Chapter 1
An Overview of the Changing Financial-Services Sector

Fill in the Blank Questions

1. ________________________ is a traditional service provided by banks in which the banks store the valuables of their customers and certify their true value.
   Answer: Safekeeping of valuables

2. The fact that financial institutions make loans based on confidential information is the ________________________ theory of banking.
   Answer: delegated monitoring

3. ________________________ refers to when a financial institution trades one form of currency for another. An example of this would be when the bank trades dollars for yen for a fee.
   Answer: currency exchange

4. A(n) ________________________ is a traditional service which permits a depositor to write a draft in payment for goods and services.
   Answer: demand deposit (checking account)

5. ________________________ is a service provided by banks where the bank lends money to individuals for the purchase of durable and other goods.
   Answer: Consumer lending

6. The ________________________ of a bank is a traditional service where the bank manages the financial affairs and property of individuals (and in some cases businesses).
   Answer: trust services

7. Companies such as Merrill Lynch and Sears which offered some but not all banking services in the 1980s were called ______________________.
   Answer: nonbank banks

8. The loosening of government regulation and control of financial institutions is called ______________________.
   Answer: deregulation

9. ___________________________ is an alternative to lending in which the financial institution purchases the equipment and rents it to its customers.
   Answer: Equipment leasing services

10. The__________________________ is a landmark act which allows financial service providers to offer an expanded menu of financial services for the customer. This law allows banks to truly become conglomerate financial service providers.
    Answer: Financial Services Modernization Act (Gramm-Leach-Bliley Act)

11. The country with the most banks is ______________________.
    Answer: United States

12. According to Congress a ____________ is defined as any institution that can qualify for deposit insurance administered by the FDIC.
    Answer: Bank

13. A bank which spans regions, nations, and continents, offering the widest menu of financial services is known as a __________bank.
    Answer: money-center bank

14. _____________ refers to the movement of businesses across industry lines in order to broaden its base.
    Answer: Convergence

15. Banks which serve primarily households and small firms are known as ____________ banks.
    Answer: retail

16. Banks that sell deposits and make loans to businesses and individuals are known as ______banks.
    Answer: commercial

17. Banks which underwrite issues of new securities for their corporate customers are known as ________ banks.
    Answer: investment

18. Banks which function under a federal charter through the Comptroller of the Currency in the United States are known as ____________ banks.
Answer: National

19. Banks which supply both debt and equity capital to businesses are known as _________ banks.
Answer: merchant

20. A bank that offers its services only over the internet is known as a(n) _____________ .
Answer: virtual bank

21. When a local merchant sells the accounts receivables they hold against their customer to a bank this generally known as _____________________________.
Answer: discounting commercial notes

22. A(n) _______________________ offers loans to commercial enterprises (such as appliance dealers) or to individuals using funds borrowed in the open market or from other financial institutions. Examples of this type of financial service provider include GMAC Financial Services and Household Finance.
Answer: finance company

23. A(n) _______________________ buys and sells securities on behalf of their customers and for their own accounts. Examples of this type of financial service provider include Merrill Lynch and Charles Schwab.
Answer: security broker (or dealer)

24. A(n) ______________________________ sells shares mainly to upscale investors in a broad group of different kinds of assets including nontraditional investments in commodities, real estate, loans to ailing companies and other risky assets.
Answer: hedge fund

25. When a bank agrees to handle the cash collections and disbursements for a company and invest any temporary cash surpluses in interest bearing assets, they are providing ___________ services to their customers.
Answer: cash management

True/False Questions

T F 26. Under U.S. federal law, an institution making only loans to households and offering uninsured checkable deposits and savings deposits qualifies as a commercial bank.
Answer: False

T F 27. Nonbank banks can offer deposits to the public, but these deposits are not eligible for insurance coverage by the FDIC.
Answer: False

T F 28. The etymological roots of the word "bank" trace this word back to an Italian term referring to a **"money-changer's table".**
Answer: True

T F 29. According to the textbook, banks are those financial institutions that today offer the widest range of financial services of any business firm in the economy.
Answer: True

T F 30. According to the delegated monitoring theory banks are able to attract borrowing customers because they pledge confidentiality.
Answer: True

T F 31. Managing the financial affairs and property of individuals and business firms falls under the type of banking service line known as <u>cash management services.</u>
Answer: False

T F 32. The role performed by banks in the economy in which they transform savings into credit is known as the <u>intermediation role.</u>
Answer: True

T F 33. The role performed by banks in which they stand behind their customers when those customers are unable to pay a debt obligation is known as the <u>guarantor role.</u>
Answer: True

T F 34.When banks serve as conduits for government policy this is referred to as their <u>agency role.</u>
Answer: False

T F 35. According to the textbook, high-volume banking is required to make efficient use of automation and other technological innovations.
Answer: True

T F 36. The number of independently owned banks has risen in the United States over the last decade.
Answer: False

T F 37. Money-center banks usually service local communities, towns, and cities, offering a narrow menu of services to the public.
Answer: False

T F 38. A greater proportion of major corporations have deserted the banking system in recent years to raise borrowed funds directly from the open market.
Answer: True

T F 39. The recent erosion of the banking market share relative to other financial institutions means that banking is a dying industry.
Answer: False

T F 40. Lending institutions act as delegated monitors and can diversify and reduce their risk exposure, resulting in increased safety for savers' funds.
Answer: True

T F 41. Current theory suggests that banks exist because of imperfections in our financial system.
Answer: True

T F 42. Today U.S. banks account for approximately fifty percent of the largest banks in the world.
Answer: False

T F 43. According to the textbook, traditional banking may be on the decline.
Answer: True

T F 44. Convergence refers to the fact that the number of bank mergers has increased in recent years.
Answer: False

T F 45. Banks which offer virtually all financial services are known as **universal banks**.
Answer: True

T F 46. Life insurance companies, securities firms, and mortgage companies all compete with the traditional bank.
Answer: True

Multiple Choice Questions

47. In the United States a commercial bank qualifies as a "bank" under federal law if it offers:
    A) Consumer installment loans, CDs
    B) Savings deposits, commercial loans
    C) Checking accounts, commercial loans
    D) Security investments, inventory loans to business customers
    E) Commercial deposit accounts, consumer savings plans
    Answer: C

48. E. F. Hutton, J.C. Penney, and Sears Roebuck are among leading firms that in the1980's organized competitors with banks that are known as:
    A) Nonbank Banks
    B) Discount Security Brokerage Companies
    C) Money Market Funds
    D) Finance Companies
    E) Investment Banking Units
    Answer: A

49. A study of history shows that one of the first services offered by banks was:
    A) Equipment Leasing
    B) Currency Exchange
    C) Security Brokerage and Underwriting
    D) Sale of Real Estate
    E) None of the above
    Answer: B

50. Banks perform the indispensable task of:
    A) Creating money without making loan.
    B) Absorbing the excess liquidity created by other financial institutions
    C) Intermediating between surplus-spending individuals or institutions and deficit-spending individuals or institutions
    D) Issuing risky deposits
    E) None of the above
    Answer: C

51. The view that depositors hire banks to analyze the financial condition of prospective borrowers and continually evaluate the condition of outstanding loans is referred to as:
    A) Delegated monitoring
    B) The concept of financial intermediation

C) The liquidity function in banking
D) Market imperfection theory
E) The efficiency contribution of banking
Answer: A

52. Which of the following has been an important trend regarding consolidation and geographic expansion in banks?
A) Increased bank branching activity
B) The formation of more holding companies to purchase smaller banks
C) Mergers among some of the largest banks in the industry
D) A and C above
E) All of the above.
Answer: E

53. Included among leading structural trends in the U.S. banking industry in recent years are:
A) The number of independently owned banks has declined
B) The average size of individual banking firms has increased
C) Entry across state lines from neighboring states has increased
D) A and B only
E) All of the above.
Answer: E

54. Smaller, locally focused commercial and savings banks that offer narrower but more personalized menu of financial services are known as:
A) Money center banks
B) Community banks
C) Mutual Funds
D) State banks
E) Fringe banks.
Answer: B

55. The banking services that includes executing buy and sell orders for security trading customers and marketing new securities to raise funds for corporations and other institutions is referred to:
A) Comprehensive Packaging
B) Wrap-around Accounts
C) Investment Banking
D) Professional Banking
E) None of the above.
Answer: C

56. A bank that wires funds for the purchase of a beach house in South Carolina for a customer in Oklahoma is carrying out the __________ of banks.
A) The intermediation role
B) The payment role
C) The guarantor role
D) The agency role

E) The policy role
Answer: B

57. Examples of imperfections in the financial system which allow banks to exist include which of the following?
A) Informational asymmetry
B) Efficiency of markets
C) All individuals and businesses have full information about all investment opportunities.
D) All individuals and businesses have no difficulty meeting their liquidity needs on their own.
E) All of the above are examples of the imperfections that exist.
Answer: A

58. A bank which manages the investment portfolio and pays the bills of an elderly customer who is unable to do it for him or herself is carrying out the __________ of banks.
A) The intermediation role
B) The payment role
C) The guarantor role
D) The agency role
E) The policy role
Answer: D

59. Which of the following is a trend that has affected all banks today?
A) Increased isolation of banks in the U.S.
B) Decreased competition from other financial institutions
C) Decreased amount of services provided by modern banks
D) Rising funding costs
E) Increased regulations
Answer: D

60. Which of the following is **not** a current trend in the banking industry?
A) The number of banks is declining
B) The number of bank branches is declining
C) The number of bank services is increasing
D) The number of bank competitors is increasing
E) Bank industry convergence
Answer: B

61. Which of the following types of banks would most likely offer the largest number of financial services?
   A) A retail bank
   B) A community bank
   C) A commercial bank
   D) A universal bank
   E) An international bank
   Answer: D

62. The phenomenon of **convergence** refers to:
   A) Financial service firms expanding into other product lines
   B) Firms reducing their product lines
   C) Bank merger activity
   D) Globalization in banking
   E) Technological innovation in banking
   Answer: A

63. Bank equipment leasing activity involves:
   A) A bank leasing its office facilities instead of buying
   B) A bank buying equipment and then leasing the item to a customer
   C) A customer buying equipment and then leasing it to a bank
   D) A bank leasing computer equipment
   E) None of the above
   Answer: B

64. Wholesale banks are those banks that:
   A) Sell at a discount relative to all commercial banks
   B) Only make loans to the wholesale industry
   C) Lend almost exclusively to farmers
   D) Are large banks which serve corporations and government
   E) Have only retail customers
   Answer: D

65. Jonathan Robbins has an account in a bank that does not have a physical branch. Jonathan does all of his banking business over the internet. What type of bank does Jonathan have his account at?
   A) Virtual Bank
   B) Mortgage Bank
   C) Community Bank
   D) Affiliated Bank
   E) None of the above
   Answer: A

66. The Edmond National Bank serves only the City of Edmond, Oklahoma and concentrates on providing the best possible service to this city. What type of bank is this most likely to be?

A) Virtual Bank
B) Mortgage Bank
C) Community Bank
D) Affiliated Bank
E) None of the above
Answer: C

67. The Charleston Southern Bank makes loans for families to purchase new and existing homes but does not take deposits. What type of bank is this most likely to be?
A) Virtual Bank
B) Mortgage Bank
C) Community Bank
D) Affiliated Bank
E) None of the above
Answer: B

68. Which of the following is considered a fringe bank?
A) Community Bank
B) Wholesale Bank
C) Merchant Bank
D) Payday Lender
E) None of the above
Answer: D

69. During the middle ages, banks encountered religious opposition because:
A) Loans to the poor often carried high interest rates
B) Loans and deposits were primarily for wealthy customers
C) The Industrial Revolution demanded new methods of making payments and obtaining credit
D) Savings and wealth were lost due to war, theft and expropriation by governments
E) All of the above
Answer: A

70. Religious opposition decreased during the Renaissance because:
A) Loans to the poor often carried high interest rates
B) Loans and deposits were primarily for wealthy customers
C) The Industrial Revolution demanded new methods of making payments and obtaining credit
D) Savings and wealth were lost due to war, theft and expropriation by governments
E) All of the above
Answer: B

71. Banks like the Medici Bank in Italy and the Hochstetter Bank in Germany were successful because____ and they responded well to these new needs.
A) Loans to the poor often carried high interest rates
B) Loans and deposits were primarily for wealthy customers
C) The Industrial Revolution demanded new methods of making payments and obtaining credit

D) Savings and wealth were lost due to war, theft and expropriation by governments
E) All of the above
Answer: C

72. Early European banks were places for safekeeping of wealth because:
A) Loans to the poor often carried high interest rates
B) Loans and deposits were primarily for wealthy customers
C) The industrial revolution demanded new methods of making payments and obtaining credit
D) Savings and wealth were lost due to war, theft and expropriation by governments
E) All of the above
Answer: D

73. The U.S. government wants to prevent money laundering by drug cartels. To promote this goal, they have asked banks to report any cash deposits greater than $10,000 to the government. Which of the following roles is the bank performing?
A) The intermediation role
B) The payment role
C) The risk management role
D) The guarantor role
E) The policy role
Answer: E

74. The Edmond Wine and Cheese shop wants to buy 30 cases of French Champagne on credit. Bank of America writes a letter of credit stating that the Edmond Wine and Cheese shop is a good risk and that if they do not pay off the loan, Bank of America will. Which of the following roles is the bank performing?
A) The intermediation role
B) The payment role
C) The risk management role
D) The guarantor role
E) The policy role
Answer: D

75. Alexander Phua goes to his local bank and gets an insurance policy that protects him against loss in case he is in a car accident. Which of the following roles is the bank performing?
A) The intermediation role
B) The payment role
C) The risk management role
D) The guarantor role
E) The policy role
Answer: C

76. Chris Jones gets a cashier's check from Wachovia Bank to make his down payment on a new home. Which of the following roles is the bank performing?
A) The intermediation role
B) The payment role

C) The risk management role
D) The guarantor role
E) The policy role
Answer: B

77. The Bank, N.A. accepts deposits from thousands of individuals and lends that money to (among others) the Stillwater Body Shop to expand their work bays. Which of the following roles is the bank performing?
A) The intermediation role
B) The payment role
C) The risk management role
D) The guarantor role
E) The policy role
Answer: A

78. Major trends affecting the performance of financial firms today include all of these *except*:
A) Greater product-line diversification
B) Reduced branching
C) Geographic diversification
D) Convergence
E) Increasing automation
Answer: B

79. The First National Bank of Lakeland makes risky loans to business to expand and grow their businesses while at the same time accepting funds into checking accounts that are insured by the FDIC. Which of the following services is this bank offering to their customers?
A) Risky arbitrage services
B) Liquidity services
C) Ability of the bank to evaluate information
D) Divisibility of money services
E) Credit services
Answer: A

80. Jonathan Wynn knows that if he wanted to purchase a Treasury Bill, the minimum amount he would spend would be close to $10,000. He also knows that he could deposit $1,000 in a money market deposit account at a bank and earn about the same rate of interest. Jonathan does not have $10,000 to invest in a Treasury Bill. If Jonathan puts his money in the bank, which service that a bank can provide is he taking advantage of?
A) Risky arbitrage services
B) Liquidity services
C) Ability of the bank to evaluate information
D) Divisibility of money services
E) Credit services
Answer: D

81. Nick Rodr gets a loan from the First State Bank of Guthrie to purchase a new refrigerator for his

condo. What service that a bank provides is he taking advantage of?
A) Risky arbitrage services
B) Liquidity services
C) Ability of a bank to evaluate information
D) Divisibility of money services
E) Credit services
Answer: E

82. Drew Davis goes to his local bank to get help developing a financial plan and making investment decisions. Which of the more recent services banks offer is Drew taking advantage of?
A) Getting a consumer loan
B) Getting financial advice
C) Managing cash
D) Getting venture capital services
E) Buying a retirement plan
Answer: B

83. The Bartholemew Bakery receives a lot of payments in cash. They deposit it in their local bank who invests the money in an interest bearing account until it is needed to pay bills. Which of the financial services banks offer is the Bartholemew bakery taking advantage of?
A) Getting a consumer loan
B) Getting financial advice
C) Managing cash
D) Getting venture capital services
E) Buying a retirement plan
Answer: C

84. MyWebCast is a new company that makes it easy for individuals to create streaming videos on the internet to share with friends and family for a small fee. MyWebCast wants to expand their offerings of video streaming services but needs cash to be able to do this. The Second National Bank of Oklahoma City, through a subsidiary, gives them the cash they need for an ownership share in the company. Which of the more recent services that banks offer is MyWebCast taking advantange of?
A) Getting a consumer loan
B) Getting financial advice
C) Managing cash
D) Getting venture capital services
E) Buying a retirement plan
Answer: D

85. Chandriga Suppiah has opened a Roth IRA with North Carolina State Bank and plans on making regular contributions to this account until she retires. Which of the financial services is Chandriga taking advantage of?
A) Getting a consumer loan
B) Getting financial advice
C) Managing cash
D) Getting venture capital services

E) Buying a retirement plan
Answer: E

86. Banks with less than ___________in assets are generally called community banks.
A) More than $1 billion
B) Less than $1 billion
C) More than $10 billion
D) Less than $1 trillion
E) More than $1 trillion
Answer: B

87. The principal functions and services offered by many financial-service firms today include:
A) Lending and investing money
B) Making payments of behalf of customers to facilitate their purchases of goods and services
C) Managing and protecting customers' cash and other property
D) Assisting customers in raising and investing funds profitably
E) All of the above
Answer: E

88. Which of the following is considered a depository financial institution?
A) Mortgage company
B) Mutual fund
C) Savings and Loan associations
D) Federal Reserve
E) Insurance company
Answer: C

89. Which of the following is not a purpose of bank regulation:
A) Guarantee minimal profitability of the banking system
B) Provide monetary stability
C) Ensure safety and soundness of banks
D) Provide competitive financial system
E) Protect consumers from abuses by banks
Answer: A

90. During the financial crisis of 2007-2009, the collapse of Lehman Brothers and the bailout of Bear Stearns reaffirmed the importance of the fundamental principle of:
A) Superior management
B) Globalization
C) Government bailout
D) Regulatory arbitrage
E) Public trust and confidence in the system
Answer: E

Chapter 2
The Impact of Government Policy and Regulation on the Financial-Services Industry

Fill in the Blank Questions

1. The ________________________ was created as part of the Glass Steagall Act. In the beginning it insured deposits up to $2,500.
   Answer: FDIC

2. The________________________ is the law that states that a bank must get approved from their regulatory body in order to combine with another bank.
   Answer: Bank Merger Act

3. One tool that the Federal Reserve uses to control the money supply is ___________________.
   The Federal Reserve will buy and sell T-bills when they are using this tool of monetary policy.
   Answer: open market operations

4. The__________________________ was created in 1913 in response to a series of economic depressions and failures. Its principal role is to serve as the lender of last resort and to stabilize the financial markets.
   Answer: Federal Reserve

5. The __________________________ prevented banks from crossing state lines and made national banks subject to the branching laws of their state. This act was later repealed by the Riegle Neal Interstate Banking law.
   Answer: McFadden-Pepper Act

6. Because the FDIC levies fixed insurance premiums regardless of risk, this leads to a problem called the ______________________ among banks. The fixed premiums encourage all banks to accept greater risk.
   Answer: moral hazard

7. In 1980, __________________________ was passed and lifted government ceilings on deposit interest rates in favor of free market interest rates.
   Answer: DIDMCA

8. One tool that the Federal Reserve uses to control the money supply is ___________________. The Federal Reserve will change the interest rate they charge for short term loans when they are using this tool of monetary policy.
Answer: changing the discount rate

9. The first major federal banking law in the U.S. was the __________________________. This law was passed during the Civil War and set up a system for chartering national banks and created the OCC.
Answer: National Banking Act

10. The_________________________ was passed during the Great Depression. It separated investment and commercial banks and created the FDIC.
Answer: Glass-Steagall Act

11. The__________________________ brought bank holding companies under the jurisdiction of the Federal Reserve.
Answer: Bank Holding Company Act

12. The__________________________ allows bank holding companies to acquire banks anywhere in the United States. However, no one bank can control more than 30 percent of the deposits in any one state or more than 10 percent of the deposits across the country.
Answer: Riegle-Neal Interstate Banking Act

13. The _________________________ allows banks to affiliate with insurance companies and securities firms either through a holding company or as a subsidiary.
Answer: Gramm-Leach-Bliley Act (Financial Services Modernization Act)

14. Customers of financial-service companies may _____________________ of having their private information shared with a third party such as a telemarketer. However, in order to do this they must tell the financial-services company in writing that they do not want their personal information shared with outside parties.
Answer: opt out

15. The federal bank regulatory agency which examines the most banks is the ______________.
Answer: FDIC

16. The _________________ requires financial service companies to report suspicious activity in customer accounts to the Treasury Department.
Answer: U.S. Patriot Act

17. The central bank of the new European Union is known as the ________________________.
Answer: European Central Bank or ECB

18. The ______________________ Act prohibits banks and other publicly owned firms from publishing false or misleading financial performance information.
Answer: Sarbanes-Oxley

19. One of the main roles of the Federal Reserve today is ________________. They have three tools that they use today to carry out this role; open market operations, the discount rate and legal reserve requirements.
Answer: monetary policy

20. The __________________________ is the center of authority and decision making within the Federal Reserve. It consists of seven members appointed by the president for terms not exceeding 14 years.
Answer: Board of Governors

21. The main regulators of insurance companies are ___________________________ .
Answer: state insurance commissions

22. Federal Credit Unions are regulated and examined by ______________________.
Answer: the National Credit Union Administration.

23. The ___________________________ makes it easier for victims of identity theft to file fraud alerts and allows the public to apply for a free credit report once a year.
Answer: Fair and Accurate Credit Transactions Act (FACT Act)

24. The _____________________________ makes it faster and less costly for banks to clear checks. It allows for banks to electronically send check images instead of shipping paper checks across the country.
Answer: Check 21 Act

25. The _____________________________ was created by the National Banking Act and is part of the Treasury Department. It is the primary regulator of National Banks.
Answer: Office of the Comptroller of the Currency (OCC)

26. The __________________________ proposes various regulations applying to the financial markets to combat the recent credit crisis. This "bail-out" bill granted the US Treasury the means to purchase troubled loans, allowed the FDIC to temporarily increase deposit insurance, and permitted the government to inject additional capital into the banking system.
Answer: The Emergency Economic Stabilization Act of 2008

True/False Questions

T F 27. Federal Reserve Act authorized the creation of the Federal Deposit Insurance Corporation.
Answer: False

T F 28. In the United States, fixed fees charged for deposit insurance, regardless of how risky a bank is, led to a problem known as moral hazard.
Answer: True

T F 28. Government-sponsored deposit insurance typically encourages individual depositors to monitor their banks' behavior in accepting risk.
Answer: False

T F 29. The Federal Reserve changes reserve requirements frequently because the affect of these changes is so small.
Answer: False

T F 30. The Bank Merger Act and its amendments requires that Bank Holding Companies be under the jurisdiction of the Federal Reserve.
Answer: False

T F 31. National banks cannot merge without the prior approval of the Comptroller of the Currency.
Answer: True

T F 32. The Truth in Lending (or Consumer Credit Protection) Act was passed by the U.S. Congress to outlaw discrimination in providing bank services to the public.
Answer: False

T F 33. The federal law that states individuals and families cannot be denied a loan merely because of their age, sex, race, national origin or religious affiliation is known as the Competitive Equality in Banking Act.
Answer: False

T F 34. Under the terms of the 1994 Riegle-Neal Interstate Banking law bank holding companies can acquire a bank anywhere inside the United States, subject to Federal Reserve Board approval.
Answer: True

T F 35. The 1994 federal interstate banking bill does not limit the percentage of statewide or nationwide deposits that an interstate banking firm is allowed to control.

Answer: False

T F 36. The term "regulatory dialectic" refers to the dual system of banking regulation in the United States and selected other countries where both the federal or central government and local governments regulate banks.
Answer: False

T F 37. The moral hazard problem of banks is caused by the fixed insurance premiums paid by banks and causes banks to accept greater risk.
Answer: True

T F 38. When the Federal Reserve buys T-bills through its open market operations, it causes the growth of bank deposits and loans to decrease.
Answer: False

T F 39. When the Federal Reserve increases the discount rate it generally causes other interest rates to decrease.
Answer: False

T F 40. The National Bank Act (1863) created the Federal Reserve which acts as the lender of last resort.
Answer: False

T F 41. FIRREA (1989) allowed bank holding companies to acquire nonblank depository institutions and, if desired, convert them into branch offices.
Answer: True

T F 42. The Sarbanes-Oxley Act allows banks, insurance companies, and securities firms to form Financial Holding Companies (FHCs).
Answer: False

T F 43. The Gramm-Leach-Bliley Act of 1999 essentially repeals the Glass-Steagall Act passed in the 1930s.
Answer: True

T F 44. Passed in 1977, the Equal Credit Opportunity Act prohibits banks from discriminating against customers merely on the basis of the neighborhood in which they live.
Answer: False

T F 45. The tool used by the Federal Reserve System to influence the economy and behavior of banks is known as moral hazard.

Answer: False

T F 46. One of the principal reasons for government regulation of financial firms is to protect the safety and soundness of the financial system.
Answer: True

Multiple Choice Questions

47. Banks are regulated for which of the reasons listed below?
A) Banks are leading repositories of the public's savings.
B) Banks have the power to create money.
C) Banks provide businesses and individuals with loans that support consumption and investment spending.
D) Banks assist governments in conducting economic policy, collecting taxes and dispensing government payments.
E) All of the above.
Answer: E

48. An institutional arrangement in which federal and state authorities both have significant bank regulatory powers is referred to as:
A) Balance of Power
B) Federalism
C) Dual Banking System
D) Cooperative Regulation
E) Coordinated Control
Answer: C

49. The law that set up the federal banking system and provided for the chartering of national banks was the:
A) National Bank Act
B) McFadden-Pepper Act
C) Glass-Steagall Act
D) Bank Merger Act
E) Federal Reserve Act
Answer: A

50. The federal law that prohibited federally supervised commercial banks from offering investment banking services on privately issued securities is known as:
A) The Glass-Steagall Act
B) The Bank Merger Act
C) The Depository Institutions Deregulation and Monetary Control Act
D) The Federal Reserve Act
E) None of the Above
Answer: A

51. The Gramm-Leach-Bliley Act (Financial Services Modernization Act) calls for linking

government supervision of the financial-services firm to the types of activities that the firm undertakes. For example the insurance portion of the firm would be regulated by state insurance commissions and the banking portion of the firm would be regulated by banking regulators. This approach to government supervision of financial services is known as:

A) Consolidated regulation and supervision.
B) Functional regulation.
C) Services oversight.
D) Umbrella supervision and regulation.
E) None of the above.
Answer: B

52. The Federal Reserve policy tool under which the Fed attempts to bring psychological pressure to bear on individuals and institutions to conform to the Fed's policies, using letters, phone calls, and speeches, is known as:
A) Margin requirements
B) Moral suasion
C) Discount window supervision
D) Conference and compromise
E) None of the above.
Answer: B

53. The 1994 law that allowed bank holding companies to acquire banks anywhere in the U.S. is:
A) The Glass-Steagall Act
B) The Federal Deposit Insurance Corporation Improvement Act
C) The National Bank Act
D) The Riegle-Neal Interstate Banking and Branching Efficiency Act.
E) None of the above.
Answer: D

54. The federal law that allowed the Federal Reserve to set margin requirements is:
A) The National Banking Act.
B) The McFadden-Pepper Act.
C) The Glass Steagall Act.
D) The Federal Reserve Act.
E) None of the above.
Answer: C

55. Of the principal reasons for regulating banks, what was the primary purpose of the National Banking Act (1863)?
A) Protection of the public's savings
B) Control of the money supply
C) Providing support for government activities
D) Maintaining confidence in the banking system
E) Preventing banks from realizing monopoly powers
Answer: C

56. Of the principal reasons for regulating banks, what was the primary purpose of the Federal Reserve Act of 1913?
A) Protection of the public's savings
B) Control of the money supply
C) Preventing banks from realizing monopoly powers
D) Ensuring an adequate and fair supply of loans
E) None of the above.
Answer: B

57. The law that allows lifted government deposit interest ceilings and allowed them to pay a competitive interest rate is:
A) The National Banking Act.
B) The Glass Steagall Act.
C) The Bank Merger Act.
D) DIDMCA
E) None of the above.
Answer: D

58. The law that allows banks to affiliate with insurance companies and security brokerage firms to form financial services conglomerates is
A) The National Banking Act
B) The Glass Steagall Act
C) The Garn St. Germain Act
D) The Riegle Neal Interstate Banking Act
E) The Gramm-Leach-Bliley Act (Financial Services Modernization Act)
Answer: E

59. Of the principal reasons for regulating banks, what was the primary purpose of the Truth in Lending Law?
A) Protection of the public's savings
B) Control of the money supply
C) Preventing banks from realizing monopoly powers
D) Ensuring an adequate and fair supply of loans
E) None of the above.
Answer: D

60. Which of the following is an unresolved issue in the new century?
A) What should be done about the regulatory safety net set up to protect small depositors?
B) If financial institutions are allowed to take on more risk, how can taxpayers be protected from paying the bill when more institutions fail?
C) Does functional regulation actually work?
D) Should regulators allow the mixing of banking and commerce?
E) All of the above are unresolved issues
Answer: E

61. The law that made bank and nonbank depository institutions more alike in the services they could

offer and allowed banks and thrifts to more fully compete with other financial institutions is:
A) The National Banking Act
B) The Federal Reserve Act
C) The Garn-St. Germain Act
D) The Riegle-Neal Interstate Banking and Branching Efficiency Act
E) The Gramm-Leach-Bliley Act (Financial Services Modernization Act)
Answer: C

62. The law that allowed bank holding companies to acquire nonbank depository institutions and convert them to branches is:
A) The National Banking Act
B) The Garn-St. Germain Act
C) FIRREA
D) The Riegle-Neal Interstate Banking and Branching Efficiency Act
E) None of the Above
Answer: C

63. The equivalent of the Federal Reserve System in Europe is known as the:
A) European Union
B) Bank of London
C) Basle Group
D) European Central Bank
E) Swiss Bank Corporation
Answer: D

64. The new financial organization created by Gramm-Leach-Bliley is the
A) Financial Holding Company
B) Bank Holding Company
C) European Central Bank
D) Financial Service Corporation
E) Financial Modernization Organization
Answer: A

65. The act which requires financial institutions to share information about customer identities with government agencies is:
A) The Sarbanes-Oxley Act
B) The U.S. Treasury Department Act
C) The 9/11 Act
D) The USA Patriot Act
E) The Gramm-Leach-Bliley Act
Answer: D

66. The 1977 law that prevents banks from "redlining" certain neighborhoods, refusing to serve those areas is:
A) The National Banking Act
B) The Garn-St. Germain Act
C) FIRREA

D) The Riegle-Neal Interstate Banking and Branching Efficiency Act
E) Community Reinvestment Act (CRA)
Answer: E

67. Common minimum capital requirements on banks in leading industrialized nations that are based on the riskiness of their assets is imposed by:
A) The National Banking Act
B) FIRREA
C) The International Banking Act
D) The Basel Agreement
E) None of the Above
Answer: D

68. The fastest growing crime in the U.S. is:
A) Financial statement misrepresentation
B) Bank robberies
C) Individual privacy violations
D) Credit card fraud
E) Identity theft
Answer: E

69. The oldest federal bank agency is the:
A) OCC
B) FDIC
C) FRS
D) FHC
E) BHC
Answer: A

70. The federal agency that regulates the most banks is the:
A) OCC
B) FDIC
C) FRS
D) FHC
E) BHC
Answer: B

71. Which federal banking act requires that financial service providers establish the identity of any customers opening new accounts?
A) Sarbanes-Oxley Act
B) USA Patriot Act
C) Check 21 Act
D) The FACT Act
E) Bankruptcy Abuse Prevention and Consumer Protection Act
Answer: B

72. Which federal banking act prohibits publishing false or misleading information about the financial performance of a public company and requires top corporate officers to vouch for the accuracy of their company's financial statements?
A) Sarbanes-Oxley Act
B) USA Patriot Act
C) Check 21 Act
D) The FACT Act
E) Bankruptcy Abuse Prevention and Consumer Protection Act
Answer: A

73. Which federal banking act reduces the need for banks to transport paper checks across the country?
A) Sarbanes-Oxley Act
B) USA Patriot Act
C) Check 21 Act
D) The FACT Act
E) Bankruptcy Abuse Prevention and Consumer Protection Act
Answer: C

74. Which federal banking act forces more individuals to repay at least part of what they owe and will push higher-income borrowers into more costly forms of bankruptcy?
A) Sarbanes-Oxley Act
B) USA Patriot Act
C) Check 21 Act
D) The FACT Act
E) Bankruptcy Abuse Prevention and Consumer Protection Act
Answer: E

75. Which federal banking act requires the Federal Trade Commission to make it easier for victims of identity theft to make theft reports and requires credit bureaus to help victims resolve the problem?
A) Sarbanes-Oxley Act
B) USA Patriot Act
C) Check 21 Act
D) The FACT Act
E) Bankruptcy Abuse Prevention and Consumer Protection Act
Answer: D

76. The _________ allows adequately capitalized bank holding companies to acquire banks in any state.
A) Riegle-Neal Interstate Banking and Branching Efficiency Act
B) Competitive Equality Banking Act
C) Financial Institutions Reform, Recovery and Enforcement Act
D) Federal Deposit Insurance Corporation Improvement Act
E) Depository Institutions Deregulation and Monetary Control Act
Answer: A

77. One of the earliest theories regarding the impact of regulation on banks was developed by George Stigler. He contends that:
A) Firms in regulated industries actually seek out regulations because they bring monopolistic rents.
B) Regulations shelter firms from changes in demand and cost, lowering its risk.
C) Regulations can increase consumer confidence which increases customer loyalty to regulated firms.
D) Depository institutions should be regulated no differently than any other corporation with no subsidies or special privileges.
E) None of the above
Answer: A

78. Samual Peltzman had an opposing view to George Stigler on the impact of regulation on banks. He contends that:
A) Firms in regulated industries actually seek out regulations because they bring monopolistic rents.
B) Regulations shelter firms from changes in demand and cost, lowering its risk.
C) Regulations can increase consumer confidence which increases customer loyalty to regulated firms.
D) Depository institutions should be regulated no differently than any other corporation with no subsidies or special privileges.
E) None of the above
Answer: B

79. There is an important debate raging today regarding whether banks should be regulated at all. George Benston contends that:
A) Firms in regulated industries actually seek out regulations because they bring monopolistic rents.
B) Regulations shelter firms from changes in demand and cost, lowering its risk.
C) Regulations can increase consumer confidence which increases customer loyalty to regulated firms.
D) Depository institutions should be regulated no differently than any other corporation with no subsidies or special privileges.
E) None of the above
Answer: D

80. The European Central Bank has the main goal of:
A) Ensuring the economy grows at an adequate rate.
B) Keeping unemployment low.
C) Ensuring price stability.
D) Ensuring an adequate and fair supply of loans.
E) All of the above
Answer: C

81. Which of the following has become the principal tool of central bank monetary policy today?
A) Open market operations
B) Changing the discount rate
C) Changing reserve requirements
D) Using moral suasion

E) None of the above
Answer: A

82. The Federal Reserve buys Treasury Bills in the open market. This will tend to:
A) Cause interest rates in the market to rise
B) Cause interest rates in the market to fall
C) Cause reserves held at the Federal Reserve to decrease
D) Cause a decrease in the growth of deposits and loans
E) All of the above
Answer: B

83. Which federal banking act extends deposit insurance coverage on qualified retirement accounts from $100,000 to $250,000 and authorizes the FDIC to periodically increase deposit insurance coverage to keep up with inflation?
A) Sarbanes-Oxley Act
B) The Gramm-Leach-Bliley Act
C) Check 21 Act
D) The FACT Act
E) Federal Deposit Insurance Reform Act
Answer: E

84. The Financial Services Regulatory Relief Act of 2006 does the following:
A) Adds selected new service powers to depository institutions
B) Loosens regulations on depository institutions
C) Grants the Federal Reserve authority to pay interest on depository institutions' legal reserves
D) All of the above
E) None of the above
Answer: D

85. The Emergency Economic Stabilization Act passed in 2008 during the global credit crisis allowed the following:
A) An emergency sale of "bad assets"
B) Temporary increase of FDIC deposit insurance to $250,000 for all deposits
C) Injections of capital by the government into banks and other qualified lenders
D) Closer surveillance of the mortgage market participants, such as brokers and lenders
E) All of the above
Answer: E

Chapter 3
The Organization and Structure of Banking and the Financial-Services Industry

Fill in the Blank Questions

1. A(n) ___________________ is a machine located at the merchant's place of business which allows depositors to use their debit card to pay for purchases directly.
   Answer: POS

2. A(n) _____________________ is a bank which offers its full range of services from several locations.
   Answer: branch bank

3. A(n) _____________________ is a bank which offers its full range of services from only one location.
   Answer: unit bank

4. A(n)________________________ is a corporation chartered for the express purpose of holding the stock of one or more banks.
   Answer: Bank Holding Company

5. Managers who value fringe benefits, plush offices and ample travel budgets over the pursuit of maximum returns for stockholders are exhibiting signs of __________________________.
   Answer: Expense Preference Behavior

6. A(n) _______________________ can invest in corporate stock as sell as loan money to help finance the start of new ventures or support the expansion of existing businesses.
   Answer: Merchant bank

7. A bank which operates exclusively over the internet is known as a ___________ bank.
   Answer: Virtual

8. One new 21st century bank organizational structures is _____________________ . This is a special type of holding company that may offer the broadest range of financial services.
   Answer: Financial Holding Company (FHC)

9. The key problem in a large money center bank is ______________________. Managers may be

knowledgeable about banking practices but may be less informed about products and services of subsidiary companies.
Answer: span of control

10. The Gramm-Leach-Bliley Act moved the U.S. banking industry closer to ___________ banking in which banks may provide securities, insurance, and other financial products.
Answer: universal

11. A bank that is not associated with a bank holding company is called a(n) _____________ bank.
Answer: independent

12. ____________________ is a view of how modern corporations operate which analyzes the relationship between a firm's owners and its managers.
Answer: Agency theory

13. Many experts believe that _______________________ , the relationships that exist between managers, the board of directors and stockholders, is more complicated in financial institutions.
Answer: Because of government regulations.

14. _____________________________ is the idea that there will be a lower cost of production per unit as the firm gets larger.
Answer: Economies of scale

15. ____________________________ is the idea that there will be lower cost of producing multiple services using the same organization and resources.
Answer: Economies of scope

16. Over the years, managers of banks and other financial institutions have evolved different organizational forms to address changes in the industry. Indeed, these firms are organized to carry out various roles in the most efficient way. This is referred to as ________________________.
Answer: Organizational form follows function

True/False Questions

T F 17. Bank size is <u>not</u> considered a significant factor in determining how banks are organized.
Answer: False

T F 18. Nearly three quarters of all U.S. banks exceed $100 million in asset size apiece.
Answer: False

T F 19. Nearly all U.S. banks with federal or state charters have their deposits insured by the Federal Deposit Insurance Corporation.

Answer: True

T F 20. State-chartered banks in the United States represent about a quarter of all U.S.-chartered banks, while national banks account for approximately three quarters of all U.S. chartered banks.
Answer: False

T F 21. The majority of all U.S. banks are members of the Federal Reserve System.
Answer: False

T F 22. A banking corporation chartered by either federal or state governments that operates only one full-service office is called a unit bank.
Answer: True

T F 23. Over half of all U.S. states today limit branching activity.
Answer: False

T F 24. The average U.S. bank is larger in size (in terms of number of branch offices) than the average Canadian bank.
Answer: False

T F 25. Despite the rapid growth of automation in U.S. banking, there are more full-service branch banking offices than automated teller machines across the whole U.S.
Answer: False

T F 26. In the United States there are more one-bank holding companies than multi-bank holding companies.
Answer: True

T F 27. Bank holding companies hold more than 90 percent of the industry's assets in the United States.
Answer: True

T F 28. Research evidence suggests that banks taken over by interstate banking organizations have generally <u>increased</u> their market shares over their competitors within the same state and generally are <u>more</u> profitable than their competitors.
Answer: False

T F 29. The concentration of bank deposits at the local level (that is in urban communities and rural counties) has displayed only moderate changes in recent years.
Answer: True

T F 30. There is evidence that branch banks charge higher fees for some banking services than do unit banks.
Answer: True

T F 31. Branch banks tend to offer a wider menu of services than unit banks.
Answer: False

T F 32. Recent research suggests that branch banks tend to be more profitable than either unit or holding company banks, while interstate banks tend to be the most profitable of all.
Answer: False

T F 33. Less than 10 percent of the largest banks in the U.S. control almost 90 percent of the industry assets.
Answer: True

T F 34. Agency theory suggests that bank management will always pursue the goal of maximizing the return of the bank's shareholders.
Answer: False

T F 35. Recent research suggests that the relationship between bank size and the cost of production per unit is roughly U shaped.
Answer: True

T F 36. Bank holding companies that want to achieve the goal of risk reduction in earnings risk through interstate banking can achieve the same level of risk reduction by entering any of the fifty states.
Answer: False

T F 37. Bank holding companies are allowed to own nonbank businesses as long as those businesses offer services closely related to banking.
Answer: True

T F 38. Banks tend to have a higher proportion of outside directors than a typical manufacturing firm.
Answer: True

T F 39. Banks which operate entirely on the web are known as **invisible** banks.
Answer: False

T F 40. Banks acquired by holding companies are referred to as **affiliated banks**.
Answer: True

T F 41. Bank organizational structure has become more complex in recent years.
Answer: True

T F 42. There are only a very small number of unit banks in the U.S. today.
Answer: False

T F 43. Traditional brick-and-mortar bank branch offices are on the decline in the U.S. today.
Answer: False

T F 44. Community banks are usually smaller banks that are devoted principally to the markets for smaller, locally based deposits and loans.
Answer: True

T F 45. The question of whether financial firms operate as efficiently as possible requires researchers to look into the issue of x-efficiency. The concept requires an assessment of the financial firm's operating costs in relation to its cost-efficient frontier.
Answer: True

Multiple Choice Questions

46. In banking, organizational form follows __________ because banks usually are organized in such a way as to carry out the tasks and supply the services demanded of them. The term that correctly fills in the blank in the sentence above is:
A) Bank size
B) Management's decision
C) Function
D) Regulation
E) Location
Answer: C

47. Which one of the following is charged with setting policy and overseeing a bank's performance?
A) Stockholders
B) Board of directors
C) Regulators

D) Depositors
E) None of the above.
Answer: B

48. The largest banks possess some potential advantages over small and medium-size banks, according to the textbook. What specific advantage of the largest banks over small and medium-sized banks is not mentioned in the text?
A) Greater diversification geographically and by product line
B) Availability of financial capital at lower cost
C) Greater professional expertise to allocate capital to the most promising products and services
D) Better positioned to take advantage of the opportunities afforded by interstate banking.
E) All of the above were mentioned in the text as advantages typically possessed by the largest banks.
Answer: E

49. Before any financial services can be offered to anyone a bank in the United States must have a:
A) Certificate of deposit insurance
B) Charter of incorporation
C) List of established customers
D) New building constructed to be the bank's permanent home
E) None of the above.
Answer: B

50. In the United States there are close to __________ commercial banks in operation. Which number shown below is closest to the actual total number of U.S. banks operating in the U.S.?
A) 20,500
B) 13,500
C) 11,500
D) 9,000
E) 7,500
Answer: E

51. One of the few states that has opted out of interstate banking is:
A) New York
B) Ohio
C) Texas
D) Montana
E) None of the above
Answer: D

52. The concentration of U.S. bank deposits in the hands of the largest banks has _________ during the most recent period,
A) Declined
B) Increased
C) Remained essentially unchanged
D) Exhibited large fluctuations in both directions

E) None of above.
Answer: B

53. Bank holding company organizations have several advantages over other types of banking organizations. Among the advantages mentioned in this chapter is:
A) Greater ease of access to capital markets
B) Tax advantage
C) Product-line diversification
D) All of the above.
E) None of the above.
Answer: D

54. A company which owns the stock of three different banks is known as a(n):
A) Unit Bank
B) Interstate Bank
C) One Bank Holding Company
D) Multi Bank Holding Company
E) None of the above
Answer: D

55. Which of the following is considered an advantage of branch banking?
A) Increased availability and convenience of services
B) Decreased chance of failure
C) Reduced transaction costs
D) B and C above
E) All of the above
Answer: E

56. The types of nonbank businesses a bank holding company can own include which of the following?
A) Retail Computer Store
B) Security Brokerage Firm
C) Retail Grocery Store
D) Wholesale Electronic Distribution Company
E) All of the above
Answer: B

57. A bank which offers its full range of services from only one office is known as a:
A) Unit Bank
B) Branch Bank
C) Correspondent Bank
D) Bank Holding Company
E) None of the above
Answer: A

58. Why did so many states and the federal government finally enact interstate banking laws?
A) The need for new capital in order to revive struggling economies
B) The expansion of services by nonbank financial institutions
C) Competition from neighboring states that already liberalized their laws
D) Advances in technology which allowed banks to service customers in broader geographic areas
E) All of the above are reasons for the passage of interstate banking laws
Answer: E

59. What is a bank holding company?
A) It is a bank that offers all of its services out of one office
B) It is a bank that offers all its services out of several offices
C) It is a corporation formed to hold the stock of one or more banks
D) It is a merchant bank
E) None of the above
Answer: C

60. Which of the following is a type of service a bank holding company is not allowed to own?
A) Merchant banking company
B) Savings and loan association
C) Retail electronics equipment sales company
D) Security brokerage firm
E) Insurance agency
Answer: C

61. In the last decade, the number of banks has __________ and the number of branches has _________.
A) Declined; Increased
B) Grown; Increased
C) Grown; Decreased
D) Declined; Decreased
E) Stabilized; Stabilized
Answer: A

62. Websites known as **electronic branches** offer all of the following except:
A) Internet banking services
B) ATMs
C) Point of sales terminals
D) Computer and phone services connecting customers
E) Traveler's checks
Answer: E

63. Relative to manufacturing firms, banks tend to have a (the) ___________ number of board members.

A) Same
B) Larger
C) Smaller
D) Unknown
E) None of the above
Answer: B

64. The percentage of unit banks in the U.S. today is approximately:
A) 10%
B) 30%
C) 50%
D) 75%
E) 100%
Answer: B

65. The 'typical' community bank has:
A) $300 million in assets and is located in a smaller city in the Midwest.
B) $25 billion in assets and is located in a large city in the East
C) $100 million in assets and is located in a large city the South
D) $10 billion in assets and is located in a small city in the West
E) None of the above
Answer: A

66. The 'typical' money center bank has:
A) $250 million in assets and is located in a smaller city in the Midwest
B) $25 billion in assets and is located in a large city in the East
C) $100 million in assets and is located in a large city in the South
D) $10 billion in assets and is located in a small city in the West
E) None of the above
Answer: B

67. The majority of banks today are:
A) Federally chartered
B) Uninsured
C) State Chartered
D) National Banks
E) All of the above
Answer: C

68. 'Member' banks are:
A) Members of the FDIC
B) National Banks

C) Unit Banks
D) Members of the Federal Reserve
E) All of the above
Answer: D

69. _____________ and _____________ banks tend to be larger and hold more of the public's deposits.
A) National and Member
B) State and Nonmember
C) National and Uninsured
D) State and Insured
E) None of the above
Answer: A

70. Which of the following is a reason for the rapid growth in branch banks?
A) Exodus of population from cities to suburban areas
B) Bank convergence
C) Business failures
D) Decreased costs of brick and mortar
E) All of the above
Answer: A

71. Under the Bank Holding Company Act control of a bank is assumed to exist only if:
A) The bank holding company acquires 100% of the bank's stock
B) The bank holding company acquires 50% or more of the bank's stock
C) The bank holding company acquires 25% or more the bank's stock
D) The bank holding company acquires three banks
E) None of the above
Answer: C

