PASS PRO Questions

1.

Which of the following are examples of model risk?

I. A VaR model that has been prepared by an external contractor.
II. A mark-to-market model that cannot be understood by risk managers.
III. A VaR model that does not allow for the adjustment of market correlations.
IV. A mark-to-market model that relies on volatility figures prepared by the trader being monitored.

A. I and III.

B. II and IV.

C. II, III and IV.

D. I, II, III and IV.

2.

Which of the following would be regarded as best practice in risk management policy?

A. The disaster recovery plan needs to be updated as the processes undergo change.

B. Studies of audit reports for assessing operations risk need to be modified to reflect changes in operations procedure after the production of report.

C. In the initial phase of implementing operations risk, it is essential to involve business heads to assess the extent of loss once the loss event occurs.

D. All of the above.

3.

Which of the following best describes the process of measurement of operations risk?

I. Directly estimate the expected loss due to operations risk.
II. Find out the probability of operational failure and then measure the amount of expected loss given the failure.
III. Find out the probability of operational failure, adjusted for any risk mitigation techniques deployed, and then measure the amount of expected loss given the failure.

A. I only.

B. II only.

C. III only.

D. I and III.

4.

Which of the following is TRUE with regard to operational risk?

A. It is easier to find the causes of loss than the extent of loss.

B. There is no value added by investing time in finding the causes of loss.

C. It is not possible to have more than one cause for any single event of loss.

D. None of the above.

5.

An insurance company selling health insurance seeks to give discounts to non-smoking people who agree to not to take up smoking during the period of cover. Which of the following is TRUE?

A. The company is seeking to avoid moral hazard.

B. The company is seeking to avoid adverse selection.

C. This is a standard provision to attract more sales.

D. All of the above.

6.

Which of the following are examples of model risk?

I. A VaR model that has been prepared by an external contractor.
II. A mark-to-market model that cannot be understood by risk managers.
III. A VaR model that does not allow for the adjustment of market correlations.
IV. A mark-to-market model that relies on volatility figures prepared by the trader being monitored.

A. I and III.

B. II and IV.

C. II, III and IV.

D. I, II, III and IV.

7.

Which of the following gives the correct order of the degree of sophistication of risk measurement tools?

A. Credit > operations > market.

B. Market > credit > operations.

C. Operations > credit > market.

D. Operations > market > credit.

8.

Which of the following would be regarded as best practice in risk management policy?

A. The disaster recovery plan needs to be updated as the processes undergo change.

B. Studies of audit reports for assessing operations risk need to be modified to reflect changes in operations procedure after the production of report.

C. In the initial phase of implementing operations risk, it is essential to involve business heads to assess the extent of loss once the loss event occurs.

D. All of the above.

9.

Which of the following is TRUE? A firm should:

I. always take insurance against expected operations losses.
II. always set aside economic capital against expected operations losses.
III. set aside a provision (reduce revenue) for expected operations losses.

A. I only.

B. II only.

C. III only.

D. I or II depending on cost of insurance.

10.

Over the past decade, the IMF has been involved in bailing out several highly indebted emerging market countries, which had built up unsustainable amounts of external dollar-linked loans. This is an example of:

A. gaming.

B. arbitrage.

C. moral hazard.

D. global cooperation to improve the liquidity of markets.

11.

An insurance company selling health insurance has a statement in its contract, which absolves the insurer from any liability if it is found that the insured party had hidden any known illnesses. Which of the following is TRUE?

A. The company is seeking to avoid moral hazard.

B. The company is seeking to avoid adverse selection.

C. This is a standard provision to help the insurer avoid any large claims in future.

D. All of the above.

12.

Which one of the following cases can be considered an example of operational risk?

A. A bank makes a loss due to fall in the value of the dollar.

B. A bank makes a loss due to a trade that the counter-party refuses to recognize.

C. A bank reports a loss due to unprecedented mortgage repayments by its customers.

D. A bank that is highly exposed to a small number of borrowers suffers a loss when they unexpectedly default together.

13.

Firms that procure catastrophe insurance are more liable to be exposed to such an incident than those who are not insured. The insurance industry term for this phenomenon is:

A.

moral hazard.

B. carelessness trap.

C. adverse selection.

D. survivorship bias.

14.

Which of the following are examples of model risk?

I. A VaR model that has been prepared by an external contractor.
II. A mark-to-market model that cannot be understood by risk managers.
III. A VaR model that has been validated by risk managers and the research department.
IV. A mark-to-market model that relies on volatility figures prepared by the trader being monitored.

A. I and III.

B. II and IV.

C. II, III and IV.

D. I, II, III and IV.

15.

Which of the following are NOT related to operational risk?

A. Database server crash.

B. Error in a confirmation form.

C. Loss on an equity portfolio due to a crash in the dollar exchange rate.

D. A lawsuit by a client due to inappropriate conduct of a research analyst.

16.

A risk model should be vetted to:

A. eliminate the risk of gaming.

B. ensure that the model works for all types of instruments.

C. ensure that the model works under all market environments.

D. ensure that the assumptions behind the model are reasonable are accurate.

17.

Which of the following is an example of process risk?

A. A delay in deal entry.

B. The wrong specification of an algorithm for model.

C. An FX derivative structurer accepts a bribe to deliberately give a wrong price.

D. None of the above.

18.

Which of the following is FALSE?

A. Insurance firms face adverse selection risk, but not moral hazard.

B. Moral hazard is due to the fact the counterparty has more information about itself than others.

C. Adverse selection is the probability that the person who has been covered for a risk, will seek to assume further risk, as the downside has been covered.

D. All of the above.

19.

The value of catastrophic losses can only be estimated via:

A. KMV model.

B. Insurance cover.

C. RAROC models.

D. Delta-gamma approach.

20.

Which of the following are NOT related to operational risk?

A. Database server crash.

B. Default by counter-party.

C. Error in a confirmation form.

D. An unauthorized agreement signed by a rogue trader.

21.

Which of the following is an example of operational control risk?

I. Limit excesses.
II. Hardware failure.
III. Very high volumes of business.

A. I only.

B. II only.

C. III only.

D. I and III.

22.

