Reading 88

INTRODUCTION TO RISK MANAGEMENT

1. (B) **Model risk.**

Explanation

Model risk is an example of a non-financial risk. Other examples include operational risk, solvency risk, regulatory risk, governmental or political risk, legal risk, tail risk, and accounting risk. Financial risks include credit risk, liquidity risk, and market risk.

(Module 88.1, LOS 88.f)

2. (A) **scenario analysis.**

Explanation

Scenario analysis involves modelling the effects of changes in multiple inputs at the same time. Stress testing examines the effects of changes in a single input. Risk shifting refers to managing a risk by modifying the distribution of outcomes.

(Module 88.1, LOS 88.g)

3. (C) **interactions among different risks.**

Explanation

The various financial and non-financial risks interact in many ways. A risk management process should consider these interactions among risks rather than treating them each in isolation.

(Module 88.1, LOS 88.f)

4. (C) **The financial strength of an organization is one of the factors it should consider when determining its risk tolerance.**

Explanation

Financial strength is an important factor in an organization's risk tolerance because it reflects the organization's ability to withstand losses. Even if its risk tolerance is low, an organization may choose to bear some risks that are consistent with achieving the organization's objectives. Risk tolerance includes risks that arise from within the organization as well as risks from outside.

(Module 88.1, LOS 88.d)

5. (B) **identify the risks faced by an organization.**

Explanation

The risk management process should identify an organization's risk tolerance, identify the risks it faces, and monitor or address these risks. The goal is not to minimize or eliminate risks.

(Module 88.1, LOS 88.a)

6. (C) **transfer a risk.**

Explanation

Buying insurance transfers a risk to the insurance company. Shifting a risk is changing the distribution of outcomes, typically with a derivatives contract. Preventing a risk refers to taking steps such as strengthening security procedures.

(Module 88.1, LOS 88.g)

7. (B) **disciplining managers who exceed their risk budgets.**

Explanation

Corrective actions against individuals are not specifically part of a risk management framework. Features of a risk management framework include establishing risk governance policies, determining risk tolerance, identifying and measuring risks, managing or mitigating risks, monitoring exposures to risks, performing strategic risk analysis, and communicating risk levels through the organization.

(Module 88.1, LOS 88.b)

8. (A) **human error or faulty processes will cause losses.**

Explanation

Operational risk arises from faulty processes or human error within the organization. Solvency risk is the risk that the organization will run out of cash and therefore be unable to continue operating. Tail risk is the risk that extreme events are more likely than the organization's managers have assumed.

(Module 88.1, LOS 88.f)

9. (C) **tail risk.**

Explanation

VaR and Conditional VaR are measures of tail risk, the probability of or magnitude of extreme negative outcomes in the tail of a distribution.

(Module 88.1, LOS 88.g)

10. (A) credit risk, market risk, and liquidity risk.

Explanation

Credit risk, market risk, and liquidity risk are examples of financial risk. Solvency risk and tax risk are classified as non-financial risks.

(Module 88.1, LOS 88.f)

11. (A) beta.

Explanation

Beta measures the market risk of an asset or portfolio. Duration measures the interest rate sensitivity of the value of a fixed-income security or portfolio. Rho measures the interest rate sensitivity of the value of a derivative.

(Module 88.1, LOS 88.g)

12. (C) senior management's oversight of the organization's risk management.

Explanation

Risk governance is a general term that encompasses multiple functions of senior management. Determining the risk tolerance of the organization and allocating the organization's resources by considering their risk characteristics (risk budgeting) are elements of management's risk governance responsibility.

(Module 88.1, LOS 88.c)