72. When a bank holding company acquires a nonbank business it must be approved by:
A) The FDIC
B) The Comptroller of the Currency
C) The Federal Reserve
D) The President of the U.S.
E) All of the above
Answer: C

73. Many financial experts believe that the customers most likely to be damaged by decreased competition include:
A) Large corporations in large cities
B) Households and business in smaller cities and towns

C) Households that earn more than a billion dollars a year
D) Students away at college
E) None of the above
Answer: B

74. According to Levonian and Rose in order to achieve some reduction in earnings risk, interstate banks must expand into at least:
A) 2 states
B) 4 states
C) 6 states
D) 10 states
E) 25 states
Answer: B

75. The major competitors of banks have:
A) Fewer but much larger service providers
B) Fewer but smaller service providers
C) More but smaller service providers
D) More but larger service providers
E) None of the above
Answer: A

76. Of the following countries in Europe, which has the largest number of banks?
A) Belgium
B) France
C) Germany
D) Great Britain
E) None of the above
Answer: C

77. Which country's banks were owned by the state until the 1990's?
A) Belgium
B) France
C) Germany
D) Italy
E) None of the above
Answer: D

78. When financial service providers offer a range of services including banking, insurance and securities services it is known as:
A) Consolidation
B) Convergence

C) Economies of scale
D) E-Efficiencies
E) None of the above
Answer: B

79. The gradual evolution of markets and institutions such that geographic boundaries <u>do not</u> restrict financial transactions is known as:
A) Deregulation
B) Integration
C) Re-regulation
D) Globalization
E) Moral suasion
Answer: D

80. Banks with less than _______ in assets are generally called community banks.
A) More than $1 billion
B) Less than $1 billion
C) More than $5 million
D) Less than $1 trillion
E) More than $1 trillion
Answer: B

81. Nonbank financial firms that supply insurance coverage to customers borrowing money to guarantee repayment of a loan are referred to as:
A) Merchant Bankers
B) Factoring Companies
C) Savings Associations
D) Investment Bankers
E) Credit Insurance Underwriters
Answer: E

82. A financial holding companies (FHC), defined as a special type of holding company that may offer the broadest range of financial services such as securities and insurance activities, were allowed under which act?
A) Riegle-Neal Interstate Banking and Branching Efficiency Act
B) The Competitive Equality in Banking Act
C) The Basel Agreement
D) The FDIC Improvement Act
E) The Gramm-Leach-Bliley Financial Services Modernization Act
Answer: E

Chapter 4
Establishing New Banks, Branches, ATMs, Telephone Services, and Web Sites

Fill in the Blank Questions

1. The state banking commissions (at the state level) and the Office of the Comptroller of the Currency (at the federal level) are the only ones able to issue a(n)______________________ for a new U.S. bank.
   Answer: charter

2. The______________________ issues charters for new national banks.
   Answer: The Office of the Comptroller of the Currency (OCC)

3. The____ issues charters for new state banks.
   Answer: state banking commission

4. ______________________ is demonstrated by organizers of new banks by showing that local banks are not conveniently located or fail to offer some key services.
   Answer: public need

5. Banks which offer services from inside grocery stores and other retail outlets are offering services from a(n)______________________ branch.
   Answer: in-store

6. A(n)______________________ terminal in a retail store allows a customer to pay for goods and services by instantly debiting their checking account.
   Answer: POS

7. A(n)______________________ combines a computer terminal, record keeping system and vault cash in one unit allowing customers to withdraw money, check deposit balances and which may provide other limited services 24 hours a day.
   Answer: ATM

8. "Virtual" banks are found on the______________________ and more and more banks are using this medium to deliver selected services.
   Answer: Internet

9. A(n)______________________ is a full service facility which offers many of the same services as the home or main office.
Answer: branch office

10. The______________________ can be calculated when the present value of the future net cash flows are set equal to the initial cash outflow. It is the interest rate that is actually earned on a new project.
Answer: expected rate of return (internal rate of return)

11. ____ reduces a bank's overall risk exposure by establishing service facilities in different market areas.
Answer: Geographic diversification

12. An)______________________ is a bank that offers its services only through the Internet. It does not have any brick and mortar offices.
Answer: virtual bank

13. ____ will allow customers to carry pocket-sized terminals with them and pay for goods and services and transfer funds as needed from this pocket terminal. These are already popular in Europe.
Answer: digital cash (or smart cards)

14. The acronym ACH stands for _______________ .
Answer: automated clearinghouse

15. For most of the history of financial service providers, 'convenience' has meant __________.
Answer: location

16. Another name for a 'new' financial institution is ________________.
Answer: de novo

17. New depository institutions are required to have insurance from the___________________.
Answer: FDIC (Federal Deposit Insurance Corporation)

18. The most effective delivery channel of financial services appears to be ______________ which combines full-service branches and electronic, limited service facilities within the same firm.
Answer: multi-channel

19. The ____________________ of a new ATM is the present value of the future stream of cash savings discounted at the firm's required rate of return less the total cash outlay for the ATM.
Answer: net present value

20. Fees for ATM's are larger and more common if a customer uses another financial institution's ATM because most institutions charge each other _______________________ fees.
Answer: interchange

True/False Questions

T F 21. The FDIC Improvement Act requires that all new depository institutions have FDIC insurance.
Answer: True

T F 22. One argument frequently presented for regulation and control over bank chartering activity is that banks can create more money than any other financial institution.
Answer: True

T F 23. State banking commissions, on average, impose tougher standards for chartering new banks than the federal chartering agency, the Comptroller of the Currency.
Answer: False

T F 24. One of the benefits of applying for a federal banking charter is that banks chartered there need not join the Federal Reserve System.
Answer: False

T F 25. Getting a bank charter from the Comptroller of the Currency means that the bank will simultaneously apply for FDIC insurance so no duplication of effort occurs.
Answer: True

T F 26. Most new banks are situated along major routes of travel for commuters going to work or to shopping areas and schools.
Answer: True

T F 27. "Public need" is usually established with federal or state chartering authorities by showing that existing banks in the area are adequately profitable and have satisfactory amounts of capital.
Answer: False

T F 28. Society pays a price if it restricts the number of bank charters below the number that the private sector normally would generate due to lessened competition.
Answer: True

T F 29. Most U.S. banks are chartered in urban areas.
Answer: True

T F 30. The total number of full-service branch offices has declined in the United States in recent years.
Answer: False

T F 31. Newly designed bank branch offices in recent years have emphasized more heavily effective communication of service options to the customer in an effort to promote service sales.
Answer: True

T F 32. More desirable bank branch office sites normally have residents who are above-average in age.
Answer: True

T F 33. Higher levels of savings deposits are usually to be found in those bank branch office locations where there is an above-average proportion of older heads of households and where there is a large proportion of residents who own their own homes.
Answer: True

T F 34. The optimal choice for a new branch site must be that site that offers the bank the highest expected rate of return on the capital invested in the project.
Answer: False

T F 35. To close a bank branch office in the United States a bank must give its customers 30 days advance notice.
Answer: False

T F 36. Bank branch offices are often specially configured today to maximize sales opportunities.
Answer: True

T F 37. One of the keys to branch office profitability is to apply the latest information technology and thereby lower personnel costs.
Answer: True

T F 38. Access to a P0S terminal is gained through the use of a credit card.
Answer: False

T F 39. On-line P0S terminals substantially out-number off-line P0S service systems.
Answer: False

T F 40. One half of all transactions through an ATM machine are deposits.
Answer: False

T F 41. The first ATM machine could only handle cash withdrawals.
Answer: True

T F 42. ATMs are profitable for all banks since they can eliminate tellers at branches that have ATMs.
Answer: False

T F 43. Research indicates that States with more liberal chartering standards experience a higher rate of bank failures.
Answer: False

T F 44. More recently the issue of public need has become an increasingly important factor in the granting of bank charters.
Answer: False

T F 45. In the short-term newly-chartered banks fail at a higher rate than established banks.
Answer: False

T F 46. The majority of new banks do not become profitable for at least a decade.
Answer: False

T F 47. The OCC does not charter internet-only banks.
Answer: False

T F 48. Payment by electronic direct deposit now comprises over 50 percent of all transactions.
Answer: False

T F 49. When considering possible location for new branches, the expected rate of return is the only decision that management should consider.
Answer: False

T F 50. The proposed new branch's negative return correlation with existing branch offices and other assets can serve to lower the overall bank's riskiness and is an important justification for branch establishment. This is referred to as geographic diversification effect.

Answer: True

Multiple Choice Questions

51. U.S. banking laws require the organizers of a proposed new bank to demonstrate:
    A) Adequate future earnings prospects
    B) Adequate owners' capital will be available
    C) Evidence of a public need for a new bank
    D) Existing banks will not be endangered
    E) All of the above.
    Answer: E

52. One of the benefits of securing a state bank charter instead of a federal bank charter is:
    A) It brings added prestige
    B) It results in the automatic receipt of federal deposit insurance
    C) It is often able to lend a higher percentage of its capital and surplus to a single borrower
    D) A state bank must join the Federal Reserve System
    E) None of the above.
    Answer: C

53. One of the benefits of securing a federal (national) bank charter instead of a state bank charter is:
    A) Federal rules can pre-empt state laws
    B) It is generally easier and less costly to secure a federal charter
    C) It is often able to lend a higher percentage of its capital and surplus to a single borrower
    D) Lower supervisory fees
    E) None of the above.
    Answer: A

54. The number of bank charters issued annually in the United States has averaged about:
    A) 1000
    B) 2000
    C) 10
    D) 100
    E) None of the above
    Answer: D

55. The existence of branch banking in a given state:
    A) Encourages more new banks to be chartered
    B) Discourages some new banks from being chartered
    C) Results in more bank failures than normal
    D) Results in lower operating cost per unit of service
    E) None of the above.

Answer: B

56. Most new banks:
  A) Become profitable in the first 3 years of their operation
  B) Have pro-competitive effects on the markets they enter
  C) Survive rather than fail
  D) All of the above are correct
  E) None of the above are correct.
  Answer: D

57. Most new U.S. banks are chartered in:
  A) Small communities where there is very little existing competition.
  B) Relatively large urban areas where organizers can earn higher expected rates of return on their investment.
  C) Rural areas where they will be more convenient for customers.
  D) All of the above.
  E) A and C, only.
  Answer: B

58. A charter of incorporation to start a new U.S. bank can be issued by:
  A) The Office of the Comptroller of the Currency.
  B) The state banking commissions of each state.
  C) The Federal Deposit Insurance Corporation (FDIC).
  D) All of the above.
  E) A and B, only.
  Answer: E

59. Which factor(s) does OCC assess during the application process for a national bank charter?
  A) Market demand
  B) Probably customer base
  C) Competition and economic conditions
  D) Risks inherent in the services to be offered to the public
  E) All of the above
  Answer: E

60. One of the benefits of applying for a federal (national) bank charter over a state charter is:
  A) It brings added prestige
  B) It results in the automatic receipt of federal deposit insurance
  C) There is better technical support in the event of problems
  D) A and C above.
  E) All of the above.
  Answer: D

61. According to the textbook, the disadvantages of a federal charter include which of the following:
A) Closer supervision of banking activities.
B) Stricter standards for capital.
C) More stringent limits on the offering of new services.
D) All of the above.
E) B and C only.
Answer: D

62. Key factors that organizers of a proposed new bank use in evaluating their investment opportunity include which of the following?
A) Expected return on bank stock.
B) Risk to the shareholders.
C) Demonstrated public need.
D) Track record of existing banks that serve the same or a similar area.
E) All of the above.
Answer: E

63. The FDIC Improvement Act of 1991 requires a bank closing one of its branches to give its customers a minimum notice of:
A) 90 days
B) 60 days
C) 30 days
D) 10 days
E) None of the above
Answer: A

64. The most desirable sites for full-service bank branch offices usually have which of the following characteristics?
A) Heavy traffic volume
B) Large numbers of retail shops and stores
C) Above-average age populations
D) All of the above.
E) None of the above.
Answer: D

65. Typically much less costly to build and maintain, costing as little as one-fourth the expense incurred in constructing and operating as a stand-alone branch, and experiencing more traffic flow than conventional branches are:
A) ATMs
B) P0S terminals
C) ACHs
D) In-Store branches
E) ALMs
Answer: D

66. Computer facilities in retail shops and stores that permit a customer to instantly pay for goods and services electronically by deducting the cost of each purchase directly from his or her deposit account are known as:
A) ATMs
B) P0S terminals
C) ACHs
D) In-store branches.
E) ALMs
Answer: B

67. A so-called PIN gives a bank customer access to his or her account through a(n):
A) ACH
B) Bank-by-mail service
C) ATM
D) Electronic calculator
E) None of the above
Answer: C

68. Computer terminals which allow customers to make cash withdrawals, check deposit balances and make deposits without dealing with a teller are known as:
A) ATMs
B) POS terminals
C) ACHs
D) In-store branches
E) ALMs
Answer: A

69. Which of the following is one of the common services provided by banks on the internet today?
A) Applying for a loan
B) Opening an account
C) Making payments (especially recurring utility bills)
D) All of the above
E) None of the above
Answer: C

70. A bank is thinking about building a new branch. They think this new branch will generate 20 percent of the business of the bank after it is opened. The bank expects the return for this branch will be 15 percent with a standard deviation of 5 percent. Currently the bank has a 12 percent rate of return with a standard deviation of 4 percent. The correlation between the bank and the new branch is expected to be .25. What is this bank's total expected return after adding this branch?
A) 15 percent
B) 12.6 percent
C) 12 percent
D) 14.4 percent
Answer: B

71. A bank is thinking about building a new branch. They think this new branch will generate 20 percent of the business of the bank after it is opened. The bank expects the return for this branch will be 15 percent with a standard deviation of 5 percent. Currently the bank has a 12 percent rate of return with a standard deviation of 4 percent. The correlation between the branch and the bank is expected to be .25. What is this bank's expected standard deviation after adding this branch?

A) 12.84 percent
B) 3.35 percent
C) 4.36 percent
D) 3.58 percent
Answer: D

72. The Clearwater National Bank is thinking about building a new branch. This new branch is anticipated to generate 5 percent of the business of the bank after it is opened. The bank expects the return for this branch will be 15 percent with a standard deviation of 5 percent. Currently the bank has a 10 percent rate of return with a standard deviation of 5 percent. The correlation between the bank and the new branch is expected to be -0.3. What is this bank's total expected return after adding this branch?

A) 15 percent
B) 10 percent
C) 15.25 percent
D) 10.25 percent
Answer: D

73. The Clearwater National Bank is thinking about building a new branch. This new branch is anticipated to generate 5 percent of the business of the bank after it is opened. The bank expects the return for this branch will be 15 percent with a standard deviation of 5 percent. Currently the bank has a 10 percent rate of return with a standard deviation of 5 percent. The correlation between the bank and the new branch is expected to be -0.3. What is this bank's expected risk (measured by the standard deviation) after adding this branch?

A) 21.91 percent
B) 12.84 percent
C) 4.68 percent
D) 3.58 percent
Answer: C

74. In the above problem, the proposed new branch will _______ overall risk exposure and produce a(an) ______ effect. Fill in the appropriate answers.

A) increases; economies of scale
B) increases; economies of scope
C) reduces; convergence
D) reduces; geographic diversification
Answer: D

75. In the U.S, what is the average population per branch office?

A) 4000
B) 8000
C) 10,000
D) 15,000

E) None of the above
Answer: A

76. Suppose Second National Bank is considering adding 5 new ATM machines. Each machine costs $25,000 and installation costs are $15,000 per machine. Second National Bank expects the new machines to save $.33 per transaction and expects 250,000 transactions per year on the new machines. They expect the new machines to last for 15 years. If Second National Bank needs to earn 14 percent interest on this investment, what is the net present value of this investment?
A) $506,729
B) $306,729
C) $272,269
D) 381,729
Answer: B

77. Suppose Third State Bank wants to add a new branch office. They have determined that the cost of construction on the new facility will be $1.5 million with another $500,000 in organizational costs. Third State Bank has estimated that they will generate $319,522 in net revenues. If the new branch is expected to last 20 years, what is the expected rate or return on this investment? (Round to the nearest whole percent)
A) 6 percent
B) 21 percent
C) 15 percent
D) 32 percent
Answer: C

78. Suppose Third State Bank wants to add a new branch office. They have determined that the cost of construction on the new facility will be $1.5 million with another $500,000 in organizational costs. Third State Bank has estimated that they will generate $319,522 in net revenues. If the Third State Bank requires a 17% return on its money, what is this project's net present value?
A) $201,805
B)-$201,805
C) $1,798,195
D) -$1,798,195
Answer: B

79. Which of the following is true concerning branch offices?
A) The number of full service offices in the U.S. have shrunk in recent years.
B) An ideal location for a new branch bank is one with below average population density
C) Branch offices are generally cheaper to establish than chartering a whole new banking corporation
D) The decision about whether to establish a new branch is a cash management problem
E) All of the above are true
Answer: C

80. Murphy National Bank is thinking about adding a new branch in a very different market area. They estimate that the new office will have an expected return of 16% with a standard deviation of 8%. Currently they have an expected return of 12% with a standard deviation of 4%. The correlation between the new branch and the bank is estimated to be .20. The bank estimates that the new branch will represent 15 percent of the revenues of the bank. What is the expected return of the bank with the new branch?
A) 12.6 percent
B) 15.4 percent
C) 4.6 percent
D) 7.4 percent
Answer: A

81. Murphy National Bank is thinking about adding a new branch in a very different market area. They estimate that the new office will have an expected return of 16% with a standard deviation of 8%. Currently they have an expected return of 12% with a standard deviation of 4%. The correlation between the new branch and the bank is estimated to be .20. The bank estimates that the new branch will represent 15 percent of the revenues of the bank. What is the bank's expected risk (measured by the standard deviation) with the new branch? Round to the nearest .1 percent.
A) 14.6 percent
B) 3.8 percent
C) 4.6 percent
D) 7.4 percent
Answer: B

82. In what merger region of the country do the most newly-chartered banks occur?
A) Northeast
B) Southeast
C) Midwest
D) Southwest
E) West
Answer: B

83. In the short-term newly-chartered banks fail at a (n) __________ rate than established banks.
A) lower
B) same
C) higher
D) extremely higher
E) unknown
Answer: A

84. Chester National Bank is considering adding a new branch bank. They know that it will cost $2.5 million to build the branch and they believe that it will generate $214,526 per year for the next 25 years. Chester National Bank requires a return of 10% on all new projects it undertakes. What is this project's net present value? (Round to the nearest $100)
   A) -$552,700
   B) -$3,052,700
   C) $1,947,300
   D) $2,863,200
   E) $5,363,200
   Answer: A

85. Chester National Bank is considering adding a new branch bank. They know that it will cost $2.5 million to build the branch and they believe that it will generate $214,526 per year for the next 25 years. Chester National Bank requires a return of 10% on all new projects it undertakes. What is this project's expected rate of return or internal rate of return? (Round to the nearest whole percent)
   A) 10%
   B) 7%
   C) 12%
   D) 2%
   E) 25%
   Answer: B

86. The Chahad Bank wants to open a new branch in a distance city with very different economic conditions. Currently, the bank has an expected return of 15% with a standard deviation of 7%. The new branch is expected to have a return of 20% with a standard deviation of 10%. The correlation between the bank and the new branch is -.3. The new branch is expected to be 10% of the bank's revenues. What is the expected return of the bank if they add the new branch?
   A) 35%
   B) 19.5%
   C) 17.5%
   D) 15.5%
   E) None of the above
   Answer: D

87. The Chahad Bank wants to open a new branch in a distance city with very different economic conditions. Currently, the bank has an expected return of 15% with a standard deviation of 7%. The new branch is expected to have a return of 20% with a standard deviation of 10%. The correlation between the bank and the new branch is -.3. The new branch is expected to be 10% of the bank's revenues. What is the standard deviation of this bank if they add the new branch? (Round your answer to the nearest .1%)
   A) 36.9%
   B) 6.1%
   C) 50.3%
   D) 7.1%

E) 6.7%
Answer: B

88. The Boyer Bank wants to add a new ATM machine in a busy mall. They know the new machine will cost $60,000 with another $30,000 to install it and the necessary security measures in the mall. They expect to save $.27 per transaction and generate 100,000 per year. They expect the new machine to last 8 years. If they need to earn a 12% return what is the NPV of this project? (Round your answer to the nearest $1000)
A) $126,000
B) $44,000
C) $134,000
D) $27,000
E) $117,000
Answer: B

89. The Boyer Bank wants to add a new ATM machine in a busy mall. They know the new machine will cost $60,000 with another $30,000 to install it and the necessary security measures in the mall. They expect to save $.27 per transaction and generate 100,000 per year. They expect the new machine to last 8 years. What is the expected rate of return or internal rate or return of this project? (Round your answer to the nearest .1%)
A) 25%
B) 3.3%
C) 30%
D) 12%
E) 2.4%
Answer: A

90. A group of six investors wants to open a new bank. In their application to the Comptroller of the Currency, they discuss that the community they want to do business in has a median income of $55,000, that there are approximately 75,000 homes in the community and that there is approximately $5.6 million in sales generated in the community on any given day. Which decision factor for seeking a new charter are the investors discussing?
A) The level of economic activity in the community
B) The growth of economic activity in the community
C) The need for a new financial firm
D) The strength and character of the local competition
E) None of the above
Answer: A

91. A group of six investors wants to open a new bank. In their application to the Comptroller of the Currency, they discuss that new housing starts in the area are up 19% from a year ago with an additional 25 families moving into the community every month. School enrollment has also increased 14% from the previous year. Which decision factor for seeking a new charter are the investors discussing?
A) The level of economic activity in the community
B) The growth of economic activity in the community

C) The need for a new financial firm
D) The strength and character of the local competition
E) None of the above
Answer: B

92. A group of six investors want to open a new bank. In their application to the Comptroller of the Currency, they discuss that the population per banking office is up to 6,000. In addition, growth in the community is to the west of town and there is only one bank serving that part of the community and a new housing subdivision has just started in this part of town that should include 350 new homes. Which decision factor for seeking a new charter are the investors discussing?
A) The level of economic activity in the community
B) The growth of economic activity in the community
C) The need for a new financial firm
D) The strength and character of the local competition
E) None of the above
Answer: C

93. A group of six investors wants to open a new bank. In their application to the Comptroller of the Currency, they discuss that there are six banks already in the community and that the largest of these has just acquired one of the smaller banks. These six banks do a moderate amount of advertising in the community. There is also one credit union that has one office and a savings bank that has two branches on the east side of town. Growth in the community is to the west. Which decision factor for seeking a new charter are the investors discussing?
A) The level of economic activity in the community
B) The growth of economic activity in the community
C) The need for a new financial firm
D) The strength and character of the local competition
E) None of the above
Answer: D

94. A group of six investors wants to open a new bank in the community of Edmond, Oklahoma. They have submitted their application to the Comptroller of the Currency. What type of bank would they be if their application is approved?
A) A state, member bank
B) A state, insured bank
C) A national bank
D) A national bank without FDIC insurance
E) None of the above
Answer: C

95. The Cassil National Bank charges their customers \$.50 per transaction for using the ATM machine if their deposit balance is below \$500. They charge \$.25 per transaction for using the ATM if their deposit balance is between \$500 and \$1000. If their customer's deposit balance is over \$1000, there is no charge for using the ATM machine. This is an example of:
A) An interchange fee
B) An independent pricing schedule

C) A conditional pricing schedule
D) A surcharge fee
E) None of the above
Answer: C

96. Which of the following would not be a telephone service a customer could get from a bank call center?
A) The current balance on their account
B) A fax copy of a loan application for the bank
C) A Verification of what transactions have passed through the account
D) Access to their safety deposit box
E) All of the above are telephone services a customer could get from a bank call center
Answer: D

97. What categories do authentication factors generally fall in?
A) Something a customer knows
B) Something a customer has
C) Something a customer is
D) All of the above
E) None of the above
Answer: D

98. The Jones State Bank is thinking about adding a branch office on the west side of Edmond, Oklahoma. Growth of new homes in the area has averaged 15% per year over the last five years and is expected to continue at that rate in the future. Which factor would this address when considering whether to add a new branch?
A) Traffic count
B) Number of retail shops
C) Average age of the local population
D) Population Density
E) Population Growth
Answer: E

99. The Jones State Bank is thinking about adding a branch office on the west side of Edmond, Oklahoma. Jones State Bank has done a study and found that the site where they want to build sees 35,000 cars pass in an average day. Which factor would this address when considering whether to add a new branch?
A) Traffic count
B) Number of retail shops
C) Average age of the local population
D) Population Density
E) Population Growth
Answer: A

100. The Jones State Bank is thinking about adding a branch office on the west side of Edmond, Oklahoma. Jones State Bank has discovered that area surrounding the proposed site averages 4 houses per acre and has several subdivisions that each have 300 to 400 homes. Which factor would this address when considering whether to add a new branch?
A) Traffic count
B) Number of retail shops
C) Average age of the local population
D) Population Density
E) Population Growth
Answer: D

101. The Jones State Bank is thinking about adding a branch office on the west side of Edmond, Oklahoma. Jones State Bank has done a survey of local residents near the area where they want to build and has discovered that most residents are in their 50's and 60's. Which factor would this address when considering whether to add a new branch?
A) Traffic count
B) Number of retail shops
C) Average age of the local population
D) Population Density
E) Population Growth
Answer: C

102. The Fred National Bank is thinking about adding a branch office on the west side of town. The Fred National Bank has done a survey and has discovered that the mean household income in the area is $76,000 per year. Which factor would this address when considering to add a new branch?
A) Number of retail shops
B) Average income level of households
C) Ratio of population to branches
D) Number of service facilities operated by financial service competitors
E) Population density
Answer: B

103. The First State Bank is proposing to acquire The Second National Bank, to form The First State MegaBank, which will be a state member bank (a member of the Federal Reserve System) and carry federal deposit insurance. Which regulatory agency must approve the merger?
A) Office of the Comptroller of the Currency
B) Federal Deposit Insurance Corporation
C) The state banking board
D) Federal Reserve
E) U.S. Treasury
Answer: D

104. The First National Bank is proposing to take over The Second State Bank, to form The First National MegaBank, which will be a national bank. Which regulatory agency must approve the merger?
A) Office of the Comptroller of the Currency
B) Federal Deposit Insurance Corporation
C) The state banking board
D) Federal Reserve

E) U.S. Treasury

Answer: A

105. Which of the following is not an advantage of ATMs?
    A) A limited commitment of resources
    B) Lower cost per transaction
    C) Personalized service
    D) Lower staffing needs
    E) Geographic accessibility

Answer: A

Chapter 5
The Financial Statements of Banks and Their Principal Competitors

Fill in the Blank Questions

1. Fed funds purchased is an example of ________________________ along with Eurodollar borrowings.
   Answer: non deposit borrowings

2. The short term securities of the bank, including T-Bills and commercial paper, are often called ___________________________ because they are the second line of defense to meet demands for cash.
   Answer: secondary reserves

3. ___________________________ is a noncash expense on the bank's income statement which allows the bank to account for future bad loans.
   Answer: Provision for loan losses

4. ___________________________ is the difference between interest income and interest expenses for a financial institution.
   Answer: Net interest income

5. ___________________________ are the primary long term liabilities of the bank. These liabilities are paid only after deposits have been paid in the event of bankruptcy.
   Answer: Subordinated notes and debentures

6. A(n)___________________________ is where the financial institution agrees to guarantee repayment of a customer's loan received from a third party.
   Answer: standby credit agreement

7. A(n)___________________________ is a short term collateralized loan. The collateral that is used generally consists of T-Bills.
   Answer: repurchase agreement

8. A(n)___________________________ is a deposit account which pays an interest rate competitive with money market mutual funds and which generally has limited check writing ability.
   Answer: money market deposit account

9. ______________________ is the sum of all outstanding IOU's owed to the bank in the form of consumer, real estate, commercial and agriculture loans as well as other types of credit

extensions.
Answer: gross loans

10. A financial institution often records the value of its assets and liabilities at _______________ which is the original or historical cost of the asset.
Answer: book value

11. The principal types of___________________________ include fee income, income from fiduciary activities and services charges on deposits.
Answer: noninterest income

12. The___________________________ shows the amount of revenues received and expenses incurred over a specific time period.
Answer: Report of Income (income statement)

13. The___________________________ lists the assets, liabilities and equity capital held by the bank on a given date.
Answer: Report of Condition (balance sheet)

14. ______________ is labeled "Accounting for Derivative Instruments and Hedging Activities."
Answer: FASB 133

15. ________________ labeled "Accounting for Derivative Instruments and Hedging Activities" and its recent amendments, FASB 138, are designed to make derivatives more publicly visible on corporate financial statements.
Answer: FASB 133

16. Under _____________ banks must account for the expected loss of interest income on nonperforming loans when calculating their loan-loss provision.
Answer: FASB 114

17. Temporarily buying and selling securities by a securities firm in a thinly traded market so as to influence the price is known as _________________.
Answer: painting the tape

18. The activity of manipulating the financial statements to artificially enhance the banks financial strength is known as ___________________.
Answer: window dressing or 'creative accounting'

19. 19. ____ is direct and indirect investment in

real estate. These are properties obtained for compensations for nonperforming loans.
Answer: Other Real Estate Owned (OREO)

19. 20. ____ consists of interest income received on loans from customers that has not yet been earned by the bank under accrual accounting methods.
Answer: Unearned discount income

19. 21. _________________________________ can be held by individuals and nonprofit institutions, bear interest and permit drafts from being written against the account to pay third parties.
Answer: Now accounts

19. 22. In the worldwide banking system, ___________________________________ represent transferable time deposits in a variety of currencies and are often the principal source of short term borrows by banks.
Answer: Eurocurrency Borrowings

19. 23. One part of ____________________________________ arises from fees charged for ATM and POS transactions.
Answer: Other Noninterest Income

19. 24. Fees that arise from a financial firm's trust activities, fees for managing a corporations' interest and dividend payments and fees for managing corporate or individual retirement plans are all included in the category of fees arising from ____________________________________.
Answer: fiduciary activities

19. 25. Checking account maintenance fees and overdraft fees are included in the noninterest income account under ______________________________________ .
Answer: service charges on deposit accounts

True/False Questions

T F 26. On a bank's income statement (Report of Income) deposit costs are financial inputs.
Answer: True

T F 27. Loans and leases are financial outputs on a financial institution's balance sheet or Report of Condition.
Answer: True

T F 28. Nondeposit borrowings are a financial input on a bank's balance sheet or Report of Condition.
Answer: True

T F 29. The cost of nondeposit borrowings is a financial input on a bank's income statement or Report of Income.
Answer: True

T F 30. Securities income is a financial output listed on a financial institution's Report of Condition.
Answer: False

T F 31. Net loans on a bank's balance sheet are derived by deducting the allowance for loan losses and unearned discounts from gross loans.
Answer: True

T F 32. When a loan is classified as nonperforming any accrued interest recorded on the bank's books, but not actually received, must be deducted from a bank's loan revenues.
Answer: True

T F 33. In U.S. banking, securities gains are treated as ordinary income.
Answer: True

T F 34. Most banks report securities gains as a component of their total noninterest income.
Answer: False

T F 35. A bank displaying trading account securities on its balance sheet is serving as a security dealer and plans to sell those securities before they reach maturity.
Answer: True

T F 36. Bad loans normally do not affect a bank's current income.
Answer: True

T F 37. The expensing of a worthless loan usually must occur in the year that loan become worthless.
Answer: True

T F 38. Recoveries on loans previously charged off are added to the Provision for Loan Losses (PLL) account on a bank's income statement.
Answer: False

T F 39. Loan-loss reserves set aside to cover a particular loan or loans expected to be a problem

or present the bank with above-average risk are known as specific reserves.
Answer: True

T F 40. U.S. banks (especially those with $500 million or more in total assets) are required to file financial statements audited by an independent public accountant with their principal federal regulatory agency.
Answer: True

T F 41. Off-balance-sheet items for a bank are fee generating transactions which are not recorded on their balance sheet.
Answer: True

T F 42. The experience method of accounting for future loan loss reserves allows a bank to deduct from their income statement up to .6 percent of their eligible loans.
Answer: False

T F 43. After the Tax Reform Act of 1986, large banks (>$500 million in assets) were required to use the reserve method of accounting for future loan loss reserves.
Answer: False

T F 44. The number one source of revenue for a bank based on dollar volume is loan income.
Answer: True

T F 45. In looking at comparative balance sheets, it can be seen that large banks rely more heavily on nondeposit borrowings while small banks rely more heavily on deposits.
Answer: True

T F 46. The Pension Fund industry is now larger than the Mutual Fund industry.
Answer: False

T F 47. Off-balance-sheet items for banks have declined in recent years.
Answer: False

T F 48. Except for banks, Savings & Loans and Savings Banks hold the most deposits.
Answer: True

T F 49. "Painting the tape" refers to the practice whereby banks understate their nonperforming loans.
Answer: False

T F 50. Financial statements issued by banks and nonblank financial service firms are looking increasingly similar today.
Answer: True

Multiple Choice Questions

51. 51. Bank assets fall into each of the following categories except:
A. A) Loans.
B. B) Investment securities.
C. C) Demand deposits.
D. D) Noninterest cash and due from banks.
E. E) Other assets.
Answer: C

52. 52. Banks generate their largest portion of income from:
A. Loans.
B. Short-term investment.
C. Demand deposits.
D. Long-term investments.
E. Certificates of deposit.
Answer: A

52. 53. Loans typically fall into each of the following categories except:
A. A) Real estate.
B. B) Consumer.
C. C) Commercial and Industrial (business).
D. D) Agricultural.
E. E) Municipal.
Answer: E

54. Which of the following adjustments are made to gross loans and leases to obtain net loans and leases?
A. The loan and lease loss allowance is subtracted from gross loans
B. Unearned income is subtracted from gross interest received
C. Investment income is added to gross interest received
D. A and B.
E. A. and C.
Answer: D

54. An example of a contra-asset account is:
A. A) The loan and lease loss allowance.
B. B) Unearned income.
C. C) Buildings and equipment.
D. D) Revenue bonds.
E. E) The provision for loan loss.
Answer: A

56. 56. The noncash expense item on a bank's Report of Income designed to shelter a bank's current earnings from taxes and to help prepare for bad loans is called:
A) Short-term debt interest

B) Noninterest expense
C) Provision for taxes
D) Provision for possible loan losses
E) None of the above.
Answer: D

57. 57. A financial institution's bad-debt reserve, as reported on its balance sheet, is called:
A) Unearned income or discount
B) Allowance for possible loan losses
C) Intangible assets
D) Customer liability on acceptances
E) None of the above
Answer: B

57. 58. When a bank serves as a security dealer for certain kinds of securities (mainly federal, state, and local government obligations) the value of these securities is usually recorded in what account on a bank's Report of Condition?
A) Investment Securities
B) Taxable and Tax-Exempt Securities
C) Trading Account Securities
D) Secondary Reserves
E) None of the above
Answer: C

57. 59. The difference between noninterest income and noninterest expenses on a bank's Report of Income is called:
A) Net Profit Margin
B) Net Interest Income
C) Net Income After Provision for Possible Loan Losses
D) Income or Loss Before Income Taxes
E) Net Noninterest Income
Answer: E

57. 60. The account that is built up by annual noncash expense deductions and is subtracted from Gross Loans on the Report of Condition is:
A) Unearned income
B) Nonperforming loans
C) Allocated loan risk deductions
D) Allowance for possible loan losses
E) None of the above.
Answer: D

57. 61. Nonperforming loans are credits on which any scheduled loan repayments and interest payments are past due for more than:
A) 30 days
B) 60 days
C) 90 days

D) 180 days
E) None of the above.
Answer: C

62. 62. One-time only transactions that often involve financial assets or real property pledged as collateral behind a loan and upon which the bank has foreclosed affect a bank's account known as:
A) Allowance for loan losses
B) Nonrecurring sales of assets
C) Asset gains or losses
D) Provision for loan and security losses
E) None of the above.
Answer: B

63. 63. The use of fixed assets, rather than financial assets, in order to increase earnings flowing to a bank's stockholders is known as:
A) Plant and equipment investment
B) Financial leverage
C) Operating leverage
D) Nondeposit capital
E) None of the above.
Answer: C

63. 64. Banks depend heavily upon borrowed funds supplied by customers with little owners' capital invested. This means that banks make heavy use of:
A) Financial leverage
B) Capital restructuring
C) Operating Leverage
D) Margin borrowing
E) None of the above.
Answer: A

63. 65. When a loan is considered uncollectible, the bank's accounting department will write (charge) it off the books by reducing the _______ and the _______________ accounts. Which choice below correctly fills in the blank in the preceding sentence?
A) PLL and Gross Loans
B) ALL and Net Loans
C) ALL and Gross Loans
D) PLL and Net Loans
E) None of the above.
Answer: C

66. 66. The common banking practice of selling those investment securities that have appreciated in order to reap a capital gain and holding onto those securities whose prices have declined is known as:
A) Gains trading

B) Performance banking
C) Loss control trading
D) Selective portfolio management
E) None of the above.
Answer: A

67. 67. Noninterest revenue sources for a bank are called:
A) Commitment fees on loans
B) Fee income
C) Supplemental income
D) Noninterest margin
E) None of the above.
Answer: B

68. 68. Large U.S. banks must use which of the methods listed below to determine their provision for loan loss expense?
A) Experience method
B) Reserve method
C) Specific charge-off method
D) Historical cost method
E) None of the above.
Answer: C

69. 69. A bank's temporary lending of excess reserves to other banks is labeled on the balance sheet as:
A) Fed Funds Purchased
B) Fed Funds Sold
C) Money Market Deposits
D) Securities Purchased for Resale
E) None of the above
Answer: B

70. 70. A bank sells shares of its common stock with a par value of $100 for $200 in the market. Which two accounts on the bank's balance sheet are going to be affected?
A) Retained earnings and capital surplus accounts
B) Subordinated notes and debentures and commons stock outstanding accounts
C) Retained earnings and common stock outstanding accounts
D) Common stock outstanding and capital surplus accounts
E) Only the common stock outstanding account is affected
Answer: D

70. 71. A type of letter of credit which is widely used in international trade is known as:
A) Banker's acceptance
B) Commercial paper
C) Repurchase agreement
D) Fed funds purchased

E) None of the above
Answer: A

70. 72. A bank which starts with ALL of $1.48 million at the beginning of the year, charges off worthless loans of $.94 million during the year, recovers $.12 million on loans previously charged off and charges current income for a $1.02 million provision for loan losses will have an ALL at the end of the year of:
A) $.66 million
B) $3.32 million
C) $1.68 million
D) $1.28 million
E) The same amount as at the beginning of the year
Answer: C

70. 73. A bank that has total interest income of $67 million and total noninterest income of $14 million. This bank has total interest expenses of $35 million and total noninterest expenses (excluding PLL) of $28 million. Its provision for loan losses is $6 million and its taxes are $5. What is this bank's net *interest* income?
A) $7
B) -$14
C) $18
D) $32
E) None of the above
Answer: D

70. 74. A bank that has total interest income of $67 million and total noninterest income of $14 million. This bank has total interest expenses of $35 million and total noninterest expenses (excluding PLL) of $28 million. Its provision for loan losses is $6 million and its taxes are $5. What is this bank's net *noninterest* income?
A) $7
B) -$14
C) $18
D) $32
E) None of the above
Answer: B

70. 75. A bank that has total interest income of $67 million and total noninterest income of $14 million. This bank has total interest expenses of $35 million and total noninterest expenses (excluding PLL) of $28 million. Its provision for loan losses is $6 million and its taxes are $5. What is this bank's net income?
A) $7
B) -$14
C) $18
D) $32
E) None of the above
Answer: A

70. 76. Which of the following financial statements shows the revenues and expense of a bank over a set period of time?
A) The statement of stockholders equity
B) The funds-flow statement
C) The report of financial condition
D) The report of income
E) None of the above
Answer: D

70. 77. Which of the following accounts is sometimes called the bank's primary reserves?
A) Cash and deposits due from bank
B) Investment securities
C) Trading account securities
D) Fed funds sold
E) None of the above
Answer: A

70. 78. Which of the following assets is the largest asset item on the bank's balance sheet?
A) Securities
B) Cash
C) Loans
D) Bank Premises
E) None of the above
Answer: C

70. 79. What financial service industry category is second to the banking industry in total assets held:
A) Mutual funds
B) Thrifts
C) Investment banks
D) Insurance companies
E) Pension funds
Answer: A

70. 80. FASB Rule 115 focuses primarily on bank:
A) Deposit sources
B) Investments in marketable securities
C) Derivatives trading
D) Loan-loss reserves
E) Federal funds
Answer: B

70. 81. Which of the following most accurately describes the principal type(s) of bank noninterest income:
A) Fees from fiduciary transactions
B) Fees from deposit transactions

C) Fees from securities transactions
D) Fees from additional noninterest income
E) All of the above
Answer: E

70. 82. Fee income arising from fiduciary transactions include all of the following except:
A) Checking account maintenance fees
B) Fees for managing and protecting a customer's property
C) Fees for recordkeeping for corporate security
D) Fees for dispersing interest and dividend payments for a corporation
E) Fees for managing corporate and individual retirement plans
Answer: A

70. 83. You know the following information about the Miller State Bank:

Gross Loans	$300
Miscellaneous Assets	$50
Deposits	$390
Total Equity	$50
Common Stock Par	$5
Non-Deposit Borrowings	$60
Investment Securities	$150
Net Premises	$40
Surplus	$5
Allowance for Loan Losses	$50
Deposits	$390
Total Assets	$500
Gross Premises	$70

Given this information, what is this firm's Net Loans?
A) $250
B) $350
C) $500
D) $50
E) $150
Answer: A

70. 84. You know the following information about the Miller State Bank

Gross Loans	$300
Miscellaneous Assets	$50
Deposits	$390
Total Equity	$50
Common Stock Par	$5
Non-Deposit Borrowings	$60
Investment Securities	$150
Net Premises	$40
Surplus	$5
Allowance for Loan Losses	$50
Deposits	$390

Total Assets	$500
Gross Premises	$70

Given this information, what is this firm's Depreciation?
A) $250
B) $30
C) $70
D) $40
E) $110
Answer: B

70. 85. You know the following information about the Miller State Bank

Gross Loans	$300
Miscellaneous Assets	$50
Deposits	$390
Total Equity	$50
Common Stock Par	$5
Non-Deposit Borrowings	$60
Investment Securities	$150
Net Premises	$40
Surplus	$5
Allowance for Loan Losses	$50
Deposits	$390
Total Assets	$500
Gross Premises	$70

Given this information, what is this firm's Total Liabilities?
A) $390
B) $60
C) $450
D) $500
E) $50
Answer: C

70. 86. You know the following information about the Miller State Bank

Gross Loans	$300
Miscellaneous Assets	$50
Deposits	$390
Total Equity	$50
Common Stock Par	$5
Non-Deposit Borrowings	$60
Investment Securities	$150
Net Premises	$40
Surplus	$5
Allowance for Loan Losses	$50
Deposits	$390
Total Assets	$500
Gross Premises	$70

Given this information, what is this firm's Undivided Profits?

A) $50
B) $5
C) $10
D) $40
E) $450
Answer: D

70. 87. You know the following information about the Miller State Bank

Gross Loans	$300	
Miscellaneous Assets	$50	
Deposits	$390	
Total Equity	$50	
Common Stock Par	$5	
Non-Deposit Borrowings	$60	
Investment Securities	$150	
Net Premises	$40	
Surplus	$5	
Allowance for Loan Losses	$50	
Deposits	$390	
Total Assets	$500	
Gross Premises		$70

Given this information, what is this firm's Total Liabilities Plus Equity?
A) $250
B) $450
C) $150
D) $50
E) $500
Answer: E

70. 88. You know the following information about the Davis National Bank

Total Interest Expenses	($500)
Total Non Interest Income	$100
Securities Gains (Losses)	$ 50
Income Taxes	($ 80)
Dividends to Stockholders	($ 40)
Total Interest Income	$800
Total Non Interest Expenses	($150)
Provision for Loan Losses	($100)

Given this information, what is this firm's Net Interest Income?
A) $300
B) $150
C) ($50)
D) $120
E) $80
Answer: A

70. 89. You know the following information about the Davis National Bank

Total Interest Expenses	($500)
Total Non Interest Income	$100
Securities Gains (Losses)	$ 50
Income Taxes	($ 80)
Dividends to Stockholders	($ 40)
Total Interest Income	$800
Total Non Interest Expenses	($150)
Provision for Loan Losses	($100)

Given this information, what is this firm's Net Non Interest Income?
A) $300
B) $150
C) ($50)
D) $120
E) $80
Answer: C

70. 90. You know the following information about the Davis National Bank

Total Interest Expenses	($500)
Total Non Interest Income	$100
Securities Gains (Losses)	$ 50
Income Taxes	($ 80)
Dividends to Stockholders	($ 40)
Total Interest Income	$800
Total Non Interest Expenses	($150)
Provision for Loan Losses	($100)

Given this information, what is this firm's Pretax Net Operating Income (or Net Income before Extraordinary Items)?
A) $300
B) $150
C) ($50)
D) $120
E) $80
Answer: B

70. 91. You know the following information about the Davis National Bank

Total Interest Expenses	($500)
Total Non Interest Income	$100
Securities Gains (Losses)	$ 50
Income Taxes	($ 80)
Dividends to Stockholders	($ 40)
Total Interest Income	$800
Total Non Interest Expenses	($150)
Provision for Loan Losses	($100)

Given this information, what is this firm's Net Income?

A) $300
B) $150
C) ($50)
D) $120
E) $80
Answer: D

70. 92. You know the following information about the Davis National Bank

Total Interest Expenses	($500)
Total Non Interest Income	$100
Securities Gains (Losses)	$ 50
Income Taxes	($ 80)
Dividends to Stockholders	($ 40)
Total Interest Income	$800
Total Non Interest Expenses	($150)
Provision for Loan Losses	($100)

Given this information, what is this firm's Increase in Undivided Profits?
A) $300
B) $150
C) ($50)
D) $120
E) $80
Answer: E

70. 93. You know the following information about the Davis National Bank

Total Interest Expenses	($500)
Total Non Interest Income	$100
Securities Gains (Losses)	$ 50
Income Taxes	($ 80)
Dividends to Stockholders	($ 40)
Total Interest Income	$800
Total Non Interest Expenses	($150)
Provision for Loan Losses	($100)

Given this information, what is this firm's Total Revenues?
A) $800
B) $850
C) $150
D) $950
Answer: D

70. 94. You know the following information about the Webb State Bank

Accumulated Depreciation	$40
Net Loans	$600
Fed Funds Purchased and Repurchase Agreements	$200
Cash and Due from Banks	$50
Trading Account Securities	$40

Miscellaneous Assets	\$100
Deposits	\$500
Undivided Profits	\$140
Gross Premises	\$90
Surplus	\$40
Subordinated Debt	\$100
Investment Securities	\$160
Common Stock Par	\$20
Gross Loans	\$700

Given this information, what is this firm's Allowance for Loan Losses?
A) \$1300
B) \$1000
C) \$50
D) \$200
E) \$100
Answer: E

70. 95. You know the following information about the Webb State Bank

Accumulated Depreciation	\$40
Net Loans	\$600
Fed Funds Purchased and Repurchase Agreements	\$200
Cash and Due from Banks	\$50
Trading Account Securities	\$40
Miscellaneous Assets	\$100
Deposits	\$500
Undivided Profits	\$140
Gross Premises	\$90
Surplus	\$40
Subordinated Debt	\$100
Investment Securities	\$160
Common Stock Par	\$20
Gross Loans	\$700

Given this information, what is this firm's Net Premises?
A) \$130
B) \$1000
C) \$50
D) \$200
E) \$100
Answer: C

70. 96. You know the following information about the Webb State Bank

Accumulated Depreciation	\$40
Net Loans	\$600
Fed Funds Purchased and Repurchase Agreements	\$200
Cash and Due from Banks	\$50
Trading Account Securities	\$40

Miscellaneous Assets	$100
Deposits	$500
Undivided Profits	$140
Gross Premises	$90
Surplus	$40
Subordinated Debt	$100
Investment Securities	$160
Common Stock Par	$20
Gross Loans	$700

Given this information, what is this firm's Total Non Deposit Borrowings?