Which of the following documents can be used to estimate the probability of occurrence of an operations loss?

A. Business plan.

B. Operations plan.

C. Disaster recovery plan.

D. All of the above.

23.

Which of the following statements best describes the operations strategic risk?

A. The risk that the strategy adopted by top management has operation loopholes leading to losses.

B. The risk that competitors steal a firm's strategy document through industrial espionage.

C. The risk that the firm's operations are hampered due to changes in competitive environment and regulation.

D. All of the above.

24.

The fixed income desk in your bank can usually cater to six clients in a day. Due to an increase in business, the desk caters to ten clients. You are worried that the pressure might lead to the misspecification of a model, leading to losses in market operations. How would you classify this risk?

A. Model risk.

B. Market risk.

C. Operations risk.

D. Derivatives risk.

25.

Which of the following are components of inventory risk?

I. Credit risk.
II. Market risk.
III. Liquidity risk.
IV. Operational risk.

A. I and II.

B. III and IV.

C. I, III and IV.

D. II, III and IV.

26.

Which of the following correctly describes the order of the risk management processes?

A. Measure => Identify => Monitor => Control.

B. Control => Identify => Measure => Monitor.

C. Identify => Measure => Control => Monitor.

D. Monitor => Identify => Control => Measure.

27.

Your bank is currently not very active in exotic derivatives. The new management, which took over the reins recently, is considering rapidly expanding and capturing a significant share of this

market. It also plans to employ a large pool of new talent, design new procedures, quickly increase automation by dumping legacy systems and using the latest technology. As the head of risk management, which of the following should fit into your assessment during this transition period?

I. A large number of technological changes would increase the level of operations risks significantly.
II. With the use of derivatives, the proportion of market risk in the overall risk profile of the bank will fall quickly.
III. In the effort to win market share, the derivatives team would be forced to seek market risk, increasing its proportion in the overall risk profile.

A. I only.

B. II only.

C. III only.

D. I and III.

28.

Which of the following policies, if implemented, would increase operational risk?

I. All conversations with clients are recorded on tape.
II. Compensation scheme for trader is directly linked to calendar revenues.
III. To value current positions, price information is obtained from external sources.
IV. Individuals responsible for committing to transaction are also held responsible for clearance and accounting functions.

A. I and III.

B. II and IV.

C. I, II, and III.

D. II, III and IV.

29.

The allocation of a bank's capital would be applied against:

I. 99 percent VaR.
II. Extreme "tail" events (high stress losses).
III. High Frequency, low severity events (expected losses).

A. I only.

B. III only.

C. I and II.

D. II and III.

30.

Money laundering is the process by which:

A. criminals generate illegal funds.

B. criminals hide the origins of their illegally generated funds.

C. criminals utilize illegal funds.

D. law enforcement officers track down illegal funds.

31.

Which of the following correctly describes the order of the risk management processes?

A. Measure => Identify => Monitor => Control.

B. Control => Identify => Measure => Monitor.

C. Identify => Measure => Control => Monitor.

D. Monitor => Identify => Control => Measure.

32.

The allocation of a bank's capital should be applied against:

I. Extreme "tail" events (high stress losses).
II. High Frequency, low severity events (expected losses).
III. Low Frequency, high severity events (unexpected losses).

A. I only.

B. II only.

C. III only.

D. I and III.

33.

Your bank runs a successful exotic derivatives desk, known to be at the forefront of innovations in new structures and a market leader. The business head of this desk has argued that, given the complexity of his business, he should be allowed to carry out a self assessment of the risks involved in the business. He further doubts the ability of the risk management department to understand the risks of this complex business. Which of the following is the MOST appropriate response?

I. He seems to be a successful manager. Usually successful managers evaluate the situation accurately. Go along with his assessment.
II. A successful manager is usually very powerful in the organization. Contradicting his assessment could aggravate top management. We should wait until he slips before making our point.
III. A risk manager is an expert in evaluating risks associated with financial businesses. He need not fully understand each and every detail of the business. He must be able to ask for relevant information and should be able to correctly interpret the information received.

A. I only.

B. II only.

C. III only.

D. I and II.

34.

Rank the exposure to various risks faced by commercial banks from highest to lowest.

A. Credit, operational, market.

B. Operational, market, credit.

C. Market, credit, operational.

D. Operational, credit, market.

35.

Operational risk capital should be sufficient to provide a cushion against:

I. expected losses.
II. unexpected losses.
III. catastrophic losses.

A. I only.

B. II only

C. I and II.

D. I and III.

36.

Your bank is currently not very active in exotic derivatives. The new management, which took over the reins recently, is considering rapidly expanding and capturing a significant share of this market. It also plans to employ a large pool of new talent, design new procedures, quickly increase automation by dumping legacy systems and using the latest technology. As the head of risk management, which of the following should fit into your assessment during this transition period?

I. A large number of technological changes would increase the level of operations risks significantly.
II. With the use of derivatives, the proportion of market risk in the overall risk profile of the bank will fall quickly.
III. In the effort to win market share, the derivatives team would be forced to seek market risk, increasing its proportion in the overall risk profile.

A. I only.

B. II only.

C. III only.

D. I and III.

37.

Which of the following is not a stage in the money laundering process?

A. Layering.

B. Placement.

C. Structuring.

D. Integration.

38.

Which of the following are stages in the money laundering process?

I. Placement.
II. Integration.
III. Structuring.
IV. Origination.

A. I and II.

B. III and IV.

C. I, III and IV.

D. II, III and IV.

39.

The procedure of ensuring that the portfolio values resulting from a risk model match those observed currently in the market is called:

A. vetting.

B. calibration.

C. forecasting

D. back-testing.

40.

The allocation of a bank's capital would be applied against:

I. 99 percent VaR.
II. Extreme "tail" events (high stress losses).
III. High Frequency, low severity events (expected losses).

A. I only.

B. III only.

C. I and II.

D. II and III.

41.

A firm is expected to cover the expected losses by:

A. capital reserves.

B. insurance cover.

C. operating profits.

D. no specific provision.

42.

