

72. Question A research analyst at a global financial consulting firm is preparing a report on hedge funds. The report covers different hedge fund strategies, including their application, their risk and return characteristics, and how their payoffs under different circumstances compare to those of other asset classes and option strategies. Which of the following statements would be correct for the analyst to include in the report?
- A The payoff structure for a trend-following hedge fund with perfect foresight resembles that of a lookback straddle, which allows the owner to buy at the lowest price and sell at the highest.
 - B Global macro funds are backward looking and the returns they generate are highly correlated to those of equity indices.
 - C In a merger arbitrage strategy, the stock of the target company is sold short with the expectation that the merger deal fails and the target company stock loses value.
 - D The returns of event-driven distressed hedge funds tend to be positively correlated to the returns of lookback straddles and negatively correlated to the returns of high-yield bonds.

73. Question Quant Banking Corporation (QBCo) is a large financial institution based in Brazil. QBCo's core liquid assets include Brazil government bonds, cash, and foreign sovereign bonds. In addition to receiving deposits, QBCo raises funds by issuing secured short-term debt and unsecured long-term debt. The CRO of the bank is analyzing the investment committee's proposal to sell QBCo's holdings of UK government bonds and allocate the proceeds to extend new loans denominated in BRL to corporations headquartered in Brazil. The new loans would be held to maturity and fully collateralized by high quality foreign sovereign securities. The CRO estimates that UK government bonds currently account for approximately 15% of QBCo's total assets. The estimated mark-to-market values and average value-weighted durations of the bank's assets and liabilities before implementation of the proposal are given below:

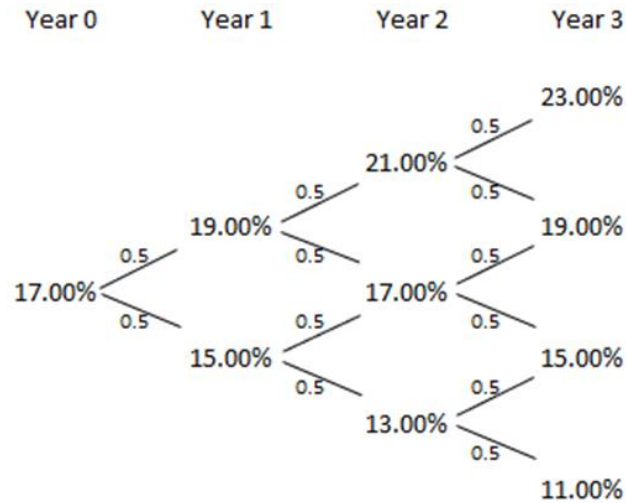
	Market value	Average value-weighted duration
Total assets	BRL 60 billion	6 years
Total liabilities	BRL 50 billion	6 years

Assuming no change to the average value-weighted duration of assets, no other changes to QBCo's asset and liability structure, and all foreign exchange exposures are fully hedged, which of the following will be correct if the bank implements the new proposal?

- A The credit quality of QBCo's assets will not necessarily decrease from issuing new loans to corporations headquartered in Brazil.
- B QBCo should manage its leverage-adjusted duration gap by taking long positions in government bond futures to address the risk of rising interest rates.
- C The trading book VaR of QBCo will show significant increase.
- D The liquidity coverage ratio of QBCo will show significant increase.

74. Question

An analyst on the emerging markets fixed-income desk of an investment bank has been asked to construct a term structure model of interest rates for one of the countries the desk covers. After conducting initial research, the analyst assumes that the 1-year spot rate for each of the next 3 years is expected to be 17.00% and that the interest rate process can be represented by the following risk-neutral interest rate tree:



Which of the following correctly describes the shape of the term structure that will result from the given interest rate tree?

- A Slightly downward sloping, since discounting the terminal cash flow over longer time periods when interest rates exhibit volatility results in slightly lower spot rates.
- B Flat, since the interest rate tree is based on the assumption that all expected 1-year spot rates are equal.
- C Slightly upward sloping, since there is an opportunity cost associated with long-term interest rates.
- D Steeply upward sloping, since investors will demand higher long-term interest rates as compensation for interest rate volatility.

