Topic 1 - 5

Test ID: 8450890

Question #1 of 25

Question ID: 438572

Value at risk (VaR) is the:

✗ **A)** **average loss exceeding a specified threshold.**

✓ **B)** maximum expected loss for a given confidence level.

✗ **C)** the worst possible loss for an asset.

✗ **D)** minimum expected loss for a given confidence level.

Explanation

VaR is the maximum expected loss for a given confidence level assuming normal market returns. It is the minimum expected loss for a given significance level.

Question #2 of 25

Question ID: 438568

The risk of sustaining significant losses due to the inability to take or exit a position at a fair price is most likely:

✗ **A)** **credit event risk.**

✗ **B)** operational risk.

✓ **C)** liquidity risk.

✗ **D)** market risk.

Explanation

Liquidity risk is the risk of sustaining significant losses due to the inability to take or exit a position at a fair price.

Question #3 of 25

Question ID: 495061

When adhering to best practices in corporate governance, the board of directors should most likely:

I. watch out for the interests of the debtholders.
II. maintain its independence from management.

✗ **A)** **II only.**

✗ **B)** I only.

✓ **C)** Both I and II.

✗ **D)** Neither I nor II.

Explanation

The board would watch out for the interests of shareholders as well as other stakeholders, such as debtholders, by considering if any of management's decisions contain extreme downside risk. The board should maintain its independence from management. A key measure involved would be that the chief executive officer (CEO) would not also be the chairman of the board because there is already an inherent conflict with the CEO being on both the management team and the board of directors.

Question #4 of 25

Question ID: 438566

The risk that a counterparty will fail to deliver its obligation is:

✓ **A) settlement risk.**

✗ **B)** model risk.

✗ **C)** delivery risk.

✗ **D)** people risk.

Explanation

Settlement risk is the risk that a counterparty will fail to deliver its obligation.

Question #5 of 25

Question ID: 495065

Regarding the interdependence of risk management related functional units within a firm, which of the following list of activities are most likely associated with senior management?

✗ **A) Books and settles trades, reconciles front- and back-office positions, and prepares and decomposes daily P&L.**

✗ **B)** Develops valuation and finance policy, ensures integrity of P&L, and manages business planning process.

✗ **C)** Establishes and manages risk exposure, ensures timely, accurate, and complete deal capture, and signs off on official P&L.

✓ **D)** Approves business plans and targets, sets risk tolerance, and ensures performance.

Explanation

The senior management functional unit approves business plans and targets, sets risk tolerance, establishes policy, and ensures performance.

Question #6 of 25

Question ID: 495068

The chief risk officer (CRO) is responsible for all risks facing a company, and is specifically responsible for developing and implementing an enterprise risk management (ERM) strategy. Which of the following statements is correct regarding the role and responsibilities of the CRO?

✓ **A) The CRO develops a framework of management policies, including setting the overall risk appetite of the firm.**

✗ **B)** The CRO is a mid-level management responsible for assisting with ERM.

✗ **C)** The CRO typically reports to the heads of credit, market, operational, and insurance risks.

✗ **D)** The creation of the CRO role is the only solution to establishing risk oversight.

Explanation

The CRO provides overall leadership, vision, and direction for ERM and develops a framework of management policies, including setting the overall risk appetite of the firm. The CRO is a top-level executive responsible for overall risk management in a centralized role. Reporting to the CRO typically are the heads of the various risk functions, including the heads of credit, market, operational, and insurance risks. The creation of the CRO role is not the only solution to establishing top-level risk oversight (the firm's audit committee could also take on this role).

Question #7 of 25

Question ID: 495071

A risk appetite framework (RAF) may be used to help a firm manage risk and implement proper corporate governance. Which of the following statements correctly reflects a firm's risk appetite? Risk appetite:

✗ **A)** **must exceed a firm's risk capacity, which is the minimum amount of risk the firm should take.**

✗ **B)** together with the firm's RAF should be viewed as a set of standalone rules or tasks.

✓ **C)** is the amount and type of risk that a firm is able and willing to accept in pursuit of its business objectives.

✗ **D)** is a system of values and behaviors present in employees throughout the firm.

Explanation

Risk appetite is defined as the amount and type of risk that a firm is able and willing to accept in pursuit of its business objectives. The firm's risk appetite must not exceed its risk capacity (i.e., the maximum amount of risk the firm can take). Risk culture is a system of values and behaviors present in employees (including management) throughout a firm. The RAF needs to be viewed as an integral part of a firm's risk culture (i.e., not viewed as standalone rules or tasks).

