

C. Getting into a currency futures contract

D. Adding a risk premium to the bid amount

Q.20 Pick the piece of information likely to be omitted from a firm's risk appetite description.

A. The types of risks the firm is willing to tolerate, specifying the risks to hedge and the ones to assume

B. The preferred risk management tools e.g, insurance, derivatives, etc.

C. The maximum loss the firm is willing to incur at a given confidence limit and time

D. The timings of cash flows from the firm's projects

Q.22 Swiss Inc. is an international company that sells goods to international customers, sometimes under suitable credit agreements. As a result, the company usually hedges the resulting currency and interest rate risks using various instruments like futures. Which of the following actions is **least likely** to form part of the company's risk mapping exercise at the start of the financial year?

A. Developing the risk appetite statement

B. Developing a list of assets and liabilities, specifying the relevant currencies

C. Developing appropriate financial instruments to hedge the risks

D. None of the above

Q.23 Distinguish between exchange-traded and over-the-counter risk management instruments.

A. Exchange-traded instruments are standardized and exchange-tradable while over-the-counter instruments are non-standardized, privately negotiated financial contracts that cannot be traded on an exchange.

B. Over-the-counter instruments are standardized and exchange-tradable while exchange-traded instruments non-standardized, privately negotiated financial contracts that cannot be traded on an exchange.

C. Exchange-traded instruments are those instruments that only deal with intangible financial assets while over-the-counter instruments only deal with commodities such as coffee.

D. Exchange-traded instruments have time to maturity of less than one year while over-the-counter instruments have longer maturity periods.

Q.24 A reputable bank is approached by a newly-formed private company wishing to enter into an option contract on the British pound. The bank's risk managers prefer an exchange-traded option to an over-the-counter one. Which of the following statements best explains the managers' preference?

A. The exchange-traded option would be more efficient

B. Over-the-counter instruments often involve time-consuming, grueling negotiations between parties

C. The exchange-traded option is more likely to be honored compared to the OTC contract

D. The exchange-traded option would involve less transactional costs compared to the OTC option

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Q.25 A firm borrows funds at a variable interest rate. Buying which of the following instruments would help the firm protect itself against increases in the market rate of interest?

A. Currency forward contracts

B. Options on interest rate futures

C. Currency swaps

D. None of the above

Q.26 Which of the following is not a common characteristic of interest rate swaps?

A. Payments made by both parties are in different currencies

B. The contract is usually based on a ''notional'' principal amount

C. They trade over the counter

D. Interest rate swaps are used to hedge against or speculate on changes in interest rates.

Q.29 A construction firm wishes to enter into cleared derivative positions to manage risks such as price variation of raw materials and increase interest rates. However, the firm is aware of a few problems that could accompany the decision to invest in exchange-traded derivatives. Which of the following should NOT be worrisome for the management of the firm?

A. Liquidity risk

B. Counterparty risk

C. Market risk

D. Transaction costs

Q.30 Besides credit risk, counterparties in a derivative position face another major type of risk. Which one is it?

A. Interest rate risk

B. Foreign exchange risk

C. commodity price risk

D. Market risk

Q.39 Celina John is a junior analyst at Franklin Investments. She is studying the advantages and disadvantages of hedging in order to propose hedging practices for her clients. Following are some of the points she has written down in her email. Which of the following disadvantages of hedging is not correct?

A. Hedging can divert management's focus from its core business activities.

B. Hedging can increase the variability of the firm's value instead of decreasing the variability.

C. Hedging and derivative is a zero-sum game of transferring risk.

D. Hedging can result in multiplied losses if flawed hedging strategies are used.

Q.41 The board of directors of BRT Inc. is determining the risk appetite of the firm. It believes increasing the firm's risk appetite will introduce BRT to new potential business opportunities and increase the rewards to stakeholders. However, changing the risk appetite of a firm can be a cause of conflict between parties. Determining the risk appetite of a firm can cause the greatest conflict between:

A. Management and debtholders.

B. Management and shareholders.

C. Shareholders and the board of directors.

D. Shareholders and debtholders.

Q.42 Anadolu Tire Company is the market leader in the tires manufacturing sector in Turkey. It acquires its raw material from its neighbor, Iran, on fixed trade terms and pays the supplier in the local Turkish currency. Anadolu also sells its tires to some eastern European countries and accepts payments in Euro. Based on the business perspective of Anadolu, determine which of the following risk it should hedge.

A. Pricing risk.

B. Foreign currency risk.

C. Interest rate risk.

D. Market risk.

Q.43 Which of the following statements are correct regarding static hedging and dynamic hedging strategies?
I. In static hedging, the risk is recognized at the beginning, and the appropriate hedging position is opened
II. A dynamic hedging strategy is more complex as the underlying risky position may change with time
III. Static hedging requires more time and monitoring effort
IV. Dynamic hedging requires additional transaction costs to maintain the risky position hedged

A. I & IV

B. I, II & III

C. I, II & IV

D. I, II, III & IV

Q.44 Which of the following is not an attribute of exchange-traded and over-the-counter (OTC) financial instruments?

A. Exchange-traded instruments are more simple and standardized.

B. Over-the-counter financial instruments are more liquid than exchange-traded instruments.

C. Exchange-traded instruments are easier to price than OTC instruments.

D. Over-the-counter financial instruments contain default risk.

Q.5036 A firm has a total risk capacity of $600 million. Senior managers have set a risk appetite at $300 million. Which of the following would most likely be within the acceptable risk profile for the firm?

A. $400 million

B. $250 million

C. $900 million

D. $450 million

Reading 3: The Governance of Risk Management

Q.21 Which of the following statements best describes the role of the board in risk management?

A. Issuing guidelines on how to manage risks

B. Developing the risk appetite statement and objectives the managers should strive to meet within the risk management framework

C. Regularly reviewing decisions made by managers regarding risk exposures

D. Choosing the risk exposures to hedge, the risks to mitigate, and those to avoid altogether

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Q.45 Which of the following statements best describes corporate governance in today's business world?

A. The process by which the board of directors delegates duties to hired professionals who oversee the day-to-day running of the company.

B. The system of rules, practices, processes, and regulations guiding risk managers when determining a company's risk appetite.

C. The system of rules, regulations, practices, and processes by which a company's board of directors looks after the needs of various stakeholders within the broader agenda of meeting business objectives.

D. The tools used by the board of directors to drive business strategy, corporate responsibility, and streamline the interests of the company's shareholders.

Q.46 In the aftermath of the 2007/2009 financial crisis, most companies created the position of Chief Risk Officer (CRO). Which of the following statements about the CRO is INCORRECT?

A. The CRO reports directly to the shareholders.

B. The CRO acts as the chief advisor to the board on all matters of risk.

C. The CRO gives guidance to lower level (line) managers about risk identification and management, making suggestions for risk mitigation.

D. The CRO plays a starring role when determining the company's risk appetite.

Q.48 Which of the following is the main reason why the board is required to ensure that staff compensation/reward schemes are risk-adjusted?

A. Compensation that's not commensurate with tasks given may demotivate staff or keep away potential recruits most qualified for the positions.

B. Higher risks should lead to higher earnings.

C. Remuneration that's too high may negatively affect a company's solvency by increasing recurrent expenditure to unsustainable amounts.

D. Risk-adjusted remuneration packages can help to reduce conflict of interests.

Q.49 The following are some of the roles of a bank's audit committee of the board. Which one is not?

A. Developing the bank's risk appetite statement.

B. Scrutinizing financial statements to ensure the accuracy of the reported figures.

C. Ensuring that the bank complies with the minimum/best-practice standards in all key activities.

D. Continuously reviewing the independence of the statutory auditor/audit firm.

Q.50 Most organizations have both executive and non-executive directors. Which one of the following is *not* a valid difference between the two categories?

A. While executive directors work full-time, non-executive directors work on a part-time basis.

B. While executive directors get involved in the day-to-day management of the company, non-executive directors do not participate in management responsibilities.

C. Executive directors are usually not independent, whereas non-executives should be independent.

D. While executive directors are appointed to the board by shareholders, non-executive directors are appointed by the nomination committee.

Q.52 In which way can suppliers and customers reward good corporate governance?

A. Accepting a lower rate of return on their investment.

B. Demanding a higher rate of return on their investment.

C. Actively doing business with the company in favorable terms.

D. Giving extra benefits to company executives.

Q.53 Which of the following committees is charged with approving and authorizing compensation of top company executives?

A. Audit committee.

B. Risk Management committee.

C. Compensation committee.

D. None of the above.

Q.54 The effective oversight role of the audit committee contributes to:

A. Reliable financial reporting.

B. More effective corporate governance.

C. Credible audit functions.

D. All of the above.

Q.55 Explain the meaning of a 'fiduciary duty' within the bounds of corporate governance.

A. A duty that arises out of a contractual agreement.

B. A duty that is not stipulated in a company's constitution, but nonetheless expected to be performed by management.

C. A duty imposed on a person because of the position of trust and confidence in which they stand in relation to another.

D. None of the above.

Q.56 The large-scale corporate collapses witnessed in the early 2000s, including the Global Financial crisis of 2007, all had important themes (causal factors) that risk professionals must understand if we are to avoid a recurrence of such financially crumbling events. Which of the following statements about these past crises is inaccurate?

A. Most collapses occurred as a result of executives abusing their trust and a lack of oversight.

B. Incentive payments and greed did not play any role in the collapses.

C. There was a tendency of management to take on risks that were not fully understood.

D. The collapses had a negative impact on the accounting profession.

Q.57 Most companies now have several subsets of the board called 'board committees.' Why are such committees formed?

A. To directly report to shareholders on specific issues.

B. To enable the directors to reduce their individual liability and therefore serve more confidently.

C. To enhance the overall effectiveness of the board.

D. To introduce independence, thereby enabling verification of decisions/materials brought to the attention of the entire board.

Q.58 The following are examples of agency costs, except:

A. Dividends

B. Monitoring fees

C. Audit fees

D. Delegated authorities

Q.59 Which of the following is correct?
I. Directors may award themselves such salary payments as they think fit, without taking into account the remuneration guidelines detailed in the company's Articles of Association
II. Directors must receive a salary, just like other junior employees of the company
III. Directors only receive a salary if the constitution of the company explicitly allows it

A. I only

B. II only

C. III only

D. I and III only

Q.60 Muhammad Ismail, a research analyst, has recently learned in a seminar on the quality of research report writing that the firm's corporate governance is as important as the valuation of the firm's assets. He has noted the following points regarding the implication of good corporate governance. Which of them are not considered best practices of corporate governance?

A. The board of director should be comprised of a majority of independent members.

B. A director from outside of the industry should be provided training before joining the board.

C. The board will consider the interests of stakeholders, including debtholders, while taking decisions.

D. The CEO of the firm must also be the chairman of the board of directors in order to bring consistency in the board decisions.

Q.61 Which of the following combinations is likely to affect the independence of the board?

A. Chief Executive Officer as a member of the board of directors.

B. Chairman of the board as a member of the remuneration committee.

C. Chief Executive Officer as the Chairman of the remuneration committee.

D. Chairman of the board as the Chairman of the ethics committee.

Q.62 Woody Daren is an independent journalist who publishes his analysis on one blue-chip firm every week on his blog. Recently, Woody published an article on the best practices of Arrow Corp's risk management and its risk committee. Which of the following features that he published is an incorrect practice?

A. The business practices and risk management activities of Arrow Corp. strive for economic performance instead of accounting performance.

B. The compensation of the risk staff is based on risk-adjusted performance.

C. The members of the risk committee have deep knowledge of risk issues and accounting practices.

D. Most individuals that sit on the risk committee should also sit on the audit committee to align incentives between the two entities.

Q.63 George Hitman is a Risk Advisory Director on the board of Temple Tools Inc. George has passed FRM part 1 and is currently preparing for the FRM part 2 exam. Which of the following is NOT a duty of the Risk Advisory Director?

A. To attend audit committee meetings and advise the committee to increase the firm's effectiveness.

B. To Design the risk management program of a firm.

C. To review and analyze the firm's risk management policies and reports.

D. To review related parties and related-party transactions.

Q.64 Due to the presence of agency risk in the majority of organizations, it is necessary for the board to form a compensation committee to ensure appropriate risk is taken in relation to the long-term risk objectives. Its principal role is to design and approve the remuneration plans of management. Which of the following remuneration structures can be a potential cause of agency risk?

A. Compensation with bonuses based on long-term revenues and objectives.

B. Compensation with no guaranteed bonuses.

C. Compensation with the clawback clause on previous bonuses if the long-term goals are unachieved.

D. Compensation with the bonuses based on share prices.

Q.65 David Lennon, a corporate trainer, has finalized some of the roles and responsibilities of the audit committee of the organizations which he is going to add in his presentation on the subject of the audit committee of the board. Which of the following is NOT the role of the audit committee?
I. The audit committee is responsible for the reasonable accuracy of the organization's financial statements
II. The audit committee is responsible for ensuring that the organization has taken measures to avoid misstated errors and fraud
III. The audit committee is responsible for ensuring that the remuneration of key management must be aligned with the goals of other stakeholders
IV. Members of the audit committee must have the knowledge of basic accounting principles of US GAAP and IFRS
V. The audit committee is responsible for ensuring that the management strategies are focused on economic profits

A. I & II

B. III & V

C. III, IV & V

D. II, III & V

Q.66 The various functional units of an organization work interdependently to ensure the accurate and timely development of an organization's profit and loss statement. For instance, several functional units provide their input to develop the P&L statement in an investment bank. Which of the following functional units is likely to approve the final P&L statement?

A. Operations unit

B. Finance unit

C. Senior management

D. Risk management unit

Reading 4: Credit Risk Transfer Mechanisms

Q.3718 What are the contractual specifications for the protection seller of a credit default swap?

A. The protection buyer pays a premium to the protection seller at regular time intervals until a credit event occurs, in which case the protection seller pays the protection buyer compensation for the credit event.

B. If a credit event occurs, the protection seller is obliged to exchange contractually specified assets for government bonds.

C. The protection seller pays a premium to the protection buyer at regular time intervals until a credit event occurs, in which case the protection buyer pays the protection seller compensation for the credit event.

D. If the underlying of the credit default swap is a bond issued by a specific corporation, only this corporation can act as a protection seller.

