

# **FRM Part II Exam**

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Questions with Answers - Current Issues in Financial Markets

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## **Reading 166: Digital Resilience and Financial Stability. The Quest for Policy Tools in The Financial Sector**

Q.5757 Which of the following is correct regarding cyber and ICT risk events in relation to systemic financial risk?

- A. They primarily result in physical damage to the institution's infrastructure, leading to financial losses.
- B. They can undermine public confidence in the financial system, leading to panic and potential bank runs or market sell-offs.
- C. They are mainly concerned with the personal data breaches of individual customers, without broader systemic implications.
- D. They primarily cause a temporary decrease in the stock market value of the affected institution.

The correct answer is **B**.

Cyber and ICT risk events at financial institutions, such as significant cyber attacks or operational disruptions due to technological failures, can have systemic implications. One of the primary ways these risks lead to systemic financial risk is by undermining public confidence in the stability and reliability of the financial system. This erosion of trust can trigger panic among consumers and investors, leading to phenomena like bank runs, where customers withdraw their deposits en masse, or market sell-offs, where investors rapidly sell off their holdings. These reactions can exacerbate the financial instability, spreading the impact from a single institution to the broader financial system, thus creating a systemic risk.

**A is incorrect** because while cyber and ICT risk events can cause financial losses, they do not primarily result in physical damage to infrastructure. The systemic risk arises more from the operational disruptions and the loss of confidence they engender, rather than physical damages.

**C is incorrect** because while personal data breaches are a significant concern, they are only one aspect of cyber and ICT risks. The systemic implications extend beyond individual customer data breaches and encompass broader operational and reputational risks that can affect the entire financial system.

**D is incorrect** because the impact of cyber and ICT risks on a financial institution's stock market value is a possible consequence but is not the primary pathway to systemic financial risk. The systemic risk relates more to operational and confidence-related aspects of the financial system as a whole, rather than the stock market value of a single institution.

### **Things to Remember**

- Cyber risk events refer to the potential for loss or harm related to technical infrastructure or data within an organization.

- ICT (Information and Communication Technology) risk events encompass a broader range of risks related to the use of technology in an organization.
  - Systemic financial risk refers to the risk of a widespread disruption or collapse of the financial system, rather than just isolated to individual institutions.
  - Operational disruptions from cyber and ICT risks can have cascading effects on other financial institutions and markets.
  - Public confidence is a critical factor in maintaining financial stability, and events that erode this confidence can lead to systemic risk.
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Q.5758 In the context of financial institutions, what is a key factor that amplifies the systemic risk associated with cyber and ICT risks?

- A. Increased investment in innovative financial products
- B. Reliance on physical currency and traditional banking methods
- C. Dependency on interconnected digital platforms and services
- D. Shift towards more regulated financial environments

The correct answer is **C**.

The systemic risk associated with cyber and ICT risks in financial institutions is significantly amplified by their dependency on interconnected digital platforms and services. Modern financial institutions are heavily integrated through digital means, including cloud computing, online transaction processing systems, and other digital services. When a cyber or ICT risk event (like a data breach or system failure) occurs in such an interconnected environment, it can quickly propagate to other institutions and parts of the financial system. This interconnectedness can turn a localized risk event into a systemic threat, affecting the stability and reliability of the entire financial sector.

**A is incorrect because** while investment in innovative financial products can introduce new risks, it is not a key factor in amplifying systemic risk specifically related to cyber and ICT risks. These systemic risks are more directly tied to the digital interconnectedness of financial operations.

**B is incorrect because** modern financial institutions have largely moved away from reliance on physical currency and traditional banking methods. The systemic risks associated with cyber and ICT incidents are largely due to the reliance on digital and networked systems, not traditional methods.

**D is incorrect because** a shift towards more regulated financial environments aims to reduce risks, including cyber and ICT risks. Regulation typically involves implementing safeguards and risk management practices, which would mitigate rather than amplify systemic risks.