A) $1000
B) $300
C) $800
D) $200
E) $500

Answer: B

70. 97. You know the following information about the Webb State Bank

Accumulated Depreciation	$40
Net Loans	$600
Fed Funds Purchased and Repurchase Agreements	$200
Cash and Due from Banks	$50
Trading Account Securities	$40
Miscellaneous Assets	$100
Deposits	$500
Undivided Profits	$140
Gross Premises	$90
Surplus	$40
Subordinated Debt	$100
Investment Securities	$160
Common Stock Par	$20
Gross Loans	$700

Given this information, what is this firm's Total Liabilities?

A) $1000
B) $300
C) $800
D) $200
E) $500

Answer: C

70. 98. You know the following information about the Webb State Bank

Accumulated Depreciation	$40
Net Loans	$600
Fed Funds Purchased and Repurchase Agreements	$200
Cash and Due from Banks	$50
Trading Account Securities	$40
Miscellaneous Assets	$100
Deposits	$500

Undivided Profits	$140
Gross Premises	$90
Surplus	$40
Subordinated Debt	$100
Investment Securities	$160
Common Stock Par	$20
Gross Loans	$700

Given this information, what is this firm's Total Equity?

A) $1000
B) $300
C) $800
D) $200
E) $500

Answer: D

70. 99. You know the following information about the Webb State Bank

Accumulated Depreciation	$40
Net Loans	$600
Fed Funds Purchased and Repurchase Agreements	$200
Cash and Due from Banks	$50
Trading Account Securities	$40
Miscellaneous Assets	$100
Deposits	$500
Undivided Profits	$140
Gross Premises	$90
Surplus	$40
Subordinated Debt	$100
Investment Securities	$160
Common Stock Par	$20
Gross Loans	$700

Given this information, what is this firm's Total Assets?

A) $1000
B) $300
C) $800
D) $200
E) $500

Answer: A

70. 100. You know the following information about the Taylor National Bank

Provision for Loan Losses	($100)
Income Taxes	($140)
Non Interest Income	$500
Dividends	($60)
Securities Gains (Losses)	($50)
Interest Income	$1500
Non Interest Expense	$750
Interest Expenses	$750

Given this information, what is this firm's Net Interest Income?

A) $150
B) $210
C) $400
D) ($250)
E) $750
Answer: E

70. 101. You know the following information about the Taylor National Bank

Provision for Loan Losses	($100)
Income Taxes	($140)
Non Interest Income	$500
Dividends	($60)
Securities Gains (Losses)	($50)
Interest Income	$1500
Non Interest Expense	$750
Interest Expenses	$750

Given this information, what is this firm's Net Non Interest Income?
A) $150
B) $210
C) $400
D) ($250)
E) $750
Answer: D

70. 102. You know the following information about the Taylor National Bank

Provision for Loan Losses	($100)
Income Taxes	($140)
Non Interest Income	$500
Dividends	($60)
Securities Gains (Losses)	($50)
Interest Income	$1500
Non Interest Expense	$750
Interest Expenses	$750

Given this information, what is this firm's Net Operating Income or Net Income Before Extraordinary Income?
A) $150
B) $210
C) $400
D) ($250)
E) $750
Answer: C

70. 103. You know the following information about the Taylor National Bank

Provision for Loan Losses	($100)
Income Taxes	($140)

Non Interest Income	$500
Dividends	($60)
Securities Gains (Losses)	($50)
Interest Income	$1500
Non Interest Expense	$750
Interest Expenses	$750

Given this information, what is this firm's Net Income?
A) $150
B) $210
C) $400
D) ($250)
E) $750
Answer: B

70. 104. You know the following information about the Taylor National Bank

Provision for Loan Losses	($100)
Income Taxes	($140)
Non Interest Income	$500
Dividends	($60)
Securities Gains (Losses)	($50)
Interest Income	$1500
Non Interest Expense	$750
Interest Expenses	$750

Given this information, what is this firm's Increase in Undivided Profits?
A) $150
B) $210
C) $400
D) ($250)
E) $750
Answer: A

70. 105. You know the following information about the Taylor National Bank

Provision for Loan Losses	($100)
Income Taxes	($140)
Non Interest Income	$500
Dividends	($60)
Securities Gains (Losses)	($50)
Interest Income	$1500
Non Interest Expense	$750
Interest Expenses	$750

Given this information, what is this firm's Total Revenues?
A) $1500
B) $2000
C) $2050
D) $1950
E) $1450
Answer: B

Chapter 6
Measuring and Evaluating the Performance of Banks and Their Principal Competitors

Fill in the Blank Questions

1. The equity multiplier for a bank measures the amount of ______________________ of the bank and is one part of the evaluation of the bank's ROE.
   Answer: leverage (debt)

2. ____________________________ is the risk that has to do with the quality of the bank's assets and, in particular, the bank's loans.
   Answer: Credit risk

3. Solvency (or capital) risk for a bank can be measured by___________________________. List one way solvency risk can be measured.
   Answer: Purchased Funds/Total Liabilities (There are several other ratios that can answer this question as well)

4. ___________________________ are the assets of a financial institution that will mature or be repriced within a set period of time.
   Answer: Interest Sensitive Assets

5. ___________________________ is the risk that the value of the financial institution's asset portfolio (particularly government or other marketable securities) will decline in value.
   Answer: Market risk

6. Eurodollars, Fed Funds, Repurchase Agreements, and large CDs together are know as ______________________.
   Answer: Purchased Funds

7. ___________________________ is the risk that the financial institution may not be able to meet the needs of depositors for cash.
   Answer: Liquidity risk

8. ___________________________ are loans which are past due by 90 days or more.
   Answer: Nonperforming loans

9. ___________________________ reflects the bank's portfolio management policies and the mix and yield on the bank's securities and is one part of the evaluation of ROE.
Answer: Asset utilization

10. ___________________________ reflects the effectiveness of the expense management of the bank and is one part of the evaluation of ROE.
Answer: Net profit margin

11. ___________________________ measures the return to stockholders on their investment in the bank. It is the product of net profit margin, asset utilization and the equity multiplier.
Answer: ROE

12. ___________________________ measures the amount of debt or leverage a bank has and is one part of the evaluation of the bank's ROE) It is generally a number larger than one.
Answer: Equity multiplier

13. The___________________________ is a standardized report provided by federal regulators which reports the balance sheet, income statement and other data for all federally supervised banks. It has this year's data as well as three previous years and also contains information on peer institutions.
Answer: Uniform Bank Performance Report

14. ___________________________ measures the bank's risk of long run survival. It measures the bank's capital position and shows if there has been any erosion of capital over time.
Answer: Solvency risk (or capital risk)

15. ___________________________ is the risk that shifting interest rates in the market will adversely affect a financial institution's net income or the value of its assets or equity.
Answer: Interest rate risk

16. The _____________________ Act restricts combined auditing and consulting relationships in order to promote auditor independence and objectivity.
Answer: Sarbanes-Oxley

17. _________________________________ is one of the most widely respected private institutions that rates the credit quality of financial institutions.
Answer: Thomson’s BankWatch, Inc.

18. __________________________ refers to the uncertainty regarding the financial firm's earnings due to failures in computer systems, errors, misconduct by employees, lightening strikes and similar events.
Answer: Operational (transactional) risk

19. ______________________________ refers to variability in earnings resulting from actions taken by the legal system including unenforceable contracts, lawsuits and adverse judgements.
Answer: Legal risk

20. _____________________________ includes violations of rules and regulations. It can include failure to hold adequate capital which can lead to costly corrective actions.
Answer: Compliance risk

21. ________________________ is the uncertainty associated with public opinion. Negative publicity (whether true or not) can affect a financial firm's earnings by dissuading customers from using the services of the institution.
Answer: Reputation risk

22. As data processing of financial information becomes more important, managers of financial firms can realize cost savings from _______________________, transferring tasks from inside to firm itself to other firms specializing in information technology.
Answer: outsourcing

23. A traditional measure of earnings efficiency is the ______________________ or total interest income over total earnings assets less total interest expenses over total interest bearing bank liabilities. It measures the effectiveness of a firm's intermediation function in the borrowing and lending of money.
Answer: earnings spread

24. One part of ROE is _______________________ or net income over pre-tax net operating income which measures the financial firm's use of security gains and losses and other tax management tools to minimize tax exposure.
Answer: tax management efficiency

25. Net profit margin can be split into two parts, ________________ and tax management efficiency. The first part is pre-tax net operating income over total operating revenue which looks at how many dollars of revenue survive after operating expenses are removed.
Answer: expense control efficiency

True/False Questions

T F 26. Financial institutions that pursue the "quiet life" as a goal are really pursuing risk minimization.
Answer: True

T F 27. Attempting to maximize a bank's stock value is the key objective for banks which should have priority over all other bank goals.
Answer: True

T F 28. If the expected stream of future bank shareholder dividends rises, a bank's stock price should also rise, other factors held constant.
Answer: True

T F 29. If the discount factor associated with the value of a bank's stock rises, the bank's stock price should rise, other factors held constant.
Answer: False

T F 30. A bank's ROA equals its ROE times the ratio of total assets divided by total equity capital.
Answer: False

T F 31. According to the textbook a bank's asset-utilization ratio reflects the mix and yield on the bank's portfolio of assets.
Answer: True

T F 32. The bank's profit margin or ratio of net after-tax income to total operating revenue is a measure of financial leverage for a bank.
Answer: False

T F 33. The ratio of a bank's net after-tax income to pre-tax net operating income is described in the text as a measure of tax management efficiency.
Answer: True

T F 34. In the textbook the ratio of pre tax net operating income to total operating revenues is described as a measure of the effectiveness of a financial institution's expense-control efficiency.
Answer: True

T F 35. The ratio of non-performing assets to total loans and leases is a measure of credit risk in banking.
Answer: True

T F 36. The measure of a bank's efficiency and return known as the "earnings spread" subtracts total interest expenses from all the bank's interest income and these two items are then divided by total assets.
Answer: False

T F 37. In recent years the U.S. banking industry's equity multiplier has generally risen in response to regulatory pressure to raise more capital.
Answer: False

T F 38. If a bank adds more full-time employees and posts the same net operating income, its employee productivity ratio, as defined in the text, must fall.
Answer: True

T F 39. The most profitable U.S. banks in terms of both ROA and ROE are medium-size institutions in the asset size range of $100 million to $10 billion, according to the textbook.
Answer: True

T F 40. ROA measures how capably the management of a financial institution has been converting the institution's assets into net earnings.
Answer: True

T F 41. The noninterest margin is generally <u>positive</u> for most banks.
Answer: False

T F 42. The ratio of nonperforming assets to total loans and leases is considered to be a measure of a bank's <u>market risk</u>.
Answer: False

T F 43. <u>Charge-offs</u> represent securities a bank decides to sell because they have declined in value.
Answer: False

T F 44. Loans past due for 90 days or more are classified as <u>nonperforming assets.</u>
Answer: True

T F 45. The ratio of cash and government securities to total assets is considered to be a measure of liquidity risk in banking.
Answer: True

T F 46. The ratio of uninsured deposits to total deposits is considered to be a measure of credit risk in banking.
Answer: False

T F 47. The interest rate spread between market yields on bank debt issues (such as capital notes and CDs) and the market yields on government securities of the same maturity is considered to be a measure of market risk in banking.
Answer: False

T F 48. The ratio of a bank's net operating income to the number of a bank's full-time-equivalent employees is called the employee productivity ratio.
Answer: True

T F 49. Smaller banks usually have fewer liquid assets than larger banks.
Answer: False

T F 50. The bank's asset utilization ratio reflects the effectiveness of the bank's expense management.
Answer: False

T F 51. The FDIC is a private credit rating company which provides credit ratings on the short term and long term securities issued by banks.
Answer: False

T F 52. During the 1980's the Comptroller of the Currency, the Federal Reserve and the FDIC created a new tool to help them analyze the financial condition of banks. This new tool is called the Uniform Bank Performance Report.
Answer: True

T F 53. Liquidity risk for a bank examines the quality of the bank's assets and, in particular, the quality of the bank's loans.
Answer: False

T F 54. The bank's degree of asset utilization (AU) or ratio of total operating revenue to total assets is a measure of asset management efficiency, especially in terms of the mix and yield on assets.
Answer: True

T F 55. According the case study of the failure of Superior Bank of Chicago and the FDIC's takeover of this institution in 2001, the main problem was attributed to misleading accounting practices of inflating asset values and revenues deflating liabilities and expenses. The Sarbanes-Oxley Accounting Standards Act of 2002 addresses this issue and expressly encourages combining auditing and consulting relationships in order to promote efficiency and profitability of financial institutions.
Answer: False

Multiple Choice Questions

56. The ratio of a bank's interest income from its loans and security investments less interest expenses on debt issued divided by total earning assets measures a bank's:
A) Net operating margin
B) Net return before special transactions
C) Net interest margin
D) Return on assets
E) None of the above
Answer: C

57. ROE for a bank is calculated by:
A) Dividing net after-tax income by total equity capital.
B) Dividing total operating revenue less operating expenses by total assets.
C) Deducting total interest expenses from total interest income and dividing by total equity capital.
D) Noninterest income less noninterest expenses divided by total earning assets.
E) None of the above.
Answer: A

58. The difference between such sources of bank income as service charges on deposits and trust-service fees and such sources of bank expenses as salaries and wages and overhead expenses divided by total assets or total earning assets is called the:
A) Net profit margin
B) Net operating margin
C) Net noninterest margin
D) Net return on assets
E) None of the above
Answer: C

59. A bank's ROE equals its ROA times its:
A) Net profit margin

B) Total assets divided by total equity capital
C) Total operating revenues divided by total assets
D) Ratio of net after-tax income to total operating revenues
E) None of the above.
Answer: B

60. The earnings spread for a bank is equal to:
A) Total interest income divided by total earning assets less total interest-expense divided by total interest-bearing bank liabilities.
B) Total interest income less total interest expenses divided by earning assets.
C) Total operating revenues less total operating expenses divided by total assets.
D) Total cash and noncash expenses subtracted from interest and noninterest income divided by total assets.
E) None of the above.
Answer: A

61. The so-called employee productivity ratio for a bank is equal to:
A) Net operating revenue less total interest expenses per employee.
B) Total interest and noninterest expense per employee
C) Net operating income per full-time-equivalent employee
D) Total operating earnings less salaries and wages expense per employee.
E) None of the above.
Answer: C

62. According to the textbook the most profitable banks in the United States in 2007 fell in the asset size range of:
A) Under $25 million in total assets
B) Under $100 million in total assets
C) Between $100 million and $10 billion in total assets
D) Over $10 billion in total assets
E) None of the above.
Answer: D

63. A bank's stock price will tend to rise if the:
A) Value of the stream of future stockholder dividends is expected to increase
B) The banking organization's perceived level of risk has fallen
C) Expected dividends increase, while perceived level of risk declines
D) All of the above.
E) None of the above.
Answer: D

64. The ratio that equals total interest income divided by total earning assets less total interest expense divided by total interest-bearing liabilities is known as the:
A) Earnings base
B) Earnings spread

C) Net income margin
D) Net return prior to special transactions
E) None of the above
Answer: B

65. What do loans and security investments represent for a bank?
A) Earning assets
B) Classified assets
C) Discretionary accounts
D) Market-valued assets
E) None of the above
Answer: A

66. The so-called tax-management efficiency ratio consists of:
A) Total tax liabilities over net income
B) Tax-exempt assets over taxable assets
C) Net income over pre-tax net operating income
D) Taxes owed over total liabilities of a bank
E) None of the above.
Answer: C

67. The ratio of net loans to total assets is considered to be a measure of what form of risk in banking?
A) Credit risk
B) Liquidity risk
C) Market risk
D) Interest-rate risk
E) None of the above
Answer: B

68. OE for a bank reflects:
A) How well the assets of the bank are managed
B) The bank's use of leverage
C) How well the bank controls expenses
D) All of the above
E) None of the above
Answer: D

69. A ratio that can be used to measure a bank's credit risk would be:
A) Net loans/total assets
B) Interest sensitive assets/interest sensitive liabilities
C) Total assets/number of full time employees
D) Nonperforming loans/total loans
Answer: D

70. A bank that has a low profit margin most likely:
A) Is doing a poor job of controlling expenses
B) Has a small amount of financial leverage
C) Has a small amount of liquidity risk
D) Has assets that are not very productive
E) None of the above
Answer: A

71. A bank that has a high asset utilization (AU) ratio most likely:
A) Is doing a poor job of controlling expenses
B) Has a small amount of financial leverage
C) Has a small amount of liquidity risk
D) Is allocating assets to the most productive investments
E) None of the above
Answer: D

72. Which of the following would be the best example of a ratio used to examine the cost of one of the bank's liabilities?
A) Demand deposits/ total assets
B) Interest on time deposits/ total time deposits
C) Interest on real estate loans/ total real estate loans
D) Interest sensitive assets/ interest sensitive liabilities
Answer: B

73. Which of the following would be the best example of a ratio used to examine the return of one of the bank's assets?
A) Demand deposits/ total assets
B) Interest on time deposits/ total time deposits
C) Interest on real estate loans/ total real estate loans
D) Interest sensitive assets/ interest sensitive liabilities
Answer: C

74. Which of the following would be the best example of a ratio used to examine the bank's interest rate risk?
A) Demand deposits/ total assets
B) Interest on time deposits/ total time deposits
C) Interest on real estate loans/ total real estate loans
D) Interest sensitive assets/ interest sensitive liabilities
Answer: D

75. A bank expects to pay a dividend next year of $3.45 and also expects dividends to grow at a rate of 7% from now on. If the appropriate discount rate is 15%, what should this bank's stock price be in the market?
A) $23.00
B) $43.13
C) $46.14

D) $49.29
E) $24.61
Answer: B

76. Using the information listed below for Carter State Bank, what is this bank's ROE?

Net income	$55 million
Total operating revenue	$650 million
Total assets	$4,055 million
Total equity capital	$350 million

A) 8.46 percent
B) 16.03 percent
C) 15.71 percent
D) 1.36 percent
E) None of the above
Answer: C

77. Using the information listed below for Carter State Bank, what is this bank's ROA?

Net income	$55 million
Total operating revenue	$650 million
Total assets	$4,055 million
Total equity capital	$350 million

A) 8.46 percent
B) 16.03 percent
C) 15.71 percent
D) 1.36 percent
E) None of the above
Answer: D

78. Using the information listed below for Carter State Bank, what is this bank's net profit margin?

Net income	$55 million
Total operating revenue	$650 million
Total assets	$4,055 million
Total equity capital	$350 million

A) 8.46 percent
B) 16.03 percent
C) 15.71 percent
D) 1.36 percent
E) None of the above
Answer: A

79. Using the information listed below for Carter State Bank, what is this bank's asset utilization ratio?

Net income	$55 million
Total operating revenue	$650 million
Total assets	$4,055 million
Total equity Capital	$350 million

A) 8.46 percent
B) 16.03 percent
C) 15.71 percent
D) 1.36 percent
E) None of the above
Answer: B

80. The TRC Bank has a net profit margin of 7.5%, an asset utilization ratio of 18%, an equity multiplier of 20 times. What is this bank's ROA?
A) 27.00 percent
B) 1.35 percent
C) 7.50 percent
D) 1.50 percent
E) 3.6 percent
Answer: B

81. The TRC Bank has a net profit margin of 7.5%, an asset utilization ratio of 18%, an equity multiplier of 20 times. What is this bank's ROE?
A) 27.00 percent
B) 1.35 percent
C) 7.50 percent
D) 1.50 percent
E) 3.6 percent
Answer: A

82. The Smith-James Bank has an ROE of 17.5%, an asset utilization ratio of 13% and a net profit margin of 9%. What is this bank's ROA?
A) 14.96 percent
B) 1.58 percent
C) 1.17 percent
D) 134.62 percent
E) None of the above
Answer: C

83. The Smith-James Bank has an ROE of 17.5%, an asset utilization ratio of 13% and a net profit margin of 9%. What must this bank's equity multiplier be?
A) 14.96 times
B) 1.58 times

C) 1.17 times
D) 134.62 times
E) None of the above
Answer: A

84. What is the equity multiplier for a bank where equity is equal to 10 percent of total assets?
A) 90.0
B) 10.0
C) 1.1
D) 110.0
E) 1.0
Answer:

85. Which of the following ratios would be a measure of credit risk?
A) Nonperforming Loans/Net Loans
B) Net Loans/Total Assets
C) Interest Sensitive Assets/Interest Sensitive Liabilities
D) Equity Capital/Total Assets
E) None of the above
Answer: A

86. Which of the following ratios would be a measure of market risk?
A) Nonperforming Loans/Net Loans
B) Net Loans/Total Assets
C) Interest Sensitive Assets/Interest Sensitive Liabilities
D) Equity Capital/Total Assets
E) None of the above
Answer: E

87. In recent years banks have been __________ profitable than (as) S&Ls and Savings Banks.
A) More
B) Less
C) As
D) Much more
E) Much less
Answer: A

88. Operational risk includes which of the following?
A) Failure of bank's computer system
B) Closure of a bank for three months due to flooding from a major hurricane
C) Embezzlement of funds of a bank by a teller of the bank
D) Closure of a bank for two weeks due to a fire from a lightening strike
E) All of the above are example of operational risk
Answer: E

89. Brian Smith, CEO of Carter National Bank, decides that interest rates are going to fall in the future and as a result buys $100 million in 30 year Treasury Bonds for the bank's security portfolio. Instead, interest rates rise causing the value of these bonds to fall. This would be an example of which of the following types of risk?
A) Operational risk
B) Legal risk
C) Compliance risk
D) Strategic risk
E) Reputation risk
Answer: D

90. Chaos State Bank has an old computer system which can go down for weeks at a time, leaving customers unable to access their accounts online. Many customers have left the bank for banks with more reliable computer systems. Which type of risk would this be an example of?
A) Operational risk
B) Legal risk
C) Compliance risk
D) Strategic risk
E) Reputation risk
Answer: A

91. Carson County State Bank has a ratio of equity capital to total assets of 2.5%. The FDIC which regulates this bank has determined that this is not enough equity capital and is making the bank issue new stock in the market. In addition, they are not allowing the bank to issue a dividend to their current stockholders. Which type of risk would this be an example of?
A) Operational risk
B) Legal risk
C) Compliance risk
D) Strategic risk
E) Reputation risk
Answer: C

92. Everett Bank has just learned that there is a disgruntled former employee who has created a blog that is telling everyone that Everett Bank has halved their customer service representatives and so customers have great difficulty getting through to a live person when there is a problem with their account. Everett is worried that they may lose customers as a result. Which type of risk would this be an example of?
A) Operational risk
B) Legal risk
C) Compliance risk
D) Strategic risk

E) Reputation risk
Answer: E

93. Norman Bank made a loan of $1,000,000 to Jarod LeFevre. Jarod has declared bankruptcy and Norman Bank has just learned that the judge in the case has ruled that Jarod does not have to pay any of the loan back or forfeit any of his assets. Which type of risk would this be an example of?
A) Operational risk
B) Legal risk
C) Compliance risk
D) Strategic risk
E) Reputation risk
Answer: B

94. Forrest Fennell is thinking about investing in Capital City Bank. He is examining certain ratios of the bank including the ratio of nonperforming loans to total loans and leases and the provision for loan losses to total loans and leases. What type of risk is Forrest attempting to measure with these ratios?
A) Credit risk
B) Liquidity risk
C) Market risk
D) Interest rate risk
E) Operational risk
Answer: A

95. Gerald Wilkens is thinking about investing in Tallahassee State Bank. He is examining certain ratios of the bank including the ratio of cash assets and government securities to total assets and purchased funds to total assets. What type of risk is Gerald attempting to measure with these ratios?
A) Credit risk
B) Liquidity risk
C) Market risk
D) Interest rate risk
E) Operational risk
Answer: B

96. Amy Farmer is thinking about investing in the Guthrie National Bank. She is examining certain ratios of the bank including the ratio of the book value of the assets to the market value of the assets and the market value of the bonds held by the bank to their recorded value. What type of risk is Amy attempting to measure with these ratios?
A) Credit risk

B) Liquidity risk
C) Market risk
D) Interest rate risk
E) Operational risk
Answer: C

97. Paul Smith is thinking about investing in Capital City Bank. He is examining certain ratios of the bank including the ratio of interest sensitive assets to interest sensitive liabilities and uninsured deposits to total deposits. What type of risk is Paul attempting to measure with these ratios?
A) Credit risk
B) Liquidity risk
C) Market risk
D) Interest rate risk
E) Operational risk
Answer: D

98. The Garic State Bank of New Orleans was under water for three weeks after Hurricane Katrina hit the state. The lobby is full of mud and other debris. Many of the valuables stored in the bank's safety deposit boxes have been ruined. John Garic, the President and CEO of the bank, has been working night and day to reopen the bank. What type of risk has John been dealing with?
A) Credit risk
B) Liquidity risk
C) Market risk
D) Interest rate risk
E) Operational risk
Answer: E

99. Castle State Bank has the following financial information.

Balance Sheet		**Income Statement**	
Cash	$100	Interest Income	$400
Securities Investments	$600	Interest Expenses	($150)
Net Loans	$1200	Non-Interest Income	$50
Net Premises and Equip.	$300	Non-Interest Expenses	($100)
Total Assets	$2200	Provision for Loan Losses	($60)
Deposits	$1100	Pre Tax Net Operating Income	$140
Non-Deposit Borrowings *	$800	Securities Gains (Losses)	($40)
Equity Capital	$300	Taxes	($45)
Total Liabilities and Equity	$2200	Net Income	$55
* All Purchased Funds			

Use this information to calculate Castle State Bank's ROE
A) 20.45%
B) 18.33%
C) 12.22%
D) 7.33%
E) 2.5%
Answer: B

100. Castle State Bank has the following financial information.

Balance Sheet		**Income Statement**	
Cash	$100	Interest Income	$400
Securities Investments	$600	Interest Expenses	($150)
Net Loans	$1200	Non-Interest Income	$50
Net Premises and Equip.	$300	Non-Interest Expenses	($100)
Total Assets	$2200	Provision for Loan Losses	($60)
Deposits	$1100	Pre Tax Net Operating Income	$140
Non-Deposit Borrowings *	$800	Securities Gains (Losses)	($40)
Equity Capital	$300	Taxes	($45)
Total Liabilities and Equity	$2200	Net Income	$55
* All Purchased Funds			

Use this information to calculate Castle State Bank's ROA
A) 20.45%
B) 18.33%
C) 12.22%
D) 7.33%
E) 2.5%
Answer: E

101. Castle State Bank has the following financial information.

Balance Sheet		**Income Statement**	
Cash	$100	Interest Income	$400
Securities Investments	$600	Interest Expenses	($150)
Net Loans	$1200	Non-Interest Income	$50
Net Premises and Equip.	$300	Non-Interest Expenses	($100)
Total Assets	$2200	Provision for Loan Losses	($60)
Deposits	$1100	Pre Tax Net Operating Income	$140
Non-Deposit Borrowings *	$800	Securities Gains (Losses)	($40)
Equity Capital	$300	Taxes	($45)
Total Liabilities and Equity	$2200	Net Income	$55
* All Purchased Funds			

Use this information to calculate Castle State Bank's net profit margin

A) 20.45%
B) 18.33%
C) 12.22%
D) 7.33%
E) 2.5%
Answer: C

102. Castle State Bank has the following financial information.

Balance Sheet		**Income Statement**	
Cash	$100	Interest Income	$400
Securities Investments	$600	Interest Expenses	($150)
Net Loans	$1200	Non-Interest Income	$50
Net Premises and Equip.	$300	Non-Interest Expenses	($100)
Total Assets	$2200	Provision for Loan Losses	($60)
Deposits	$1100	Pre Tax Net Operating Income	$140
Non-Deposit Borrowings *	$800	Securities Gains (Losses)	($40)
Equity Capital	$300	Taxes	($45)
Total Liabilities and Equity	$2200	Net Income	$55

* All Purchased Funds

Use this information to calculate Castle State Bank's asset utilization ratio

A) 20.45%
B) 18.33%
C) 12.22%
D) 7.33%
E) 2.5%
Answer: A

103. Castle State Bank has the following financial information.

Balance Sheet		**Income Statement**	
Cash	$100	Interest Income	$400
Securities Investments	$600	Interest Expenses	($150)
Net Loans	$1200	Non-Interest Income	$50
Net Premises and Equip.	$300	Non-Interest Expenses	($100)
Total Assets	$2200	Provision for Loan Losses	($60)
Deposits	$1100	Pre Tax Net Operating Income	$140
Non-Deposit Borrowings *	$800	Securities Gains (Losses)	($40)
Equity Capital	$300	Taxes	($45)
Total Liabilities and Equity	$2200	Net Income	$55

* All Purchased Funds

Use this information to calculate Castle State Bank's equity multiplier
A) 20.45 times
B) 18.33 times
C) 12.22 times
D) 7.33 times
E) 2.5 times
Answer: D

104. Castle State Bank has the following financial information.

Balance Sheet		**Income Statement**	
Cash	$100	Interest Income	$400
Securities Investments	$600	Interest Expenses	($150)
Net Loans	$1200	Non-Interest Income	$50
Net Premises and Equip.	$300	Non-Interest Expenses	($100)
Total Assets	$2200	Provision for Loan Losses	($60)
Deposits	$1100	Pre Tax Net Operating Income	$140
Non-Deposit Borrowings *	$800	Securities Gains (Losses)	($40)
Equity Capital	$300	Taxes	($45)
Total Liabilities and Equity	$2200	Net Income	$55

* All Purchased Funds

Use this information to calculate Castle State Bank's earnings spread
A) 37.5%
B) 22.22%
C) 14.33%
D) 7.89%
E) 2.5%
Answer: C

105. Harrison Bank has the following financial information.

Net Profit Margin	12.5%
Net Income	$1000
Total Assets	$62,500
Total Equity	$6250

What is this bank's ROA?
A) 1.6%
B) 10%
C) 12.8%
D) 16%
E) None of the above
Answer: A

106. Harrison Bank has the following financial information.

Net Profit Margin	12.5%
Net Income	$1000
Total Assets	$62,500
Total Equity	$6250

What is this bank's ROE?
A) 1.6%
B) 10 %
C) 12.8%
D) 16%
E) None of the above
Answer: D

107. Harrison Bank has the following financial information.

Net Profit Margin	12.5%
Net Income	$1000
Total Assets	$62,500
Total Equity	$6250

What is this bank's Equity Multiplier
A) 1.6 times
B) 10 times
C) 12.8 times
D) 16 times
E) None of the above
Answer: B

108. Harrison Bank has the following financial information.

ROE	16%
Net Income	$1000
Total Assets	$62,500
Total Equity	$6250

What is this bank's asset utilization ratio?
A) 1.6%
B) 10%
C) 12.8%
D) 16%

E) None of the above
Answer: C

109. Harrison Bank has the following financial information.

Net Profit Margin	12.5%
Net Income	$1000
Total Assets	$62,500
Total Equity	$6250

What is this bank's total operating revenue?
A) $125
B) $8000
C) $488,281
D) $31,250,000
E) None of the above
Answer: B

110. Which assets are excluded from risk assets?
A) Real Estate Loans
B) Commercial Paper
C) Plant and Equipment
D) Commercial and Industrial Loans
E) All of the above are risk assets
Answer: C

Chapter 7
Risk Management for Changing Interest Rates: Asset-Liability Management and Duration Techniques

Fill in the Blank Questions

1. The ___________________ view of assets and liabilities held that the amount and types of deposits was primarily determined by customers and hence the key decision a bank needed to make was with the assets.
   Answer: asset management

2. Recent decades have ushered in dramatic changes in banking. The goal of __________________ was simply to gain control of the bank's sources of funds.
   Answer: liability management

3. The__________________________ is the interest rate that equalizes the current market price of a bond with the present value of the future cash flows.
   Answer: yield to maturity (YTM)

4. The __________________ risk premium on a bond allows the investor to be compensated for their projected loss in purchasing power from the increase in the prices of goods and services in the future.
   Answer: inflation

5. The __________________ shows the relationship between the time to maturity and the yield to maturity of a bond. It is usually constructed using treasury securities since they are assumed to have no default risk.
   Answer: yield curve

6. The __________________ risk premium on a bond reflects the differences in the ease and ability to sell the bond in the secondary market at a favorable price.
   Answer: liquidity

7. ___________________________are those assets which mature or must be repriced within the planning period.
   Answer: Interest-sensitive assets

8. __________________________ is the difference between interest-sensitive assets and interest-sensitive liabilities.
   Answer: Dollar interest-sensitive gap

9. A(n)___________________________ means that the bank has more interest-sensitive liabilities than interest-sensitive assets.
Answer: negative interest-sensitive gap (liability sensitive)

10. The bank's___________________________ takes into account the idea that the speed (sensitivity) of interest rate changes will differ for different types of assets and liabilities.
Answer: weighted interest-sensitive gap

11. ___________________________ is the coordinated management of both the bank's assets and its liabilities.
Answer: Funds management

12. ___________________________ is the risk due to changes in market interest rates which can adversely affect the bank's net interest margin, assets and equity.
Answer: Interest rate risk

13. The___________________________ is the rate of return on a financial instrument using a 360 day year relative to the instrument's face value.
Answer: bank discount rate

14. The ___________________________ component of interest rates is the risk premium due to the probability that the borrower will miss some payments or will not repay the loan.
Answer: default risk premium

15. __________________ is the weighted average maturity for a stream of future cash flows. It is a direct measure of price risk.
Answer: Duration

16. ___________________________ is the difference between the dollar-weighted duration of the asset portfolio and the dollar-weighted duration of the liability portfolio.
Answer: Duration gap

17. A(n)___________________________ duration gap means that for a parallel increase in all interest rates the market value of net worth will tend to decline.
Answer: positive

18. A(n)____________________________ duration gap means that for a parallel increase in all interest rates the market value of net worth will tend to increase.
Answer: negative

19. The __________________ refers to the periodic fluctuations in the scale of economic activity.
Answer: business cycle

20. The__________________________ is equal to the duration of each individual type of asset weighted by the dollar amount of each type of asset out of the total dollar amount of assets.
Answer: duration of the asset portfolio

21. The__________________________ is equal to the duration of each individual type of liability weighted by the dollar amount of each type of asset out of the total dollar amount of assets.
Answer: duration of the liability portfolio

22. A bank is __________________ against changes in its net worth if its duration gap is equal to zero.
Answer: immunized (insulated or protected)

23. The relationship between a change in an asset's price and an asset's change in the yield or interest rate is captured by __________________________.
Answer: convexity

24. The change in a financial institution's __________________ is equal to difference in the duration of the assets and liabilities times the change in the interest rate divided by the starting interest rate times the dollar amount of the assets and liabilities.
Answer: net worth

25. When a bank has a positive duration gap a parallel increase in the interest rates on the assets and liabilities of the bank will lead to a(n) __________________ in the bank's net worth.
Answer: decrease

26. When a bank has a negative duration gap a parallel decrease in the interest rates on the assets and liabilities of the bank will lead to a(n)_________________________ in the bank's net worth.
Answer: decrease

27. U.S. banks tend to do better when the yield curve is upward-sloping because they tend to have ____________ maturity gap positions.
Answer: positive

28. One government-created giant mortgage banking firms which have subsequently been privatized is the _________________________.
Answer: FNMA or Fannie Mae (or FHLMC or Freddie Mac)

29. One part of interest rate risk is ________________________. This part of interest rate risk reflects that as interest rates rise, prices of securities tend to fall.
Answer: price risk

30. One part of interest rate risk is ___________________________. This part of interest rate risk reflects that as interest rates fall, any cash flows that are received before maturity are invested at a lower interest rate.
Answer: reinvestment risk

31. When a borrower has the right to pay off a loan early which reduced the lender's expected rate of return it is called ________________.
Answer: call risk

32. In recent decades, banks have aggressively sought to insulate their assets and liability portfolios and profits from the ravages if interest rate changes. Many banks now conduct their asset-liability management strategy with the help of an _______________________________ which often meets daily.
Answer: asset-liability committee

33. ____________________ is interest income from loans and investments less interest expenses on deposits and borrowed funds divided by total earning assets.
Answer: Net interest margin (NIM)

34. __________________________ are those liabilities that which mature or must be repriced within the planning period.
Answer: Interest-sensitive liabilities

35. Variable rate loans and securities are included as part of ___________________________ for banks.
Answer: repriceable assets

36. Money market deposits are included as part of ____________________ for banks.
Answer: repriceable liabilities

37. Interest sensitive assets less interest sensitive liabilities divided by total assets of the bank is known as ______________________.
Answer: relative interest sensitive gap

38. Interest sensitive assets divided by interest sensitive liabilities is known as ____________.
Answer: Interest sensitivity ratio

39. ______________________is a measure of interest rate exposure which is the total difference in dollars between those assets and liabilities that can be repriced over a designated time period.
Answer: Cumulative gap

40. ______________________ is the phenomenon that interest rates attached to various assets often change by different amounts and at different speeds than interest rates attached to various liabilities,
Answer: basis risk

True/False Questions

T F 41. Usually the principal goal of asset-liability management is to maximize or at least stabilize a bank's margin or spread.
Answer: True

T F 42. Asset management strategy in banking assumes that the amount and kinds of deposits and other borrowed funds a bank attracts are determined largely by its management.
Answer: False

T F 43. The ultimate goal of liability management is to gain control over a financial institution's sources of funds.
Answer: True

T F 44. If interest rates fall when a bank is in an asset-sensitive position its net interest margin will rise.
Answer: False

T F 45. A liability-sensitive bank will experience an increase in its net interest margin if interest rates rise.
Answer: False

T F 46. Under the so-called <u>liability</u> <u>management</u> view in banking the key control lever banks possess over the volume and mix of their liabilities is <u>price.</u>
Answer: True

T F 47. Under the so-called <u>funds management</u> view bank management's control over assets must be coordinated with its control over liabilities so that asset and liability management are internally consistent.
Answer: True

T F 48. Bankers cannot determine the level or trend of market interest rates; instead, they can only react to the level and trend of rates.
Answer: True

T F 49. Short-term interest rates tend to rise more slowly than long-term interest rates and to fall more slowly when all interest rates in the market are headed down.
Answer: False

T F 50. A financial institution is liability sensitive if its interest-sensitive liabilities are less than its interest-sensitive assets.
Answer: False

T F 51. If a bank's interest-sensitive assets and liabilities are equal than its interest revenues from assets and funding costs from liabilities will change at the same rate.
Answer: True

T F 52. Banks with a positive cumulative interest-sensitive gap will benefit if interest rates rise, but lose income if interest rates decline.
Answer: True

T F 53. Banks with a negative cumulative interest-sensitive gap will benefit if interest rates rise, but lose income if interest rates decline.
Answer: False

T F 54. For most banks interest rates paid on liabilities tend to move more slowly than interest rates earned on assets.
Answer: False

T F 55. Interest-sensitive gap techniques do not consider the impact of changing interest rates on stockholders equity.
Answer: True

T F 56. Interest-sensitive gap, relative interest-sensitive gap and the interest-sensitivity ratio will often reach different conclusions as to whether the bank is asset or liability sensitive.
Answer: False

T F 57. The yield curve is constructed using corporate bonds with different default risks so the bank can determine the risk/return tradeoff for default risk.
Answer: False

T F 58. Financial securities that are the same in all other ways may have differences in interest rates that reflect the differences in the ease of selling the security in the secondary market at a favorable price.
Answer: True

T F 59. Financial institutions face two major kinds of interest rate risk. These risks include price risk and reinvestment risk.
Answer: True

T F 60. Interest-sensitive gap and weighted interest-sensitive gap will always reach the same conclusion as to whether a bank is asset sensitive or liability sensitive.
Answer: False

T F 61. Weighted interest-sensitive gap is less accurate than interest-sensitive gap in determining the affect of changes in interest rates on net interest margin.
Answer: False

T F 62. A bank with a positive duration gap experiencing a rise in interest rates will experience an increase in its net worth.
Answer: False

T F 63. A bank with a negative duration gap experiencing a rise in interest rates will experience an increase in its net worth.
Answer: True

T F 64. Duration is a direct measure of the reinvestment risk of a bond.
Answer: False

T F 65. A bank with a positive duration gap experiencing a decrease in interest rates will experience an increase in its net worth.
Answer: True

T F 66. A bank with a negative duration gap experiencing a decrease in interest rates will experience an increase in its net worth.
Answer: False

T F 67. Duration is the weighted average maturity of a promised stream of future cash flows.
Answer: True

T F 68. Duration is a direct measure of the price risk of a bond.
Answer: True

T F 69. A bond with a greater duration will have a smaller price change in percentage terms when interest rates change.
Answer: False

T F 70. Long-term interest rates tend to change very little with the cycle of economic activity.
Answer: True

T F 71. A bank with a duration gap of zero is immunized against changes in the value of net worth due to changes in interest rates in the market.
Answer: True

T F 72. Convexity is the idea that the rate of change of an asset's price varies with the level of interest rates.
Answer: True

T F 73. The change in the market price of an asset's price from a change in market interest rates is roughly equal to the asset's duration times the change the interest rate divided by the original interest rate.
Answer: True

T F 74. U.S. banks tend to do better when the yield curve is upward-sloping.
Answer: True

T F 75. Net interest margin tends to rise for U.S. banks when the yield curve is upward-sloping.
Answer: True

T F 76. Financial institutions laden with home mortgages tend be immune to interest-rate risk.
Answer: False

T F 77. If a Financial Institution's net interest margin is immune to interest-rate risk then so is its net worth.
Answer: False

Multiple Choice Questions

78. When is interest rate risk for a bank greatest?
    A) When interest rates are volatile.
    B) When interest rates are stable.
    C) When inflation is high.
    D) When inflation is low.
    E) When loan defaults are high.
    Answer: A

79. A bank's IS GAP is defined as:
    A) The dollar amount of rate-sensitive assets divided by the dollar amount of rate-sensitive liabilities.
    B) The dollar amount of earning assets divided by the dollar amount of total liabilities.
    C) The dollar amount of rate-sensitive assets minus the dollar amount of rate-sensitive liabilities.
    D) The dollar amount of rate-sensitive liabilities minus the dollar amount of rate-sensitive assets.
    E) The dollar amount of earning assets times the average liability interest rate.
    Answer: C

80. According to the textbook, the maturing of the liability management techniques, coupled with more volatile interest rates, gave birth to the ___________________ approach which dominates banking today. The term that correctly fills in the blank in the preceding sentence is:
    A) Liability management
    B) Asset management
    C) Risk management
    D) Funds management
    E) None of the above.
    Answer: D

81. The principal goal of interest-rate hedging strategy is to hold fixed a bank's:
    A) Net interest margin
    B) Net income before taxes
    C) Value of loans and securities
    D) Noninterest spread
    E) None of the above.
    Answer: A

82. A bank is asset sensitive if its:
    A) Loans and securities are affected by changes in interest rates.
    B) Interest-sensitive assets exceed its interest-sensitive liabilities.
    C) Interest-sensitive liabilities exceed its interest-sensitive assets.
    D) Deposits and borrowings are affected by changes in interest rates.
    E) None of the above.
    Answer: B

83. The change in a bank's net income that occurs due to changes in interest rates equals the overall change in market interest rates (in percentage points) times _____________. The choice below that correctly fills in the blank in the preceding sentence is:
A) Volume of interest-sensitive assets
B) Price risk of the bank's assets
C) Price risk of the bank's liabilities
D) Size of the bank's cumulative gap
E) None of the above.
Answer: D

84. A bank with a negative interest-sensitive GAP:
A) Has a greater dollar volume of interest-sensitive liabilities than interest-sensitive assets.
B) Will generate a higher interest margin if interest rates rise.
C) Will generate a higher interest margin if interest rates fall.
D) A and B.
E) A and C.
Answer: E

85. The net interest margin of a bank is influenced by:
A) Changes in the level of interest rates.
B) Changes in the volume of interest-bearing assets and interest-bearing liabilities.
C) Changes in the mix of assets and liabilities in the bank's portfolio.
D) All of the above.
E) A and B only.
Answer: D

86. The discount rate that equalizes the current market value of a loan or security with the expected stream of future income payments from that loan or security is known as the:
A) Bank discount rate
B) Yield to maturity
C) Annual percentage rate (APR)
D) Add-on interest rate
E) None of the above.
Answer: B

87. The interest-rate measure often quoted on short-term loans and money market securities such as U.S. Treasury bills is the:
A) Bank discount rate
B) Yield to maturity
C) Annual percentage rate (APR)
D) Add-on interest rate
E) None of the above
Answer: A

88. A bank whose interest-sensitive assets total $350 million and its interest-sensitive liabilities amount to $175 million has:
    A) An asset-sensitive gap of 525 million
    B) A liability-sensitive gap of $175 million
    C) An asset-sensitive gap of $175 million
    D) A liability-sensitive gap of $350 million
    E) None of the above.
    Answer: C

89. A bank has a 1-year $1,000,000 loan outstanding, payable in four equal quarterly installments. What dollar amount of the loan would be considered rate sensitive in the 0 – 90 day bucket?
    A) $0
    B) $250,000
    C) $500,000
    D) $750,000
    E) $1,000,000
    Answer: B

90. A bank has Federal funds totaling $25 million with an interest rate sensitivity weight of 1.0. This bank also has loans of $105 million and investments of $65 million with interest rate sensitivity weights of 1.40 and 1.15 respectively. This bank also has $135 million in interest-bearing deposits with an interest rate sensitivity weight of .90 and other money market borrowings of $75 million with an interest rate sensitivity weight of 1.0. What is the weighted interest-sensitive gap for this bank?
    A) $50.25
    B) $-15
    C) -$50.25
    D) $34.25
    E) None of the above
    Answer: A

91. A bond has a face value of $1000 and five years to maturity. This bond has a coupon rate of 13 percent and is selling in the market today for $902. Coupon payments are made annually on this bond. What is the yield to maturity (YTM) for this bond?
    A) 13%
    B) 12.75%
    C) 16%
    D) 11.45%
    E) Cannot be calculated from the information given
    Answer: C

92. A treasury bill currently sells for $9,845, has a face value of $10,000 and has 46 days to maturity. What is the bank discount rate on this security?
    A) 12.49%
    B) 12.13%
    C) 12.30%
    D) 2%

E) None of the above
Answer: B

93. The _______________ is determined by the demand and supply for loanable funds in the market. The term that correctly fills in the blank in the preceding sentence is:
A) The yield to maturity
B) The banker's discount rate
C) The holding period return
D) The risk-free real rate of interest
E) The market rate of interest on a risky loan
Answer: D

94. A bank with a positive interest-sensitive gap will have a decrease in net interest income when interest rates in the market:
A) Rise
B) Fall
C) Stay the same
D) A bank with a positive interest-sensitive gap will never have a decrease in net interest income
Answer: B

95. The fact that a consumer who purchases a particular basket of goods for $100 today has to pay $105 next year for the same basket of goods is an example of which of the following risks:
A) Inflation risk
B) Default risk
C) Liquidity risk
D) Price risk
E) Maturity risk
Answer: A

96. A bank has Federal Funds totaling $25 million with an interest rate sensitivity weight of 1.0. This bank also has loans of $105 million and investments of $65 million with interest rate sensitivity weights of 1.40 and 1.15 respectively. This bank also has $135 million in interest-bearing deposits with an interest rate sensitivity weight of .90 and other money market borrowings of $75 million with an interest rate sensitivity weight of 1.0. What is the dollar interest-sensitive gap for this bank?
A) $50.25
B) $-15
C) -$50.25
D) $34.25
E) None of the above
Answer: B

97. If a bank has a positive GAP, an increase in interest rates will cause interest income to __________, interest expense to__________, and net interest income to __________.