Q.3719 The practice of approving mortgages in order to sell them as mortgage-backed securities is known as:

A. Originate-to-distribute

B. Originate-to-keep

C. Principal-agent engineering

D. A credit default swap

Q.3720 Which of the following best explains why the 2001-2002 economic slowdown did NOT result in heavy losses for the banking sector?

A. Rapid foreclosure of insolvent/loss-making corporate borrowers.

B. A substantial increase in investment in government bonds.

C. Cash injections by the Federal Reserve.

D. Hedging through credit derivatives and securitization of assets.

Q.3721 Global Tech has declared its intention to bring to the market a 10-year senior bond issue at par with a coupon rate of 23%, offering a spread of 1200 basis points over the corresponding 10-year Treasury issue. An investor is keen to enter into a total return swap that matures in one year with the senior bonds that are about to be issued as the reference obligation. Under the terms of the contract, payments will be exchanged semiannually, where the total return receiver will pay the six-month Treasury rate plus 328 basis points. What is the 10-year Treasury rate at the time the bonds are issued?

A. 10%

B. 12%

C. 11%

D. 13%

Q.3722 Which of the following is most likely correct?
Credit default swaps contributed to the financial crisis of 2007-2009 by:

A. Allowing protection buyers to specify who bears the credit risk on a given security.

B. Requiring no collateral from both protection buyers and sellers.

C. Making it easier for sellers of insurance to assume and conceal risk.

D. Identifying those who took concentrated positions on one side of a trade.

Q.3723 Which of the following statements are correct? Credit default swaps:

I. Present high levels of risk and are only be used by the wealthy
II. Allow lenders to insure themselves against the risk that a borrower will default.
III. It should only be used by people seeking high returns from low risk.
IV. Do not require collateral to be posted by either the buyer or the seller of the insurance.

A. II and IV

B. I and III

C. II only

D. IV only

Q.3724 The purpose of credit derivatives is to:

A. Transfer the risk from one party to another.

B. Increase the risk, so that the return is larger.

C. Postpone the risk for both parties in the transaction.

D. Eliminate risk for both parties in the transaction.

Q.3725 Which of the following is NOT one of the methods of settling credit default swaps?

A. Auction

B. Physical

C. Cash

D. None of the above

Q.3726 A credit default swap:

A. Has to be settled at maturity.

B. Will not be settled if no credit event has occurred.

C. Need not be settled until maturity.

D. Settlement is not contingent on any credit events.

Q.3727 In a credit default swap transaction:

A. The protection buyer is long on risk.

B. The protection seller is short on risk.

C. The protection seller makes periodic payments.

D. The protection buyer makes periodic payments.

Q.3729 An investor wishes to purchase a 5-year BBB-rated bond issued by BAC Corporation but does not want to bear the out-of-pocket costs and the inconvenience associated with long-term financing arrangements, actually going long the bond, and taking delivery. Suppose also that a bank owns the same bond and would like to extend a loan to BAC Corporation but its loans to BAC and investments in BAC debt instruments have fully exhausted its capacity to lend to BAC. Which of the following instruments would best suit the two parties in these circumstances?

A. Credit spread swap option

B. Total return swap

C. Credit default swap

D. Collateralized loan obligation

Q.3730 Two parties decide to engage in a 2-year credit default swap. Assume that the reference entity is BAC Corporation. The notional amount of the contract is $10 million, and the contract is cash-settled.
After one year, a default event occurs, and the bonds are valued at $8.5 million at the time of default. Which of the following is most likely correct?

A. The protection buyer receives $1.5 million in compensation.

B. The protection buyer continues to pay premiums for one more year.

C. The protection buyer delivers the bond to the protection seller .

D. There is no compensation paid to the protection buyer.

Q.3731 An investor approaches a swap dealer wishing to engage in a total return swap. The underlying asset is $10 million principal amount of a 9% BB-rated 5-year corporate bond that has semiannual interest payments. The swap dealer agrees to pay the total return on this bond for the coming 6 months in return for payments based on (1) an interest rate of 6-month LIBOR plus a spread of 30 basis points and (2) a notional principal amount equal to the face value of the underlying asset, $10 million.

At the swap date, the bond is worth par, and the 6-month LIBOR is 6%. Suppose that at the termination date, the value of the bond has still not changed. Determine the net payment and the party that is owed. (Use discrete compounding.)

A. Net payment = $315,000 ; owed party is the investor

B. Net payment = $450,000; owed party is the swap dealer

C. Net payment = $0; no owed party

D. Net payment = $135,000; owed party is the investor

Reading 5: Modern Portfolio Theory (MPT) and the Capital Asset Pricing Model (CAPM)

Q.38 Henry Ellen, an FRM candidate, has recently studied William Sharpe's Capital Asset Pricing Model (CAPM) as part of the FRM books. As per his understanding of the model, he has come up with a list of broad assumptions. Which of the following assumptions of the CAPM model is INCORRECT?

A. CAPM assumes that all capital markets are perfectly competitive.

B. As per CAPM, investors should not be concerned with unsystematic risk.

C. CAPM does not consider transaction costs.

D. Beta can be decreased via diversification.

Q.179 A property development company faces the following problems:
I. Labor costs
II. Interest rate risk
III. Environmental challenges
IV. Poor project management
V. Inflation

Which of the above risks would be taken into account when estimating the company's beta?

A. I, II, & IV

B. II & IV

C. II & V

D. I, III, & IV

Q.180 Which of the following is NOT an assumption of the standard Capital Assets Pricing Model (CAPM)?

A. Investors incur some transactional costs when trading assets.

B. There are no taxes, making investors indifferent between capital gains and dividends/income.

C. Assets can be divided infinitely, making it possible to hold fractional shares.

D. There's unlimited short selling/ a perfectly liquid market.

Q.181 Consider a graph with expected return on the vertical axis and standard deviation on the horizontal axis. What's the name of the line that connects the risk-free rate and the optimal risky portfolio?

A. The efficient frontier

B. The characteristic line

C. The indifference curve

D. The capital market line

Q.182 The difference between the capital market line (CML) and the efficient frontier (EF) is that:

A. The CML represents possible combinations of portfolios consisting of all possible proportions between the market portfolio and a risk-free asset while the EF represents all possible combinations of efficient portfolios, taking into account only risky assets in varying proportions.

B. The EF represents possible combinations of portfolios consisting of all possible proportions between the market portfolio and a risk-free asset while the CML represents all possible combinations of efficient portfolios, taking into account only risky assets in varying proportions.

C. The CML represents a few possible combinations of portfolios consisting of various proportions between the market portfolio and a risk-free asset while the EF represents all possible combinations of efficient portfolios, taking into account only risk-free assets in varying proportions.

D. The EF represents possible combinations of portfolios consisting of all possible proportions between the market portfolio and a risk-free asset while the CML represents all possible combinations of efficient portfolios, taking into account only risky assets in fixed proportions.

Q.183 An investor holds a portfolio comprised of a risk-free asset and a market portfolio. Given the following information, compute the expected return of the portfolio.
Risk-free rate = 5%
Expected market return = 25%
Standard deviation of market portfolio = 10%
Standard deviation of portfolio = 5%

A. 0.25

B. 0.0015

C. 0.1

D. 0.15

Q.184 According to the CAPM, the risk premium expected to be received by a stockholder increases:

A. Directly with beta.

B. Inversely with beta.

C. Inversely with systematic risk.

D. Directly with total risk.

Q.185 Under the CAPM, if a stock has a beta of 2, then for every percentage point performance attained by the market over above the risk-free rate, we would expect the stock to achieve:

A. 1 percentage point return.

B. 2 percentage points extra return.

C. 1 percentage points lower return.

D. Impossible to determine.

Q.186 A beta close to zero indicates:

A. A stock with a less stable return than the market as a whole.

B. A stock with a more stable return than the market as a whole.

C. An ETF replicating the corporate bond market.

D. A stock with historically higher returns compared to the market as a whole.

Q.188 An asset has a standard deviation of 30% and 0.8 as its correlation coefficient of returns with the market index. Given that the standard deviation of the market return is 20%, calculate the asset's beta.

A. 0.24

B. 2.4

C. 1.4

D. 1.2

Q.189 You have been given the following asset weights and betas for a 4-asset portfolio:

Asset	Beta	Portfolio Weight
1	1.3	30%
2	0.97	23%
3	1.7	37%
4	1.4	10%

If the market risk-free rate is 5%, what is the portfolio beta?

A. 1.3

B. 2.3

C. 1.4

D. 0.3

Q.190 An FRM exam candidate makes the following comments during an online discussion with fellow candidates:

I. On the capital market line, investors are only compensated for bearing systematic risks
II. The capital market line assumes that investors hold two portfolios:
    i. a risky portfolio of all assets each weighted according to its market value relative to the total market value and
    ii. the risk-free asset
III. The CML can be used to determine the required rate of return for individual securities.

Are the candidate's comments correct?

A. All the comments are correct.

B. Only II is correct.

C. Only I and II are correct.

D. None of the comments are correct.

Q.191 When a security is plotted on the security market line (SML) chart and found to appear above the SML, it's considered:

A. Undervalued and a profitable buy for investors.

B. Overvalued and a profitable buy for investors.

C. Undervalued and a profitable short sell for investors.

D. Overvalue and a profitable short sell for investors.

Q.192 You have been provided with the following information regarding the stock of Translink, an international air transport company:

- Risk-free rate = 3%
- Expected market risk premium = 5%
- Translink beta = 1.5

Use the capital asset pricing model to determine the expected return of Translink.

A. 7.5%

B. 10.5%

C. 6%

D. 8%

Q.193 John Powel gathers the following information regarding the stock of Swisscom, an internet service provider:

- Beta for Swisscom = 0.8
- Risk-free rate = 5%
- Powel's expected rate of return for Swisscom = 7%

Use this information to determine the expected market return.

A. 8%

B. 12%

C. 7.5%

D. 5%

Q.194 Which of the following is NOT included in the underlying assumptions of the Capital Asset Pricing Model (CAPM)?

A. There are no income taxes, which is why investors are indifferent between dividends and capital gains.

B. Short selling is not allowed.

C. There are no transactions costs.

D. Investors can borrow and lend unlimited amounts at the risk-free rate.

Q.195 Julia and Frank are two traders that have recently joined the New York Stock Exchange (NYSE). During their daybreak, they discussed their understanding of the Capital Market Line (CML) and Market Portfolio Theory.
Julia, who is a senior trader, stated that the capital market line (CML) is the tangent line drawn from the point of the risk-free asset to the feasible region for risky assets, and all investors invest in some combination of risk-free assets and market securities, which lies on the CML.

Frank added that the market portfolio is a universally agreed upon optimal risky portfolio that lies on the CML.

Determine if the explanations of Julia and Frank are correct.

A. Julia is correct, and Frank is also correct.

B. Julia is incorrect, while Frank is correct.

C. Julia is correct, while Frank is incorrect.

D. Julia is incorrect, and Frank is also incorrect.

Q.196 Steven Thomson is the head of the portfolio risk management team. His team has recently forwarded him an intra-departmental valuation report that contains expected return and standard deviation calculations of one of the diversified portfolios he manages. Given that the team has used different measures to compute the expected return of the portfolio, determine which of the following is appropriate for measuring the expected return of individual securities.

A. Sharpe ratio

B. CML

C. CAPM

D. Beta

Q.197 During an employment interview, a candidate is given the question to select the appropriate formulas for the computation of an asset's beta. Out of the four following formulas for the beta, one of them is INCORRECT. Which one?

A. Covariance of asset's return with the market return / Variance of the market returns.

B. (Correlation of asset's return and market return * Standard deviation of asset returns * Standard deviation of market returns)/Variance of the market returns.

C. Correlation of asset's return and market return * (Standard deviation of asset returns / Standard deviation of market returns).

D. Covariance of asset's return and market return * (Standard deviation of asset returns / Standard deviation of market returns).

Q.198 Huma Ahmed is a junior portfolio analyst who has recently switched from the fixed income portfolio management unit to his firm's equity portfolio management unit. On her first day, she was asked by her senior portfolio analyst to compute the portfolio's beta that contains 5 assets. Using the data provided in the table, determine the beta of the portfolio.

Asset	Return	Weight	Beta
1	1.3%	0.10	0.35
2	10%	0.25	0.20
3	6%	0.25	0.15
4	9%	0.30	0.60
5	16%	0.10	0.40

A. 1.7

B. 0.34

C. 0.09

D. -1.1

Q.199 According to CAPM, which of the following risks should an investor be compensated for?

A. Systematic risk only.

B. Unsystematic risk only.

C. Both systematic and unsystematic risk.

D. Both systematic risk and asset-specific-risk.

Q.200 Assume you are a junior portfolio analyst for a Chinese asset management company based in Beijing and you are given the task to evaluate the stock of Sun Cruise Inc. using CAPM. If the expected return of the market is 17%, the stock beta is 0.89, the risk-free rate is 6%, and the market risk premium is 11%, then the computed required rate of return of Sun Cruise Inc. is:

A. 17%

B. 15.8%

C. 10.45%

D. 11%

Q.201 Which of the following is a **major** difference between Treynor and Sharpe measures?

A. While the Treynor measure uses beta as the risk measure to assess the volatility of a portfolio relative to the market, the Sharpe measure takes into account the total risk exposure and hence uses the standard deviation.

B. While the Sharpe measure uses beta as the risk measure to assess the volatility of a portfolio relative to the market, the Treynor measure takes into account the total risk exposure, hence uses the standard deviation.

C. The Treynor measure is more straightforward and easier to calculate as compared to the Sharpe measure.

D. All of the above.

Q.202 The Jensen portfolio evaluation measure:

A. is a measure of return per unit of risk, as measured by standard deviation.

B. is an absolute measure of return over and above that predicted by the CAPM.

C. is a measure of return per unit of risk, as measured by beta.

D. B and C

Q.203 John Cook, a retired surgeon, has the following assets:
A house and land worth $150,000 in total
An undiversified securities portfolio worth $700,000
A fleet of automobiles worth $160,000

Between the Treynor and the Sharpe measures, which measure would be of more concern to Mr. Cook?