### Things to Remember

- Cyber risk refers to the potential loss or harm that an organization may suffer due to a breach of its information systems or data.
  - ICT (Information and Communication Technology) risks encompass a broader range of risks related to the use of technology in an organization, including cyber risks.
  - Systemic risk is the risk of a breakdown in an entire system, such as the financial system, rather than just one individual part.
  - Interconnectedness in the financial system refers to the links and dependencies between different institutions and markets, which can lead to the rapid spread of risks.
  - Cloud computing and online transaction processing systems are examples of digital platforms and services that financial institutions heavily rely on.
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Q.5759 What aspect of a financial institution's operations makes it particularly vulnerable to systemic risks arising from cyber and ICT incidents?

- A. The routine use of manual processes in daily operations.
- B. High dependency on global supply chains for physical assets.
- C. Extensive use of customer service centers for client interactions.
- D. Integration with and reliance on real-time electronic payment systems.

The correct answer is **D**.

The integration with and reliance on real-time electronic payment systems significantly contribute to a financial institution's vulnerability to systemic risks arising from cyber and ICT incidents. These systems are critical for the daily operations of financial institutions, enabling instant processing of transactions and transfers. A cyber or ICT incident affecting these systems can not only disrupt the institution's ability to conduct transactions but also impact other institutions and clients reliant on these services. Due to the real-time and interconnected nature of these systems, any disruption can have immediate and widespread consequences, potentially leading to systemic financial risks.

**A is incorrect because** the use of manual processes is typically associated with lower cyber and ICT risk exposure. Systemic risks in this context are more closely tied to automated and digital systems.

**B is incorrect because** while global supply chains are important, they are more relevant to physical assets and less so to the cyber and ICT risks that primarily impact digital and operational aspects of financial institutions.

**C is incorrect because** customer service centers, while important for client interactions, do not typically play a central role in the systemic risks associated with cyber and ICT incidents. These risks are more directly linked to the core digital transaction and processing systems.

### **Things to Remember**

- Cyber risk: The risk of financial loss, disruption, or damage to an organization's reputation resulting from the failure of its information technology systems.
- ICT (Information and Communication Technology) risk: The risk associated with the use of information and communication technologies, including cyber threats, data breaches, and system failures.
- Systemic risk: The risk of widespread disruption or instability within a financial system, where the failure of one institution or component can trigger a chain reaction affecting others.
- Operational risk: The risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events.
- Real-time payment systems: Electronic payment systems that enable immediate transfer of funds between parties, increasing efficiency but also vulnerability to cyber threats.

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Q.5764 FinTechCo, a prominent financial technology company, has recently integrated its advanced cloud-based payment system with several major banks worldwide. This system offers faster transaction processing and enhanced data analytics capabilities. However, a critical vulnerability in FinTechCo's system is exploited by cyber attackers, leading to a temporary shutdown of its services. Considering this scenario, what is a likely systemic risk consequence of the cyber attack on FinTechCo's cloud-based payment system?

- A. An immediate surge in FinTechCo's research and development spending to enhance cybersecurity measures.

- B. Interruption in transaction processing at major banks, leading to a temporary freeze in global financial transactions.
- C. A significant long-term shift in consumer behavior towards non-digital financial transactions across the affected regions.
- D. A temporary decline in FinTechCo's market share in the financial technology sector.

The correct answer is **B**.

The scenario highlights the systemic risk associated with the integration of a single technology provider, FinTechCo, with major banks globally. The exploitation of a vulnerability in FinTechCo's system can lead to widespread interruptions in transaction processing. Since several major banks rely on this system for their operations, the cyber attack's impact isn't confined to FinTechCo but extends to these banks, potentially leading to a temporary freeze in financial transactions globally. This situation demonstrates how a single point of failure in a highly interconnected financial system can propagate systemic risks.

**A is incorrect because** while an increase in R&D spending is a plausible aftermath of a cyber attack, it represents a strategic response by FinTechCo and does not directly contribute to systemic financial risk.

**C is incorrect because** a significant long-term shift in consumer behavior towards non-digital transactions, though possible, is more of a gradual societal response and does not constitute an immediate systemic risk arising from the cyber attack.

**D is incorrect because** a decline in FinTechCo's market share, while a potential consequence of the cyber attack, does not directly translate into a systemic risk for the global financial system. It pertains more to the company's competitive standing rather than an operational risk affecting the entire financial sector.

