Exam IV: Case Studies: Standards: Governance, Best Practices and Ethics - 2015 Edition

PRMIA 8009

Version Demo

Total Demo Questions: 14

Total Premium Questions: 145

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Topic Break Down

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Topic 1, Case Studies	73
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QUESTION NO: 1

A PRMIA member is offered a highly paid work assignment on the condition that some aspects of assignment are not to be done according to PRMIA standards.

What should they do?

A. Perform the assignment, noting in the final report the standards to which the assignment was done

B. Accept the assignment, produce and deliver two reports according to both standards

C. Accept the assignment, and prior to doing any work, report the conflict of interest to the organization's compliance department

D. The PRMIA member should place the integrity of the risk management profession and users of risk management above their own personal interests, and refuse the work

ANSWER: D

Explanation:

The PRMIA member should place the integrity of the risk management profession and users of risk management above their own personal interests, and refuse the work. A condition requiring work to depart from applicable PRMIA professional standards creates a direct ethical conflict: the financial benefit to the individual must not override the member's duty to professional integrity, competence, and the interests of those who rely on risk-management work. Refusing the engagement is the appropriate action because it avoids participating in conduct that could compromise the quality, reliability, or credibility of the analysis and its conclusions. Ethical professional practice requires members to act honestly and responsibly, uphold the profession's reputation, and avoid allowing commercial pressure to dictate a lower standard of work. Merely disclosing a departure after accepting the work would not cure the underlying issue, because the assignment itself is conditioned on nonconforming conduct. PRMIA's professional expectations emphasize integrity and ethical conduct as core obligations of membership and certification holders. The relevant principles are reflected in PRMIA's Code of Ethics and its Professional Risk Manager certification information, which identify professional standards and ethical conduct as essential to the risk-management profession.

QUESTION NO: 2

In the case of National Australia Bank, which of the following was present?

A. A window of time between close of day for reporting purposes and back office checking that allowed traders to hide losses using fictitious trades

B. The Board received risk management information that was incorrect, incomplete or insufficiently detailed

C. Both A and B

D. Neither A nor B

ANSWER: C

Explanation:

Both A and B is correct. The National Australia Bank foreign-currency-options trading incident exposed a control environment in which fictitious offsetting trades could be used to conceal the traders' true positions and losses. A timing gap between the end-of-day reporting process and subsequent back-office confirmation and checking created an opportunity for false trades to remain in internal reports long enough to mask the underlying exposure. This meant reported profit-and-loss and position information could be materially misleading at a critical point in the control cycle.

The incident also demonstrated that risk information reaching the Board was not adequate for effective oversight. Information was incomplete and insufficiently detailed to give directors a reliable picture of the scale of foreign-exchange-options risk, the control weaknesses, and the significance of warning indicators. Effective governance requires boards to receive timely, accurate, meaningful risk reporting that supports challenge and escalation, rather than reports that can be distorted by weak processes or poorly aggregated data. APRA's review treated the event as a broad governance, risk-management, and control failure, not merely an isolated trader misconduct event. See APRA's release of its NAB review report and NAB's 2004 annual financial report.

QUESTION NO: 3

National Australia Bank and Barings cases are similar in that:

A. Losses kept increasing while rogue trader(s) hid their positions

B. The back offices had inadequate procedures

C. Both A and B

D. None of the above

ANSWER: C

Explanation:

Both A and B is correct because the National Australia Bank foreign-exchange-options losses and the Barings collapse each illustrate how unauthorized trading losses can grow when positions and their true valuations are concealed from independent control functions. In both events, the individuals involved used mechanisms that obscured the economic reality of their trading exposures, preventing timely escalation and allowing losses to accumulate. The cases also demonstrate a fundamental operational-risk and governance failure: back-office and control procedures did not provide effective independent verification, reconciliation, exception reporting, and segregation of duties. At Barings, the lack of separation between trading and settlement activities was especially significant; at NAB, control processes failed to detect deceptive transactions and irregular reporting promptly. These are closely related lessons, because hidden positions persist only where the operational-control environment does not independently test, reconcile, and challenge front-office activity. The Basel Committee identifies segregation of duties, independent verification, and sound internal controls as core operational-risk-management expectations. The case histories remain important examples of why firms need robust governance, timely risk reporting, and effective challenge by independent risk and operations functions. See the Basel Committee's Principles for the Sound Management of Operational Risk and the APRA review of NAB's foreign-currency-options losses.

