PRMIA ORM 8010 Practice Questions

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Question 1

Question Type: MultipleChoice

Which of the following statements are true:

1. The set of UoMs used for frequency and severity modeling should be identical

2. UoMs can be grouped together into larger combined UoMs using judgment based on the knowledge of the business

3. UoMs can be grouped together into combined UoMs using statistical techniques

4. One may use separate sets of UoMs for frequency and severity modeling

Options:

A- 1, 2 and 3
B- 4 only
C- 2, 3 and 4
D- All of the above

Answer:

C

Explanation:

One may use separate UoMs for frequency and severity modeling, for example, a combined UoM may be used for estimating the frequency of cyber attacks in a scenario, while the severity may be modeled using a more granular line-of-business UoM. Therefore statement I is false, while statement IV is true. Statement II is correct, UoMs can be grouped together into larger units based on the facts relating to the business, controls and the business environment. Similarly, UoMs can be grouped together based on statistical clustering techniques using the 'distance' between the units of measure and combining UoMs that are closer to each other. In addition, it is also possible to combine both business knowledge and statistical algorithms to combine UoMs.

Question 2

Question Type: MultipleChoice

A key problem with return on equity as a measure of comparative performance is:

Options:

A- that return on equity is not adjusted for risk
B- that return on equity are not adjusted for cash flows being different from accounting earnings
C- that return on equity measures do not account for interest and taxes
D- that return on equity ignores the effect of leverage on returns to shareholders

Answer:

A

Explanation:

The major problem with using return on equity as a measure of performance is that return on equity is not adjusted for risk. Therefore, a riskier investment will always come out ahead when compared to a less risky investment when using return on equity as a performance metric.

Return on equity does not ignore the effect of leverage (though return on assets does) because it considers the income attributable to equity, including income from leveraged investments.

Return on equity is generally measured after interest and taxes at the company wide level, though at business unit level it may use earnings before interest and taxes. However this does not create a problem so long as all performance being covered is calculated in the same way.

Cash flows being different from accounting earnings can create liquidity issues, but this does not affect the effectiveness of ROE as a measure of performance.

Question 3

Question Type: MultipleChoice

If the default hazard rate for a company is 10%, and the spread on its bonds over the risk free rate is 800 bps, what is the expected recovery rate?

Options:

A- 40.00%
B- 20.00%

C- 8.00%
D- 0.00%

Answer:

B

Explanation:

The recovery rate, the default hazard rate (also called the average default intensity) and the spread on debt are linked by the equation Hazard Rate = Spread/(1 - Recovery Rate). Therefore, the recovery rate implicit in the given data is = 1 - 8%/10% = 20%.

Question 4

Question Type: MultipleChoice

A bank expects the error rate in transaction data entry for a particular business process to be 0.005%. What is the range of expected errors in a day within +/- 2 standard deviations if there are 2,000,000 such transactions each day?

Options:

A- 80 to 120 errors in a day
B- 60 to 80 errors in a day
C- 0 to 200 errors in a day
D- 90 to 110 errors in a day

Answer:

A

Explanation:

Error rates are generally modeled using the Poisson distribution. Recall that the Poisson distribution has only one parameter - - which is its mean and also its variance.

In the given case, the mean number of errors is 2,000,000 x 0.005% = 100. Since this is the variance as well, the standard deviation is 100 = 10. Therefore the range of outcomes within 2 standard deviations of the mean is 100 +/- (2*10) = 80 to 120 errors in a day.

Question 5

Question Type: MultipleChoice

In respect of operational risk capital calculations, the Basel II accord recommends a confidence level and time horizon of:

Options:

A- 99.9% confidence level over a 10 day time horizon
B- 99% confidence level over a 10 year time horizon
C- 99% confidence level over a 1 year time horizon
D- 99.9% confidence level over a 1 year time horizon

Answer:

D

Explanation:

Choice 'd' represents the Basel II requirement, all other choices are incorrect.

