

GARP FINANCIAL RISK MANAGER (FRM) PART 2 PRACTICE EXAM (SAMPLE)

STUDY GUIDE



SAMPLE STUDY GUIDE WITH LIMITED QUESTIONS

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Table of Contents

Copyright	1
Table of Contents	2
Introduction	3
How to Use This Guide	4
Questions	5
Answers	8
Explanations	10
Next Steps	16

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Introduction

Preparing for a certification exam can feel overwhelming, but with the right tools, it becomes an opportunity to build confidence, sharpen your skills, and move one step closer to your goals. At Examzify, we believe that effective exam preparation isn't just about memorization, it's about understanding the material, identifying knowledge gaps, and building the test-taking strategies that lead to success.

This guide was designed to help you do exactly that.

Whether you're preparing for a licensing exam, professional certification, or entry-level qualification, this book offers structured practice to reinforce key concepts. You'll find a wide range of multiple-choice questions, each followed by clear explanations to help you understand not just the right answer, but why it's correct.

The content in this guide is based on real-world exam objectives and aligned with the types of questions and topics commonly found on official tests. It's ideal for learners who want to:

- Practice answering questions under realistic conditions,
- Improve accuracy and speed,
- Review explanations to strengthen weak areas, and
- Approach the exam with greater confidence.

We recommend using this book not as a stand-alone study tool, but alongside other resources like flashcards, textbooks, or hands-on training. For best results, we recommend working through each question, reflecting on the explanation provided, and revisiting the topics that challenge you most.

Remember: successful test preparation isn't about getting every question right the first time, it's about learning from your mistakes and improving over time. Stay focused, trust the process, and know that every page you turn brings you closer to success.

Let's begin.

How to Use This Guide

This guide is designed to help you study more effectively and approach your exam with confidence. Whether you're reviewing for the first time or doing a final refresh, here's how to get the most out of your Examzify study guide:

1. Start with a Diagnostic Review

Skim through the questions to get a sense of what you know and what you need to focus on. Your goal is to identify knowledge gaps early.

2. Study in Short, Focused Sessions

Break your study time into manageable blocks (e.g. 30 – 45 minutes). Review a handful of questions, reflect on the explanations.

3. Learn from the Explanations

After answering a question, always read the explanation, even if you got it right. It reinforces key points, corrects misunderstandings, and teaches subtle distinctions between similar answers.

4. Track Your Progress

Use bookmarks or notes (if reading digitally) to mark difficult questions. Revisit these regularly and track improvements over time.

5. Simulate the Real Exam

Once you're comfortable, try taking a full set of questions without pausing. Set a timer and simulate test-day conditions to build confidence and time management skills.

6. Repeat and Review

Don't just study once, repetition builds retention. Re-attempt questions after a few days and revisit explanations to reinforce learning. Pair this guide with other Examzify tools like flashcards, and digital practice tests to strengthen your preparation across formats.

There's no single right way to study, but consistent, thoughtful effort always wins. Use this guide flexibly, adapt the tips above to fit your pace and learning style. You've got this!

Questions

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- 1. In the Ho-Lee Model, what does 'dr' represent?**
 - A. The average rate of interest over time
 - B. The drift of the short-term rate
 - C. The change in the short-term interest rate
 - D. The total short-term market rate
- 2. What does Expected Positive Exposure (EPE) calculate?**
 - A. The net present value of future cash flows
 - B. The average positive exposure over a specified time
 - C. The total collateral required for future transactions
 - D. The projected delinquency rate on receivables
- 3. What is the Z-value corresponding to a 90% confidence level?**
 - A. 1.96
 - B. 1.65
 - C. 2.58
 - D. 2.33
- 4. What risk does the Credit VaR (CVAR) model primarily focus on?**
 - A. Liquidity risk
 - B. Market risk
 - C. Credit risk
 - D. Operational risk
- 5. What is a characteristic of a normal distribution in conditional distribution?**
 - A. Mean equals zero
 - B. Variance equals one
 - C. Mean equals beta times $\bar{m}$
 - D. Standard deviation equals beta
- 6. Which shape represents positive convexity in finance?**
 - A. Hill
 - B. Valley
 - C. Flat
 - D. Plateau