QUESTION NO: 4

Zheng Zhu wants to open a new PRMIA Chapter in Wuhan, China. He can do this if:

A. At least 100 members live within 50 miles

B. A local business sponsors the chapter

C. Approved by the Board of Directors

D. All of the above

ANSWER: C

Explanation:

Approved by the Board of Directors is correct because establishing a PRMIA chapter is an organizational governance decision, rather than something that occurs automatically upon meeting a local membership threshold or obtaining commercial sponsorship. A chapter represents PRMIA in a geographic market, uses the association's name and standards, and forms part of its member-engagement structure. Consequently, authorization must come through PRMIA's formal governance process, with the Board of Directors having ultimate authority over the association's affairs and organizational arrangements.

Board approval ensures that a proposed Wuhan chapter is aligned with PRMIA's mission, policies, operating standards, and global chapter framework. It also provides accountability for leadership selection, permitted activities, branding, member communications, and the chapter's ongoing relationship with the association. The prospective chapter leader would therefore submit or support the required proposal and satisfy applicable chapter-formation procedures, but the decisive condition in this question is approval by the Board of Directors. PRMIA describes its global professional community and local engagement through its official website at PRMIA; its association background and governance context are available at About PRMIA.

QUESTION NO: 5

Finite insurance is reinsurance which

A. transfers only a limited amount of risk at the usual reinsurance price

B. transfers the total risk at less cost than traditional reinsurance

C. transfers the total risk at the usual reinsurance price

D. transfers only a limited amount of risk at less cost than traditional reinsurance

ANSWER: D

Explanation:

Finite insurance is reinsurance which **transfers only a limited amount of risk at less cost than traditional reinsurance**. Its defining feature is that the reinsurer's ultimate exposure is deliberately capped or otherwise constrained through features such as aggregate limits, experience accounts, retrospective premium mechanisms, multiyear arrangements, or profit-sharing provisions. Because the reinsurer is assuming a limited and structured amount of underwriting risk rather than the broader, more volatile risk commonly covered by conventional reinsurance, the reinsurance premium is generally lower than the price of comparable traditional risk-transfer cover.

Finite reinsurance can nevertheless serve legitimate risk-financing purposes: it can smooth results over time, provide capacity for defined adverse-loss scenarios, and align the cedant's and reinsurer's incentives. The critical analytical point is the extent of genuine insurance risk transferred, since accounting treatment depends on whether the arrangement transfers significant insurance risk rather than functioning principally as a financing arrangement. The NAIC's statutory accounting framework addresses risk-transfer analysis for reinsurance, and the SEC has also highlighted the importance of appropriately evaluating and disclosing finite-risk arrangements. See the NAIC Financial Reporting resources and the SEC's *interpretive guidance on accounting and disclosure considerations*.

QUESTION NO: 6

The Risk Management Infrastructure of an organization must:

I. To the extent possible, avoid silos of control and oversight

II. Have budgets set by the business unit leaders

III. Actively provide ongoing professional development for risk management staff and require them to be committed to standards of best practice, conduct and ethics in their work

IV. Provide general risk management and related corporate governance training for employees of the organization as a Whole

A. I only

B. I, III and IV only

C. I and III only

D. All of these are expected of the Risk Management Infrastructure

ANSWER: B

Explanation:

I, III and IV only is correct because an effective risk-management infrastructure is enterprise-wide, independent in its challenge function, and embedded in the organization's culture. Avoiding unnecessary silos enables material risks, control weaknesses, and interconnected exposures to be identified and escalated across business lines rather than being assessed in isolation. This supports consistent risk appetite implementation and clear reporting to senior management and the board.

