**CFA LEVEL-III, Practice Questions | Solutions**

**Reading # 25:** *Risk Management*

Question 1 - #93243

Your answer: A was correct!

Monitoring and evaluation includes the ability to easily identify data problems, identify position limit violations, perform diagnostics on pricing and VAR measures computed by the analytics system, and allow for risk adjustments and performance evaluation.

Question 2 - #92893

Your answer: B was correct!

Duration and delta by themselves are not sufficient measures of bond and option risk. Second order effects (convexity and gamma) must also be considered. Risk managers should consider asset sensitivities to factors as well as how those sensitivities change. Both remaining responses are correct.

Question 3 - #93215

Your answer: B was incorrect. The correct answer was C) the risk associated with both currencies and commodities.

Market risk is a subset of financial risk. Market risk includes commodities, currencies, equity prices, and interest rates.

Question 4 - #93234

Your answer: B was correct!

Since return and risk go together, risk managers should determine the appropriate level of risk that is acceptable. The acceptable level should be based upon the nature of the firm and the risk tolerance of the stakeholders. Those that manage risk should be separate from those that take the risks.

Question 5 - #93194

Your answer: B was incorrect. The correct answer was A) Sortino ratio.

The Sortino ratio examines the downside risk of returns. It is calculated as the portfolio return minus the minimum acceptable return (MAR) divided by a standard deviation that only uses returns below the MAR. It is similar to the target semivariance. Since Rouse’s portfolio has had consistently higher returns, she should not be penalized for any variability on the upside. Standard deviation and the Sharpe ratio (which uses the standard deviation in the denominator) examine all returns, whether they correspond to positive or negative alphas. The use of these measures would result in risk measurements that are unfairly high in Rouse’s case.

Question 6 - #92353

Your answer: B was incorrect. The correct answer was A) in some industries require its computation and reporting.

The regulation in some industries address VAR, but many do not.

Question 7 - #126906

Part 1)

Your answer: B was incorrect. The correct answer was C) Both are correct.

Both MinRisk and McGuire are correct.

VAR can be considered a minimum loss expected over a time horizon at a given probability. In this particular case, one would expect to exceed the VAR 5% of the time. MinRisk interpretation is also correct. Watch the wording in VAR questions.

VAR is a measure that combines probabilities over a certain time horizon with dollar amounts, which in the statement means that one expects to lose at least $5 million in five trading days out of 100. (Study Session 14, LOS 25.e)

Part 2)

Your answer: B was correct!

Variance-covariance method.

The variance-covariance method, also known as the delta-normal method, only requires estimates of mean and standard deviation of returns to estimate VAR. This is the closest method to which Smitherspoon refers. (Study Session 14, LOS 25.f)

Part 3)

Your answer: B was correct!

Response 1 is almost a definition of VAR. Response 2 might appear incorrect at first, because of the reference to the 90% confidence interval. Remember, however, that VAR considers only the lower tail of the distribution. To calculate the 95% VAR we use the Z-value corresponding to a 90% confidence interval (1.65), because that isolates the lower 5% of the distribution. Response 3 has an incorrect component. The last statement about calculating the overall VAR directly is correct; you must incorporate the correlations of the managers' returns to calculate the overall fund standard deviation. That is the problem with using individual VARs to calculate a fund VAR; VAR is not additive. Adding individual VARs overstates the fund VAR, because adding them ignores the correlations of individual manager's returns. (Study Session 14, LOS 25.e)

Part 4)

Your answer: B was incorrect. The correct answer was A) $400 million.

$400 million

The current surplus is $100 million, resulting in a SAR of $500 million. The asset base is expected to generate $100 million this year ($2,000 million × 0.05). The 5% SAR of $500 when the surplus is $100 million indicates that the underfunding of the plan at year end when the surplus will have increased $100 million to $200 million will be $400 (= 100 − 500) or more, 5% of the time. (Study Session 14, LOS 25.f)

Part 5)

Your answer: B was correct!

VAR will be a more relevant risk measure for Quality because its portfolio experiences less turnover and because VAR is evaluated more frequently.

