INSTITUTE OF ACTUARIAL & QUANTITATIVE STUDIES

Subject: Basel

Chapter: Unit-1

Category: Practice Question Solution

1. B

Reason – The three common lines of defense suggested by the Basel Committee on Banking Supervision and employed by firms to control operational risks are: (1) business line management, (2) an independent operational risk management function, and (3) independent reviews of operational risks and risk management.

2. D

Reason – Based on the choices provided, the best match for the scenario is a violation of Principles 5 and 6. It is clear that the bank has not considered the incentives that are related to risk taking in the bank. Bridgewater has been given the risk appetite and tolerance statements but senior managers keep rewarding Bridgewater for high returns and seem to be ignoring the fact that they are the result of higher risks. Thus, there are incentives linked to increasing risk. The governance structure may or may not be well defined, but regardless, is not being adhered to.

3. A

Reason – The operational risk management framework (i.e., the Framework) must define, describe, and classify operational risk and operational loss exposure. Hampton is likely working on Framework documentation. Framework documentation is overseen by the board of directors and senior management.

4. C

Reason – Mathis is asking for managers to identify potential risk events, which he will use to assess potential outcomes of these risks. This is an example of scenario analysis. Scenario analysis is a subjective process where business line managers and risk managers identify potential risk events and then assess potential outcomes of those risks.

5. C

Reason – A functionally independent corporate operational risk function is desirable in a bank but is not necessary for an effective control environment. This is especially true for a small bank, which might roll all risk management activities into one risk management group (i.e., not segregated by type of risk). An effective control environment should include the following five components: (1) a control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring activities.

6. A

Reason

Operational risks must be proactively managed by a bank's board of directors and senior managers as well as its business line managers and employees. There are 12 fundamental principles of operational risk management suggested by the Basel Committee.