A) Increase, increase, increase
B) Increase, decrease, increase
C) Increase, increase, decrease
D) Decrease, decrease, decrease
E) Decrease, increase, increase
Answer: A

98. If a bank has a negative GAP, a decrease in interest rates will cause interest income to __________, interest expense to__________, and net interest income to __________.
A) Increase, increase, increase
B) Increase, decrease, increase
C) Increase, increase, decrease
D) Decrease, decrease, decrease
E) Decrease, decrease, increase
Answer: E

99. A treasury bill currently sells for $9,845, has a face value of $10,000 and has 46 days to maturity. What is the yield to maturity on this security?
A) 12.49%
B) 12.13%
C) 12.30%
D) 2%
E) None of the above
Answer: A

100. The Third National Bank of Edmond reports a net interest margin of 5.83%. It has total interest revenues of $275 million and total interest expenses of $210 million. What does this bank's earnings assets have to be?
A) $4717 million
B) $3602 million
C) $1115 million
D) $3.790 million
E) None of the above
Answer: C

101. The Third National Bank of Edmond reports a net interest margin of 5.83%. It has total interest revenues of $275 million and total interest expenses of $210 million. This bank has earnings assets of $1115. Suppose this bank's interest revenues rise by 8 percent and its interest expenses and earnings assets rise by 10 percent next year. What is this bank's new net interest margin?
A) 5.83%
B) 7.09%
C) 3.59%
D) 5.38%
E) 7.80%
Answer: D

102. Which of the following is part of funds management?
A) The goal of funds management is simply to gain control over the bank's funds sources.
B) Since the amount of deposits a bank holds is determined largely by its customers, the focus of the bank should be on managing the assets of the bank.
C) Management of the bank's assets must be coordinated with management of the bank's liabilities.
D) The spread between interest revenues and interest expenses is unimportant.
E) None of the above
Answer: C

103. If Fifth National Bank's asset duration exceeds its liability duration and interest rates rise, this will tend to ___________________ the market value of the bank's net worth.
A) Lower
B) Raise
C) Stabilize
D) Not affect
E) None of the above
Answer: A

104. If Main Street Bank has $100 million in commercial loans with an average duration of 0.40 years; $40 million in consumer loans with an average duration of 1.75 years; and $30 million in U.S. Treasury bonds with an average duration of 6 years, what is Main Street's asset portfolio duration?
A) 0.4 years
B) 1.7 years
C) 2.7 years
D) 4.1 years
E) None of the above
Answer: B

105. A bank has an average asset duration of 4.7 years and an average liability duration of 3.3 years. This bank has $750 million in total assets and $500 million in total liabilities. This bank has:
A) A positive duration gap of 8.0 years.
B) A negative duration gap of 2.5 years.
C) A positive duration gap of 1.4 years.
D) A positive duration gap of 2.5 years.
E) None of the above.
Answer: D

106. A bank has an average asset duration of 1.15 years and an average liability duration of 2.70 years. This bank has $250 million in total assets and $225 million in total liabilities. This bank has:
A) A negative duration gap of 1.55 years.
B) A positive duration gap of 1.28 years.
C) A negative duration gap of 3.85 years.

D) A negative duration gap of 1.28 years.
E) None of the above.
Answer: D

107. The duration of a bond is the weighted average maturity of the future cash flows expected to be received on a bond. Which of the following is a true statement concerning duration?
A) The longer the time to maturity, the greater the duration
B) The higher the coupon rate, the higher the duration
C) The shorter the duration, the greater the price volatility
D) All of the above are true
E) None of the above are true
Answer: A

108. A bond has a duration of 7.5 years. Its current market price is $1125. Interest rates in the market are 7% today. It has been forecasted that interest rates will rise to 9% over the next couple of weeks. How will this bank's price change in percentage terms?
A) This bond's price will rise by 2 percent.
B) This bond's price will fall by 2 percent.
C) This bond's price will fall by 14 .02 percent
D) This bond's price will rise by 14.02 percent
E) This bond's price will not change
Answer: C

109. A bank has an average asset duration of 5 years and an average liability duration of 3 years. This bank has total assets of $500 million and total liabilities of $250 million. Currently, market interest rates are 10 percent. If interest rates fall by 2 percent (to 8 percent), what is this bank's change in net worth?
A) Net worth will decrease by $31.81 million
B) Net worth will increase by $31.81 million
C) Net worth will increase by $27.27 million
D) Net worth will decrease by $27.27 million
E) Net worth will not change at all
Answer: B

110. A bank has an average asset duration of 5 years and an average liability duration of 3 years. This bank has total assets of $500 million and total liabilities of $250 million. Currently, market interest rates are 10 percent. If interest rates fall by 2 percent (to 8 percent), what is this bank's duration gap?
A) 2 years
B) –2 years
C) 3.5 years
D) –3.5 years
E) None of the above
Answer: C

111. A bank has an average asset duration of 5 years and an average liability duration of 9 years. This bank has total assets of $1000 million and total liabilities of $850 million. Currently, market interest rates are 5 percent. If interest rates rise by 2 percent (to 7 percent), what is this bank's change in net worth?

A) Net worth will decrease by $50.47 million
B) Net worth will increase by $50.47 million
C) Net worth will decrease by $240.95 million
D) Net worth will increase by $240.95 million
E) Net worth will not change at all

Answer: B

112. A bank has an average asset duration of 5 years and an average liability duration of 9 years. This bank has total assets of $1000 million and total liabilities of $850 million. Currently, market interest rates are 5 percent. If interest rates rise by 2 percent (to 7 percent), what is this bank's duration gap?

A) –4 years
B) 4 years
C) 2.65 years
D) –2.65 years
E) 12.65 years

Answer: D

113. A bank has $100 million of investment grade bonds with a duration of 9.0 years. This bank also has $500 million of commercial loans with a duration of 5.0 years. This bank has $300 million of consumer loans with a duration of 2.0 years. This bank has deposits of $600 million with a duration of 1.0 years and nondeposit borrowings of $100 million with an average duration of .25 years. What is this bank's duration gap? These are all of the assets and liabilities this bank has.

A) This bank has a duration gap of 14.75 years
B) This bank has a duration gap of 15.03 years
C) This bank has a duration gap of 3.55 years
D) This bank has a duration gap of 3.75 years
E) This bank has a duration gap of 5.15 years

Answer: D

114. Which of the following statements is true concerning a bank's duration gap?

A) If a bank has a positive duration gap and interest rates rise, the bank's net worth will decline
B) A bank with a positive duration gap has a longer average duration for its assets than for its liabilities
C) If a bank has a zero duration gap and interest rates rise, the bank's net worth will not change
D) If a bank has a negative duration gap and interest rates rise, the bank's net worth will increase
E) All of the above are true statements

Answer: E

115. A bank has an average duration for its asset portfolio of 5.5 years. This bank has total assets of $1000 million and total liabilities of $750 million. If this bank has a zero duration gap, what must

the duration of its liabilities portfolio be?
A) 7.33 years
B) 4.125 years
C) 7.5 years
D) 5.5 years
E) None of the above
Answer: A

116. A bond has a face value of $1000 and coupon payments of $80 annually. This bond matures in three years and is selling for $1000 in the market. Market interest rates are 8%. What is this bond's duration?
A) 3 years
B) 2.78 years
C) 1.95 years
D) 4.31 years
E) None of the above
Answer: B

117. A bond has a face value of $1000 and coupon payments of $120 annually. This bond matures in three years and is selling in the market for $1160. Market interest rates are 6%. What is this bond's duration?
A) 3 years
B) 5.71 years
C) 1.96 years
D) 2.71 years
E) None of the above
Answer: D

118. A bond is selling in the market for $950 and has a duration of 6 years. Market interest rates are 9% and are expected to decrease to 7% in the near future. What will this bond's price be after the change in market interest rates?
A) $969
B) $931
C) $1055
D) $854
E) $950
Answer: C

119. A bond is selling in the market for $1100 and has a duration of 4.5 years. Market interest rates are 5% and are expected to increase to 7% in the near future. What will this bond's price be after the change in market interest rates?
A) $1006
B) $1194
C) $1122

D) $1078
E) $1100
Answer: A

120. Which of the following is a true statement?
A) The longer the time to maturity of a security the smaller the duration
B) The lower the coupon rate of a security the smaller the duration
C) For a given duration and change in interest rates, the change in the price of the security will be larger for a lower starting level of interest rates
D) The duration of a security remains constant no matter the level of market interest rates
E) All of the above are true statements
Answer: C

121. The fact that the rate of change in an asset's price varies with the level of interest rates is known as:
A) Duration
B) Convexity
C) Maturity
D) Yield
E) None of the above
Answer: B

122. U.S. banks tend to fare best when the yield curve is:
A) Flat
B) Downward-sloping
C) Vertical
D) Upward-sloping
E) Kinked
Answer: D

123. Carolina National Bank knows that the interest rate on its loans change faster and by a larger amount than the interest rate on its deposits. What type of risk is this an example of?
A) Default risk
B) Inflation risk
C) Liquidity risk
D) Call risk
E) Basis risk
Answer: E

124. Havoc State Bank has a loan that it fears will not be repaid because the company is going into bankruptcy. What type of risk would this be an example of?
A) Default risk
B) Inflation risk
C) Liquidity risk
D) Call risk

E) Basis risk
Answer: A

125. The Carter National Bank is worried because it knows that the municipal bonds it has in its bond portfolio can be difficult to sell quickly. What type of risk would this be an example of?
A) Default risk
B) Inflation risk
C) Liquidity risk
D) Call risk
E) Basis risk
Answer: C

126. The Jackson State Bank is worried because many of the loans it has made are home mortgages which can be paid off early by the homeowner. What type of risk would this be an example of?
A) Default risk
B) Inflation risk
C) Liquidity risk
D) Call risk
E) Basis risk
Answer: D

127. A bank is liability sensitive if its:
A) Deposits and nondeposit borrowings are affected by changes in interest rates
B) Interest-sensitive assets exceed interest-sensitive liabilities
C) Interest-sensitive liabilities exceed its interest-sensitive assets
D) Loans and securities are affected by changes in interest rates
E) None of the above
Answer: C

128. Which of the following would be an example of a repriceable asset?
A) Money the bank has borrowed from the money market
B) Cash in the vault
C) Demand deposits that do not pay interest
D) Short term securities issued by the government about to mature owned by the bank
E) All of the above are examples of repriceable assets
Answer: D

129. Which of the following would be an example of a repriceable liability?
A) Money the bank has borrowed from the money market
B) Cash in the vault
C) Demand deposits that do not pay an interest rate
D) Short term securities issued by the government about to mature owned by the bank
E) All of the above are examples of repriceable assets
Answer: A

130. Which of the following would be an example of a nonrepriceable asset?
A) Money the bank has borrowed from the money market
B) Cash in the vault
C) Demand deposits that do not pay an interest rate
D) Short term securities issued by the government about to mature owned by the bank
E) All of the above are examples of repriceable assets
Answer: B

131. Which of the following would be an example of a nonrepriceable liability?
A) Money the bank has borrowed from the money market
B) Cash in the vault
C) Demand deposits that do not pay an interest rate
D) Short term securities issued by the government about to mature owned by the bank
E) All of the above are examples of repriceable assets
Answer: C

132. The Tidewater State Bank has $1000 in total assets (all of which are earning assets), $700 of which will be repriced with in the next 90 days. This bank also has $800 in total liabilities, $400 of which will be repriced within the next 90 days. Currently, the bank is earning 8% on its assets and is paying 5% on its liabilities. If interest rates do not change in the next ninety days, what is this bank's net interest margin?
A) 8%
B) 5%
C) 4%
D) 1.4%
E) Cannot tell from the information given
Answer: C

133. The Tidewater State Bank has $1000 in total assets (all of which are earning assets), $700 of which will be repriced with in the next 90 days. This bank also has $800 in total liabilities, $400 of which will be repriced within the next 90 days. Currently, the bank is earning 8% on its assets and is paying 5% on its liabilities. What is the dollar interest-sensitive gap of this bank?
A) -$200
B) -$100
C) $200
D) $300
E) $600
Answer: D

134. The Tidewater State Bank has $1000 in total assets (all of which are earning assets), $700 of which will be repriced with in the next 90 days. This bank also has $800 in total liabilities, $400 of which will be repriced within the next 90 days. Currently, the bank is earning 8% on its assets

and is paying 5% on its liabilities. If interest rates on both assets and liabilities rise by 2% in the next 90 days, what would this bank's net interest margin be?
A) 4%
B) 4.4%
C) 4.6%
D) 2.4%
E) 6%
Answer: C

135. The Tidewater State Bank has $1000 in total assets (all of which are earning assets), $700 of which will be repriced with in the next 90 days. This bank also has $800 in total liabilities, $400 of which will be repriced within the next 90 days. Currently, the bank is earning 8% on its assets and is paying 5% on its liabilities. If interest rates on both assets and liabilities rise by 2% in the next 90 days, what should happen to this bank's net interest margin?
A) It should rise
B) It should fall
C) It should stay the same
D) Cannot be determined from the above information
Answer: A

136. The Tidewater State Bank has $1000 in total assets (all of which are earning assets), $700 of which will be repriced with in the next 90 days. This bank also has $800 in total liabilities, $400 of which will be repriced within the next 90 days. Currently, the bank is earning 8% on its assets and is paying 5% on its liabilities. If interest rates on both assets and liabilities decrease by 2% in the next 90 days, what would this bank's net interest margin be?
A) 3.4%
B) 4%
C) .4%
D) 5.6%
E) 2%
Answer: A

137. The Tidewater State Bank has $1000 in total assets (all of which are earning assets), $700 of which will be repriced with in the next 90 days. This bank also has $800 in total liabilities, $400 of which will be repriced within the next 90 days. Currently, the bank is earning 8% on its assets and is paying 5% on its liabilities. If interest rates on both assets and liabilities decrease by 2%, what should happen to this bank's net interest margin?
A) It should rise
B) It should fall
C) It should stay the same
D) Cannot be determined from the above information
Answer: B

138. The Arnold National Bank has a bond portfolio that consists of bonds with 5 years to maturity and a 9% coupon rate. These bonds are selling in the market for $1126. Coupon payments are made annually on this bond. What is the yield to maturity on these bonds?

A) 3%
B) 6%
C) 9%
D) 12%
E) None of the above
Answer: B

139. The Arnold National Bank has a bond portfolio that consists of bonds with 5 years to maturity and a 9% coupon rate. These bonds are selling in the market for $1126. Coupon payments are made annually on this bond. What is duration of these bonds?
A) 3.77 years
B) 4.29 years
C) 5 years
D) 9 years
E) None of the above
Answer: B

140. The Harris State Bank has $2000 in total assets (all of which are earning assets), $500 of which will be repriced in the next 90 days. This bank also has $1600 in total liabilities, $1000 of which will be repriced in 90 days. The bank currently earns 9% on its assets and pays 4% on its liabilities. If interest rates do not change in the next 90 days, what is this bank's net interest margin?
A) .5%
B) .8%
C) 1.8%
D) 5.8%
E) None of the above
Answer: D

141. The Harris State Bank has $2000 in total assets (all of which are earning assets), $500 of which will be repriced in the next 90 days. This bank also has $1600 in total liabilities, $1000 of which will be repriced in 90 days. The bank currently earns 9% on its assets and pays 4% on its liabilities. What is the dollar interest sensitive gap of this bank?
A) $400
B) -$1100
C) -$500
D) $1000
E) None of the above
Answer: C

142. The Harris State Bank has $2000 in total assets (all of which are earning assets), $500 of which will be repriced in the next 90 days. This bank also has $1600 in total liabilities, $1000 of which will be repriced in 90 days. The bank currently earns 9% on its assets and pays 4% on its liabilities. If interest rates on both assets and liabilities rise by 2% in the next 90 days, what would be this bank's net interest margin?
A) 4.2%
B) 5.3%

C) 5.8%
D) 6.2%
E) 7.8%
Answer: B

143. The Harris State Bank has $2000 in total assets (all of which are earning assets), $500 of which will be repriced in the next 90 days. This bank also has $1600 in total liabilities, $1000 of which will be repriced in 90 days. The bank currently earns 9% on its assets and pays 4% on its liabilities. If interest rates on both assets and liabilities rise by 2% in the next 90 days, what should happen to this bank's net interest margin?
A) It should rise
B) It should fall
C) It should stay the same
D) Cannot be determined from the information given
Answer: B

144. The Harris State Bank has $2000 in total assets (all of which are earning assets), $500 of which will be repriced in the next 90 days. This bank also has $1600 in total liabilities, $1000 of which will be repriced in 90 days. The bank currently earns 9% on its assets and pays 4% on its liabilities. If interest rates on both assets and liabilities fall by 2% in the next 90 days, what would be this bank's net interest margin?
A) 3.8%
B) 5.4%
C) 5.8%
D) 6.3%
E) 7.8%
Answer: D

145. The Harris State Bank has $2000 in total assets (all of which are earning assets), $500 of which will be repriced in the next 90 days. This bank also has $1600 in total liabilities, $1000 of which will be repriced in 90 days. The bank currently earns 9% on its assets and pays 4% on its liabilities. If interest rates on both assets and liabilities fall by 2% in the next 90 days, what should happen to this bank's net interest margin?
A) It should rise
B) It should fall
C) It should stay the same
D) Cannot be determined from the information given?
Answer: A

146. Maryellen Epplin notices that a particular T-Bill has a banker's discount rate of 9% in the *Wall Street Journal*. She knows that this T-Bill has 20 days to maturity and has a face value of $10,000. What price is this T-Bill selling for in the market?
A) $9100
B) $10,000
C) $9950
D) $1900
E) None of the above

Answer: C

147. Maryellen Epplin notices that a particular T-Bill has a banker's discount rate of 9% in the *Wall Street Journal*. She knows that this T-Bill has 20 days to maturity and has a face value of $10,000. What is the yield to maturity on this T-Bill?
A) 9%
B) .5%
C) 4.5%
D) 9.17%
E) None of the above
Answer: D

148. The Raymond Burr National Bank has $1000 in assets with an average duration of 5 years. This bank has $800 in liabilities with an average duration of 6.25 years. What is the duration gap of this bank?
A) -1.25 years
B) 0 years
C) 1.25 years
D) -2.25 years
E) None of the above
Answer: B

149. The Raymond Burr National Bank has $1000 in assets with an average duration of 5 years. This bank has $800 in liabilities with an average duration of 6.25 years. Market interest rates start at 6% and fall by 1%. What is the change in net worth of this bank?
A) $11.29
B) $-11.29
C) $0
D) -$22.22
E) $22.22
Answer: C

150. The interest rate on one year Treasury Bonds is 5%. The interest rate on five year Treasury Bonds is 7.5%. The interest rate on ten year Treasury Bonds is 10%. What is true about the yield curve?
A) It is upward sloping
B) It is downward sloping
C) It is a horizontal line
D) Cannot be determined from the information given
Answer: A

Chapter 8
Risk Management: Financial Futures, Options, Swaps, and other Hedging Tools

Fill in the Blank Questions

1. A(n) __________________________ is an agreement between a buyer and a seller today which calls for the delivery of a particular security in exchange for cash at some future date for a set price.
   Answer: financial futures contract

2. A financial institution goes __________________________ in the futures market by selling a futures contract.
   Answer: short

3. A financial institution goes __________________________ in the futures market by buying a futures contract.
   Answer: long

4. __________________________ is the difference in interest rates (or prices) between the cash market and the futures market on an underlying security.
   Answer: Basis

5. The__________________________ is the fee the buyer must pay to be able to put securities to or to call securities away from the option writer.
   Answer: option premium

6. A(n)__________________________ allows the holder the right to either sell securities to another investor (put) or buy securities from another investor (call) for a set price before the expiration date.
   Answer: option

7. Futures contracts are__________________________ daily which means that the futures contracts settled each day as the market value of the futures contracts change.
   Answer: marked to market

8. Most options today are traded on a(n)__________________________. These options are standardized to make offsetting an existing position easier.
   Answer: organized exchange

9. A(n)__________________________ means that the buyer of the option contract is betting that the market price of the underlying security will decline in the future.
Answer: put option

10. A(n)__________________________ means that the buyer of the option contract is betting that the market price of the underlying security will increase in the future.
Answer: call option

11. A(n)__________________________ is where a borrower with a lower credit rating enters into an agreement with a borrower with a higher credit rating to exchange interest payments.
Answer: quality swap

12. In an interest rate swap, the_________________________ or principal amount is not exchanged.
Answer: notional

13. A(n)__________________________ is an interest rate swap which offsets the original interest rate swap agreement.
Answer: reverse swap

14. In an interest rate swap agreement , __________________ reduces the default risk. This is where the swap parties exchange only the net difference between interest payments owed.
Answer: netting

15. A(n)__________________________is a contract where two parties exchange interest payments in order to save money and hedge against interest rate risk.
Answer: interest rate swap

16. A(n)__________________________ is an agreement between two parties where they agree to exchange different currencies. It is designed to reduce exchange rate risk.
Answer: currency swap

17. A(n)__________________________ protects the holder from rising market interest rates. It sets the maximum interest rate that a lender can charge on the loan.
Answer: interest rate cap

18. A(n)____protects the lender from falling interest rates. It is the minimum rate that the borrower must pay on a variable-rate loan.
Answer: interest rate floor

19. A(n)_________________________ is where there is both a minimum and a maximum interest rate set on a loan.
Answer: interest rate collar

20. In an interest-rate swap, the principal amount of the loan, usually called the _________________________, is not exchanged.
Answer: notional amount

21. The category of derivative contract with the largest use by banks is __________.
Answer: swaps

22. The _______ is the spread between the cash price and futures price of an underlying asset.
Answer: basis

23. An interest-rate ________ would protect the swap party receiving a floating-rate payment in the swap.
Answer: floor

24. An interest-rate _______ would protect the swap party receiving a fixed-rate payment and paying a floating-rate in a swap.
Answer: cap

25. The combination of both a cap and floor is known as an interest-rate _________.
Answer: collar

26. One reason that banks use derivatives is to generate important _________________, money that does not come from interest earned on loans and securities.
Answer: fee income

27. ____________________ are financial assets that derive their value from some underlying instrument.
Answer: derivatives

28. The _________________________ largest banks account for more than 99 percent of derivatives activity in the U.S.
Answer: 25

29. When an investor buys or sells a futures contract, they must deposit a(n) _______________ when

they first enter into the contract.
Answer: initial margin

30. On the exchange floor, ____________________ execute orders received from the public to buy and sell the futures contract at the best possible price.
Answer: floor brokers

31. The financial futures markets are designed to shift the risk of interest rate fluctuations from risk-avers investors to ___________________.
Answer: speculators

32. Futures contracts can be traded ____________________, without the help of an organized exchange.
Answer: over the counter

33. The ___________________________ is determined by the clearing house and is used to the marked-to-market amount.
Answer: settlement price (SETTLE)

34. The most actively traded futures contract in the world is the ___________________. It is traded on exchanges in Chicago, London, Tokyo, Singapore and elsewhere and allows investors the opportunity to hedge against market interest rate changes.
Answer: three-month Eurodollar time deposit futures contract

35. The buyer of a call option has the right to buy from the writer of the option contract securities at the _______________________________.
Answer: exercise (or strike) price

True/False Questions

T F 36. One of the most popular methods of neutralizing duration gap risks is to buy and sell financial futures contracts.
Answer: True

T F 37. The financial futures markets are designed to shift the risk of interest rate fluctuations from risk-averse investors to speculators who are willing to accept and possibly profit from such risks.
Answer: True

T F 38. When a financial institution offers to sell financial futures contract, it is "going short" in futures and is agreeing to take delivery of certain kinds of securities on a stipulated date at a predetermined price.
Answer: False

T F 39. There are some significant limitations to financial futures as interest-rate hedging devices, among them is a special form of risk known as credit risk.
Answer: False

T F 40. An effective hedge is one where the positive or negative returns earned in the cash market are approximately offset by the profit or loss from futures trading.
Answer: True

T F 41. A hedging tool that provides "one-sided" insurance against interest rate risk is the interest rate option, which, like financial futures contracts, obligates the parties to the contract to either deliver or take delivery of securities.
Answer: False

T F 42. U.S. Treasury bond futures contracts call for the future delivery of U.S. T-bonds with minimum denominations of $100,000 and minimum maturities of 15 years.
Answer: True

T F 43. A futures hedge against interest-rate changes generally requires a bank to take an opposite position in the futures market from its current position in the cash market.
Answer: True

T F 44. The <u>short hedge</u> in financial futures contracts is most likely to be used in situations where a bank would suffer losses due to falling interest rates.
Answer: False

T F 45. The <u>long hedge</u> in financial futures contracts is most likely to be used in situations where a bank would suffer losses due to rising interest rates.
Answer: False

T F 46. The <u>short hedge</u> would usually be the correct choice if a bank is concerned about avoiding lower than expected yields from loans and security investments.
Answer: False

T F 47. A financial institution with a positive interest-sensitive gap and anticipating falling interest rates could protect against loss by covering the gap with a <u>long hedge</u>.
Answer: True

T F 48. A financial institution confronted with a negative interest-sensitive gap could avoid unacceptable losses from rising interest rates by covering the gap with a short hedge.
Answer: True

T F 49. The sensitivity of the market price of a financial futures contract depends upon the duration of the security to be delivered under the futures contract.
Answer: True

T F 50. In U.S. banking any gain or loss from futures trading must be "coincidental" to the main purpose of the trading--interest-rate hedging.
Answer: True

T F 51. If a U.S. bank's financial futures trading can be linked to a particular asset or liability position where it faces interest-rate risk exposure, that bank must take immediate recognition of any losses or gains it experiences from futures trading.
Answer: False

T F 52. According to the textbook the two principal uses of option contracts by banks are to protect the value of a bond portfolio or to hedge against interest-sensitive or duration gaps.
Answer: True

T F 53. Banks are generally writers (sellers) of put and call option contracts.
Answer: False

T F 54. The market value of a futures contract changes daily as the market price of the underlying security price changes.
Answer: True

T F 55. A futures contract is "marked to market" weekly to reflect the current market price of the contract. This means that one or the other party has to make a cash payment to the exchange at the end of each week.
Answer: False

T F 56. If a financial institution makes an offsetting sale and purchase of the same futures contract, it has no obligation either to deliver or take delivery of the contract.
Answer: True

T F 57. A bank will use a short hedge in the futures market to avoid higher borrowing costs or to protect against declining asset values.
Answer: True

T F 58. One of the significant disadvantages of using futures contracts to hedge against interest rate risk is the high commissions that must be paid to brokers.
Answer: False

T F 59. Basis risk is the difference in the interest rates (or prices) of the same security between the cash market and the futures market.
Answer: True

T F 60. In the typical quality swap a borrower with a positive duration gap is more likely to pay all or part of the other swap party's long-term interest rate.
Answer: True

T F 61. A currency swap is where two parties agree to exchange interest payments in order to hedge against interest rate risk.
Answer: False

T F 62. In most interest rate swaps netting reduces the default risk because the parties actually exchange only the difference in the interest payments.
Answer: True

T F 63. One advantage of an interest rate swap agreement is that the brokerage fees are very small.
Answer: False

T F 64. Unlike futures contracts, interest rate swap agreements have no basis risk.
Answer: False

T F 65. Interest rate caps protect the lender from falling interest rates.
Answer: False

T F 66. Interest rate floors protect the lender from falling interest rates.
Answer: True

T F 67. An interest rate collar sets both a minimum and a maximum interest rate on a variable rate loan agreement.
Answer: True

T F 68. Basis risk exists on interest rate swaps because the interest rate on the swap agreement may differ from the interest rate on assets and liabilities that the parties hold.
Answer: True

T F 69. A reverse swap is where the parties exchange the principal payments instead of the interest payments on loans.
Answer: False

T F 70. An interest-rate cap on a loan would protect the lender.
Answer: False

T F 71. Many banks are not only users of derivative products but also dealers.
Answer: True

T F 72. Most derivatives (measured by notional value) are traded on organized exchanges.
Answer: False

T F 73. An interest-rate cap will become more valuable as interest rates rise.
Answer: True

T F 74. Virtually all banks in the U.S. use derivative contracts to hedge their risks.
Answer: False

T F 75. The number of futures contracts needed to hedge a position increases as the bank's duration gap increases.
Answer: True

T F 76. A financial institution with a negative gap would like to receive the floating rate in an interest-rate swap.
Answer: False

Multiple Choice Questions

77. A financial institution with a negative gap could reduce the risk of loss due to changing interest rates by:
A) Extending asset maturities
B) Increasing short-term interest-sensitive liabilities
C) Using financial futures or options contracts.
D) All of the above.
E) None of the above.
Answer: D

78. If a bank has a positive gap, that is, if it is asset sensitive, the bank can hedge its interest-rate risk by which of the following activities:
A) Reduce its asset maturities.
B) Reduce maturities of its liabilities.
C) Use a long hedge.
D) All of the above.
E) A and C only.
Answer: E

79. A significant limitation to financial futures as an interest-rate hedging device is a special form of risk known as ___________ risk. Which of the following terms correctly completes the statement?
A) Default
B) Basis
C) Credit
D) Market
E) None of the above.
Answer: B

80. The realized return to a bank from a combined cash and futures market trading operation is composed of which of the following elements:
A) Return earned in the cash market.
B) Profit or loss from futures trading.
C) Difference between the opening and closing basis between cash and futures markets.
D) All of the above.
E) B and C only.
Answer: D

81. Advantages of trading financial futures to hedge interest-rate risk include which of the following:
A) Only a fraction of the value of the contract must be pledged as collateral.
B) Brokers' commissions are relatively low.
C) There is no risk in trading futures contracts.
D) All of the above.
E) A and B only.
Answer: E

82. An option buyer can:
A) Exercise the option.
B) Sell the option to another buyer.
C) Allow the option to expire.
D) All of the above.
E) A and B only.
Answer: D

83. A bank wishing to avoid higher borrowing costs would be most likely to use:
A) A short or selling hedge in futures.
B) A long or buying hedge in futures.
C) A call option on futures contracts.
D) B and C above.
E) None of the above.
Answer: A

84. A bank seeking to avoid lower than expected yields from loans and security investments would be most likely to use:
A) A short or selling hedge in futures.
B) A long or buying hedge in futures.
C) A put option on futures contracts.
D) B and C above.
E) None of the above.
Answer: B

85. The gain or loss to a bank from the use of a financial futures contract depends upon:
A) The duration of the underlying security named in the futures contract
B) The initial futures price
C) The change expected in interest rates divided by 1 + the original interest rate.
D) All of the above.
E) None of the above.
Answer: D

86. The number of futures contracts that a bank will need in order to fully hedge the bank's overall interest rate risk exposure and protect the bank's net worth depends upon (among other factors):
A) The relative duration of bank assets and liabilities.
B) The duration of the underlying security named in the futures contract.
C) The price of the futures contract.
D) All of the above.
E) None of the above.
Answer: D

87. A put option would most likely be used to:
A) Protect fixed-rate loans and securities.
B) Protect variable-rate loans and securities.
C) Offset a positive interest-sensitive gap.
D) Offset a negative interest-sensitive gap.
E) None of the above.
Answer: A

88. A call option would most likely be used to:
A) Protect the value of fixed-rate loans and securities.
B) Offset a negative interest-sensitive gap.
C) Offset a positive duration gap.
D) Offset a negative duration gap.
E) None of the above.
Answer: D

89. According to the textbook, the most popular option contracts used by banks today include:
A) Federal Funds futures contracts.
B) Eurodollar time deposit futures contracts.
C) U.S. Treasury bond futures contract.
D) All of the above.
E) None of the above.
Answer: D

90. A futures contract which calls for the delivery of a $100,000 T-bond with a minimum of 15 years to maturity is called a:
A) U.S. Treasury bond futures contract
B) One-month LIBOR futures contract
C) Eurodollar time deposit futures contract
D) Federal Funds futures contract
E) None of the above
Answer: A

91. A financial institution that sells a particular futures contract and later purchases the same contract back is executing:
A) A long hedge
B) A short hedge
C) A sideways hedge
D) An up-side-down hedge
E) None of the above
Answer: B

92. A financial institution that uses a long hedge is most likely:
A) Trying to avoid higher borrowing costs
B) Trying to avoid declining asset values
C) Trying to avoid lower than expected yields on from loans and securities
D) A and B above
Answer: C

93. A bank that uses a short hedge is most likely:
A) Trying to avoid higher borrowing costs
B) Trying to avoid declining asset values
C) Trying to avoid lower than expected yields on from loans and securities
D) A and B above
Answer: D

94. Suppose a bank has an asset duration of 5 years and a liability duration of 2.5 years. This bank has $1000 million in assets and $750 million in liabilities. They are planning on trading in a Treasury bond future which has a duration of 8.5 years and which is selling right now for $99,000 for a $100,000 contract. How many futures contracts does this bank need to fully hedge itself against interest rate risk?
A) 3714 contracts
B) 3125 contracts
C) 2971 contracts
D) 371 contracts
E) None of the above
Answer: A

95. A bank wishes to sell $350 million in new 30-day time deposits next month. Today interest rates are 7 percent. However, next month interest rates are expected to rise to 7.75 percent. What is the potential loss in profit for the month from this increase in interest rates? (Use a 360 day year)
A) $27.125 million
B) $24.500 million
C) $.2188 million
D) $2.625 million
E) There is no potential loss from this increase
Answer: C

96. A futures contract on a 30 day Eurodollar time deposit is currently selling at an IMM index of 95.75 percent. The IMM index on a 30 day Eurodollar time deposit for immediate delivery is 95.10 percent. What is the basis risk for the futures contract?
A) 65 basis points
B) –65 basis points
C) 490 basis points
D) 425 basis points
E) There is no basis risk on this contract
Answer: A

97. Suppose a T-Bond futures contract has a duration of 9 years and has a current market price of $98,750. Market interest rates are 6 percent today but are expected to rise to 7.5 percent. What is the change in this futures contract's market price from this change in interest rates?
A) $12,577
B) -$12,577
C) $62,883
D) -$62,883
E) None of the above
Answer: B

98. Suppose a Eurodollar time deposit futures contract has a duration of .5 years and has a current market price of $950,000. Market interest rates are 8.5 percent and are expected to fall to 7.5 percent. What is the change in this futures contract's market price from this change in interest rates?
A) $4378
B) -$4378
C) $30,645
D) -$30,645
E) None of the above
Answer: A

99. A financial institution that goes long in the futures market:
A) Has the right to accept delivery of the underlying security at the contract price if they wish
B) Has the right to make delivery of the underlying security at the contract price if they wish
C) Is obligated to accept delivery of the underlying security at the contract price
D) Is obligated to make delivery of the underlying security at the contract price
Answer: C

100. A bank that goes short in the futures market:
A) Has the right to accept delivery of the underlying security at the contract price if they wish
B) Has the right to make delivery of the underlying security at the contract price if they wish
C) Is obligated to accept delivery of the underlying security at the contract price
D) Is obligated to make delivery of the underlying security at the contract price
Answer: D

101. A financial institution that buys a put option:
A) Has the right to accept delivery of the underlying security at the contract price if they wish
B) Has the right to make delivery of the underlying security at the contract price if they wish
C) Is obligated to accept delivery of the underlying security at the contract price
D) Is obligated to make delivery of the underlying security at the contract price
Answer: B

102. A bank that buys a call option:
A) Has the right to accept delivery of the underlying security at the contract price if they wish
B) Has the right to make delivery of the underlying security at the contract price if they wish
C) Is obligated to accept delivery of the underlying security at the contract price
D) Is obligated to make delivery of the underlying security at the contract price
Answer: A

103. Interest rate hedging devices used by banks today include which of the following:
A) Financial futures contracts.
B) Interest-rate options contracts.
C) Interest rate swaps.
D) Interest rate caps, floors, and collars.
E) All of the above.
Answer: E

104. An interest rate swap is:
A) A way to change a bank's exposure to interest rate fluctuations.
B) A way to achieve lower borrowing costs.
C) A way to convert from fixed rates to floating rates.
D) A way to transform actual cash flows through the bank to more closely match desired cash flow patterns.
E) All of the above.
Answer: E

105. An interest rate collar:
A) Combines a rate floor and a rate cap into one agreement.
B) Ranges in maturity from a few days to a few weeks.
C) Protects a lender from rising interest rates.
D) All of the above.
E) B and C only.
Answer: A

106. An agreement where two parties agree to exchange different currencies is known as:
A) An interest rate swap
B) A currency swap
C) A swaption
D) A quality swap
E) None of the above
Answer: B

107. The part of an agreement which allows one or both parties to make certain changes to the agreement or eliminate the agreement is called:
A) An interest rate swap
B) A currency swap
C) A swaption
D) A quality swap
E) None of the above
Answer: C

108. An agreement where a party with a lower credit rating enters into an agreement to exchange interest payments with a borrower having a higher credit rating is know as:
A) An interest rate swap
B) A currency swap
C) A swaption
D) A quality swap
E) None of the above
Answer: D

109. Which of the following is an advantage of an interest rate swap agreement?
A) Little or no basis risk
B) Low brokerage fees
C) Increased flexibility over other hedging techniques
D) Little or no credit risk
E) All of the above are advantages of interest rate swap agreements.
Answer: C

110. Which of the following is a disadvantage of an interest rate swap agreement?
A) Basis risk
B) High brokerage fees
C) Default risk
D) Interest rate risk
E) All of the above are disadvantages of interest rate swap agreements.
Answer: E

111. Interest rate swaps:
A) First developed in the 1980s
B) Are one of the oldest interest rate hedging devices
C) Allows for the exchange of different currencies by two parties
D) Are rigid and inflexible
E) Are none of the above
Answer: A

112. Interest rate caps:
A) First developed in the 1980s
B) Are one of the oldest interest rate hedging devices
C) Allow for the exchange of different currencies by two parties
D) Protect lenders from falling interest rates
E) B and D above
Answer: B

113. The approximate percentage of banks who reportedly use derivative contracts is:
A) 12%
B) 25%
C) 50%
D) 75%
E) 100%
Answer: A

114. All of the following interest-rate futures contracts are traded on exchanges except:
A) Eurodollar futures contract
B) Treasury Bond futures contract
C) Eurodollar time deposit futures contract
D) Federal Funds futures contract
E) Corporate Bond futures contract
Answer: E

115. A bank with a duration gap of 2 years and total assets of $100 million uses a futures contract with a duration of .5 years and a price of $100,000 to hedge. The number of contracts that are needed is:
A) 2000
B) 4000
C) 8000
D) 10,000
E) 20,000
Answer: B

116. The floating-rate payer in a swap may want to buy an interest-rate:
A) Floor
B) Cap
C) Collar
D) Option
E) Neither a floor nor a cap
Answer: B

117. When an investor first purchases or sells a futures contract, she must make a deposit to the exchange. This is called the:
A) Initial margin
B) Floor broker
C) Settlement price
D) Open interest
E) Clearinghouse
Answer: A

118. The person who executes orders in the futures market for the public is called the:
A) Day trader
B) Floor broker
C) Bank examiner
D) Speculator
E) Scalper
Answer: B

119. When contracts are marked to market at the end of each day, the amount that is used to determine this is called the:
A) Initial margin
B) Floor broker
C) Settlement price
D) Open interest
E) Clearinghouse
Answer: C

120. The number of contracts that have been established and not yet offset or exercised is called ______________________ by the *Wall Street Journal*.
A) Initial margin
B) Floor broker
C) Settlement price
D) Open interest
E) Clearinghouse
Answer: D

121. The amount of initial margin, the settlement price and other rules regarding trading futures contract are determined by:
A) SEC
B) Floor brokers
C) Dealers
D) Open interest
E) Clearinghouse
Answer: E

122. Julie Wells has found a Treasury Bond futures contract that has a duration of 8.5 years and is currently selling for $97,500. Interest rates are currently 8% and are expected to rise 1.5%. What is the change in this future contract's price for this change in interest rates?
A) $1462.50
B) $12,431.25
C) -$11,521.42
D) -$1462.50
E) -$12,431.25
Answer: C

123. The Kromwell Community Bank has an average duration for its asset portfolio of 6 years. It also has an average duration for its liability portfolio of 2.5 years. This bank has $ $500 million in total assets and $450 million in liabilities. The Kromwell Community Bank is thinking about hedging their risk by using a Treasury Bond futures contract with a duration of 7.5 years and a price of $98,000. How many futures contracts will the Kromwell Community Bank need use to hedge their risk?
A) 2381 contracts
B) 2551 contracts
C) 3061 contracts
D) 4464 contracts
E) None of the above
Answer: B

124. A Treasury Bond futures contract is selling in the market for $98,225 and has a duration of 8 years. The same Treasury Bond is selling in the cash market for $98,625 and has a duration of 8.25 years. What is the basis for this futures contract?
A) $400
B) .25 years
C) $28,156.25
D) $1600
E) None of the above
Answer: A

125. What type of futures contract tends to accurately predict the consensus opinion as to actions to be taken by the Federal Open Market Committee in the future?
A) U.S. Treasury Bond futures contract
B) Eurodollar time deposit futures contract
C) One month LIBOR futures contract
D) Federal Funds futures contract
E) All of the above
Answer: D

126. Which of the following is one of the risks the OCC requires banks to measure and set limits on?
A) Strategic risk
B) Reputation risk
C) Price risk
D) Liquidity risk
E) All of the above
Answer: E

127. What is the objective of a fair value hedge?
A) To offset the losses due to changes in the value of an asset or liability
B) To reduce the risk associated with future cash flows
C) To maximize future cash flows
D) To maximize the value of an asset or minimize the value of a liability
E) None of the above
Answer: A

128. What is the objective of a cash flow hedge?
A) To offset the losses due to changes in the value of an asset or liability
B) To reduce the risk associated with future cash flows
C) To maximize future cash flows
D) To maximize the value of an asset or minimize the value of a liability
E) None of the above
Answer: B

129. Which of the following is a characteristic of a swap buyer?
A) Prefers flexible, short-term interest rate
B) Generally has a higher credit rating
C) Often has a positive duration
D) Generally has a large holding of short-term assets
E) All of the above
Answer: C

130. Which of the following is a characteristic of a swap seller?
A) Prefers fixed-rate longer term loans
B) Generally has a lower credit rating
C) Often has a positive duration
D) Generally has a large holding of short-term assets
E) All of the above
Answer: D

131. Which of the following is a characteristic of a swap buyer?
A) They generally have a lower credit rating
B) They prefer fixed rate longer term loans
C) They often have a positive duration
D) They generally have substantial holdings of longer term assets
E) All of the above
Answer: E

132. Which of the following is a characteristic of a swap seller?
A) They generally have a higher credit rating
B) They prefer flexible short-term interest rate
C) They often have a negative duration
D) They generally have large holdings of short-term assets
E) All of the above
Answer: E

133. A swap where the notional amount is constant is called:
A) A quality swap
B) A bullet swap
C) An amortizing swap
D) An accruing swap
E) None of the above
Answer: B

134. A swap where the notional amount declines over time is called:
A) A quality swap
B) A bullet swap
C) An amortizing swap
D) An accruing swap
E) None of the above
Answer: C

135. A swap where the notional amount accumulates over time is called:
A) A quality swap
B) A bullet swap
C) An amortizing swap
D) An accruing swap
E) None of the above
Answer: D

136. Which of the following is a difference between futures and forward contracts?
A) Futures contracts are market-to-market daily, while forward contracts are not
B) Buyers and sellers deal directly with each other on forward contracts but go through organized exchanges in futures contracts
C) Futures contracts are standardized, forward contracts generally are not
D) Forward contracts are generally more risky because no exchange guarantees the settlement of each contract if one or the other party to the contract defaults
E) All of the above are differences between futures and forward contracts
Answer: E

137. The daily settlement process that credits gains or deducts losses from a futures customer's account is called:
A) The variation margin
B) Marking-to-market
C) The initial margin
D) The maintenance margin
E) The notional value
Answer: B

138. Assume that two firms, one considered a high credit risk (HCR) and the other a low credit risk (LCR), are considering an interest rate swap. Each can borrow at the following rates:

	Fixed Rate	Variable Rate
LCR	8%	5%
HCR	12%	7%

An interest rate swap would be beneficial to both parties if:
A) The LCR firm wants to borrow at the fixed rate and the HCR firm wants to borrow at the variable rate.
B) The HCR firm wants to borrow at the fixed rate and the LCR firm wants to borrow at the variable rate.
C) Both firms want to borrow at the variable rate.
D) Both firms want to borrow at the fixed rate.

E) An interest rate swap would be never beneficial in this situation.

Answer: B

Chapter 9
Risk Management: Asset-Backed Securities, Loan Sales, Credit Standbys, and Credit Derivatives

Fill in the Blank Questions

1. When a bank sets aside a group of income-earning assets and then sells securities based upon those assets it is ________________________ those assets.
   Answer: securitizing

2. Often when loans are securitized they are passed on to a _________________________who pools the loans and sells securities.
   Answer: special purpose entity

3. A(n) _________________________ allows a homeowner to borrow against the residual value of their residence.
   Answer: home equity loan

4. _________________________ allow the bank to generate fee income after they have sold a loan. The bank continues to collect interest and principal from the borrowers and passes these collections to the loan buyers.
   Answer: Servicing rights

5. In a _________________________ an outsider purchases part of a loan from the selling financial institution. Generally the purchaser has no influence over the terms of the loan contract.
   Answer: participation loan

6. A(n) _________________________ is a contingent claim of the bank that issues it. The issuing bank, in return for a fee, guarantees the repayment of a loan received by its customer or the fulfillment of a contract made by its customer to a third party.
   Answer: standby credit agreement

7. A(n) _________________________ occurs when two banks agree to exchange a portion or all of the loan repayments of their customers.
   Answer: credit swap

8. A(n) __________________ guards against the losses in the value of a credit asset. It would pay off if the asset declines significantly in value or if it completely turns bad.
   Answer: credit option.

9. A(n) _________________________ combines a normal debt instrument with a credit option. It allows the issuer of the debt instrument to lower its loan repayments if some significant factor changes.
   Answer: credit linked note

10. The _________________________ of a standby letter of credit is a bank or other investor who is concerned about the safety of funds committed to the recipient of the standby letter of credit.
    Answer: beneficiary

11. A(n) _________________________ guarantees the swap parties a specific rate of return on their credit asset. Bank A may agree to pay the total return on the loan to Bank B plus any appreciation in the market value of the loan. In return Bank A will often get LIBOR plus a fixed spread plus any depreciation in the value of the loan.
    Answer: total return swap

12. The _________________________ is the party that is requesting a standby letter of credit.
    Answer: account party

13. The __________________ is the bank or financial institution which guarantees the payment of the loan in a standby letter of credit.
    Answer: issuer

14. A(n) _________________________ is a loan sale where ownership of the loan is transferred to the buyer of the loan, who then has a direct claim against the borrower.
    Answer: assignment

15. Another type of loan sale is a(n) _________________________which is a short dated piece of a longer maturity loan, entitling the purchaser to a fraction of the expected loan income.
    Answer: loan strip

16. A relatively new type of credit derivative is a **CDO** which stands for __________________.
    Answer: collateralized debt obligation

17. Insurance companies are a prime __________ of credit derivatives.
    Answer: seller

18. A(n) _________________________ is an over-the-counter agreement offering protection against loss when default occurs on a loan or other debt instrument.
    Answer: credit derivative

19. A(n) ________________________ is related to the credit option and is usually aimed at lenders able to handle comparatively limited declines in value but wants insurance against serious losses.
Answer: credit default swap

20. There has been an explosion in _____________________ in recent years. These instruments rest on pools of credit derivatives that mainly insure against defaults on corporate bonds. The creators of these instruments do not have to buy and pool actual bonds but can create these instruments and generate revenues from selling and trading in them.
Answer: synthetic CDOs (Collateralized debt obligations)

21. A __________________________ rates the securities to be sold from a pool of securitized loans so that investors have a better idea of what the new securities are likely to be worth.
Answer: credit rating agency

22. A(n) __________________________ is an assurance that investors will be repaid in the event of the default of the underlying loans in a securitization. These can be internal or external to the securitization process and lower the risk of the securities.
Answer: credit enhancement

23. When the FHLMC creates CMOs they often use different ____________________ which each promise a different coupon rate and which have different maturity and risk characteristics.