Question 6

Question Type: MultipleChoice

Under the credit migration approach to assessing portfolio credit risk, which of the following are needed to generate a distribution of future portfolio values?

Options:

A- The forward yield curve
B- A specified risk horizon
C- A rating migration matrix
D- The approach considers only default risk, and ignores the risk to portfolio value from credit downgrades

Answer:

D

Explanation:

The credit migration approach to assessing portfolio credit risk involves obtaining a distribution of future portfolio values from the ratings migration matrix. First, the frequencies in the matrix are used as probabilities, and expected future values of the securities belonging to each rating category are calculated. These are then discounted to the present using the discount rate appropriate to the 'future' rating category. This gives us a forward distribution of the value of each security in the portfolio. These are then combined using the default correlations between the issuers. The default correlation between the issuers is often proxied using asset returns, and recognizing that default occurs when asset values fall below a certain threshold. A distribution for the future value of the portfolio is generated using simulation, and from this distribution the Credit VaR can be calculated.

Thus, we need the migration matrix, the risk horizon from which the present values need to be calculated, and the forward yield curve or the discount curve for each rating category for the risk horizon. Thus, Choice 'd' is the correct answer.

Question 7

Question Type: MultipleChoice

The 99% 10-day VaR for a bank is $200mm. The average VaR for the past 60 days is $250mm, and the bank specific regulatory multiplier is 3. What is the bank's basic VaR based market risk capital charge?

Options:

A- $250mm
B- $200mm
C- $750mm
D- $600mm

Answer:

C

Explanation:

The current Basel rules for the basic VaR based charge for market risk capital set market risk capital requirements as the maximum of the following two amounts:

1. 99%/10-day VaR,

2. Regulatory Multiplier x Average 99%/10-day VaR of the past 60 days

The 'regulatory multiplier' is a number between 3 and 4 (inclusive) calculated based on the number of 1% VaR exceedances in the previous 250 days, as determined by backtesting.

- If the number of exceedances is <= 4, then the regulatory multiplier is 3.

- If the number of exceedances is between 5 and 9, then the multiplier = 3 + 0.2*(N-4), where N is the number of exceedances.

- If the number of exceedances is >=10, then the multiplier is 4.

So you can see that in most normal situations the risk capital requirement will be dictated by the multiplier and the prior 60-day average VaR, because the product of these two will almost often be greater than the current 99% VaR.

The correct answer therefore is = max(200mm, 3*250mm) = $750mm.

Interestingly, also note that a 99% VaR should statistically be exceeded 1%*250 days = 2.5 times, which means if the bank's VaR model is performing as it should, it will still need to use a reg multiplier of 3.

Question 8

Question Type: MultipleChoice

Which of the following statements is true in respect of a non financial manufacturing firm?

1. Market risk is not relevant to the manufacturing firm as it does not take proprietary positions

2. The firm faces market risks as an externality which it must bear and has no control over

3. Market risks can make a comparative assessment of profitability over time difficult

4. Market risks for a manufacturing firm are not directionally biased and do not increase the overall risk of the firm as they net to zero over a long term time horizon

Options:

A- 3 only
B- 4 only
C- 1and 2

D- 3 and 4

Answer:

A

Explanation:

A non-financial firm such as a manufacturing company faces market risks similar to those faced by financial firms, except perhaps for not being exposed to risks from the equity markets. Non financial firms commonly face interest rate risks in respect of their debts, commodity price risks in respect of their inputs and products, and foreign currency risks in respect of their overseas operations. It is therefore not correct to say that the manufacturing firm does not face market risk because it does not take proprietary positions. While decisions on positions may not be actively taken, positions in foreign exchange (eg, through overseas debtors owing foreign currency, or liabilities in foreign currencies to overseas suppliers), commodities (through exposure to the need for raw material and inventory of finished goods) and interest rates (through debt financed, whether at fixed or floating rates) exist and create market risk much in the same way as they would for a proprietary position. Therefore statement I is incorrect.