In the review of one business unit, it is found that the level of operations risk is unacceptably high. The management provides for the economic capital to cover the extra, unexpected risk uncovered in the review. Which of the following steps are not feasible in future efforts to reduce the level of risk?

A. The management may decide to sell the business unit, in the view of high risk.

B. The management can decide to invest more funds to develop a computer system, which can increase the level of automation and reduce the level of risk.

C. The management can consider appointing an external consultant to suggest methods to improve the internal controls and reduce the level of risk.

D. None of the above.

43.

Which one of the following financial institutions suffered severe losses due to the fraudulent activity of a copper trader?

A. LTCM.

B. Herstatt.

C. Barings.

D. Sumimoto.

44.

Which of the following statements do you disagree with?

I. It is important that the operations risk assessment should lead to some action plans on which management can act.
II. Given the current state of development of operations risk measurement, it would be almost impossible to use any objective methods to evaluate.
III. Given the current state of development of operations risk measurement, it is not possible to bring transparency to the process of evaluating operations risk.

A. I only.

B. II only.

C. III only.

D. II and III.

45.

Which of the following correctly describes the order of the risk management processes?

A. Identify => Measure => Monitor => Control.

B. Identify => Measure => Control => Monitor.

C. Identify => Monitor => Measure => Control.

D. Identify => Control => Measure => Monitor.

46.

The three components of the operations risk do NOT include:

A. operational policy risk.

B. operational failure risk.

C. operational strategy risk.

D. external dependency risk.

47.

Which one of the following cases can be considered an example of operational risk?

A. A bank makes a loss due to a fall in the value of the dollar.

B. A bank makes a loss in one of its divisions that allowed a rogue trader to take very large positions.

C. A bank that is highly exposed to a small number of borrowers suffers a loss when they unexpectedly default together.

D. A fund suffers a loss when its manager makes certain investments in small unquoted companies that subsequently become delisted from the stock exchange.

48.

Which of the following statement(s) is (are) TRUE, with respect to operations risk?

I. Banks should consider buying insurance coverage for catastrophic losses.
II. Banks should provide sufficient economic capital to cover catastrophic losses.
III. Banks should provide sufficient economic capital to cover unexpected severe losses.

A. I only.

B. II only.

C. III only.

D. I and III.

49.

Which of the following policies, if implemented, would increase operational risk?

I. All conversations with clients are recorded on tape.
II. Compensation scheme for trader is directly linked to calendar revenues.
III. To value current positions, price information is obtained from external sources.
IV. Individuals responsible for committing to transactions are also held responsible for clearance and accounting functions.

A. I and III.

B. II and IV.

C. I, II, and III.

D. II, III and IV.

50.

You have appointed an external consultant to help you in risk management process. He suggests comparing the estimated operational loss assessed by your department with the insurance premium quoted by top-notch insurance companies to cover that risk. Do you agree with the idea?

I. Yes. Insurance premiums are one of the acceptable ways of discovering the expected losses.
II. No. Insurance premiums are not an acceptable way of discovering the expected losses.
III. No. Apart from the risk cover, the insurance premium contains a provision for covering the expenses of the insurance company and the profit margin of the insurance company.

A.

I only.

B. II only.

C. III only.

D. II and III.

51.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in 50 years and has an equal probability of resulting in a loss of between $30 million and $100 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against a loss of over 60 million?

A. $0.74 million.

B. $0.91 million.

C. $2.28 million.

D. $2.80 million.

52.

Consider the loss due to fire in the datacenter of a bank. This event is estimated to occur once in 50 years and has a equal probability of causing a loss between $20 million and $80 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against a loss of over 60 million?

A. $0.33 million.

B. $0.47 million.

C. $3 million.

D. $4.2 million.

53.

The distribution of potential losses due to operational risk is developed using:

I. insurance coverage.
II. loss severity distribution.
III. the probability of operational failure.
IV. the size, volume and concentration of transactions.

A. I and IV.

B. II and III.

C. II, III and IV.

D. I, II, III and IV.

54.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in ten years and has an equal probability of resulting in a loss of between $20 million and $40 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against a loss of over $15 million?

A. $2.75 million.

B. $3.00 million.

C. $3.44 million.

D. $3.75 million.

55.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in 50 years and has an equal probability of causing a loss between $5 million and $25 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against a loss of over $10 million?

A. $0.23 million.

B. $0.26 million.

C. $0.4 million.

D. $0.47 million.

56.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in 25 years and has an equal probability of resulting in a loss of between $20 million and $120 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against a loss of over 50 million?

A. $1.96 million.

B. $2.38 million.

C. $4.86 million.

D. $4.00 million.

57.

Consider the loss due to fire in the datacenter of a bank. This event is estimated to occur once in 50 years and has a equal probability of causing a loss $20 million and $80 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against this loss?

A. $0.4 million.

B. $0.8 million.

C. $1 million.

D. $1.6 million.

58.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in 25 years and has an equal probability of resulting in a loss of between $60 million and $90 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against this loss?

A. $1.8 million.

B. $2.4 million.

C.

$3.0 million.

D. $3.6 million.

59.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in 50 years and has an equal probability of resulting in a loss of between $40 million and $150 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against this loss?

A. $0.8 million.

B. $1.5 million.

C. $1.9 million.

D. $3.0 million.

60.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in 50 years and has an equal probability of resulting in a loss of between $10 million and $75 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against a loss of over 65 million?

A. $0.13 million.

B. $0.22 million.

C. $5.53 million.

D. $9.10 million.

61.

Stressing testing reveals the losses that are:

A. likely to occur frequently and cannot be ignored.

B. likely to occur during the normal course of business.

C. likely to be infrequent but could cost the survival of the firm.

D. unlikely to every happen and can be ignored by well-diversified firms.

62.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in 25 years and has an equal probability of resulting in a loss of between $10 million and $50 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against this loss?

A. $0.4 million.

B. $1.0 million.

C. $1.2 million.

D. $2.0 million.

63.

The distribution of potential losses due to operational risk is developed using:

I. loss severity distribution.
II. loss volatility distribution.
III. loss frequency distribution.
IV. transaction size distribution.

A. I and III.

B. II and IV.

C. II, III and IV.

D. I, II, III and IV.

64.