7. Which of the following is an important component for calculating liquidity duration?

- A. Net asset value
- B. Total daily volume
- C. Annualized yield
- D. Brokerage fees

8. In Term Structure Model 1, what does 'dr' represent?

- A. The duration of bonds
- B. Change in interest rates over a small time interval
- C. The drift rate of the market
- D. Annual bond volatility

9. What are sovereign risks?

- A. Risks associated with corporate debts
- B. Risks of a government defaulting on its debt obligations
- C. Risks linked to individual investors
- D. Risks related to changes in private sector borrowing

10. What is expected shortfall used to measure?

- A. The total amount of potential profits in finance
- B. The average loss when losses exceed the Value at Risk (VaR) threshold
- C. The average gain in investment portfolios over a period
- D. The total investment cost needed to achieve a specific return

Answers

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1. C
2. B
3. B
4. C
5. C
6. B
7. B
8. B
9. B
10. B

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Explanations

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1. In the Ho-Lee Model, what does 'dr' represent?

- A. The average rate of interest over time
- B. The drift of the short-term rate
- C. The change in the short-term interest rate**
- D. The total short-term market rate

In the Ho-Lee Model, 'dr' specifically refers to the change in the short-term interest rate. This model is primarily used for pricing interest rate derivatives and modeling the term structure of interest rates. It incorporates a stochastic process to represent the dynamics of interest rates, and 'dr' captures increments in the short-term interest rate, which helps to reflect its movement over time. Understanding this change is crucial for risk management and derivative pricing, as it enables practitioners to model the uncertainty associated with future interest rate paths. This incremental change can fluctuate based on various market factors, making it a vital component of the model. Additionally, other options do not accurately reflect the meaning of 'dr' in this context. For example, the average rate of interest over time does not capture the dynamic nature of interest rate changes, while the drift of the short-term rate pertains to a broader concept of upward or downward trends in rates, rather than the specific incremental changes represented by 'dr.' Lastly, the total short-term market rate refers to the existing market rate and does not denote changes over time, making these interpretations less fitting in the context of the Ho-Lee Model.

2. What does Expected Positive Exposure (EPE) calculate?

- A. The net present value of future cash flows
- B. The average positive exposure over a specified time**
- C. The total collateral required for future transactions
- D. The projected delinquency rate on receivables

Expected Positive Exposure (EPE) specifically measures the average positive exposure that a financial institution has at a given time over a specified time horizon. It is a key metric in counterparty credit risk management and reflects the potential future credit exposure that could arise from fluctuations in the value of derivatives and other financial instruments. EPE focuses on the times during which the exposure is positive, thus providing an average, rather than looking at the total net present value of cash flows or the total collateral required, which would not accurately represent the risk profile from a credit exposure perspective. Moreover, it does not relate to the delinquency rate on receivables, as EPE is geared towards assessing the potential risk from derivative trading activities rather than collections or cash flows from accounts receivable. This makes the average positive exposure over a specified time the correct interpretation of what EPE calculates.

3. What is the Z-value corresponding to a 90% confidence level?

- A. 1.96
- B. 1.65**
- C. 2.58
- D. 2.33

At a 90% confidence level, the Z-value reflects the point in the standard normal distribution beyond which only 10% of the data lies. To find this value, you would look for the Z-value that corresponds to the upper tail of the distribution. In standard normal distribution terms, a 90% confidence level means that 5% of the area is in each tail of the distribution (since the total area under the curve is 100%). This leaves 90% in the middle. The Z-value that corresponds to the cumulative probability of 0.95 (which accounts for the 90% in the middle plus the 5% in the upper tail) is approximately 1.645. For practical purposes in many scenarios, it is often rounded to 1.65. Therefore, the Z-value for a 90% confidence level is correctly identified as 1.65, representing the point at which the probability of a value falling below it is 90%. This understanding is crucial for applications in financial risk management, particularly in value-at-risk (VaR) calculations and other risk assessments.

