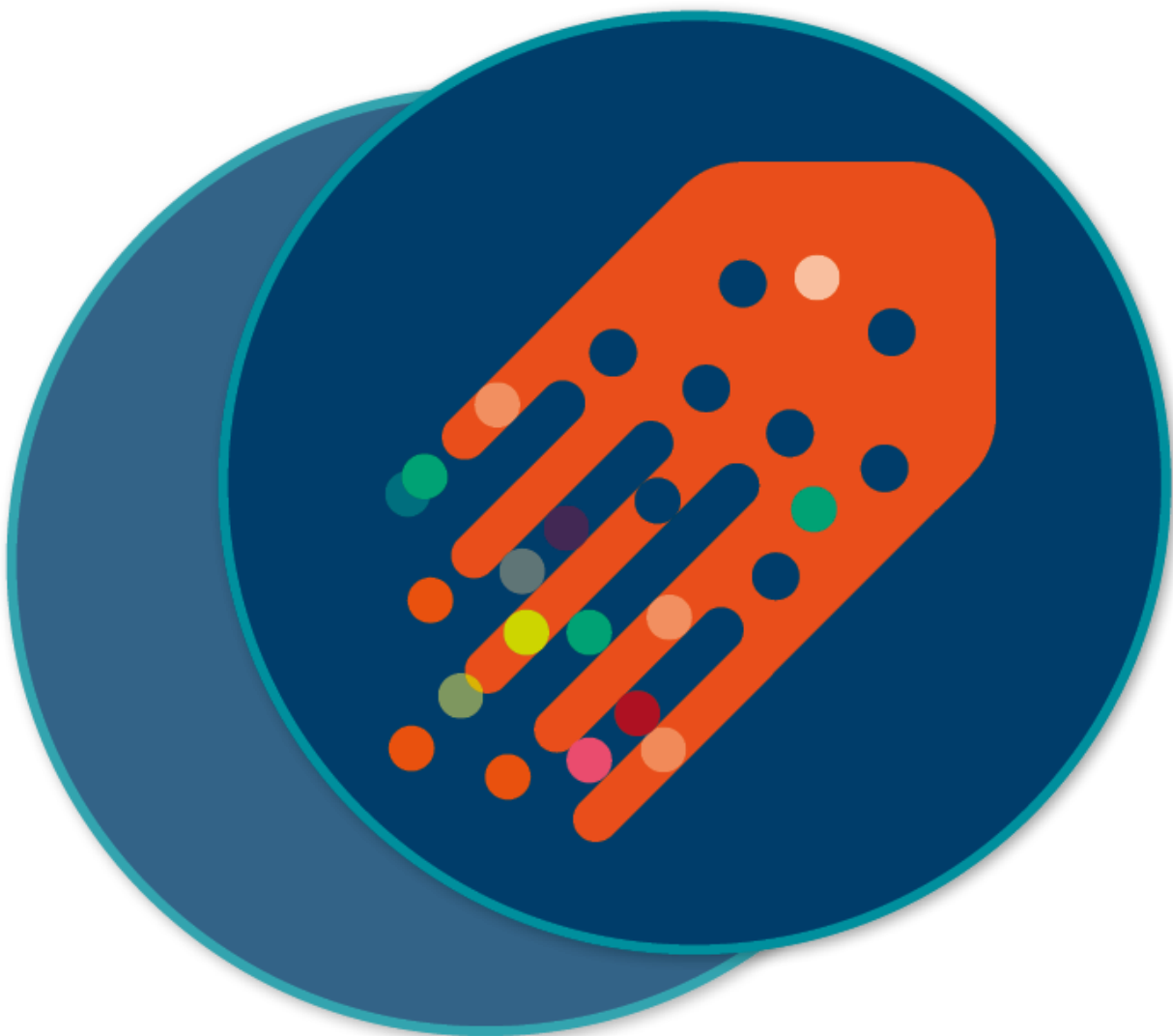


ACT Practice Paper

Certificate in Treasury – MicroCredentials

Principles of risk management

Practice Paper



Practice paper for the Certificate in Treasury – MicroCredential – Principles of risk management (PRM)

Based on the syllabus assessed from 07 October 2025.

Introduction

This practice paper has been produced by the Awarding Body at the Association of Corporate Treasurers (ACT) to assist students in their preparation for the PRM MicroTest. It contains a practice assessment for the specified MicroTopic as well as practice answers.