A. The Treynor measure

B. The Treynor measure for the portfolio and the Sharpe measure for the other assets

C. The Sharpe measure

D. None of the two measures

Q.204 A 10-year research on 3 distinct portfolios and the market reveals the following information:

Portfolio	Average Annual Return	Standard Deviation	Beta
1	14%	21	1.15
2	16%	24	1.00
3	20%	28	1.25
S&P500	12%	20	

If the risk-free rate is 6%, then use the Treynor measure to rank the portfolios from the lowest to the highest.

A. 1, 2, 3

B. 2, 3, 1

C. 3, 2, 1

D. 1, 3, 2

Q.205 A 10-year research on 3 distinct portfolios and the market reveals the following information:

Portfolio	Average Annual Return	Standard Deviation	Beta
1	14%	21	1.15
2	16%	24	1.00
3	20%	28	1.25
S&P500	12%	20	

If the risk-free rate is 6%, which portfolio carries the largest market risk?

A. 1

B. 2

C. 3

D. S&P 500

Q.206 A 10-year research on 3 distinct portfolios and the market reveals the following information:

Portfolio	Average Annual Return	Standard Deviation	Beta
1	14%	21	1.15
2	16%	24	1.00
3	20%	28	1.25
S&P 500	12%	20	

Given that the risk-free rate of return is 6%, use the Sharpe measure to rank the portfolios from the lowest to the highest.

A. 1, 3, 2

B. 2, 3, 1

C. 2, 1, 3

D. 1, 2, 3

Q.207 Under Jensen's differential return measure, which of the following indicates superior market timing on the part of the manager?

A. A zero alpha.

B. A positive alpha.

C. Statistically significant negative alpha.

D. Statistically significant positive alpha.

Q.208 Suppose you have two portfolios with the same average return, the same standard deviation of returns, but portfolio Y has a lower beta than portfolio X. Which of the following statements is true according to the Sharpe measure?

A. Portfolio X performs better than portfolio Y.

B. Portfolios X and Y perform equally.

C. Portfolio Y outperforms portfolio X.

D. None of these are correct.

Q.209 You have been given the following data for a managed portfolio:

Beta = 1.2

Alpha = 1%

Average return = 14%

Risk-free rate = 4%

Calculate the return on the market portfolio basing your calculations on Jensen's measure of portfolio performance.

A. 15.45%

B. 13%

C. 11.5%

D. 1.3%

Q.210 The Treynor, Sharpe, and Jensen measures of portfolio performance are derived from CAPM. Which of the following statements is correct regarding measures of portfolio performance?

A. All three measures are equally efficient at evaluating the performance of a manager.

B. All three measures have the same denominator.

C. Unlike the Treynor and Jensen measures, the Sharpe measure takes into account the total risk of a portfolio.

D. The Treynor and Sharpe measures use systematic risk, as represented by beta.

Q.211 What is the tracking error?

A. The standard deviation of the return of the benchmark portfolio.

B. The average of the differences between the returns of the risky portfolio and the benchmark return.

C. The standard deviation of the differences between portfolio return and the benchmark return.

D. The difference between the return based on the Treynor measure and Jensen's measure.

Q.212 Typically, the manager is required to keep the tracking error ______ a stated threshold. In this regard, transaction costs should be _______.

A. Below, minimized

B. Above, minimized

C. Below, eliminated

D. Above, maximized

Q.213 A certain fund manager typically generates an alpha of 1% and a tracking error of 2.25%. Determine the information ratio.

A. 0.3

B. 0.5

C. 2.25

D. 0.444

Q.214 Over a 15-year period, the manager of a certain fund used a covered call strategy in an attempt to increase the return of the fund. The mean of the 15 portfolio returns is 0.0519, and the minimum acceptable return is 4%. Given that the downside deviation, as measured by the the standard deviation of returns below the target is 0.0017569, compute the Sortino ratio.

A. 6.77

B. -2247.2

C. 0.0119

D. 0.04

Q.215 Which of the following best explains how a manager can achieve superior portfolio performance?

A. The ability to time market returns.

B. The ability to identify risk.

C. Superior timing and ability to select undervalued securities.

D. Neither selection nor timing: it is impossible to do this in any type of market.

Q.216 Nisha J. is a junior portfolio analyst at ABZ Investments located in Pakistan. She has been directed by her head of department to use one of the four performance measure metrics, namely CAPM, Sharpe ratio, Treynor ratio, and Jensen's alpha. She is further advised to use a more forward-looking measure and more appropriate for comparing well-diversified portfolios. Which of the following performance measures should she select?

A. CAPM

B. Sharpe Ratio

C. Treynor Ratio

D. Jensen Alpha

Q.217 Sean and Adam are two asset managers in a specific firm. During their discussion with regard to portfolio performance measures, Adam made the following statements:
Statement 1: If the Sharpe ratio of the portfolio is greater than the Sharpe ratio of the market portfolio, it indicates the portfolio performs better for every additional unit of risk.
Statement 2: Jensen's alpha measure for the market portfolio is always 0.

Which of these statements is/are correct?

A. Statement 1 is correct, while statement 2 is incorrect

B. Statement 1 is incorrect, while statement 2 is correct

C. Both statements are correct

D. Both statements are incorrect

Q.218 As an analyst, you are analyzing the portfolio that focuses on the automotive industry. The portfolio contains 12 stocks in total with 6 stocks from the automotive industry, 3 stocks from car financing firms, and 3 stocks from car lubricant manufacturers. The expected return of the portfolio is 31% with a standard deviation of 19% while the expected return of the market is 22% with a standard deviation of 16%. Given that the risk-free rate is 5% and the portfolio's beta is 0.9, compute the Treynor ratio of the portfolio.

A. 0.1

B. 1.37

C. 0.19

D. 0.29

Q.219 The expected return of an investor's portfolio is 31% with a standard deviation of 19% while the expected return of the market is 22% with a standard deviation of 16%. Given that the risk-free rate is 5% and the portfolio's beta is 0.9, determine the difference between the Sharpe ratio of the portfolio and the Sharpe ratio of the market.

A. 0.31

B. 0.5

C. 1.06

D. 0.12

Q.220 Ross Linn is analyzing the performance of different stocks of a portfolio using the alpha measure of performance. Linn has compiled the following data regarding UUA:
Covariance = 0.027
Variance of the stock = 12%
Risk-free rate of return = 6%
Expected market return = 13%
Actual stock's return = 14.5%
Beta = 1.1

Determine the correct alpha of UUA's stock and its appropriate interpretation.

A. The alpha of UUA is 0.8% and the stock has underperformed the market.

B. The alpha of UUA is 0.8% and the stock has outperformed the market.

C. The alpha of UUA is -4.625% and the stock has underperformed the market.

D. The alpha of UUA is -4.625% and the stock has outperformed the market.

Q.221 Paul Thomson is the Chief Investment Officer (CIO) of Continental Investments Inc., an asset management company that supervises three portfolios managed by three different portfolio managers. All the portfolios have the same level of risk as the benchmark index. If Thomson is interested in knowing which of the three portfolio managers possess the best stock-picking skills, then which of the following statement is true?

A. The manager with the highest tracking error has the best stock-picking skills.

B. The manager with the lowest tracking error has the best stock-picking skills.

C. The manager with the lowest information ratio has the best stock-picking skills.

D. The manager with the lowest Sharpe ratio has the best stock-picking skills.

Q.222 Bella Sean is a senior portfolio manager in a UK-based firm. She has recently rejoined the office after her maternity leave. During her absence, her subordinate, Vikram Singh, was managing one of her portfolios. She now notices that Vikram has significantly deviated from the benchmark portfolio in order to earn higher gains than the portfolio. If Bella wants to assess if Singh's deviation from the benchmark has reaped appropriate returns, then which of the following measures must she use?

A. Tracking error

B. Information ratio

C. Sortino ratio

D. Jensen alpha

Q.3468 A portfolio is constructed of two assets, including a risky asset with a standard deviation of 18% and a risk-free asset. Suppose the weight of the risk-free asset in the portfolio is 35%, then calculate the standard deviation of the portfolio.

A. 0.180

B. 0.063

C. 0.117

D. 0.0575

Q.3469 A portfolio manager is constructing a portfolio composed of two assets. Asset A is a risky asset with an expected return of 14% and a standard deviation of 22%, and asset B is a risk-free asset with an expected return of 9%. If the portfolio manager increases the weight of the risky asset to 130%, then the expected return of the portfolio is *closest to*:

A. 0.182

B. 0.155

C. 0.167

D. 0.1123

Q.3470 The expected return of the Karachi Stock exchange is 17%, and the rate on Pakistan's risk-free bonds is 7.5%. Suppose the beta of Bata Corporation shares is 0.75, what is the required rate of return on Bata Corporation's shares?

A. 0.1263

B. 0.2025

C. 0.1673

D. 0.1463

Q.3471 Which of the following portfolios is/are most appropriately priced?
I. A portfolio with an estimated return above the securities market line (SML).
II. A portfolio with an estimated return plotted on the SML.
III. A portfolio with an estimated return below the SML.

A. Portfolios I & II

B. Portfolio II

C. Portfolios II & III

D. All of the above

Q.3472 Which of the following measures of risk-adjust returns does NOT use beta?

A. Treynor measure

B. Jensen's alpha

C. Sharpe ratio

D. None of the above

Q.3473 Two portfolios have the following characteristics:

Portfolio	Return	Beta
A	8%	0.7
B	7%	1.1

Given a market return of 10% and a risk-free rate of 4%, calculate Jensen's Alpha for both portfolios and comment on which portfolio has performed better.

A. -0.2% and -3.6% respectively
Portfolio A has performed better than Portfolio B.

B. -0.2% and -3.6% respectively
Portfolio B has performed better than Portfolio A.

C. 0.2% and 3.6% respectively
Portfolio B has performed better than Portfolio A.

D. 3.6% and 0.2% respectively
Portfolio A has performed better than Portfolio B.

Q.3474 Which of the following portfolio performance evaluation measures is (are) only based on systematic risk?

A. Sharpe ratio

B. Treynor ratio

C. All of the above

D. None of the above

Q.3476 The line that shows all portfolios that an investor can create once we allow for a risk-free asset is called the:

A. Efficient frontier

B. Capital allocation line

C. Capital market line

D. Beta

Q.3477 Which of the following is NOT an assumption of the capital asset pricing model?

A. Investors require higher returns with higher risks

B. Unlimited short-selling is permissible

C. All investors have the same one period time horizon

D. Investors are subject to taxes and transaction costs

Q.3478 Which of the following uses systematic risk on the X-axis?

A. Security market line

B. Capital market line

C. Capital allocation line

D. All of the above

Q.3479 The standard deviation of an asset's return is 10%, and the standard deviation of markets return is 14%. If the correlation of returns with the market index is 0.7, then what is the beta of the asset?

A. 1

B. 0.1

C. 1.8

D. 0.5

Q.3480 The expected return of a portfolio is 17% and the return on risk-free assets in the portfolio is 8%. The beta of the portfolio is 1.2, and the standard deviation of the portfolio is 5.5%. Assuming that an investor invests 115% of his savings in this portfolio, what is his expected return?

A. 18.35%.

B. 19.55%.

C. 12.5%.

D. 0.1345

Q.3481 Kate Williams is a portfolio risk analyst for Hampton Funds. She is assigned to calculate the beta of Lion Inc. shares. What is its beta if the standard deviation of market returns is 19% and the covariance of Lions returns with the market return is 0.163?

A. 0.85

B. 4.51

C. 0.0451

D. 2.55

Q.3482 What is the expected return of a stock if the expected market return is 11%, the risk-free rate is 9%, and the stock's beta is 0.91?

A. 0.11

B. 0.1991

C. 0.1082

D. 0.1753

Q.3483 What is the covariance of an asset's returns with the market if the beta of the asset is 1.7 and the variance of market returns is 20%?

A. 0.34

B. 0.85

C. 0.12

D. 8.5

Q.3484 What is the market risk premium if the expected return on the market is 13%, the average stock's beta is 1, and the risk-free rate is 8%?

A. 9%

B. 13%

C. 5%

D. 0%

Q.3485 What is the market risk premium if the expected return on a stock is 12% while its beta is 1.5? Assume the risk-free rate is 6% and the return on the market, i.e. market risk is 10%.

A. 6%

B. 4%

C. 10%

D. 12%

Q.3486 What is the beta of a certain stock with a risk-free rate of 2.1% and a return of 14.2%, given that the expected return of the market is 17%?

A. 1

B. 1.5

C. 1.2

D. 0.81

Q.3487 The standard deviation of a portfolio is 15%. If the portfolio's return is 22%, and the risk-free return is 6%, then what is the Sharpe ratio of the portfolio?

A. 0.91

B. 1.07

C. 1.46

D. 1.98

Q.3488 Which of the following measures excess return per unit of total risk?

A. Jensen's alpha

B. Treynor ratio

C. Sharpe ratio

D. All of the above

Q.3489 The 10-year US Treasury rate is 5% and the return on the S&P 500 index is 10%. If the beta of Orange Inc. is 1.2, what is the expected return on shares of Orange Inc.?

A. 11%

B. 15%

C. 17%

D. 8%

Q.3490 Which of the following statements is appropriate regarding the plot of undervalued stocks on the security market line?

A. Undervalued stocks plot above the SML

B. Undervalued stocks plot under the SML

C. Stocks always plot on the SML

D. None of the above

Q.3491 Company ABC is expected to return 15% per year to its investors, the market expected return is 8%, and the risk-free rate is 3.5%. What is ABC's stock beta?

A. 1.4375

B. 1.875

C. 2.5556

D. 3.3333

Reading 6: The Arbitrage Pricing Theory and Multifactor Models of Risk and Return

Q.223 The following are inputs to a multifactor return model for any stock, EXCEPT:

A. Firm-specific return.

B. Deviation of macroeconomic factors from the expected values.

C. The xpected return for the stock.

D. Aggregate market risk.

Q.224 Define arbitrage as used in the context of security trading.

A. The exploitation of undervalued assets so as to increase returns.

B. The exploitation of security mispricing aimed at making risk-free profits.

C. The skill of accurately timing returns so as to obtain optimal profit from a security.

D. The exploitation of illegal trading channels aimed at making tax-free profits.

Q.225 A financial risk manager exam candidate makes the following comments:
I. Factor loadings indicate the responsiveness of the stock return to a change in the factor
II. Firm-specific returns cannot be explained by macro factors.