The infrastructure must also maintain the competence and integrity of risk professionals. Ongoing professional development helps staff keep pace with changing products, models, regulations, and risk techniques, while commitment to best practice, conduct, and ethics supports sound judgment and the credibility of risk advice. Risk culture is not confined to the risk function: general risk-management and corporate-governance training for employees makes accountability practical throughout the organization, including among staff who originate, manage, record, or monitor risk.

These elements align with PRMIA's emphasis on professional standards and ethical conduct, available through its professional risk-management resources, and with the Basel Committee's expectation that banks establish a strong risk culture, effective independent risk management, and organization-wide understanding of risk responsibilities. See the Basel Committee's corporate governance principles.

QUESTION NO: 7

When describing the reasons for the collapse of China Aviation Oil, which of the following was not cited?

A. No properly defined risk management policies in place and general lack of oversight by senior management

B. Time value was not taken into account during the contract valuation process C. Loss generating positions were rolled over by selling options on larger positions to generate cash premiums' to settle existing position losses

C. Senior management in China were aware of the positions but did not understand the complexities of risk managing them

ANSWER: C

Explanation:

Senior management in China were aware of the positions but did not understand the complexities of risk managing them is the statement that was not cited as a reason for China Aviation Oil's collapse. The case-study account focuses on the failure to escalate and disclose the accumulating derivatives exposures and losses through appropriate governance channels. The relevant issue was not that senior management in China had been kept fully informed but lacked sufficient technical sophistication; rather, information reaching the parent company and board was incomplete, delayed, or did not provide an adequate picture of the scale and risk of the trading positions. This distinction matters in governance analysis. Effective risk oversight requires timely, accurate, and sufficiently granular reporting of material exposures, including valuation, liquidity implications, limits, and stress outcomes. A parent or board cannot exercise meaningful challenge or intervention when management does not provide that information. The China Aviation Oil episode is consequently used as a cautionary example of deficient reporting, control, and escalation surrounding speculative derivatives activity. Singapore's Monetary Authority has documented enforcement action arising from the CAO matter, while the Singapore High Court record describes the facts and governance context associated with the company's losses. See the Monetary Authority of Singapore's CAO enforcement release and the Singapore High Court judgment record.

QUESTION NO: 8

As LTCM started to have major losses, it compounded its problems by doing what?

A. Trying to borrow more money from major money centre banks

B. Issuing Subordinated Debt

C. Returning capital to the general partners before others

D. Unwinding its' more liquid trades thereby creating more liquidity risk overall

ANSWER: D

Explanation:

Unwinding its more liquid trades, thereby creating more liquidity risk overall, is correct. During the 1998 market dislocation, Long-Term Capital Management faced large margin calls and losses on highly leveraged convergence and relative-value positions. In seeking cash and reducing exposures, the fund sold assets and closed positions that could be traded most readily. This response was damaging because the remaining portfolio became disproportionately concentrated in difficult-to-sell, highly correlated, and less liquid positions. The fund therefore became more exposed to a worsening liquidity spiral: the assets easiest to monetize had already been reduced, while the positions still held could require substantial price concessions or could not be exited quickly in stressed markets. LTCM's scale, leverage, and extensive counterparty relationships meant that this liquidity deterioration increased concern about forced sales and broader market disruption. The Federal Reserve Bank of New York facilitated a private-sector recapitalization to avoid a disorderly liquidation of the portfolio. The episode is a classic illustration that liquidity management must consider the composition of the residual portfolio, not merely the cash raised immediately from asset sales. See the Federal Reserve's account of Long-Term Capital Management and the U.S. Treasury's Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management.

QUESTION NO: 9

Which of the following was the key contributory risk factor to the problems at LTCM in the summer of 1998?