75. Question The CRO of Bank Alpha is reviewing a report from the US Federal Reserve on the recent supervisory stress test performed on Bank Alpha. The report notes that while Bank Alpha continues to build its capital levels and strengthen its ability to lend during periods of stressed market conditions, the bank's recent acquisition of a large regional competitor and its growing exposure to digital assets make it vulnerable under "severely adverse" scenarios. After discussing the stress test report, Bank Alpha's board of directors asks the CRO to critically review the bank's risk management practices. A summary of the CRO's findings is given below:

- Item 1: Bank Alpha applies a counterparty's marginal default probability and the correlation of its own credit spread with the counterparty's credit spread as key inputs in stress testing counterparty credit risk.
- Item 2: Bank Alpha incorporates scenario analysis in its capital planning process but only considers scenarios that lead to the quantification of risk.
- Item 3: Bank Alpha considers that contingency funding planning stress scenarios are independent of its liquidity stress scenarios.
- Item 4: Bank Alpha complies with the regulatory requirement in sharing information about cyber-security threats with peer banks to enable regulators effectively monitor and mitigate systemic risk.

Which of the findings reported by the CRO in relation to Bank Alpha's stress testing and scenario analysis is aligned with best practices?

- A Item 1
- B Item 2
- C Item 3
- D Item 4

76. Question A credit analyst at an investment firm is estimating the 99% credit VaR of a 1-year zero-coupon bond, the only debt issued by the firm. The analyst obtains relevant data presented below:

- Face value of the firm's 1-year zero-coupon bond: CNY 630 million
- The bond's expected 1-year probability of default (PD): 6%
- The bond's 1-year recovery rate: 90%

Assuming the variation of the future value of the bond is solely due to the possibility of default, and the analyst's estimate of the value of the bond in 1 year at the 99% confidence level is CNY 567 million, what is the bond's implied 1-year 99% credit VaR?

- A CNY 2.52 million
- B CNY 3.40 million
- C CNY 3.78 million
- D CNY 6.30 million

77. Question A risk analyst at a bank is asked to prepare a report that tracks the relationship between volatility and asset performance. The analyst assesses the performance of various asset classes using empirical evidence over the last three decades and compares returns on those asset classes with changes in market volatility. Which of the following would be a correct statement for the analyst to include in the report?
- A Currency strategies such as currency carry trades tend to perform poorly during periods of high volatility.
 - B When volatility is rising, all assets are either positively or negatively affected, with the exception of risk-free bonds.
 - C Whether the relationship between stock returns and volatility is positive or negative depends on the phase of the business cycle.
 - D When volatility is rising, stock returns tend to increase but bond returns tend to decrease.

78. Question A junior risk analyst at an investment bank is using a rating migration matrix to calculate the default probability of a corporate bond issuer. The 1-year credit migration matrix is presented below:

Current rating	Rating in the next period			
	A	B	C	Default
A	90%	8%	0%	2%
B	5%	76%	10%	9%
C	1%	14%	69%	16%

Which of the following statements is correct?

- A A corporate bond that is currently rated A, and maintains the same rating up to the end of year 1, has a 1.8% chance of default in year 2.
- B A corporate bond that is currently rated B, and maintains the same rating up to the end of year 1, has an 8.1% chance of default in year 2.
- C A corporate bond that is currently rated B will default over a 2-year period with a probability of 15.9%.
- D A corporate bond that is currently rated C will default over a 2-year period with a probability of 27.0%.