### Things to Remember

- **Cybersecurity Risk:** Cyber attacks pose a significant risk to financial institutions and technology companies, highlighting the importance of robust cybersecurity measures.
- **Systemic Risk:** Systemic risk refers to the risk of widespread disruption or instability within an entire financial system, often stemming from interconnectedness and interdependencies.
- **Interconnected Financial Systems:** The integration of technology providers with major banks creates interdependencies that can amplify the impact of a cyber attack, leading to systemic risks.
- **Operational Risk:** Operational risk includes the risk of loss resulting from inadequate or

failed internal processes, systems, or external events, such as cyber attacks.

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Q.5765 Which of the following correctly describes cyber risk in the context of financial institutions?

- A. The potential for reduced operational efficiency due to outdated technology and systems.
- B. The likelihood of encountering legal disputes related to breaches of online banking regulations.
- C. The risk associated with unauthorized access or attacks on digital systems, compromising data security and integrity.
- D. The financial risk stemming from failed IT projects or investments in technology that do not yield the expected returns.

The correct answer is **C**.

Cyber risk in financial institutions involves the risk of unauthorized access, use, disclosure, disruption, modification, or destruction of the institution's digital systems and data. This encompasses various forms of cyber attacks and breaches, such as hacking, malware, and phishing, which pose threats to the confidentiality, integrity, or availability of sensitive financial data. These risks are particularly pertinent due to the critical reliance of financial institutions on digital technologies for secure and efficient operations.

**A is incorrect because** while outdated technology can impact operational efficiency, this does not encapsulate the essence of cyber risk, which is more about security breaches and unauthorized access to systems.

**B is incorrect because** legal disputes related to online banking regulations are more aligned with compliance and regulatory risks, not directly indicative of cyber risk, which specifically deals with digital data and system security.

**D is incorrect because** financial risks from failed IT projects or poor technology investments, while relevant, do not directly represent cyber risk. Cyber risk specifically pertains to threats and vulnerabilities in the digital and cyber aspects of operations, not the financial outcomes of technology investments.

### Things to Remember

- Cyber risk is a growing concern for financial institutions due to the increasing sophistication of cyber attacks and the interconnected nature of digital systems.
- Financial institutions are attractive targets for cyber criminals due to the vast amounts

of sensitive financial data they hold.

- Regulatory bodies, such as the FFIEC in the United States, provide guidelines and frameworks for managing cyber risk in financial institutions.
  - Cyber risk management involves a combination of technical controls, employee training, incident response plans, and regular assessments to identify and mitigate vulnerabilities.
  - Cyber insurance is a tool that financial institutions can use to transfer some of the financial risks associated with cyber attacks.
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Q.5768 What's the main challenge in adopting cooperative arrangements as a macroprudential tool to address cyber and ICT risks in the financial sector?

- A. Developing advanced technological solutions for shared cybersecurity platforms.
- B. Aligning diverse interests and ensuring equitable contributions among competitive financial institutions.
- C. Coordinating global response strategies across different regulatory jurisdictions.
- D. Obtaining sufficient funding for establishing and maintaining cooperative cybersecurity initiatives.

The correct answer is **B**.

A major challenge in implementing cooperative arrangements as a macroprudential tool to manage cyber and ICT risks is aligning the diverse interests of different financial institutions and ensuring equitable contributions from all participants. Given the competitive nature of the financial sector, institutions may be hesitant to share sensitive information or resources, making it difficult to establish effective cooperative frameworks. Balancing collective security needs with individual institutional interests is a delicate task that requires careful negotiation and trust-building. These arrangements must find a way to harmonize the various competitive dynamics within the sector to enhance collective cyber resilience effectively.

**A is incorrect** while developing technological solutions is important, the primary challenge in cooperative arrangements is not the technical aspect but the alignment of interests among competitive entities.

**C is incorrect** coordinating global strategies is a broader challenge that extends beyond the specific scope of cooperative arrangements within individual financial sectors.

**D is incorrect** obtaining funding, although important, is not the central challenge. The main difficulty lies in managing the competitive dynamics and ensuring fair participation and contribution from all involved institutions in the cooperative arrangement.

