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*Operational Risk Manager (ORM)*

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### Question: 88

What would be the correct order of steps to addressing data quality problems in an organization?

- A. Assess the current state, design the future state, determine gaps and the actions required to be implemented to eliminate the gaps
- B. Articulate goals, do a 'strategy-fit' analysis and plan for action
- C. Design the future state, perform a gap analysis, analyze the current state and implement the future state
- D. Call in external consultants

**Answer:** A

Explanation:

The correct answer is choice 'a'

The correct order of steps to addressing data quality problems in an organization would include:

### Question: 89

Which of the following is not a permitted approach under Basel II for calculating operational riskcapital

- A. the internal measurement approach
- B. the basic indicator approach
- C. the standardized approach
- D. the advanced measurement approach

**Answer:** A

Explanation:

The Basel II framework allows the use of the basic indicator approach, the standardized approach and the advanced measurement approaches for operational risk. There is no approach called the 'internal measurement approach' permitted for operational risk. Choice 'a' is therefore the correct answer.

### Question: 90

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?

- 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  $2,000,000 \times 0.005\% = 100$ . Since this is the variance as well, the standard deviation is  $\sqrt{100} = 10$ . Therefore the range of outcomes within 2 standard deviations of the mean is  $100 \pm (2 \times 10) = 80$  to 120 errors in a day.

### Question: 91

Which of the following is the best description of the spread premium puzzle:

- A. The spread premium puzzle refers to observed default rates being much less than implied default rates, leading to lower credit bonds being relatively cheap when compared to their actual default probabilities
- B. The spread premium puzzle refers to dollar denominated non-US sovereign bonds being priced at a significant discount to other similar USD denominated assets
- C. The spread premium puzzle refers to AAA corporate bonds being priced at almost the same prices as equivalent treasury bonds without offering the same liquidity or guarantee as treasury bonds
- D. The spread premium puzzle refers to the moral hazard implicit in the monoline insurance market

**Answer: A**

Explanation:

Choice 'a' is the correct answer. The other choices represent non-sensical statements.

### Question: 92

Loss provisioning is intended to cover:

- A. Unexpected losses
- B. Losses in excess of unexpected losses
- C. Both expected and unexpected losses
- D. Expected losses

**Answer: D**

Explanation:

Loss provisioning is intended to cover expected losses. Economic capital is expected to cover unexpected losses. No capital or provisions are set aside for losses in excess of unexpected losses, which will ultimately be borne by equity. Choice 'd' is the correct answer.

### Question: 93

Which of the following credit risk models relies upon the analysis of credit rating migrations to assess credit risk?

- A. KMV's EDF based approach
- B. The CreditMetrics approach
- C. The actuarial approach
- D. The contingent claims approach

**Answer: B**

Explanation:

The correct answer is Choice 'b'. The following is a brief description of the major approaches available to model credit risk, and the analysis that underlies them:

**Question: 94**

Under the standardized approach to calculating operational risk capital under Basel II, negative regulatory capital charges for any of the business units:

- A. Should be ignored completely
- B. Should be offset against positive capital charges from other business units
- C. Should be included after ignoring the negative sign
- D. Should be excluded from capital calculations

**Answer: B**

Explanation:

According to Basel II, in any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit. Therefore Choice 'b' is the correct answer.

**Question: 95**

The probability of default of a security over a 1 year period is 3% .

What is the probability that it would not have defaulted at the end of four years from now?

- A. 11.47%
- B. 88.53%
- C. 12.00%
- D. 88.00%

**Answer: B**

Explanation:

The probability that the security would not default in the next 4 years is equal to the probability of survival raised to the power four. In other words,  $= (1 - 3\%)^4 = 88.53\%$ .

Choice 'b' is the correct answer.

**Question: 96**

There are two bonds in a portfolio, each with a market value of \$50m. The probability of default of the two bonds are 0.03 and 0.08 respectively, over a one year horizon.

If the probability of the two bonds defaulting simultaneously is 1.4%, what is the default correlation between the two?

- A. 0%

- B. 100%
- C. 40%
- D. 25%

**Answer: D**

Explanation:

Probability of the joint default of both A and B =

Probability of the joint default of both A and B =

$P(A \text{ defaults} \cap B \text{ defaults}) =$

$$(\text{Default Correlation of A\&B}) * \sqrt{(P(A)(1 - P(A)))(P(B)(1 - P(B)))} + P(A)P(B)$$

We know all the numbers except default correlation, and we can solve for it.  $\text{DefaultCorrelation} * \text{SQRT}(0.03 * (1 - 0.03) * 0.08 * (1 - 0.08)) + 0.03 * 0.08 = 0.014$ . Solving, we get default correlation = 25%

**Question: 97**

A bullet bond and an amortizing loan are issued at the same time with the same maturity and with the same principal .

Which of these would have a greater credit exposure halfway through their life?