While the firm faces market risks as an externality (as do financial firms for that matter, though often they seek such exposure to profit from their view on which way the externality will express itself), it is incorrect to say that these risks must be borne. They can be measured and hedged. Therefore statement II is incorrect.

The results of a manufacturing firm will include gains and losses arising from exposure to market risk, and will cloud the true profitability of the business. A firm with significant unhedged overseas sales may show vastly different results across time periods due to the FX gains and losses, making comparative assessment of profitability difficult. Therefore statement III is correct.

Market risks for a manufacturing firm may be directionally biased in terms of exposure, ie there may be a consistent 'long' position in a particular commodity that the firm produces, and a consistent 'short' position in the commodities consumed. In the same way, directional biases may exist in FX or interest rate exposures too. Regardless of the bias, the existence of market risk exposures increase the volatility of the income stream and make the firm more risky, even though the long term expected returns from such exposures is zero (ie, returns may be zero but standard deviation is not). Therefore statement IV is not correct as market risks form non financial firms do increase the overall risk of the firm.

Question 9

Question Type: MultipleChoice

There are three bonds in a diversified bond portfolio, whose default probabilities are

independent of each other and equal to 1%, 2% and 3% respectively over a 1 year time horizon. Calculate the probability that exactly 1 of the three bonds will default.

Options:

A- .011%
B- 2%
C- 5.8%
D- 0%

Answer:

C

Explanation:

The probability that only one of the three bonds will default is equal to the sum of the probabilities of the three scenarios where one bond defaults and the other two survive. This probability is given by 1%*(1 - 2%)*(1 - 3%) + (1 - 1%)*2%*(1 - 3%) + (1 - 1%)*(1 - 2%)*3% = 5.7818%. Choice 'c' is the correct answer.

Question 10

Question Type: MultipleChoice

Which of the following statements are true:

1. Top down approaches help focus management attention on the frequency and severity of loss events, while bottom up approaches do not.

2. Top down approaches rely upon high level data while bottom up approaches need firm specific risk data to estimate risk.

3. Scenario analysis can help capture both qualitative and quantitative dimensions of operational risk.

Options:

A- 3 only
B- 2 and 3
C- 1 only

D- 2 only

Answer:

B

Explanation:

Top down approaches do not consider event frequency and severity, on the other hand they focus on high level available data such as total capital, income volatility, peer group information on risk capital etc. Bottom up approaches focus on severity and frequency distributions for events. Statement I is therefore not correct.

Top down approaches do indeed rely upon high level aggregate data and tend to infer operational risk capital requirements from these. Bottom up approaches look at more detailed firm specific information. Statement II is correct.

Scenario analysis requires estimating losses from risk scenarios, and allows incorporating the judgment and views of managers in addition to any data that might be available from internal or external loss databases. Statement III is correct. Therefore Choice 'b' is the correct answer.

Question 11

Question Type: MultipleChoice

Which of the following belong in a credit risk report?

Options:

A- Exposures by country
B- Exposures by industry
C- Largest exposures by counterparty
D- The approach considers only default risk, and ignores the risk to portfolio value from credit downgrades

Answer:

D

Explanation:

All the listed variables are relevant to management monitoring the credit risk profile of an institution, therefore Choice 'd' is the correct answer.

Question 12

Question Type: MultipleChoice

Which of the following distributions is generally not used for frequency modeling for operational risk

Options:

A- Binomial
B- Poisson
C- Gamma
D- Negative binomial

Answer:

C

Explanation:

Frequency modeling is performed using discrete distributions that have a positive integer as a resultant - this allows for the number of events per period of time to be modeled. Of the distributions listed above, Poisson, negative binomial and binomial can be used for modeling frequency distributions. The Poisson and negative binomial distributions are encountered the most in practice.

The gamma distribution is a continuous distribution and cannot be used for frequency modeling.

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