Consider the risk of a fire in the data center of a bank. This event is estimated to occur once in 50 years and has an equal probability of resulting in a loss of between $10 million and $70 million (with a zero probability of the loss being outside this range). What is the fair value of a 1-year insurance to protect the bank against this loss?

A. $0.2 million.

B. $0.7 million.

C. $0.8 million.

D. $1.4 million.

65. Which of the following approaches to operational risk recognize operational risks are a direct consequence of a company's internal system and hence, operational risk can be managed by changes in business processes?

A. Systems Dynamics Approach.

B. Regression Analysis.

C. Trend Analysis.

D. All of the above.

66. Which of the following statements are TRUE?

A. The main objective of the regulator is to ensure that the failure of a financial institution does not create too much externality.

B. The objective of shareholders is to ensure that the risk capital of the financial institution is efficiently deployed to maximize the return within the constraint on maximum economic risk.

C. Both of the above.

D. Neither of the above.

67. The occurrence frequency is modeled using Poisson distribution and severity frequency using Pareto distribution. Which of the following techniques is being described in the above statement?

A. Trend Analysis.

B. Scenario Analysis.

C. Monte-Carlo Simulation.

D. Systems Dynamics Approach.

68. Which of the following statements is LEAST controversial?

A. A successful risk management system should take the regulatory minimum standards, as a necessary, but not sufficient condition for measurement of its success.

B. A successful risk management system should take the regulatory minimum standards as the ultimate goal. Trying to achieve more is a waste of resources.

C. A successful risk management system should look at managing the capital allocation decisions as the only objective. The regulatory issues are not a worry of this department.

D. None of the above.

69. Which of the following statements are TRUE?

I. Qualitative measures must not be used in operational risk.
II. The assessments by the business managers should not be used as a direct input while using qualitative measures.
III. Any complex operational risk management process requires a mix of both quantitative and qualitative measures.

A. I and II.

B. I and III.

C. II and III.

D. I, II and III.

70. This system uses a reasoned conclusion approach to gain meaningful relationships from past data. The process involved has four steps starting with data identification and definition of expected output. The data is then converted into usable data (for example non-numerical data is converted into numerical equivalents). The mathematical relationships between the inputs and outputs are established using various algorithms. And finally, the performance is judged against the expectations.

Which of the following techniques is described above?

A. Risk Mapping.

B. Trend Analysis.

C. Scenario Analysis.

D. Neural Network Approach.

71. Which of the following statements are FALSE?

I. For operational risk, sources of relevant data are not a source of worry.
II. External Risk Drivers are not part of an operational risk measurement process.
III. The risk drivers need to be stress-tested for effects due to change in environment, increase in complexity. Such stressed drivers can help the risk manager identify any correlations that were not visible at the start.

A. I and II.

B. I and III.

C. II and III.

D. I, II and III.

72. As a first step towards operational risk measurement, the firm needs to identify the sources of operational risk. A good approach is to map the risks using two classification methods to create a matrix of risks. How many such matrices are needed?

A. One matrix classifying the risks on two parameters.

B. Two matrices, one for the probability of occurrence of any risk event and another for estimated severity given an event.

C. We require as many matrices as the basic risk events.

D. If we have n risk events and m parameters, we require n x m matrices.

73. Which of the following techniques do not attempt to create a model for the occurrence frequency and the severity separately?

A. Fuzzy Logic.

B. Trend Analysis.

C. Monte Carlo Simulation.

D. Systems Dynamics Approach.

74. Which of the following is NOT a decision factor in selecting a technique for measurement of operational risk?

I. Culture of the organization.
II. Organization's business process.
III. Resources allocated for risk management process.

A. I and II.

B. I and III.

C. II and III.

D. I, II and III.

75. If the objective of an exercise is to control the firm-wide risk, which of the following approaches is better suited for risk assessment?

A. Top down.

B. Bottom up.

C. Consultation.

D. Discretionary.

76. Which of the following statements are FALSE?

A. The tools for market VAR are advanced sufficiently to have a seamless aggregation or decomposition of the risks.

B. The tools for operational VAR are advanced sufficiently to have a seamless aggregation or decomposition of the risks.

C. The market risk VAR is measured at a portfolio level and at a profit level center also.

D. All of the above.

77.

Which of the following is an advantage of the top-down approach of measuring operational risk?

A. Good level of detail.

B. Use of easily accessible historical data.

C. Incorporation of interlinkages between different business lines.

D. Aggregation of data from external sources with the internally recorded data.

78.

Operational risk has a significant impact on:

A. both market and credit risk.

B. neither market nor credit risk.

C. market risk but not credit risk.

D. credit risk but not market risk.

79.

For which of the following types of risk are the VAR models least developed?

A. Credit risk.

B. Operational risk.

C. Fixed income risk.

D. Equity market risk.

80. Which of the following statement is CORRECT in your view?

A. The experiences of applying quantitative tools for operational risk have a long successful history.

B. Actuarial concepts and statistical tools for operational risk modeling MUST be exclusively relied upon.

C. The use of indicators such as sales, expenses, profits, and number of transactions as a proxy for the relative level of operational risk is too crude to produce meaningful and consistent results.

D. All of the above.

81. Which of the following is NOT a quantitative risk assessment tool?

A. Delphi.

B. Regression.

C. Trend analysis.

D. Actuarial analysis.

82. Which of the following statements are TRUE?

A. In market VAR measurement, the approach is more quantitative than qualitative.

B. In operational VAR, given the current level of development, the qualitative aspects play a central role and the quantitative aspects play a support role.

C. It is necessary to use to use a combination of qualitative and quantitative tools for operational VAR measurement.

D. All of the above.

83.

For which of the following types of risk is it most common to use actuarial models for measurement?

A. Credit risk.

B. Operational risk.

C. Fixed income risk.

D. Equity market risk.

84. Which of the following approaches to operational risk measurement is more likely to miss the inter-linkages among various activities?

