GARP FINANCIAL RISK MANAGER (FRM) PART 1 PRACTICE EXAM (SAMPLE)

STUDY GUIDE



SAMPLE STUDY GUIDE WITH LIMITED QUESTIONS

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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.

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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!

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Questions

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1. What are the three main types of credit risk?

A. Operational risk, market risk, and liquidity risk

B. Concentration risk, migration risk, and sovereign risk

C. Default risk, concentration risk, and migration risk

D. Equity risk, interest rate risk, and credit risk

2. What is the primary objective of financial risk management?

A. To maximize returns from investments

B. To identify, assess, and mitigate potential losses

C. To ensure regulatory compliance

D. To forecast market trends

3. What is the formula to calculate the Single Monthly Mortality Rate (SMM)?

A. SMM = 1 - (1 - CPR)^(1/12)

B. SMM = CPR / 12

C. SMM = (1 - CPR)^(1/12)

D. SMM = CPR + 1

4. What is the typical sign of Delta for call options?

A. Positive

B. Negative

C. Zero

D. Indeterminate

5. What is meant by "systemic risk"?

A. The risk affecting individual companies

B. The risk of failure across an entire financial system

C. The risk of market volatility

D. The risk of operational mishaps

6. What does a high Gamma value indicate about an option?

A. High sensitivity of Delta to changes in the underlying asset price

B. High probability of exercise

C. High risk of loss

D. High returns expected

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7. What are the three main types of financial risks?

A. Market risk, inflation risk, and interest rate risk

B. Market risk, credit risk, and operational risk

C. Currency risk, market risk, and commodity risk

D. Liquidity risk, credit risk, and market risk

8. How is Precision calculated using the Confusion Matrix?

A. True/All

B. True Positive/Positive

C. True Positive/True

D. False/All

9. What is non-systematic risk?

A. The risk affecting the entire market

B. The risk specific to an industry or company

C. The risk of total market collapse

D. The risk associated with interest rates

10. What formula represents the hedge ratio in finance?

A. HR = Cov(s,f) / sigma(p)

B. HR = Cov(s,f) / Beta(s,f)

C. HR = Beta(s,f) = Cov(s,f) / sigma(p)

D. HR = Sigma(p) / Cov(s,f)

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Answers

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

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Explanations

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1. What are the three main types of credit risk?

A. Operational risk, market risk, and liquidity risk

B. Concentration risk, migration risk, and sovereign risk

C. Default risk, concentration risk, and migration risk

D. Equity risk, interest rate risk, and credit risk

The three main types of credit risk include default risk, concentration risk, and migration risk, making this the correct answer. Default risk refers to the probability that a borrower will be unable to meet their contractual obligations, such as failing to make principal or interest payments. It is the most fundamental component of credit risk since it directly impacts the lender's potential losses. Concentration risk arises when a financial institution has a significant portion of its total credit exposure in a single borrower or a group of borrowers with similar characteristics. This type of risk can lead to greater losses if the highly concentrated positions experience defaults, as the impact is magnified. Migration risk, on the other hand, pertains to the potential changes in the credit quality of borrowers or securities that can lead to a downgrade in ratings. This affects the overall portfolio's value and loss expectation, as borrowers may move into lower credit categories, increasing the likelihood of default. Understanding these aspects of credit risk is crucial for financial institutions to manage their portfolios effectively and mitigate potential losses. Other options listed do not accurately represent the key types of credit risk. For instance, operational and market risks relate to broader financial risks not limited to the credit aspect, while equity and interest rate risks pertain to different types of financial exposures

2. What is the primary objective of financial risk management?

A. To maximize returns from investments

B. To identify, assess, and mitigate potential losses

C. To ensure regulatory compliance

D. To forecast market trends

The primary objective of financial risk management is to identify, assess, and mitigate potential losses. This involves understanding the various risks that can affect an organization's financial health—such as credit risk, market risk, and operational risk—and implementing strategies to manage those risks effectively. By systematically identifying and assessing risks, organizations can take proactive measures to minimize potential negative impacts on their assets and overall performance. While maximizing returns from investments, ensuring regulatory compliance, and forecasting market trends are important aspects of financial decision-making, they are not the primary focus of risk management. The essence of financial risk management lies in its preventive approach—anticipating potential problems before they arise and putting measures in place to safeguard against them. This approach ultimately contributes to the stability and sustainability of an organization's financial operations.