I. Model Risk

II. Lack of Transparency

III. Breakdown of Historical Correlations

IV. Over Regulation by Federal Regulators

A. I and III only

B. III only

C. III and IV only

D. All of these were key elements of the problems at LTCM

ANSWER: B

Explanation:

III only is correct because Long-Term Capital Management's positions depended heavily on the expectation that historically observed pricing relationships and correlations across markets would persist or converge. Following Russia's debt default and devaluation in August 1998, market participants rapidly sought liquidity and safety. This produced an exceptional "flight to quality" and a sharp widening of spreads in instruments that LTCM had expected to converge. Relationships embedded in historical data became unreliable precisely when the fund's highly leveraged portfolio was most exposed.

The core lesson is that correlation is not constant: in stressed markets, assets and spreads can move together in ways that are materially different from normal-period estimates. LTCM's strategies were therefore vulnerable to a regime change in market behavior, with adverse moves occurring simultaneously across many positions. The Federal Reserve Bank of New York's account of the episode describes the extraordinary market dislocations and the resulting deterioration in LTCM's positions: New York Fed Economic Policy Review. The U.S. Government Accountability Office likewise identifies the severe market disruption following the Russian crisis as central context for the fund's distress: GAO report on LTCM.

QUESTION NO: 10

Washington Mutual's acquisition of Long Beach Financial changed its business model and increased its credit loss profile because

A. The resulting loss rate for Washington Mutual was more than 3 times higher than other mortgage lenders tracked by the FDIC

B. the two banks were focussed in different markets

C. Long Beach Financial had losses which it hadn't realized at the time of the takeover

D. Of a general deterioration of credit quality generally

ANSWER: A

Explanation:

The resulting loss rate for Washington Mutual was more than 3 times higher than other mortgage lenders tracked by the FDIC is correct because the acquisition brought Long Beach Financial's high-risk subprime mortgage lending platform into Washington Mutual's business. Washington Mutual consequently moved beyond its historically more traditional thrift and mortgage-banking activities toward a materially greater reliance on risk-layered and subprime residential lending. This was not merely a change in product volume: it altered the credit characteristics of the loans being originated and retained, exposing the firm to substantially higher expected defaults and losses when house prices weakened and borrowers faced payment stress.

The reported comparison of Washington Mutual's loss rate with FDIC-tracked mortgage lenders is therefore evidence of the changed credit-loss profile associated with that strategic shift. In a governance and risk-management context, the case illustrates why an acquisition must be assessed not only for earnings growth and market share, but also for how it changes portfolio risk appetite, underwriting quality, concentration risk, and capital needed to absorb stressed credit losses. The Financial Crisis Inquiry Commission documents Washington Mutual's expansion into higher-risk mortgage lending and its resulting vulnerabilities; the FDIC's crisis study provides broader supervisory context on the bank's failure and mortgage-credit losses. See the Financial Crisis Inquiry Commission final report and the FDIC's Crisis and Response study.

QUESTION NO: 11

A Board receives risk reports that aggregate all exposures into a single green, amber or red indicator. The most significant weakness in this reporting approach is that it may:

A. Obscure the underlying concentrations, assumptions and emerging limit breaches

B. Prevent management from using risk limits

C. Require directors to approve each individual trade

D. Eliminate the need for escalation procedures

ANSWER: A

Explanation:

Obscure the underlying concentrations, assumptions and emerging limit breaches is correct. High-level indicators can be useful summaries, but they are insufficient if they conceal the drivers of risk, concentrations by business or counterparty, changes in data quality, model limitations, or material exceptions. Directors need information that is accurate, timely, sufficiently detailed, and capable of supporting challenge.

Effective risk reporting should permit the Board and its risk committee to understand both the overall risk profile and the material components that give rise to it. The Basel Committee's Principles for effective risk data aggregation and risk reporting emphasize accuracy, completeness, timeliness, adaptability, and clarity of risk reports.