Coupling a high turnover with a long time horizon decreases VAR's usefulness. VAR is calculated for a specific portfolio at a point in time. High turnover will change a portfolio's composition, which will also change the underlying statistical characteristics of the portfolio. These changes in statistical characteristics then decrease the usefulness of VAR calculations, especially in situations with long time horizons. (Study Session 14, LOS 25.e)

Part 6)

Your answer: B was correct!

Stober is correct, and Robertson is incorrect.

Gamma is the second derivative of the change in the underlying asset price movements. Stober correctly defines delta. (Study Session 15, LOS 37.e,f)

Question 8 - #91915

Your answer: B was incorrect. The correct answer was C) $1,499,000.

VAR = Vp[Expected return-(z)(standard deviation)]

Expected return = (0.25)(12) + (0.25)(14) + (0.25)(5) + (0.25)(14) = 11.25%

VAR = 2,000,000[0.1125 − (1.65)(0.22)] = −501,000

2,000,000 − 501,000 = 1,499,000

Question 9 - #93216

Your answer: B was incorrect. The correct answer was C) high liquidity risk, which means high financial risk.

The bid/ask spread is a good measure of liquidity. The larger the spread the greater the liquidity risk. Liquidity risk is a subset of financial risk—the larger the liquidity risk, the larger the financial risk.

Question 10 - #93190

Your answer: B was incorrect. The correct answer was A) it is computationally intensive.

For the Monte Carlo method, the advantages are that it does not require the normality assumption, and it is flexible insofar as it can accommodate a variety of assumptions regarding complex relationships. The main disadvantage is that it is often computationally intensive.

Question 11 - #92203

Your answer: B was correct!

While value at risk may indicate risks that need to be hedged, it is not a hedging tool as such.

Question 12 - #93246

Your answer: B was incorrect. The correct answer was C) is not useful for determining the probability of an expected loss.

Stress analysis is useful for determining the magnitude, but not necessarily the probability, of an expected loss. This is why stress testing is such a good compliment for VAR, which determines the probability for a loss, but not the magnitude. Both remaining statements are incorrect—stress testing incorporates both delta and gamma risks, it is a good way to highlight inappropriate assumptions, and it can be used with any VAR estimate.

Question 13 - #93286

Your answer: B was incorrect. The correct answer was C) Exposure to risk of being taken over.

Stress analysis makes the risk manager become aware of the consequences of market moves, liquidity crises, and other factors that affect the business of a firm. As a result, the manager can be prepared with proper hedges and advance contingency planning to combat adverse situations. The analysis also highlights the extent of the potential loss so that the manager can decide the extent of exposure to such risk. Risk of being taken over as a target is usually not a concern of this analysis.

Question 14 - #92242

Your answer: B was correct!

VAR, which measures downside risk, more completely captures the attitudes of many market participants towards risk.

Question 15 - #92774

Your answer: B was correct!

Commodity prices are a source of financial risk.

Question 16 - #92907

Your answer: B was incorrect. The correct answer was C) Position limit.

A position limit places a dollar nominal cap on a given position. By placing a maximum dollar amount on each position, the firm will diversify its capital across a greater number of sectors. A liquidity limit is a position limit that is based on trading volume so that liquidity risk is minimized. Risk factor limits restrict the exposure of the portfolio to individual risk factors.

Question 17 - #92416

Your answer: B was incorrect. The correct answer was A) across asset classes such as bonds and stocks.

VAR measures risk comparably across asset classes. Thus, the risk of a bond portfolio can be compared to that of an equity portfolio. This type of comparison is not very meaningful using other risk measures.

Question 18 - #93200

Your answer: B was incorrect. The correct answer was A) $54,250.

The expected outcome is $20,000. Given the standard deviation of $45,000 and a z-score of 1.65 (95% confidence level for a one-tailed test), the VAR is –54,250 [= 20,000 – 1.65 (45,000)].

Question 19 - #92127

Your answer: B was incorrect. The correct answer was C) Decentralization of risk monitoring and control procedures.

An effective enterprise risk management system should provide for performance monitoring by a risk management committee that reports directly to upper management. Both remaining responses above are all components of an effective enterprise risk management system.

Question 20 - #91517

Your answer: B was incorrect. The correct answer was A) minimal data is needed.

Historical VAR requires a lot of returns data, which may not be available for some asset classes.