Ideally, you should have completed the majority of your studies for PRM before attempting this practice paper. You should allow yourself 90 minutes to complete the exam. You should then review your performance to identify areas of weakness on which to concentrate the remainder of your study time.

Although the practice paper in this guide is typical of a PRM assessment, it should be noted that it is not possible to test every single aspect of the Learning Outcomes in any one particular assessment. To prepare properly for the MicroTest, you should make full use of the tuition options where available and read as widely as possible to ensure that all Learning Outcomes have been covered.

Assessment technique: PRM

The best approach to multiple choice assessments is to work methodically through the questions. You should not spend too much time on any one question. If you cannot make up your mind, you should leave the question, flagging it to come back to later.

When all of the questions have been answered, it is prudent to use any remaining time to go through each question again, carefully, to double-check that nothing has been missed. Altering just one incorrect response to a correct response could make the difference between passing and failing.

Assessment information

The PRM assessment consist of 44 questions, split into sections A, B and C; and is worth a total of 80 marks.

PRM MicroTest specification:

Section	Number of questions	Marks available	Question format
Section A	17 Multiple Choice questions (MCQs) and 8 Multiple Response questions (MRQs).	25	This section will test a cross-section of knowledge to achieve breadth of syllabus coverage.
Section B	3 mini scenario with 5 accompanying MCQs.	15	This section will test a cross-section of knowledge to achieve breadth of syllabus coverage.
Section C	4 longer form questions.	40	This section will be based on mini-scenarios common to practice. Questions will test knowledge, analysis, application and justification as appropriate.
Total	44	80	

Under exam conditions, 90 minutes is allowed for the PRM MicroTest.

When you take your actual MicroTest, you will be sitting online using your own PC/Laptop. You have access to an online scientific calculator, but for the purpose of this test, you may use a non-programmable scientific calculator.

Questions

SECTION A

Section A is made up of 17 Multiple Choice questions and 8 Multiple Response questions and is worth a total of 25 marks.

17 Multiple Choice questions: 17 x 1 mark questions.

8 Multiple Response questions: 8 x 1 mark questions.

The purpose of this section is to test a cross-section of knowledge to achieve breadth of syllabus coverage.

1 Question Text:

What is the maximum loss to a writer of a European put where the premium is 20, the strike price is 100 and the underlying price is 90?

Options

- A Maximum loss is 120.
- B Maximum loss is 70.
- C* Maximum loss is 80.
- D Maximum loss is 90.

Mark/Score: 1

2 Question Text:

What is the all-in payoff to the buyer of a stock price put option, if the strike is GBP15, the price at maturity is GBP10 and the premium paid is GBP1?

Options

- A*** Profit GBP4.
- B** Unlimited profit.
- C** Profit GBP5.
- D** Loss GBP4.

Mark/Score: 1

3 Question Text:

What is the all-in break even point for the purchaser of a call option with a strike price of 200, if the premium paid is 30?

Options

- A*** 230.
- B** 170.
- C** 200.
- D** 30.

Mark/Score: 1

4 Question Text:

What is the maximum loss to the buyer of a stock call option if the strike price is USD150 and the premium paid is USD30?

Options

- A*** USD30.
- B** USD150.
- C** USD180.
- D** The loss potential is unlimited.

Mark/Score: 1

5 Question Text:

If a security has a mean price of 55 and a standard deviation of 1, what is the Z value corresponding to a security price of 60?

Options

- A*** 5.
- B** 4.
- C** 1.
- D** 6.

Mark/Score: 1

6 Question Text:

Which of the following is an unrewarded risk?

Options

- A** An investment in some new machinery that develops a fault.
- B*** An investment in systems to comply with regulatory reporting.
- C** The launch of a new product that due to poor profitability is quickly discontinued.
- D** The recruitment of a new finance director who decides not to accept the offered role.

Mark/Score: 1

7 Question Text:

Which of the following most accurately describes risk and uncertainty?

Options

- A*** Risk is associated with an outcome that could be positive or negative whereas uncertainty is where the future event is unknown.
- B** Risk is the chance of a financial loss and uncertainty is a future event that may occur.
- C** Risk is the probability of a loss and uncertainty is an unknown event.
- D** The higher the risk the higher the return and the higher the uncertainty the higher the return.

