Department of Commercial Accounting

RISK IN FINANCIAL SERVICES 2B

RFS22B2

Final Assessment Opportunity

November Examination 2016

Time: 2 hours
Marks: 70

Assessor: Oliver Takawira
Moderator: Yusuf Patel (Internal)

INSTRUCTIONS:
- This paper consists of 7 pages (including the cover page).
- Start each question on a new page.
- Calculators are allowed

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70 120 minutes
QUESTION 1 - (30 marks)

1.1 Which of the following distributions is commonly used in financial services?
A. Lognormal
B. Exponential
C. Logarithmic
D. Exponential logarithmic

1.2 A maturity ladder is a device for:
A. Comparing currency pairs across the intra-day trading period
B. Comparing cash inflows and outflows, over a specified time period
C. Assessing the liquidity of financial controls, such as the cash flow statement
D. Analysing which instruments require cash for margin calls

1.3 Which of the following factors could affect the riskiness of investment in shares?
A. The investor’s credit rating
B. Quantification of the investor’s operational risk scenarios
C. Platform stability
D. Strategic risk of the issuing institution

1.4 Which of the following is a measure of asset liquidity risk?
A. Bid-offer spread
B. Flow turbulence
C. Liquid pool urgency
D. Dynamic granularity

1.5 If a fund’s beta value increased from 0.55 to 0.85, what does this indicate?
A. Competitiveness has improved
B. Volatility has increased
C. Charges have been increased
D. Performance has moved more in line with the market

1.6 When managing an investment portfolio, what is the main purpose of ‘performance attribution reporting’?
A. To ensure compliance with the investment mandate
B. To identify the strong and weak components
C. To benchmark performance against the market in general
D. To quantify the degree of volatility

1.7 The ratio of the bid/offer spread to an asset’s mid-price can be used to compare different assets. What does it mean if asset A has a higher ratio than asset B?
A. A is more liquid than B
B. B is more liquid than A
C. A is more volatile than B
D. B is more volatile than A
1.8 Direct investment in which one of the following asset classes is likely to present the greatest liquidity risk?
A. Property
B. Overseas equities
C. UK equities
D. Gilts

1.9 One of the key weaknesses of using standard deviation as a measure of investment risk is that:
A. it ignores dividend reinvestment
B. it ignores short-term volatility
C. it assumes past experiences will tend to continue
D. it assumes a lack of any form of competitor activity

1.10 Where the interest rate under an investment arrangement is 8% but the `annual equivalent rate` is slightly higher than 8%, this means that:
A. the interest rate is variable rather than fixed
B. the interest is payable at least twice a year
C. the investment period is less than one year
D. the investment earns simple, not compound, interest

1.11 If the nominal return under an investment is 11% and inflation is running at 2.5%, then 8.5% is normally described as the investment's:
A. gross yield
B. net yield
C. real return
D. invisible return

1.12 Which of the following would most contribute to model risk?
A. Difficulty in hiring risk staff who can obtain regulatory approval for the model
B. Lack of netting agreements between counterparties
C. Data errors in the model's inputs
D. The programming language used to construct the model

1.13 Which of the following is an attribute of a normal distribution curve?
A. It is symmetrical about its standard deviation
B. It is plotted about its median
C. Its average value is always greater than its standard deviation
D. It is defined by its standard deviation and its mean

1.14 An effective market risk management function will ensure that the VaR measurement process is:
A. Monitored by the company secretary
B. Monitored externally rather than internally
C. Carried out by the compliance department
D. Carried out in conjunction with other methods
1.15 How does good succession planning help to maintain effective risk governance?
A. It prevents reward for failure
B. It encourages staff authority
C. It offsets the impact of change
D. It ensures the delegation of responsibility

1.16 Consistent confidence levels and time-levels are fundamental to which of the following challenges to establishing an enterprise risk management programme?
A. Aggregation
B. Cultural
C. Measurement
D. Timescale

1.17 Enterprise risk is BEST defined as the:
A. aggregation of all the risks faced by a firm
B. appreciation of the credit risk associated with a firm acquiring new business
C. impact of a firm`s risk profile on its available risk capital
D. process of applying the discipline of risk management to a firm`s operations