79. Question An analyst at a fixed-income investment company is evaluating different ways the company uses to estimate the VaR of its corporate bond portfolios. The portfolios consist of a large number of bonds with a wide range of maturities. The analyst examines the possibility of using a mapping approach to simplify the estimation process. Which of the following statements would the analyst be correct to make regarding the approaches to mapping fixed-income portfolios?
- A The VaR estimated using the principal mapping approach understates the true risk of a portfolio since it ignores coupon payments and any risk associated with them.
 - B The VaR estimated using the duration mapping approach replaces the portfolio with a zero-coupon bond whose maturity equals the duration of the portfolio.
 - C The VaR estimated using the principal mapping approach differs from the undiversified VaR estimated using the duration mapping approach due to an adjustment made for correlations.
 - D The VaR estimated using the cash-flow mapping approach is less accurate than the VaR estimated using the duration mapping approach since it does not account for the timing of cash flows.
80. Question A packaging materials manufacturer is considering a project that has an estimated RAROC of 12%. Suppose that the risk-free rate is 4% per year, the expected market rate of return is 10% per year, and the company's equity beta is 1.6. The manufacturer uses the adjusted RAROC metric as the criterion to decide whether or not to accept the project. Which of the following correctly describes the decision the company should make and the rationale for making that decision?
- A Reject the project because the adjusted RAROC is higher than the market expected excess return.
 - B Accept the project because the adjusted RAROC is higher than the market expected excess return.
 - C Reject the project because the adjusted RAROC is lower than the risk-free rate.
 - D Accept the project because the adjusted RAROC is lower than the risk-free rate.

2025 FRM Part II Practice Exam #2 – Answer Key

1.	B	21.	C	41.	D	61.	D
2.	A	22.	B	42.	B	62.	B
3.	C	23.	A	43.	A	63.	B
4.	D	24.	A	44.	B	64.	B
5.	A	25.	C	45.	C	65.	A
6.	C	26.	C	46.	A	66.	A
7.	A	27.	B	47.	B	67.	C
8.	B	28.	B	48.	B	68.	D
9.	C	29.	C	49.	C	69.	A
10.	B	30.	D	50.	A	70.	A
11.	B	31.	B	51.	D	71.	B
12.	B	32.	B	52.	C	72.	A
13.	D	33.	B	53.	B	73.	A
14.	A	34.	B	54.	A	74.	A
15.	C	35.	B	55.	A	75.	A
16.	B	36.	C	56.	C	76.	A
17.	B	37.	A	57.	C	77.	A
18.	B	38.	D	58.	B	78.	A
19.	C	39.	C	59.	D	79.	B
20.	B	40.	B	60.	B	80.	C

1.	Question	A group of newly hired investment analysts at a large wealth management firm is undergoing training on the company's investment practices. Part of the training focuses on hedge fund investments and addresses how the firm evaluates the risk management processes and procedures of a hedge fund being considered for investment. The analysts learn that the firm performs comprehensive due diligence on the hedge fund's investment environment, as well as on its operational environment and business practices. Which of the following is correct about a hedge fund investor's due diligence on the operational environment of a hedge fund?
	A	An investor should assess the qualifications of the fund's investment team members but does not need to do the same for other fund personnel.
	B	An investor should investigate the fund's compliance practices but does not need to ensure that the fund has an in-house compliance function.
	C	An investor should review the fund documents but does not need to verify with the fund's law firm whether they are responsible for the content of these documents.
	D	An investor should ask if the fund uses third-party service providers but does not need to inquire about the fund's relationships with these service providers.
	Correct Answer	B
	Explanation	<p>B is correct. Compliance is one of the critical areas of investigation during due diligence. Most firms today have either their own in-house compliance function or an outsourced relationship with a compliance service provider.</p> <p>A is incorrect. An assessment must be made whether the operations, accounting, treasury, technology, compliance, and other personnel are truly qualified for the positions they hold and the products the fund is trading.</p> <p>C is incorrect. An investor needs to verify with the listed law firm in the fund documents that they were responsible for the original content and for any updates.</p> <p>D is incorrect. A due diligence process includes validation of a fund's internal procedures and its relationships or exposure to important service providers.</p>
	Section	Risk Management and Investment Management
	Learning Objective	Explain how due diligence can be performed on a hedge fund's operational environment.
	Reference	Kevin R. Mirabile, Hedge Fund Investing: A Practical Approach to Understanding Investor Motivation, Manager Profits, and Fund Performance, 2nd Edition (Hoboken, NJ: Wiley Finance, 2016). Chapter 12. Performing Due Diligence on Specific Managers and Funds

