

Spotlight CPD Test

Risk Management

Question 1

The first stage in managing risk is the determination of objectives. Which of the following is NOT a sensible risk management objective?

- (a) reduce volatility in reported earnings
- (b) reduce volatility in end-year balance sheet
- (c) reduce risk of breaching loan covenants
- (d) reduce volatility in accounts of all group companies of an international group
- (e) don't know

Answer

The right answer is (d) reduce volatility in accounts of all group companies.

All of the other possible answers are potentially sensible given the position and circumstances of the business. In a group, though, particularly an international group, performance can be hedged in functional currency terms or in the various currencies of the subsidiaries. In the former case, the risk management objective would be aligned with the ultimate investors' interests. If performance is managed / hedged against subsidiary currencies then that may well introduce more volatility than necessary for group investors – with an inevitable impact on share price. Individual subsidiary performance is of more interest internally.

Question 2

It has been said that the broad range of risks faced by corporate entities can be categorised as Business Risks, Financial Risks and Operational Risks. Using this categorisation, for most non-financial corporates which of the following would best represent the optimal risk management stance?

- (a) business risk should be ignored, operational risk should be enhanced
- (b) financial risk should be reduced, operational risk should be ignored
- (c) business risk should be enhanced, financial risk should be managed
- (d) financial risk should be reduced, operational risk should be eliminated
- (e) don't know

Answer

The right answer is (d) financial risk should be reduced, operational risk should be eliminated. This answer is likely to be contentious. The underlying principle is that risk exposure should only be countenanced at all if there is a reward to compensate for the risk. So for operational risks such as the risk of employee fraud the application of that principle would be that, because there is no potential reward, a company's management should ensure that there is minimal exposure. There is no upside to the risk only downside therefore exposure to this risk is a one way bet; remove the risk. For business risk the application of the principle is more complex. Investors have probably invested in that specific business because it has particular business characteristics; market position, imminence of new products and such like – this being their core competence. In that case there is considerable potential for reward for being exposed to risk so the company's executive should seek appropriate exposure. The executives' judgement is being backed to know when to enhance exposure and when to try to limit that exposure. It follows then that business risk should be either enhanced or reduced depending on the judgement taken.

Financial risk is a little clearer in that there is potential reward for taking risk, but for non-financial corporations, it would not normally be argued that risk-reward judgement in this area was a core competence. So as a rule the risk would be reduced but because this is not always possible, the risk often has to be transformed into a different sort of risk – this is why the term “managed” is often used rather than the more straightforward term “reduced”.

Question 3

When interest rate risk strategy is considered which of the following should be given prime importance?

- (a) correlation between business performance and the interest rate cycle
- (b) whether fixed rate or floating rate will generate the lowest cost over the life of the loan
- (c) whether interest rates are likely to increase or decrease
- (d) whether credit conditions are likely to ease or harden over the life of the loan
- (e) don't know

Answer

The right answer is (a) correlation between business performance and the interest rate cycle. Any risk management policy should try to ensure that when business performance is weak then costs are either low or at least, not high. So the link between performance and the interest rate cycle should be of prime importance to ensure that poor performance does not occur when rates are highest. Decisions about lowest cost or the direction of interest rates are really about making opportunistic gains – not about risk management at all.

Question 4

In attempting to understand and manage treasury risk, which of the following are the most important relationships for a risk manager to develop?

- (a) other managers within treasury
- (b) other managers in other finance departments
- (c) other managers in purchasing and selling departments
- (d) other managers in the audit function
- (e) don't know

Answer

The right answer is (c) other managers in purchasing and selling departments. We need here to distinguish between corporate risk and personal risk. If we are concerned with corporate risk, which we should be, then the key decisions about how and when payments are likely to be incurred are going to be notified first from the initiating departments - purchasing and selling rather than anywhere else. Developing relationships here enables the treasury to influence action and to explain the impact on risk management before the decision is taken rather than after. Personal risk is best managed by doing the job well rather than “keeping in” with audit.

Question 5

In common with many other companies, ABC plc makes no claim to understand the drivers of financial markets. In trying to evaluate the risk that market prices represent for the company, those prices that are particularly relevant for the company are tracked over an extended period and subjected to statistical analysis.

Which of the following represents the confidence that should be applied to the resulting risk measures?

- (a) use the measures, but make sure that unacceptable outcomes are always hedged
- (b) accept 95% confidence levels
- (c) accept 99% confidence levels
- (d) These measures are of no practical value
- (e) Don't know

Answer

The right answer is (a) use the measures, but make sure that unacceptable outcomes are always hedged.

The issue being addressed here is that it is tempting to assume that a 95% (or 99%) confidence level represents a fairly sure thing. Value at risk typically uses these confidence levels and it is often taken that the value at risk quoted will not be exceeded. But a level of 95% confidence means that once in 20 events, the outcome will be outside the range expected – or once per normal working month. 99% confidence means that exceptions will occur about twice a year. If the exception results in significant pain for the company, that frequency may be unacceptable. But – and it is a big but – as Nassim Nicholas Talib puts it in his book “The Black Swan”, think of the turkey’s experience. Each morning the turkey has seen the farmer approach and produce food. The turkey has witnessed this for a thousand mornings, a reasonable track record for any set of observations. But on the 1001st morning the farmer approaches and unknown to the turkey, it is just before Christmas! The 1002nd morning is not observed by this turkey. How often do we check market prices and assume that the thousand and first morning will be similar to the previous thousand?

The Black Swan by Nassim Nicholas Talib, Penguin Books

Question 6

A risk management framework has been espoused by the ACT in its courses and publications in recent years. This involves the initial process of risk identification followed by an initial estimate of severity, termed risk assessment. If warranted the next stage is risk evaluation where a more detailed analysis of the scale of risk is undertaken. This is then the basis for any risk response – i.e. action to mitigate the problem. The final stage is then reporting, to ensure that action and its impact is monitored and reported within the firm. The framework is then completed by the feedback loop that returns to the start and repeats the process.

Why is it important that the framework is completed by the feedback loop?

- (a) it's important to keep checking
- (b) any response that removes one risk may change things and therefore create new risks
- (c) to demonstrate that the company is serious about risk management
- (d) it's just a way of making the process 'ongoing'
- (e) don't know

Answer

The right answer is (b) any response that removes one risk may change things and therefore create new risks.

Practical risk managers know that very often risk is not removed, it is merely transformed into a different form. So, as an example, managing a currency risk by moving manufacturing to a different currency of cost does not eliminate risk – it just changes one set of risks for another set. The feedback loop is intended to make sure that these new risks are caught and included in the

analysis rather than left unrecognised. This is a simple example, but in a complex group it is not difficult to imagine situations arising that might be much less predictable.