4. What risk does the Credit VaR (CVAR) model primarily focus on?

- A. Liquidity risk
- B. Market risk
- C. Credit risk**
- D. Operational risk

The Credit VaR (CVAR) model primarily focuses on credit risk, which pertains to the risk of loss due to a borrower's failure to make required payments. This model quantifies the potential loss in value of credit exposures over a specified time horizon under normal market conditions, within a certain confidence interval. By estimating the maximum expected loss in the value of a portfolio of credit instruments, CVAR provides critical insights needed for firms to manage and mitigate the credit risk associated with their portfolios effectively. Credit risk includes considerations of counterparty default probabilities, recovery rates in the event of default, and exposure at default. This makes the CVAR particularly suited to addressing risks directly related to borrowers' creditworthiness rather than risks associated with liquidity, market conditions, or operational failures. Understanding this distinction is crucial for risk managers in implementing relevant strategies and measures to safeguard against potential losses from credit defaults.

5. What is a characteristic of a normal distribution in conditional distribution?

- A. Mean equals zero
- B. Variance equals one
- C. Mean equals beta times $\bar{m}$**
- D. Standard deviation equals beta

In the context of conditional distributions, particularly when analyzing financial variables, a characteristic of a normal distribution is that the mean of the conditional distribution can be expressed as beta multiplied by the unconditional mean ($\bar{m}$). This reflects the relationship between the conditional mean and the overall expected outcome in a normal distribution framework. When dealing with conditional distributions, particularly in the context of time-series analysis or the application of regression models, beta represents the sensitivity or the slope of the regression line in predicting the dependent variable based on the independent variable. The unconditional mean, denoted as $\bar{m}$, provides the baseline expectation before any conditions are imposed. The expression of the conditional mean in terms of these two variables indicates how expectations adjust based on new information, thereby portraying the fundamental properties of a normal distribution in the financial setting. The other choices relate to specific traits of a standard normal distribution but do not encapsulate the concept of conditional distributions as effectively. The statements about the mean equaling zero or variance equaling one refer specifically to the standard normal distribution, which is a special case. Similarly, the notion that the standard deviation equals beta is too narrowly defined and does not address the broader implications of conditional expectations. Thus, the identification of the mean as beta times the unconditional mean accurately captures

6. Which shape represents positive convexity in finance?

- A. Hill
- B. Valley**
- C. Flat
- D. Plateau

Positive convexity in finance is represented by a "valley" shape. This shape indicates that as interest rates decrease, the price of a bond increases at an increasing rate, and vice versa for interest rate increases. This behavior is crucial for understanding the risk and return dynamics of fixed-income securities. The reason a valley shape signifies positive convexity lies in the curvature of the bond's price-yield relationship. In this context, positive convexity suggests that the bond's price is more sensitive to decreases in interest rates than to increases, which is an advantageous characteristic for bondholders. It reduces the potential for losses when interest rates rise while allowing for greater gains when rates fall. In contrast, a hill shape would imply negative convexity, where price sensitivity diminishes with falling interest rates. A flat shape would suggest no convexity, indicating a linear relationship between price and yield, which does not capture the complexities of interest rate risk effectively. A plateau area indicates a lack of responsiveness to interest rate changes, which is not indicative of positive convexity.

7. Which of the following is an important component for calculating liquidity duration?

- A. Net asset value
- B. Total daily volume**
- C. Annualized yield
- D. Brokerage fees

Liquidity duration refers to the time it takes for an investment or portfolio to convert into cash without significantly affecting its market price. In this context, total daily volume is a crucial component because it measures the liquidity of the asset or security in question. Higher daily trading volumes typically indicate that an asset can be sold more easily without impacting its price adversely. This means that when assessing liquidity duration, one must consider how quickly and efficiently the asset can be sold in the market, which is directly reflected in the total daily volume. The other components mentioned, while relevant in other contexts, do not specifically address the liquidity aspect in the same direct manner. Net asset value pertains to the overall value of an asset or fund and does not provide insight into how quickly that asset can be converted to cash. Annualized yield is more relevant to the return side of the investment rather than its liquidity. Brokerage fees deal with the cost of executing trades but do not influence the duration an asset can be held before encountering liquidity constraints. Thus, total daily volume is the primary indicator of liquidity shortfall and is essential for calculating liquidity duration effectively.