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3. What is the formula to calculate the Single Monthly Mortality Rate (SMM)?

A. SMM = 1 - (1 - CPR)^(1/12)

B. SMM = CPR / 12

C. SMM = (1 - CPR)^(1/12)

D. SMM = CPR + 1

The formula for the Single Monthly Mortality Rate (SMM) is based on the Conditional Prepayment Rate (CPR). The correct formula, SMM = 1 - (1 - CPR)^(1/12), represents the probability of a mortgage loan being prepaid in a single month, considering the annualized CPR. Understanding this formula involves recognizing that the CPR is typically an annualized rate of prepayment. To convert it into a monthly rate that calculates the likelihood of prepayment in just one month, we evaluate the complement of the survival rate (1 - CPR), which indicates the proportion of loans that are not prepaid. Raising this complement to the power of (1/12) adjusts the rate from an annual basis to a monthly basis. Finally, subtracting this value from 1 gives us the probability of prepayment occurring in that month, effectively deriving the SMM. This approach captures the idea that as time progresses, the likelihood of a loan surviving without prepayment diminishes, which is essential in mortgage-backed security analysis and risk assessment. Other formulations, like simply dividing CPR by 12 or adding CPR to 1, do not accurately reflect the relationship between monthly and annual prepayment rates and therefore do not provide the correct calculation for

4. What is the typical sign of Delta for call options?

A. Positive

B. Negative

C. Zero

D. Indeterminate

The typical sign of Delta for call options is positive. Delta measures the sensitivity of an option's price to changes in the price of the underlying asset. For call options, a positive Delta indicates that as the price of the underlying asset increases, the price of the call option also tends to increase. This relationship exists because call options give the holder the right, but not the obligation, to purchase the underlying asset at a specified strike price, which becomes more valuable as the asset's price rises. A positive Delta usually ranges between 0 and 1 for call options, signifying that an increase in the underlying asset's price will lead to an increase in the option's price, reflecting the intrinsic value that the call option gains as it moves further "in-the-money." In contrast, put options typically have a negative Delta, indicating that their prices decrease as the price of the underlying asset rises. The sign of Delta provides critical insights into the behavior of options pricing and helps traders assess their positions effectively.

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5. What is meant by "systemic risk"?

A. The risk affecting individual companies

B. The risk of failure across an entire financial system

C. The risk of market volatility

D. The risk of operational mishaps

Systemic risk refers to the potential for the failure of one entity to trigger widespread disruption across an entire financial system or market. It arises from the interconnectedness of financial institutions and markets, where the distress of a single institution can lead to a chain reaction affecting many others. This risk is particularly significant during times of economic stress, where the failure of a large bank or critical financial institution can jeopardize the stability of the entire economic system. In contrast to the notion of systemic risk, the other concepts refer to more isolated risk factors. Individual company risk pertains to issues that affect a specific firm, such as bankruptcy or mismanagement, rather than the broader financial landscape. Market volatility, while important, deals with fluctuations in asset prices and does not inherently suggest systemic failure. Operational mishaps relate to internal failures within a company, such as technological failures or human error, which do not have the expansive impact that systemic risk implies.

6. What does a high Gamma value indicate about an option?

A. High sensitivity of Delta to changes in the underlying asset price

B. High probability of exercise

C. High risk of loss

D. High returns expected

A high Gamma value signifies a strong sensitivity of Delta to changes in the underlying asset price. In options trading, Delta measures how much the price of an option is expected to change when there is a $1 change in the price of the underlying asset. Gamma is the derivative of Delta with respect to the underlying price, meaning it measures the rate of change of Delta itself. When Gamma is high, it indicates that Delta will vary significantly with small changes in the underlying asset's price. This characteristic is particularly important for traders who need precise adjustments in their positions. A high Gamma can represent a scenario where the option is in-the-money or nearing the money, suggesting more volatile price movements as expiration approaches. This sensitivity allows traders to better manage their risk and make an informed decision about option strategies, particularly around key market movements. The other choices do not accurately reflect the implications of a high Gamma value. High probability of exercise, high risk of loss, and high returns expected relate to different concepts in option pricing and risk management, rather than to the sensitivity of Delta to changes in the price of the underlying asset.