Question #8 of 25

Question ID: 495069

The chief risk officer (CRO) generally reports to the CEO but could also have a dotted line relationship to both the CEO and to the board of directors in order to minimize any potential friction between the CRO and the CEO due to:

I. basis risk hedging.
II. regulatory issues.

✗ **A)** **Neither I nor II.**

✗ **B)** I only.

✓ **C)** II only.

✗ **D)** Both I and II.

Explanation

The dotted line relationship is intended to minimize any potential friction between the CRO and the firm's CEO or other top executives due potentially to excessive risk taking, regulatory issues, or outright fraud by the CEO or executives.

Question #9 of 25

Question ID: 495075

Which of the following statements correctly identifies a challenge associated with firm-wide risk aggregation?

I. Separate business units will set their risk appetite parameters, but there is no set method for the firm to use in determining whether the sum of those parameters is acceptable for the firm's total risk appetite.
II. When assuming that the quantitative measures of risk are reliable and accurate, there is still the problem with properly

measuring the less quantifiable risks.

- ✓ **A) Both I and II.**
- ✗ **B)** Neither I nor II.
- ✗ **C)** I only.
- ✗ **D)** II only.

Explanation

Firm-wide risk aggregation is problematic because the separate business units will set their risk appetite parameters, but there is no set method for the firm to use in determining whether the sum of those parameters is acceptable for the firm's total risk appetite. Also, when assuming that the quantitative measures of risk are reliable and accurate, there is still the problem with properly measuring the less quantifiable risks.

Question #10 of 25

Question ID: 495064

Stella Webster, FRM, is assessing the role and responsibilities of her firm's audit committee. Which of the following statements is incorrect regarding the audit committee? The audit committee (as part of the board):

- ✓ **A) discusses and approves the remuneration of key management personnel.**
- ✗ **B)** monitors the underlying systems in place regarding financial reporting, regulatory compliance, internal controls, and risk management.
- ✗ **C)** has traditionally been responsible for the accuracy of the firm's financial statements and its regulatory reporting requirements.
- ✗ **D)** must ensure that the firm has taken all steps to avoid the risk that the financial statements are materially misstated as a result of undiscovered errors and/or fraud.

Explanation

Discussing and approving the remuneration of key management personnel is the role of the compensation committee, not the audit committee.

Question #11 of 25

Question ID: 495058

Taylor Lawson is giving a presentation on the differences between static and dynamic hedging strategies. Which of the following statements is correct regarding these two hedging strategies?

- ✗ **A) A static hedging strategy is a complex process in which the risky investment position is initially determined and an appropriate hedging vehicle is used to match that position as close as possible and for as long as required.**
- ✓ **B)** Significantly more time and monitoring efforts are required with a dynamic hedging strategy compared to a static hedging strategy.
- ✗ **C)** A static hedging strategy recognizes that the attributes of the underlying risky position may change with time.
- ✗ **D)** A dynamic hedging strategy is a more simple process than a static hedging strategy.

Explanation

A static hedging strategy is a simple process. In contrast, a dynamic hedging strategy is a more complex process that recognizes that the attributes of the underlying risky position may change with time. Significantly more time and monitoring efforts are required with a dynamic hedging strategy.

Question #12 of 25

Question ID: 495057

The board of directors should help a company determine whether to hedge specific risk factors. Regarding the role of the board, which of the following statements is incorrect?

- ✗ **A)** **The board must ensure that its goals are stated in a clear and actionable manner.**
- ✗ **B)** The board needs to help set and communicate the firm's risk appetite in a quantitative and/or qualitative manner.
- ✓ **C)** The board should ignore time horizon when determining its risk management goals for management to achieve.
- ✗ **D)** The board should clarify its objectives in terms of whether it is accounting or economic profits that are to be hedged.

Explanation

The board must be definitive in the time horizon when determining its risk management goals for management to achieve. For example, the use of a futures contract to hedge future sales receipts will result in a mismatch of profits for accounting purposes.

Question #13 of 25

Question ID: 495062

Which of the following actions correctly reflect a specific duty of the risk advisory director? The risk advisory director should review and analyze:

- ✗ **A)** **risk management practices of competitors, but not risk management practices of the industry.**
- ✗ **B)** any audit reports from internal audits, but not from external audits.
- ✓ **C)** the firm's risk appetite and its impact on business strategy.
- ✗ **D)** the firm's financial statements, but not the firm's disclosures.

Explanation

The role of the board of directors in governance would include the review and analysis of:

- The firm's risk management policies.
- The firm's periodic risk management reports.
- The firm's appetite and its impact on business strategy.
- The firm's internal controls.
- The firm's financial statements and disclosures.
- The firm's related parties and related party transactions.
- Any audit reports from internal or external audits.
- Corporate governance best practices for the industry.
- Risk management practices of competitors and the industry.