Question 21 - #92522

Your answer: B was incorrect. The correct answer was A) The impact on the portfolio is measured by examining an input at an extreme level.

In factor push analysis, a factor or factors are pushed to an extreme to examine the impact on the portfolio. In scenario analysis, the effect on the portfolio from simultaneous changes in several factors is examined, which provides several different scenarios. In maximum loss optimization, the risk factors that have the greatest potential impact on the portfolio are identified. Once the factors are identified, procedures are put in place to limit their impact. In worst-case scenario analysis, all factors are pushed to their most damaging impact on the portfolio. Factor push analysis, maximum loss optimization, and worst-case scenario analysis are all forms of stressing models.

Question 22 - #92737

Your answer: B was correct!

This is true by definition. The sources of financial risk are: liquidity risk, credit risk, commodity prices, equity prices, exchange rates, interest rates.

Question 23 - #92041

Your answer: B was incorrect. The correct answer was A) Allocating capital according to the returns generated.

An effective enterprise risk management system would allocate capital on a risk-adjusted basis. Capital should not be allocated solely according to returns without accounting for risk. Both remaining responses above are all components of an effective enterprise risk management system.

Question 24 - #91871

Your answer: B was incorrect. The correct answer was A) The manager of the Matrix Small Cap Index Fund calculates a historical daily VAR at the 95% confidence level of $4,080 using Russell 2000 Index returns from 1987-2001. The manager of the Smith Small Cap Index Fund, which is the same size as the Matrix Small Cap Index Fund, calculates a historical daily VAR at the 95% confidence level of $4,210 using Russell 2000 Index returns from 1990-2001.

The manager of the Matrix Small Cap Fund uses index data from 1987-2001, while the manager of the Smith Small Cap Index Fund uses index data from 1990-2001, and each comes up with a different VAR calculation. This discrepancy illustrates that historical VAR is sample driven in that different samples of the same data, in this case Russell 2000 Index returns, may lead to different VAR’s. Both remaining answer choices describe situations where VAR may differ, but none are the result of a weakness in historical VAR.

Question 25 - #92118

Your answer: B was incorrect. The correct answer was C) Market risk Financial risk

Financial and non-financial risk factors are general terms. Financial risk factors are those associated with external capital markets and the transactions within external markets. Non-financial risk factors capture other types of risk. Financial risk factors include market risk, liquidity risk, credit risk, and sovereign risk. Market risk pertains to the factors that affect firm or portfolio values (e.g. interest rates, exchange rates, equity prices, commodity prices, etc.). Non-financial risk factors include settlement (Herstatt) risk, operations risk, model risk, sovereign risk, regulatory risk, and other miscellaneous risk factors. Note that sovereign risk has both financial and non-financial risk components.

Question 26 - #91536

Your answer: B was incorrect. The correct answer was A) For some assets you may face model risk.

The historical method uses actual returns for the position in question. An advantage of the historical method is not having to assume any particular distribution. A disadvantage is that it assumes past performance is representative of what can occur in the future, which may not be the case. The Monte Carlo simulation method for calculating VAR usually involves generating random numbers with a computer. The generated numbers represent possible returns of the asset or portfolio. An advantage is that Monte Carlo simulation does not require the normality assumption and can accommodate the required assumptions for complex relationships. A disadvantage is the requirement for many managerial assumptions and a great deal of computer time and calculations. The historical method and Monte Carlo Simulation both suffer from modeling risk.

Question 27 - #92547

Your answer: B was correct!

Stress testing cannot be used to eliminate all risk from a position. It only highlights the extent of losses in different states and enables contingency planning, which is one of its benefits.

Question 28 - #93192

Your answer: B was incorrect. The correct answer was A) Monte Carlo simulation.

Monte Carlo simulation is subject to model risk.

Question 29 - #92451

Your answer: B was incorrect. The correct answer was C) set risk limits.

The investor has used the value at risk framework to set risk limits for the portfolio.

Question 30 - #92817

Your answer: B was correct!

Credit risk is a type of financial risk.

Question 31 - #92025

Your answer: B was incorrect. The correct answer was C) may be much greater.

VAR is a benchmark that gives an estimate of what magnitude of loss would not be unusual. The actual loss for any given time period can be much greater.