2.	Question	A risk manager in the stress testing group at a large bank is presenting at a conference about best practices in stress testing operational risk. The manager compares different types of stress testing approaches, including macroeconomic stress testing, parameter stress testing, and reverse stress testing. The manager then discusses the most suitable applications of each stress testing approach. Which of the following statements is the most appropriate use of the macroeconomic stress testing approach?
	A	Assessing potential changes in dependencies between different measurable and immeasurable risks faced by the bank
	B	Stress testing the operational resilience of different important business services provided by the bank
	C	Analyzing the impact of a three-standard-deviation increase in interest rates on the modeled value of the bank's bond portfolio
	D	Determining how severe a financial market crisis would need to be in order to result in the bank's insolvency
	Correct Answer	A
	Explanation	<p>A is correct. Macroeconomic stress testing is a holistic approach that aims to stress both measurable and immeasurable risks and the dependencies between them.</p> <p>B is incorrect. Reverse stress testing is more suitable for stress testing operational resilience, since the event of an intolerable disruption can be used as the predefined outcome and scenarios can then be identified that could result in this outcome. More discussion about operational resilience and its goals is found in Chapters 1 and 4, including the focus on disruptions of important business services.</p> <p>C is incorrect. This is an example of a parameter stress testing approach, which uses a statistical change in a parameter (the interest rate) to assess the impact on a modeled output.</p> <p>D is incorrect. This describes reverse stress testing, which begins with the outcome (insolvency) and assesses potential scenarios to result in that outcome.</p>
	Section	Operational Risk and Resilience
	Learning Objective	Describe elements of a stress-testing framework for financial institutions and explain best practices for stress testing.
	Reference	Global Association of Risk Professionals. Operational Risk and Resilience, New York, NY: Pearson, 2022. Chapter 7. Integrated Risk Management

3. Question A market-maker on the foreign exchange (FX) desk at an investment bank has been asked to provide a quote for an FX call option that expires in 7 months. The option has a strike price (K) to spot price (S_0) ratio of 1.075. The market-maker references the following implied volatility surface when creating the quote:

Time to expiration	Strike price to spot price ratio (K/S_0)				
	0.90	0.95	1.00	1.05	1.10
1 month	9.25	8.55	8.05	8.70	9.45
3 months	9.10	8.70	8.30	8.75	9.15
6 months	9.45	9.05	8.70	9.10	9.45
1 year	9.65	9.50	9.35	9.55	9.75

What implied volatility should the market-maker use to create the quote?

- A 9.18%
- B 9.28%
- C 9.34%
- D 9.65%

Correct Answer C

Explanation C is correct. There are two interpolations to be made to find the correct reference implied volatility. One is time and the other is the K/S_0 ratio.

To get 7-month reference implied volatilities with a K/S_0 ratio of 1.075, interpolate between 6-month and 1-year in the K/S ratios of 1.05 and 1.10.

We need to add one month's worth of the difference between the 6-month and 1-year volatilities to the 6-month volatility: $9.10 + 1/6*(9.55-9.10) = 9.175$; $9.45 + 1/6*(9.75-9.45) = 9.5$. Then average these two numbers since 1.075 is exactly between 1.05 and 1.1. Thus, $(9.175+9.5)/2=9.3375$.

A is incorrect. This uses the volatilities at the 1.05 K/S_0 ratio and only interpolates time.

B is incorrect. This uses the volatilities at 6 months and only interpolates K/S_0 .

D is incorrect. This uses the volatilities at 12 month and only interpolates K/S_0 .

Section Market Risk Measurement and Management

Learning Objective Describe volatility term structures and volatility surfaces and how they may be used to price options.