24. Lenders can set aside a group of loans on their balance sheet, issue bonds and pledge the loans as collateral against the bonds in ____________________________. These usually stay on the bank's balance sheet as liabilities.

25. FNMA (Fannie Mae) and FHLMC (Freddie Mac) are examples of ________________________. They appear to have the unofficial backing of the federal government in the event of default.
Answer: government sponsored enterprises (GSEs)

True/False Questions

T F 26. Securitization is designed to turn illiquid loans into liquid assets in the form of securities sold in the open market.
Answer: True

T F 27. Securitization has the added advantage of generating fee <u>income</u> for banks.
Answer: True

T F 28. Securitized assets cannot be removed from a bank's balance sheet until they mature.
Answer: False

T F 29. Securitization raises the level of competition for the best-quality loans among banks.
Answer: True

T F 30. Servicing rights on loans sold consist of the collection of interest and principal payments from borrowers and monitoring borrower compliance with loan terms.
Answer: True

T F 31. A loan sold by a bank to another investor with recourse means the bank has given the investor a call option on the loan.
Answer: False

T F 32. An account party will seek a bank's standby credit guarantee if the bank's fee for issuing the guarantee is less than the value assigned the guarantee by its beneficiary.
Answer: True

T F 33. Securitization tends to lengthen the maturity of a bank's assets.
Answer: False

T F 34. Securitized assets as a source of bank funds are subject to reserve requirements set by the Federal Reserve Board.
Answer: False

T F 35. Securitizations of commercial loans usually carry the same regulatory capital requirements for a bank as the original loans themselves.
Answer: True

T F 36. Most loans that banks sell off their balance sheets have minimum denominations of at least a million dollars.
Answer: True

T F 37. Most loans that banks sell off their balance sheets carry interest rates that usually are connected to long-term interest rates (such as the 30-year Treasury bond rate).
Answer: False

T F 38. In a participation loan the purchaser is an outsider to the loan contract between the financial institution selling the loan and the borrower.
Answer: True

T F 39. The buyer of a loan participation must watch <u>both</u> the borrower and the seller bank closely.
Answer: True

T F 40. Under an assignment ownership of a loan is transferred to the buyer, though the buyer still holds only an indirect claim against the borrower.
Answer: False

T F 41. Loan sales are generally viewed as risk-reducing for the selling financial institution.
Answer: True

T F 42. In a CMO, the different tiers (or tranches) of security purchasers face the same prepayment risk.
Answer: False

T F 43. A standby letter of credit substantially reduces the issuing bank's interest rate risk and liquidity risk.
Answer: False

T F 44. Securitization of loans can easily be applied to business loans since these loans tend to have similar cash flow schedules and comparable risk structures.
Answer: False

T F 45. The advantage of a credit swap is that it allows each bank in the swap to broaden its market area and spread out its credit risk on its loans.
Answer: True

T F 46. Bank use of credit derivatives is dominated by the largest banks.
Answer: True

T F 47. The credit derivatives market has grown nine-fold during the recent years.
Answer: True

T F 48. Banks are the principal sellers of credit derivatives.
Answer: False

T F 49. Banks are one of the principal buyers of credit derivatives.
Answer: True

T F 50. Insurance companies are one of the principal sellers of credit derivatives.
Answer: True

Multiple Choice Questions

51. Securitized assets carry a unique form of risk called:
    A) Default risk
    B) Inflation risk
    C) Interest-rate risk
    D) Prepayment risk
    E) None of the above
    Answer: D

52. Short-dated pieces of a longer-term loan, usually maturing in a few days or weeks, are called:
    A) Loan participations
    B) Servicing rights
    C) Loan strips
    D) Shared credits
    E) None of the above
    Answer: C

53. The party for whom a standby credit letter is issued by a bank is known as the:
    A) Account party
    B) Beneficiary
    C) Representative
    D) Credit Guarantor
    E) None of the above
    Answer: A

54. When a bank issues a standby credit guarantee on behalf of one of its customers, the party receiving the guarantee is known as the:
    A) Account party
    B) Beneficiary
    C) Obligator
    D) Servicing agent
    E) None of the above
    Answer: B

55. Securitization had its origin in the selling of securities backed by _____________
    A) Credit card receivables
    B) Residential mortgage loans
    C) Computer leases
    D) Automobile loans
    E) Truck leases
    Answer: B

56. Loan-backed securities, which closely resemble traditional bonds, carry various forms of credit enhancements, which may include all of the following, EXCEPT:
    A) Credit letter guaranteeing repayment of the securities.
    B) Set aside of a cash reserve.
    C) Division into different risk classes.
    D) Early payment clauses.
    E) None of the above.
    Answer: D

57. In some instances, a bank will sell loans and agree to give the loan purchaser recourse to the seller for all or a portion of those loans that become delinquent. In this case, the purchaser, in effect, gets a:
    A) Call option.
    B) Put option.
    C) Forward contract.
    D) Futures contract
    E) None of the above.
    Answer: B

58. The key advantages of issuing standby letters of credit include which of the following:
    A) Letters of credit generate fee income for the bank.
    B) Letters of credit typically reduce the borrower's cost of borrowing.
    C) Letters of credit can usually be issued for a relatively low cost.
    D) The probability is low that the issuer of the letter of credit will be called upon to pay.
    E) All of the above.
    Answer: E

59. Banks that issue standby letters of credit may face which of the following types of risk?
    A) Prepayment risk.
    B) Interest-rate risk.
    C) Liquidity risk.
    D) All of the above.
    E) B and C only.
    Answer: E

59. By agreeing to service any assets that are packaged together in the securitization process a bank can:
    A) Ensure the assets that are packaged and securitized remain in the package and are not sold off.
    B) Choose the best loans to go through the securitization process.
    C) Earn added fee income.
    D) Liquidate any assets it chooses.
    E) None of the above.
    Answer: C

60. The difference in interest rates between securitized loans themselves and the securities issued against the loans is referred to as:
    A) The funding gap
    B) Residual income.
    C) Service returns
    D) Security income
    E) None of the above
    Answer: B

61. If a credit letter is issued to backstop payments on loan-backed securities, the credit letter is a form of:
    A) Collateralized asset
    B) Residual income
    C) Direct loan obligation
    D) Credit enhancement
    E) None of the above
    Answer: D

62. Loan sales by banks are generally of two types: (a) participation loans; and (b)__________. The term that correctly fills in the blank above is:
    A) Assignments
    B) Recourse loans
    C) Direct loans
    D) Subscription loans
    E) None of the above.
    Answer: A

63. A standby credit letter is a (or an):
    A) Securitized strip
    B) Loan strip
    C) Contingent obligation
    D) Indirect loan
    E) None of the above.
    Answer: C

64. A bank that wants to protect itself from higher credit costs due to a decrease in its credit rating might purchase _________________________ .
A) A credit risk option
B) A standby letter of credit
C) A credit linked note
D) A credit swap
E) None of the above
Answer: A

65. When two banks simply agree to exchange a portion of their customers' loan repayments, they are using:
A) A credit option
B) A standby letter of credit
C) A credit linked note
D) A credit swap
E) None of the above
Answer: D

66. A debt instrument which allows the issuer to lower its coupon payments if some significant factor changes is called:
A) A credit option
B) A standby letter of credit
C) A credit linked note
D) A credit swap
E) None of the above
Answer: C

67. Which of the following is a risk of using credit derivatives?
A) Credit derivatives do not protect against credit risk exposure
B) The partner in the swap or option contract may fail to perform
C) Regulators may decide to lower the amount of capital needed for banks using these derivatives
D) Regulators may decide that these derivatives make the bank more stable and efficient
E) All of the above are risks of using credit derivatives
Answer: B

68. A securitized asset where the asset used to back the securities is a loan based on the residual value of a homeowner's residence is called:
A) A mortgage backed security
B) A credit card backed security
C) An automobile backed security
D) A loan backed bond
E) A home equity loan backed security
Answer: E

69. A financial institution plans to issue a group of bonds backed by a pool of automobile loans. However, they fear that the default rate on the automobile loans will rise well above 4 percent of the portfolio – the projected default rate. The financial institution wants to lower the interest payments if the loan default rate rises too high. Which type of credit derivative contract would you most recommend for this situation?
A) Credit linked note
B) Credit option
C) Credit risk option
D) Total return swap
E) Credit swap
Answer: A

70. A bank is about to make a $50 million project loan to develop a new oil field and is worried that the petroleum engineer's estimates of the yield on the field are incorrect. The bank wants to protect itself in case the developer cannot repay the loan. Which type of credit derivative contract would you most recommend for this situation?
A) Credit linked note
B) Credit option
C) Credit risk option
D) Total return swap
E) Credit swap
Answer: B

71. A bank plans to offer new subordinated notes in the open market next month but knows that its credit rating is being reviewed by a credit rating agency. The bank wants to avoid paying sharply higher credit costs. Which type of credit derivative contract would you most recommend for this situation?
A) Credit linked note
B) Credit option
C) Credit risk option
D) Total return swap
E) Credit swap
Answer: C

72. A bank is concerned about excess volatility in its cash flows from some recent business loans it has made. Many of these loans have a fixed rate of interest and the bank's economics department has forecast a sharp increase in interest rates. The bank wants more stable cash flows. Which type of credit derivative contract would you most recommend for this situation?
A) Credit linked note
B) Credit option
C) Credit risk option
D) Total return swap
E) Credit swap
Answer: D

73. A bank has a limited geographic area. It would like to diversify its loan income with loans in other market areas but does not want to actually make loans in those areas because of their limited experience in those areas. Which type of credit derivative contract would you most recommend for this situation?
A) Credit linked note
B) Credit option
C) Credit risk option
D) Total return swap
E) Credit swap
Answer: E

74. A bank has a long term relationship with a particular business customer. However, recently the bank has become concerned because of a potential deterioration in the customer's income. In addition, regulators have expressed concerns about the bank's capital position. The business customer has asked for a renewal of its $25 million dollar loan with the bank. Which credit derivative can help this situation?
A) Credit swap
B) Loan sale
C) Loan securitization
D) Credit risk option
E) Credit linked notes
Answer: B

75. A bank has placed 5000 consumer loans in a package to be securitized. These loans have an annual yield of 15.25 percent. This bank estimates that the securities on these loans are priced to yield 10.95 percent. The bank expects 1.45 percent of the loans will default. Underwriting and advisory services will cost .25 percent and a credit guarantee if more loans default than expected will cost .35 percent. What is the residual income from this loan securitization?
A) 3.70 percent
B) 4.30 percent
C) 2.25 percent
D) 5.15 percent
E) None of the above
Answer: C

76. Bank use of credit derivatives is dominated by
A) Community Banks
B) The largest (over $1 billion) banks
C) The retail banks
D) None of the banks
E) Banks do not use credit derivatives yet
Answer: B

77. According to the text, in 2005 the securitization of loans reached:
A) Million dollar market
B) Billion dollar market
C) Trillion dollar market
D) Market unknown in value
E) Small but growing market
Answer: C

78. The principal sellers of credit derivatives include all of the following except:
A) Insurance companies
B) Securities dealers
C) Fund management firms
D) Banks
E) None of the above
Answer: D

79. The bank or other lender whose loans are pooled is called:
A) The originator
B) The special purpose entity
C) The trustee
D) The servicer
E) The credit enhancer
Answer: A

80. Loans that are to be securitized pass to _________________. This helps ensure that if the lender goes bankrupt it does not affect the credit status of the pooled loans.
A) The originator
B) The special purpose entity
C) The trustee
D) The servicer
E) The credit enhancer
Answer: B

81. Someone appointed to ensure that the issuer fulfills all the requirements of the transfer of the loans to the pool and provides all of the services promised to investors in the securities is called:
A) The originator
B) The special purpose entity
C) The trustee
D) The servicer
E) The credit enhancer
Answer: C

82. Someone who collects the payments on the securitized loans and passes those payments on to the trustee is called:
A) The originator
B) The special purpose entity
C) The trustee
D) The servicer
E) The credit enhancer
Answer: D

83. Investors in securitized loans normally receive added assurance that they will be repaid in the form of guarantees against default issued by:
A) The originator
B) The special purpose entity
C) The trustee
D) The servicer
E) The credit enhancer
Answer: E

84. When an issuer of securitized loans divides them into different risk classes or tranches, they are providing an:
A) Internal credit enhancement
B) External credit enhancement
C) Internal liquidity enhancement
D) External liquidity enhancement
E) None of the above
Answer: A

85. When an issuer of securitized loans includes a standby letter of credit with the securitized loans, they are providing an:
A) Internal credit enhancement
B) External credit enhancement
C) Internal liquidity enhancement
D) External liquidity enhancement
E) None of the above
Answer: B

86. When an issuer of securitized loans sets aside a cash reserve to cover loan defaults, they are providing an:
A) Internal credit enhancement
B) External credit enhancement
C) Internal liquidity enhancement
D) External liquidity enhancement
E) None of the above
Answer: A

87. Which of the following is an advantage of securitizing loans?
A) Diversifying a lender's credit risk exposure
B) Reducing the need to monitor each individual loan's payment stream
C) Transforming illiquid assets into liquid securities
D) Serving as a new source of funds for lenders and attractive investments for investors
E) All of the above are advantages of securitizing loans
Answer: E

88. Why are securitized loans often issued through a special purpose entity?
A) Because the securitized loans often add risk to the bank and need to be held separately
B) Because the securitized loans are not profitable for the bank and need to be held separately
C) Because the special purpose entity might fail and this prevents the failure of the bank
D) Because the bank might fail and this protects the credit status of the securitized loans
E) All of the above
Answer: D

89. A group of pooled loans used is expected to yield a return of 23%. The coupon rate promised to investors on securities issued against the pool of loans is 8%. The default rate on the pooled loans is expected to be 4.5%. The fee to compensate a servicing institution for collecting payments on the loans is 2%. Fees to set up credit and liquidity enhancements are 3%. The fee for providing advising how to set up the pool of securitized loans is 1%. What is the residual income on this pool of loans?
A) 18.5%
B) 9%
C) 4.5%
D) 2%
E) None of the above
Answer: C

90. The coupon rate promised investors on securities issued against a pool of loans is 6.5%. The default rate on the pool of loans is expected to be 3.5%. The fee to compensate a servicing institution for collecting payments on the loan is 2%. Fees to set up credit and liquidity enhancements are 5%. The residual income on this pool of loans is 7%. What is the expected yield on this pool of loans?
A) 24%
B) 12%
C) 10%
D) 6.5%
E) None of the above
Answer: A

91. In a collateralized mortgage obligation (CMO) a tranche:
A) Promises a different return (coupon) to investors
B) A liquidity enhancement
C) Carries a different risk exposure
D) A and C above
E) All of the above
Answer: D

92. What is one of the advantages of using loan-backed bonds?
A) Loans used as collateral for the bonds can be sold before the maturity of the bonds
B) Loan-backed bonds have longer maturities than deposits
C) Banks do not have to meet regulatory capital requirements on loans used as collateral
D) Banks can use less loans as collateral than the amount of bonds issued
E) All of the above are advantages of loan-backed bonds
Answer: B

93. What is one of the disadvantages of using loan backed bonds?
A) The cost of funding often rises
B) There is greater default risk on the bonds
C) Loans used as collateral for the bonds must be held until the bonds reach maturity
D) Loan backed bonds have shorter maturities than deposits
E) All of the above are disadvantages of loan-backed bonds
Answer: C

94. According to the textbook, what is the minimum size of the loan-backed securities offering that are likely to be successful?
A) $1 million
B) $10 million
C) $25 million
D) $50 million
E) $1 trillion
Answer: D

95. Which of the following is a concern regulators have about securitization?
A) The risk of being an underwriter for asset-backed securities that cannot be sold
B) The risk of acting as a credit enhancer and underestimating the need for loan-loss reserves
C) The risk that unqualified trustees will fail to protect investors in asset-backed instruments
D) The risk that loan servicers will be unable to satisfactorily monitor loan performance
E) All of the above are concerns regulators have about securitization
Answer: E

96. What prompted a surge in loan sales in the 1980s?
A) A wave of corporate buyouts
B) An increase in lesser developed country loans
C) A loosening of government regulations
D) An increase in international lending
E) None of the above
Answer: A

97. Why have the use of standby credit letters grown in recent years?
A) The growth of bank loans sought by companies in recent years
B) The decreased demand for risk reduction devices
C) The high cost of standby credit letters in recent years
D) The rapid growth of direct financing by companies
E) All of the above
Answer: D

98. Which of the following is true regarding regulatory rules for standby credit letters issued by banks?
A) They must list the standby credit letter as a liability on their balance sheet
B) They must count standbys as loans
C) They do not have to apply the same credit standards for approving standbys as direct loans
D) They can apply lower capital standards to standbys than loans
Answer: B

99. Which of the following is true regarding regulatory rules for standby credit letters issued by banks?
A) They must list the standby credit letter as a liability on their balance sheet
B) They do not have to list standby credit letters when assessing the risk exposure to a single credit customer
C) They must apply the same credit standards for approving standby credit letters as direct loans
D) They can apply lower capital standards to standby credit letters than loans
E) None of the above is true
Answer: C

100. Regular collateralized debt obligations (CDO) have been surpassed by:
A) Credit swaps
B) Credit options
C) Credit default swaps
D) Total return swaps
E) Synthetic collateralized debt obligations
Answer: E

101. According to research, off-balance-sheet standby credit letters reduce risk by:
A) Increasing diversification of assets
B) Reducing the need for documentation
C) Reducing probability of losses

D) Avoiding capital requirements
E) Increasing concentration of risk exposure
Answer: A

102. What is the advantage of credit swaps for each partner?
A) Broaden the number of markets
B) Broaden the variety of markets from which they collect loan revenues and principal
C) Spread out the risk in the loan portfolio
D) Avoiding capital requirements
E) A, B, and C
Answer: E

103. What are the ways to reduce the risk of standby credit letters?
A) Avoid renegotiating the terms of loans of SLC customers
B) Specialize in SLCs issued by the same region and industry
C) Sell participations in standbys in order to share risk with other lending institutions
D) Do not count standbys as loans when assessing the bank's risk exposure
E) All of the above are the ways to reduce the risk
Answer: C

104. The lesson(s) of the credit crisis of 2007-2009 is that the "bankruptcy remote" arrangement of the special-purpose entity (SPE):
A) Reduces the need for securitization
B) Eliminates the probability of bankruptcy of the originator institution
C) May create problems if the underlying loans go bad in great numbers
D) Eliminates the need for a trustee
E) All of the above are correct
Answer: C

105. The lesson from the credit crisis of 2007-2009 is that securitized assets and credit swaps are:
A) Complex financial instruments
B) Difficult to correctly value and measure in terms of risk exposure
C) Affected by cyclically sensitive markets in which financial problems may spread and result in a financial contagion
D) Possible to set in motion a financial contagion that cannot be easily stopped without active government intervention
E) All of the above are correct
Answer: E

Chapter 10
The Investment Function in Banking and Financial-Services Management

Fill in the Blank Questions

1. A(n) __________________________ is a security issued by the federal government which has less than one year to maturity when it is issued.
   Answer: Treasury bill

2. Debt instruments issued by cities, states and other political entities and which are exempt from federal taxes are collectively known as __________________________ .
   Answer: municipal securities

3. The investment maturity strategy which calls for the bank to have one half of its investment portfolio in very short term assets and one half of its investment portfolio in long term assets is known as the __________________________ .
   Answer: barbell strategy

4. A(n) __________________________ is a security where the interest portion of the security is sold separately from the principal portion of the security.
   Answer: stripped security

5. __________________________ are the way the federal, state and local governments guarantee the safety of their deposits with banks.
   Answer: Pledging requirements

6. The most aggressive investment maturity strategy calls for the bank to continually shift the maturities of its securities in responses to changes in interest rates and is called the ___________________.
   Answer: rate expectation strategy

7. __________________________ is the risk that the bank will have to sell part of its investment portfolio before their maturity for a capital loss.
   Answer: Liquidity risk

8. __________________________ is the risk that the economy of the market area they service may take a down turn in the future.
   Answer: Business risk

9. __________________ is the risk that the company whose bonds the financial institution owns may retire the entire issue of corporate bonds in advance of their maturity leaving the bank with the risk of earnings losses resulting from reinvesting the cash at lower interest rates.
Answer: Call risk

10. A security issued by the federal government with 1 to 10 years to maturity when it is issued is called a(n) __________________________.
Answer: Treasury note

11. A short term debt security issued by major corporations is known as __________________.
Answer: commercial paper

12. The investment maturity strategy which calls for the bank to have all of their investment assets in very short term maturities is called the _________________________.
Answer: front-end-loaded policy

13. A money market security which represents a bank's commitment to pay a stipulated amount of money on a specific future date under specific conditions and which is often used in international trade is known as a(n) _________________________.
Answer: bankers' acceptance

14. A(n) _________________________ is an interest-bearing receipt for the deposit of funds in a bank for a stipulated time period. Ones that are oriented towards business customers or institutions are known as jumbos.
Answer: certificate of deposit

15. _________________________ are any securities which reach maturity in under one year.
Answer: Money market securities

16. _________________________ are any securities whose original maturity exceeds one year.
Answer: Capital market securities

17. Securities sold by Fannie Mae, Freddie Mac and others are known as _________________________.
Answer: federal agency securities

18. Claims against the expected income and principal generated by a pool of similar-type loans are known as _________________________.
Answer: securitized assets

19. The long term debt obligations of major corporations are known as ________________________.
Answer: corporate bonds

20. The investment maturity strategy which calls for the bank to have all of their investment assets in very long term maturities is known as the _________________________.
Answer: back-end-loaded policy

21. Financial Institutions may invest in municipal bonds issued by smaller local governments. These bonds are known as ____________ bonds.
Answer: bank qualified

22. Marketable notes and bonds sold by agencies owned by the government or sponsored by the government are known as ____________________________________.
Answer: government agency securities

23. A security issued by the federal government with greater than 10 years to maturity when it is issued is called a(n) _______________________________.
Answer: Treasury Bond

24. _______________________ are time deposits of fixed maturity issued by the world's larges banks headquartered in financial centers around the globe. The heart of this market is centered in London.
Answer: Eurocurrency deposits

25. _______________________ are a type of municipal bond that are backed by the full faith and credit of the issuing government.
Answer: General obligation bonds

26. ___________________________ are a type of municipal bond that are paid only from certain stipulated source of funds.
Answer: Revenue bonds

27. ________________________ are closely related to CMOs and partition the cash flow from a pool of mortgage loans or mortgage backed securities into multiple maturity classes in order to reduce the cash-flow uncertainty of investors.
Answer: Real Estate Mortgage Investment Conduits (REMICs)

28. _____________________ is the risk that loans will be terminated or paid off ahead of schedule. This is a particular problem with residential home mortgages and other consumer loans that are pooled and used as collateral in securitized assets.
Answer: Prepayment risk

29. A lending institution that sells lower-yielding securities at a loss in order to reduce current taxable income while simultaneously purchasing higher-yielding new securities in order to boost future returns is doing a(n) ____________________.
Answer: tax swap

30. A(n) ____________________ is a picture of how market interest rates differ across loans securities of varying times to maturity.
Answer: yield curve

True/False Questions

T F 31. Investments in securities provide diversification for a bank's assets because most loans come from the local areas served by a bank's offices.
Answer: True

T F 32. Bank income from loans is fully taxable.
Answer: True

T F 33. Investment securities are expected to "dress up" a bank's balance sheet, according to the textbook.
Answer: True

T F 34. Investment securities are expected to help stabilize a financial institutions's income.
Answer: True

T F 35. A short-term IOU offered by major corporations that is of short maturity (most of these lOUs mature in 90 days or less) is known as a CMO.
Answer: False

T F 36. Prepayment risk on securitized assets generally increases when interest rates rise.
Answer: False

T F 37. Stripping a security eliminates prepayment risk.
Answer: False

T F 38. According to the textbook the dominant security held in U.S. bank investment portfolios is state and local government bonds.
Answer: False

T F 39. Interest income and capital gains from a bank's portfolio of investment securities is taxed in the United States as ordinary income.
Answer: True

T F 40. Eurocurrency deposits that some banks purchase as investments generally carry higher market yields than domestic time deposits issued by comparable-size U.S. banks.
Answer: True

T F 41. Bankers' acceptances are considered to be among the safest of all money market instruments.
Answer: True

T F 42. An eligible acceptance is one that can be used as collateral for borrowing from a Federal Reserve bank.
Answer: True

T F 43. When a bank irrevocably guarantees a commercial paper issue, the bank's credit rating substitutes for the borrower's credit rating.
Answer: True

T F 44. The principal risk banks face from investing in structured notes is credit (default) risk.
Answer: False

T F 45. The principal risk to a financial institution buying CMOs is market risk.
Answer: False

T F 46. Stripped mortgage-backed securities fully protect investors from having to reinvest their income at lower and lower interest rates.
Answer: False

T F 47. Stripped mortgage-backed securities make maturity matching of bank assets and liabilities easier to accomplish than do most other investment securities that banks buy.
Answer: False

T F 48. Lower interest rates increase the present value of all projected cash flows from a loan-backed security so that its market value could rise.
Answer: True

T F 49. Treasury bills are the long term debt obligations issued by the federal government.
Answer: False

T F 50. Commercial paper is the short term debt instrument issued by major banks.
Answer: False

T F 51. Treasury notes and bonds are issued by the federal government and are coupon instruments.
Answer: True

T F 52. Interest rate risk is the risk financial institutions face due to changes in market interest rates.
Answer: True

T F 53. One investment maturity strategy popular among smaller institutions is the ladder or spaced maturity policy. It is popular because it does not take much expertise to implement.
Answer: True

T F 54. One investment maturity strategy, called the front end loaded policy, requires that the bank put all of its investment portfolio in long term securities.
Answer: False

T F 55. Business risk is the risk that the bank will experience a cash shortage and will have to sell some of its investments securities.
Answer: False

T F 56. Inflation risk is the possibility that the purchasing power of interest income and repaid principal from a security or loan will be eroded by rising prices for goods and services.
Answer: True

T F 57. Call risk refers to the right of debt collectors to call in the loans in advance of maturity and get an early repayment.
Answer: False

T F 58. If interest rates fall, a callable bond at par has the potential for large increases in price.
Answer: False

T F 59. The yield to maturity is the discount rate that equates a security's purchase price with the stream of income expected until it is sold to another investor.
Answer: False

Multiple Choice Questions

60. An important investment security popular with banks that must by law mature within one year from the date of issue and which has a high degree of safety and marketability is the:
A) Treasury bill
B) Treasury note
C) FNMA note
D) Bankers' acceptance
E) Eurodollar CD
Answer: A

61. A bank's promise to pay the holder a designated amount of money on a designated future date and is often used in international trade is known as a (or an):
A) Promissory guarantee
B) Discount security
C) Bankers' acceptance
D) In the money option
E) Accretion note
Answer: C

62. Pools of mortgages put together either by a government agency or by a private investment banking corporation to raise more loanable funds for the issuer are known as a (or an):
A) Accretion bond
B) Participation certificate
C) CMO
D) Stripped security
E) Commercial paper
Answer: C

63. Fluctuations in the timing of cash payments flowing from an underlying pool of securitized assets is referred to as:
A) Income risk
B) Prepayment risk
C) Liquidity risk
D) Capital risk
E) None of the above
Answer: B

64. Principal roles that a financial institution's investment portfolio play include which of the following?
A) Income stability
B) Geographic diversification
C) Hedging interest rate risk

D) Backup liquidity
E) All of the above
Answer: E

65. _____________ is the method by which banks can provide a safeguard for the deposits of governmental units.
A) Hedging
B) Collateralization
C) Pledging
D) Securitization
E) Window dressing
Answer: C

66. The most aggressive investment maturity strategy that calls for the bank to continually shift the maturities of its securities in response to changes in interest rates and other economic conditions is the
A) Barbell strategy
B) Rate expectations approach
C) Front-end-loaded policy
D) Ladder approach
E) None of the above
Answer: B

67. Which of the following statements is (are) correct regarding duration?
A) In comparing two bonds with the same yield to maturity and the same maturity, a bond with a higher coupon rate will have a longer duration.
B) In comparing two loans with the same maturity and the same interest rate, a fully amortized loan will have a shorter duration than a loan with a balloon payment.
C) The duration will always be shorter than the maturity for all debt instruments.
D) All of the above
E) B and C
Answer: B

68. Which of the following is not one of the Capital Market instruments in which banks invest?
A) U.S. Treasury notes
B) Corporate notes and bonds
C) U.S. Treasury bonds
D) Municipal bonds
E) Commercial paper
Answer: E

69. Which of the following is true of Treasury bills?
A) Interest on Treasury bills is exempt from state income taxes.
B) Interest on Treasury bills is exempt from federal income taxes.
C) Treasury bills pay a lower pretax yield than comparable corporate securities.
D) All of the above are true.

E) A and C only
Answer: E

70. In recent years security dealers have assembled pools of federal agency securities whose principal interest yield may be periodically reset based on what happens to a stated interest rate or may carry multiple coupon rates that are periodically adjusted; the foregoing describes a:
A) Financial futures contract
B) Revenue-anticipation note
C) Zero coupon instrument
D) Structured note
E) None of the above
Answer: D

71. Banks are generally not allowed to invest in speculative grade bonds. What kind of risk is this designed to limit?
A) Liquidity risk
B) Business risk
C) Credit risk
D) Tax exposure
E) Interest rate risk
Answer: C

72. A security where the interest payments and the principal payments are sold separately is called:
A) A Treasury note
B) An accretion
C) A structured note
D) A stripped security
E) None of the above
Answer: D

73. Which of the following is true? Mortgage prepayment risk:
A) Is higher on high interest rate mortgages
B) Is felt most dramatically when interest rates rise
C) Is eliminated by the use of mortgage backed securities
D) Is eliminated by the purchase of a stripped mortgage obligation
E) All of the above are true
Answer: A

74. A bank replaces 5-year corporate bonds with a yield to maturity of 9.75 percent with 5-year municipal bonds with a yield to maturity of 7 percent. This bank is in the 35 percent tax bracket and these bonds have the same default risk. What is the most likely reason this bank changed from the corporate to the municipal bonds?
A) Liquidity risk

B) Business risk
C) Credit risk
D) Tax exposure
E) Interest rate risk
Answer: D

75. Suppose a bank has found bank qualified municipal bonds which have a nominal gross rate of return of 8 percent and that it can borrow funds needed for this purchase at a rate of 6.25 percent. This bond is in the 35 percent tax bracket. What is the net after-tax return on this bond?
A) 5.20 percent
B) 3.5 percent
C) 1.75 percent
D) 0 percent
E) None of the above
Answer: B

76. An investor can invest in either a tax-exempt security that pays 5% or a taxable corporate security of comparable risk and maturity that pays 8%. At what marginal tax rate will the investor be indifferent between these two securities?
A) 25.0%
B) 32.5%
C) 37.5%
D) 57.5%
E) 62.5%
Answer: C

77. Which of the following would not be considered a bank qualified municipal security?
A) A Columbia County general obligation bond to modernize the county fire department.
B) A Bucks County general obligation bond to build a new sewer plant.
C) A City of San Marcos general obligation bond to pay for street repairs.
D) A City of Chicopee general obligation bond to pay for a new city jail.
E) A Treasury bond to finance government debt.
Answer: E

78. A bond has three years to maturity and has a coupon rate of 15 percent. This bond is selling in the market for $1072 and has a yield to maturity of 12%. What is the duration of this bond?
A) 3 years
B) 1 year
C) 1.92 years
D) 2.45 years
E) 2.64 years
Answer: E

79. A bond has six years to maturity and has a coupon rate of 7.5 percent. Coupon payments are made annually and this bond has a face value of $1000. This bond is selling in the market for $1127. What is the yield to maturity on this bond?
A) 7.5 percent
B) 5 percent

C) 11.5 percent
D) 2.5 percent
E) None of the above
Answer: B

80. A bond has eight years to maturity and a coupon rate of 6.5 percent. Coupon payments are made annually and this bond has a face value of $1000. This bond is selling in the market for $862. What is the yield to maturity on this bond?
A) 6.5 percent
B) 10 percent
C) 8.5 percent
D) 9 percent
E) None of the above
Answer: D

81. A bond has eight years to maturity and a coupon rate of 6.5 percent. Coupon payments are made annually and this bond has a face value of $1000. This bond is selling in the market for $862. If this bond is sold at the end of four years for $1046, what is the holding period return on this bond?
A) 6.5 percent
B) 12 percent
C) 9 percent
D) 6 percent
E) None of the above
Answer: B

82. A security which was created by the Treasury to protect against inflation risk is called a(n):
A) CMO
B) FNMA
C) GNMA
D) TIPS
E) CD
Answer: D

83. A financial institution that is concerned about the possibility that the purchasing power of both the interest income and principal income will decline on a loan is concerned about which of the following things?
A) Business risk
B) Liquidity risk
C) Tax exposure
D) Credit risk
E) Inflation risk
Answer: E

84. A bank that is concerned that the economic conditions of the market area they serve may take a

downturn with falling demand for loans and higher bankruptcies in the areas is concerned about which of the following things?
A) Business risk
B) Liquidity risk
C) Tax exposure
D) Credit risk
E) Inflation risk
Answer: A

85. Which of the following is a characteristic of Treasury bills?
A) They are coupon instruments
B) They are the short term debt instruments issued by major corporations
C) They are discount securities
D) They have more risk than other money market securities
E) All of the above are characteristics of Treasury bills
Answer: C

86. The investment maturity strategy which calls for the bank to put all of their investment assets into very long term securities is called the:
A) Front-end-loaded maturity policy
B) Back-end-loaded maturity policy
C) Ladder or spaced maturity policy
D) Barbell investment portfolio strategy
E) Rate expectation approach
Answer: B

87. The Lancaster State Bank is thinking about purchasing a corporate bond that has a yield of 8.5%. This bank has a marginal tax rate of 25%. What is the after-tax yield on this bond?
A) 11.33%
B) 8.5%
C) 6.375%
D) 2.125%
E) None of the above
Answer: C

88. The Ferson National Bank is thinking about purchasing a municipal bond that has a yield of 5.5%. This bank has a marginal tax rate of 30%. What is the after-tax yield on this bond?
A) 7.86%
B) 5.5%
C) 3.85%
D) 1.65%
E) None of the above
Answer: B

89. The Stumbaugh State Bank is thinking about purchasing a corporate bond that has a yield of 9%.

This bank has a marginal tax rate of 40%. What is the after-tax yield on this bond?
A) 15%
B) 9%
C) 5.4%
D) 3.6%
E) None of the above

90. The Price Perpetual Bank has purchased a bond that has a coupon rate of 5.5% and a face value of $1000. It has 11 years to maturity and is selling in the market for $887.52. The bond makes annual coupon payments. What is the yield to maturity on this bond?
A) 7%
B) 5.5%
C) 11%
D) 4.70%
E) None of the above
Answer: A

91. The Price Perpetual Bank has purchased a bond that has a coupon rate of 5.5% and a face value of $1000. It has 11 years to maturity and is selling in the market for $887.52. The bond makes annual coupon payments. The Price Perpetual Bank is planning on selling this bond at the end of 5 years for $1036.50. What is the holding period return on this bond?
A) 5.5%
B) 7%
C) 11%
D) 9%
E) None of the above
Answer: D

92. The Farmer National Bank has purchased a bond that has a coupon rate of 11.5% and a face value of $1000. It has 16 years to maturity and is selling in the market for $1309.80. The bond makes annual coupon payments. What is the yield to maturity on this bond?
A) 11.5%
B) 16%
C) 8%
D) 12.21%
E) None of the above
Answer: C

93. The Farmer National Bank has purchased a bond that has a coupon rate of 11.5% and a face value of $1000. It has 16 years to maturity and is selling in the market for $1309.80. The bond makes annual coupon payments. The Farmer National Bank plans on selling this bond at the end of 8 years for $1071. What is the holding period return on this bond?
A) 7%
B) 8%
C) 11.5%
D) 16%
E) None of the above

Answer: A

94. The Johnson National Bank has purchased a bond that has a coupon rate of 5.5% and a face value of $1000. It has 4 years to maturity and is selling in the market for $917. The bond makes annual coupon payments. What is the yield to maturity on this bond?
A) 5.5%
B) 4.0%
C) 1.5%
D) 8%
E) None of the above

95. The Johnson National Bank has purchased a bond that has a coupon rate of 5.5% and a face value of $1000. It has 4 years to maturity and is selling in the market for $917. The bond makes annual coupon payments. What is the duration of this bond?
A) 3.38 years
B) 3.68 years
C) 4.00 years
D) 5.50 years
E) None of the above
Answer: B

96. The Sheets Savings and Loan Association has purchased a bond that has a coupon rate of 7.5% and a face value of $1000. It has 5 years to maturity and is selling in the market for $1063. The bond makes annual coupon payments. What is the duration of this bond?
A) 7.50 years
B) 5.00 years
C) 4.65 years
D) 4.37 years
E) None of the above
Answer: D

97. The Dillinger State Bank has purchased a bond from the Interstate Manufacturing Company that has 15 years to maturity and has a coupon rate of 12.5%. Market interest rates have recently declined to 8% and the Dillinger State Bank is worried that the Interstate Manufacturing Company will retire the bond and issue new ones with a lower coupon rate. What type of risk is the Dillinger State Bank worried about?
A) Credit risk
B) Interest-rate risk
C) Business- risk
D) Call risk
E) Prepayment risk
Answer: E

98. The Terrell State Bank is a small bank located in Guyman, Oklahoma. All of their loans are agriculture and small business loans in Guyman. They want to buy a municipal bond from the

state of South Carolina. What type of risk are they likely trying to reduce with this purchase?
A) Credit risk
B) Interest-rate risk
C) Business risk
D) Call risk
E) Prepayment risk
Answer: C

99. The Caldwell National Bank has purchased a bond that pays a coupon rate of 10.5%. They are a little concerned because they believe rates will decrease in the future and they will not be able to reinvest the coupon payments at the same rate. What type of risk are they concerned about?
A) Credit risk
B) Interest rate risk
C) Business risk
D) Call risk
E) Prepayment risk
Answer: B

100. Moody's Investor Service has added the numbers 1, 2 and 3 to some of their ratings. What type of risk are these ratings attempting to measure?
A) Credit risk
B) Interest rate risk
C) Business risk
D) Call risk
E) Prepayment risk
Answer: A

101. The Roy State Bank has just purchase a portfolio of asset backed securities. What type of risk do these securities have that other securities do not have?
A) Credit risk
B) Interest rate risk
C) Business risk
D) Call risk
E) Prepayment risk
Answer: E

102. The Carey State Bank has purchased a bank-qualified municipal bond with a yield of 6%. This bank has had to borrow funds to make this purchase at a cost of 5.25%. This bank is in the 40% tax bracket. What is the net after-tax return on this bank-qualified municipal bond?
A) 6.00%
B) .75%
C) 2.85%
D) 2.43%
E) None of the above
Answer: D

103. The Wesson Wisconsin State Bank has purchased a bank-qualified municipal bond with a yield of 7.5%. This bank had to borrow funds to make this purchase at a cost of 6%. This bank is in the 25% tax bracket. What is the net after-tax return on this bank-qualified municipal bond?
A) 7.5%
B) 2.7%
C) 3.0%
D) 1.5%
E) None of the above
Answer: B

104. The Goodknight Company has issued securities with 45 days to maturity. What type of security have they issued?
A) Commercial Paper
B) Banker's Acceptance
C) Corporate Bond
D) Certificate of Deposit
E) Municipal Bond
Answer: A

105. The Dakota National Bank has purchased a security issued by the state of Tennessee that has 20 years to maturity. What type of security have they purchased?
A) Commercial Paper
B) Banker's Acceptance
C) Corporate Bond
D) Certificate of Deposit
E) Municipal Bond
Answer: E

Chapter 11
Liquidity and Reserves Management: Strategies and Policies

Fill in the Blank Questions

1. A(n) __________________ is an asset which can be converted into cash easily, which has a relatively stable price and is reversible so that the seller can recover their original investment with little risk of loss.
   Answer: liquid asset

2. When a financial institution sells assets to manage liquidity it faces _________________________. They lose the future earnings on those assets, they face transaction costs on those sales and the assets most easily sold often have the lowest return.
   Answer: opportunity costs

3. _________________________ is when the financial institution borrows money in the money market to meet their liquidity needs.
   Answer: Purchased (borrowed) liquidity

4. The _________________________ is the total difference between its sources and uses of funds.
   Answer: liquidity gap

5. _________________________ are the deposits and other borrowings of the bank which are very interest sensitive or where the bank is sure they will be withdrawn during the current period.
   Answer: "Hot money" liabilities

6. The _________________________ is the idea that management should make all good loans and count on its ability to borrow funds if it does not have the liquidity to meet its cash needs.
   Answer: customer relationship doctrine

7. _________________________ are the assets the bank must by law hold behind its deposits. In the U.S. only vault cash and deposits held with the Federal Reserves can be used to meet these requirements.
   Answer: Legal reserves

8. A(n) _________________________ is the account the bank must have at the Federal Reserve to cover any checks drawn against the bank.
   Answer: clearing balance

9. A(n) _________________________ is a service developed by banks where the bank shifts money out of accounts with reserve requirements and into savings accounts overnight.
   Answer: sweeps account

10. The _________________________ is a 14 day period stretching from a Thursday to a Wednesday. This is the period in which the bank has to keep their average daily level of required reserves for a particular computation period.
    Answer: reserve maintenance period

11. _________________________ is the availability of cash in the amount needed at a reasonable cost.
    Answer: Liquidity

12. The oldest approach to meeting liquidity needs which relies on the sale of liquid assets to meet liquidity demands is called _________________________.
    Answer: asset liquidity management

13. Under a _________________________ strategy some of the expected demands for liquidity are stored in assets, while others are backstopped by arrangements for lines of credit from banks or other suppliers of funds.
    Answer: balanced liquidity management

14. A(n) _________________________ is the person in the bank responsible for the bank's cash position and meeting legal reserve requirements.
    Answer: money position manager

15. The method used in the U.S. to determine a bank's legal reserve requirement in which the period for holding legal reserves follows the period used to calculate the required amount of legal reserves is called _________________________.
    Answer: lagged reserve accounting

16. The fed funds rate is generally most volatile on bank __________ day.
    Answer: settlement

17. Many depository institutions hold __________ balances (extra reserves) to help prevent overdraft penalties.
    Answer: precautionary

18. Not all _______ banks around the world have reserve requirements.
    Answer: central

19. For several decades, the largest banks around the world have chosen ________________ which calls for borrowing immediately spendable funds to cover all anticipated demands for liquidity.
Answer: liability management

20. The _______________________ approach to managing liquidity starts with two simple facts, liquidity rises as deposits increase and loans decrease and liquidity falls when deposits fall and loans increase.
Answer: sources and uses of funds

21. In the ________________________approach to managing liquidity deposits and other sources of funds are divided into categories and then liquidity managers must set aside liquid funds according to some desired operating rule.
Answer: structure of funds

22. Many financial service institutions estimate their liquidity needs based upon experience and industry averages. This approach to managing liquidity is called the ______________ approach.
Answer: liquidity indicator

23. Many analysts believe there is only one sound method for assessing a financial institution's liquidity needs. This method centers on ______________________.
Answer: discipline of the financial marketplace (signals from the marketplace)

24. The _______________ for deposits and other reservable liabilities and for vault cash holdings is a two week period extending from Tuesday to a Monday two weeks later.
Answer: reserve computation period

25. If total legal reserves held are greater than required reserves the bank has ___________.
Answer: excess reserves

26. If total legal reserves held are less than required reserves the bank has _____________.
Answer: a reserve deficit

27. The _______________________ is where a money position manager can cover a large reserve deficit quickly. It is usually one of the cheapest places to borrow but is also frequently volatile.
Answer: federal funds market

28. One of the ratios used in the liquidity indicator approach to managing a financial institution's liquidity needs is _________________. This ratio is cash and due from depository institutions divided by total assets where a greater ratio indicates a stronger liquidity position.
Answer: cash position indicator

True/False Questions

T F 29. Liquid assets must have a reasonably stable price so that the market is deep enough to absorb the sale without a significant loss of value.
Answer: True

T F 30. Asset liquidity management (or asset conversion) involves storing liquidity in assets, such as deposits and jumbo CDs.
Answer: False

T F 31. Asset liquidity management (or asset conversion) involves storing liquidity in assets, such as cash and marketable securities.
Answer: True

T F 32. Liquid assets generally have a stable price but are not necessarily reversible.
Answer: False

T F 33. Asset conversion is considered to be a costless approach to liquidity management.
Answer: False

T F 34. One principle of sound bank liquidity management is to be sure to sell first those assets with the least profit potential.
Answer: True

T F 35. Borrowed liquidity (liability) management is less risky for a financial institution than is asset conversion.
Answer: False

T F 36. A financial institution's liquidity gap represents the difference between its sources and uses of liquid funds.
Answer: True

T F 37. A bank expects to lose its "hot money" liabilities, according to the textbook.
Answer: True

T F 38. According to the customer relationship doctrine a bank should turn down any loan requests for which it does not have enough deposits on hand but should help its borrowing customer obtain funds from some other source (such as by issuing a letter of credit to backstop the customer's loan from another lender).
Answer: False

T F 39. A U.S. bank can run up to a 5-percent deficit in its legal reserve requirement without incurring an interest penalty from the Federal Reserve System.
Answer: False

T F 40. Most liquidity problems in banking arise from inside a bank, not from its customers.
Answer: False

T F 41. Holdings of liquid assets at U.S. banks have experienced a gradual decline in recent years.
Answer: True

T F 42. The Federal Reserve has been lowering deposit reserve requirements in recent years.
Answer: True

T F 43. The liquidity indicator, core deposits divided by total assets, is a measure of stored liquidity.
Answer: False

T F 44. A bank's money position manager is responsible for insuring that the bank maintains an adequate level of legal reserves.
Answer: True

T F 45. If a bank in the United States runs a legal reserve deficit of more than 2 percent of its required daily average legal reserve position it will be assessed an interest penalty equal to the Federal Reserve's discount rate plus 5 percent.
Answer: False

T F 46. If a bank receives more checks deposited to the accounts it holds than checks drawn against its deposit accounts, the bank's legal reserves will tend to increase.
Answer: True

T F 47. According to the textbook if a bank's liquidity deficit is expected to last for only a few hours, the federal funds market or the central bank's discount window is normally the preferred source of funds.
Answer: True

T F 48. Banks making heavy use of borrowed sources of liquidity must wrestle with the problem of interest cost uncertainty, according to the textbook.
Answer: True

T F 49. All central banks impose reserve requirements on the banks they regulate.
Answer: False

T F 50. The sources and uses of funds method of estimating a bank's liquidity requirements divides the bank's liabilities into three types (hot money, vulnerable funds and stable funds) and estimates the probability of each being withdrawn from the bank.
Answer: False

T F 51. One of the problems with liquidity management for a bank is that rarely does the demand for funds equal the supply of funds at a given time.
Answer: True

T F 52. One of the problems with liquidity management for a bank is that there is a trade-off between bank liquidity and profitability.
Answer: True

T F 53. The liquidity problem for banks is made easier because most of their liabilities are not subject to immediate repayment.
Answer: False

T F 54. The liquidity problem for banks is made easier because depositors and borrowers are not sensitive to changing interest rates.
Answer: False

T F 55. The oldest approach to liquidity management is the asset liquidity management approach.
Answer: True

T F 56. Some central banks around the world impose reserve requirements on bank loans.
Answer: True

T F 57. Some central banks around the world impose reserve requirements on nondeposit liabilities.
Answer: True

T F 58. Interest in bank and financial service liquidity management is a relatively new phenomenon which arose following the 9/11 crisis.
Answer: False

T F 59. Bank robberies have declined in recent years.