1.18 A bank is conducting six individual stress test scenarios as part of its liquidity risk management activities. In order to satisfy Basel II`s Principles for Sound Liquidity Risk Management, these scenarios:
A. must be personally signed off by the CEO or equivalent
B. must be based on situations actually experienced
C. must also be assessed in combination
D. must include at least three prescribed by the Basel Committee

1.19 Which of the following statistical methods is used when conducting operational risk scenario modelling?
A. Credit migration probabilities
B. Normal distribution
C. Lognormal distribution
D. Confidence level

1.20 Deflation is MOST likely to occur when:
A. the market is considered to be excessively liquid
B. the market is considered to be dislocated
C. there is a loose fiscal policy in place
D. there is a loose monetary policy in place

1.21 Which of the following business functions, participating in an enterprise risk management programme, would be MOST likely to introduce initiatives to directly address the risks from external threats and opportunities?
A. Finance department
B. Market risk department
C. Operational risk team
D. Strategy team
1.22 How has Basel II influenced the issue of enterprise risk management (ERM)?
A. By encouraging firms to adopt an ERM approach
B. By banning ERM other than in exceptional circumstances
C. By making it more complicated to achieve an ERM approach
D. By linking ERM to profitability

1.23 In relation to VaR, what is the main purpose of back testing?
A. To prove the reliability of historical data
B. To compare predicted values to actual results
C. To establish the liquidity risk
D. To confirm the relevance of the sample trading period

1.24 The volatility of an investment’s value can be quantified mathematically by calculating the investment’s:
A. Variance
B. Inter-quartile range
C. Beta
D. Standard deviation

1.25 The risk of loss through being unable to obtain a price on a product when required is which ONE of the following types of market risk?
A. Commodity risk
B. Basis risk
C. Liquidity risk
D. Volatility risk

1.26 Where an asset has a negative beta, the asset can be expected to:
A. have no price correlation with the market
B. offer a risk-free return
C. increase in value as the market falls
D. always fall below benchmark values

1.27 Where the individual assets within a fund are negatively correlated, this should normally:
A. increase the degree of investment risk
B. reduce the degree of investment risk
C. increase the degree of liquidity risk
D. reduce the degree of liquidity risk

1.28 A liquidity gap analysis which shows a net positive figure for a particular month indicates that:
A. anticipated cash inflows exceed anticipated cash outflows
B. anticipated cash outflows exceed anticipated cash inflows
C. projected income exceeds projected expenditure
D. projected expenditure exceeds projected income
1.29 Which of the following processes would be considered to provide a firm-wide risk management approach?
A. Operational risk policy
B. Enterprise risk management
C. Value-at-risk models
D. Cost-based provisioning

1.30 How does an enterprise risk management approach help those with corporate governance responsibilities?
A. Compares risk profiles for similar organizations
B. Enables regulations to be modified
C. Gives a single view of the firm’s risk profile
D. Quantifies risk using a diversification scale

QUESTION 2 - (9 marks)

2.1 What is Investment Risk? (2)

2.2 Clearly distinguish between systematic risk and non-systematic risk. (2)

2.3 What are the two components of total returns? (2)

2.4 Calculate the real rate of return given that the nominal rate of return is 12% per annum and the annual rate of inflation is 8% per annum. (3)

QUESTION 3 - (8 marks)

3.1 What is the definition of Funding Liquidity risk? (2)

3.2 What are the four key measures of asset liquidity risk? (4)

3.3 Define Market Dislocation. (2)

QUESTION 4 - (8 marks)

4.1 What is corporate governance? (2)

4.2 List and elaborate the three lines of defence in corporate governance. (3)

4.3 What is the underlining statement of Knowledge Management by the BIS? (2)

4.4 Explain and give an example the term Due Diligence (1)
QUESTION 5 - (8 marks)

5.1 What is the definition of Model Risk? (2)

5.2 Differentiate between historical simulation and back testing. (2)

5.3 Model risk emanates from operational risk and occurs primarily for two reasons: Name and explain the two (2) reasons? (4)

QUESTION 6 - (7 marks)

6.1 What do you understand by the term enterprise risk management? (2)

6.2 Differentiate between firm risk and client risk. (2)

6.3 What are three challenges of implementing an ERM programme? (3)