Which of these statements is/are correct?

A. I and II are both correct.

B. Only I is correct.

C. Both I and II are incorrect.

D. Only II is correct.

Q.226 The common stock of Swisscom Inc. is examined with a single factor model using unexpected percent changes in GDP as the single factor. You have been provided with the following data:
Expected return for Swisscom = 10%
GDP factor-beta = 2
Expected GDP growth = 2%

Revised macroeconomic information strongly suggests that the GDP will grow by a whopping 5% as opposed to the original prediction of 2%. Assuming there's no new information regarding firm-specific events, calculate the revised expected return using a single factor model.

A. 10.6%

B. 6%

C. 20%

D. 16%

Q.227 ShipLink, a United States cargo company, considers the return earned on its stock as heavily sensitive to GDP and consumer sentiments. You have been given the following data:
Expected return for Shiplink stock = 10%
GDP factor beta = 2
Expected growth in GDP = 3%
Consumer sentiment factor beta = 2.5
Expected growth in consumer sentiment = 2%

Suppose revised macroeconomic data suggests the GDP will grow by 4% rather than 3% and that consumer sentiments will grow by 3% rather than 2%. Determine the revised return for Shiplink stock, assuming no new information is available regarding the firm-specific return.

A. 18%

B. 25%

C. 14.5%

D. 4.5%

Q.228 A manager uses a two-factor model to examine the returns of two assets, X and Y. The two factors are unexpected percentage changes in inflation (IF) and consumer sentiment (CS). The following data has also been given:

$E(R_X) = 10\%$

$E(R_Y) = 12\%$

$\beta_{X,IF} = \beta_{Y,IF} = 2$

$\beta_{X,CS} = \beta_{Y,CS} = 2$

All other factors constant, which of the following statements is true?

A. Asset Y is more sensitive to inflation than asset X.

B. Inflation and consumer sentiment have different effects on the returns of X and Y.

C. An arbitrage opportunity exists.

D. None of the above are true.

Q.229 Thomas Hammer has held a well-diversified portfolio consisting of several assets for 3 years, a period during which he has made consistent profits year after year. He mulls adding one more security to his portfolio. If the new security has a positive covariance with the portfolio, Which of the following statements would be true if Hammer went ahead with his plan?

A. The new, bigger portfolio would definitely earn a higher profit for the following year.

B. The new, bigger portfolio would have more nonsystematic and less systematic risk than the current portfolio.

C. The new, bigger portfolio would have more systematic risk as well as more nonsystematic risk.

D. The new, bigger portfolio would have more systematic risk and insignificant nonsystematic risk.

Q.230 Consider a single factor APT. Portfolio X has a beta of 1.2 and an expected return of 18%. Portfolio Y has a beta of 1.0 and an expected return of 14%. You are further provided with a risk-free rate of 6%. Assuming you wanted to exploit an arbitrage opportunity, you would take a short position in:

A. Y and use the proceeds to take a long position in X.

B. Y and use the proceeds to take a long position in the risk-free asset.

C. X and use the proceeds to take a long position in Y.

D. X and use the proceeds to take a long position in the risk-free asset.

Q.231 When the equilibrium price relationship is violated, an investor will try to take as large a position as possible. This is an example of:

A. Risk-free arbitrage.

B. The capital asset pricing model.

C. The mean-variance frontier.

D. The single factor security market line.

Q.232 What is the major difference between CAPM and the APT?

A. APT places more emphasis on systematic risks.

B. APT downplays the importance of diversification.

C. APT recognizes multiple systematic factors.

D. APT recognizes multiple unsystematic factors.

Q.233 Which of the following statements is true regarding the security market line derived from the arbitrage pricing theory?

A. It shows the expected return in relation to portfolio variance, represented by σ^2.

B. It has a downward slope.

C. The x-axis intercept is equal to the expected return on the market portfolio.

D. Any well-diversified portfolio may serve as the benchmark portfolio.

Q.234 The following are factors used by Fama and French in their multifactor model, EXCEPT:

A. The Return on the market index ($R_m - R_f$).

B. The Return earned by small stocks over and above the return on large stocks.

C. The Return earned by high book-to-market stocks over and above the low book-to-market stocks.

D. None: All the above factors are used.

Q.235 A portfolio Z is subject to two risk factors, A and B, with factor betas of 0.3 and 0.5, respectively. A fund manager wishes to hedge away all of the exposure to both A and B, yet he's not ready to sell the portfolio at any cost. Choose the strategy best placed to achieve the manager's desired goal.

A. Short sell a hedge portfolio with 50% allocation to factor A portfolio, 30% allocation to factor B portfolio, and 20% allocation to the risk-free asset.

B. Short sell a hedge portfolio with 30% allocation to factor A portfolio, 50% allocation to factor B portfolio, and 20% allocation to the risk-free asset.

C. Buy a hedge portfolio with 50% allocation to factor A portfolio, 30% allocation to factor B portfolio, and 20% allocation to the risk-free asset.

D. Buy a hedge portfolio with 30% allocation to factor A portfolio, 50% allocation to factor B portfolio, and 20% allocation to the risk-free asset.

Q.236 Which of the following best explains why the APT is considered more flexible than the CAPM?

A. It uses multiple systematic factors, not just a single aggregated factor, to represent the total market risk.

B. Just like the CAPM, the APT allows for the use of a single factor through the single factor model which can be extended to include more factors.

C. With the APT, the benchmark portfolio in the security market line does not have to be the true market portfolio.

D. None of the above.

Q.238 Suzy Ye is a junior equity research analyst at a research firm based in South Korea. For the first time, she is using the multifactor model to compute the stock return of the Wong Kong Corp (WK). She has compiled the following data for the computation of the return:
Wong Kong's expected stock return: 7%
Expected GDP growth: 4.5%
Expected Inflation: 2.5%
GDP factor beta: 1.5
Inflation factor beta: 2
Risk-free rate: 2%

Suppose the actual GDP growth and actual inflation of South Korea are 3% and 2.9%, respectively, then which of the following is an accurate estimate of the stock return?

A. 7.55%

B. 10.05%

C. 5.55%

D. 18.75%

Q.239 The single-factor model indicates that the return is based on a firm-specific variable and a macroeconomic variable such as inflation, GDP growth, interest rates, consumer sentiments, etc. These factors combined with the expected return of the asset allow hedging the risk of those assets whose returns change with the changes in macroeconomic variables. In the single-factor model, the macroeconomic variables are used as inputs in the form of:

A. Deviation of the macroeconomic variable from its expected value.

B. Actual value of the macroeconomic variable multiplied by its sensitivity to the asset.

C. Expected value the macroeconomic variable multiplied by the beta factor.

D. Deviation of the macroeconomic variable from its expected value multiplied by the beta factor.

Q.240 As an analyst, you are analyzing a number of stocks of German Tech companies trading on the TecDAX. You come across two stocks DESolars AG and GERTech Co., with expected returns of 4.9% and 5.1%, respectively. In order to assess if an arbitrage opportunity exists between two stocks, you compile the following data to be used in the two-factor model:
Actual GDP Growth: 2%
Expected GDP Growth: 2%
Actual CPI: 1.7%
Expected CPI: 1.5%
DESolars (GDP) beta: 1.1
DESolars (CPI) beta: 0.9
GERTech (GDP) beta: 1.1
GERTech (CPI) beta: 0.9

Considering the given data, identify which of the following statement is true?

A. An arbitrage opportunity does not exist because both stocks have different expected returns.

B. An arbitrage opportunity exists because both firms have the same beta factor.

C. An arbitrage opportunity does not exist because both firms have the same beta.

D. An arbitrage opportunity exists because both firms have different returns for the same systematic risk.

Q.241 Creative Investments Co. holds a brainstorming and strategy-building session before the trading hours in order to prepare the analysts and traders for the day. While conducting the session Craig Lee, head of the equity department, made the following statements regarding the impact of diversification on the residual risk of a portfolio:
Statement 1: "The part of the asset's risk that is uncorrelated with the volatility of the market portfolio is called nonsystematic risk."
Statement 2: "The part of the asset's risk that is due to the positive covariance of that asset's returns with market returns is called the systematic risk or diversifiable risk."
Statement 3: "As the number of assets in a portfolio increases, the systematic risk of the portfolio decreases."

Which of the following statement is/are correct?

A. Statement 1 only

B. Statement 3 only

C. Statements 1 and 2

D. Statements 2 and 3

Q.242 During a Securities Analysis seminar at one of the top business schools in Mumbai, a student asked the moderator to define the assumptions that constitute the single-factor security market line. The moderator stated that the following assumptions are made while drawing the single-factor security market line:

I. Returns follow a k-factor process
II. A mean-variance efficient market portfolio exists
III. Well-diversified portfolios can be created
IV. No arbitrage opportunities exist

Which of the above assumptions do(es) NOT hold true in the creation of the single-factor security market line?

A. Assumption I only

B. Assumption IV only

C. Assumptions I and II

D. Assumptions II and III

Q.243 Kevin Brett is an American portfolio manager who manages an emerging factor market portfolio that focuses on the blue-chip firms from Brazil. He fears that the stocks of these blue-chip firms are highly dependent on factors like the GDP of Brazil and the value of the Brazilian Real. He believes his portfolio can decline in value due to changes in these two main factors. The portfolio's Brazilian GDP beta is 0.40 and the Brazilian Real beta is 0.3. Which of the following strategies should Brett accept in order to hedge both factors?

A. Short sell a hedge portfolio that allocates 40% exposure to the Brazilian GDP factor portfolio, 30% to the Brazilian Real factor portfolio, and 30% to the risk-free asset.

B. Buy a hedge portfolio that allocates 40% exposure to the Brazilian GDP factor portfolio, 30% to the Brazilian Real factor portfolio, and 30% to the risk-free asset.

C. Buy a hedge portfolio that allocates 30% exposure to the first Brazilian GDP factor portfolio, 40% to the Brazilian Real factor portfolio, and 30% to the market portfolio.

D. Short sell a hedge portfolio that allocates 70% exposure to the risk-free asset and 30% to the market portfolio.

Q.4452 All the following are factors of the Fama-French Model, EXCEPT:

A. Market factor.

B. The difference in expected returns of high-beta stocks minus small-beta stocks.

C. The difference in expected returns of a portfolio of high book-to-market stocks minus a portfolio of low book-to-market stocks.

D. The difference in expected returns of small stocks minus big stocks.

Q.4454 In the Fama-French three-factor model, in addition to the market factor and the HML factor, what is the other factor and what does it refer to?

A. The momentum factor, WML, which captures the outperformance of past winners in relation to past losers.

B. The SMB factor, which captures the outperformance of high book-to-market stocks in relation to low book-to-market stocks.

C. The SMB factor, which captures the outperformance of small firms in relation to the larger firms.

D. The momentum factor, WML, which captures the outperformance of high-growth stocks in relation to low-growth stocks.

Reading 7: Risk Data Aggregation and Reporting Principles

Q.245 The following are some of the benefits of having an effective risk data aggregation and reporting system, EXCEPT:

A. An increased ability to avoid losses.

B. An increased ability to identify the routes to return to financial health after a tumultuous period.

C. An increased ability to make strategic decisions, reduce the chances of loss, and increases efficiency.

D. An increased ability to identify projects with optimal returns for investment purposes.

Q.247 Prime Bank, a global systematically important bank (G-SIB) has incurred big losses resulting from a range of issues, including too many bad debts due to improper lending decisions and investment in futures without prior due diligence. The bank is now in deep capital problems and struggling to meet day-to-day funding needs. The bank's management turns to an expert of the Basel committee recommendations for advice. Which of the following potential benefits would result from risk data aggregation, particularly taking into account the bank's current situation?

A. Increased bank efficiency.

B. A clearer definition of the bank's risk appetite.

C. Improved resolvability of the bank's problems.

D. Improved data confidentiality, integrity and availability.

Q.248 After making losses in two consecutive financial years, the board of a G-SIB bank directs the bank's chief supervisor to submit a report containing position and risk exposure information for all relevant risks. The supervisor proceeds to summarize a report that includes detailed information about specific risks such as credit risk, operational risk, and market risk. However, the report falls short of adequate stress tests and forecasts. Which of the following effective risk data aggregation principle set forth by the Basel Committee on Banking Supervision did the supervisor most likely violate?

A. Principle 3 - Accuracy and integrity

B. Principle 8 - Comprehensiveness

C. Principle 9 - Clarity and usefulness

D. Principle 4 - Completeness

Q.249 Mike Harvey is the risk management supervisor at an Indian bank. He wishes to establish principles for effective risk data aggregation in line with Basel committee recommendations. The bank has historically been lenient regarding risk data gathering and processing and Harvey intends to remedy the situation. Which of the following statements is incorrect concerning the accuracy principle?

A. Risk reports should exclude mathematical descriptions and logistical relationships so as to make them less sophisticated and enhance comprehension.

B. Error reports should be created to highlight and explain errors in the data.

C. The bank should clearly define the process used to create risk reports.

D. The risk reports should include reasonable checks of the data.

Q.250 According to the committee, “A bank's risk data aggregation capabilities and risk reporting practices should be subject to strong governance arrangements consistent with the other principles and guidance established by the Basel Committee.” Which of the following statements is in divergence with the governance principle?

A. Risk data aggregation should form an integral part of the risk management framework.

B. It is ideal to have multiple sources of risk data for each type of risk facing the organization so as to enhance reliability.

C. Timely integration of risk data should be carried out immediately a new firm is acquired.

D. Human and financial resources should be directed towards risk data aggregation and therefore the board should approve the framework.

Q.251 Olive Park is the head of risk management at a Korean Bank. She has been tasked with preparing a report for the bank's board of directors scheduled to meet in the near future. The report will inform several important decisions to be made by the board regarding relevant bank risks.
In an email sent to the directors prior to the meeting, Park assures them of the accuracy, reasonableness, and completeness of her submission. She points out that a large amount of quantitative data in the report will make it hard for the report to be fully understood by non-risk management professionals. She also plans to distribute the report to all the relevant parties in a timely manner while still maintaining confidentiality. Which of the following effective risk data aggregation principle set forth by the Basel Committee on Banking Supervision did Park most likely violate?