Question 32 - #93214

Your answer: B was correct!

Risk management was once simply thought as hedging risk. Now managers must look at it from several perspectives. Various types of risks must be defined, measured and selectively managed. A desired level of risk must be selected and the actual risk monitored to see if it is in line with that selected level.

Question 33 - #92716

Your answer: A was incorrect. The correct answer was B) settlement risk.

This is a classic example of settlement risk.

Question 34 - #93206

Your answer: B was correct!

Where the stress testing approach is weak, the VAR approach is strong and vice versa. A possible way to combine the two approaches would be to compute the capital requirements using each method and then use the larger of the two values. This ensures that the capital requirement meets the needs of both approaches.

Question 35 - #92945

Your answer: B was incorrect. The correct answer was A) Equity prices.

There are three types of market risk: interest rates, exchange rates, and equity prices.

Question 36 - #92515

Your answer: C was correct!

In stylized scenarios, one or more risk factors are changed to measure their impact on the portfolio. Some forms of stylized scenarios are similar to industry standards. The risk factors mentioned in the question are from those specified by the Derivatives Policy Group. In factor push analysis, a factor or factors are pushed to an extreme to examine the impact on the portfolio. In worst-case scenario analysis, all factors are pushed to their most damaging impact on the portfolio.

Question 37 - #93188

Your answer: B was incorrect. The correct answer was C) is exposed to model risk.

The Monte Carlo VAR methodology uses a returns generation model to develop a set of returns scenarios or paths. If the model is incorrect, the validity of the VAR estimates is questionable. The historical VAR methodology will suffer model risk only if insufficient daily data is available, and a model is employed to derive estimates.

Question 38 - #92763

Part 1)  
Your answer: B was incorrect. The correct answer was C) Shilton's absentee ownership.

As long as Shilton has a man he believes is competent in charge and a comprehensive plan in place, his presence at the office is not required. Many people own businesses and let others run them. The issue here is the process, not the company owner. Good ERM systems will select the best possible risk models and decide in advance which risks to ignore and which to hedge. The Shilton Capital system did neither. A good risk-management system will have a committee to oversee the process and ensure that proper stress testing is performed on all risky investments. (Study Session 14, LOS 25.b)

Part 2)  
Your answer: B was incorrect. The correct answer was C) Wainwright's.

While political risks cannot be hedged directly, Shilton Capital could address Hatchett's issues through insurance, currency swaps, or a combination of both. It is impossible to know exactly what could happen, but trouble comes when the currency falls for whatever reason, so the key is creating a hedge in the event that the currency falls, rather than trying to predict which disasters to prepare for. Cline's risks could be hedged with swaps, though this technique would eat into the profitability of the strategy. Wainwright's political risks would be extremely difficult to hedge away. It is very difficult to hedge away the risks of political change or a change in customers' perceptions of the market. (Study Session 14, LOS 25.d)

Part 3)  
Your answer: B was incorrect. The correct answer was A) set up a currency swap.

Nonfinancial risks are difficult to measure, and a VAR is only as good as the estimates used to derive it. Sovereign risk is not relevant here because it reflects only the government's willingness to make good on its debts. The best option among those presented would be a currency swap, which could be used to hedge against declines in the value of Extralatian currency. (Study Session 14, LOS 25.i)

Part 4)  
Your answer: B was incorrect. The correct answer was A) Hatchett.

Miller's instructions for Stone are a blunt but effective way of controlling the damage. The actions may seem drastic, but they will go a long way toward mitigating the risk. Wainwright's problem cannot be easily hedged away. Doing nothing may be the best option, particularly considering these are not problems the company can address without a lot of time and negotiation. However, the advice to Hatchett was bad. If Extralatian currency falls, currency in neighboring countries is unlikely to rise, and may fall in sympathy, or be affected by the same political issues. As such, a better hedge would be to attempt to sell those neighbors' currencies forward before they fall. The strategy isn't perfect, but it could counteract some of the risk. As the instructions currently stand, Hatchett would be doubling down on her bet, which exacerbates the risk rather than mitigating it. (Study Session 14, LOS 25.d)

Part 5)  
Your answer: B was correct!