- A. Indeterminate with the given information
- B. They would have identical exposure half way through their lives
- C. The amortizing loan
- D. The bullet bond

**Answer: D**

Explanation:

A bullet bond is a bond that pays coupons covering interest during the life of the bond and the principal at maturity. An amortizing loan pays the interest as well as a part of the principal with every payment. Therefore, the exposure of the amortizing loan continually reduces, and approaches zero towards the end of its life. The bullet bond will always have a higher exposure at any time during its life when compared to an equivalent amortizing loan. Hence Choice 'd' is the correct answer.

**Question: 98**

Which of the following belong to the family of generalized extreme value distributions:

- I. Frechet
- II. Gumbel
- III. Weibull
- IV. Exponential
- A. IV

- B. I, II and III
- C. II and III
- D. All of the above

**Answer: B**

Explanation:

Extreme value theory focuses on the extreme and rare events, and in the case of VaR calculations, it is focused on the right tail of the loss distribution.

In very simple and non-technical terms, EVT says the following:

**Question: 99**

In estimating credit exposure for a line of credit, it is usual to consider:

- A. a fixed fraction of the line of credit to be the exposure at default even though the currently drawn amount is quite different from such a fraction.
- B. the full value of the credit line to be the exposure at default as the borrower has an informational advantage that will lead them to borrow fully against the credit line at the time of default.
- C. only the value of credit exposure currently existing against the credit line as the exposure at default.
- D. the present value of the line of credit at the agreed rate of lending.

**Answer: A**

Explanation:

Choice 'a' is the correct answer. Exposures such as those to a line of credit of which only a part (or none) may be drawn at the time of assessment present a difficulty when attempting to quantify credit risk. It is not correct to take the entire amount of the line as the exposure at default, and likewise the current exposure is likely to be too aggressively low a number to consider.

While the borrower has an information advantage in that he would be aware of the deterioration in credit standing before the bank and would probably draw cash prior to default, it is unlikely that the entire amount of the line of credit would be drawn in all cases. In some cases, none may be drawn. In other cases, the bank would become aware of the situation and curtail or cancel access to the credit line in a timely fashion.

Therefore a fixed proportion of existing credit lines is considered a reasonable approximation of the exposure at default against credit lines.

**Question: 100**

Which of the following should be included when calculating the Gross Income indicator used to calculate operational risk capital under the basic indicator and standardized approaches under Basel II?

- A. Insurance income
- B. Operating expenses
- C. Fees paid to outsourcing service providers
- D. Net non-interest income

**Answer: D**

Explanation:

Gross income is defined by Basel II (see para 650 of the Basel standard) as net interest income plus net non-interest income. It is intended that this measure should: (i) be gross of any provisions (e.g. for unpaid interest); (ii) be gross of operating expenses, including fees paid to outsourcing service providers; (iii) exclude realised profits/losses from the sale of securities in the banking book; and (iv) exclude extraordinary or irregular items as well as income derived from insurance.

What this means is that gross income is calculated without deducting any provisions or operating expenses from net interest plus non-interest income; and does not include any realised profits or losses from the sale of securities in the banking book, and also does not include any extraordinary or irregular item or insurance income.

Therefore operating expenses are to be notto be deducted for the purposes of calculating gross income, and neither are any provisions. Profits and losses from the sale of banking book securities are not considered part of gross income, and so isn't any income from insurance or extraordinary items.

Of the listed choices, only net non-interest income needs to be included for gross income calculations, and the others are to be excluded. Therefore Choice 'd' is the correct answer. Try to remember the components of gross income from the definition above because in the exam the question may be phrased differently.

**Question: 101**

According to the Basel II framework, subordinated term debt that was originally issued 4 years ago with a maturity of 6 years is considered a part of:

- A. Tier 2 capital
- B. Tier 1 capital
- C. Tier 3 capital
- D. None of the above

**Answer: A**

Explanation:

According to the Basel II framework, Tier 1 capital, also called core capital or basic equity, includes equity capital and disclosed reserves.

Tier 2 capital, also called supplementary capital, includes undisclosed reserves, revaluation reserves, general provisions/general loan-loss reserves, hybrid debt capital instruments and subordinated term debt issued originally for 5 years or longer.

Tier 3 capital, or short term subordinated debt, is intended only to cover market risk but only at the discretion of their national authority. This only includes short term subordinated debt originally issued for 2 or more years.

An interesting thing to note is the difference between 'subordinated term debt' under Tier 2 and the 'short term subordinated debt' under Tier 3. The distinction is based upon the years to maturity at the time the debt was issued. The remaining time to maturity is not relevant.

For the subordinated term debt included under Tier 2, the amount that can be counted towards capital is reduced by 20% for every year when the debt is due within 5 years. This takes care of the time to maturity problem for Tier

2subordinated debt. For Tier 3 short term subordinated debt, this is not an issue because debt will only qualify for Tier 3 if it has a lock-in clause stipulating that the debt is not required to be repaid if the effect of such repayment is to take the bank below minimum capital requirements.



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