A. Principle 11 - Distribution

B. Principle 9 - Clarity and usefulness

C. Principle 8 - Comprehensiveness

D. Principle 1 - Governance

Q.252 Which of the following goes against the principle of accuracy and integrity as set forth by the Basel Committee?

A. It's most desirable to have a single authoritative source of risk data for each type of risk facing an organization.

B. Data should be aggregated manually at all times so as to minimize the probability of errors.

C. Risk personnel should have direct access to risk data so as to effectively refine, validate, reconcile, and process the data for use in reports.

D. Controls put in place to monitor risk data should be as robust as those used in financial accounting.

Q.253 According to the Basel committee, who bears the responsibility of setting the frequency of risk management report and distribution?

A. The chief risk officer only

B. The bank supervisor only

C. The board of directors and senior management

D. The risk management department

Q.254 In an attempt to promote and institute strong and effective data aggregation capabilities, the Basel committee has put forth several principles. Which of the following principles is correctly matched with a recommendation to be followed in accordance with the given principle?

A. The timeliness principle recommends that an organization should continually update its system to accommodate changes in best practices.

B. The accuracy principle recommends that the risk data be reconciled with the supervisor's estimates before aggregation.

C. The integrity principle recommends that only automated processes should be used when aggregating risk data.

D. The completeness principle recommends that an organization should ensure it captures all material risk exposures before risk data aggregation can be done.

Q.255 Which of the following principles states that "data should be available by business line, legal entity, asset type, industry, region and other groupings, as relevant for the risk in question, that permit identifying and reporting risk exposures, concentrations and emerging risks?"

A. Data architecture and infrastructure

B. Clarity and usefulness

C. Completeness

D. Inclusivity

Q.256 While working on a risk report, two senior risk professionals made the decision to forego automation and fill data entries by hand. The two made that decision after a brainstorming exercise alongside other junior employees. In their report, the pair gave details as to why it was necessary to forego automation and why they had full confidence in the accuracy and integrity of the data. This scenario describes a:

A. The justified exception to the principle of accuracy and integrity

B. Breach of regulations

C. Manual workaround

D. Breach of confidentiality

Q.257 Which of the following is NOT a valid reason as to why senior management and the board of directors should keep accurate and timely risk data aggregation reports?

A. The report helps the management to track the organization's risk exposure and ensure risk limits are observed.

B. The board members may be asked to provide the reports during an impromptu visit by the bank's supervisors.

C. The management uses the reports to make important decisions regarding risk and investment opportunities.

D. Senior management need reliable, relevant and up-to-date information when making decisions during periods of financial stress and/or crisis.

Q.258 According to the principle of adaptability, "a bank should be able to generate aggregate risk data to meet a broad range of on-demand, ad-hoc risk management reporting requests, including requests during stress/crisis situations, requests due to changing internal needs and requests to meet supervisory queries." Which of the following is NOT included in the adaptability principle?

A. Data customization to fit the user's needs - takeaway, dashboards, anomalies, etc.

B. Flexible data aggregation processes that allow managers to swiftly assess risks for decision-making purposes.

C. Capabilities to incorporate regulatory changes.

D. Capabilities to withhold some pieces of information that could paint the company in a bad light.

Q.259 Kevin Stanley, a senior risk consultant at Wansley Consultation Company, is currently providing risk consultation to the RUSSBANK's recently opened retailed operations in Ukraine. RUSSBANK is one the largest Russian banks that has recently started retail operations in the Ukrainian market. Ukraine has a history of a large number of bank failures due to very low recovery rates. Since RUSSBANK has entered the Ukrainian market for the first time and it is not familiar with the retail market yet, Kevin referred the bank management and board to the Basel Committee's recommendation to improve its aggregation and reporting of risk data. Given that the effective risk data aggregation has several potential benefits, which of the following benefits is essential to RUSSBANK's success?

A. Increased ability to anticipate problems.

B. Identify routes to return to financial health.

C. Improved resolvability.

D. Increased market share.

Q.260 Which of the following is not a key governance principle related to risk data aggregation and risk reporting practices that were provided by the Basel Committee?

A. Data architecture and infrastructure

B. Conciseness

C. Distribution

D. Frequency

Q.261 Muhammad Zubair, head of compliance at Miliyon Investment Bank, quoted a key governance principle related to risk data aggregation provided by the Basel Committee, which states that "a bank should be able to generate accurate and reliable risk data to meet normal and stress/crisis reporting accuracy requirements. Furthermore, data should be aggregated on a largely automated basis so as to minimize the probability of errors." Which of the following principles is Zubair referring to?

A. Governance

B. Completeness

C. Accuracy & Integrity

D. Timeliness

Q.262 Vijay Kumar, Sonnet Bank's Chief Risk Officer, writes in the management discussion and analysis (MD&A) section of the bank's annual report that Sonnet Bank, at all times, devotes its human and financial resources to the improvement of risk data aggregation as it considers data aggregation and reporting a part of the bank's planning processes. He also writes that the bank has established multiple data models that are used as robust automated reconciliation measures. Kumar's comments are aligned with one of the key principles of risk data aggregation. Identify that principle.

A. Adaptability

B. Comprehensiveness

C. Distribution

D. Data Architecture and Infrastructure

Q.263 During a regular compliance meeting, a senior compliance manager made the following comments related to the key governance principles of risk data aggregation:
Comment 1: "The principle of completeness requires that the risk data should be aggregated in a timely manner and data should meet all requirements for risk management reporting. It also requires supervisors to review the timeliness and specific frequency requirements of bank risk data in normal and crisis periods."
Comment 2: "The principle related to adaptability requires banks to generate aggregate risk data that is easier for managers to use in stress tests and scenario analyses. The data should be flexible, customizable, and available for ad hoc data requests to assess emerging risks."

Determine which of the following comments are correct.

A. Comment 1 is correct whereas comment 2 is incorrect.

B. Comment 1 is incorrect whereas comment 2 is correct.

C. Comment 1 is correct, and comment 2 is also correct.

D. Comment 1 is incorrect, and comment 2 is also incorrect.

Q.264 Which of the following key principles of risk data aggregation requires banks to document both the automated and the manual workarounds, and also requires banks to define why and when human interventions are critical for data accuracy?

A. Timeliness

B. Adaptability

C. Accuracy and integrity

D. Clarity and usefulness

Q.265 The principle of comprehensive requires banks to create reports:
I. That contains position and risk exposure information for credit risk, liquidity risk, market risk, and operational risk
II. That should satisfy senior management in terms of coverage, analysis, and comparability with other banks
III. That should provide a historical review of the bank's risk appetite and past stress tests.

Which of the following statements is/are aligned with the principle of comprehensiveness?

A. Statement I

B. Statements II & III

C. Statements I & III

D. All statements are aligned with the principle of comprehensiveness

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Reading 8: Enterprise Risk Management and Future Trends

Q.67 Which of the following best explains the concept silo-based risk management?

A. The process of managing each type of risk individually.

B. Management risks by subdividing the total exposure into specific and systematic risks.

C. The process where each business unit within an organization manages only the risks directly affecting its own functions.

D. The process of subdividing the total risk exposure into major and minor risks of the business.

Q.68 Which of the following arguments best explains why some companies prefer siloed risk management to ERM?

A. The silo approach simplifies the risk management process as each business unit works on a small 'slice' of the total risk exposure.

B. The silo approach promotes specialization, thus helps to develop a rich variety of risk management expertise within the organization.

C. The silo approach enables organizations to extensively analyze each risk without overlooking important aspects.

D. Managing risks in silos is more efficient and takes a shorter time compared to ERM.

Q.69 Define Enterprise Risk Management (ERM).

A. The process of managing all the different categories of risks facing the organization.

B. The process of dividing risks into different categories for analysis by the various autonomous units within an organization.

C. Application of risk management across an enterprise in a holistic, consistent, and structured way.

D. Application of risk management across an autonomous business unit/department in a structured, consistent way.

Q.70 In an online discussion between a risk manager and an international businessman, the businessman makes the following comment: “I run several autonomous business units that manage risks independently. I see no point in shifting to enterprise risk management, despite the current fad about it. ERM is too complex and implementing it would just disrupt the smooth working of the different units and hamper their progress.” The risk manager feels that the businessman is wrong and decides to write back to the businessman refuting his comments. Which of the following would NOT form part of your response to the businessman?

A. ERM would bring out the interrelationships between the different units in terms of risk.

B. ERM would exclusively tackle downside risks, thus may help the company to offer consistent returns to shareholders.

C. An elaborate ERM framework can give the company a bird's eye view of the marketplace, thus enabling the company to identify and exploit favorable opportunities before competitors are able to do so.

D. ERM can help to identify cross-business risks and help the company to learn from past mistakes.

Q.81 In the recent past, a certain bank has had a poor relationship with its regulator. The CEO asks the CRO to suggest some of the actions the company could take in a bid to improve this relationship in the future. Which of the following presents a possible recommendation?

A. Sending a delegation to the regulator's office aimed at resetting relations between the two sides.

B. Developing a robust internal supervisory policy.

C. Setting up a special board committee charged with improving relations with the regulator.

D. Forgetting the past and focusing on the future.

Q.3840 Which of the following statements is correct as far as Enterprise Risk Management is concerned?

A. Independent operations of ERM dimensions motivate the success of the ERM framework in a firm

B. ERM advocates viewing of risk across business lines by looking at the diversification and the concentration of the risk

C. The ERM looks at the level of each risk type in the firm and assesses them independently

D. All of the above

Reading 9: Learning From Financial Disasters

Q.112 In the lead-up to the 2007/2009 financial crisis, Lehman Brothers had positioned itself as the leading institution in the mortgage-backed securities market. Which of the following **best** explains why the firm failed so spectacularly despite boasting huge amounts of capital?

A. The firm was highly leveraged, reducing its ability to absorb losses

B. A large number of the firm's mortgage-backed securities were built upon sub-prime mortgage assets

C. The firm was considered too big to fail

D. A lack of confidence among investors which in turn led to a lack of funding

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Q.113 The Barings incident came up **mainly** due to:

A. The actions of a single trading official

B. The lack of adequate control systems and the failure of management to exercise even the basic oversight roles

C. Collusion between back-office staff and a junior level manager

D. The massive earthquake that hit Japan in 1995, triggering unprecedented losses in the stock market

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Q.114 The trouble among Savings and Loans Associations (S&Ls) in the United States can be traced down to an increase in interest rates and inflation, which collectively served to reduce the profit margin initially enjoyed by the heavily regulated S&Ls. The regulator responded by relaxing some of the stringent rules. For example, the limit on deposit insurance coverage was raised from $40,000 to $100,000 to make it easier for troubled or insolvent institutions to attract deposits to lend with. Which of the following problems did this particular change create?

A. S&Ls engaged in even riskier lending activities

B. Taxpayers were forced to pay for the increase

C. There was a huge bailout after a large number of S&Ls failed

D. All of the above

Q.115 Which of the following served as the main source of funding for Lehman Brothers in the lead-up to the 2007/2009 financial crisis?

A. Bond market

B. Repo market

C. Stock sale

D. Reserves

Q.117 The following statements are true regarding Long-Term Capital Management (LTCM), except:

A. LTCM is categorized as a financial disaster caused by large market moves but not misleading reporting.

B. The incident highlighted the importance of stress testing to look at the effects of a competitor holding similar assets unexpectedly exiting the market.

C. LTCM was founded with the aim of tapping short-term positions instead of focusing on the long term.

D. LTCM models assumed that historical relationships were useful predictors of future relationships, albeit in the absence of external economic shocks.

Q.119 Consider the following statements:
I. LTCM models assumed that low frequency/high severity events were correlated over a period of time
II. LTCM models accounted for the spikes in correlations among asset class prices during economic shocks
Select the true statement(s):

A. I

B. II

C. Both I and II

D. None

Q.120 Which of the following risks was realized in the Metallgesellschaft case study?

A. Market risk.

B. Interest rate risk.

C. Funding liquidity risk.

D. Operational risk.

Q.121 Metallgesellschaft Refining and Marketing (MGRM), a U.S. subsidiary of the German oil company Metallgesellschaft, lost over $1.5 billion as a result of a poor dynamic hedging strategy. What triggered the loss? The company:

A. Adopted an outdated and largely ineffective hedging strategy called a “stack-and-roll hedge”.

B. Bought too many long terms futures contracts.

C. Failed to predict the significant rise in oil prices in 1993.

D. Suffered a significant decline in oil prices resulting in huge unrealized losses and subsequent margin calls.

Q.122 In the modern business world, it's not uncommon to find organizations recording phone conversations between clients and staff. Which of the following best explains why firms must exercise caution when engaging in such an exercise as highlighted by the Bankers Trust incident?

A. Taping conversations can have a negative impact on the ability of staff to freely and candidly engage with clients.

B. The recorded conversations can be used against the organizations as evidence during lawsuits.

C. The exercise may not yield significant results and may actually deal a heavy blow to staff/management trust.

D. Taping conversations could consume considerable time and energy, which could otherwise be channeled into more productive business.

Q.124 Which of the following was most influential in the Metallgesellschaft case study?

A. German accounting rules of the time.

B. Outright fraud.

C. Flawed computer-based software.

D. Timing differences in the cash flows of its long and short positions.

Q.126 Which of the following led to Enron failure

A. Governance risk

B. Liquidity risk

C. Foreign currency risk

D. Credit risk

Q.127 Which of the following characterizes the early stages of a financial disaster?

A. Excessive optimism about future asset prices.

B. Excessive pessimism about future asset prices.

C. The collapse of the housing mortgage market.

D. Stagnating share price.

Q.128 Nick Leeson, a junior trader at the Singapore office of British Barings, took speculative derivative positions in an effort to recover past losses that he was able to hide fraudulently. The speculative positions further increased the size of losses that lead to Barings bankruptcy in 1995. Which of the following is the cause of the losses?
I. Little management oversight of the settlement process
II. The speculative long-long futures positions

A. I only

B. II only

C. I & II

D. None of the above

Q.129 Between 1986 and 1995, nearly a third of the 3,234 savings and loan associations in the United States failed. It is widely accepted that overregulation played a role in the crisis. How exactly did this happen?