8. In Term Structure Model 1, what does 'dr' represent?

- A. The duration of bonds
- B. Change in interest rates over a small time interval**
- C. The drift rate of the market
- D. Annual bond volatility

In Term Structure Model 1, 'dr' represents the change in interest rates over a small time interval. This notation is commonly used in mathematical finance and represents a differential change, highlighting how interest rates can vary over infinitesimally small time frames. Understanding this concept is crucial as it relates directly to how interest rates evolve and influence the pricing and valuation of bonds over time. Options that relate to duration or volatility of bonds, while important concepts in fixed income, do not accurately define 'dr' in the context of this model. The term "drift rate" refers to a component used in certain stochastic models, but 'dr' specifically denotes the change in interest rates, making the representation vital for modeling interest rate dynamics in fixed income analysis.

9. What are sovereign risks?

- A. Risks associated with corporate debts
- B. Risks of a government defaulting on its debt obligations**
- C. Risks linked to individual investors
- D. Risks related to changes in private sector borrowing

Sovereign risks refer specifically to the risk that a government will default on its debt obligations. This can occur when a nation cannot meet its repayment commitments on government bonds or loans. Such risks are significant because they can have widespread implications for both domestic and global markets. A default can lead to a downgrade of the country's credit rating, increase borrowing costs, and adversely affect economic stability. In the context of international finance, sovereign risk is crucial for investors who hold government bonds or engage in cross-border lending. When considering investments in a country, understanding the local government's financial health, economic policies, and political stability can provide insights into the likelihood of a default occurring. The other options reflect risks associated with different financial areas but do not capture the essence of sovereign risk. Corporate debt risks pertain to businesses rather than governments, individual investor risks are personal investment-related concerns, and changes in private sector borrowing do not directly relate to government obligations. Thus, the focus on government default risk accurately defines sovereign risks in the financial context.

10. What is expected shortfall used to measure?

- A. The total amount of potential profits in finance
- B. The average loss when losses exceed the Value at Risk (VaR) threshold**
- C. The average gain in investment portfolios over a period
- D. The total investment cost needed to achieve a specific return

Expected shortfall, also known as conditional value at risk (CVaR), is used to measure the average loss that an investment could expect to incur in the worst-case scenarios, specifically when losses exceed the threshold set by Value at Risk (VaR). This metric provides a more comprehensive assessment of risk in a portfolio because, unlike VaR, which only identifies the maximum loss over a specified time frame at a certain confidence level, expected shortfall takes into account the severity of loss during those extreme events. By focusing on the average of the potential losses that exceed the VaR, expected shortfall captures the tail risk more effectively, making it a valuable tool for understanding the risk profile of an investment, especially in stress scenarios. This characteristic is particularly important for risk management, as it helps financial institutions and investors to prepare adequately for potential severe downturns. The other options don't align with the purpose of expected shortfall. While total potential profits and average gains are important financial metrics, they do not reflect the risk associated with losses. The total investment cost also does not pertain to measuring risk from losses, making them unrelated to the concept of expected shortfall.

Next Steps

Congratulations on reaching the final section of this guide. You've taken a meaningful step toward passing your certification exam and advancing your career.

As you continue preparing, remember that consistent practice, review, and self-reflection are key to success. Make time to revisit difficult topics, simulate exam conditions, and track your progress along the way.

If you need help, have suggestions, or want to share feedback, we'd love to hear from you. Reach out to our team at hello@examzify.com.

Or visit your dedicated course page for more study tools and resources:

<https://garpfrm2.examzify.com>

We wish you the very best on your exam journey. You've got this!

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