Mark/Score: 1

8 Question Text:

Which of the following is a downside of using variance-covariance methodology for Value at Risk (VaR)?

Options

- A*** It does not support optionality.
- B** It is too complex for management to understand.
- C** It is not a useful methodology.
- D** It is not a good measure of risk for portfolios with low volatility.

Mark/Score: 1

9 Question Text:

If a company takes out an interest rate swap to convert its long term foreign currency floating debt to fixed debt, which of the following risks would increase for the company?

Options

- A** Commercial risk.
- B*** Counterparty risk.
- C** Foreign exchange transaction risk.
- D** Interest rate risk.

Mark/Score: 1

10 Question Text:

A travel company provides a brochure with a price list for the next season.

Which type of risk is the company exposed to?

Options

- A** Operational risk
- B*** Pre-transaction risk.
- C** Transaction risk.
- D** Translation risk.

Mark/Score: 1

11 Question Text:

Which of the following best describes a negative pledge?

Options

- A*** A covenant to prevent subsequent lenders having better terms than the original lender.
- B** A restriction on lending where acquisitions or disposal are material.
- C** An agreement to exclude an asset from the basket of securities for a repo.
- D** An agreement to renegotiate the commitment fees on a bank facility.

Mark/Score: 1

12 Question Text:

Which of the following is the most likely reason why corporates do not often take out financial derivatives for their translation risks?

Options

- A** Shareholders may have a preference for having this risk in their portfolio.
- B** There are no financial derivatives that accurately match the revaluations on the exposures.
- C** They are already naturally hedged.
- D*** They have no cash effect and only an accounting impact.

Mark/Score: 1

13 Question Text:

Which of the following are features of a basis swap?

Options

- A** Both legs of the swap transaction are fixed but use different benchmarks.
- B*** Both legs of the swap transaction are variable rates but use different benchmarks.
- C** The payable leg of the swap is fixed and the receivable leg is variable.
- D** The receivable leg of the swap is fixed and the payable leg is variable.

Mark/Score: 1

14 Question Text:

Which **TWO** of the following are both operational risks?

Options

- A*** system failures and fraudulent activity.
- B** system failure and adhering to the terms of existing debt.
- C** fraudulent activity and changing market value of debt.
- D** Adhering to the terms of debt and the changing market value of debt.

Mark/Score: 1

15 Question Text:

Which of the following is the primary responsibility of a corporate's risk committee?

Options

- A** Defining the risk policies and procedures.
- B** Evaluating the effectiveness of the internal and external audit process.
- C** Setting the corporate's risk limits and deciding upon which instruments to use for hedging strategy.
- D*** Setting the risk strategy and vision which is supported by policies and principles.

Mark/Score: 1

16 Question Text:

Which of the following are responsibilities of the audit committee:

Options

- A*** internal controls, external auditor independence and effectiveness of the audit function.
- B** internal controls and the integrity and timeliness of the financial statements.
- C** independence of external auditors, appointment of internal auditors and timeliness of the financial statements.
- D** independence of external auditors, effectiveness of internal audit function and timeliness of the financial statements.

Mark/Score: 1

17 Question Text:

Which of the following is the most appropriate method for an organisation to attempt to manage 'black swan' events?

Options

- A** Identifying and hedging the main exposures as they become known.
- B** Optimising the hedging programme.
- C*** Setting up robust and broad hedging strategies and policy.
- D** Taking no action as corporates need to take risk to make money.

Mark/Score: 1

18 Question Text:

Which **TWO** of the following actions would help to diversify risk?

Options

- A** Building more robust internal controls for the process.
- B** Investing in assets that are perfectly correlated with the portfolio.
- C*** Having access to multiple funding sources.
- D*** Investing in different asset classes.
- E** Taking out an insurance product on the specified risks.

Mark/Score: 1

19 Question Text:

Which of the following factors influence the risk appetite of a business?

Select **ALL** that apply.

Options

- A** Accessibility to hedging instruments.
- B*** The capital structure of the business.
- C*** The industry sector.
- D*** The shareholders' propensity for risk.
- E** The volatility of financial markets.

Mark/Score: 1

20 Question Text:

Which of the following are weaknesses of using quantitative data to measure risk?

Select **ALL** that apply.