Purchasing out-of-the-money call options would presumably allow Stone to cover his short positions at below-market rates in the event of a major rally. Doing nothing is a counterintuitive solution, but it has merit because of Campbell's investment strategy. In the event that unusual increases in stock prices overwhelm Stone's market-neutral model, Campbell's investments are likely to rise. Campbell's portfolio is not as concentrated as Stone's, but it does have some risk-reduction features in the context of Stone's portfolio. However, notional position limits on securities would be unlikely to help, because Stone's portfolio is concentrated in one sector, and in the situation portrayed above, all of the stocks moved in the same direction. When all of the stocks tend to move in the same direction, assigning limits to the size of each stock position will have little effect on the overall risk of the portfolio. (Study Session 14, LOS 25.m)

Part 6)  
Your answer: B was incorrect. The correct answer was A) model risk.

Active risk is a measure of market risk relative to a benchmark, which is not applicable here. Sovereign risk reflects the chance that a foreign government will not honor its obligations, while credit risk reflects the possibility of default, neither of which gets to the heart of Wainwright's problems. The trouble here is model risk, because Wainwright's model apparently did not consider the political risks of a tax change. (Study Session 14, LOS 25.d)

Question 39 - #93210

Your answer: B was incorrect. The correct answer was A) -$19,800.

VAR = (portfolio value)[expected Rp - Z(σ)]

($1,000,000)[0.12 - (2.33)(0.06)]

= -$19,800

Question 40 - #93242

Your answer: B was incorrect. The correct answer was C) Creating a centralized data warehousing system.

Establishing a centralized data warehousing system is the most difficult step in an ERM system because it involves coordinating an enormous amount of information from potentially different data systems requiring the output to be standardized and comparable across the institution.

Question 41 - #92050

Your answer: B was incorrect. The correct answer was A) Regulatory risk.

Regulatory risk is due to the fact that different securities in a firm’s portfolio are subject to regulation by different regulatory bodies. Although the LDC Bank is sure to have exposure to regulatory risk, it is not explicitly described in these transactions. Model risk refers to the risk that models may fail due to poor inputs or construction. The bank’s use of simulation to predict country default is subject to model risk. Herstatt risk or settlement risk is the possibility that one party could default on a contract while the other is settling. This has been a problem in foreign exchange markets due to time differences and is certainly possible in the LDC Bank’s currency swap.

Question 42 - #91805

Your answer: B was correct!

The historical method uses past values and makes no explicit assumptions about inputs. It assumes that past patterns are indicative of future patterns.

Question 43 - #93227

Your answer: B was correct!

A useful analytics system for an ERM is used for assessing risk, not valuing individual assets. The useful system would include several VAR methodologies including historical VAR and Monte Carlo simulation, credit risk analysis, liquidity risk analysis, operational risk analysis, and legal risk analysis.

Question 44 - #93191

Your answer: B was correct!

The historical method of VAR relies on past patterns continuing into the future thus you are extrapolating in a linear fashion into the future. The analytical method assumes a normal distribution. The Monte Carlo method relies on neither assumption and any distribution or correlation between assets can be used. This leads to modeling risk in the Monte Carlo simulation because if your inputs are inaccurate your output will also be inaccurate.

Question 45 - #91528

Your answer: B was correct!

Special purpose vehicles are subsidiaries set up by a parent company to engage in certain transactions. Generally, they are separate from the parent organization and not liable for the debt of the parent company. They are capitalized in a way that results in a high credit rating, and can, therefore, engage in transactions that the parent cannot.

Question 46 - #93201

Your answer: B was correct!

The variance/covariance VAR methodology relies on the assumption that returns are normally distributed.

Question 47 - #92863

Your answer: B was incorrect. The correct answer was C) Interest rate risk.

There are three types of market risk: interest rates, exchange rates, and equity prices.

Question 48 - #93198

Part 1)  
Your answer: B was incorrect. The correct answer was C) measures risk comparably across asset classes.

VAR measures risk comparably across asset classes. The result is that with VAR, the risk of a bond portfolio can be compared against the risk of an equity portfolio. It is quite versatile in a portfolio management context. This is one of VAR’s key strengths. (Study Session 14, LOS 25.g)

Part 2)  
Your answer: C was incorrect. The correct answer was B) agree and add that this is due to its inherent model risk.