Answer: False

T F 60. Discount window loans jumped dramatically the day following 9/11.
Answer: True

T F 61. A bank or financial service institution can meet reserve requirements by selling Treasury securities in its portfolio.
Answer: True

T F 62. All central banks around the world have some specified reserve requirement.
Answer: False

T F 63. Core deposit ratio is used as one of the liquidity indicators for depository institutions and is defined as the ratio of core deposits to total assets.
Answer: True

T F 64. Loan commitments ratio measures the volume of promises a lender has made to its customers to provide credit up to pre-specified amount over a given time period.
Answer: True

Multiple Choice Questions

65. A financial institution that has ready access to immediately spendable funds at reasonable cost at precisely the time those funds are needed is:
A) Risk free
B) Liquid
C) Efficient
D) Profitable
E) None of the above
Answer: B

66. Which of the following is not a reason that banks to hold liquid assets?
A) To meet customer's needs for currency.
B) To meet capital requirements.
C) To meet required reserves.
D) To compensate for correspondent bank services.
E) To assist in the check clearing process.
Answer: B

67. The two most pressing demands for liquidity from a bank come from, first, customers withdrawing their deposits and, second, from:
A) Credit requests from those customers the bank wishes to keep

B) Checks being cashed at local stores and directly from the bank
C) Demands for wired funds from correspondent banks.
D) Legal reserve requirements set by the Federal Reserve Board.
E) None of the above.
Answer: A

68. A bank expects in the week about to begin $30 million in incoming deposits, $20 million in deposit withdrawals, $15 million in revenues from the sale of nondeposit services, $25 million in customer loan repayments, $5 million in sales of bank assets, $45 million in money market borrowings, $60 million in acceptable loan requests, $10 million in repayments of bank borrowings, $5 million in cash outflows to cover other operating expenses, and $10 million in dividend payments to its stockholders. This bank's net liquidity position for the week is:
A) $30 million
B) $20 million
C) $10 million
D) $15 million
E) None of the above
Answer: D

69. There is a trade-off problem between liquidity and:
A) Risk exposure
B) Safety.
C) Profitability
D) Efficiency
E) None of the above
Answer: C

70. Financial institutions face significant liquidity problems because of:
A) Imbalances between the maturities of their assets and their principal liabilities.
B) Their high proportion of liabilities subject to immediate withdrawal.
C) Their sensitivity to changes in interest rates.
D) Both A and B
E) All of the above.
Answer: E

71. Sources of liquidity for banks include:
A) Deposit inflows
B) Money market borrowings
C) Sales of marketable securities
D) Loan repayments
E) All of the above
Answer: E

72. Which of the following is not a source of liquidity for financial institutions?
A) Deposits
B) Money market borrowings

C) Sales of marketable securities
D) Dividend payments to stockholders
E) All of the above
Answer: D

73. Which of the following liquidity strategies is the most effective for banks today?
A) Asset Management
B) Liability Management
C) Balanced Liquidity Management
D) All of the above
E) A and B above
Answer: C

74. When a bank's sources of liquidity exceed it uses of liquidity, the bank will have a _______________ liquidity gap.
A) Positive
B) Negative
C) Cyclical
D) Seasonal
E) None of the above
Answer: A

75. "Core deposits", "hot money", and "vulnerable money" are categories of funds under which of the following methods of estimating a bank's liquidity needs?
A) Sources and Uses of Funds Approach
B) Structure of Funds Approach
C) Liquidity Indicator Approach
D) None of the above
E) A and C
Answer: B

76. Factors that influence a bank's choice among the various sources of reserves include which of the following?
A) Immediacy of the need
B) Duration of the need
C) Interest rate outlook
D) Regulations
E) All of the above
Answer: E

77. The risk that liquid funds will not be available in the volume needed by a bank is often called:
A) Market risk
B) Price risk
C) Availability risk
D) Interest-rate risk
E) None of the above

Answer: C

78. A bank following an _________________________ liquidity management strategy must take care that those assets with the least profit potential are sold first. The strategy that correctly fills in the blank in the foregoing sentence is:
A) Asset conversion
B) Liability management
C) Availability
D) Funds source
E) None of the above
Answer: A

79. When some of a bank's expected demand for liquidity are stored in its assets, while other unexpected cash needs are met from near-term borrowings this approach to liquidity management is described by which of the terms listed below?
A) Liability management
B) Asset conversion
C) Borrowed liquidity management
D) Balanced liquidity management
E) None of the above
Answer: D

80. The notion that bank management should strive to meet all good loans that walk in the door in order to build lasting customer relationships is referred to as the:
A) Asset conversion liquidity strategy
B) Customer relationship doctrine
C) Loan accommodation doctrine
D) Balanced funds management doctrine
E) None of the above
Answer: B

81. A bank manager responsible for overseeing the institution's legal reserve account is called:
A) Reserve manager
B) Money market manager
C) Money position manager
D) Legal counselor
E) None of the above
Answer: C

82. If a bank's management uses "the discipline of the financial marketplace" to gauge its liquidity position one indicator of this market test of the adequacy of a bank's liquidity position is:
A) The bank's return on equity capital
B) The volume of bank stock outstanding
C) The bank's return on assets

D) The size of risk premiums on CDs the bank issues
E) None of the above
Answer: D

83. Which of the following is an example of a use of funds for the bank?
A) A customer withdraws $1000 from their account
B) A borrower repays $1500 of a loan they have received
C) The bank issues a $1,000,000 CD
D) The bank sells $5,000,000 of T-Bills
E) None of the above are uses of funds
Answer: A

84. Which of the following is an example of a source of funds?
A) A customer withdraws $1000 from their account
B) A borrower repays $1500 of a loan they have received
C) A bank increases its Fed funds sold by $1,000,000
D) The bank purchases $5,000,000 in T-Bills
E) None of the above are uses of funds
Answer: B

85. A bank currently has $150 million in "hot money" deposits against which they want to hold an 80 percent reserve. This bank has $90 million in vulnerable deposits against which they want to hold a 30 percent reserve and this bank has $45 million in stable deposits against which they want to hold a 5 percent reserve. The legal reserves for this bank are 5 percent of all deposits. What is this bank's liability liquidity reserve?
A) $149.25 million
B) $285 million
C) $141.7875 million
D) $216.60 million
E) None of the above
Answer: C

86. A bank maintains a clearing balance of $5,000,000 with the Federal Reserve. The Federal funds rate is currently 6.5 percent. What credit will this bank earn over the reserve maintenance period to offset any fees charged this bank by the Federal Reserve?
A) $325,000
B) $8,357,143
C) $194,444
D) $12,639
E) None of the above
Answer: D

87. A bank maintains a clearing balance of $1,000,000 with the Federal Reserve. The Federal funds rate is currently 4.5 percent. What credit will this bank earn over the reserve maintenance period

to offset any fees charged this bank by the Federal Reserve?
A) $17,500
B) $1,750
C) $45,000
D) $12,500
E) None of the above
Answer: B

88. A bank currently holds $105 million in transaction deposits subject to legal reserves but has managed to enter into sweep account arrangements affecting $55 million of these accounts. Given that the bank must hold 3 percent legal reserves up to $47.8 million of transaction deposits and 10 percent legal reserves on any amount above that, how much has this bank reduced its total legal reserves as a result of these sweep arrangements?
A) $5.500 million
B) $1.449 million
C) $7.119 million
D) $1.619 million
E) None of the above
Answer: A

89. A bank money manager estimates that the bank will experience a liquidity deficit of $400 million with a probability of 10 percent, a liquidity deficit of $900 million with a probability of 20 percent, a liquidity surplus of $600 million with a probability of 30 percent and a liquidity surplus of $1200 with a probability of 40 percent over the next month. What is this bank's expected liquidity deficit or surplus over this next month?
A) $880 liquidity surplus
B) $440 liquidity deficit
C) $440 liquidity surplus
D) $880 liquidity deficit
E) None of the above
Answer: C

90. A bank expects in the week to come $55 million in incoming deposits, $75 million in acceptable loan requests, $35 million in money market borrowings, $10 million in deposit withdrawals and $30 million in loan repayments. This bank is expecting a:
A) Liquidity deficit
B) Liquidity surplus
C) Balanced liquidity position
D) None of the above
Answer: B

91. A financial institution has estimated that its growth rate in deposits over the last ten years has averaged 6 percent per year. This is the __________________________ of estimating future deposits.
A) Trend component
B) Seasonal component

C) Cyclical component
D) Stationary component
E) None of the above
Answer: A

92. A financial institution has estimated that over the last ten years the deposit withdrawals during Christmas time is about 25% higher than during any other time of the year. This is the _________________________ of estimating future deposits.
A) Trend component
B) Seasonal component
C) Cyclical component
D) Stationary component
E) None of the above
Answer: B

93. Which of the following is a guideline for liquidity managers of banks?
A) The liquidity manager must keep track of the activities of all departments of the bank
B) The liquidity manager must know in advance (if possible) the plans of major creditors and depositors
C) The liquidity manager should make sure the bank has clear priorities and objectives for liquidity management
D) The liquidity manager must analyze the liquidity needs of the bank on a continuous basis
E) All of the above are guidelines for liquidity managers
Answer: E

94. A manager that uses ratios such as cash and due from banks to total assets and U.S. government securities to total assets to measure their liquidity position is using:
A) The sources and uses of funds approach
B) The structured funds approach
C) The liquidity indicator approach
D) Signals from the market place
E) None of the above
Answer: C

95. A manager that examines the stock price behavior of the bank and the risk premium on the bank CD's to measure their liquidity position is using:
A) The sources and uses of funds approach
B) The structured funds approach
C) The liquidity indicator approach
D) Signals from the marketplace
E) None of the above
Answer: D

96. A manager that looks at deposit increases and decreases and loan increases and decreases among other things to measure their liquidity position is using:
A) The sources and uses of funds approach

B) The structured funds approach
C) The liquidity indicator approach
D) Signals from the marketplace
E) None of the above
Answer: A

97. Which of the following statements is correct?
A) The demands for liquidity and sources of liquidity for a bank are generally equal to each other
B) Most liquidity problems in banking arise from outside the bank
C) The liquidity problems for a bank are made easier because most of their liabilities are not subject to immediate repayment
D) Liquidity management is easy for a bank because a bank that is very liquid is also very profitable.
E) All of the above statements are correct
Answer: B

98. The Fed funds market is most volatile on bank:
A) Computation day
B) Settlement day
C) Reserve day
D) Maintenance day
E) Holiday
Answer: B

99. The Fed funds rate usually hovers around the Feds:
A) Target rate
B) Set rate
C) Quoted rate
D) Limit rate
E) Average rate
Answer: A

100. A bank or financial service institution can generally meet reserve requirements using all of the following except:
A) Selling liquid investments
B) Borrowing in the fed funds market
C) Drawing on any excess correspondent balances
D) Borrowing in the repo market
E) Selling new shares
Answer: E

101. The Shirley State Bank has $90 in transaction deposits subject to legal reserves. This bank must hold 3 percent legal reserves up to $43.9 of transaction deposits and 10 percent legal reserves on any amount above this. What is this bank's total legal reserves?

A) $2.700 million
B) $1.449 million
C) $5.924 million
D) $4.170 million
E) None of the above
Answer: C

102. John Camey, the money manager of the First State Bank, has estimated that the bank has a 20 percent chance of a liquidity deficit of $700, a 30 percent chance of a liquidity deficit of $200, a 30 percent chance of a liquidity surplus of $400 and a 20 percent chance of a liquidity surplus of $900 over the next week. What is this bank's expected liquidity deficit or surplus over the next week?
A) $100 liquidity surplus
B) $100 liquidity deficit
C) $400 liquidity surplus
D) $500 liquidity surplus
E) $0 liquidity surplus
Answer: A

103. A bank currently has $50 million in stable deposits against which they want to keep 10% reserves, $100 in vulnerable deposits against which they want to keep 40% reserves and they have $50 million in "hot money' deposits against which they want to keep 90% reserves. The legal reserves for this bank are 10% of all deposits. What is this bank's liability liquidity reserve?
A) $90 million
B) $81 million
C) $70 million
D) $20 million
E) None of the above
Answer: B

104. The Hollingsworth National Bank maintains a clearing balance of $7,000,000 with the Federal Reserve. The Federal Funds rate is currently 5.25 percent. What is the credit this bank will earn over the maintenance period to offset any fees charged this bank by the Federal Reserve?
A) $367,500
B) $1021
C) $14,292
D) $30,625
E) None of the above
Answer: C

105. A bank must maintain an average daily balance at the Fed of $600. In the first 2 days of the maintenance period, they maintain a balance of $450, the next three days they maintain a balance of $700, the next two days they maintain a balance of $650, the next three days they maintain a balance of $450 and the next three days they maintain a balance of $650. What does their balance at the Fed have to be on the last day of the maintenance period in order to have a zero cumulative reserve deficit?

A) $600
B) $400
C) $500
D) $800
E) None of the above
Answer: D

106. A bank must maintain an average daily balance at the Fed of $700. On the first day of the maintenance period they maintain a balance of $750, the next two days they maintain a balance of $725, the next three days they maintain a balance of $625, the next two days they maintain a balance of $775, the next two days they maintain a balance of $700 and the next two days they maintain a balance of $675. What does their balance have to be on the last day of the maintenance period in order to have a cumulative reserve <u>deficit</u>?
A) $700
B) $650
C) $750
D) $325
E) None of the above
Answer: B

107. David Ashby has just paid off the balance on his home mortgage with First American Bank. What source of liquidity does this represent to the bank?
A) Incoming customer deposit
B) Revenues from the same of nondeposit services
C) Customer loan repayment
D) Sale of an asset
E) Borrowings from the money market
Answer: C

108. The Harmony Bank of the South has just increased its Federal Funds Purchased. What source of liquidity does this represent to the bank?
A) Incoming customer deposit
B) Revenues from the same of nondeposit services
C) Customer loan repayment
D) Sale of an asset
E) Borrowings from the money market
Answer: D

109. The Peace Bank of Ohio has just received a $50 million credit at the local clearing house. Which type of factor affecting legal reserves is this for the bank?
A) A controllable factor increasing legal reserves
B) A noncontrollable factor increasing legal reserves
C) A controllable factor decreasing legal reserves
D) A noncontrollable factor decreasing legal reserves
E) None of the above
Answer: B

110. The Sasser State Bank has just sold $25 million in Treasury Bills. Which type of factor affecting legal reserves is this for the bank?
A) A controllable factor increasing legal reserves
B) A noncontrollable factor increasing legal reserves
C) A controllable factor decreasing legal reserves
D) A noncontrollable factor decreasing legal reserves
E) None of the above
Answer: A

111. The Hora National Bank has just received notice that a large depositor with the bank wants to close their account immediately. Which type of factor affecting legal reserves is this for the bank?
A) A controllable factor increasing legal reserves
B) A noncontrollable factor increasing legal reserves
C) A controllable factor decreasing legal reserves
D) A noncontrollable factor decreasing legal reserves
E) None of the above
Answer: D

112. The Simpson State Bank of Stillwater has just sold Federal Funds to another bank in their Federal Reserve district. Which type of factor affecting legal reserves is this for the bank?
A) A controllable factor increasing legal reserves
B) A noncontrollable factor increasing legal reserves
C) A controllable factor decreasing legal reserves
D) A noncontrollable factor decreasing legal reserves
E) None of the above
Answer: C

113. The Burr Bank has just calculated the ratio of U.S. Government Securities to Total Assets. Which liquidity indicator is this?
A) Cash position indicator
B) Liquid securities indicator
C) Net federal funds and repurchase agreement position
D) Capacity ratio
E) Hot money ratio
Answer: B

114. The HTR Bank of Summerville has just calculated the ratios of money market (short term) assets to volatile liabilities. Which liquidity indicator is this?
A) Cash position indicator
B) Liquid securities indicator
C) Net federal funds and repurchase agreement position
D) Capacity ratio
E) Hot money ratio
Answer: E

115. Which of the following is an option when a liquidity deficit arises and the bank wants to borrow liquidity to cover the deficit?
A) Selling Treasury Bills
B) Reducing their correspondent deposits with another bank
C) Selling a municipal bond
D) Issuing a jumbo CD
E) All of the above
Answer: D

116. Which of the following is an option when a liquidity deficit arises and the bank wants to use their stored liquidity in their assets to cover the deficit?
A) Borrowing in the Federal Funds market
B) Issuing a jumbo CD
C) Selling Treasury Bills
D) Increasing their correspondent deposits with another bank
E) All of the above
Answer: C

117. The Taylor Treadwell Bank has just calculated the ratio of net loans and leases to total assets. Which liquidity indicator is this?
A) Cash position indicator
B) Liquid securities indicator
C) Net federal funds and repurchase agreement position
D) Capacity ratio
E) None of the above
Answer: D

118. The Taylor Treadwell Bank has just calculated the ratio of demand deposits to total time deposits. Which liquidity indicator is this?
A) Deposit composition ratio
B) Liquid securities indicator
C) Net federal funds and repurchase agreement position
D) Capacity ratio
E) None of the above
Answer: A

Chapter 12
Managing and Pricing Deposit Services

Fill in the Blank Questions

1. A(n) __________________________ requires the bank to honor withdrawals immediately upon request.
   Answer: demand deposit

2. A(n) __________________________ is an interest bearing checking account and gives the bank the right to insist on prior notice before customer withdrawals can be honored.
   Answer: Negotiable order of withdrawal (NOW)

3. A(n) __________________________ is a short-maturity deposit which pays a competitive interest rate. Only 6 preauthorized drafts per month are allowed and only 3 of these can be by check.
   Answer: money market deposit account

4. __________________________ are designed to attract funds from customers who wish to set aside money in anticipation of future expenditures or financial emergencies.
   Answer: Thrift deposits

5. __________________________ are the stable base of deposited funds that are not highly sensitive to movements in market interest rates and tend to remain with a depository institution.
   Answer: Core deposits

6. Some people feel that everyone is entitled access to a minimum level of financial service no matter their income level. This issue is called the issue of __________________________.
   Answer: basic (lifeline) banking

7. __________________________ is a way of pricing deposit services in which the rate or return or fees charged on the deposit account are based on the cost of offering the service plus a profit margin.
   Answer: Cost plus pricing

8. When financial institutions tempt customers by paying postage both ways in bank-by-mail services or by offering free gifts such as teddy bears, they are practicing ___________.
   Answer: nonprice competition

9. The __________________________is the added cost of bringing in new funds.
Answer: marginal cost

10. __________________________ pricing is where the financial institution sets up a schedule of fees in which the customer pays a low or no fee if the deposit balance stays above some minimum level and pays a higher fee if the balance declines below that minimum level.
Answer: Conditional

11. When a customer is charged a fixed charge per check this is called ___________________ pricing.
Answer: flat rate

12. When a customer is charged based on the number and kinds of services used, with the customers that use a number of services being charged less or having some fees waived, this is called ___________________ pricing.
Answer: relationship

13. __________________________ is part of the new technology for processing checks where the bank takes a picture of the back and the front of the original check and which can now be processed as if they were the original.
Answer: Check imaging

14. A(n) __________________________ is a thrift account which carries a fixed maturity date and generally carries a fixed interest rate for that time period.
Answer: time deposit

15. A(n) __________________________ is a conditional method of pricing deposit services in which the fees paid by the customer depend mainly on the account balance and volume of activity.
Answer: deposit fee schedule

16. The __________________________ was passed in 1991 and specifies the information that institutions must disclose to their customers about deposit accounts.
Answer: Truth in Savings Act

17. The __________________________ must be disclosed to customers based on the formula of one plus the interest earned divided by the average account balance adjusted for an annual 365 day year. It is the interest rate the customer has actually earned on the account.
Answer: annual percentage yield (APY)

18. A(n) __________________________ is a retirement plan that institutions can sell which is designed for self-employed individuals.
Answer: Keogh plan

19. Deposit institution location is most important to ______-income consumers.
Answer: low

20. _____-income consumers appear to be more influenced by the size of the financial institution.
Answer: high

21. For decades depository institutions offered one type of savings plan. _______could be opened with as little as $5 and withdrawal privileges were unlimited.
Answer: Passbook savings deposits

22. _____________________CD's allow depositors to switch to a higher interest rate if market rates rise.
Answer: Bump-up

23. __________________CD's permit periodic adjustments in promised interest rates.
Answer: Step-up

24. __________________CD's allow the depositor to withdraw some of his or her funds without a withdrawal penalty.
Answer: Liquid

25. A(n) _____________________, which was authorized by Congress in 1997, allows individuals to make non-tax-deductible contributions to a retirement fund that can grow tax free and also pay no taxes on their investment earnings when withdrawn.
Answer: Roth IRA

26. Due to the fact that they may be perceived as more risky, ______________ banks generally offer higher deposit rates than traditional banks.
Answer: virtual

27. _________________________ are accounts in domestic banking institutions where the U.S. Treasury keeps most of their operating funds.
Answer: Treasury Tax and Loan Accounts (TT&L accounts)

28. _______________________ is a process where merchants and utility companies take the information from a check an individual has just written and electronically debits the individual's account instead of sending the check through the regular check clearing process.
Answer: electronic check conversion

29. On October 28, 2004, __________________ became the law, permitting depository institutions to electronically transfer check images instead of the checks themselves.
Answer: Check 21

30. The ________________________ to the cost plus pricing derives the weighted average cost of all funds raised and is based on the assumption that it is not the cost of each type of deposit that matters but rather the weighted average cost of all funds that matters.
Answer: pooled-funds cost approach

True/False Questions

T F 31. The volume of <u>core deposits</u> at U.S. banks has been growing in recent years relative to other categories of deposits.
Answer: False

T F 32. The U.S. Treasury keeps most of its operating funds in TT&L deposits, according to the textbook.
Answer: True

T F 33. Deposits owned by commercial banks and held with other banks are called <u>correspondent deposits.</u>
Answer: True

T F 34. The <u>implicit</u> <u>interest rate</u> on checkable deposits equals the difference between the cost of supplying deposit services to a customer and the amount of the service charge actually assessed that customer.
Answer: True

T F 35. Legally imposed interest-rate ceilings on deposits were first set in place in the United States after passage of the Bank Holding Company Act.
Answer: False

T F 36. Gradual phase-out of legal interest-rate ceilings on deposits offered by U.S. banks was first authorized by the Glass-Steagall Act.
Answer: False

T F 37. The contention that there are certain banking services (such as small loans or savings and checking accounts) that every citizen should have access to is usually called <u>socialized banking.</u>
Answer: False

T F 38. Domestic deposits generate legal reserves.
Answer: True

T F 39. Excess legal reserves are the source out of which new bank loans are created.
Answer: True

T F 40. Demand deposits are among the most volatile and least predictable of a bank's sources of funds with the shortest potential maturity.
Answer: True

T F 41. IRA and Keogh deposits have great appeal for bankers principally because they can be sold bearing relatively low (often below-market) interest rates.
Answer: False

T F 42. In general, the longer the maturity of a deposit, the lower the yield a financial institution must offer to its depositors because of the greater interest-rate risk the bank faces with longer-term deposits.
Answer: False

T F 43. The availability of a large block of core deposits decreases the duration of a bank's liabilities.
Answer: False

T F 44. Interest-bearing checking accounts, on average, tend to generate lower net returns than regular (noninterest-bearing) checking accounts.
Answer: False

T F 45. Personal checking accounts tend to be more profitable than commercial checking accounts.
Answer: False

T F 46. NOW accouts can be held by businesses and individuals and are interest bearing checking accounts.
Answer: False

T F 47. A MMDA is a short term deposit where the bank can offer a competitive interest rate and which allows up to 6 preauthorized drafts per month.
Answer: True

T F 48. A Roth IRA allows an individual to accumulate investment earnings tax free and also pay no tax on their investment earnings when withdrawn provided the taxpayer follows the rules on this new account.
Answer: True

T F 49. Competition tends to raise deposit interest costs.
Answer: True

T F 50. Competition lowers the expected return to a bank from putting its deposits to work.
Answer: True

T F 51. A bank has full control of its deposit prices in the long run.
Answer: False

T F 52. Nonprice competition for deposits has tended to distort the allocation of scarce resources in the banking sector.
Answer: True

T F 53. Deposits are usually priced separately from loans and other bank services.
Answer: True

T F 54. According to recent Federal Reserve data no-fee savings accounts are on the decline.
Answer: True

T F 55. According to recent survey information provided by the staff of the Federal Reserve Board the average level of fees on most types of checking and NOW accounts appear to have risen.
Answer: True

T F 56. The Truth in Savings Act requires a bank to disclose to its deposit customer the frequency with which interest is compounded on all interest-bearing accounts.
Answer: True

T F 57. Under the Truth in Savings Act customers must be informed of the impact of any early deposit withdrawals on the annual percentage yield they expect to receive from an interest-bearing deposit.
Answer: True

T F 58. The number one factor households consider in selecting a bank to hold their checking account is, according to recent studies cited in this chapter, low fees and low minimum balance.
Answer: False

T F 59. The number one factor households consider in choosing a bank to hold their savings deposits, according to recent studies cited in this chapter, is location.
Answer: False

T F 60. Conditionally free deposits for customers mean that as long as the customers do not go above a certain level of deposits there are no monthly fees or per transaction charges.
Answer: False

T F 61. When a bank temporarily offers higher than average interest rates or lower than average customer fees in order to attract new business they are practicing conditional pricing.
Answer: False

T F 62. Web-centered banks with little or no physical facilities are known as ________ banks
Answer: True

T F 63. The total dollar value of checks paid in the United States has grown modestly in recent years.
Answer: False

T F 64. There are still a number of existing problems with online bill-paying services which has limited the growth.
Answer: True

T F 65. The depository institutions which tend to have the highest deposit yields are credit unions.
Answer: False

T F 66. Urban markets are more responsive to deposit interest rates and fees than rural markets.
Answer: False

T F 67. Research indicates that at least half of all households and small businesses hold their primary checking account at a depository institution situated within 3 miles of their location.
Answer: True

Multiple Choice Questions

68. Deposit accounts whose principal function is to make payments for purchases of goods and services are called:
    A) Drafts
    B) Second-party payments accounts
    C) Thrift deposits
    D) Transaction accounts
    E) None of the above
    Answer: D

69. Interest payments on regular checking accounts were prohibited in the United States under terms of the:
    A) Glass-Steagall Act
    B) McFadden-Pepper Act
    C) National Bank Act
    D) Garn-St. Germain Depository Institutions Act
    E) None of the above
    Answer: A

70. Money-market deposit accounts (MMDAs), offering flexible interest rates, accessible for payments purposes, and designed to compete with share accounts offered by money market mutual funds, were authorized by the:
    A) Glass-Steagall Act
    B) Depository Institutions Deregulation and Monetary Control Act (DIDMCA)
    C) Bank Holding Company Act
    D) Garn-St.Germain Depository Institutions Act
    E) None of the above
    Answer: D

71. The stable and predictable base of deposited funds that are not highly sensitive to movements in market interest rates but tend to remain with the bank are called:
    A) Time deposits
    B) Core deposits
    C) Consumer CDs
    D) Nontransaction deposits
    E) None of the above
    Answer: B

72. Noegotiable Orders of Withdrawal (NOW) accounts, interest-bearing savings accounts that can be used essentially the same as checking accounts, were authorized by:
A) Glass-Steagall Act
B) Depository Institutions Deregulation and Monetary Control Act (DIDMCA)
C) Bank Holding Company Act
D) Garn-St. Germain Depository Institutions Act
E) None of the above
Answer: B

74. A deposit which offers flexible money market interest rates but is accessible for spending by writing a limited number of checks or executing preauthorized drafts is known as a:
A) Demand deposit
B) NOW account
C) MMDAs
D) Time deposit
E) None of the above
Answer: C

75. The types of deposits that will be created by the banking system depend predominantly upon:
A) The level of interest rates
B) The state of the economy
C) The monetary policies of the central bank
D) Public preference
E) None of the above.
Answer: D

76. The most profitable deposit for a bank is a:
A) Time deposit
B) Commercial checking account
C) Personal checking account
D) Passbook savings deposit
E) Special checking account
Answer: B

77. Some people feel that individuals are entitled to some minimum level of financial services no matter what their income level. This issue is often called:
A) Lifeline banking
B) Preference banking
C) Nondiscriminatory banking
D) Lifeboat banking
E) None of the above
Answer: A

78. The formula Operating Expense per unit of deposit service + Estimated overhead expense + Planned profit from each deposit service unit sold reflects what deposit pricing method listed below?
A) Marginal cost pricing
B) Cost plus pricing
C) Conditional pricing
D) Upscale target pricing
E) None of the above.
Answer: B

79. Using deposit fee schedules that vary deposit prices according to the number of transactions, the average balance in the deposit account, and the maturity of the deposit represents what deposit pricing method listed below?
A) Marginal cost pricing
B) Cost plus pricing
C) Conditional pricing
D) Upscale target pricing
E) None of the above.
Answer: C

80. The deposit pricing method that favors large-denomination deposits because services are free if the deposit account balance stays above some minimum figure is called:
A) Free pricing
B) Conditionally free pricing
C) Flat-rate pricing
D) Upscale target pricing
E) Marginal cost pricing
Answer: B

81. The federal law that requires U.S. depository institutions to make greater disclosure of the fees, interest rates, and other terms attached to the deposits they sell to the public is called the:
A) Consumer Credit Protection Act
B) Fair Pricing Act
C) Consumer Full Disclosure Act
D) Truth in Savings Act
E) None of the above.
Answer: D

82. Depository institutions selling deposits to the public in the United States must quote the rate of return pledged to the owner of the deposit which reflects the customer's average daily balance kept in the deposit. This quoted rate of return is known as the:
A) Annual percentage rate (APR)
B) Annual percentage yield (APY)
C) Daily deposit yield (DDY)
D) Daily average return (DAR)
E) None of the above.
Answer: B

83. According to recent studies cited in this book, in selecting a bank to hold their checking accounts household customers rank first which of the following factors?
A) Safety
B) High deposit interest rates
C) Convenient location
D) Availability of other services
E) Low fees and low minimum balance.
Answer: C

84. According to recent studies cited in this chapter, in choosing a bank to hold their savings deposits household customers rank first which of the following factors?
A) Familiarity
B) Interest rate paid
C) Transactional convenience
D) Location
E) Fees charged.
Answer: A

85. According to recent studies cited in this chapter, in choosing a bank to supply their deposits and other services business firms rank first which of the following factors?
A) Quality of financial advice given
B) Financial health of lending institution
C) Whether loans are competitively priced
D) Whether cash management and operations services are provided.
E) Quality of bank officers.
Answer: B

86. A financial institution that charges customers based on the number of services they use and gives lower deposit fees or waives some fees for a customer that purchases two or more services is practicing:
A) Marginal cost pricing
B) Conditional pricing
C) Relationship pricing
D) Upscale target pricing
E) None of the above
Answer: C

87. A bank determines from an analysis on its deposits that account processing and other operating expenses cost the bank $3.95 per month. It has also determined that its non operating expenses on its deposits are $1.35 per month. The bank wants to have a profit margin which is 10 percent of monthly costs. What monthly fee should this bank charge on its deposit accounts?
A) $5.30 per month
B) $3.95 per month
C) $5.83 per month
D) $5.70 per month
E) None of the above
Answer: C

88. A bank determines from an analysis on its deposits that account processing and other operating expenses cost the bank $4.45 per month. The bank has also determined that nonoperating expenses on deposits are $1.15 per month. It has also decided that it wants a profit of $.45 on its deposits. What monthly fee should this bank charge on its deposit accounts?
A) $6.05
B) $5.60
C) $5.15
D) $4.45
E) None of the above
Answer: A

89. A customer has a savings deposit for 45 days. During that time they earn $5 in interest and have an average daily balance of $1000. What is the annual percentage yield on this savings account?
A) 0.5%
B) 4.13%
C) 4.07%
D) 4.5%
E) None of the above
Answer: B

90. A customer has a savings account for one year. During that year they earn $65.50 in interest. For 180 days they have $2000 in the account for the other 180 days they have $1000 in the account. What is the annual percentage yield on this savings account.
A) 6.55%
B) 3.28%
C) 4.37%
D) 8.73%
E) None of the above
Answer: C

91. If you deposit $1,000 into a certificate of deposit that quotes you a 5.5% APY, how much will you have at the end of 1 year?
A) $1,050.00
B) $1,055.00
C) $1,550.00
D) $1,005.50
E) None of the above.
Answer: B

92. A bank quotes an APY of 8%. A small business that has an account with this bank had $2,500 in their account for half the year and $5,000 in their account for the other half of the year. How much in total interest earnings did this bank make during the year?
A) $300
B) $200
C) $400
D) $150
E) None of the above
Answer: A

93. Conditional deposit pricing may involve all of the following factors except:
A) The level of interest rates
B) The number of transactions passing through the account
C) The average balance in the account
D) The maturity of the account
E) All of the above are used
Answer: A

94. Customers who wish to set aside money in anticipation of future expenditures or financial emergencies put their money in
A) Drafts
B) Second-party payment accounts
C) Thrift Deposits
D) Transaction accounts
E) None of the above
Answer: C

95. A savings account evidenced only by computer entry for which the customer gets a monthly printout is called:
A) Passbook savings account
B) Statement savings plan
C) Negotiable order of withdrawal
D) Money market mutual fund
E) None of the above
Answer: B

96. A traditional savings account where evidenced by the entries recorded in a booklet kept by the customer is called:
A) Passbook savings account
B) Statement savings plan
C) Negotiable order of withdrawal
D) Money market mutual fund
E) None of the above
Answer: A

97. An account at a bank that carries a fixed maturity date with a fixed interest rate and which often carries a penalty for early withdrawal of money is called:
A) Demand deposit
B) Transaction deposit
C) Time deposit
D) Money market mutual deposit
E) None of the above
Answer: C

98. A time deposit that has a denominations greater than $100,000 and are generally for wealthy individuals and corporations is known as a:
A) Negotiable CD
B) Bump-up CD
C) Step-up CD
D) Liquid CD
E) None of the above
Answer: A

99. A time deposit that is non-negotiable but where the promised interest rate can rise with market interest rates is called a:
A) Negotiable CD
B) Bump-up CD
C) Step-up CD
D) Liquid CD
E) None of the above
Answer: B

100. A time deposit that allows for a periodic upward adjustment to the promised rate is called a:
A) Negotiable CD
B) Bump-up CD
C) Step-up CD
D) Liquid CD
E) None of the above
Answer: C

101. A time deposit that allows the depositor to withdraw some of his or her funds without a

withdrawal penalty is called a:
A) Negotiable CD
B) Bump-up CD
C) Step-up CD
D) Liquid CD
E) None of the above
Answer: D

102. What has made IRA and Keogh accounts more attractive to depositors recently?
A) Allowing the bank to have FDIC insurance on these accounts
B) Allowing the fund to grow tax free over the life of the fund
C) Allowing the depositor to pay no taxes on investment earnings when withdrawn
D) Requiring banks to pay at least 6% on these accounts to depositors
E) Increasing FDIC insurance coverage to $250,000 on these accounts
Answer: E

103. The dominant holder of bank deposits in the U.S. is:
A) The private sector
B) State and local governments
C) Foreign governments
D) Deposits of other banks
E) None of the above
Answer: A

104. The deposit pricing method absent of any monthly account maintenance fee or per-transaction fee is called:
A) Free pricing
B) Conditionally free pricing
C) Flat-rate pricing
D) Marginal cost pricing
E) Nonprice competition
Answer: A

105. The deposit pricing method that charges a fixed charge per check or per period or both is called:
A) Free pricing
B) Conditionally free pricing
C) Flat-rate pricing
D) Marginal cost pricing
E) Nonprice competition
Answer: C

106. The deposit pricing method that focuses on the added cost of bringing in new funds is called:
A) Free pricing
B) Conditionally free pricing
C) Flat-rate pricing
D) Marginal cost pricing

E) Nonprice competition
Answer: D

107. Prior to Depository Institution Deregulation and Control Act (DIDMCA), banks used _______. This tended to distort the allocation of scarce resources.
A) Free pricing
B) Conditionally free pricing
C) Flat-rate pricing
D) Marginal cost pricing
E) Nonprice competition
Answer: E

108. A customer has a savings deposit for 60 days. During that time they earn $11 and have an average daily balance of $1500. What is the annual percentage yield on this savings account?
A) .73%
B) 4.3%
C) 4.5%
D) 4.7%
E) None of the above
Answer: C

109. A customer has a savings deposit for 15 days. During that time they earn $15 and have an average daily balance of $2200. What is the annual percentage yield on this savings account?
A) .68%
B) 16.36%
C) 16.59%
D) 17.98%
E) None of the above
Answer: D

110. A bank determines from an analysis on its deposits that account processing and other operating expenses cost the bank $4.15 per month. It has also determined that its none operating expenses on its deposits are $1.65 per month. The bank wants to have a profit margin which is 10 percent of monthly costs. What monthly fee should this bank charge on its deposit accounts?
A) $6.38 per month
B) $5.80 per month
C) $4.57 per month
D) $4.15 per month
E) None of the above
Answer: A

111. A bank has $200 in checking deposits. Interest and noninterest costs on these accounts are 4%. This bank has $400 in savings and time deposits with interest and noninterest costs of 8%. This bank has $200 in equity capital with a cost of 24%. This bank as estimated that reserve requirements, deposit insurance fees and uncollected balances reduce the amount of money

available on checking deposits by 10% and on savings and time deposits by 5%. What is this bank's before-tax cost of funds?
A) 11.00%
B) 11.32%
C) 11.50%
D) 12.00%
E) None of the above
Answer: B

112. A bank has $100 in checking deposits. Interest and noninterest costs on these accounts are 8%. This bank has $600 in savings and time deposits with interest and noninterest costs of 12%. This bank has $100 in equity capital with a cost of 26%. This bank has estimated that reserve requirements, deposit insurance fees and uncollected balances reduce the amount of money available on checking deposits by 20% and on savings and time deposits by 5%. What is the bank's before-tax cost of funds?
A) 13.05%
B) 13.25%
C) 15.33%
D) 19.17%
E) None of the above
Answer: A

113. A bank has $500 in checking deposits. Interest and noninterest costs on these accounts are 6%. This bank has $250 in savings and time deposits with interest and noninterest costs of 14%. This bank has $250 in equity capital with a cost of 25%. This bank has estimated that reserve requirements, deposit insurance fees and uncollected balances reduce the amount of money available on checking deposits by 15% and on savings and time deposits by 4%. What is the bank's before-tax cost of funds?
A) 15.00%
B) 12.75%
C) 13.42%
D) 15.74%
E) None of the above
Answer: C

114. A bank expects to raise $30 million in new money if it pays a deposit rate of 7%. It can raise $60 million in new money if it pays a deposit rate of 7.5%. It can raise $80 million in new money if it pays a deposit rate of 8% and it can raise $100 million in new money if it pays a deposit rate of 8.5%. This bank expects to earn 9% on all money that it receives in new deposits. What deposit rate should the bank offer on its deposits, if they use the marginal cost method of determining deposit rates?
A) 7%
B) 7.5%
C) 8%
D) 8.5%
E) None of the above
Answer: B

115. A bank expects to raise $30 million in new money if it pays a deposit rate of 7%. It can raise $60 million in new money if it pays a deposit rate of 7.5%. It can raise $80 million in new money if it pays a deposit rate of 8% and it can raise $100 million in new money if it pays a deposit rate of 8.5%. This bank expects to earn 9% on all money that it receives in new deposits. What is the marginal cost of deposits if the bank raises their deposit rate from 7 to 7.5%?
A) .5%
B) 7.5%
C) 8.0%
D) 9.5%
E) 10.5%
Answer: C

116. Under the Truth in Savings Act, a bank must inform its customers of the terms being quoted on their deposits. Which of the following is not one of the terms listed?
A) Loan rate information
B) Balance computation method
C) Early withdrawal penalty
D) Transaction limitations
E) Minimum balance requirements
Answer: A

117. Which of these Acts is attempting to address the low savings rate of workers in the U.S. by including an automatic enrollment ("default option") in employees' retirement accounts?
A) The Economic Recovery Tax Act of 1981
B) The Tax Reform Act of 1986
C) The Tax Relief Act of 1997
D) The Pension Protection Act of 2006
E) None of the above
Answer: D

118. Business (commercial) transaction accounts are generally more profitable than personal checking accounts, according to the textbook. Which of the following explain the reasons for this statement:
A) The average size of the business transaction is smaller than the personal transaction
B) Lower interest expenses are associated with commercial deposit transaction
C) The bank receives more investable funds in the commercial deposits transaction
D) A and B
E) B and C
Answer: E

119. A bank expects to raise $30 million in new money if it pays a deposit rate of 7%. It can raise $60 million in new money if it pays a deposit rate of 7.5%. It can raise $80 million in new money if it pays a deposit rate of 8% and it can raise $100 million in new money if it pays a deposit rate of 8.5%. This bank expects to earn 9% on all money that it receives in new deposits. What is the marginal cost of deposits if this bank raises their deposit rate from 7.5% to 8%?
A) .5%
B) 7.5%
C) 8.0%
D) 9.5%
E) 10.5%
Answer: D

120. A bank expects to raise $30 million in new money if it pays a deposit rate of 7%. It can raise $60 million in new money if it pays a deposit rate of 7.5%. It can raise $80 million in new money if it pays a deposit rate of 8% and it can raise $100 million in new money if it pays a deposit rate of 8.5%. This bank expects to earn 9% on all money that it receives in new deposits. What is the marginal cost of deposits if this bank raises their deposit rate from 8% to 8.5%?
A) .5%
B) 7.5%
C) 8.0%
D) 9.5%
E) 10.5%
Answer: E

121. A bank expects to raise $20 million in new money if it pays a deposit rate of 7%. It can raise $60 million in new money if it pays a deposit rate of 7.5%. It can raise $100 million in new money if it pays a deposit rate of 8% and it can raise $120 in new money if it pays a deposit rate of 8.5%. This bank expects to earn 9.5% on all money that it receives in new deposits. What deposit rate should the bank offer on its deposits, if it uses the marginal cost method of determining deposits rates?
A) 7%
B) 7.5%
C) 8%
D) 8.5%
E) None of the above
Answer: C

122. A bank expects to raise $20 million in new money if it pays a deposit rate of 7%. It can raise $60 million in new money if it pays a deposit rate of 7.5%. It can raise $100 million in new money if

it pays a deposit rate of 8% and it can raise \$120 in new money if it pays a deposit rate of 8.5%. This bank expects to earn 9.5% on all money that it receives in new deposits. What is the marginal cost of deposits if this bank raises their deposit rate from 8 to 8.5%?

A) 11%
B) 8.75%
C) 7.75%
D) 7%
E) .5%
Answer: A

123. A bank expects to raise \$20 million in new money if it pays a deposit rate of 7%. It can raise \$60 million in new money if it pays a deposit rate of 7.5%. It can raise \$100 million in new money if it pays a deposit rate of 8% and it can raise \$120 in new money if it pays a deposit rate of 8.5%. This bank expects to earn 9.5% on all money that it receives in new deposits. What is the marginal cost of deposits if this bank raises their deposit rate from 7.5% to 8%?