A. S&Ls were required to pay depositors a rate of interest that was significantly lower than that offered elsewhere.

B. S&Ls were not allowed to offer commercial loans so as to avoid risky lending.

C. Only a very limited amount of deposit insurance was allowed .

D. All of the above.

Q.130 In the 1980s, the savings and loans industry in the United States suffered through a period of distress. The distress can be traced down to:

I. A decline in the effectiveness of Regulation Q in preserving the spread between the cost of money and the rate of return on assets
II. An inability to vary the return on assets with increases in the rate of interest required to be paid for deposits
III. Increased competition on the deposit gathering and mortgage origination sides of the business
IV. Elimination of regulations initially designed to prevent lending excesses and minimize failures

A. I, II, and IV

B. II and III

C. I and IV

D. All of the above

Q.131 Which of the following dynamic hedging strategies was used by Metallgesellschaft Refining and Marketing (MGRM)?

A. Stack-and-roll

B. Delta hedging

C. Stop-loss strategy

D. Dynamic delta-hedging

Q.132 Funding liquidity risk played a critical role in which of the following financial scandals?

A. Orange County

B. Savings and Loans Crisis

C. SWIFT

D. Metallgesellschaft Refining and Marketing

Q.133 Long-Term Capital Management, a hedge fund started by ex-employees of Citigroup, posted returns of 43% and 41% in the first two years of its formation due to its positions in global equity, derivatives, and fixed income assets. After the 1998 financial crisis in Russia, the fund lost 44% of its capital. Which of the following factors lead to the financial disaster of LTCM?
I. Use of highly leveraged positions, which was possible due to waived initial margin requirements
II. Use of flawed trading models because it failed to account for the spike in correlations among asset class prices during times of economic crisis/shock.

A. I only

B. II only

C. Both I & II

D. None of the factors

Q.134 Which of the following involves the purchase of a hedging instrument that very closely matches the position to be hedged and is typically held for as long as the underlying position is kept?

A. Dynamic hedge strategy

B. Static hedge strategy

C. Stack-and-roll hedge strategy

D. Delta-hedge strategy

Q.4318 The trader known as the London Whale lost at least $6.2 billion for JPMorgan Chase & Co. in 2012. In the first three months of that year, the number of days reporting losses exceeded the number of days reporting profits. In an attempt to conceal these losses, the CIO came up with a new valuation system. The CIO had hitherto (up to that point) valued credit derivatives by:

A. Marking them at or near the midpoint price in the daily range of prices.

B. Marking them above the midpoint price in the daily range of prices.

C. Marking them below the midpoint price in the daily range of prices.

D. Marking them at prices that were at significant variance to the midpoints of dealer quotes in the market.

Q.4319 After consistently breaching risk limits, CIO traders at JPMorgan Chase & Co. proposed a total overhaul of the VaR model in use at the time, claiming that the model was too conservative. A new VaR model was eventually developed. Which of the following statements is most likely correct?

A. The new model was developed and by CIO traders in collaboration with the office of the Comptroller of Currency.

B. The new model resulted in risk numbers that were 50% higher than prior numbers.

C. The new model successfully corrected the mathematical flaws present in the first model, which had produced highly overstated risk estimates.

D. The new model was eventually revoked and the prior one reinstated.

Q.4320 In 2012, J.P. Morgan Chase lost more than $6.2 billion dollars from an exposure to a massive credit derivatives portfolio in its London office. How did a lack of adequate management oversight manifest?

A. Senior managers at the bank would receive daily risk reports from traders but never read them.

B. The bank had no risk committee to monitor the activities of CIO traders.

C. Senior management ignored the breaching of risk limits.

D. Senior management did not hold even a single meeting to evaluate the goings-on at the CIO.

Q.4321 What was the main purpose of the Chief Investment Office, CIO, at J.P. Morgan Chase Bank in the run-up to the London Whale scandal?

A. To monitor the operations of traders .

B. To invest excess deposits.

C. To look into ways in which the bank could reduce its regulatory capital requirements.

D. To raise funds for investment by floating long-term high-yield bonds.

Q.4322 At the height of the 2007/2009 financial crisis, J.P. Morgan Chase Bank constructed a synthetic credit portfolio (SCP) motivated by the need to protect itself against adverse credit scenarios such as widening credit spreads. The bank’s synthetic credit portfolio (SCP) was comprised of:

A. Call options on stocks featured in the S&P 500 index.

B. Credit default swaps featured in standardized credit default swap indices.

C. Short and long oil futures positions.

D. Mortgage-backed securities .

Q.4323 The infamous collapse of the oldest merchant bank in England, Barings Bank, in 1995 after 233 years of existence, can be traced down to one key reason:

A. A bank run

B. The Kobe earthquake in Japan, which rattled financial markets in Asia and hence, severely affected the bank's activities.

C. Largely unchecked speculative trades.

D. A total overhaul of the board of directors which resulted in the loss of investor confidence.

Q.4324 Which of the following is the main reason that led to the scale of losses suffered by the Orange County portfolio in 1994?

A. Excessive use of leverage.

B. Overreliance on equity.

C. An unexpected increase in interest rates by the Federal Reserve.

D. Stringent collateral demands by providers of emergency capital.

Q.4325 The Orange County case illustrates how complex financial products characterized by large amounts of leverage can create significant losses. The fund heavily invested in:

A. Mortgage-backed securities.

B. Equities.

C. Inverse floating-rate notes.

D. Credit default swaps.

Q.4326 The Orange County case illustrates how complex financial products characterized by large amounts of leverage can create significant losses. Mr. Robert Citron, the fund's treasurer, heavily invested in inverse floating-rate notes expecting:

A. Interest rates to rise.

B. Interest rates to fall.

C. A recession in the near future.

D. The corporation tax rate to rise.

Q.4327 The financial scandals at Bankers Trust and Orange County have one thing in common:

A. They involved the use of complex financial instruments with an eye on high returns.

B. Both collapsed as a result of a crippling run.

C. Both were eventually acquired and dismantled.

D. Both invested heavily in mortgage-backed securities.

Q.4328 Which of the following lessons is *most relevant* to the Orange County case?

A. Every firm needs to have more than a basic understanding of the risks that are inherent in its business models.

B. Reporting and monitoring of positions and risks (i.e., back-office operations) must be separated from trading (i.e., front-office operations).

C. Risk managers have a responsibility to analyze reported business profits and determine if they seem logical in light of the positions held.

D. Outsized or strangely consistent profits should be independently investigated and rigorously monitored in order to verify that they are real, generated in accordance with the firm's policies and procedures.

Q.4329 The Volkswagen scandal of 2015 highlighted the need for companies to:

A. Invest in social media to ensure a fast spread of positive information.

B. Uphold ethical conduct and demonstrate their commitment to environmental, social, and governance-related best practices.

C. To hire qualified professionals capable of detecting anomalies before it's too late.

D. To nurture and protect their brand name by investing in research and development.

Q.5038 In the early 1990s, Metallgesellschaft, a German oil company, suffered a loss of $1.33 billion in their hedging program. They rolled over short-dated futures to hedge long term exposure created through their long-term fixed-price contracts to sell heating oil and gasoline to their customers. After a time, they abandoned the hedge because of large negative cash flow. The cash-flow pressure was due to the fact that MG had to hedge its exposure by:

A. Short futures and there was a decline in oil price.

B. Long futures and there was a decline in oil price.

C. Short futures and there was an increase in oil price.

D. Long futures and there was an increase in oil price.

Reading 10: Anatomy of the Great Financial Crisis of 2007-2009

Q.135 At the turn of the new millennium, mortgage lenders began offering customers adjustable mortgage rates with "teaser rates." What was the immediate effect of the move?

A. The number of mortgage applications sharply decreased.

B. The number of mortgage applications started to increase.

C. The price of houses started to rise.

D. The price of houses started to decline.

Q.136 The following are reasons why the demand for homes sharply increased between 2000 and 2006. Which one had the smallest impact?

A. Mounting pressure on lenders by the federal government to increase lending to low- and medium-income families.

B. A change from fixed-rate repayment terms to more flexible terms, capped by the so-called teaser rates.

C. A steadily increasing middle-class population.

D. A lack of adequate regulation of the real estate sector by the federal government.

Q.137 A non-recourse mortgage is a mortgage whereby:

A. The borrower is given flexible repayment terms, including variable interest rates and a grace period.

B. If the borrower defaults, the lender can take possession of the assets used as collateral as well as other assets of the borrower.

C. If the borrower defaults, the lender can only take possession of the assets used as collateral and not any other assets of the borrower.

D. The borrower can only sell the assets used as collateral with express authority from the lender.

Q.139 Distinguish between an Asset-Backed Security (ABS) and a Collateralized debt obligation (CDO)

A. An asset-backed security is a security created from the cash flows of a financial asset while a CDO is an ABS created from a financial asset whose income is variable.

B. An asset-backed security is a security created from the cash flows of a financial asset while a CDO is an ABS created from a financial asset whose income is fixed.

C. An asset-backed security is a security created from the cash flows of a mortgage while a CDO is an ABS created from a non-mortgage financial asset.

D. An asset-backed security is a security created from the cash flows of a secured financial asset while a CDO is an ABS created from a non-secured financial asset.

Q.140 An asset-backed security is usually divided into three tranches: the senior tranche, mezzanine tranche, and equity tranche. Which of the following correctly categorizes the three tranches in terms of risk, from the riskiest to the least risky?

A. Senior tranche; Equity tranche; Mezzanine tranche

B. Mezzanine tranche; Equity tranche; Senior tranche

C. Mezzanine tranche; Senior tranche; Equity tranche

D. Equity tranche; Mezzanine tranche; Senior tranche

Q.141 Which of the following best explains how credit rating agencies contributed to the financial crisis of 2007/2008?

A. Credit rating agencies colluded to give major financial institutions “undue” health.

B. Rating agencies did not sound the alarm bells early enough after detecting the deteriorating financial stability of the economy's major players.

C. Rating agencies underestimated the risks inherent in asset-backed securities and CDOs.

D. Rating agencies overestimated the risks borne by asset-backed securities and CDOs, leading to low demand for those financial instruments.

Q.142 Experts attribute the 2007/2008 financial crisis to several causes that collectively aggravated the economic strain resulting in a large-scale disaster. Which of the following is not a cause of the crisis?

A. Relaxed lending requirements that increased the number of subprime mortgages that would later default.

B. Irrational exuberance/False confidence - the perception that home prices would continue to rise unabated and indefinitely.

C. Underestimation of risks inherent in ABSs and CDOs by major credit rating agencies.

D. The collusion of middle east governments to intentionally hike the price of oil.

Q.143 Which of the following amounts to agency cost in regard to how the 2008 financial crisis unfolded?

A. Prospective homeowners lying about their income and mortgage security.

B. A lack of government regulation of the property market in the period leading to the crisis.

C. Rating agencies were paid for their ratings and would overlook potential financial pitfalls so as to impress their clients.

D. Failure by Congress and the Senate to crack down on relaxed lending even after a few leaders brought the matter to the floors of the two houses.

Q.144 The following are some of the key lessons learned by risk managers from the 2007/2008 financial crisis. Which one is not?

A. Human psychology plays a key role in financial markets. In particular, the assumption that bullish markets will exist indefinitely is incorrect and borders on irrational exuberance.

B. Traditional correlations can be relied upon to give near-accurate predictions of markets.

C. There's a need to align the compensation packages of traders with the interests of their employers. In particular, bonuses should be spread out over several years, with a provision to pay back part of the bonus if a year of good performance is followed by a downturn in performance.

D. Instead of overreliance on data provided by rating agencies, investors should also do their own market analysis before committing their resources that appear very profitable.

Q.145 A bank recently pooled together subprime mortgages and created three tranches: the senior, mezzanine, and the equity tranches. The senior tranche has:

A. Lower return than the equity tranche but higher return than the mezzanine tranche.

B. Higher return than the equity tranche but lower return than the mezzanine tranche.

C. Lower risk than both the equity and mezzanine tranches.

D. Lower risk than the mezzanine tranche but higher risk than the equity tranche.

Q.146 Ninja borrowers refer to:

A. Borrowers who have not been subjected to vetting or any other attempt aimed at ascertaining their credentials.

B. Borrowers who have a near-zero credit history.

C. Borrowers with assets insufficient to secure the mortgages awarded.

D. Borrowers with no income, no job, and no assets.

Q.147 Capital M bank originates and securitizes mortgages creating asset-backed securities. The bank then invests in these same securities. Which of the following best describes such a scenario?

A. Regulatory arbitrage

B. Securitization

C. Irrational exuberance

D. Agency costs

Q.148 What is the relationship between the senior tranche of an ABS and its ABS CDO equivalent regarding risk?

A. The senior tranche of an ABS is riskier than the senior tranche of the ABS CDO.

B. The senior tranche of an ABS is less risky than the senior tranche of the ABS CDO.

C. The senior tranche of an ABS and the senior tranche of an ABS CDO have the same level of risk.

D. None of the above.

Q.149 In the aftermath of the 2007/2008 financial crisis, a lot of progress has been made so as to avert future crises. Which of the following would be termed as a regulatory response aimed at reducing the frequency and possibly the impact of future financial crises?

A. Improved transparency in financial markets.

B. Increased international cooperation.

C. Improved alignment of the objectives of traders and their employers.

D. All the above.

Q.150 One of the factors associated with the Credit Crisis of 2007 is the relaxed lending standards of lenders. Lenders began to attract new entrants in the housing market by offering adjustable-rate mortgages (ARMs) and teaser rates. The teaser rates are defined as:

A. The mortgage rates that are mentioned on the mortgage's promotional material.

B. The very low rates that are offered for the first few years before the rates increased significantly in later years.

C. The fixed mortgage rate that is calculated as LIBOR plus specific basis points.

D. The fixed rates at which a defaulting borrower can restructure the mortgage.

Q.152 During the training session of newly selected graduate trainees of a reputable Chinese investment bank, the moderator asked some trainees to explain their understanding of the term "Securitization." Below are some of the explanations provided by trainees. Which of them is closely related to securitization?

A. Trainee A: Securitization is the process of securing a mortgage with a security or collateral which the lender can use in the case of default.

B. Trainee B: Securitization is the financial asset created from the cash flows of financial assets including mortgages, loans, auto loans, and bonds.