Reference John C. Hull, Options, Futures, and Other Derivatives, 11th Edition (New York, NY: Pearson, 2022). Chapter 20. Volatility Smiles

4.	Question	A midsize bank specializing in residential mortgages and credit cards is planning to offer a new commercial loan product. The bank has an existing credit rating model for its residential mortgage products which has performed well and has been successfully backtested over several years, but the CRO considers whether the bank should develop and implement a new model for the commercial loan product. In addition, the CRO wants to ensure that the bank follows best practices for the development, validation, and implementation of any models that it uses. Which of the following actions should the CRO recommend that the bank take?
	A	Apply the strongly performing existing model to the new commercial loan product given the model's successful track record.
	B	Develop a new model for the commercial loan product and avoid the use of qualitative or judgmental adjustments to the model's quantitative output.
	C	Make the model development team responsible for validating all of the bank's models that are currently operational.
	D	Perform sensitivity analysis on all models used by the bank to identify market conditions under which they might perform poorly.
	Correct Answer	D
	Explanation	<p>D is correct. Sensitivity analysis and other checks for the robustness and stability of a model should be repeated periodically. This analysis can help assess the model's performance given a wide range of market conditions and identify those conditions (such as interest rate or financial market environments) in which the model might not perform as effectively and therefore its use should be constrained under these conditions.</p> <p>A is incorrect. Even a fundamentally sound model producing accurate outputs consistent with the design objective of the model may exhibit high model risk if it is misapplied or misused. Applying a residential mortgage model to a commercial loan product would be an example of misapplication.</p> <p>B is incorrect. Best practices do not preclude the inclusion of qualitative or judgmental aspects of models. In some cases, banks may take statistical output from a model and modify it with judgmental or qualitative adjustments as part of their model development process. While such practices may be appropriate, banks should ensure that any such adjustments made as part of the development process are conducted in an appropriate and systematic manner, and are well documented.</p> <p>C is incorrect. Validation should be performed by parties who are independent of the model development team to avoid conflicts of interest.</p>
	Section	Operational Risk and Resilience
	Learning Objective	<p>Explain best practices for the development and implementation of models.</p> <p>Describe elements of an effective model risk management process.</p>
	Reference	"Supervisory Guidance on Model Risk Management," Federal Deposit Insurance Corporation, June 7, 2017

5.	Question	A portfolio manager at a US-based hedge fund has been searching for potential return opportunities in the environment of declining global interest rates experienced after the global financial crisis (GFC) of 2007-2009. The manager identifies the existence of a positive cross-currency basis between two currencies and notes that this positive basis has persisted since the GFC. What is the most appropriate explanation for this persistence?
	A	The costs for arbitrageurs to finance their positions are increasingly reflected in the basis.
	B	The costs of credit value adjustments have increased, as arbitrage positions typically eliminate counterparty risks.
	C	Regulatory changes have permitted an increase in US banks' speculative proprietary trading activities.
	D	The addition of a liquidity risk cost to swap pricing is no longer required given the decline in the overall level of interest rates in the global economy.
	Correct Answer	A
	Explanation	<p>A is correct. After the crisis, structural changes in how market participants price market, credit, counterparty, and liquidity risks tightened limits to arbitrage with the result that arbitrage now incurs a balance sheet cost which is persistent. The cost for all arbitrage participants to finance offsetting positions, are now being reflected in the FX swap basis.</p> <p>B is incorrect. The pricing of credit value adjustments has now been incorporated into the price and arbitrage positions do not always eliminate counterparty risks.</p> <p>C is incorrect. Regulatory changes such as the Volcker rule have required US banks to limit speculative proprietary trading activities. Additional regulations such as Basel III and US leverage ratios require market participants to hold capital in proportion to their derivatives and other exposures.</p> <p>D is incorrect. Liquidity risk costs need to be priced into transactions by market participants. Although overall funding costs may have decreased this does not mean that a charge is no longer required.</p>
	Section	Liquidity and Treasury Risk Management
	Learning Objective	Identify key factors that affect the cross-currency swap basis.
	Reference	Claudio Borio, Robert McCauley, Patrick McGuire, Vladyslav Sushko, 2016. "Covered Interest Parity Lost: Understanding the Cross-Currency Basis," BIS Quarterly Review.