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7. What are the three main types of financial risks?

A. Market risk, inflation risk, and interest rate risk

B. Market risk, credit risk, and operational risk

C. Currency risk, market risk, and commodity risk

D. Liquidity risk, credit risk, and market risk

The three main types of financial risks are market risk, credit risk, and operational risk. Market risk arises from fluctuations in the value of investments due to changes in market conditions. This encompasses various factors such as price volatility in stock markets, interest rates, and foreign exchange rates that can affect the overall market environment. Credit risk involves the potential for loss due to a borrower's failure to repay a loan or meet contractual obligations. This is particularly important for financial institutions and investors, as it directly impacts their profitability and stability. Operational risk is related to failures in internal processes, people, and systems, or from external events. This can include anything from technical failures to fraud, and it highlights the risk that arises from day-to-day operations. Together, these risks represent significant concerns for financial institutions and firms, requiring comprehensive risk management strategies to mitigate their impact. Understanding these categories allows practitioners to better assess and manage the various challenges that financial entities may face.

8. How is Precision calculated using the Confusion Matrix?

A. True/All

B. True Positive/Positive

C. True Positive/True

D. False/All

Precision is a crucial metric for evaluating the performance of a classification model, particularly in contexts where the positive class is of primary interest. Precision specifically measures the accuracy of positive predictions made by the model. To understand how it is calculated using the Confusion Matrix, it's essential to recognize the components involved. In a Confusion Matrix, the key terms include: - True Positives (TP): The number of correctly predicted positive instances. - False Positives (FP): The number of incorrectly predicted positive instances. - True Negatives (TN): The number of correctly predicted negative instances. - False Negatives (FN): The number of incorrectly predicted negative instances. Precision is defined mathematically as: \[\text{Precision} = \frac{\text{True Positives (TP)}}{\text{True Positives (TP)} + \text{False Positives (FP)}} \] This formula indicates that precision focuses specifically on the positive class predictions made by the model, assessing how many of those predictions were actually correct (True Positives) in relation to all instances that were predicted as positive (True Positives + False Positives). This is particularly useful in scenarios where the cost of a false positive is high, as it directly informs how many

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9. What is non-systematic risk?

A. The risk affecting the entire market

B. The risk specific to an industry or company

C. The risk of total market collapse

D. The risk associated with interest rates

Non-systematic risk refers to the type of risk that is specific to a particular company or industry, rather than the overall market. It encompasses factors such as management decisions, operational performance, or competitive pressures that affect only that specific entity. For example, if a company faces a lawsuit or a data breach, this risk only impacts that company and not the broader market. Investors can mitigate non-systematic risk through diversification, which involves spreading investments across various industries or companies so that the negative performance of one does not significantly impact the overall portfolio. This contrasts with systematic risk, which influences the entire market, such as economic recessions or interest rate changes, and cannot be easily mitigated through diversification. Understanding the nature of non-systematic risk is crucial for effective risk management within investment strategies.

10. What formula represents the hedge ratio in finance?

A. HR = Cov(s,f) / sigma(p)

B. HR = Cov(s,f) / Beta(s,f)

C. HR = Beta(s,f) = Cov(s,f) / sigma(p)

D. HR = Sigma(p) / Cov(s,f)

The hedge ratio is a crucial concept in finance, particularly in the context of risk management and derivatives trading. It measures the proportion of a position being hedged relative to the exposure being hedged, allowing for a strategic reduction of risk. The correct formula for the hedge ratio is expressed as Beta(s,f) = Cov(s,f) / sigma(p). In this context, Beta represents the sensitivity of the asset's price relative to the price movements of a benchmark or market portfolio. Specifically, it reflects how much the price of an asset (the security) is expected to change when the price of the benchmark (the asset to which it is compared) changes. The covariance (Cov(s,f)) quantifies the degree to which two variables move in relation to each other—in this case, the security and the factor it is being hedged against. Meanwhile, sigma(p), which represents the volatility of the price of the benchmark, serves as a normalization factor, allowing the hedge ratio to be calculated effectively. Having the hedge ratio defined in terms of Beta makes it clear how the asset's risk aligns with the overall market risk represented by the benchmark. This can be particularly useful when constructing a hedging strategy, as it allows traders and risk managers to tailor their positions

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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:

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

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