A) 11%
B) 8.75%
C) 7.75%
D) 7%
E) .5%
Answer: B

Chapter 13
Managing Nondeposit Liabilities

Fill in the Blank Questions

1. Dollar denominated CDs issued outside the U.S. are called _________________________.
   Answer: Eurodollar CDs

2. The CDs large foreign banks sell through their U.S. branches are called _________________________.
   Answer: Yankee CDs

3. When a bank buys funds from other financial institutions in order to cover good quality loan demand and to satisfy deposit reserve requirements they are practicing _________________________.
   Answer: liability management

4. When the first priority of a bank is to make loans to all good quality loan customers they are following the _________________________.
   Answer: customer relationship doctrine

5. Originally __________________ consisted exclusively of deposits held by U.S. banks at the Federal Reserve banks which were loaned from one bank to another.
   Answer: federal funds

6. _________________________ is the short-term notes, with maturities ranging from 3 to 4 days to 9 months, issued by well known companies.
   Answer: Commercial paper

7. A _________________________ is the temporary sale of high-quality, easily-liquidated assets accompanied by the agreement to buy back those assets on a future specific date at a predetermined price.
   Answer: repurchase agreement

8. Because the interest rate on CDs, commercial paper and other nondeposit borrowings (except borrowings from the Federal Reserve discount window) are determined by supply and demand conditions in the market they all face __________________ risk.
   Answer: interest rate

9. The spread between current and expected loans and investments and the current and expected deposit inflows and other sources of funds is known as the _________________________.
Answer: funds gap

10. A(n) _________________________ is an interest bearing receipt for funds issued by a bank with a minimum denomination of $100,000.
Answer: negotiable (jumbo) CD

11. Because there is a danger that the bank in need of funds will not be able to find someone willing to grant the bank a loan at a reasonable rate, they face _________________________.
Answer: credit availability risk

12. The Federal Reserve will make loans through its _________________________.
Answer: discount window

13. The securities most often used in a repurchase agreement are _________________________.
Answer: T-Bills

14. Virtually all nondeposit borrowing of a bank are ______-term rather than _______-term debt.
Answer: short, long

15. Repurchase Agreements (RPs) are very similar to Federal Funds and are often viewed as ____________ federal funds transactions.
Answer: collateralized

16. A repurchase agreement (RP) whereby the collateral is specifically identified is known as a conventional or ____________ RP.
Answer: fixed-collateral

17. A ______________ repurchase agreement (RP) is one in which the underlying collateral is not identified precisely and thus allows some substitution.
Answer: General Collateral Finance

18. The type of discount window loan with generally the highest rates of interest is known as ___________ credit.
Answer: secondary

19. The type of discount window loan with generally the lowest rate of interest is known as __________ credit.
Answer: seasonal

20. Federal Reserve balances of banks can be transferred from one institution to another in seconds through the Fed's wire transfer network called the __________________.
    Answer: Fedwire

21. One of the three types of loans in the Fed Funds market, __________________ are unwritten agreements, negotiated via wire or telephone, with the borrowed funds returned the next day.
    Answer: overnight loans

22. One of the three types of loans in the Fed Funds market, ________________ are longer-term Fed Funds contracts lasting several days, weeks or months, often accompanied by a written contract.
    Answer: term loans

23. One of the three types of loans in the Fed Funds market, ________________ are automatically renewed each day unless either the borrower or lender decides to end this agreement.
    Answer: continuing contracts

24. When financial institution borrows in the RP market, this loan is listed as ___________________.
    Answer: Securities Sold under Agreements to Repurchase

25. ____________________________are nondeposit borrowings that are fully collateralized by home mortgages and have maturities ranging from overnight to 20 years.
    Answer: Advances from the Federal Home Loan Banks

True/False Questions

26. The traditional and principal source of bank funds is <u>deposits.</u>
    Answer: True

27. Asset management (i.e., conversion of assets to cash) is regarded as an interest-sensitive approach to raising funds.
    Answer: False

28. Deposits have been growing faster than nondeposit sources of funds in recent years among U.S. banks.
    Answer: False

29. Federal funds today consist exclusively of deposits held at the Federal Reserve banks.
    Answer: False

30. There are <u>no</u> reserve requirements on Federal funds borrowings in the U.S.
Answer: True

31. Accommodating banks buy and sell Federal funds simultaneously.
Answer: True

32. Loans of Federal funds under a continuing contract are automatically renewed each day unless either the borrower or the lender decides to end the agreement.
Answer: True

33. The loan from a Federal Reserve bank which normally lasts only a few days and is designed to provide immediate aid in meeting a bank's legal reserve requirement is known as <u>extended credit.</u>
Answer: False

34. Yankee CDs are issued by large savings and loan associations and other nonbank savings institutions.
Answer: False

35. The volume of variable-rate CDs exceeds the volume of fixed-rate CDs among U.S. banks.
Answer: False

36. Liability management is considered to be an <u>interest-sensitive</u> approach to raising bank funds.
Answer: True

37. Funds raised by the use of liability management techniques are considered to be <u>flexible.</u>
Answer: True

38. Liability management banking calls for using <u>price</u> (the interest rate offered) as the control lever to regulate incoming funds.
Answer: True

39. The most common type of federal funds loans are term loans.
Answer: False

40. Longer-term federal funds contracts lasting several days, weeks, or months, often accompanied by a written contract, are called <u>continuing contracts</u>.
Answer: False

41. According to the FDIC Improvement Act undercapitalized U.S. banks cannot be granted discount window loans for more than 60 days in each 120-day period.
Answer: True

42. The largest foreign banks active in the United States sell CDs through their U.S. branches called Yankee CDs.
Answer: True

43. Under current federal law commercial banks in the United States can issue commercial paper as direct obligations of the banks.
Answer: False

44. Nondeposit funds do have the advantage of quick availability compared to most types of deposits, but are not as stable a funding source for banks as are time and savings deposits.
Answer: True

45. Longer-term federal funds contracts which are automatically renewed each day unless either the borrower or the lender decides to end the agreement are called term loans,
Answer: False

46. The main use of federal funds today is still the traditional one. Federal funds provide a mechanism that allows banks short of legal reserves to tap into immediately available funds from other institutions possessing temporarily idle funds.
Answer: True

47. One of the factors to consider when a bank chooses among nondeposit funding sources is the relative cost. In general, the cheapest source of short-term funds is the Fed Funds market.
Answer: True

48. There are no restrictions on getting a Federal Reserve loan and because it is the cheapest source of short-term funds most banks will use this source of funds exclusively.
Answer: False

49. CDs must be issued with maturities of at least 7 days.
Answer: True

50. Loans from the Fed Funds market must be backed by collateral.
Answer: False

51. In recent years financial institutions have gotten better at managing interest rate risk.
Answer: True

52. Large banks depend more on nondeposit borrowings than small banks.
Answer: True

53. Although there is an active federal funds spot market, there is currently no associated futures market for federal funds.
Answer: False

54. Repurchase Agreement (RPs) transactions are perceived to be less risky than equivalent federal funds transactions.
Answer: True

55. Interest rates in the Repurchase Agreement (RP) market are quoted on a 360-day basis.
Answer: True

56. Seasonal credit discount window loans generally have the highest interest rates.
Answer: False

57. Primary credit is defined as loans available for short terms and normally considered beneficial for the borrower because it carries an interest rate slightly below the target Fed funds rate.
Answer: False

58. When the general credit conditions are tight, there is a possibility that not every borrower will be accommodated by a lender. This chance of credit rationing is referred to as credit availability risk.
Answer: True

59. The size of a financial institution has an effect on the type of nondeposit funding source that it will consider. For example, larger depository institutions have the credit standing to sell the largest negotiable CDs, while the Fed funds market is suitable for smaller institutions.
Answer: True

60. Only federal regulators can limit the terms (amount, frequency, and use) of borrower funds by the U.S. depository institutions.
Answer: False

Multiple Choice Questions

61. The doctrine that the <u>first</u> priority of a bank is to make loans to all those customers from whom the bank expects to receive positive net earnings is called the:
    A) Funds management doctrine
    B) Customer relationship doctrine
    C) Loan priority doctrine
    D) Revenue flows doctrine
    E) None of the above.
    Answer: B

62. The doctrine that banks should be able to buy the reserves they need to cover good-quality loan requests is known as:
    A) Funds Management
    B) Asset Management
    C) Liability Management
    D) Asset-Liability Coordinated Management
    E) None of the above.
    Answer: C

63. With liability management banking the control lever to regulate incoming bank funds is:
    A) Management discretion
    B) The volume of loan demand the bank faces.
    C) Deposit growth
    D) Price
    E) None of the above.
    Answer: D

64. The most popular domestic source of borrowed reserves for U.S. banks is:
    A) Federal funds market
    B) Money market negotiable CDs
    C) Eurodollar market
    D) Borrowings from the Federal Reserve Banks
    E) Commercial paper market
    Answer: A

65. The phrase "short-term borrowings of immediately available money" refers to:
    A) Negotiable CDs
    B) Eurodollar deposits
    C) Commercial paper issues
    D) Borrowings of legal reserves at the Federal Reserve banks
    E) None of the above.
    Answer: E

66. Large time deposits are generally referred to as:
    A) Mini CDs.
    B) Jumbo CDs.
    C) Large CDs.
    D) Giant CDs.
    E) Super CDs.
    Answer: B

67. The source of short-term funds for commercial banks that was developed to tap temporary surplus funds held by large corporate and wealthy individual customers is:
    A) Federal funds.
    B) Commercial paper.
    C) Eurodollar deposits.
    D) Negotiable CDs.
    E) None of the above.
    Answer: D

68. First National Bank has new loan requests of $225 million, needs to purchase $100 million in U.S. Treasury securities to meet pledging requirements, and anticipates draws against credit lines of $135 million. Deposits received today total $215 million and the bank expects to bring in an additional $100 million next week. What is First National's estimated funds gap for the coming week?
    A) $225 million.
    B) $145 million.
    C) $135 million.
    D) $100 million.
    E) None of the above.
    Answer: B

69. First National Bank has new loan requests of $175 million, needs to purchase $50 million in U.S. Treasury securities to meet pledging requirements, and anticipates draws against credit lines of $45 million. Deposits received today total $140 million and the bank expects to bring in an additional $230 million next week. What is First National's estimated funds gap for the coming week?
    A) $225 million.
    B) $145 million.
    C) $135 million.
    D) $100 million.
    E) None of the above.
    Answer: D

70. Factors that will affect a bank's decision as to which nondeposit sources of funds it will use to cover its projected funds gap include which of the following?
    A) The relative cost of raising the funds.

B) The length of time the funds will be required.
C) The risk associated with each source of funds.
D) The size of the bank.
E) All of the above.
Answer: E

71. First National Bank is planning to raise $30 million through an offering of negotiable CDs. The current rate for similar CDs is 5.5%. Noninterest cost rate for CDs is 0.25 percent. First National pays a deposit insurance premium of 0.0023 per dollar of insured deposits. Due to other immediate cash needs, only $25 million will be fully invested. What is the effective cost rate of borrowing in the CD market?
A) 6.9%
B) 7.2%
C) 6.0%
D) 5.5%
E) None of the above.
Answer: B

72. CDs that are sold by the largest foreign banks through their U.S. branches are called:
A) Thrift CDs.
B) Domestic CDs.
C) EuroCDs.
D) Yankee CDs.
E) None of the above.
Answer: D

73. Accommodating banks perform what role?
A) They act as intermediaries in the Eurodollar market.
B) They issue negotiable CDs for themselves and for other banks.
C) They sell commercial paper to raise funds for themselves and other firms belonging to their bank holding company.
D) They buy and sell federal funds simultaneously in order to make a market for reserves of customer banks.
E) None of the above.
Answer: D

74. A federal funds loan that is automatically renewed each day unless either the borrower or the lender decides to end the loan agreement is known as a:
A) Overnight loan.
B) Continuing contract.
C) Term loan.
D) Rollover loan agreement
E) None of the above
Answer: B

75. Longer-term federal funds contracts lasting several days, weeks, or months, often accompanied by a written contract, are known as:
A) Term loans.
B) Continuing contracts
C) Rollover loans.
D) Federal funds mutuality agreements
E) None of the above
Answer: A

76. The federal law that restricts Federal Reserve lending to undercapitalized banks and to banks that are "viable entities" is the:
A) Riegle Community Development and Regulatory Improvement Act
B) FDIC Improvement Act.
C) Financial Institutions Reform, Recovery, and Enforcement Act.
D) Depository Institutions Deregulation and Monetary Control Act.
E) None of the above.
Answer: B

77. The bank funding source that is really a "hybrid" account is the:
A) Federal funds loan.
B) Repurchase agreement.
C) Negotiable CD.
D) Eurodollar deposit.
E) None of the above.
Answer: C

78. A bank plans on borrowing $150 million through an RP transaction collateralized by T-bills. The bank plans on borrowing the money for 5 days and the current RP rate is 5.25 percent. What is this bank's total interest cost in dollars?
A) $7,875,000
B) $107,877
C) $21,875
D) $109,375
E) None of the above
Answer: D

79. Suppose a bank promises an annual return of 6.5 percent on a three month (90 day) $150,000 CD) What will be the total amount due the customer at the end of the three month period?
A) $152,437.50
B) $2,437.50
C) $150,000
D) $152,404.11
E) None of the above
Answer: A

80. The short-term notes, with maturities ranging from 3 or 4 days to 9 months, issued by well known companies are known as:
A) Negotiable CDs
B) Commercial paper
C) Federal funds
D) Repurchase agreements
E) None of the above
Answer: B

81. The TRC Bank is planning on raising $500 million in a new offering of commercial paper through its holding company. The plan on using $475 million of it to fund new loans. The current interest rate for similar commercial paper is 6.45 percent and they expect .25 percent in issuing costs. What is the effective rate of interest on this issue of commercial paper?
A) 6.65%
B) 6.45%
C) 7.05%
D) 6.79%
E) None of the above
Answer: C

82. An agreement where one party agrees to sell T-bills to another party and at the same time agrees to buy them back at a set price is known as:
A) A repurchase agreement
B) Commercial paper
C) Federal Funds
D) Negotiable CDs
E) None of the above
Answer: A

83. Which of the following is not an advantage of using a repurchase agreement?
A) The bank gains excess reserves which can used to make new deposits
B) The bank makes use of high-quality but low yielding assets without losing them permanently
C) If the agreement is made with a bank who keeps a checkable deposit with the bank it can reduce both the bank's deposits and reserve requirements
D) The interest rate the bank has to pay is usually low
E) All of the above are advantages of using a repurchase agreement
Answer: A

84. Which of the following is an example of a longer term nondeposit funding source?
A) Federal funds
B) Repurchase agreements
C) Capital notes and debentures
D) Negotiable CDs
E) None of the above
Answer: C

85. Suppose a bank expects to issue 45 day negotiable CDs for $150 million. The interest rate on these CDs is 6.35%. What is the dollar amount in interest the bank will owe on these CDs at the end of the 45 days?
A) $9,525,000
B) $1,190,625
C) $76,200,000
D) $6,750,000
E) None of the above
Answer: B

86. Dollar denominated CDs issued by banks outside the United States are known as:
A) Domestic CDs
B) Euro CDs
C) Yankee CDs
D) Commercial paper
E) None of the above
Answer: B

87. A repurchase agreement (RP) in which the collateral is specifically identified is known as:
A) A conventional RP
B) A General Collateral Finance RP
C) A specific RP
D) A general RP
E) An individual RP
Answer: A

88. A conventional Repurchase Agreement (RP) is ________ flexible for the borrower than (as) a General Collateral Finance RP.
A) More
B) Less
C) As
D) Unknown
E) None of the above
Answer: B

89. The following types of loans are all available at the discount window except:
A) Adjustment credit
B) Primary credit
C) Secondary credit
D) Seasonal credit
E) None of the above
Answer: A

90. In addition to the Federal Reserve, another governmental agency has also been loaning large amounts of money to banks and thrift institutions and is known as the:
A) FDIC
B) OCC
C) OTS
D) FHLB
E) RTC
Answer: D

91. The Bridges State Bank has new loan requests of $315 and wants to purchase $125 million in U.S. Treasury securities and anticipates draws on lines of credit in the amount of $65 million. Deposits received today totaling $205 million and the bank expects to bring in an additional $185 million in deposits next week. What is the estimated funds gap for the Bridges State Bank?
A) $505 million
B) $390 million
C) $115 million
D) $315 million
E) None of the above
Answer: C

92. The Williams National Bank has new loan requests of $585 million and wants to purchase $160 in U.S. Treasury securities. They also anticipate draws on lines of credit in the amount of $120 million. This bank received deposits totaling $300 million and they expect to bring in an additional $340 million in deposits next week. What is the estimated funds gap of the Williams National Bank?
A) $225 million
B) $585 million
C) $640 million
D) $865 million
E) None of the above
Answer: A

93. The Willis Savings Bank is comparing the prevailing interest rate in the Fed Funds market with that in the negotiable CD market. They are making sure to include the noninterest costs and the deposit insurance costs as well as the amount of money that will actually be available for new loans. Which factor that affects a bank's use of non-deposit sources of funds is the bank examining?
A) The relative cost of raising the funds
B) The length of time the funds will be required
C) The risk associated with each source of funds
D) The size of the bank
E) Regulations
Answer: A

94. The First State Bank of Summerville knows that, if they issue commercial paper through a subsidiary, money is very tight and the interest rate on the commercial paper may very high.

What factor that affects a bank's use of non-deposit sources of funds is the bank concerned about?
A) The relative cost of raising the funds
B) The length of time the funds will be required
C) The risk associated with each source of funds
D) The size of the bank
E) Regulations
Answer: C

95. The First State Bank of Summerville knows that, if they issue a large amount of the negotiable CD, money is tight. As a result, they choose to ration the credit and lend only to their most loyal clients. What risk factor that affects a bank's use of nondeposit sources of funds is the concern here?
A) Interest rate changes
B) The length of time the funds will be required
C) The relative cost of raising the funds
D) Credit availability
E) Regulations
Answer: D

96. The manager of the First National Bank of Edmond needs $100 million this afternoon to satisfy an unexpected loan demand from an excellent customer of the bank. What factor that affects a bank's use of nondeposit sources of funds is the manager concerned about?
A) The relative cost of raising the funds
B) The length of time the funds will be required
C) The risk associated with each source of funds
D) The size of the bank
E) Regulations
Answer: B

97. The First State Bank of Summerville needs to raise $500,000 in nondeposit sources of funds. They know that the Eurodollar market requires a minimum denomination of $1 million. What factor that affects a bank's use of nondeposit sources of funds is this bank concerned about?
A) The relative cost of raising the funds
B) The length of time the funds will be required
C) The risk associated with each source of funds
D) The size of the bank
E) Regulations
Answer: D

98. Bank of America is concerned because they have heard that the Federal Reserve Board may impose legal reserve requirements on money borrowed in the Fed Funds market. Which factor that affects a bank's use of nondeposit sources of funds is this bank concerned about?
A) The relative cost of raising the funds
B) The length of time the funds will be required

C) The risk associated with each source of funds
D) The size of the bank
E) Regulations
Answer: E

99. The Bank of Boulder is planning on issuing $45 million in negotiable CDs. Currently other similar CDs have an interest rate of 4.75%. The Bank of Boulder has estimated that its noninterest costs of issuing these CDs are .15%. The Bank of Boulder must pay a deposit insurance premium of .0023 per dollar of insured funds. Due to other immediate cash needs, only $40 million of the funds raised will be fully invested. What is the effective cost rate for the Bank of Boulder to borrow in the CD market? (Round your answer to the nearest .01%)
A) 4.75%
B) 4.90%
C) 5.10%
D) 5.79%
E) None of the above
Answer: D

100. The Lawrence Bank of Cleveland is planning on issuing $60 million in negotiable CDs. Currently other similar CDs have an interest rate of 5.15%. The Lawrence Bank of Cleveland has estimated that is noninterest costs of issuing these CDs will be .2%. The Lawrence Bank of Cleveland must pay a deposit insurance premium of .0023 per dollar of insured funds. Due to other immediate cash needs, only $50 of the funds raised will be full invested. What is the effective cost rate for the Lawrence Bank of Cleveland to borrow in the CD market? (Round your answer to the nearest .01%)
A) 6.71%
B) 6.42%
C) 5.58%
D) 5.15%
E) None of the above
Answer: A

101. CDs issued by savings institutions are called:
A) Thrift CDs
B) Domestic CDs
C) Euro CDs
D) Yankee CDs
E) Variable rate CDs
Answer: A

102. When a foreign branch lends a Eurodeposit to its home office in the U.S., how is this listed on the balance sheet of the home office?
A) Loan from Subsidiary
B) Liabilities to Foreign Branches
C) Securities Sold under Agreement to Repurchase
D) Bankers Acceptance
E) None of the above

Answer: B

103. A Fed Funds loan that is an unwritten agreement negotiated via wire or telephone with the borrowed funds returned the next day is known as:
A) An overnight loan
B) A continuing contract
C) A term loan
D) A daytime loan
E) None of the above
Answer: A

104. A bank plans on borrowing $225 million for 10 days through a RP transaction collateralized by T-Bills. The current RP rate is 4.5%. What is this bank's total interest cost in dollars?
A) $10,125,000
B) $1,125,000
C) $281,250
D) $28,125
E) None of the above
Answer: C

105. A bank plans on borrowing $450 million for 20 days through a RP transaction collateralized by T-Bills. The current RP rate is 6.25%. What is this bank's total interest cost in dollars?
A) $28,125,000
B) $78,125
C) $1,406,250
D) $1,562,500
E) None of the above
Answer: D

106. A bank promises an annual return of 7.75 percent on a 180 day, $250,000 CD. What will be the total amount due the customer at the end of the six month period?
A) $269,375.00
B) $259,687.50
C) $9687.50
D) $250,000.00
E) None of the above
Answer: B

107. A bank promises an annual return of 4.85% on a 60 day, $300,000 CD. What will be the total amount due to the customer at the end of the two month period?
A) $302,425
B) $314,550
C) $14,550
D) $2,425
E) None of the above

Answer: A

108. The HTR Bank is planning on raising $750 million in a new offering of commercial paper through its holding company. They plan on using $725 million of it to fund new loans. The current interest rate for similar commercial paper is 7.15% and they expect .15% in issuing costs. What is the effective rate of interest on this issue of commercial paper?
A) 7.30%
B) 7.15%
C) 7.40%
D) 7.55%
E) None of the above
Answer: D

109. The Carter State Bank is planning on raising $600 million in a new offering of commercial paper through its holding company. They plan on using $500 million of it to fund new loans. The current interest rate for similar commercial paper is 4.85% and they expect .3% in issuing costs. What is the effective rate of interest on this issue of commercial paper?
A) 5.15%
B) 6.18%
C) 5.82%
D) 4.85%
E) None of the above
Answer: B

110. Setting the Federal Reserve primary-credit discount rate above the Fed Funds rate mirrors what credit facilities used by several European central banks?
A) The Vince credit facilities
B) The Adam Smith credit facilities
C) The Lombard credit facilities
D) The Lower Back credit facilities
E) None of the above
Answer: C

Chapter 14
Investment Banking, Insurance, and Other Sources of Fee Income

Fill in the Blank Questions

1. When bank customers purchase stocks, bonds, mutual funds, and annuities through the bank, these products are referred to as ________________________.
   Answer: investment products

2. A(n) __________________ mutual fund is a mutual fund offered through a bank's affiliated company. The bank acts as a transfer agent, custodian and offers investment advise in this type of mutual fund.
   Answer: proprietary

3. When a financial institution offers a(n) __________________ mutual fund, it acts as broker for an unaffiliated mutual fund or group of funds and does not act as an investment advisor.
   Answer: nonproprietary

4. A(n) _________________________ promises a customer who deposits a lump sum a guaranteed rate of return over the life of the contract. This type of investment generates a continuous, level income stream over the life of the contract.
   Answer: fixed rate annuity

5. A(n) _________________________ gives the bank the right to manage the estate of a living person without a court order. This can be amended by the customer as desired.
   Answer: living(or revocable) trust

6. A(n) _________________________ is a savings instrument in which the customer makes cash payments to an investment manager who invests them in an earning asset. Later the purchaser receives a stream of income from those assets.
   Answer: annuity

7. _________________________ is the bringing together of two or more firms from different industries in order to create a conglomerate offering multiple services.
   Answer: Convergence

8. The ____brings more than one product or service together to reduce the overall risk of the revenue flows through the company.
   Answer: product line diversification effect

9. _______________________ emerge when financial organization grows in size and is able to reduce its cost of production per unit of output.

Answer: Economies of scale

10. _________________________ are the potential cost savings that result from being able to use the same management, employees and physical resources to offer multiple products.
Answer: Economies of scope

11. A(n) _________________________ is a contract that promises to pay a cash payment to the beneficiary in the event of the death of the policy holder.
Answer: life insurance policy

12. A(n) _________________________ _________________________ is a contract that promises to reimburse policy holders for personal injury, property damage and other losses in exchange for the policy holder's premium payments.
Answer: property-casualty insurance policy

13. The most rapidly growing source of income for banks is ________ income.
Answer: fee

14. __________________ are one of the earliest services provided by banks and involves the management of customer's property and other assets.
Answer: trust services

15. Trust department activities usually center upon establishing a ____________ relationship with a customer.
Answer: fiduciary

16. The trust department can be a significant source of ____________ for a bank or financial holding company.
Answer: deposits

17. _______________ are financial advisors to corporations, governments and other large institutions and their clients raise new capital, enter new markets, merger or acquire other firms and sell their firm to other firms.
Answer: Investment bankers

18. _________________ is the purchase for resale of new stocks, bonds and other financial instruments in the money and capital markets on behalf of clients who need to raise new money.
Answer: Security underwriting

19. Under law and industry practice a ___________________ is supposed to be set up between an

IB’s security underwriting and client advising divisions and the internal unit where proprietary trading of stocks and bonds take place to prevent the transfer of insider information about clients.
Answer: Chinese wall

20. Passage of the ____________________________ of 1999 granted banks, securities firms and insurance companies the right to apply to the Federal Reserve Board to become a financial holding company (FHC).
Answer: Gramm-Leach-Bliley Act (GLB Act)

21. ________________ is the value of a share in a mutual fund . It is the value of the assets held by the mutual fund less any liabilities divided by the number of mutual fund shares outstanding.
Answer: Net asset value

22. A(n) _____________________________ behaves like an index tracking mutual fund but unlike traditional mutual funds trade all day long on stock exchanges. This allows mutual fund oriented investors to ‘play the market’.
Answer: exchange traded funds (ETFs)

23. ______________ are private investment partnerships whose shares are offered primarily to wealthy individuals and major institutions that often use high stakes bets on the direction the market will take.
Answer: Hedge funds

24. One of the advantages offered by mutual funds is having a ____________ who monitors the performance of each security held by the fund.
Answer: Professional money manager

25. According to the textbook, one likely outcome of the current financial crisis for both commercial and investment banks is __________________.
Answer: Greater regulation or regulatory scrutiny

True/False Questions

T F 26. A bank's nondeposit investment products include IRAs, Keoghs and MMDAs.
Answer: False

T F 27. A nonproprietary mutual fund is where the bank acts as a broker for a nonaffiliated mutual fund but does not act as an investment advisor.
Answer: True

T F 28. Trust services have no impact on the deposits of the bank.
Answer: False

T F 29. Trust services are a relatively new service for banks.
Answer: False

T F 30. The product line diversification effect occurs when a traditional banking service and a nontraditional banking service are not very correlated with each other and reduce the overall risk of the bank.
Answer: True

T F 31. While the trust department performs a variety of roles their activities center on establishing a fiduciary relationship with the customer.
Answer: True

T F 32. A proprietary mutual fund is where the bank sells a mutual fund through one of their affiliated companies and where the bank can act as an investment advisor.
Answer: True

T F 33. An annuity is a company that offers shares in a pool of securities (stocks, bonds, etc.) and flows through any earnings generated to the shareholding customer.
Answer: False

T F 34. A mutual fund is a savings instrument where the customer makes cash payments to an investment manager who invests them in earning assets. Later the purchaser receives a stream of income from these assets.
Answer: False

T F 35. Customers have no rights to opt out of having their private information collected by banks and other financial-service firms shared with other financial-services firms.
Answer: False

T F 36. One attractive feature of investment banking is that it is generally less risky than commercial banking.
Answer: False

T F 37. The first mutual fund was offered in France.
Answer: False

T F 38. State Street Bank in Boston is a good example of a fee-focused banking company.
Answer: True

T F 39. An insurance product or annuity sold by a depository institution is NOT insured by the FDIC.
Answer: True

T F 40. As a consequence of recent legislation, banks cannot offer insurance products or services.
Answer: False

T F 41. As a consequence of recent legislation, securities firms and insurance companies have the right to apply to the Federal Reserve Board to become a financial holding company.
Answer: True

T F 42. Investment bankers are financial advisors to individuals and act as brokers and dealers for those individuals.
Answer: False

T F 43. Traditionally the most profitable and best known investment banking activity is providing client advice.
Answer: False

T F 44. The prohibition against combining investment banking and commercial banking activity during the Depression centered on possibly forcing customers seeking loans to buy securities the IB was trying to sell and increasing the risk exposure of commercial banking firms.
Answer: True

T F 45. A 'Chinese wall' is supposed to prevent the transfer of insider information about clients between the investment banker's security underwriter division and the internal unit where proprietary trading of stocks and bonds takes place.
Answer: True

Multiple Choice Questions

46. Customers purchasing nondeposit investment accounts sold by a bank operating in the United States must be told in writing:
A) Investment accounts are not federally insured
B) Investment accounts are not deposits in nor guaranteed by a depository institution
C) Investment accounts could suffer loss of principal
D) All of the above.
E) None of the above.
Answer: D

47. A trust department's activities often center around establishing:
A) An independent relationship with the customer
B) A partnership relationship with the customer
C) A fiduciary relationship with the customer
D) A subservient relationship with the customer
E) None of the above
Answer: C

48. A bank would offer insurance services in addition to traditional banking services if it believed in the potential the benefits of:
A) Reputation
B) Economies of scale
C) Economies of scope
D) Investment services
E) None of the above
Answer: C

49. Which of the following is an example of a nondeposit investment product of the bank?
A) Time deposit
B) NOW account
C) Passbook savings account
D) Proprietary mutual fund
E) All of the above
Answer: D

50. Which of the following trust agreements allows wealth to be passed free of gift and estate tax to heirs?
A) Revocable trust
B) Irrevocable trust
C) Charitable trust
D) Indenture trusts
E) None of the above
Answer: B

51. Which of the following trust agreements allows the bank trust officer to act on behalf of a living customer?
A) Revocable trust
B) Irrevocable trust
C) Charitable trust
D) Indenture trusts
E) None of the above
Answer: A

52. Which of the following trust agreements is used to back the issue of securities by a corporation?
A) Revocable trust
B) Irrevocable trust
C) Charitable trust
D) Indenture trusts

E) None of the above
Answer: D

53. A bank is considering adding life insurance underwriting to the services it offers. It has estimated that the expected return and standard deviation of its traditional services are 12 percent and 6 percent respectively. It has also estimated that the expected return and standard deviation of its new underwriting services are 18 percent and 10 percent respectively. The correlation between these services has been estimated to be +.10 and the bank estimates that 90 percent of its business will be from traditional services and 10 percent from the new underwriting services. What is the expected return of the new combination of services?
A) 17.40%
B) 12.60%
C) 5.59%
D) 15.00
E) None of the above
Answer: B

54. A bank is considering adding life insurance underwriting to the services it offers. It has estimated that the expected return and standard deviation of its traditional services are 12 percent and 6 percent respectively. It has also estimated that the expected return and standard deviation of its new underwriting services are 18 percent and 10 percent respectively. The correlation between these services has been estimated to be +.10 and the bank estimates that 90 percent of its business will be from traditional services and 10 percent from the new underwriting services. What is the expected standard deviation of the new combination of services?
A) 6.40%
B) 12.60%
C) 5.59%
D) 9.08%
E) None of the above
Answer: C

55. A bank is considering adding life insurance underwriting to the services it offers. It has estimated that the expected return and standard deviation of its traditional services are 12 percent and 6 percent respectively. It has also estimated that the expected return and standard deviation of its new underwriting services are 18 percent and 10 percent respectively. The correlation between these services has been estimated to be +.10 and the bank estimates that 90 percent of its business will be from traditional services and 10 percent from the new underwriting services. If the bank is expecting that the overall risk of the bank will be reduced from adding the life insurance underwriting to the bank, what type of effect are they expecting?
A) Product Line Diversification Effect
B) Economies of Scope Effect
C) Economies of Scale Effect
D) Geographic Diversification Effect
E) None of the above
Answer: A

56. When a bank is expecting that the overall risk of FHC will be reduced when they

combine investment banking services with the traditional banking services, what type of effect are they expecting?
A) Product Line Diversification Effect
B) Economies of Scope Effect
C) Economies of Scale Effect
D) Geographic Diversification Effect
E) None of the above
Answer: A

57. When a bank is expecting to be able to employ the same managers, employees and physical resources to offer multiple products and generate costs savings they are expecting which of the following effects?
A) Product Line Diversification Effect
B) Economies of Scope Effect
C) Economies of Scale Effect
D) Geographic Diversification Effect
E) None of the above
Answer: B

58. Trust Department activities include all of the following except:
A) safeguarding
B) asset management
C) generate large deposits
D) lending
E) source of new deposits
Answer: D

59. A financial holding company may include all of the following services except:
A) IPO
B) Consumer lending
C) Trust services
D) Investment banking
E) Insurance
Answer: A

60. Historically, what has prevented universal banks from operating in the United States?
A) The Universal Bank Prohibition Act
B) The Glass-Stegall Act
C) Sarbanes-Oxley Act
D) Universal banks have less risk diversification capabilities than traditional U.S. based banks.
E) A and C
Answer: B

61. Among potential advantages of combining various financial services activities in one FHC are all of the following <u>except</u>:
A) Supplementing traditional sources of funds with new funds

B) Supplementing traditional revenue with new revenue sources
C) Lowering the cost of service production through economies of scale and scope
D) Reducing the risk of failure
E) Increasing earnings fluctuations
Answer: E

62. If the correlation between revenues from traditional banking and nontraditional services offered by a bank rises, potential diversification benefits:
A) Will rise
B) Will fall
C) Will remain the same
D) Will remain the same but only under certain conditions
E) Cannot be determined
Answer: B

63. A company that offers shares in a pool of securities and flows through any earnings generated to the shareholders is called:
A) A mutual fund
B) An annuity
C) The net asset value
D) A hedge fund
E) None of the above
Answer: A

64. A savings instrument where the customer makes a lump sum payment to the investment manager who invests the payment in earning assets and later receives a stream of income from the assets is called:
A) A mutual fund
B) An annuity
C) The net asset value
D) A hedge fund
E) None of the above
Answer: B

65. A customer's *pro rata* value of a share in a mutual fund if the assets of the fund were liquidated and liabilities paid off is called:
A) A mutual fund
B) An annuity
C) The net asset value
D) A hedge fund
E) None of the above
Answer: C

66. A private partnership whose shares are primarily offered to wealthy individuals and large institutions and which often makes high-stakes bets on the direction of the market is called:

A) A mutual fund
B) An annuity
C) The net asset value
D) A hedge fund
E) None of the above
Answer: D

67. A bank is considering adding security underwriting services to the services it offers. It has estimated that the expected return and standard deviation of its traditional service are 8% and 10% respectively. It has estimated that the expected return and standard deviation of its new securities underwriting services are 16% and 20% respectively. The correlation between these services has been estimated to be -0.3 and the bank estimates that 80% of its business will be from traditional services and 20% from the new services. What is the expected return of the new combined firm?
A) 8.0%
B) 9.6%
C) 12.0%
D) 14.4%
E) 16%
Answer: B

68. A bank is considering adding security underwriting services to the services it offers. It has estimated that the expected return and standard deviation of its traditional service are 8% and 10% respectively. It has estimated that the expected return and standard deviation of its new securities underwriting services are 16% and 20% respectively. The correlation between these services has been estimated to be -.3 and the bank estimates that 80% of its business will be from traditional services and 20% from the new services. What is the standard deviation of the new combined firm?
A) 7.8%
B) 10.0%
C) 12.0%
D) 15.5%
E) 20.0%
Answer: A

69. A bank is considering adding security brokerage services to the services it offers. It has estimated that the expected return and standard deviation of its traditional service are 6% and 14% respectively. It has estimated that the expected return and standard deviation of its new securities brokerage services are 14% and 24% respectively. The correlation between these services has been estimated to be -.4 and the bank estimates that 60% of its business will be from traditional services and 40% from the new services. What is the expected return of the new combined firm?
A) 14.0%
B) 10.8%
C) 10.0%
D) 9.2%
E) 6.0%
Answer: D

70. A bank is considering adding security brokerage services to the services it offers. It has estimated that the expected return and standard deviation of its traditional service are 6% and 14% respectively. It has estimated that the expected return and standard deviation of its new securities brokerage services are 14% and 24% respectively. The correlation between these services has been estimated to be -.4 and the bank estimates that 60% of its business will be from traditional services and 40% from the new services. What is the standard deviation of the new combined firm?
A) 24.00%
B) 18.00%
C) 15.07%
D) 14.00%
E) 9.91%
Answer: E

Chapter 15
The Management of Capital

Fill in the Blank Questions

1. The risk that has to do with banks trading in foreign currencies is called ________________________.
   Answer: exchange risk

2. The risk that has to do with fraud, embezzlement and bank robberies is called _________________.
   Answer: crime risk

3. ________________________ is measured by the par value of the shares of common equity outstanding.
   Answer: Common stock

4. _________________ is the amount in excess of par value paid by the bank's shareholders.
   Answer: Surplus

5. ________________________ are the net earnings of the bank which have been kept by the bank rather than distributed as dividends to stockholders.
   Answer: Undivided Profits (or retained earnings)

6. Core capital such as common stock, surplus, undivided profits, qualifying noncumulative preferred stock, etc. is referred to as _________________ capital as defined by the Basel agreement.
   Answer: Tier 1

7. The international treaty involving the U.S. and 11 other leading industrialized countries to impose common capital requirements on all banks is known as the ________________________.
   Answer: Basel Agreement

8. Supplemental capital such as the allowance for loan losses, subordinated debt, mandatory convertible debt, intermediate-term preferred stock, cumulative preferred perpetual stock and equity notes is more commonly known as ________________________.
   Answer: Tier 2 capital

9. When items on a bank's balance sheet are multiplied by the appropriate risk-weighting factor they are often called _________________________.
Answer: risk-weighted assets

10. The fact that a bank may suffer deficiencies in quality control, inefficiencies in producing and delivering of services, weather damage, aging or faulty computer systems, errors in judgment by management and fluctuations in economy that could adversely affect the bank's performance is known as _________________________ risk.
Answer: operational

11. One defense against risk for the bank is to spread out a bank's credit accounts and deposits among a wide variety of customers, including large and small accounts different industries, etc. This defense is known as _________________________.
Answer: portfolio diversification

12. One defense against risk is for the bank to seek out customers located in different communities or in different countries. This defense is known as _________________________.
Answer: geographic diversification

13. When all else fails, the ultimate defense against risk in banking is _________________________.
Answer: owners' capital (net worth)

14. The largest component of capital among thrift institutions is _____________.
Answer: retained earnings

15. The largest component of capital among banks is ____________.
Answer: surplus

16. ____________ models attempt to measure price or market risk of a portfolio of assets and attempt to determine the maximum loss they might sustain over a designated period of time.
Answer: Value at risk (VaR)

17. The latest revision to the Basel accord is known as __________ and will affect only about 20 of the largest U.S. banks and a handful of leading foreign banks.
Answer: Basel II

18. ____________ models measure lender exposure to defaults or credit downgrades.
Answer: Credit Risk

19. Credit risk models will be ________ widely used when Basel II takes effect.
Answer: more

20. At the center of the debate of the Basel Agreement is the__________________, headquartered in Basel Switzerland , which assists central banks in their transactions with each other and serves as a forum for international financial issues.
Answer: Bank for International Settlements (BIS)

21. __________________ represents funds set aside for contingencies such as legal action against the institution as well as providing a reserve for dividends expected to be paid but not yet declared and a sinking fund to retire stock or debt in the future.
Answer: Equity reserves

22. ______________________________ are debt securities repayable from the sale of stock.
Answer: Equity commitment notes

23. ___________________________ is a hybrid form of equity capital issued to investors through a trust company, The funds raise are loaned to the financial firm. Dividends paid to stockholders on this time of capital are tax deductible.
Answer: Trust preferred stock

24. ___________________________ is long-term debt capital whose claims legally follow claims of depositors.
Answer: Subordinated notes and debentures

25. ________________________________for banks include mortgage servicing rights and purchased credit card relationships and can be counted as part of bank capital.
Answer: Identifiable intangible assets

True/False Questions

T F 26. In the field of banking, capital refers principally to those funds contributed by a bank's <u>owners.</u>
Answer: True

T F 27. According to the textbook capital and risk are intimately related to each other.
Answer: True

T F 28. One fundamental purpose for regulating capital is to limit losses to the federal government arising from deposit insurance claims.
Answer: True

T F 29. Deposit insurance subsidized by government encourages banks to increase their ratios of capital to deposits.
Answer: False

T F 30. Tier 2 includes undivided profits.
Answer: False

T F 31. Core capital includes the surplus account for stock.
Answer: True

T F 32. Under the international capital (Basel) agreement Tier 2 capital must be raised to a minimum of 4 percent of risk-weighted assets.
Answer: False

T F 33. Off-balance-sheet commitments of banks carry capital requirements under the international (Basel) capital requirements.
Answer: True

T F 34. Portfolio diversification refers to seeking out customers located in different communities or countries, which presumably will experience different economic conditions.
Answer: False

T F 35. Geographic diversification refers to the spreading out credit accounts and deposits among a wide variety of customers, including large and small business accounts, different industries, and households with a variety of sources of income and collateral.
Answer: False

T F 36. The last line of defense against bank failure is owner's capital, according to the textbook.
Answer: True

T F 37. Under the FDIC Improvement Act of 1991 a U.S. bank possessing a leverage ratio greater than 4 percent would be considered well capitalized.
Answer: False

T F 38. Under the FDIC Improvement Act of 1991 a bank whose leverage ratio drops to 2 percent or less is considered to be critically undercapitalized.
Answer: True

T F 39. Recent research suggests that interest-rate contracts display considerably less risk exposure than do foreign-currency contracts.
Answer: True

T F 40. The Basel Agreement on capital as drafted in the 1980s failed to deal with market risk.
Answer: True

T F 41. If a bank benefits when the value of a foreign currency rises, the bank is said to be in a short position.
Answer: False

T F 42. If a bank benefits when a foreign currency declines in value, then the bank is in a long position.
Answer: False

T F 43. If the ratio of tangible equity capital to total assets is 2 percent or less it is subject to being placed in conservatorship or receivership if its capital ratios are not increased within a prescribed period of time even if its net worth is still positive.
Answer: True

T F 44. According to recent research, bank stock prices usually drop within a week after a dividend cut is announced.
Answer: True

T F 45. Equity notes are considered to be part of Tier 1 capital.
Answer: False

T F 46. The most important source of thrift capital in terms of dollar volume is common stock (par value).
Answer: False

T F 47. The daily rate at which robberies have occurred in the U.S. has continued to climb in the 1990s.
Answer: False

T F 48. One of the reasons to regulate the capital position of banks is to limit the risk of bank failures, especially large bank failures.
Answer: True

T F 49. Deposits with the Federal Reserve banks are considered to have moderate credit risk and are therefore placed in the 50 percent risk weight category.
Answer: False

T F 50. The largest component of capital among banks is retained earnings.
Answer: False

T F 51. VaR models provide a single number which indicates the potential for losses on a portfolio of assets.
Answer: True

T F 52. VaR models are most successful in assessing potential risk when the assets are non-traded.
Answer: False

T F 53. Credit risk models will probably not be needed when Basel II takes effect.
Answer: False

T F 54. One of the key innovations which have been proposed in Basel II is to require banks to hold capital against operational risk.
Answer: True

T F 55. Basel II will require each bank to determine its own capital requirements based on its own calculated risk exposure.
Answer: True

T F 56. It is anticipated that Basel II may lower capital requirements for the largest banks.
Answer: True

T F 57. The global financial crisis of 2007-2009 highlighted the importance of taking into consideration a bank's exposure to market risk that arise from changes in interest rates, security prices, and currency.
Answer: True

T F 58. Smaller banks rely more heavily on internally generated capital than larger banks.
Answer: True

T F 59. A well-capitalized institution has a ratio of capital to risk-weighted assets of at least 10 percent and faces no significant regulatory restrictions on its expansion.
Answer: True

T F 60. Regulatory capital focus on the market value of equity.
Answer: False

Multiple Choice Questions

61. According to the textbook the role of capital is to:
A) Provide a cushion against failure risk.
B) Provide funds needed to organize, open, and operate a bank.
C) Promote public confidence
D) Support growth and the development of new services
E) All of the above.
Answer: E

62. The textbook discusses several alternative defenses banks have against risk. These defenses include:
A) Quality management
B) Portfolio diversification
C) Geographic diversification
D) Deposit insurance
E) All of the above.
Answer: E

63. Measured by dollar volume the largest category of capital at U.S. banks is:
A) Par value of common stock
B) Subordinated notes and debentures
C) Surplus
D) Undivided profits and capital reserves
E) None of the above.
Answer: C

64. The fundamental purposes of regulating bank capital cited in the textbook include which of the following?
A) To limit the risk of bank failures.
B) To preserve public confidence in banks.
C) To limit losses to the federal government arising from insurance claims.
D) All of the above.

E) A and B only.
Answer: D

65. The Internal Capital Growth Rate for a bank is a function of which of the following factors?
A) Profit margin.
B) Asset utilization.
C) Equity multiplier.
D) Earnings retention ratio.
E) All of the above.
Answer: E

66. Second National Bank is forecasting a return on equity of 15 percent for this year. The board of directors wants to maintain its current policy of paying the bank's stockholders 40 percent of any net earnings the bank will earn. How fast can the bank's assets grow this year without jeopardizing its ratio of capital to assets?
A) 15 percent.
B) 9 percent.
C) 8 percent.
D) 6 percent.
E) None of the above
Answer: B

67. Possible breakdowns in quality control, inefficiencies in producing and delivering financial services, weather damage, aging or faulty computer systems and simple errors in judgment by bank management illustrate what form of risk faced by banks?
A) Credit risk
B) Liquidity risk
C) Interest-rate risk
D) Operational risk
E) None of the above
Answer: D

68. The ratio of core capital to average assets is called the:
A) Supplemental Capital ratio
B) Leverage ratio
C) Long-term capital ratio
D) GAAP capital ratio
E) None of the above.
Answer: B

69. The risk that a customer the bank has entered into a contract with will fail to pay or to perform, forcing the bank to find a replacement contract that may be less satisfactory is what form of risk listed below?
A) Counterparty risk
B) Interest-rate risk

C) Operating risk
D) Credit risk
E) Liquidity risk
Answer: A

70. If a bank benefits when a foreign currency declines in value, then the bank must be in a __________ position. The term below that correctly fills in the blank in the preceding sentence is:
A) Long
B) Short
C) Negative
D) Credit risk
E) None of the above
Answer: B

71. In the United States a 'well capitalized' bank must have a ratio of capital to risk-weighted assets of at least:
A) 6 percent
B) 8 percent
C) 10 percent.
D) 5 percent.
E) None of the above
Answer: C

72. In the United States a bank to be considered 'adequately capitalized' must have a ratio of Tier 1 (or core) capital to risk-weighted assets of at least:
A) 8 percent
B) 6 percent
C) 10 percent
D) 4 percent
E) None of the above
Answer: D

73. A "well capitalized" bank in the United States must have a leverage ratio of at least:
A) 5 percent
B) 4 percent
C) 6 percent
D) 8 percent
E) None of the above
Answer: B

74. A bank has $100 million in assets in the 0 percent risk weight category, $200 million in assets in the 20 percent risk weight category, $500 million in assets in the 50 percent risk weight category and $750 million in assets in the 100 percent risk weight category. This bank has $57 million in core (Tier 1) capital. What is this bank's ratio of Tier 1 capital to risk-weighted assets?