VAR is relatively incomparable across managers due to its inherent model risk. For example, two people can be given an assignment to compute the VAR for the same underlying asset and the results will likely be different due to the use of different methodologies and model assumptions. Neither answer is necessarily wrong. The bottom line here is that peer group evaluation using VAR is not very useful unless one can be sure that the same VAR techniques and assumptions are used to evaluate all portfolios. (Study Session 14, LOS 25.g)

Part 3)  
Your answer: B was correct!

Burns is incorrect and Smith is incorrect. A particular VAR estimate is based on a given model and its parameters. In *stress testing* (or scenario analysis), the analyst varies the inputs to the VAR estimation process sometimes to the extreme and analyzes the impact of this movement on the computed VAR. Stress testing is "what if" analysis, and its main contribution is that it shows how reliable a particular VAR estimate is. (Study Session 14, LOS 25.h)

Part 4)  
Your answer: B was correct!

The fundamental problem with VAR analysis is that the analyst must estimate the "true" probability distribution for the asset or portfolio under evaluation. This means that in order to give the analyst reliable results, the quantitative model must accurately describe the price process of the asset. (Study Session 14, LOS 25.g)

Part 5)  
Your answer: B was correct!

Banks is correct but Myers’ conclusion is incorrect. Since credit risk increases when the value of the position held increases, we should focus on the *upper* not *lower* tail of the distributions of gains on positions held. (Study Session 14, LOS 25.g)

Part 6)  
Your answer: B was correct!

A key advantage of Monte Carlo simulation is the ability to deal with the assumptions required to handle complex relationships. McAdams’ statement is correct. The key advantage of the historical method is that you do not have to assume a particular distribution. Therefore, Blatt is incorrect. A major disadvantage of the historical method is that we have to assume that past performance is representative of future performance; it is not a disadvantage of the variance-covariance method. Therefore, Berry is also incorrect. (Study Session 14, LOS 25.f)

Question 49 - #92740

Your answer: B was incorrect. The correct answer was A) accounting risk.

Accounting risk does not directly involve other parties outside the firm. Therefore, it is not a source of financial risk.

Question 50 - #92939

Your answer: B was incorrect. The correct answer was A) The deviation should be reported immediately to upper management.

Using risk budgeting in enterprise risk management, a firm will allocate capital and the associated VAR to each manager depending upon management’s desired exposure to each sector. An effective enterprise risk management system should monitor violations of a risk budget so that any violations are immediately reported to upper management.

Question 51 - #93223

Your answer: B was incorrect. The correct answer was C) filing taxes.

There are five parts of the process: identify the desired level of risk, determine the current level of risk, bring the current level in line with the desired level, monitor the risk exposure to keep it line with the desired level, and alter the process to reflect new information, policies and preferences.

Question 52 - #92479

Your answer: B was incorrect. The correct answer was A) can only be ascertained after the fact.

This is a weakness of VAR. The reliability can only be known after some time has passed to see if the number and size of the losses is congruent with the VAR measure.

Question 53 - #93197

Your answer: B was incorrect. The correct answer was A) Variance/covariance.

The variance/covariance (or parametric) method is most commonly used by asset managers.

Question 54 - #93240

Your answer: B was correct!

Weatherford is correct. There should be a committee or team at the highest reaches of management to respond quickly to violations of risk guidelines.

Washington is incorrect because, although each asset’s risk and return characteristics should be investigated thoroughly, each asset should be examined from a portfolio perspective, not in isolation. The correlations between assets should be examined in order to determine the risk of the firm as a whole.

Question 55 - #93196

Your answer: B was correct!

The RoMAD (return over maximum drawdown) is the average portfolio return divided by the maximum drawdown. Drawdown refers to the percentage difference between the highest and lowest portfolio values during a period. For example, if the maximum portfolio value during a year was $1000 and the minimum was $900, the drawdown would be 10% [($1000 − $900) / $1000]. This measure does not make an assumption of normality in the returns. The Sharpe ratio (which uses the standard deviation in the denominator) assumes a normal distribution of returns. The Sortino ratio examines the downside risk of returns and also assumes a normal distribution of returns.