Options

- A** It can prevent qualitative analysis from being performed.
- B*** Limited or poor quality data limits the value of the assessment.
- C*** Numerical accuracy could result in over confidence in the results.
- D** Risk cannot be estimated with any degree of certainty as it is subjective.
- E*** There is an assumption that the future will be similar to the past.

Mark/Score: 1

21 Question Text:

Which **TWO** of the following describe the probability density function that has a longer tail on the right hand side?

Options

- A*** Positively skewed.
- B** Leptokurtic.
- C** Normal.
- D** Negatively skewed.
- E*** Log normal.

Mark/Score: 1

22 Question Text:

Which **TWO** of the following are examples of operational risk?

Options

- A** A competitor reduces the prices of its products.
- B*** A computer system has downtime due to an electrical failure.
- C*** A manufacturing plant is disrupted due to flooding.
- D** The acquisition of a competitor is poorly planned.
- E** The return on a defined benefit pension scheme is expected to fall this quarter.

Mark/Score: 1

23 Question Text:

Which of the following reasons make the management of commodity risk more challenging than the management of foreign exchange risk?

Select **ALL** that apply.

Options

- A*** A commodity price may include additional components such as transport costs.
- B** Commodity derivatives are only available over the counter.
- C*** Commodity markets are often less liquid than the foreign exchange markets.
- D** Forecast foreign exchange prices are less likely to change.
- E** Long dated commodity prices are always more expensive than long dated foreign exchange prices.

Mark/Score: 1

24 Question Text:

Why do corporates prefer to use over the counter instruments rather than exchange traded instruments?

Select **ALL** that apply.

Options

- A** Counterparty risk is limited by using a relationship bank.
- B** The pricing is more competitive with over the counter instruments.
- C*** They can be tailored more closely to the underlying exposure in terms of dates and amounts.
- D*** They provide income to their relationship banks who in turn may provide ancillary services they need.
- E*** Using them avoids the need to make daily variation margin payments.

Mark/Score: 1

25 Question Text:

Which **TWO** of the following would result in a higher premium for a call option?

If the:

Options

- A** option changes from in the money to at the money.
- B*** risk free rate rises.
- C** strike price is higher than the underlying price.
- D** time to maturity decreases.
- E*** volatility increases.

Mark/Score: 1

SECTION B

Section B consists of 3 case study based scenarios, each containing 5 multiple choice questions (MCQs), **worth 1 mark each**, relating to the case study.

These questions are all single response MCQs.

Section B will focus on smaller sections of the syllabus and requires more depth of knowledge and application to practice.

Section B – case study 513-5-3

CIQ is a large global mining company based in South Africa. CIQ wishes to modernise its treasury function and has recently updated its policies. In addition, the company has upgraded its treasury management system (TMS) and is focused on managing liquidity risk and addressing new emerging risks. The treasurer is keen to embrace treasury developments by exploring green finance initiatives. CIQ has a funding requirement in the next two years and is keen to explore environmental, social and governance (ESG) bonds although the treasurer needs to understand more about this market and has heard that the coupon is higher than non-ESG bonds. As part of the risk assessment process for these emerging risks the treasurer needs to measure the risk. At a recent ACT conference different measures of probability were discussed and the treasurer favours using what has happened in the past as an indicator to the future. CIQ is willing to take on significant risks as long as it has the necessary risk management strategies and internal controls in place.

26 Question Text:

What is a key difference between ESG bonds and non-ESG bonds?

Options

- A** Coupon on ESG bond tends to be lower than non-ESG bonds.
- B*** Coupon on ESG bonds tend to be higher than non-ESG bonds.
- C** Coupon on ESG bonds tend to be the same as non-ESG bonds.
- D** Liquidity in both markets tend to be the same.

Mark/Score: 1

27 Question Text:

What is the key risk that CIQ needs to address within the next two years?

Options

- A** Counterparty risk.
- B** Foreign exchange.
- C*** Liquidity.
- D** Technology risk.

Mark/Score: 1

28 Question Text:

What measure of probability does the treasurer prefer?

Options

- A** Estimates.
- B** Press releases or market data.
- C*** Refer to historical incidents.
- D** Statistical measures.

Mark/Score: 1

29 Question Text:

Why is CIQ willing to take on additional significant risks?

Options

- A*** Increase shareholder value.
- B** Invest surplus funds.
- C** To attract and retain staff.
- D** To keep up with the competition.

Mark/Score: 1

30 Question Text:

Who in CIQ has overall responsibility for managing these risks?