C. Trainee C: Securitization is the process of pooling mortgage loans into a pool, dividing the pool into smaller units, and selling them as financial assets to investors in order to transfer risk.

D. Trainee D: Securitization is the process of setting a bankruptcy-remote entity with the sole purpose of acquiring Asset-Backed Securities (ABS).

Q.153 Once the originator of the mortgage creates Asset-Backed Securities (ABSs) from the cash flow of its mortgages and loans, these ABSs are sold to Special Purpose Vehicles (SPVs) that allocate the cash flows of the ABS to different tranches. Typically, each security has three tranches, namely the senior tranche, the mezzanine tranche, and the equity tranche. Which tranches should have the highest expected returns and which tranche should receive the highest rating?

A. Senior tranches should receive the highest expected returns and highest ratings.

B. Equity tranches should receive the highest ratings, and senior tranches should have the highest expected returns.

C. Senior tranches should receive the highest ratings, and equity tranches should have the highest expected returns.

D. Equity tranches should receive the highest ratings, and mezzanine tranches should have the highest expected returns.

Q.154 Ravi Kumar is a junior fixed-income analyst who is comparing a 7-year AA+ rated asset-backed security collateralized debt obligation (ABS CDO) with a comparable 7-year corporate bond which is also AA+ rated. Kumar made some analogies in his report. Which of these is incorrect?

A. The equity tranche of an ABS CDO has a lower risk than the equity tranche of an original ABS.

B. The probability of loss of the ABS CDO is lower than the probability of loss of the bond.

C. Turning an ABS into an ABS CDO helps high-risk subprime mortgages turn into high-rated investments.

D. The nature of the risk of the AA+ ABS CDO is different from the AA+ bond regardless of its similar rating.

Q.155 Different players had different incentives/motivations for creating structured products like asset-backed securities (ABSs) and collateralized debt obligations (CDOs) that played an important role in the 2007 Credit Crisis. When these incentives and motivations do not align, it is known as agency cost, which is the basis of all financial crises.
Which of the following is incorrect?

A. The incentive for property valuators was to provide appropriate and honest home valuations.

B. The incentive for the creators of ABSs and ABS CDOs was profitability in the form of excess cash inflow from these investments.

C. Rating agencies were incentivized to issue favorable ratings/recommendations on ABSs and ABS CDOs.

D. Employees were highly incentivized for trading risky securitized products.

Q.156 Which of the following is NOT an implication of the crisis scenario?
I. During crises, default rates increases and recovery rates declines
II. Resecuritization results in investments that have risks that tend to exceed their expected returns

A. Statement I only

B. Statement II only

C. Statements I and II

D. None of the above

Q.287 Which of the following statements best describes how relaxed lending standards contributed to the 2007/2008 financial crisis?

A. More people applied for mortgages resulting in liquidity problems within major American banks.

B. The demand for housing took a sharp increase causing the price to increase.

C. The number of “liar” loans increased, eventually leading to default and losses among banks.

D. Banks violated federal laws leading to a major fallout between the government and the private sector.

Q.288 Which of the following best describes the consequence of offering housing mortgages on a low “teaser” interest rate in the short term followed by higher rates later during the agreed term?

A. High demand for housing in the short term and low demand in the long term.

B. Low demand for housing in the short term and high demand in the long term.

C. High borrower default rate in the short term and low default rate in the long term.

D. Low profit for the lender in the short term followed by supernormal profits in the long term.

Q.289 In the years leading up to the 2007/2008 financial crisis, what was the main motivation behind securitization of mortgage facilities by lenders in the United States?

A. To make more money from the mortgages by selling them to third-party investors.

B. To transfer risk to third-party investors.

C. To create investments opportunities for investors under recommendations by the federal government.

D. To help borrowers pay their dues faster.

Q.291 In the run-up to the 2007/2008 financial crisis, how did lenders ensure that their incentives aligned with those of the investors in asset-backed securities?

A. Maintaining exposure to the performance of the loan pool by owning the tranche that would absorb the first losses accrued – Equity tranche.

B. Agreeing to offer discounts on assets being sold.

C. Maintaining exposure to the performance of the loan pool by owning the tranche that would absorb the last losses accrued – the senior tranche.

D. Maintaining exposure to the performance of the loan pool by owning the tranche that would absorb 20% of total loss accrued.

Q.292 In the run-up to the 2007 financial crisis, banks offering mortgage facilities practiced the unusual move of investing in the tranches formed from the mortgages. By so doing, the banks:

A. Engaged in regulatory arbitrage.

B. Engaged in unethical professional behavior.

C. Were able to hide losses accrued due to “liar” borrowers.

D. All of the above.

Q.293 Which of the following best describes the concept of misaligned incentives in the outcome of the 2007/2008 financial crisis?

A. While mortgage originators were hell-bent on creating loans that could be securitized, those valuing homes were intent on providing the lowest possible valuation.

B. Mortgage originators were focused on offering loans to all credit-worthy clients, whereas rating agencies had their focus set only on high net-worth individuals who could pay more for rating services.

C. The incentive for investors in ABSs and CDOs was to find secure but highly profitable products but that of rating agencies of those products was to issue favorable recommendations so as to retain their clients (issuers of the products).

D. Mortgage originators wanted to maximize profit but those valuing homes wanted to inflate the value as much as possible so as to receive unduly high service fees.

Q.294 In 2005, Ann applied for a mortgage at a local bank. Though she had a larger-than-average risk of defaulting, the bank still went ahead and issued her the mortgage. This is an example of:

A. Illegal mortgage lending.

B. Agency costs.

C. Prime mortgage lending.

D. Subprime mortgage lending.

Q.295 Assume that the senior tranche of a 5-year, asset-backed security collateralized debt obligation (ABS CDO) is rated AAA. In addition, assume that we have a comparable 5-year gilt (government bond) that's also rated AAA. Which of the following is most likely *incorrect*?

A. There's a chance that some risks were left out while profiling the ABS CDO.

B. It's highly likely that there's irrational exuberance within financial markets.

C. The equity tranche of the same ABS CDO is riskier than the senior tranche.

D. The probability of loss under the ABS CDO is less than the probability of loss under the government bond.

Q.411 Which of the following is NOT a key factor that led to the housing bubble of 2007-2008?

A. A low interest rate environment sponsored by the US federal government which was aimed at encouraging individuals to borrow more.

B. A shift from the traditional banking system of issuer-held loans to the "originate and distribute" model.

C. Major rating agencies issuing favorable ratings on asset-backed securities.

D. None of the above.

Q.412 A severe liquidity squeeze engulfed the banking system as a result of two major trends in the sector. First, instead of issuing and holding loans on their balance sheets until maturity, banks took up the "originate and distribute" model so as to transfer risk to other investors. What was the other trend?

A. Banks increasingly financed their asset holdings with longer maturity instruments.

B. Banks increasingly financed their asset holdings with shorter maturity instruments.

C. Banks increasingly disregarded borrower information while appraising loan applications.

D. Refusal by the Federal Reserve Bank to bail out financially-strained banks.

Q.413 Which of the following statements best explains how banks created collateralized debt obligations in the build-up to the 2007-2008 financial meltdown?

A. Forming a diversified portfolio of cash-flow generating assets, pooling them together, and then repackaging the asset pool into discrete tranches that could be sold to investors.

B. Pooling together cash-generating assets, and then repackaging the asset pool into discrete slices that could be sold to investors.

C. Forming a diversified portfolio of mortgage products, pooling them together, and then repackaging the asset pool into discrete tranches that could be sold to investors.

D. Pooling together a well-diversified portfolio of mortgages, and then slicing the pool into three tranches that could be sold to investors.

Q.414 In 2005, a certain American investment firm decided to invest in an assortment of collateralized debt obligations (CDOs). To protect itself, the firm also purchased a credit default swap. This implied that:

A. The firm would pay a periodic fixed fee and in turn receive a contingent payment in the event of credit default.

B. The firm was 100% protected against credit default, and therefore cash inflows from the CDOs were guaranteed.

C. The firm would pay a fixed fee at the onset of the contract and in turn receive a contingent payment in the event of credit default.

D. The firm would pay a periodic fixed fee and, in turn, receive a contingent payment at the end of the CDO contract.

Q.415 In the period leading up to the 2007-2008 financial meltdown, what was the main problem that arose due to an increase in the maturity mismatch on the balance sheet of banks?

A. Exposure to massive cash withdrawals at short notice.

B. Exposure to credit default risk.

C. Exposure to funding liquidity risk.

D. Unprecedented legal confrontations with regulatory authorities.

Q.416 Which of the following statements best explains why securitized products were especially popular among money market and pension funds?

A. They allowed such institutions to hold assets that they were previously prevented from holding by regulatory requirements.

B. They were more profitable compared to corporate bonds.

C. Securitization enabled the funds to hold assets without disclosing such information in the balance sheet.

D. Securitized products were considered less risky compared to traditional cash-generating assets such as corporate bonds.

Q.417 In the run-up to the 2007-2008 financial crisis, it was not uncommon to find credit rating agencies issuing overly optimistic and favorable ratings and forecasts about structured financial assets. Which agency problem was behind this habit?

A. Structured financial assets initially had very low demand, and credit rating agencies wanted to push that demand up.

B. Credit rating agencies were under considerable pressure from the federal government to issue favorable ratings that would stir the economy and lead to growth.

C. Most credit rating agencies also had an ulterior interest in the financial assets that they had been paid to assess.

D. Credit rating agencies would get paid by originators of structured financial assets for their work, and also made more money than they would otherwise have made from rating corporate bonds.

Q.418 While the financial meltdown of 2007-2008 started in the US, it spread fast to other countries leading to worldwide economic turmoil. Which of the following statements best describes why the crisis spread so fast?

A. Banks in the US had been the main financiers of a multitude of smaller foreign banks, and therefore when the financiers suffered liquidity problems, the smaller banks just couldn't obtain funding.

B. Securitized assets had been held by different countries around the globe, and therefore when borrowers defaulted, all the investors incurred massive losses.

C. The US entered into a recession, and their demand for exports fell, and therefore many countries experienced a major decline in exports, triggering a worldwide recession.

D. Foreign banks in Asia, Europe and other parts of the world had bought collateralized US debt and therefore when defaults rose, these banks lost a lot of money and consequently global lending, even among banks themselves, took a downward spiral.

Q.419 Distinguish between funding liquidity and market liquidity.

A. Funding liquidity describes the ease with which expert investors can obtain funding from financiers by using purchased assets as collateral, whereas market liquidity describes the ease with which investors can raise money by selling their assets.

B. Funding liquidity describes the ease with which investors can raise money by selling their assets, whereas market liquidity describes the ease with which expert investors can obtain funding from financiers by using purchased assets as collateral.

C. Funding liquidity refers to the ability of an investor to raise funds for in-house operations while market liquidity refers to the ability to raise funds for the specific investment projects themselves.

D. Funding liquidity describes the ability of an investor to raise short-term debt while market liquidity is the ability to raise long term capital.

Q.420 Which of the following statements best describes why interbank market interest rates rose sharply relative to the Treasury bill rate during and in the aftermath of the 2007-2008 financial crisis?

A. The Federal Reserve Bank increased the rate of interest at which it was willing to lend to banks.

B. Losses incurred by banks combined with uncertainty on the part of structured investment vehicles meant that there was less money available for lending to other parties.

C. Interbank market interest rates were internationally linked while the Treasury bill rate was largely local.

D. As demand for mortgages worsened, profit streams for banks took a hit, meaning that there was less money for lending to other banks.

Q.421 Distinguish between triggers and vulnerabilities that lead to the 2007-2009 financial meltdown.

A. Triggers refer to the events that touched off the crisis while vulnerabilities refer to the fundamental/regulatory weaknesses in the financial system which amplified the initial shocks.

B. Triggers refer to the causal events of the crisis while vulnerabilities refer to the institutions that bore the brunt of the crisis.

C. Triggers were the asset-backed securities created in the run-up to the crisis while vulnerabilities refer to the institutions that bore the brunt of the crisis.

D. Triggers refer to the fundamental/regulatory weaknesses in the financial system which amplified the initial shocks, while vulnerabilities refer to the causal events of the crisis.

Q.422 The **main** vulnerability of the repo market in the time period leading up to the financial crisis had much to do with the fact that:

A. The market was largely illiquid.

B. The market was large and unregulated, and many repo agreements were backed by securitized mortgages as collateral.

C. The market was small and strictly regulated.

D. Most dealers in repo agreements were based only in the US.

Q.423 In September 2008, Lehman Brothers Holdings Inc. famously filed for Chapter 11 bankruptcy protection. What was the immediate effect of the move?

A. Other large institutional investors also followed suit.

B. The Federal Reserve moved with speed to inject capital into the firm.

C. It triggered a crisis of confidence in mortgage-backed securities.

D. It led to a run on the reserve primary money market funds after one large fund "broke the buck" .

Q.424 In the run-up to the 2007-2009 financial meltdown, the interest rates in the United States had historically been low, largely due to:

A. Low savings rates in the U.S.

B. High savings rates in the U.S.

C. Low demand for credit in the country

D. Accommodative monetary policy

Q.426 In the face of competition from money market funds and junk bonds towards the end of the 20th century, the traditional banking model became less profitable and partly contributed to the emergence of the shadow banking system. This system consisted of a set of institutions which:

A. Were not only illegal but also engaged in money laundering.

B. Were allowed to invest only in short-term financial assets such as T-bills.

C. Were non-depository, and not subject to banking regulations.

D. Were non-depository, and subject to more stringent regulations compared to banks.

Q.427 Post-2008-2009 crisis research and analysis have established that the financial crisis was "not special," but was, in fact, reminiscent of prior crises. Among the key patterns noted in the build-up was:

A. A sharp increase in housing prices.

B. Increase in public debt.

C. Negative current account balance.

D. All the above.

Q.428 August 2007 is considered to be the first "panic" month when the effects of the crisis kicked in. The month was characterized by:

A. A high number of firms that were declared bankrupt.

B. Collapse of the market for asset-backed commercial papers.

C. A record number of federal bail-outs in aid of prominent U.S. institutions.

D. The lowest dollar amount of U.S. imports.

Q.429 Which of the following is **not** a monetary policy that was implemented by the U.S Federal Reserve as a response to the 2007-2009 financial crisis?