QUESTION NO: 12

Corporate Governance …

A. Eliminates risk to the greatest extent possible

B. Is defined as the assembled knowledge and wisdom of the collective stakeholders in the organization, set to maximize shareholder value

C. Is defined as business decision making predicated on a belief in potential rewards, balanced with the knowledge, understanding and appreciation of the risk taken to pursue those potential rewards

D. Is defined as that which is best practiced within an enterprise risk management framework, guided by the PRMIA Standards of Best Practice, Conduct and Ethics above all else

ANSWER: B

Explanation:

Corporate governance is correctly described as "Is defined as the assembled knowledge and wisdom of the collective stakeholders in the organization, set to maximize shareholder value." Governance is the organizational framework through which authority is exercised, strategic direction is set, management is overseen, and accountability is established. It relies on informed contributions from the board, executive management, shareholders, and other relevant stakeholders, with the objective of directing the enterprise toward sustainable value creation. In a risk-management context, this means governance establishes the expectations, oversight structure, information flows, and challenge mechanisms that ensure material risks and opportunities are considered in decisions. It is therefore broader than a particular risk-taking decision or a risk-control activity: it is the system that guides and monitors those activities. This understanding is consistent with the OECD's description of corporate governance as involving relationships among management, the board, shareholders, and stakeholders, and providing the structure for setting objectives and monitoring performance. See the G20/OECD Principles of Corporate Governance and the IFC corporate governance overview.

QUESTION NO: 13

What was the main risk scenario on the Metallgesellschaft trading strategy?

A. Realized losses on short-term contracts against unrealized gains on the long-run contract

B. The final price of the underlying being higher than the initial price

C. The initial price of the underlying being higher than the final price

D. The short-term price of the underlying being higher than the long-run contract

ANSWER: A

Explanation:

Realized losses on short-term contracts against unrealized gains on the long-run contract is correct because Metallgesellschaft's oil-marketing subsidiary had committed to supply customers under long-dated, fixed-price contracts and sought to hedge its exposure using short-maturity futures contracts that were continually rolled over. This created a serious timing and liquidity mismatch rather than simply a directional view on the ultimate oil price. When short-dated futures generated cash losses, the firm had to meet variation-margin calls immediately. Any corresponding economic benefit from its long-term customer commitments was not readily monetizable at the same time, because those gains would emerge only over the much longer life of the delivery contracts. The key risk scenario was therefore that substantial, recurring realized cash outflows on the rolling hedge could arise well before the offsetting gains on the long-term position were realized. The episode illustrates why hedge effectiveness must be assessed not only by eventual economic offset, but also by maturity matching, funding capacity, cash-flow timing, and the effects of rolling a hedge through changing futures-curve conditions. A useful discussion of the case and its hedging implications appears in the National Bureau of Economic Research working paper on Metallgesellschaft; the importance of margining and daily settlement in futures markets is also described by CME Group.

QUESTION NO: 14

The early 2003 trading strategy of China Aviation oil was

A. to buy calls and sell puts

B. to buy puts and sell calls

C. to sell puts and buy calls

D. to sell calls and buy puts

ANSWER: A

Explanation:

China Aviation Oil's early-2003 strategy was to buy calls and sell puts. This combination created a bullish exposure to oil prices: a purchased call benefits when the underlying price rises, while a written put creates an obligation whose losses increase if prices fall. Taken together, particularly when the options have comparable strikes and maturities, the position resembles a synthetic long forward exposure. It was therefore a directional strategy rather than a simple hedge designed solely to reduce an existing commercial price risk.

This initial position is important in the China Aviation Oil case because it illustrates how its derivatives activity moved beyond routine risk management and involved increasingly significant market views and option exposures. The later evolution of its positions, including the management of losses and expansion of option trading, became central to the governance, risk-limit, valuation, and disclosure failures examined in accounts of the collapse. The Singapore criminal judgment concerning the company's former chief executive provides a detailed factual record of the derivatives trading and resulting losses: Public Prosecutor v Chen Jiulin [2007] SGDC 311. Background on the case and its significance as a derivatives-risk-management failure is also available from China Aviation Oil.