Options

- A*** The board.
- B** Senior management.
- C** All employees.
- D** Chief executive officer.

Mark/Score: 1

Section B – case study 513-5-4

Global Products (GP) has a new treasurer who is undertaking a review of treasury risks across the company. The treasurer discovers that the company does not maintain a list of treasury related risks and decides to prepare a risk register. In order to assess the risks systematically, the treasurer uses the following risk map where each risk is recorded according to its likelihood of happening and its potential impact. It is also agreed that the risk register and risk map will be updated on a regular basis.

		Likelihood of occurrence			
		Low	Medium	High	Certain
Impact	Catastrophic	B	B	A	A
	High	C	B	B	A
	Medium	D	C	B	B
	Low	D	D	C	B
	Not material	E	D	D	C

One of the risks identified on the risk register is interest rate risk. Global Products has GBP100m of borrowings at a floating rate of SONIA plus a margin of 1.5%. The financing includes an interest cover covenant which the treasurer is keen to protect. GP has been discussing with one of its relationship banks the possibility of swapping this floating rate exposure fully into fixed interest rates. The bank has quoted a fixed rate of 4.0% against SONIA flat.

31 Question Text:

Why is GP undertaking a review of treasury risks?

Options

- A** As part of the monthly reporting pack process.
- B** Audit requirement.
- C*** To help manage treasury risks in a systematic manner.
- D** To update its operational procedures manual.

Mark/Score: 1

32 Question Text:

Using the likelihood/impact matrix above, which risks should be the highest priority?

Options

- A*** Risks identified as 'A'.
- B** Risks identified as 'B'.
- C** Risks identified as 'C'.
- D** Risks identified as 'D'.

Mark/Score: 1

33 Question Text:

Why should GP regularly update the risk register?

Options

- A** For external reporting requirements.
- B** For monthly reporting requirements.
- C*** To allow management to react to changes in the business.
- D** To ensure the likelihood/impact matrix is up to date.

Mark/Score: 1

34 Question Text:

If the company entered into the interest rate swap, what type of risk response would this constitute?

Options

- A** Accept and reduce.
- B** Accept and retain.
- C** Accept and diversify.
- D*** Accept and transfer.

Mark/Score: 1

35 Question Text:

Which of the following is GP's treasurer's most important consideration in managing interest rate risk?

Options

- A** Ancillary business to its relationship bank.
- B** Greater flexibility.
- C** Minimising cash flow.
- D*** Protecting the interest cover covenant.

Mark/Score: 1

Section B – case study 513-5-5

GTA is a US car manufacturer and has recently acquired a European competitor. It is now in the process of integrating the business including head office functions such as treasury. GTA is looking to make an investment to automate a section of the assembly line and the treasurer is working with finance colleagues to determine the potential risk/return. A finance manager has asked about the risk-return trade-off. This investment is viewed as a high-risk project, so the finance manager wants to understand the impact this is likely to have on the expected return. As part of the treasury integration plan, there are several non-material risks which the treasurer feels do not need to be managed but should be monitored to ensure the materiality does not increase. The new investment is GBP20m but will be funded in USD. The treasurer is reviewing the foreign exchange (FX) risk and considering different FX strategies including possible option strategies. GTA and its subsidiaries have the necessary board approval to purchase options but are not allowed to sell options. The type of option being considered is the most common type and allows the purchaser to exercise the option at any time up to the expiry date. The treasurer is also considering zero-cost collars in order to reduce the upfront cost although this would require board approval.

36 Question Text:

Why is it important for GTA to fully understand and manage its significant risks?

Options

- A** Resources are limited.
- B*** To ensure only acceptable risks are taken.
- C** To ensure only higher expected return investments are undertaken.
- D** To identify opportunities for adding value.

Mark/Score: 1

37 Question Text:

In relation to the non-material risks, what approach is the treasurer considering?

Options

- A** Ignore as they are low probability.
- B** Ignore as they have low impact.
- C** Insure rather than hedge due to the cost.
- D*** Retain and review regularly.

Mark/Score: 1

38 Question Text:

Which type of option is being considered by GTA?

Options

- A*** American.
- B** Asian.
- C** Bermudan.
- D** European.

Mark/Score: 1

39 Question Text:

Would the treasurer consider writing options alone to hedge an underlying exposure?