Question #14 of 25

Question ID: 495067

Regarding the primary motivations for a firm to implement an enterprise risk management (ERM) initiative, which of the following motivations are most likely associated with the benefit of improved business performance?

- ✓ **A) Integration of business processes.**
- ✗ **B)** Integration of portfolio management.
- ✗ **C)** Integration of risk organization.
- ✗ **D)** Integration of risk transfer.

Explanation

There are three primary motivations for a firm to implement an ERM initiative: (1) integration of risk organization, (2) integration of risk transfer, and (3) integration of business processes. The respective benefits are better organizational effectiveness, better risk reporting, and improved business performance.

Question #15 of 25

Question ID: 495059

When evaluating methods to hedge operational and financial risks, including pricing, foreign currency, and interest rate risk, which of the following risks primarily pertain to the income statement?

I. Hedging operational risk
II. Hedging financial position risk

- ✗ **A) Neither I nor II.**
- ✓ **B)** I only.
- ✗ **C)** II only.
- ✗ **D)** Both I and II.

Explanation

Hedging operational risk covers a firm's activities in production (costs) and sales (revenue), which is essentially the income statement. Financial position risk pertains to a firm's balance sheet.

Question #16 of 25

Question ID: 492007

Unexpected volatility in an asset is often called:

- ✓ **A) risk.**
- ✗ **B)** an upward earnings surprise.
- ✗ **C)** biased expectations.
- ✗ **D)** asset price instability.

Explanation

Risk is described as unexpected volatility in asset prices or earnings.

Question #17 of 25

Question ID: 495074

Regarding current best practices for the implementation and communication of a risk appetite framework (RAF), which of the following statements is correct?

I. An effective RAF stops after the setting of risk limits.
II. Business unit managers should be responsible for managing risks across all business units.

✗ **A)** **I only.**
✗ **B)** II only.
✗ **C)** Both I and II.
✓ **D)** Neither I nor II.

Explanation

Limits are crucial to ensure the proper implementation of the RAF throughout the firm. An effective RAF must go beyond the mere setting of limits. Business unit managers should clearly be responsible for managing risk within their respective units. There should be an overt inclusion of risk within the planning process for each unit.

Question #18 of 25

Question ID: 495070

Steven Marsh is assisting with the implementation of an enterprise risk management (ERM) program for his firm. Specifically, he is analyzing the main components of a strong ERM framework. Which of the following activities is closely associated with the ERM component of portfolio management?

✗ **A)** **Quantifies risk exposures for use in risk analysis, measurement, and reporting.**
✗ **B)** Communicates a firm's internal risk management process to external stakeholders, including shareholders, creditors, regulators, and the public.
✗ **C)** Reduces or transfers out risks that are either undesirable risks or are desirable but considered concentrated.
✓ **D)** Provide a holistic view of the firm's risks if these risks are viewed as individual components of the aggregate risks facing the firm.

Explanation

Portfolio management provides a holistic view of the firm's risks if these risks are viewed as individual components of the aggregate risks facing the firm. Active portfolio management aggregates risk exposures and allows for diversification of risks (partly through offsetting risk positions) and prudent monitoring of risk concentrations against preset limits. Firms that manage each of their financial risks independently will need to integrate these risks into a comprehensive ERM process to optimize firm risk and return.

Question #19 of 25

Question ID: 495056

Abe Osbourne is a risk analyst who is evaluating the advantages and disadvantages of hedging risk exposures. Which of the following statements does not reflect an advantage of hedging?

✗ **A)** **Hedging may allow management to control its financial performance to meet the requirements of the board of directors.**
✗ **B)** Hedging may result in operational improvements within a firm.
✗ **C)** Hedging through the use of derivatives instruments such as swaps and options may be cheaper than purchasing an insurance policy.

✓ **D)** Hedging may decrease the variability of the firm's earnings due to the difference between accounting earnings and cash flows.

Explanation

Using hedging activities to decrease the variability of the firm's value may end up increasing the variability of the firm's earnings due to the difference between accounting earnings and cash flows. This is a disadvantage of hedging risk exposures in practice.

Question #20 of 25

Question ID: 495066

Bank XYZ's senior management and its board of directors currently receive fragmented risk management information from various functional units. Given the shortcomings of this approach, the chief risk officer (CRO) suggests a more centralized risk management system. Which of the following statements is correct regarding the implementation of an enterprise risk management (ERM) program?

I. ERM is crucial in establishing a firm-wide, integrated set of policies, procedures, and standards.
II. ERM is often defined as a process or activity to manage risks.