### Things to Remember

- Macroprudential tools are regulatory measures designed to address systemic risks in the financial system as a whole, rather than risks specific to individual institutions.
- Cyber and ICT risks refer to threats related to cybersecurity and information and communication technology, which can have significant impacts on financial institutions and the broader financial system.
- Cooperative arrangements involve collaboration and information sharing among different entities to address common challenges or risks collectively.
- Equitable contributions in cooperative arrangements ensure that all participants share the burden of addressing risks and benefit from the collective efforts equally.
- Trust-building is crucial in establishing effective cooperative frameworks, as entities need to have confidence in each other's intentions and capabilities to share sensitive information and resources.

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Q.5769 Which one of the following is the most significant challenge in extending macroprudential regulatory oversight to systemic technology providers, such as cloud service providers, in the financial sector.

- A. Ensuring uninterrupted service delivery during regulatory compliance checks.
- B. Balancing the need for stringent regulation with fostering technological innovation and growth.
- C. Training financial professionals to adapt to new technology-driven regulatory environments.
- D. Integrating cloud services seamlessly with existing financial regulatory frameworks.

The correct answer is **B**.

A significant challenge in extending macroprudential regulatory oversight to systemic technology

providers, like cloud service providers, is finding the right balance between enforcing stringent regulations and encouraging technological innovation and growth. This challenge arises because overly rigorous regulations may stifle innovation and adaptability in the rapidly evolving tech sector, which is crucial for the advancement of the financial industry. At the same time, insufficient regulation may fail to adequately mitigate the risks these technology providers bring to the financial system. Therefore, regulators must carefully navigate this balance to ensure both the security and the progressive development of the financial sector's technological infrastructure.

**A is incorrect** because while service delivery is important, the primary challenge in extending regulatory oversight is not about service continuity during compliance checks but about the broader regulatory balance with innovation.

**C is incorrect** because training financial professionals for new regulatory environments, though necessary, does not directly address the core challenge of regulatory balance in oversight of technology providers.

**D is incorrect because** the integration of cloud services with financial frameworks, while a technical concern, is not the central challenge related to regulatory oversight. The main issue lies in managing the balance between regulation and technological advancement.

### **Things to Remember**

- Macroprudential regulatory oversight focuses on monitoring and addressing risks to the financial system as a whole, rather than just individual institutions.
  - Systemic technology providers, such as cloud service providers, play a critical role in the infrastructure of the financial sector.
  - Regulatory compliance checks are essential for ensuring the stability and security of the financial system.
  - Technological innovation is a key driver of growth and efficiency in the financial industry.
  - Regulators need to strike a balance between promoting innovation and managing risks when overseeing technology providers.
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## **Reading 186: Monetary and fiscal policy: safeguarding stability and trust**

Q.6398 A country experiences a sudden surge in inflation due to external supply chain disruptions. The government responds with increased spending on infrastructure projects to stimulate economic activity. This combination of policies is *most likely* to:

- A. Strengthen the "region of stability" by aligning fiscal and monetary policy.
- B. Create tension between fiscal and monetary policy.
- C. Have no significant impact on inflation as the source is external.
- D. Primarily affect long-term economic growth without impacting short-term stability.

The correct answer is **B**.

In response to a surge in inflation caused by **external supply chain disruptions**, the government's decision to increase spending on infrastructure projects adds **fiscal stimulus** to the economy. This increase in spending can **conflict with monetary policy**, particularly if the central bank is already trying to combat inflation through tighter measures such as higher interest rates. The result is likely to exacerbate inflationary pressures because:

- Increased government spending boosts aggregate demand, which can further elevate prices in an inflationary environment.
- Supply-side constraints remain unaddressed, meaning the root cause of inflation persists while demand-side pressures increase.

**A is incorrect:** Fiscal and monetary policies are misaligned in this scenario, as fiscal expansion undermines monetary efforts to control inflation.

**C is incorrect:** While the source of inflation is external, domestic fiscal actions can still amplify inflationary pressures by increasing demand.

**D is incorrect:** Fiscal stimulus impacts short-term economic dynamics by increasing demand, especially during inflationary periods.