A. Top down.

B. Bottom up.

C. Consultation.

D. Discretionary.

85. Which of the following is NOT an example of quantitative operational risk measurement technique?

A. Interviews.

B. Delphi technique.

C. Both of the above.

D. Neither of the above.

86. If the objective of an exercise is to control the transaction level risk, which of the following approaches is better suited?

A. Top down.

B. Bottom up.

C. Consultation.

D. Discretionary.

87. In which of the following two approaches is it harder to convince the business manager that the operational risk attributed to his business unit correctly reflect the actual level of risk?

A. Top down.

B. Bottom up.

C. Consultation.

D. Discretionary.

88.

Which of the following is an advantage of the bottom-up approach of measuring operational risk?

A. Use of easily accessible historical data.

B. Easy to get buy-in from individual managers.

C. Incorporation of interlinkages between different business lines.

D. Aggregation of data from external sources with the internally recorded data.

89.

Which of the following is an advantage of the bottom-up approach of measuring operational risk?

A. Good level of detail.

B. Use of easily accessible historical data.

C. Incorporation of interlinkages between different business lines.

D. Aggregation of data from external sources with the internally recorded data.

90. Which of the following statements are CORRECT in your view?

A. Operational risk management is still at a nascent stage and there is an active ongoing debate regarding quantitative versus qualitative tools.

B. Market risk management is still at a nascent stage and there is an active ongoing debate regarding quantitative versus qualitative tools.

C. BOTH operational and market risk management are still at an equally nascent stage and there is an active ongoing debate regarding quantitative versus qualitative tools.

D. None of the above.

91. Which of the following results from the information asymmetry between the insurance company and the insured company?

A. The cost of self-insurance is always higher due to information asymmetry, other things being equal.

B. The cost of self-insurance is generally lower.

C. The government is reluctant to give tax-deduction (expense) status to self-insurance due to the information asymmetry between the insurance company and the insured.

D. None of the above.

92. The operational risk of a business is at an unacceptable level and the management does not see any economical means of controlling the risks. Which of the following is the BEST choice?

A. Divest.

B. Insure.

C. Invest.

D. Do nothing.

93. Which of the following need to be insured (all else being equal)?

A. Expected operational risk.

B. Unexpected operational risk.

C. Total operational risk.

D. Expected Market risk.

94. Which of the following statements is TRUE in the case of CAT bonds?

A. If the insured operational risk is not correlated with the market risk, the additional interest cost is low, leading to a relatively low effective insurance costs.

B. If the insured operational risk is highly correlated with the market risk, the additional interest cost is low, leading to a relatively low effective insurance costs.

C. If the insured operational risk is not correlated with the market risk, the additional interest cost is high, leading to a relatively high effective insurance costs.

D. None of the above.

95. In a decision to buy insurance, the cost of buying the insurance MUST be compared with:

A. the cost of additional capital.

B. the expected profit on the activity.

C. the amount of losses avoided, given that the loss event has occurred.

D. any one of the above.

96. The risk manager has conducted analysis of a decision to insure OR to provide more capital. The analysis has shown the risk must be insured. The risk manager has done the analysis assuming the cost of capital at 12%. The board has now decided to assume a cost of capital of 14% for all future projects. Which of the following describe the best course of action?

A. The risk manager should carry out the analysis again to see if the decision changes with new assumption.

B. Since the insurance may have already been purchased nothing can be done for this year.

C. This change of assumption will NOT change the decision; hence there is no need to revisit this analysis.

D. None of the above.

97. Which of the following statements is TRUE?

A. Expected operational risk should always be insured.

B. Expected operational risk should always be provided for by showing it as an expense against the expected income.

C. Capital should be allocated for expected operational risk.

D. None of the above.

98. If the operational risk is at unacceptable level, which of the following is NOT a proper choice?

A. Insure.

B. Invest.

C. Divest.

D.

Allocate.

99. The business manager is insisting on higher investment in improving the skills of the staff. Which of the following may NOT be a benefit from the point of view of the operational risk manager?

A. Reduction in capital requirement.

B. Reduction in insurance cost.

C. Reduction in operational risk.

D. None of the above.

100. The operational risk at optimal level, but the business is undercapitalized vis-à-vis the risks. Which of the following is the BEST choice?

A. Insure.

B. Invest.

C. Divest.

D. Allocate.

101. It is found that the operational risk is at the optimum level of acceptance. Also, it is found there is a balance between the capital allocated to the business and the level of risk. Which of the following actions must be taken?

A. Insure.

B. Invest.

C. Allocate.

D. None of the above.

PASS PRO Solutions

1. Correct answer: C

The fact that VaR model that has been prepared by an external contractor does not by itself lead to model risk. Rather the risk arises if the risk manager does not understand the model, or the results of the model are derived using assumptions given by the trader being monitored, or if some of the assumptions regarding market parameters are hard-coded into the model.

Study Session: 4 - RA: 1

2. Correct answer: D

In the initial phase of an operational risk implementation, the risk management department may not have sufficient experience in estimating the extent of losses. This calls for active involvement from the business management.

Study Session: 4 - RA: 1

3. Correct answer: C

It is best to control each variable separately by estimating each part of the measurement process separately. This allows proper risk control measures to be undertaken. If we directly estimate the loss, it is difficult to chart out corrective action. We do not know whether the loss is due to high frequency of low losses or low frequency of high losses.

Study Session: 4 - RA: 1

4. Correct answer: D

It is difficult to fathom the causes for apparently simple loss events and, even worse, a single loss event may have many possible causes. Establishing links between the cause and the event can help in an objective assessment of operations risks.

Study Session: 4 - RA: 1

5. Correct answer: A

The company is seeking to avoid a pitfall of rash or irresponsible behavior from its insured clients.

Study Session: 4 - RA: 1

6. Correct answer: C

The fact that VaR model that has been prepared by an external contractor does not by itself lead to model risk. Rather the risk arises if the risk manager does not understand the model, or the results of the model are derived using assumptions given by the trader being monitored, or if some of the assumptions regarding market parameters are hard-coded into the model.

Study Session: 4 - RA: 1

7. Correct answer: B

Market risk measurement tools are well developed. The credit risk measurement tools are developing. Much work is required on the measurement of operations risk.