Options

- A** Cannot tell without further information.
- B*** No.
- C** Possibly.
- D** Yes.

Mark/Score: 1

40 Question Text:

Why is the treasurer considering the use of a zero-cost collar?

Options

- A** Avoid risks which it is not expected to take.
- B** Accept and retain risk it has appetite for.
- C*** Reduce risk through internal controls or diversification.
- D** Transfer the risk to a third party.

Mark/Score: 1

SECTION C

Section C is made up of 4 case study questions and is worth a total of 40 marks.

4 longer form questions: 4 x 10 mark questions.

Please note that some questions may be broken into sub-questions (for example a,b,c) on the next page.

Questions will be based on mini-scenarios common to practice. Questions will test knowledge, analysis, application and justification as appropriate to level descriptors.

Please ensure you open and read the associated Case Study information before answering the question. This can be found above the answer box.

Case Study 514-1

Smeeth is a Swiss manufacturer of watches and has recently disposed of a glass manufacturing business in Poland for USD220m. This is a large disposal for the business and current plans are for no further acquisitions or disposals this financial year.

Smeeth plans to invest these proceeds for six months in an equity-based security that has historically achieved a 10% return. The assumptions made are that the security offers a normally distributed return with an expected mean (μ) return of GBP11m and a standard deviation (σ) of = GBP1.2m.

41 Question Text:

Using the information in the case study calculate:

1. the probability that the security will generate returns above GBP12m
2. the probability that the security will generate returns below GBP9m
3. the range where 95% of possible investment returns will fall for this investment.

(6 marks)

Mark/Score: 6

42 Question Text:

Discuss why the statistical analysis, by itself, may be inadequate when assessing the attractiveness, or otherwise, of this investment choice for Smeeth?

(4 marks)

Mark/Score: 4

Case Study 513-3

SpeedyAir (SA) is a European airline that provides flights around Europe for both holiday and business customers. After five years of strong sales growth, the pandemic has curtailed SA's sales significantly.

SA's gearing level is high and unsurprisingly over the last year both its profitability and cashflow have been significantly impacted. Also, as an airline, SA's revenues are very seasonal. The business uses a revolving credit facility (RCF) to fund cash flow deficits when they arise.

SA currently uses a risk matrix as its sole tool to prioritise its risk management actions. SA's treasurer has just updated the matrix to reflect current trading conditions. Five key financial risks have been identified as shown in Table 1 and then categorised in the matrix.

Table 1

Risk Category	Severity	Frequency	Description
Foreign exchange (FX)	10%	2 years	Sales revenue and profitability if FX rates rise.
Liquidity (LQ)	11%	4 years	Unexpected payment demands exceed available headroom within borrowing facilities available.
Funding (FU)	9%	2 years	Challenge of replacing maturing debt.
Interest rate (IR)	5%	4 years	Interest rate costs rising and lower consumer demand.
Operational (OP)	3%	5 years	Risk of significant human error in the treasury function.

Risk matrix

		Likelihood or Frequency				
		Very unlikely > 25 years	Low 10 -25 years	Medium 3- 10 years	High 1-3 years	Certain/ very probable yearly
Severity of occurrence on Earnings per Share	Catastrophic > 25%					
	High 10% - 25%			LQ	FX	
	Medium 5% - 10%			IR	FU	
	Low 2% - 5%			OP		
	Insignificant <2%					

43 Question Text:

Analyse the risk matrix produced by the treasurer and recommend, with reasons, how SA should prioritise the management of its financial risks.

(3 marks)

Mark/Score: 3

44 Question Text:

Discuss **THREE** potential shortcomings of SA's current approach to prioritising its financial risk management actions.

(3 marks)

Mark/Score: 3

45 Question Text:

Recommend and justify the actions SA should take to improve its current financial risk management strategy.

(4 marks)

Mark/Score: 4

Case Study 513-5

Friendly Forests (FF) is a UK-based company, focused on growing and foresting high grade timber, used in many applications across industry. With land across the British Isles, FF is a market leader with well recognised ESG credentials.

Given the capital-intensive nature of the industry, FF's operations carry a significant working capital burden, which it has financed via a revolving credit facility (RCF) as well as a term loan. The RCF has four years left to mature, and is currently drawn GBP80m, against a total of GBP120m.

The term loan is repayable in three-months' time, in full, and is GBP30m. FF also has issued USD and EUR denominated bonds maturing over the next three to seven years.

