Topic 8: Risk Management Failures

Test ID: 8291951

Question #1 of 7

Question ID: 438694

All of the following occurrences are examples of risk mismeasurement, except when risk managers:

- ✗ **A)** **do not understand the relationships of the distributions among different positions.**
- ✗ **B)** use subjectivity when measuring extreme and rare events.
- ✗ **C)** do not understand the distribution of returns of a single risky position.
- ✓ **D)** take known and unknown risks into account.

Explanation

Risk mismeasurement can occur when risk managers do not understand the distribution of returns of a single risky position or the relationships of the distributions among different positions. One of the key issues for risk managers is the occurrence of extreme events (those events which occur with low frequency, but high severity). Estimates of these rare events require a degree of subjectivity, which clearly has the potential for mismeasurement. Risk mismeasurement can also occur from ignoring relevant risks.

Question #2 of 7

Question ID: 438692

The role of risk management does not involve performing which of the following tasks?

- ✗ **A)** **Assess all risks faced by the firm.**
- ✗ **B)** Communicate all risks to risk-taking decision makers.
- ✓ **C)** Make sure the firm takes greater than the necessary amount of risk in order to achieve higher returns.
- ✗ **D)** Monitor and manage all risks.

Explanation

The role of risk management involves performing the following tasks: (1) assess all risks faced by the firm, (2) communicate these risks to risk-taking decision makers, and (3) monitor and manage these risks (make sure that the firm only takes the necessary amount of risk).

Question #3 of 7

Question ID: 438697

Which of the following statements does not illustrate how firms can fail to correctly monitor and manage risk on an ongoing basis?

- ✓ **A)** **Portfolio risk profiles do not change over time.**
- ✗ **B)** A firm does not have an adequate incentive structure.
- ✗ **C)** Some securities have complex relationships with market variables such as interest rate changes.
- ✗ **D)** A firm does not have an adequate culture that promotes effective risk management.

Explanation

Portfolio risk profiles can change even during the absence of trading. The properties of some securities can change for several reasons (e.g., changes in interest rates, embedded derivatives).

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Question ID: 438693

It is important for a firm to recognize all relevant risks. Failing to manage risk exposure could result from all of the following actions except:

✓ **A)** **not measuring unknown risks correctly.**

✗ **B)** not monitoring risk adequately.

✗ **C)** not communicating risks to top management.

✗ **D)** not using appropriate risk metrics.

Explanation

The process of risk management can fail if one or more of the following events occur: not measuring **known risks** correctly, not recognizing some risks, not communicating risks to top management, not monitoring risk adequately, not managing risk adequately, and not using the appropriate risk metrics. Unknown risks should be recognized, but not necessarily measured.

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Question ID: 438695

One of the severe consequences of either ignoring or not adequately using data in risk models is that the firm might expand its operations in areas where risks are not being properly considered. Which of the following statements are examples of ignoring or not adequately using data?

I. The firm assumes global market correlations stay constant during financial crises.

II. The firm accepts the assumption that AAA-rated assets are very low risk.

✓ **A)** **Both I and II.**

✗ **B)** I only.

✗ **C)** II only.

✗ **D)** Neither I nor II.

Explanation

One of the severe consequences of either ignoring or not adequately using data in risk models is that the firm might expand its operations in areas where risks are not being properly considered. For example, blindly accepting a given assumption (i.e., AAA-rated assets are very low risk) and ignoring data that would indicate the contrary. Another risk that is often ignored is increasing correlations during a time of crisis.

Question #6 of 7

Question ID: 438698

Predatory trading occurs when:

✗ **A)** **a borrower becomes worse off after a loan than before.**

✓ **B)** other firms in a market see that a large player in the market is in trouble and the other firms attempt to push the price down further in order to hurt the large player.

✗ **C)** a firm with small loss in a given market can influence the activity in that market.

✗ **D)** there is a misrepresentation in the mortgage application from the borrower side.

Explanation

Predatory trading occurs when other firms in a market see that a large player in the market is in trouble and the other firms attempt to push the price down further in order to hurt the large player. Such activity is difficult to incorporate into risk metrics.

Question #7 of 7

Question ID: 438696

Which of the following statements is incorrect regarding the importance of effectively communicating the results of the risk management process?

✗ **A)** **Timely communication that has not been distorted by intermediaries is required to effective communication.**

✓ **B)** The purpose of risk management is to allow senior managers of the firm to make the optimal strategic decisions to maximize firm stock price.

✗ **C)** The risk management process may be harmful if there is miscommunication, and the senior managers get a false sense of security from the information that is provided.

✗ **D)** Risk management efforts are wasted unless the results can be effectively communicated to the appropriate decision makers.

Explanation

The purpose of risk management is to allow senior managers of the firm to make the optimal strategic decisions to maximize **firm value**.