A. Lowering the interest rate.

B. Offering grants to major financial institutions.

C. Creation of long-term lending services in case of a high-quality collateral.

D. Large-scale purchase of bonds denominated in the Chinese Yuan.

Q.430 Which of the following government-financial sector stabilization measures had the biggest short-term impact on markets during the second and the third crisis period?

A. Recapitalizations

B. Asset purchases

C. Liquidity guarantees

D. Asset guarantees

Q.431 Which one of the following statements is incorrect?

A. Bear Sterns financed its mortgage loans largely by tapping the repo market.

B. Northern Rock invested in too many mortgages with insufficient collateral, leading to the inability to finance existing liabilities.

C. The housing crisis was activated in part by low preliminary “teaser” rates which would be increased later on during the term of repayment.

D. The financial crisis of 2007-2009 was caused by the Chinese government buying too many U.S. government bonds.

Q.432 What is the main problem with bailing out institutions during economic crises?

A. A huge number of assets have to be written off.

B. It increases the problem of adverse selection.

C. It may trigger public discontent or even disastrous demonstrations.

D. It increases the problem of moral hazard.

Q.433 Which one of the following characteristics is common in financial crises witnessed since the Great Depression?

A. They have only occurred in developed economies.

B. They are characterized by an absence of liquidity in markets.

C. They always last for a maximum of 2 years.

D. All of the answers are correct.

Q.434 What is the most important role played by the Federal Reserve in the multi-agency efforts that helped mitigate the effects of the credit crises?

A. It helped to weed out rogue traders and fraudulent dealings.

B. It restored confidence and liquidity to the financial markets.

C. It helped to limit foreign investments, therefore stabilized the current account of the U.S.

D. None of the above.

Q.435 The second panic period of the 2007-2009 financial crisis was triggered by:

A. A total collapse of the commercial paper market.

B. A big number of bankruptcy filings among financial conglomerates.

C. The declaration of bankruptcy by Lehman Brothers.

D. The collapse of the shadow banking system.

Reading 11: GARP Code of Conduct

Q.266 Jack Oboyo, a manager at Somalia's largest investment bank, is managing a portfolio that focuses on stocks from Somalia's logistics and transportation sector. Oboyo has some close contacts at the securities exchange commission of Somalia, providing him with non-public sales and profit-related data of firms that file their reports with the commission before being distributed to the general public. Oboyo uses this information to advise his employer on potential investment-grade stocks. It is common and legal in Somalia to obtain material non-public information or insider information related to public limited companies. Jack Oboyo's practice:

A. Has not violated the GARP's Code of conduct.

B. Has violated the Code related to confidentiality.

C. Has violated the Code related to professional integrity and ethical conduct.

D. Has violated the Code related to conflict of interest.

Q.267 David Bremen, FRM, has recently joined one of Austria's largest jet engine manufacturers as a Chief Risk Officer. Previously, Bremen had worked for 35 years in risk hedging and risk management in the banking sector. Based on his vast experience, David recommends his team hedge all of its foreign currency-denominated sales. He believes that most foreign currencies are most volatile at the end of every financial year. David's recommendation:

A. Has not violated the Code.

B. Has violated the Code because he has not clearly disclosed his expertise and knowledge concerning risk assessment.

C. Has violated the Code because he failed to distinguish between fact and opinion in the presentation of his recommendation.

D. Has violated the Code because he cannot delegate his team to perform hedging transactions.

Q.268 Muhammad Aslam, FRM, is a risk analyst at Financial Angels, a venture capitalist firm that invests in tech and health science-related startups and small-medium enterprises (SMEs). After careful risk assessments, the manager has approved Aslam to initiate the first round of funding for seven startups. Aslam's wife co-founded one of the selected startups. Without disclosing this information, Aslam proceeded with the manager's recommendation. Determine if Muhammad Aslam's actions are in violation of a Code.

A. No, because the recommendation of investing in seven startups, including the startup cofounded by Muhammad Aslam's wife, came from senior manager.

B. No, because the startup is founded by Muhammad Aslam's wife, not him. Therefore he can invest without disclosing this information.

C. Yes, as the Code requires a member to disclose to their employer the matters that could impair his independence and objectivity.

D. Yes, because Muhammad Aslam acted on the manager's recommendation without performing self-analysis.

Q.270 Which of the following GARP's Code of conduct requires a member to be diligent about not overstating the accuracy or certainty of results or conclusions and clearly disclosing the limits of their expertise and knowledge in areas of risk assessment?

A. Professional integrity and ethical conduct.

B. Fundamental responsibilities.

C. General accepted principles.

D. Conflict of interest.

Q.271 Jack Simpson, FRM, and John Philip, FRM, are two risk analysts and team members at Dark Well Insurance Company. Simpson recently found out that John Philip shares the company's confidential risk-related data with his friend, Louis Keynes, an investment manager at Verizon Investment Company that regularly trades Dark Well's stocks. Keynes also uses this information for personal gains. Which of the following action is in line with GARP's Code of conduct?

A. Simpson should bar John Philip from using the FRM designation as he shares the company's confidential information with outsiders.

B. Simpson should ignore John Philip's action, as Simpson is not personally involved in sharing the company's confidential information.

C. Simpson should not take any action against John Philip because the company's confidential information is being used by an outsider for personal gains only.

D. Simpson should immediately report John Philip's activities to their employer.

Q.272 A formal investigation that confirms violation of the GARP Code of Conduct can bring about serious consequences. Which of the following is a potential consequence of such a violation?

A. Mandatory participation in ethical training.

B. A temporary suspension of the GARP member's right to work in the field of risk management.

C. Withdrawal of the GARP member's right to use the FRM designation for any purpose.

D. A formal request to the GARP member's employer to withdraw certain benefits such as bonuses and other fringe benefits.

Q.273 Kelvin White, FRM, works for a consultancy firm that specializes in pension fund management in a certain city. Recently, one of his close friends who work for the city's planning and development department approached him with an offer to work as an unpaid volunteer for the department's pension fund. In turn, the department would grant White a free parking space just outside his office. Which of the following is the most appropriate thing to do before accepting the offer?

A. Do nothing as this is a volunteer job.

B. Request the department not to grant him any fringe benefit, including the free parking space.

C. Seek advice regarding the offer from one of his colleagues at the consultancy firm.

D. Disclose the details of the volunteer position to his employer.

Q.274 A GARP member working in a certain country establishes that the GARP Code of Conduct, the country's laws, and the local law applicable within the region where she conducts business all specify different requirements. The member must abide by:

A. The GARP Code of Conduct.

B. The highest standard of local law, her country's laws, or the GARP Code of Conduct.

C. The GARP Code of Conduct or the local law, whichever is higher.

D. The country's law.

Q.275 Jessica Pearson, FRM, works for an investment bank. At the end of a 2-year contractual relationship between the bank and one of its clients, the client offers Jessica a car worth USD 43,200 in part because of her outstanding expertise and professionalism throughout the period of the contract. How should Jessica proceed?

A. Accept the gift because the contract has lapsed.

B. Accept the gift but make sure that she informs her employer about it.

C. Reject the gift.

D. Reject the gift but request the client to redirect it to the bank itself.

Q.276 Green Belt Market Fund directs its two subsidiaries to buy and sell emerging market stocks simultaneously. In its monthly investment outlook literature, the company points to the overall emerging market volume as indicative of the market's liquidity. The move prompts more investors to participate in the emerging markets fund increasingly. Green Belt Market Fund most likely:

A. Did not violate the GARP Code of Conduct.

B. Violated the GARP Code of Conduct regarding conflict of interest.

C. Did not violate the GARP Code of Conduct but may have breached stock brokerage rules.

D. Violated the GARP Code of Conduct regarding professional integrity and ethical conduct.

Q.277 Theresa Conway, FRM, is a trade manager of an investment fund specializing in currency trading. In a report sent to investors, Conway outlines her trading strategy which is hinged on the appreciation of the United States dollar against other world currencies. She quantifies expected returns if the dollar appreciates by less than 5%, 5% - 10%, and by more than 10%. She also outlines possible scenarios if the dollar depreciates by similar margins. Also explicitly stated therein is that these projections are her professional opinion. Has Conway violated the GARP Code of Conduct with respect to communication?

A. Yes.

B. No, because she disclosed the basic details of her investment strategy.

C. No, because she explicitly distinguishes fact from opinion, while still giving a range of scenarios if the dollar appreciates or depreciates - therefore capturing most (or all) possible scenarios.

D. No, because it's her legal duty to communicate the details of her strategy to investors.

Q.278 Richard Leakey, FRM, is an analyst with a large portfolio of stocks, including the stock of Brighter World Limited (BWL). Leakey's uncle owns about 20,000 shares of BWL. He informs Leakey that he has created a trust in his name and placed 5,000 BWL shares into the trust. The wording of the trust prevents Leakey from selling the shares until his uncle dies, but may nonetheless vote for the shares. Leakey is due to give an updated research analysis on BWL in a fortnight. Leakey should most appropriately:

A. Disregard the situation and proceed to update the report as usual because he is not a beneficiary of the shares as of now.

B. Notify his superiors that he's no longer in a position to issue recommendations on BWL.

C. Request his uncle to amend the terms of the trust to allow him to sell the shares at any time.

D. Disclose the situation to his employer and, if given the green light to prepare a report, also disclose his new status as a beneficiary of BWL stocks.

Q.279 Paul Lambert, FRM, serves as a financial analyst for Lakeside Investments. He has been tasked with preparing a purchase recommendation on Brighter World Limited. Which of the following statements about disclosure of conflicts of interest would Lambert have to disclose fully?

A. He co-owns 30,000 of Brighter World Limited with his brother.

B. He has a significant ownership in Brighter World Limited through a family trust.

C. Lakeside is an over-the-counter market maker for Brighter World Limited's stock.

D. All of the above.

Q.280 Which of the following is NOT a fundamental responsibility of GARP members as stipulated in the Code of Conduct?

A. Members must purpose, and encourage others, to operate at the highest level of professional skills.

B. Members have a personal ethical responsibility and must maintain the highest ethical standards.

C. Members cannot delegate or outsource their ethical responsibility to others.

D. Members do not have to continue perfecting their expertise once they have passed exams and obtained all the necessary certifications.

Q.281 Chris Jefferson, FRM, is the manager of a hedge fund. Over the last 3 days, he has been investing the hedge fund by purchasing significant quantities of ABC's stock while simultaneously selling the three-month futures contract (i.e. initiating a short position in it). Although his clients are aware of the fund's general investment strategy to generate earnings, Jefferson did not inform them of the trades. One of the following statements is most likely correct. Which one?

A. Jefferson violated the GARP Code of Conduct.

B. Jefferson did not violate the GARP Code of Conduct.

C. Manipulated the price of a publicly traded security hence violated the Code of Conduct.

D. Violated the GARP Code of Conduct by failing to keep his clients in the loop regarding the transactions before they occurred.

Q.282 Carol Bauer, FRM, serves as a portfolio manager for several wealthy clients with well-diversified portfolios. Among her clients is Matthew Cook, for whom she manages a personal portfolio of stocks and government bonds. Cook recently disclosed to Bauer that he is under investigation for tax evasion related to his business, Cook Concrete. After a few days, Bauer shares that information with a friend who works at a local bank that has plans to underwrite Concrete's IPO. Carol Bauer has most likely:

A. Violated the GARP Code of Conduct with respect to confidentiality.

B. Not violated the GARP Code of Conduct with respect to confidentiality.

C. Not violated the GARP Code of Conduct because she revealed illegal activities on the part of her client.

D. Violated the GARP Code of Conduct by failing to detect the tax evasion despite being central to her client's business dealings.

Q.283 Donald Lee, FRM, is an exam proctor for the FRM part I exam. A few days before the exam, Lee emails a copy of 5 questions to each of his two friends, Martin and Joseph, who are part 1 candidates in the FRM program. Lee and his two friends had planned the distribution of exam questions months in advance. Martin proceeds to prepare for the exam. However, Joseph develops cold feet and declines to load the questions and use them to his advantage. Which of the following statements is most likely correct?

A. Donald Lee violated the GARP Code of Conduct, but Martin and Joseph did not.

B. All the three violated the GARP Code of Conduct.

C. Donald Lee and Martin violated the code, but Joseph did not.

D. Martin and Joseph violated the code, but Donald Lee did not.

Q.284 Timothy Bradley, FRM, works as a full-time financial analyst at KenBright Actuarial Services Limited(KBG). Recently, one of the company's business contacts offered him a part-time analytical job at KPMG. The work would entail establishing the right balance between equity and debt finance for KPMG. Timothy should most appropriately:

A. Not accept the work as it violates the Code of Conduct by creating a conflict of interest.

B. Accept the work as long as he obtains written consent from KBG and does it in his free time.

C. Accept the work as long as his full-time employer, KenBright Limited, agrees to all the terms of the engagement.

D. Accept the role as long as, in her own assessment, it does not interfere with her duties to KenBright Limited.

Q.285 Sally Spicer, FRM, acts as a liaison between Prime Financials (an investment management firm) and Neiman Inc. (an investment bank). Neiman Inc. intends to issue an IPO and turns to Prime Financials for underwriting services. As a way of increasing investor confidence, Sally Spicer has Prime Financials issue a trove of vague and unrealistic financial information that paints its clients in better health than it actually is. Which section of the GARP Code of conduct has most likely been violated by Spicer and her company?

A. Best practices.

B. Professional integrity and ethical conduct.

C. Fundamental responsibilities.

D. Confidentiality.

Q.286 Romney Muriuki, FRM, works as an analyst for an African Insurance firm that has a presence in 8 central African countries. In a recent report, Muriuki makes the following statements:
"Based on the fact that the firm has recorded steady growth in customer numbers over the last decade, and that the insurance penetration currently stands at 3%, I expect the trend to continue for the next 10 years. I also expect that the company will be able to translate the continually increasing revenue into significant profits."

The report describes in detail the risks facing the firm, particularly geopolitical risks associated with African countries. Muriuki's report:

A. Violated the Code by failing to distinguish factual details from his opinion.

B. Did not violate the Code.

C. Violated the code by giving a shallow professional assessment of the insurance market in Africa.

D. Violated the Code by failing to properly identify all the risks related to operations in African countries.