FF sells to a range of customers in a basket of currencies, predominantly GBP, JPY, CNY. FF also invests regularly in capital goods, the majority of which are internationally sourced and paid for in foreign currency.

There is a panel of eight relationship banks, all of which lend into the RCF, and in return, expect a share of the ancillary business. FF frequently trades FX for transaction hedging requirements and has a book of cross-currency interest rate swaps. FF periodically has surplus cash on hand, which is placed with the banking group for several days at a time, in between RCF repayment opportunities.

46 Question Text:

Explain **FOUR** types of business risks faced by FF. You are also required to describe an example of each risk in the context of FF.

(8 marks)

Mark/Score: 8

47 Question Text:

For any **TWO** of the risks identified in 1a, outline how FF can accept and transfer, or reduce, the risk.

(2 marks)

Mark/Score: 2

Case Study 513-14

Diesel Diggers (DD) is a US-based manufacturer of landscaping machinery, such as diggers and rollers. DD is highly leveraged, carrying fixed-term bonds, floating rate term loans, a non-utilised revolving credit facility (RCF) and a commercial paper programme.

DD also typically has surplus cash intra month and places this on deposit with a panel of relationship banks. Treasury policy mandates that 50% of outstanding debt must be fixed in nature. DD achieves this by overlaying a portfolio of interest rate swaps. Given the significant rise in interest rates over the past year, the board of DD has requested an update from the treasurer on how DD is exposed to this risk.

DD has recently purchased AUD call options to hedge the input cost of steel used in the production process. This matures in six months, which is the expected payment date to the vendor. DD has now become aware that the vendor may go into receivership and as a result, DD's treasurer is keen to understand the value of the option, with a view to selling it back to the bank. The back-office department has informed the treasurer that the Black Scholes model is the market standard approach to calculating the value of this European option.

48 Question Text:

Explain the **THREE** primary dimensions of the risk the board is concerned about and how this applies to DD.

(6 marks)

Mark/Score: 6

49 Question Text:

Using the desired model, describe **TWO** inputs in determining the value of the option. For each, you are also required to describe the correlation between the input and the option value.

(4 marks)

Mark/Score: 4

Case study mark scheme

Case study 514-1

1a	<p>i) $Z = (12-11)/1.2 = 0.83$, look up in table = 0.2033 = 20.33%</p> <p>ii) $Z = (9-11)/1.2 = -1.67$, look up in table = .0475 = 4.75%</p> <p>iii) $\text{GBP } 11 \pm 1.96 (1.2) = \text{GBP } 8.65 \text{ to } \text{GBP } 13.35$ (use tables or central limit theorem to identify 1.96 as the 2.5% level)</p>	<p>2 marks</p> <p>2marks</p> <p>2 marks</p> <p>(sub 6 marks)</p>
1b	<p>Historical data: Statistical analysis such as those used above are limited by looking at the past and assuming that this is likely to repeat itself. The return of 10% is higher than average long-term equity returns and may not continue.</p> <p>Low probability events: Events from a normal distribution do not take account of extreme events i.e. very low probability events such black swan events. Additionally, equities tend to be log-normal rather than a normal distribution.</p> <p>Qualitative factors: There are also other more qualitative factors that need to be considered in relation to this investment. What is the risk appetite of the business? Is this within the instruments allowed for investment? What are the chances of needing the funds within the six-month time frame?</p> <p>Diversification: Smeeth should consider the whole investment portfolio rather than individual investments as there may be diversification and correlation benefits.</p>	<p>1 mark per point</p> <p>(total 4 marks)</p> <p>Total: 10 marks</p>