Question 56 - #92646

Your answer: B was incorrect. The correct answer was C) $561,000.

VAR = (-0.0187)(30,000,000) = -$561,000 therefore the 1% daily value at risk is $561,000.

Question 57 - #93221

Your answer: B was incorrect. The correct answer was C) increase credit risk and financial risk.

OTC derivatives have much more credit risk than exchange-traded derivatives, so the credit risk will increase. Credit risk is a part of financial risk; therefore, financial risk increases too.

Question 58 - #93202

Your answer: B was correct!

Since VAR often relies on common probability distributions, it may not properly capture extreme, but possible, events. Stress testing involves evaluating the effects that these events would have on the institution and then establishing capital requirement based on the findings. The two approaches are natural complements.

Question 59 - #92768

Your answer: B was incorrect. The correct answer was A) only potential credit risk.

Since the long position can only be owed money at expiration, then that is when there is current credit risk. Prior to that, there can only be potential credit risk.

Question 60 - #91953

Your answer: B was incorrect. The correct answer was A) value at risk (VAR).

This is an often-used definition of VAR.

Question 61 - #92570

Your answer: B was incorrect. The correct answer was C) take no action at all.

Meinrod should advise the risk management committee that they should take no action at all. In most cases, when there is a risk management problem that is viewed as temporary, the best course of action is often to take no action at all.

Question 62 - #92837

Your answer: B was correct!

Risk is generally equated with uncertainty, which includes both positive and negative changes in value.

Question 63 - #91524

Your answer: B was correct!

Netting is the process of consolidating the exposures between two parties to a single net exposure that one party bears. Marking to market would not apply to a case where two parties have obligations to each other.

Question 64 - #93199

Your answer: B was correct!

The variance/covariance method relies on the assumption of normality.

Question 65 - #92406

Your answer: B was incorrect. The correct answer was A) *not* be used to set risk limits relative to a benchmark.

VAR can be used to set risk limits for a portfolio – either on an absolute level or on a relative basis versus a benchmark.

Question 66 - #92487

Your answer: B was correct!

This is true because the long position will be in-the-money, which means there is a possibility of not being paid what is owed.

Question 67 - #91529

Your answer: B was incorrect. The correct answer was A) Manager B because their return is higher in a risk budgeting context.

Using risk budgeting in enterprise risk management, we would divide the profit by the VAR allowed to generate a risk-adjusted performance measure. For manager A it is 26.7% (2,000,000 / 7,500,000). For Manager B it is 33.3% (7,000,000 / 21,000,000). Thus Manager B has better risk-adjusted performance. Note that the return on capital for each manager tells a different story. For manager A it is 1.3% (2,000,000 / 150,000,000) and it is 1.2% (7,000,000 / 590,000,000) for Manager B. So although the percentage return generated is higher for Manager A, we would conclude that Manager B has better performance when risk is considered.

Question 68 - #93244

Your answer: B was incorrect. The correct answer was A) Monitoring the process and taking any necessary corrective actions.

The risk management process is a continual process of:

Identifying and measuring specific risk exposures.

Setting specific tolerance levels.

Reporting risk exposures (deemed appropriate) to stakeholders.

Monitoring the process and taking any necessary corrective actions.

Question 69 - #92520

Your answer: B was incorrect. The correct answer was C) short option position.

The holder of a short option position has received all the income it can expect. Thus, it has no credit risk. Both remaining listed positions have some credit risk.

Question 70 - #92531

Your answer: B was incorrect. The correct answer was A) reflects only normal circumstances.

The primary purpose of stress testing is to model the effect of non-normal events that may not be reflected in the typical VAR calculation. Thus it is unlikely that stress testing would only reflect normal events. Stress testing is susceptible, however, to the analyst’s intentional and unintentional misspecification of the model, the failure to examine the by-products of major factor movements (how does a change in one factor affect the value of another), and the failure to include the simultaneous adverse movements of risk factors.

Question 71 - #93233

Your answer: B was incorrect. The correct answer was C) daily.

Risk management is a continuous process; therefore addressing it more frequently is better.

Question 72 - #92405

Your answer: B was correct!