✗ **A)** **I only.**

✗ **B)** Neither I nor II.

✗ **C)** II only.

✓ **D)** Both I and II.

Explanation

Since the concept of ERM is relatively new and is still evolving, there is a lack of a standard ERM definition. ERM is often defined as a process or activity to manage risks. ERM is crucial in establishing a firm-wide, integrated set of policies, procedures, and standards. From senior management's perspective, an ERM system provides an invaluable overall risk perspective and control.

Question #21 of 25

Question ID: 495073

Donald Turner, FRM, is reviewing the key challenges of implementing a risk appetite framework (RAF). Which of the following challenges relates specifically to training a broader range of employees on the details of the RAF and how it is beneficial in order to achieve employee acceptance?

✗ **A)** **The common view that risk appetite is mainly about setting limits.**

✓ **B)** Properly transmitting the RAF within the firm together with incorporating the RAF into making day-to-day operating decisions.

✗ **C)** The role of stress testing in the RAF.

✗ **D)** The lack of connection between risk appetite and the strategic and business planning processes.

Explanation

Although top-level management may be well versed in the RAF and its impact on the firm, it may not be the case with middle management, for example. Therefore, the challenge is to train a broader range of employees on the details of the RAF and how it is beneficial in order to achieve employee acceptance.

Question #22 of 25

Question ID: 438569

Funding liquidity risk refers to the risk:

- ✗ **A) that the government will decide to terminate a government-funded program.**
- ✓ **B)** that an institution will not be able to raise cash necessary to make debt payments.
- ✗ **C)** that a counterparty to a financial transaction will default.
- ✗ **D)** resulting from a large position size in an asset relative to the asset's typical trading lot size.

Explanation

Funding liquidity risk refers to the risk that an institution will not be able to:

- raise cash necessary to make debt payments
- fulfill cash, margin, and collateral requirements of counterparties
- meet capital withdrawals resulting in a loss

Question #23 of 25

Question ID: 495060

Management at Bank ABC is attempting to determine which types of instruments to use for risk management. When comparing exchange-traded instruments to over-the-counter (OTC) instruments, which characteristic should the bank associate with exchange-traded instruments? Exchange-traded instruments:

- ✗ **A) can be customized to suit the firm's risk management needs.**
- ✗ **B)** contain credit risk by either of the counterparties in the transaction (e.g., default risk).
- ✗ **C)** are privately traded between a bank and a firm.
- ✓ **D)** cover only certain underlying assets and are standardized.

Explanation

Exchange-traded instruments cover only certain underlying assets and are quite standardized (e.g., maturities and strike prices) in order to promote liquidity in the marketplace. OTC instruments are privately traded between a bank and a firm and thus can be customized to suit the firm's risk management needs. In addition, there is credit risk by either of the counterparties (e.g., default risk) that would generally not exist with exchange-traded instruments.

Question #24 of 25

Question ID: 495072

Regarding the relationship between a firm's risk appetite and its risk culture, which of the following statements is most likely incorrect?

- ✗ **A) There is a clear connection between a firm's risk culture and its risk appetite.**
- ✓ **B)** Qualitative measures are needed to develop a risk culture, because they are easier to measure than quantitative metrics.
- ✗ **C)** Risk culture directly impacts analysis of information pertaining to risk and ultimately impacts decisions about which risks the firm will take.
- ✗ **D)** A strong risk culture makes it easier to set a risk appetite framework (RAF).

Explanation

There needs to be the development of relevant risk management performance metrics that can objectively reward those who comply with the set risk limits. At the same time, there should be some qualitative measures developed, although they are more challenging to measure. Both quantitative and qualitative measures are needed to develop risk culture and to ensure the effectiveness of the RAF.

Question #25 of 25

Question ID: 495063

Regarding the relationship between a firm's risk appetite and its business strategy, which of the following statements is true?

- ✗ **A)** **A firm's risk appetite reflects its ability to minimize risk.**
- ✗ **B)** Business planning activities that exceed risk appetite should be maintained.
- ✓ **C)** Business strategy planning meetings require input from the risk management team.
- ✗ **D)** Consideration must be given to the downside risks of only risky business strategies.

Explanation

A firm's risk appetite reflects its tolerance (especially willingness) to accept risk. There must be a logical relationship between the firm's risk appetite and its business strategy. As a result, business strategy planning meetings require input from the risk management team right from the outset to ensure the consistency between risk appetite and business strategy. For example, planning activities are often focused on maximizing the firm's profit but some planned activities may need to be eliminated or modified because they exceed the stated risk appetite. Consideration must also be given to the downside risks of any business strategy.