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Q.6399 Understanding the functions of fiscal and monetary policy is crucial to analyzing how these mechanisms influence economic activity and shape financial markets. In your assessment, how do fiscal and monetary policies operate through different channels?

- A. Fiscal policy drives short-term interest rates, while monetary policy solely influences tax structures.
- B. Fiscal policy affects economic activity via government spending and taxes, while monetary policy impacts through interest rate adjustments.
- C. Fiscal and monetary policies independently operate on fiscal spending and open market operations.
- D. Monetary policy controls employment rates and external trade flows, whereas fiscal policy primarily adjusts currency valuations.

The correct answer is **B**.

Fiscal policy influences economic activity primarily through changes in government spending and taxation, directly impacting demand by altering the money available to both consumers and businesses. In contrast, monetary policy, managed by central banks, primarily targets economic activity by adjusting interest rates and engaging in open market operations to control liquidity in the financial system. This distinction is essential for understanding how each policy mechanism affects broader economic and market dynamics.

**A is incorrect** because fiscal and monetary policies have broader functions beyond short-term rates and tax structures.

**C is incorrect** since fiscal and monetary policies do not operate independently; they are typically viewed as complementary tools.

**D is incorrect** because monetary policy goes beyond employment rates and trade flow impacts, and fiscal policy does not primarily adjust currency valuations.

### Things to Remember

- Monetary policy uses interest rates and liquidity control for economic stability.
  - Fiscal policy leverages government spending and taxes to influence economic demand.
  - Both policies are crucial for setting the economic agenda in tandem with one another.
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Q.6400 Defining the “region of stability” is vital when assessing fiscal and monetary policy dynamics in promoting macroeconomic balance. What factors define this region of stability in terms of their joint operation?

- A. Strict adherence to low debt levels and constant interest rate policies.
- B. A volatile mix of expansionary fiscal policy and restrictive monetary regulations.
- C. Harmonized fiscal expansion and accommodative monetary policy.
- D. Fiscal austerity coupled with tight monetary policies safeguarding against inflation.

The correct answer is **C**.

The "region of stability" is characterized by a dynamic alignment between fiscal and monetary policies, where fiscal expansion is matched by accommodative monetary policy. This dual approach supports economic growth and stability by expanding demand through government spending and maintaining favorable borrowing conditions via lower interest rates. This synergy helps cushion the economy against shocks and maintains financial system integrity.

**A is incorrect** because strict adherence to low debt and constant rates does not adapt to changing economic needs.

**B is incorrect** because such a volatile policy mix disrupts economic stability rather than preserving it.

**D is incorrect** as fiscal austerity and tight monetary policies could potentially stifle economic growth and recovery.

### Things to Remember

- The region of stability reflects a responsive balance between fiscal and monetary policies to promote economic well-being.
  - Coordinated policy actions enhance resilience against economic disruptions.
  - Policy adjustments are crucial in response to external shocks to maintain stability.
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Q.6401 Following a period of economic recession, a country's central bank implements quantitative easing (QE) while the government pursues expansionary fiscal policy. According to the provided material, this combination of policies is *most likely* to:

- A. Move the economy outside the "region of stability."
- B. Lead to deflationary pressures.
- C. Primarily affect exchange rates.
- D. Support economic recovery and promote growth

The correct answer is **D**.

The combination of **quantitative easing (expansionary monetary policy)** and **expansionary fiscal policy** is designed to stimulate economic recovery during or after a recession. These policies work in tandem to:

- **Increase liquidity and demand:** QE injects money into the financial system by purchasing assets, lowering interest rates, and encouraging borrowing and spending.
- **Boost aggregate demand:** Expansionary fiscal policy increases government spending or reduces taxes, directly stimulating consumption and investment.

Together, these measures aim to promote economic recovery, reduce unemployment, and encourage growth by addressing both supply-side and demand-side issues.

**A is incorrect:** The policies are aligned in their stimulative effect. Moving outside the "region of stability" would be more likely with conflicting or excessively aggressive policies.

**B is incorrect:** Expansionary policies are generally associated with inflationary, not deflationary, pressures.

**C is incorrect:** While QE and fiscal expansion can influence exchange rates, their primary goal and effect are to stimulate domestic economic activity, not to manage currency value.

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