Value at risk (VAR) is useful to compare performance of different business units with different asset classes and risk characteristics because VAR is interpreted the same regardless of the assets in question. VAR can be used in risk budgeting where upper management allocates VAR across the different business units and the goal is to maximize return for the allocated VAR. Comparing managers based on return for a given level of risk utilizes the Sharpe ratio and not VAR.

Question 73 - #92582

Your answer: B was correct!

Financial risks are usually associated with transactions with other parties.

Question 74 - #91769

Your answer: B was incorrect. The correct answer was C) delta-normal method.

The delta-normal method uses means and variances and makes calculations under the assumption that the distribution of returns is normal.

Question 75 - #91811

Your answer: B was incorrect. The correct answer was A) marking to market.

Marking to market is the best answer. This reduces potential credit risk by converting what would otherwise be potential credit risk to current credit risk. The credit risk becomes current insofar as the counterparty is required to provide additional collateral immediately (rather than in the future).

Question 76 - #92157

Your answer: B was incorrect. The correct answer was A) Operations risk.

Operations risk is the potential for failures in the firm’s operating systems due to personnel, technological, mechanical, or other problems. Although BigBank is sure to have exposure to operations risk, it is not explicitly described in these transactions. Herstatt risk or settlement risk is the possibility that one party could default on a contract while the other is settling. This has been a problem in foreign exchange markets due to time differences and is certainly possible in BigBank’s currency swap. Liquidity risk refers to the potential for sustaining losses due to the inability to sell or buy a position quickly. BigBank’s sale of the Canadian dollars is subject to liquidity risk.

Question 77 - #91531

Your answer: A was incorrect. The correct answer was C) standard deviation using only the returns below a minimum level

The Sortino ratio examines the downside risk of returns. It is calculated as the portfolio return minus the minimum acceptable return (MAR) divided by a standard deviation that only uses returns below the MAR. It is similar to the target semivariance. Both remaining responses refer to other measures of risk-adjusted performance. The Sharpe ratio divides the excess return above the risk-free rate by the standard deviation. An example of a risk-adjusted return on invested capital (RAROC) measure would be to divide the portfolio’s expected return by the VAR. The RoMAD (return over maximum drawdown) is the average portfolio return divided by the maximum drawdown. Drawdown refers to the percentage difference between the highest and lowest portfolio values during a period.

Question 78 - #92201

Your answer: C was incorrect. The correct answer was A) is a single and easily understood measure.

VAR is an easily understood measure, but there are many ways to compute it. It is not a measure of the most that can be lost.

Question 79 - #92503

Your answer: B was incorrect. The correct answer was C) Stress analysis can be used to enhance VAR analysis by focusing on the extent of loss in an extreme event.

This is the only valid use of stress analysis among the statements listed. Both remaining statements either do not pertain to uses, even if true in some other context, or are not true.

Question 80 - #91522

Your answer: B was incorrect. The correct answer was C) market data necessary to compute VAR is often not available.

One of the strengths of the variance/covariance VAR is that the required market data is readily available in most cases.

Question 81 - #93203

Your answer: C was correct!

Common probability distributions (i.e., normal distributions) tend to place extreme low probabilities on extreme events.

Question 82 - #92090

Your answer: B was incorrect. The correct answer was A) 96.80 million.

Maximum possible loss at 95% probability = 10 − 1.65 × 8 = −3.2 million.  
Minimum value of portfolio at 95% probability = 100 − 3.2 = 96.80 million.

Question 83 - #92601

Your answer: B was correct!

Andrews should advise the risk management committee that they should revise the model. Recall that callables will outperform noncallables when interest rates rise and the callable bonds were previously priced to call. In this case, Sigma should revise their model so it accounts for the option-like features of their bonds and provides a more realistic assessment of bond performance in various interest rate scenarios.

Question 84 - #93224

Your answer: A was correct!

After setting goals and assessing the current level of risk, the firm needs to see if the goals can be achieved cost-effectively. There is no “waiting” in risk management because it is an ongoing procedure. The Monte Carlo simulation may be involved in risk management, but it is certainly not the final step.

Question 85 - #91861

Your answer: B was incorrect. The correct answer was A) 20 days, the portfolio will decline by $50,000 or more.

This means that 5 out of 100 (or one out of 20) days, the value of the portfolio will experience a loss of $50,000 or more.