Study Session: 4 - RA: 1

8. Correct answer: D

In the initial phase of an operational risk implementation, the risk management department may not have sufficient experience in estimating the extent of losses. This calls for active involvement from the business management.

Study Session: 4 - RA: 1

9. Correct answer: C

The expected losses are to be reduced from expected income. The profitability needs to be

estimated based on net expected income.

Study Session: 4 - RA: 1

10. Correct answer: C

This is an example of moral hazard as the actions of the IMF effectively constitute a free insurance policy for the foreign investors who had lent to these governments. The signal that this gives to the market is that it is OK to lend to risk countries and make large spread, as the day something goes wrong, the IMF will step in because it cannot let the countries go down.

Study Session: 4 - RA: 1

11. Correct answer: B

The company is seeking to avoid people making wrong or untrue or unsubstantiated claims to obtain favorable insurance cover.

Study Session: 4 - RA: 1

12. Correct answer: B

A and C three are examples of market risk and D is an example of credit risk. Choice B is an example of operational risk.

Study Session: 4 - RA: 1

13. Correct answer: A

Moral hazard refers to the phenomenon of firms (or individuals), whose risks are underwritten by third parties, becoming more risk taking.

Study Session: 4 - RA: 1

14. Correct answer: B

The fact that VaR model that has been prepared by an external contractor does not by itself lead to model risk. Rather the risk arises if the risk manager does not understand the model, or the results of the model are derived using assumptions given by the trader being monitored, or if some of the assumptions regarding market parameters are hard-coded into the model.

Study Session: 4 - RA: 1

15. Correct answer: C

Exchange rate movements are related to market risk. The rest are related to operational risk.

Study Session: 4 - RA: 1

16. Correct answer: D

Risk managers will vet risk models to ensure that the results are accurate.

Study Session: 4 - RA: 1

17. Correct answer: A

Process risk arises due to failure to carry out a process in the specified manner.

Study Session: 4 - RA: 1

18. Correct answer: D

Insurance firms face both moral hazard and adverse selection. Both of these definitions are also incorrect.

Study Session: 4 - RA: 1

19. Correct answer: B

Catastrophic losses are too rare to be estimated using credit default models. Their value can only be estimated via the price that insurance firms would charge for cover against such risks.

Study Session: 4 - RA: 1

20. Correct answer: B

Default by counter-party is related to credit risk. The rest are related to operational risk.

Study Session: 4 - RA: 1

21. Correct answer: D

Computer hardware failure is an example of technology risk. The other two choices are examples of operational control risk.

Study Session: 4 - RA: 1

22. Correct answer: D

All of these documents contain vital information about the assessment by the management about the occurrence of operations risks.

Study Session: 4 - RA: 1

23. Correct answer: C

Operations strategic risk covers failures and disruptions due to change in competitor strategy, regulations, etc.

Study Session: 4 - RA: 1

24. Correct answer: C

This is an example of potential Operations failure.

Study Session: 4 - RA: 1

25. Correct answer: B

Inventory risks are the non-quantifiable risks such as legal risks, liquidity risks, and operational risks. They do not include market risk or credit risk. Model risk is not really due to the portfolio but rather the inaccuracies of the asset valuation and VaR models used.

Study Session: 4 - RA: 1

26. Correct answer: C

The correct order of the risk management processes is Identify => Measure => Control (hedge) => Monitor (manage).

Study Session: 4 - RA: 2

27. Correct answer: D

The key word in this question is 'transition period'. During this time, the market risk and operations risk levels can rise significantly before falling (especially true of operations risk) below the current levels.

Study Session: 4 - RA: 2

28. Correct answer: B

Linking compensation only to revenues is flawed as it ignores the risk taken. Individual responsible for committing to transactions should not be involved with clearance and accounting functions under the separation of duties.

Study Session: 4 - RA: 2

29. Correct answer: C

The banks capital should be applied against unexpected losses and high stress losses. Provisions for expected losses should be included while pricing the bank's products and services.

Study Session: 4 - RA: 2

30. Correct answer: B

Money laundering is the process by which criminals hide the origins and ownership of funds that have been generated by illegal means, such as drugs and arms trafficking.

Study Session: 4 - RA: 2

31. Correct answer: C

The correct order of the risk management processes is Identify => Measure => Control (hedge) => Monitor (manage).

Study Session: 4 - RA: 2

32. Correct answer: D

The banks capital should be applied against unexpected losses and high stress losses. Provisions for expected losses should be included while pricing the bank's products and services.

Study Session: 4 - RA: 2

33. Correct answer: C

A credit officer in charge of aircraft manufacturer need not know minute details about aerodynamics, but he should understand the business of aircraft manufacturing and selling. Similarly, the risk manager need not know the exact pricing of each and every exotic derivative created by the desk, but he should posses the ability to know what parameters to check and what are the pitfalls.

Study Session: 4 - RA: 2

34. Correct answer: A

Commercial banking is primarily exposed to credit risk, next comes operational risk and finally market risk.

Study Session: 4 - RA: 2

35. Correct answer: B

Operational risk capital reserves need to provide a cushion against unexpected losses (at say a 95% confidence interval). Losses above this limit are covered by buying insurance. Current losses should be expensed and expected losses covered by a loss reserve.

Study Session: 4 - RA: 2

36. Correct answer: D

The key word in this question is 'transition period'. During this time, the market risk and operations risk levels can rise significantly before falling (especially true of operations risk) below the current levels.

Study Session: 4 - RA: 2

37. Correct answer: C

The three stages in money laundering are placement (money is deposited at a financial institution), layering (the money is moved from one institution to another to hide its origin) and then integration (the money is reintroduced into the legitimate economy).

Study Session: 4 - RA: 2

38. Correct answer: A

The three stages in money laundering are placement (money is deposited at a financial institution), layering (the money is moved from one institution to another to hide its origin) and then integration (the money is reintroduced into the legitimate economy).

Study Session: 4 - RA: 2

39. Correct answer: B

The procedure of ensuring that the portfolio values resulting from a risk model match those observed currently in the market is called calibration. This is done by using the correct constants and global parameters (such as correlation) for the model.