Case study 513-3

3a	<p>Risk Matrix</p> <ul style="list-style-type: none"> • FX risk should have the highest priority for SA, based on the risk map and operational risk the least priority. • Liquidity risk and funding risk should be prioritised equally, with interest rate risk having less priority than these two. • So the order is FX, LQ/FU, IR and OP • Liquidity risk probability of four years looks optimistic given the financial situation 	<p>1 mark per point (holistic marking)</p> <p>(up to 3 marks)</p>
3b	<p>Shortcomings of the current approach</p> <ul style="list-style-type: none"> • The risk matrix does not consider interdependencies and correlations between the risks. • The model is a point in time and not dynamic as risks change, so useful that it has been recently updated. • The quantification of the risks is on an arbitrary basis and lacks numeric rigour. • Liquidity risk should be a priority as lack of liquidity could result in the business ceasing to trade. Hence likely to be a much higher priority than FX. 	<p>1 mark per point (holistic marking)</p> <p>(up to 3 marks)</p>
3c	<p>Financial Risk Management strategy</p> <ul style="list-style-type: none"> • The risk matrix has omitted the most volatile risk – commodity exposure for an airline – this is likely to be more significant than FX risk so should be included in the matrix. • Given the linkages between the risks such as FX and commodities, sensitivity or scenario analysis would provide better information about the risk impact. • If profitability and cashflow fail to turnaround – liquidity is likely to become the most pressing risk and so SA should seek to obtain additional sources of funding now. <p>Other valid responses will be rewarded.</p>	<p>1 mark</p> <p>1 mark sensitivity analysis</p> <p>1 mark scenario planning</p> <p>1 mark</p>
		Total: 10 marks

Case study 513-5

<p>Q1a</p>	<p>Mark Scheme</p> <p>FX Risk</p> <p>Commodity Risk</p> <p>Credit Risk</p> <p>Liquidity Risk</p> <p>Operational Risk</p> <p><i>Any other reasonable risks, including any subsets of above (i.e. counterparty risk being a subset of Credit Risk)</i></p> <p><i>Any valid descriptions</i></p> <p><i>For each of the four risks, one mark for identifying, another for an example/description</i></p> <p>FX Risk → Trades derivatives (likely on EUR or USD sales receipts) or foreign currency capital goods purchases</p> <p>Interest Rate risk → cross currency swaps (hedging any FX or interest rate risk on the term loan, bonds or RCF)</p>	<p>8 marks for Part A</p>
<p>Q1b</p>	<p>Counterparty Risk → diversifies cash concentration by depositing surplus funds across banking group</p> <p><i>Any other reasonable risk and means of transferring it</i></p> <p><i>1 mark for each example of how to accept and transfer</i></p>	<p>2 marks for Part B</p>

Case study 513-14

<p>Q4a</p>	<p>Changing amount of interest expense or income</p> <p>If interest rates go up, we will pay more if we have floating rate debt liabilities, and if we need to undertake a new borrowing, this may be more expensive than we planned. If interest rates fall, we will earn a lower rate of return on any floating rate deposits. Interest on borrowings is a major cost for most organisations, so changes in interest rates have a potentially significant impact on profitability and, if interest rates rise, the company must still be able to service its debt. Interest on deposits is usually of secondary importance – even if deposits were to earn no interest this would be unlikely to make the company insolvent.</p> <p>Changing market values of debt outstanding</p> <p>Changes in interest rates will change the values of already issued bonds. For example, interest rates affect the value of fixed coupon bonds. This is a major risk to bond holders, and, in some circumstances, to issuers. As interest rates rise, bond prices fall. Similarly when interest rates fall, bond prices rise. Increasingly for both internal and external reporting purposes, borrowings and investments are marked to market, i.e. revalued to current market values.</p> <p>Impact on the business environment and hence on business performance</p> <p>Changes in interest rates also affect businesses indirectly, through their effect on the overall business environment. Interest rates tend to be raised at times of high economic activity as a means of curbing excessive activity, which might lead to inflation. Thus, it could be that as an organisation's interest costs rise, its performance also improves, allowing it to afford the increased interest cost. However, this is by no means universal and the effects differ between companies as to direction, timing and magnitude. The treasurer might therefore conclude that the risks from floating rate debt are too great, having taken into account the total business exposure.</p> <p><i>1 mark for each element</i></p> <p><i>1 mark for correct description and link to case</i></p>	
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<p>Q4b</p>	<p>Time to Maturity: More time = More value</p> <p>Volatility: More Volatility = More value</p> <p>Strike Price: More favourable (ie more in the Money) = More value</p> <p>Risk Free Rate: For a call, higher RF = higher value, For a put higher RF = Lower value. note this correlation is not covered in the material</p> <p>Current price of underlying asset: For a call, higher price = higher value, for a put higher price = lower value note this correlation is not covered in the material</p> <p>1 mark for the correct input, another for the correct correlation</p>	<p>6 marks for Part A</p> <p>4 marks for Part B</p> <p>Total: 10 marks</p>
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