Note: back-testing comes at a later stage when the management evaluates whether the VaR predicted by model matches the actual experience of the firm.

Study Session: 4 - RA: 2

40. Correct answer: C

The banks capital should be applied against unexpected losses and high stress losses. Provisions for expected losses should be included while pricing the bank's products and services.

Study Session: 4 - RA: 2

41. Correct answer: C

Expected losses are part of the cost of doing business and should be covered by pricing the product at a point that covers these costs.

Study Session: 4 - RA: 2

42. Correct answer: D

All of these steps are valid ways for management to choose from in a sequential manner. For example, it can directly choose option 1 or it can first try option 3, which may lead to option 2.

Study Session: 4 - RA: 2

43. Correct answer: D

Sumimoto suffered huge losses due to the activity of a copper trader. The losses amounted to $2.6 billion.

Study Session: 4 - RA: 2

44. Correct answer: D

In order to have best practices in operations risk management, it is essential to have objectivity and transparency in risk evaluation.

Study Session: 4 - RA: 2

45. Correct answer: B

The correct order of the risk management processes is Identify => Measure => Control (hedge) => Monitor (manage).

Study Session: 4 - RA: 2

46. Correct answer: A

The three components of the operations risk are: operational failure risk, operational strategy risk, and external dependency risk.

Study Session: 4 - RA: 2

47. Correct answer: B

Choice B is an example of operational risk.

Study Session: 4 - RA: 2

48. Correct answer: D

It is very difficult (or costly) for an organization to provide capital for catastrophic losses. Insurance should be based on cost-benefit analysis to cover these losses.

Study Session: 4 - RA: 2

49. Correct answer: B

Linking compensation only to revenues is flawed as it ignores the risk taken. Individual responsible for committing to transactions should not be involved with clearance and accounting functions under the separation of duties.

Study Session: 4 - RA: 2

50. Correct answer: A

Insurance premiums contain other provisions, but it is easy to estimate the industry averages for them. One can then adjust the average premiums of a few insurance companies by these estimated add-ons to find the "market price" of the risk to be covered. (An insurance company may have diversification benefit that an individual bank lacks).

Study Session: 4 - RA: 2

51. Correct answer: B

Since the loss frequency is uniform, the expected loss from this event = (60 + 100) / 2 = 80. The probability of this loss over the next year = (1/50) x (100 - 60)/(100 - 30). Therefore, the cost of the insurance = 80 / 50 / 1.75 = $0.91 million.

Study Session: 4 - RA: 3

52. Correct answer: B

Since the loss frequency is uniform, the expected loss from this event = (60 + 80) / 2 = 70. The probability of this loss over the next year = (1/50) x (80 - 60)/(80 - 20). Therefore, the cost of the insurance = 70 / 50 / 3 = $0.47 million.

Study Session: 4 - RA: 3

53. Correct answer: B

The distribution of potential losses due to operational risk is developed using loss severity and loss volatility distributions.

Study Session: 4 - RA: 3

54. Correct answer: B

Since the loss frequency is uniform, the expected loss from this event = (20 + 40) / 2 = 30. The probability of this loss over the next year = (1/10). Therefore, the cost of the insurance = 30 / 10 = $3.00 million.

Study Session: 4 - RA: 3

55. Correct answer: B

Since the loss frequency is uniform, the expected loss from this event = (10 + 25) / 2 = 17.5.

The probability of this loss over the next year = (1/50) x (25 - 10)/(25 - 5). Therefore, the cost of the insurance = 17.5 / 50 / 1.3333 = $0.26 million.

Study Session: 4 - RA: 3

56. Correct answer: B

Since the loss frequency is uniform, the expected loss from this event
= Average of threshold and maximum loss
= (50 + 120) / 2 = 85.

The probability of this loss over the next year = (120 - 50)/(120 - 20) x (1/25) = 0.28.

Therefore, the cost of the insurance = 85 x 0.028 = $2.38 million.

Study Session: 4 - RA: 3

57. Correct answer: C

Since the loss frequency is uniform, the expected loss from this event = (20 + 80) / 2 = 50. The probability of this loss over the next year = 1/50. Therefore, the cost of the insurance = 50 / 50 = $1 million.

Study Session: 4 - RA: 3

58. Correct answer: C

Since the loss frequency is uniform, the expected loss from this event = (60 + 90) / 2 = 75. The probability of this loss over the next year = 1/25. Therefore, the cost of the insurance = 75 / 25 = $3 million.

Study Session: 4 - RA: 3

59. Correct answer: C

Since the loss frequency is uniform, the expected loss from this event = (40 + 150) / 2 = 95. The probability of this loss over the next year = 1/50. Therefore, the cost of the insurance = 95 / 50 = $1.9 million.

Study Session: 4 - RA: 3

60. Correct answer: B

Since the loss frequency is uniform, the expected loss from this event = (65 + 75) / 2 = 70. The probability of this loss over the next year = (1/50) x (75 - 65)/(75 - 10) = 0.0031. Therefore, the cost of the insurance = 70 x (1/50 x 10/65) = $0.22 million.

Study Session: 4 - RA: 3

61. Correct answer: C

Stressing testing focuses on worst-case scenarios, i.e. infrequent but large losses that could threaten the survival of the firm.

Study Session: 4 - RA: 3

62. Correct answer: C

Since the loss frequency is uniform, the expected loss from this event = (10 + 50) / 2 = 30. The probability of this loss over the next year = 1/25. Therefore, the cost of the insurance = 30 / 25 = $1.2 million.

Study Session: 4 - RA: 3

63. Correct answer: A

The distribution of potential losses due to operational risk is developed using loss severity and loss frequency distributions.

Study Session: 4 - RA: 3

64. Correct answer: C

Since the loss frequency is uniform, the expected loss from this event = (10 + 70) / 2 = 40. The probability of this loss over the next year = 1/50. Therefore, the cost of the insurance = 40 / 50 = $0.8 million.

Study Session: 4 - RA: 3

65. Correct answer: A

Although most approaches to operational risk do not ignore the fact that the risk is a function of the processes, in the given choices, "Systems Dynamics Approach" is the most appropriate one.Study Session: 4 - RA: 4

66. Correct answer: C

The objectives of the regulators and the shareholders are different; hence their expectations from risk management systems are different.Study Session: 4 - RA: 4

67. Correct answer: C

The usual distributions used in Monte-Carlo Simulation are Poisson and Pareto.Study Session: 4 - RA: 4

68. Correct answer: A

The meeting of regulatory minimum is a must. However, achieving the shareholder's objective is key for creating value.Study Session: 4 - RA: 4

69. Correct answer: C

In many instances of operational risk events sufficient data is not available. Under such circumstances, a qualitative risk measure or score can be assigned.Study Session: 4 - RA: 4

70. Correct answer: D

The description fits the neural network approach.Study Session: 4 - RA: 4

71. Correct answer: A

Care must be taken to ensure that external risk drivers are given due importance. Once the risk drivers have been identified, the risk manager needs to identify the sources of relevant data.Study Session: 4 - RA: 4

72. Correct answer: B

The two matrices are required to get a clear understanding and measurement of the operational risks.Study Session: 4 - RA: 4

73. Correct answer: B

Trend analysis does not attempt to model the occurrence frequency and the severity separately.Study Session: 4 - RA: 4

74. Correct answer: D

All of the above are the decision factors.Study Session: 4 - RA: 4

75. Correct answer: A

In this approach, risk managers and senior managers together build a risk budget for the entire business and then allocate the total risk among various business units based on some parameter or indicator. Hence, top down approach is better suited for controlling macro risk.Study Session: 4 - RA: 5

76. Correct answer: B

The tools for operational VAR are NOT advanced sufficiently to have a seamless aggregation or decomposition of the risks.Study Session: 4 - RA: 5

77. Correct answer: C

In the top-down approach risk managers and senior managers work together to build a risk budget for the entire business and then allocate the total risk among various business units based on some parameter or indicator. The top-down approach eschews some levels of detail but is better at incorporating interlinkages between different business lines.

Study Session: 4 - RA: 5

78. Correct answer: A

Operational risk has a significant impact on both market and credit risk. For example, if a firm has a flaw in its procedures for recording or auditing derivatives, it can build up unmanageable market and/or credit exposures.

Study Session: 4 - RA: 5

79. Correct answer: B

The VAR models are most developed for market risk and least developed for operational risk.

Study Session: 4 - RA: 5

80. Correct answer: C

The experiences of applying quantitative tools for operational risk do not yet have a successful history. Actuarial concepts and statistical tools for operational risk modeling are too new to be relied upon exclusively.Study Session: 4 - RA: 5

81. Correct answer: A

Delphi is a qualitative tool.Study Session: 4 - RA: 5

82. Correct answer: D

In operational VAR, given the current level of development, it is imperative to use a combination of the both approaches.Study Session: 4 - RA: 5

83. Correct answer: B

The use of quantitative tools for operational risk has not been very successful. Actuarial concepts and statistical tools for operational risk modelling are too new to be relied upon exclusively.

Study Session: 4 - RA: 5

84. Correct answer: B

In this approach, operational risk assessment starts with each business manager giving a detailed impression about the risks faced in their business activity. It is likely that the business managers may not give enough weight to the business inter-linkages, especially the not-so-obvious ones.Study Session: 4 - RA: 5

85. Correct answer: C

Both Delphi technique and interviews are examples of qualitative tools.Study Session: 4 - RA: 5

86. Correct answer: B

In this approach, operational risk assessment starts with each business manager giving a detailed impression about the risks faced in their business activity. Hence, for controlling micro-level risks, the bottom up approach is better suited.Study Session: 4 - RA: 5

87. Correct answer: A

The top-down approach eschews some levels of details, making it harder to convince the business managers that the capital attributed to their activity does indeed reflect the level of risks faced by their business unit.Study Session: 4 - RA: 5

88. Correct answer: B

In the bottom-up approach operational risk assessment starts with each business manager giving a detailed impression about the risks faced in their business activity. These business unit level assessments can then be aggregated to a give a complete picture. The bottom-up approach provides a good level of detail and makes it easier to get the buy-in from individual managers given their involvement in the process.

Study Session: 4 - RA: 5

89. Correct answer: A

The bottom-up approach provides a good level of detail but can easily miss inter-linkages between various departments.1

Study Session: 4 - RA: 5

90. Correct answer: A

The tools for measuring operational risk management are still not well established.Study Session: 4 - RA: 5

91. Correct answer: B

The insurance company has to deal with this moral hazard by either having a specific provision or by requiring higher return on capital. In both cases, the cost of external insurance goes up.Study Session: 4 - RA: 6

92. Correct answer: A

In this case, since there is no economical means of controlling the risks, it is prudent to divest from the business.Study Session: 4 - RA: 6

93. Correct answer: B

Only the unexpected portion of the risk needs to be insured.Study Session: 4 - RA: 6

94. Correct answer: A

If the insured operational risk is not correlated with the market risk, the market players are willing to accept a lower return for assuming this risk, as compared to an insurance company. This leads to a reduction in the cost of the insurance.Study Session: 4 - RA: 6

95. Correct answer: A

The choice of insurance must be compared with allocating higher capital not with the expected profit. The expected profit should be sufficient to cover the lower of (cost of additional capital, cost of insurance).Study Session: 4 - RA: 6

96. Correct answer: C

Since the cost of capital has increased, the unattractiveness of providing capital will increase further. This will not change the outcome.Study Session: 4 - RA: 6

97. Correct answer: B

Since expected operational risks are foreseen, the foreseen income should be sufficiently high to cover this expected expense. There is no need to insure this.Study Session: 4 - RA: 6

98. Correct answer: D

More capital must be allocated ONLY for acceptable, but under-funded risk.Study Session: 4 - RA: 6

99. Correct answer: D

All the above benefits from an operational risk viewpoint can be considered while evaluating the investment decision.Study Session: 4 - RA: 6

100. Correct answer: D

Since the capital is insufficient to cover otherwise acceptable risks, it is essential to allocate more capital to the business.Study Session: 4 - RA: 6

101. Correct answer: D

In this case, there is no need to take any action.Study Session: 4 - RA: 6