A) 3.68 percent
B) 7.6 percent
C) 18.25 percent
D) 5.48 percent
E) None of the above
Answer: D

75. A bank has a profit margin of 5 percent, an asset utilization ratio of 11 percent , an equity multiplier of 12 and a retention ratio of 60 percent. What is this bank's ICGR?
A) 6.6 percent
B) 3.96 percent
C) 7.2 percent
D) .33 percent
E) None of the above
Answer: B

76. Which of the following would be an example of Tier 1 capital?
A) Subordinated debt capital instruments with an original maturity of at least 5 years
B) Allowance for loan and lease losses
C) Minority interest in the equity accounts of consolidated subsidiaries
D) Intermediate term preferred stock
E) All of the above
Answer: C

77. Which of the following would be an example of Tier 2 capital?
A) Subordinated debt capital instruments with an original maturity of at least 5 years
B) Undivided profits
C) Minority interest in the equity accounts of consolidated subsidiaries
D) Qualifying noncumulative preferred stock
E) All of the above
Answer: A

78. Which of the following would be an example of crime risk?
A) A bank manager that embezzles $1,000,000 from the bank
B) A bank that loses $500,000 from trading in foreign currencies
C) A $1,000,000 loan to a business on which no interest and principal has been collected in 2 years
D) A bank manager predicts that interest rates will rise. However interest rates fall causing the bank 's net income to fall by $250,000
E) All of the above are examples of crime risk
Answer: A

79. Which of the following assets fits into the 0 percent risk weight category?
A) Cash
B) Deposits at the Federal Reserve
C) Treasury Bills

D) GNMA mortgage-backed securities
E) All of the above fit into the 0 percent risk weight category
Answer: E

80. A bank that is 'well-capitalized':
A) Faces no significant regulatory restrictions
B) Cannot accept broker placed deposits without regulatory approval
C) Has limits on dividends and management fees it is allowed to pay and limits on the maximum asset growth rate among other restrictions
D) Will be placed into conservatorship or receivership if it its capital level is not increased within a certain time limit.
E) None of the above
Answer: A

81. A bank that is 'critically undercapitalized':
A) Faces no significant regulatory restrictions
B) Cannot accept broker-placed deposits without regulatory approval
C) Has limits on dividends and management fees it is allowed to pay and limits on the maximum asset growth rate among other restrictions
D) Will be placed into conservatorship or receivership if it its capital level is not increased within a certain time limit.
E) None of the above
Answer: D

82. A bank that is adequately capitalized:
A) Faces no significant regulatory restrictions
B) Cannot accept broker-placed deposits without regulatory approval
C) Has limits on dividends and management fees it is allowed to pay and limits on the maximum asset growth rate among other restrictions
D) Will be placed into conservatorship or receivership if it its capital level is not increased within a certain time limit.
E) None of the above
Answer: B

83. Which of the following is in the 100 percent risk-weight category?
A) Cash
B) General obligation municipal bonds
C) Residential mortgage loans
D) Credit card loans
E) None of the above
Answer: D

84. Which of the following is in the 50 percent risk-weight (moderate) category?
A) Cash
B) General Obligation Municipal Bonds

C) Residential Mortgage Loans
D) Credit Card Loans
E) None of the above
Answer: C

85. Which of the following is in the 20 percent risk-weight (low) category?
A) Cash
B) General obligation municipal bonds
C) Residential mortgage loans
D) Credit card loans
E) None of the above
Answer: B

86. A bank has a ROE of 14 percent and a ROA of 2 percent. What is this bank's equity capital to total assets ratio?
A) 7.00 percent
B) 14.29 percent
C) 28.00 percent
D) 16 percent
E) None of the above
Answer: B

87. A bank has $200 million in assets in the 0 percent risk-weight category. It has $400 million in assets in the 20 percent risk-weight category. It has $1000 million in assets in the 50 percent risk-weight category and has $1000 million in assets in the 100 percent risk-weight category. This bank has $96 million in Tier 1 capital and $48 million in Tier 2 capital. What is this bank's ratio of Tier 1 capital to risk assets?
A) 6.08 percent
B) 3.04 percent
C) 9.11 percent
D) 5.54 percent
E) None of the above
Answer: A

88. A bank has $200 million in assets in the 0 percent risk-weight category. It has $400 million in assets in the 20 percent risk-weight category. It has $1000 million in assets in the 50 percent risk-weight category and has $1000 million in assets in the 100 percent risk-weight category. This bank has $96 million in Tier 1 capital and $48 million in Tier 2 capital. What is this bank's ratio of Tier 2 capital to risk assets?
A) 6.08 percent
B) 3.04 percent
C) 9.11 percent
D) 5.54 percent
E) None of the above
Answer: B

89. A bank has $200 million in assets in the 0 percent risk-weight category. It has $400 million in assets in the 20 percent risk-weight category. It has $1000 million in assets in the 50 percent risk-weight category and has $1000 million in assets in the 100 percent risk-weight category. This bank has $96 million in Tier 1 capital and $48 million in Tier 2 capital. What is this bank's ratio of total capital to risk assets?
A) 6.08 percent
B) 3.04 percent
C) 9.11 percent
D) 5.54 percent
E) None of the above
Answer: C

90. A bank has a net profit margin of 5.25 percent. It has an asset utilization ratio of 45 percent and has an equity multiplier of 12. It retains 40 percent of its earnings each year. What is this bank's internal capital growth rate?
A) 28.35 percent
B) 2.36 percent
C) 11.34 percent
D) 4.8 percent
E) None of the above
Answer: C

91. The revised Basel I rules impose capital requirements for market risk on:
A) Only the largest banks
B) Only the smallest banks
C) Only moderate size banks
D) All banks
E) No banks
Answer: A

92. Bank debt which appears to be highly sensitive to the market perception of the bank's risk is which of the following?
A) Deposits
B) Fed funds
C) Repos
D) Subordinated debt capital
E) Preferred stock
Answer: D

93. Bank operational risk includes:
A) Employee fraud
B) Account errors
C) Computer breakdowns
D) Natural disasters
E) All of the above

Answer: E

94. The issue of correctly adding up all of the different types of bank risk exposure is known as:
A) Risk tallying
B) Summing risk
C) Risk aggregation
D) Risk accumulation
E) Risk totality
Answer: C

95. For a bank with deficient capital ratios, which of the following actions could be required by regulators to increase the capital ratios, all else constant?
A) Cut the bank's dividend payment
B) Increase the bank's leverage
C) Reduce the bank's holdings of cash
D) Increase the bank's growth rate by making additional commercial loans.
E) Reduce the bank's holdings of Treasury securities.
Answer: A

96. Basel II has a different set of rules for different bank size categories and the number of categories is:
A) two
B) three
C) four
D) five
E) ten
Answer: A

97. Which of the following would be an example of exchange risk?
A) A bank manager embezzles $1,000,000 from the bank
B) A bank that loses $500,000 from trading in foreign currencies
C) A $1,000,000 loan to a business on which no interest or principal has been collected in 2 years
D) A bank manager predicts interest rates will rise. However interest rates fall causing the bank's net income to fall by $250,000
E) All of the above are examples of exchange risk
Answer: B

98. Which of the following would be an example of credit risk?
A) A bank manager embezzles $1,000,000 from the bank
B) A bank that loses $500,000 from trading in foreign currencies
C) A $1,000,000 loan to a business on which no interest or principal has been collected in 2 years
D) A bank manager predicts interest rates will rise. However interest rates fall causing the bank's net income to fall by $250,000

E) All of the above are examples of credit risk
Answer: C

99. Which of the following would be an example of interest rate risk?
A) A bank manager embezzles $1,000,000 from the bank
B) A bank that loses $500,000 from trading in foreign currencies
C) A $1,000,000 loan to a business on which no interest or principal has been collected in 2 years
D) A bank manager predicts interest rates will rise. However interest rates fall causing the bank's net income to fall by $250,000
E) All of the above are examples of interest rate risk?
Answer: D

100. Which of the following would be an example of operational risk?
A) A bank teller manages to steal $250,000 over a period of several months
B) An out of date computer system causes the bank to lose $750,000
C) A bank is forced to sell $1,000,000 in loans at a loss in order to meet the needs of depositors
D) A $500,000 loan the bank has made has been deemed uncollectable
E) None of the above are examples of operational risk
Answer: B

101. Which of the following would be an example of liquidity risk?
A) A bank teller manages to steal $250,000 over a period of several months
B) An out of date computer system causes the bank to lose $750,000
C) A bank is forced to sell $1,000,000 in loans at a loss in order to meet the needs of depositors
D) A $500,000 loan the bank has made has been deemed uncollectable
E) None of the above are examples of liquidity risk
Answer: C

102. Which of the following would **not** be an example of operational risk?
A) A bank on the coast of Louisiana is hit by a hurricane and is flooded for 6 weeks
B) A bank employee acting as a derivatives trader is also the one who writes the reports on profits and losses in derivatives trading at the end of each day
C) The banks older computer system breaks down causing a loss of service to customers for 2 weeks
D) A bank robber robs a teller at gun point and gets away before police can get to the bank
E) All of the above are examples of operational risk
Answer: D

103. The Jennings Bank of Texas wants to protect itself from credit risk by making large loans to corporate customers, by making residential mortgages to families, by making agriculture loans to farmers and ranchers in the area, by making small business loans to business along main street and by making automobile loans for the car dealership across the street from the bank. What defense against risk is this bank making?
A) Portfolio diversification
B) Geographic diversification

C) Quality management
D) Increasing owners' capital
E) All of the above
Answer: A

104. The Michelson Bank of Stetson wants to protect itself from risk. It decides to make loans in Florida, Georgia, Texas and Oklahoma as well as invest in municipal bonds from California and Oregon. What defense against risk is this bank making?
A) Portfolio diversification
B) Geographic diversification
C) Quality management
D) Increasing owners' capital
E) All of the above
Answer: B

105. The Perdue Bank of Houston has just hired a new manager who has a reputation of anticipating potential problems and acting quickly to prevent those problems so that the bank stays healthy and profitable. What defense against risk is this bank making?
A) Portfolio diversification
B) Geographic diversification
C) Quality management
D) Increasing owners' capital
E) All of the above
Answer: C

106. The Norton Bank of Illinois has just issued trust preferred stock. What defense against risk is this bank making?
A) Portfolio diversification
B) Geographic diversification
C) Quality management
D) Increasing owners' capital
E) All of the above
Answer: D

107. What type of preferred stock has become popular among large banks in recent years, partly because dividends paid are tax deductible for the issuing institution?
A) Cumulative preferred stock
B) Noncumulative preferred stock
C) Convertible preferred stock
D) Trust preferred stock
E) All of the above
Answer: D

108. Even if individual banks are good at forecasting risk using VAR models there may still be problems because losses may occur at several banks at the same time due to the interdependency

of the financial system, magnifying each bank's risk exposure and possibly causing a major problem for regulators. The book calls this:
A) Systematic risk
B) Operational risk
C) Credit risk
D) Market risk
E) Liquidity risk
Answer: A

109. There are three pillars of Basel II. One of them wants to make market discipline a powerful force compelling risky banks to lower their risk exposure. What does Basel II want to do to make this happen?
A) Require minimum capital requirement based on the bank's own evaluation of its risk
B) Require greater public disclosure of each bank's true financial condition
C) Expand the risks to be evaluated to include credit risk, market risk and operational risk
D) Require supervisory review of each bank's risk evaluation procedures
E) All of the above
Answer: B

110. A bank has capital to risk weighted assets of 11.5%, Tier 1 capital to risk weighted assets of 7.2% and a leverage ratio of 5.8%. What type of bank is this?
A) Well capitalized
B) Adequately capitalized
C) Undercapitalized
D) Significantly undercapitalized
E) Critically undercapitalized
Answer: A

111. A bank has capital to risk weighted assets of 9.2%, Tier 1 capital to risk weighted assets of 5% and a leverage ratio of 4.8%. What type of bank is this?
A) Well capitalized
B) Adequately capitalized
C) Undercapitalized
D) Significantly undercapitalized
E) Critically undercapitalized
Answer: B

112. A bank has capital to risk weighted assets of 9.2%, Tier 1 capital to risk weighted assets of 4.5% and a leverage ratio of 3.7%. What type of bank is this?
A) Well capitalized
B) Adequately capitalized
C) Undercapitalized
D) Significantly undercapitalized
E) Critically undercapitalized
Answer: C

113. A bank has capital to risk weighted assets of 5.5%, Tier 1 capital to risk weighted assets of 2.8% and a leverage ratio of 2.6%. What type of bank is this?
A) Well capitalized
B) Adequately capitalized
C) Undercapitalized
D) Significantly undercapitalized
E) Critically undercapitalized
Answer: D

114. A bank has capital to risk weighted assets of 1.8%. What type of bank is this?
A) Well capitalized
B) Adequately capitalized
C) Undercapitalized
D) Significantly undercapitalized
E) Critically undercapitalized
Answer: E

115. Which of the following is *not* a weakness of Basel I risk-based capital standards?
A) They ignore interest rate risk
B) They ignore changes in value due to currency value changes
C) They ignore changes in value due to commodity price changes
D) They ignore credit risk
E) They ignore the market value
Answer: D

116. A bank has decided to retain more of their earnings, moving their retention ratio from 40% to 70%. What way of meeting their capital needs is the bank taking?
A) Changing their dividend policy
B) Issuing common stock
C) Issuing preferred stock
D) Issuing subordinated notes and debentures
E) Selling assets and leasing facilities
Answer: A

117. The First National Bank of Tucson has determined that the value of their property in Tucson has tripled in the last three years. They decide that they would like to use this property to raise funds and will rent space from the new owners of the building. What way of meeting their capital needs is the bank taking?
A) Issuing common stock
B) Issuing preferred stock
C) Issuing subordinated notes and debentures
D) Selling assets and leasing facilities
E) Swapping stock for debt instruments
Answer: D

118. The Second National Bank of Lincoln has decided that to raise funds it is going to issue new common equity through a pre-emptive rights offering so that current owners will not have that ownership diluted. What way of meeting their capital needs is the bank taking?
A) Issuing common stock
B) Issuing preferred stock
C) Issuing subordinated notes and debentures
D) Selling assets and leasing facilities
E) Swapping stock for debt instruments
Answer: A

119. The Third State Bank of Denton has decided to issue stock through a trust company and borrow the funds from the trust company. This stock pays a fixed dividend and because of the way the stock has been issued it is tax deductible. What way of meeting their capital needs in the bank taking?
A) Issuing common stock
B) Issuing preferred stock
C) Issuing subordinated notes and debentures
D) Selling assets and leasing facilities
E) Swapping stock for debt instruments
Answer: B

120. The Northwest Bank of Charlotte has decided to issue new securities that have five years to maturity that have claims to assets that follow the claims of depositors. What way of meeting their capital needs is the bank taking?
A) Issuing common stock
B) Issuing preferred stock
C) Issuing subordinated notes and debentures
D) Selling assets and leasing facilities
E) Swapping stock for debt instruments
Answer: C

121. Why do regulators prefer higher capital requirements?
A) It justifies the existence of regulatory agencies
B) It better protects the deposit insurance fund
C) It enhances bank asset quality
D) It decreases bank profitability
E) It increases bank leverage
Answer: B

122. Why do banks generally prefer lower capital requirements?
A) To minimize the impact shareholders have on management decisions
B) To increase the influence of bank regulators
C) To increase a bank's return on equity
D) To increase depositor protection
E) To maximize operating leverage

Answer: C

123. A bank has issued $5,000,000 in long term debt and since that time interest rates have risen so that it will only cost the bank $3,000,000 to buy the long term debt back. The bank decides to issue $3,000,000 in new stock and use the proceeds to retire the long term debt. What way of meeting their capital needs is the bank taking?
A) Issuing common stock
B) Issuing preferred stock
C) Issuing subordinated notes and debentures
D) Selling assets and leasing facilities
E) Swapping stock for debt instruments
Answer: E

124. Which of the following are the reasons for having the government set capital standards for financial institutions as opposed to letting the private marketplace set those standards?
A) To preserve public confidence
B) To alleviate market imperfections arising from the mispriced effect of systemic failures
C) To limit losses to the federal government arising from deposit insurance claims
D) All of the above
E) None of the above
Answer: D

125. The following are the advantages of Basel II over Basel I except:
A) Uses "bifurcated" system that takes into consideration differences in risk exposures by bank size
B) Provides for greater sensitivity to arbitrage and financial innovations
C) Applies the same minimum capital requirements to all banks
D) Broadens the types of risk considered
E) All of the above are the advantages of using Basel II
Answer: C

Chapter 16
Lending Policies and Procedures: Managing Credit Risk

Fill in the Blank Questions

1. The______________ is a uniform rating system developed by regulators where banks are given a rating from one to five in each of six categories and an overall rating from one to five.
   Answer: CAMELS

2. One of the 6 C's of lending,______________ suggests that the lender must look at the position of the business firm in the industry and the outlook of the industry to evaluate a loan.
   Answer: condition

3. One of the 6 C's of lending,______________ suggests that the lender must look to see if the borrower is legally entitled to sign a binding loan agreement. For an individual this entails making sure the borrower is of legal age to sign a contract.
   Answer: capacity

4. When a bank purchases a whole loan or a piece of a loan from another bank they are purchasing what is known as a____________________________.
   Answer: participation

5. Loans that have minor weaknesses because the bank has not followed its written loan policy or which have missing documentation are called______________ by regulators.
   Answer: criticized

6. ____________________________ are loans extended to farmers and ranchers to assist in planting crops, harvesting crops and to support the feeding and care of livestock.
   Answer: Agriculture loans

7. ____________________________ devote the bulk of their credit portfolio to large-denomination loans to corporations and other businesses and tend to be large banks.
   Answer: Wholesale lenders

8. ____________________________ are loans which are secured by land buildings and other structures. These loans can be short term construction loans or longer term loans to finance the purchase of homes and apartments among others.
   Answer: Real estate loans

9. A______________ is signed by the borrower and indicates the principal amount of the loan, the interest rate on the loan and the terms under which repayment must take place.
Answer: Promissory note

10. ____________________________ are those things a borrower must do. They are actions the borrower must take. Examples include filing periodic financial statements with the bank and purchasing insurance on any collateral pledged.
Answer: Affirmative covenants

11. ___________________________ are when lenders extend credit to banks, insurance companies, and finance companies among others.
Answer: Financial institution loans

12. ______________ are loans that carry a strong probability of loss to the bank.
Answer: Doubtful loans

13. A(n)______________ is the process of resolving a troubled loan so the bank can recover its funds.
Answer: loan workout

14. ______________ is one of the key features of any loan. This C of lending examines whether the borrower will have enough sales or income to repay the loan.
Answer: cash

15. A bank's ____ gives loan officers specific guidelines in making individual loan decisions and in shaping the overall loan portfolio.
Answer: written loan policy

16. An approach in which the lending officer focuses on changes in borrower cash flows over time is known as the _____________ cash flow method.
Answer: direct

17. _________________________ are loans granted to businesses to cover purchases of inventory, paying taxes and meeting payrolls.
Answer: Commercial and industrial loans (C&I Loans)

18. _______________________ include credit to finance the purchase of automobiles, mobile homes, appliances and other retail goods and many other purchases by consumers.
Answer: Loans to individuals (consumer loans)

19. ______________________ is where the lender buys equipment or vehicles and rents them to its customers.
Answer: Lease financing receivables

20. Smaller banks tend to emphasize ___________________ in the form of smaller denomination personal cash loans and home mortgage loans to extended to individuals and families as well as smaller business loans.
Answer: retail credit

21. The loan mix of any lending institution depends heavily on the _____________ that each loan offers compared to all other assets the lending institution can acquire.
Answer: expected yield

22. Under the ____________________________ no individual can be denied credit because of race, sex, religious affiliation, age or receipt of public assistance.
Answer: Equal Credit Opportunity Act (1974)

23. One aspect of the CAMELS rating system is ___________________ which looks at the quality of the bank's loans. Examiners look at all loans over a certain size and a random selection of all other loans when looking at this aspect of a bank.
Answer: asset quality

24. One part of the 6 C's of lending is _________________ which looks at whether the borrower has a well-defined purpose for the loan and a serious intent to repay the loan.
Answer: character

25. One of the most widely consulted sources of data on business firms is __________ which was founded in Philadelphia in 1914 to exchange credit information among business lending institutions and to organize conferences and publish educational materials to train loan officers and credit analysts.
Answer: Risk Management Associates (RMA)

26. One problem with the newer lending model called _________________ was found to at least partially contribute to the recent crisis in the mortgage market.
Answer: "Streamlining"

27. In the mortgage environment of the early 2000s, lenders were encouraged to sell individual loans and packages of loans to buy more liquid securities instead, thus shifting much of the risk of lending to capital markets. This process is referred to as __________________.
Answer: Securitization

28. Factors such as changes in the economy, natural disasters, and regulation are referred to as __________ factors, while management errors, illegal manipulation, and ineffective lending policies are considered ___________ factors.
Answer: External; internal

29. In the loan workout process, the preferred option is nearly always to seek a _______________, which gives both the lending institution and its customer the chance to restore normal operations.
Answer: Revised loan agreement

True/False Questions

T F 30. The principal reason banks are chartered by federal and state governments is to make loans to their customers.
Answer: True

T F 31. Risk in banking tends to be concentrated in a bank's loan portfolio.
Answer: True

T F 32. The largest banks have, on average, reduced their dependence on real estate loans relative to smaller banks.
Answer: True

T F 33. Real estate lending is popular with bank, in part, due to the growth of the secondary mortgage market.
Answer: True

T F 34. Banks in the United States are, on average, examined at least once every three years.
Answer: True

T F 35. Smaller banks tend to emphasize <u>wholesale</u> banking services.
Answer: False

T F 36. <u>Retail credit</u> in banking refers to such loans as residential mortgages and installment loans to individuals.
Answer: True

T F 37. Loans made by a particular bank secured by the bank's own stock are not usually permitted except under special circumstances.
Answer: True

T F 38. Federally-supervised banks in the U.S. must make an "affirmative effort" to provide loans and other services to all credit-worthy borrowers in their chosen service area.
Answer: True

T F 39. Loans to minors are not legally enforceable contracts in most states.
Answer: True

T F 40. The letter "C" in the CAMELS rating system for banks in the U.S. refers to the "condition" of a bank.
Answer: False

T F 41. The letter “M” in the CAMELS rating system for banks in the U.S. refers to the “management quality” of a bank.
Answer: True

T F 42. The process of loan review means that a loan committee must generally approve a loan before the borrower is told the loan is approved.
Answer: False

T F 43. Troubled loans normally are subject to more frequent review than are sound loans.
Answer: True

T F 44. Credit card loans are generally more profitable for small and medium-size banks than for the largest banks.
Answer: False

T F 45. Banks should concentrate their lending on those loans in which they have the greatest cost advantage.
Answer: True

T F 46. The type of bank loan experiencing the largest losses per dollar of loan is credit card loans.
Answer: True

T F 47. Construction loans by a bank fit under the loan category known as commercial and industrial loans.
Answer: False

T F 48. If the economy slows down a bank should review its outstanding loans more frequently.
Answer: True

T F 49. Foreclosure on property pledged behind a bank loan does not subject a bank to liability to clean up any environmental damage the borrower may have caused to happen.
Answer: False

T F 50. Loans granted to businesses appear to convey positive information to the market place about a borrower’s credit quality, enabling a borrower to obtain more and cheaper funds from other sources.
Answer: True

T F 51. Loans to a bank's officers can never exceed 2.5 percent of a bank's capital and unimpaired surplus or $25,000 whichever is larger and cannot be more than $100,000.
Answer: True

T F 52. Financial institutions that disagree with examiner classifications of their loans can appeal these examiner ratings.
Answer: True

T F 53. A rating of "5" is the highest and best rating that a U.S. bank can receive under the CAMEL rating system.
Answer: False

T F 54. <u>Accounts receivable financing</u> means that a bank actually takes over ownership of receivables, whereas <u>factoring</u> means that a bank merely lends money on a borrowing customer's receivables and the customer still has ownership of the receivables.
Answer: False

T F 55. A restriction against a borrower taking on new debt is an <u>affirmative covenant</u> in a loan contract.
Answer: False

T F 56. Loan review is considered to be a luxury, not a necessity for most banks, especially those with sound lending policies.
Answer: False

T F 57. Cash is one of the 6 C's of lending and refers to the fact that the lender wants to make sure the borrower has the ability to generate enough cash to repay the loan.
Answer: True

T F 58. There are three principal sources of cash to repay a loan. These are cash flows generated from sales or income, funds generated from the liquidation of assets and funds raised by selling debt or equity securities.
Answer: True

T F 59. Negative covenants require the borrower to take certain actions.
Answer: False

T F 60. Affirmative covenants restrict a borrower from doing certain things.
Answer: False

T F 61. For ease and convenience most banks have the loan review conducted by the same person

who makes the loan. This is particularly true of large banks.
Answer: False

T F 62. A loan workout is when the bank and the customer initially negotiate the terms of the loan.
Answer: False

T F 63. A written loan policy gives loan officers and the bank's management specific guidelines in making individual loan decisions and in forming the bank's loan portfolio.
Answer: True

T F 64. Commercial and industrial loans are loans to businesses to cover such things as purchasing inventory, paying taxes and meeting payroll expenses.
Answer: True

T F 65. Agriculture loans are loans that are made to individuals to finance vacations, purchase durable goods and other retail goods.
Answer: False

T F 66. The A in the CAMELS rating system stands for asset quality.
Answer: True

T F 67. Net cash flow from operations is the borrower's net income expressed in cash rather than on an accrual basis.
Answer: True

T F 68. The "direct cash flow" method and "cash flow by origin" are two very different ways of assessing the cash flows of a potential borrower.
Answer: False

T F 69. Commercial banks are the largest originator of household loans.
Answer: True

T F 70. Following the recent global credit crisis, regulators have begun to emphasize the need for loan originators to know their borrowers better and retain some of the risk on loans that they sell.
Answer: True

Multiple Choice Questions

71. The principal economic function of banks is to:
   A) Take deposits
   B) Make loans
   C) Sell financial services
   D) Encourage spending
   E) None of the above
   Answer: B

72. Loans extended to finance the purchase of automobiles, mobile homes, home appliances, and vacations are classified as:
   A) Real estate loans
   B) Financial institutions
   C) Agricultural loans
   D) Commercial and industrial loans
   E) None of the above
   Answer: E

73. According to the textbook the largest category (by dollar volume) of loans extended by U.S. banks is:
   A) Real estate loans
   B) Financial institutions
   C) Agricultural loans
   D) Commercial and industrial loans
   E) None of the above
   Answer: A

74. Banks that emphasize lending to commercial customers are labeled:
   A) Wholesale banks
   B) Retail banks
   C) Personal banks
   D) Nonbank banks
   E) Regional banks
   Answer: A

75. The vast majority of FDIC-insured institutions are classified as:
   A) Credit card banks
   B) Agricultural banks
   C) Consumer lenders
   D) Commercial lenders
   E) Mortgage lenders
   Answer: D

76. In the United States national banks cannot extend an unsecured loan to a single borrower that exceeds ______ of a national bank's capital and surplus. The correct figure that fills in the blank in the preceding sentence is:
   A) 25 percent
   B) 10 percent
   C) 15 percent

D) 20 percent
E) None of the above
Answer: C

77. Real estate loans made by national banks in the U.S. cannot exceed:
A) 15 percent of a national bank's total assets or 25 percent of its total capital.
B) A national bank's total capital and surplus or 70 percent of time and savings deposits, whichever is greater.
C) 20 percent of a national bank's capital and surplus or 80 percent of its savings deposits, whichever is smaller in amount.
D) 25 percent of capital or 10 percent of the core deposits of a national bank, whichever gives the largest amount.
E) None of the above.
Answer: B

78. Loans to finance one-to-four family homes fall under which loan category?
A) Commercial and industrial loans
B) Real estate loans
C) Loans to individuals
D) Single-payment loans
E) None of the above.
Answer: B

79. The loan category experiencing the largest losses (loan defaults) is usually:
A) Credit card loans
B) Real estate loans
C) Agricultural loans
D) Commercial and industrial loans
E) None of the above
Answer: A

80. The most costly type of loan to make (measured by the cost per dollar of loan) for a bank is usually:
A) Real estate loans
B) Agricultural loans
C) Commercial and industrial loans
D) Loans to financial institutions
E) None of the above.
Answer: E

81. Loans providing credit to finance the purchase of automobiles, mobile homes, appliances, and other retail goods to repair and modernize homes are classified under the category:
A) Financial institution loans
B) Commercial industrial
C) Loans to individuals
D) Miscellaneous loans
E) None of the above
Answer: C

82. Loans extended to farm and ranch operations to assist in planting and harvesting crops and to support the feeding and care of livestock are known as:
A) Real estate loans
B) Commercial and industrial loans
C) Land loans
D) Agricultural loans
E) None of the above.
Answer: D

83. Loans granted to businesses to cover such expenses as purchasing inventories, paying taxes, and meeting payrolls are known as:
A) Commercial and industrial loans
B) Agricultural loans
C) Real estate loans
D) Loans to individuals
E) None of the above.
Answer: A

84. A lender that makes a loan to a minor would be violating which of the 6 C's of lending?
A) Character
B) Capacity
C) Cash
D) Control
E) Collateral
Answer: B

85. A lender that makes a loan that violates its written loan policy would be violating which of the 6 C's of lending?
A) Character
B) Capacity
C) Cash
D) Control
E) Collateral
Answer: D

86. Which of the following is a factor in determining the mix of loans that a bank has?
A) The location of the bank
B) The size of the bank
C) The written loan policy of the bank
D) The experience and expertise of the management
E) All of the above are factors in determining the mix of loans
Answer: E

87. A loan to a local business to purchase a new machine would be categorized as:
A) A consumer loan
B) An agriculture loan
C) A commercial and industrial loan

D) A real estate loan
E) None of the above
Answer: C

88. The lender's secondary source of repayment in case of default is:
A) Capacity.
B) Collateral.
C) Character.
D) Capital.
E) Credit.
Answer: B

89. A lender that makes a loan to an individual whose only income is commission based and who hasn't made a sale in six weeks may be violating which of the 6 C's of lending?
A) Character
B) Capacity
C) Cash
D) Control
E) Collateral
Answer: C

90. Sean Carter has an excellent credit rating. Which of the 6 C's of lending would this piece of information belong to?
A) Character
B) Capacity
C) Cash
D) Collateral
E) Conditions
Answer: A

91. First National Bank of Edmond asks a prospective customer for her driver's license. Which of the 6 C's of lending would this piece of information belong to?

A) Character
B) Capacity
C) Cash
D) Collateral
E) Conditions
Answer: B

92. The loan officer of Second National Bank of Laramie decides to review the insurance coverage of one of its business customers. Which of the 6 C's of lending would this piece of information belong to?
A) Character
B) Capacity
C) Cash
D) Collateral
E) Conditions
Answer: D

93. The TRC Company is required by its bank to pay no dividend over $3 per share. What is this?
    A) An affirmative covenant
    B) A negative covenant
    C) A Special covenant
    D) A horizontal covenant
    E) None of the above
    Answer: B

94. A bank that primarily makes its loans to individuals, families and small businesses is:
    A) A retail bank
    B) A wholesale lender
    C) A money center bank
    D) A money market bank
    E) None of the above
    Answer: A

95. The process of resolving a troubled loan so the lender can recover its funds is called the:
    A) Loan Review
    B) Written Loan Policy
    C) Loan Workout
    D) Loan Commitment Agreement
    E) None of the above
    Answer: C

96. Which of the following is a sign of a potential loan problem?
    A) Timely receipt of financial statements from the company with a loan
    B) Increases in the stock price of the company that has a loan
    C) Increases in earnings for each of the last three years of a company
    D) Changes in the methods used to account for inventory, depreciation and other items
    E) All of the above are signs of problems with the loan
    Answer: D

97. Which of the following should be part of the written loan policy?
    A) Lending authority of each loan officer and loan committee
    B) Lines of responsibility for finding and reporting information within the loan department
    C) A statement of quality standards for all loans
    D) A statement for the preferred upper limit for total loans outstanding
    E) All of the above should be part of the written loan policy
    Answer: E

98. A lender reviews the partnership agreement of one of its small business customers. Which of the 6 C's of lending would this piece of information belong to?
    A) Character
    B) Capacity
    C) Cash
    D) Collateral
    E) Conditions

Answer: B

99. Which act requires that bank loans to insiders be priced at market?
   A) Community Reinvestment Act of 1977
   B) Equal Credit Opportunity Act of 1974
   C) Sarbanes-Oxley Act of 2002
   D) Bank Lending Act of 2003
   E) U.S. Patriot Act
   Answer: C

100. A method whereby the loan officer focuses on how the borrower cash flows may change over time is known as:
   A) Indirect cash flow
   B) Direct cash flow
   C) Pervasive cash flow
   D) Variable cash flow
   E) Total cash flow
   Answer: B

101. The South Carolina National Bank makes a loan to the Heritage Credit Union. What type of loan did this bank make?
   A) Financial institution loan
   B) Commercial and industrial loan
   C) Loans to individuals
   D) Miscellaneous loans
   E) Lease financing receivables
   Answer: A

102. A loan for Colin Beverly to purchase a new Mazda Miata would fit into which of the following categories of bank loans?
   A) Financial institution loan
   B) Commercial and industrial loan
   C) Loan to an Individual
   D) Miscellaneous loan
   E) Lease financing receivables
   Answer: C

103. The Price Bank of Edmond makes a loan to Home Depot. What type of loan has this bank made?
   A) Financial institution loan
   B) Commercial and industrial loan
   C) Loan to an individual
   D) Miscellaneous loan
   E) Lease financing receivables
   Answer: B

104. The First State Bank of Duncan buys railroad cars and rents them to the Santa Fe Railroad Company. What type of loan has this bank made?

A) Financial institution loan
B) Commercial and industrial loan
C) Loan to an individual
D) Miscellaneous loan
E) Lease financing receivables
Answer: E

105. The Third National Bank of Wichita makes a loan so that Tim Bridges can buy 1000 shares of Coca Cola stock. Which category of loans would this loan fit in best?
A) Financial institution loan
B) Commercial and industrial loan
C) Loan to an individual
D) Miscellaneous loan
E) Lease financing receivables
Answer: D

106. The First State Bank is located in Guyman, Oklahoma which is in the middle of the wheat country of Oklahoma and as a result many of its loans are agriculture loans. What factor determining the growth and mixture of loans does this fact reflect?
A) Characteristics of the market area
B) Lender size
C) The experience and expertise of management
D) The written loan policy of the bank
E) Bank regulations
Answer: A

107. The Second State Bank has less than $100 million in assets and as a result primarily makes real estate loans, other consumer loans and loans to very small businesses. What factor determining the growth and mixture of loans does this fact reflect?
A) Characteristics of the market area
B) Lender size
C) The experience and expertise of management
D) The written loan policy of the bank
E) Bank regulations
Answer: B

108. Geoff Willis and Mary Williams the president and CEO of the First National Bank of Edmond both come from a background of retail banking. As a result they have decided to focus their lending activities on consumer loans and loans to small business. What factor determining the growth and mixture of loans does this fact reflect?
A) Characteristics of the market area
B) Lender size
C) The experience and expertise of management
D) The written loan policy of the bank
E) Bank regulations
Answer: C

109. First State Bank's loan policy manual states 'that the goal of the bank is to make high quality loans for home mortgages, the purchase of automobiles and small business accounts receivables'. What factor determining the growth and mixture of loans does this fact reflect?
A) Characteristics of the market area
B) Lender Size
C) The experience and expertise of management
D) The written loan policy of the bank
E) Bank regulations
Answer: D

110. The Second National Bank has capital and surplus of $100 million. The bank has decided that the most that it can loan to the Krumlova Manufacturing Company is $15 million. What factor determining the growth and mixture of loans does this most likely reflect for this bank?
A) Characteristics of the market area
B) Lender size
C) The experience and expertise of management
D) The written loan policy of the bank
E) Bank regulations
Answer: E

111. A loan that appears to examiners to contain significant weaknesses or that represent a dangerous concentration of credit in one borrower or industry are called:
A) Criticized loans
B) Scheduled loans
C) Substandard loans
D) Doubtful loans
E) Loss loans
Answer: B

112. A loan that examiners regard as uncollectible and unsuitable to be called a bank asset is called a:
A) Criticized loan
B) Scheduled loan
C) Substandard loan
D) Doubtful loan
E) Loss loan
Answer: E

113. The law that requires banks to make 'an affirmative effort' to meet the credit needs of individuals and businesses in their trade territories is called:
A) The Sarbanes-Oxley Act
B) The Community Reinvestment Act
C) The Equal Credit Opportunity Act
D) The Truth in Lending Act
E) None of the above
Answer: B

114. The law that prevents individuals from being denied credit because of race, sex, religious affiliation, age or receipt of public assistance is called:
A) The Sarbanes-Oxley Act
B) The Community Reinvestment Act
C) The Equal Credit Opportunity Act
D) The Truth in Lending Act
E) None of the above
Answer: C

115. Dan Cross is a junior loan officer with First State Bank of Durant. He has been busy visiting local businesses to see of any of them need credit. Which step in the lending process is Dan performing?
A) Finding prospective customers
B) Evaluating a customer's character and sincerity
C) Making a site visit and evaluating a customer's credit history
D) Evaluating a prospective customer's financial condition
E) Assessing possible collateral and signing the loan agreement
Answer: A

116. Shelby Mann is a loan officer with the First National Bank. She interviews a potential loan customer to find out exactly why the person needs the loan and whether they would be serious about repaying the loan. Which step in the lending process is Shelby performing?
A) Finding prospective customers
B) Evaluating a customer's character and sincerity
C) Making a site visit and evaluating a customer's credit history
D) Evaluating a prospective customer's financial condition
E) Assessing possible collateral and signing the loan agreement
Answer: B

117. Jessica Simpson, a loan officer with First National Bank, visits the Tate Manufacturing Company and talks to other lenders to see their experience with Tate Manufacturing. What step in the lending process is Jessica performing?
A) Finding prospective customers
B) Evaluating a customer's character and sincerity
C) Making a site visit and evaluating a customer's credit history
D) Evaluating a prospective customer's financial condition
E) Assessing possible collateral and signing the loan agreement
Answer: C

118. Terry May, a loan officer with First National Bank, calculates liquidity and debt ratios for the Lava Lamp Company and also examines their cash flow statement. What step in the lending process is Terry performing?
A) Finding prospective customers
B) Evaluating a customer's character and sincerity
C) Making a site visit and evaluating a customer's credit history
D) Evaluating a prospective customer's financial condition
E) Assessing possible collateral and signing the loan agreement

Answer: D

119. Jerry LeGere, a loan officer with First National Bank, checks to see if the house pledged to back up a home mortgage has a clear title and proper insurance. What step in the lending process is Jerry performing?
A) Finding prospective customers
B) Evaluating a customer's character and sincerity
C) Making a site visit and evaluating a customer's credit history
D) Evaluating a prospective customer's financial condition
E) Assessing possible collateral and signing the loan agreement
Answer: E

120. The Tate Manufacturing Company has $150 million in sales revenue with $90 million in cost of goods sold. It has selling and administrative expenses of $10, pays annual taxes in the amount of $10 and has depreciation and other non cash expenses of $30 million. What are this firm's annual projected cash flows?
A) $150
B) $60
C) $70
D) $40
E) None of the above
Answer: C

Chapter 17
Lending to Business Firms and Pricing Business Loans

Fill in the Blank Questions

1. A(n)____ is generally used to finance the purchase of inventory to sell and take advantage of the firm's normal cash cycle to repay the loan.
   Answer: self-liquidating inventory loan

2. A(n)_______________________ is generally used to support the construction of homes, apartments, office buildings and other permanent structures.
   Answer: interim construction loan

3. Working capital loans often require _______________________. These are required deposits in the bank by the borrower whose size is dependent on the size of the credit line.
   Answer: compensating deposit balances

4. When the title to accounts receivables pledged in an asset based loan is passed to the lender and the lender takes some of the responsibility for collecting the accounts receivables this is called ______________________.
   Answer: factoring

5. A(n)_______________________ is the purchase of a publicly traded company by a small group of investors. These investors often borrow very heavily to finance the purchase of the stock of the company.
   Answer: LBO

6. ____ are potential claims against the borrower which do not show up on the borrower's balance sheet. One new form of this is due to environmental damage by the borrower.
   Answer: Contingent liabilities

7. _______________________ are designed to fund long- and medium-term investments such as the purchase of equipment. Money is borrowed in one lump sum and repayments are generally made in installments.
   Answer: Term loans

8. A(n)____ is a contractual promise by a bank to lend to a customer up to a maximum amount of money at a set interest rate (or rate mark up over prime or LIBOR). The only way the bank can renege on its promise is if there has been a "material adverse change" in the borrower's financial condition.
Answer: formal loan commitment

9. ______________________ examines how effectively assets are being utilized to generate sales and how efficiently sales are converted into cash.
Answer: Operating efficiency

10. A(n)______________________ is a loan extended to a business firm by a group of lenders in order to reduce the risk exposure to any one lending institution.
Answer: syndicated loan

11. ______________________ refers to the protection afforded creditors of a firm based on the amount of the firm's earnings.
Answer: Coverage

12. The borrower's______________________ reflects his or her ability to raise cash in a timely fashion at a reasonable cost.
Answer: liquidity

13. ____ are the ultimate standard of performance in a market oriented economy. These measure the net income that remains for owners after all expenses have been charged against revenues.
Answer: Profitability measures

14. ______________________ refers to the borrowers' use of debt in their firm.
Answer: Leverage

15. Wages and salaries to net sales, overhead expenses to net sales and cost of goods sold to net sales are all measures of ____.
Answer: a business customer's control over expenses

16. ____ is a way to price loans which starts with the costs of making a loan and adds to it a risk premium for default risk and a desired profit margin.
Answer: Cost plus loan pricing

17. The______________________ approach to pricing a loan starts with a base interest rate and adds a risk premium for default and for time to maturity.
Answer: price leadership

18. The______________________ is the interest rate charged the bank's most creditworthy customers on short-term working capital loans.
Answer: prime rate

19. _____________________ is the rate on short-term Eurocurrency deposits which range in maturity from a few days to a few months.
Answer: LIBOR

20. The_______________________________________ is a way to price loans which allows banks to compete with the commercial paper market.
Answer: below prime rate pricing

21. The______________________ is a way of pricing loans that allows a bank to take into account the entire relationship the bank has with the customer when pricing the loan.
Answer: customer profitability analysis

22. ______________________ is the average deposit balance by the customer minus the average float adjusted for reserve requirements.
Answer: Net investable funds

23. The______________________________________ is the risk premium that has to do with the quality of the borrower.
Answer: default risk premium

24. The______________________ is the risk premium that has to do with the time to maturity on the borrowed funds.
Answer: term-risk premium

25. _____________________________is the base of the cost-plus loan pricing model.
Answer: Marginal cost of raising loanable funds

26. In the price leadership model, the amount above the price rate is often called the _____________.
Answer: markup

27. A proposed loan is acceptable when the net rate of return from a customer profitability analysis is______________________ .
Answer: positive

28. SNCs are also known as _____________ loans.
Answer: syndicated

29. Weak loans considered to be substandard or doubtful in quality are also known as __________ credits.
Answer: classified

30. An interest rate most widely used to price loans extended by banks operating in the U.S. is _________.
Answer: LIBOR

31. The _______________________ is the rate considered to the most common base rate figure announced by the majority of the 25 largest banks that publish their prime rates regularly.
Answer: prevailing prime rate

32. With the advent of inflation and more volatile interest rates gave rise to a(n) ___________, tied to changes in important money market interest rates such as the 90 day commercial paper rate.
Answer: floating prime rate

33. ____________________________ loans represent the earliest form of lending that banks have carried out in their more than 2000 year history.
Answer: Commercial and industrial

34. _________________________ provide businesses with short-term credit lasting from a few days to about one year. These loans come close to self-liquidating loans.
Answer: Working capital loans

35. ____________________________ support installment purchases of automobiles, home appliances, furniture, business equipment and other durable goods by financing the receivables that dealers take on when they write installment contracts to cover customer purchases.
Answer: Retailer and equipment financing

36. One of the most aggressive competitors with banks today are ___________________. Examples include GMAC, Ford Motor Credit and GE Capital.
Answer: captive finance companies

37. The apparent size bias in the financial marketplace led to the creation of the ____________ in the 1950's to guarantee loans made to small businesses by private lending institutions.
Answer: Small Business Administration (SBA)

38. The most risky of all business loans are ________________. This is credit to finance the construction of fixed assets designed to generate a flow or revenue in future periods. This can include financing a new oil refinery or power plant or other similar fixed assets.
Answer: project loans

39. A firm's balance sheet and income statement expressed as a percentage of total assets or total sales are often called _______________.
Answer: common size ratios

40. A third financial statement used in addition to the income statement and balance sheet by lenders is the ________________. It is required by FASB and is usually readily available from borrowers.
Answer: Statement of Cash Flows

True/False Questions

T F 41. Foreclosure on property pledged behind a bank loan does not subject a bank to liability to clean up any environmental damage the borrower may have caused to happen.
Answer: False

T F 42. In the United States about 25 percent of banks' total loans consist of commercial and industrial loans.
Answer: True

T F 43. Self-liquidating business loans are designed to take advantage of the normal cash cycle in a business firm.
Answer: True

T F 44. Short-term (under one year) loans to business firms account for over half of all bank loans to businesses in the United States.
Answer: True

T F 45. Working-capital loans are normally secured by a business firm's plant and equipment.
Answer: False

T F 46. Working-capital loans, unlike most other types of business loans, usually do <u>not</u> require the customer to keep a compensating deposit balance with the lending bank.
Answer: True

T F 47. Leveraged buyouts (LBOs) involve the purchase of businesses or of selected assets from business firms with at least 75 percent of the cost of the purchase funded by current earnings and sales of stock.
Answer: False

T F 48. A project loan secured by the credit of the company or companies sponsoring the project is called a project loan granted on a <u>recourse basis.</u>
Answer: True

T F 49. Term loans normally are secured by accounts receivable and inventory.
Answer: False

T F 50. Term loans look primarily to the flow of future earnings of the borrowing business firm to amortize and retire its loan.
Answer: True

T F 51. Under recent EPA guidelines if a lender forecloses on environmentally damaged property, the lender must post that property for sale within 12 months after securing marketable title.
Answer: True

T F 52. To avoid environmental liability under recent EPA guidelines a lender must accept any <u>bona fide</u> offer for property foreclosed upon if the offer would fully repay the remaining amounts owed.
Answer: True

T F 53. Under current federal laws a lender is required to make an environmental site assessment of the borrower's property in order to avoid environmental liability.
Answer: False

T F 54. Floorplanning agreements typically include a loan-loss reserve, built up from interest earned as borrowers repay their installment loans.
Answer: True

T F 55. If a bank's agent visits a dealer using floorplanning and finds any inventory items sold for which the bank providing financing has not received payment, the loan will be immediately foreclosed upon.
Answer: False

T F 56. When a bank examines a borrower's operating efficiency they are looking at the protection afforded creditors from the borrower's earnings.
Answer: False

T F 57. The firm's coverage ratios measure how carefully the firm's management monitor and control its expenses.
Answer: False

T F 58. Liquidity measure a business firm's ability to raise cash in a timely fashion at a reasonable cost.
Answer: True

T F 59. The ultimate standard of performance in a market-oriented economy is how much net income remains after all expenses have been charged against revenues.
Answer: True

T F 60. The business loan pricing method that relies upon banks knowing what their costs are is the <u>price leadership</u> model.
Answer: False

T F 61. The price leadership method of loan pricing includes a markup for default risk, but not for term risk.
Answer: False

T F 62. The sum of the default-risk premium plus the term risk premium on a business loan is one of the elements of the cost-plus loan pricing method.
Answer: False

T F 63. In order to control the risk exposure on their business loans most banks use both price and credit rationing to regulate the size and composition of their loan portfolios.
Answer: True

T F 64. In a period of rising interest rates the times-prime method causes the customer's loan rate to rise faster than the prime-plus method.
Answer: True

T F 65. If interest rates fall, a customer's loan rate will decline more rapidly under the times-prime method than under the prime-plus method of business loan pricing.
Answer: True

T F 66. Banks attempting to compete with the growing commercial paper market developed the cost-plus business loan pricing method.
Answer: False

T F 67. The loan-pricing method that takes the whole customer relationship into account when pricing each loan request is known as the cost-benefit loan pricing method.
Answer: False

T F 68. The loan-pricing technique known as CPA can be used to identify the most profitable types of bank customers and loans and also who are the most successful loan officers.
Answer: True

T F 69. The basic strength of the cost plus loan pricing method is that it considers the competition from other lenders.
Answer: False

T F 70. The basic weakness of the cost plus loan pricing method is that it does not consider the competition from other lenders when setting the loan price.
Answer: True

T F 71. The basic strength of the below prime market pricing model is that it allows the bank to compete with the commercial paper market.
Answer: True

T F 72. The basic weakness of the below prime market pricing model is that there are narrow margins or markups on loans.
Answer: True

T F 73. The majority of syndicated loans are held by banks.
Answer: False

T F 74. Syndicated loans are a type of working capital loan.
Answer: False

T F 75. According to the textbook, small business lending by banks is on the decline.
Answer: True

T F 76. The amount of business lending tends to rise during periods of expansion.
Answer: True

T F 77. The amount of business lending tends to fall during recessionary periods.
Answer: True

T F 78. Financial institutions generally use internal credit rating systems to evaluate credit quality.
Answer: True

Multiple Choice Questions

79. Short-term lending to support the construction of homes, apartments, office buildings, shopping centers, and other permanent structures is known as a (or an):
A) Self-liquidating
B) Working capital loan
C) Interim construction loan
D) Asset-based loan
E) None of the above
Answer: C

80. Business loans designed to fund long- and medium-term business investments, such as the purchase of equipment or the construction of physical facilities, covering a period longer than one year are known as:
A) Working capital loans
B) Term loans
C) Interim construction financing
D) Durable goods loan
E) None of the above
Answer: B

81. A loan whose principal is not due to be paid back until the loan's term ends and in which only interest is paid periodically during the life of the loan is called a (or an):
A) Working capital loan
B) Project loan
C) Bullet loan
D) Interim construction loan
E) None of the above
Answer: C

82. A credit agreement in which a business customer may borrow up to a pre-specified limit, repay all or a portion of the borrowing, and reborrow as necessary until the credit line matures is known as a (an):
A) Interim construction
B) Project loan
C) Working-capital loan
D) Revolving line of credit
E) None of the above
Answer: D

83. When analyzing a commercial loan credit request, which of the following statements is (are) correct?
A) The lender should evaluate the potential income available to service the loan.
B) The lender should evaluate the potential cash flow available to service the loan.
C) The lender should be certain that the loan is adequate to meet the needs of the borrower.
D) A and B
E) B and C
Answer: E

84. Banks oftentimes bid on the opportunity to finance the entire inventory of an automobile dealer through a ___________ arrangement.
A) Factoring
B) Floorplanning
C) Project loan
D) Revolving line of credit
E) None of the above
Answer: B

85. The most common sources that lenders look to for repayment of business loans include all of the following <u>except</u>:
A) The borrower's cash flow
B) Assets pledged as collateral
C) Relatives of the borrowe.
D) The borrowers net worth
E) None of the above
Answer: C

86. When analyzing the financial statements of a business, a credit analyst will look for ratios in which of the following categories:
A) Profitability.
B) Coverage
C) Efficiency
D) Liquidity
E) All of the above are categories of ratios bankers will look for
Answer: E

87. Recent federal guidelines put in place by the Federal Deposit Insurance Corporation require banks to develop written procedures to protect against loss from environmental damage. These procedures are known as the:
A) Lender Protection Program
B) Environmental Risk Assessment Program
C) Lender Liability Security Program
D) Environmental Pollution Control Program
E) None of the above.
Answer: B

88. Term loans normally are secured by:
A) Fixed assets
B) Accounts receivable
C) Inventories
D) Personal property
E) None of the above.
Answer: A

89. Under court interpretation of the Comprehensive Environmental Response, Compensation and Liability Act of 1980 lenders may be liable for clean-up costs of hazardous substances if:
A) The lender in involved in managing property with hazardous wastes
B) The lender has a strong association with the property owner
C) The lender has managed its customer's firms and there are toxic wastes involved
D) All of the above
E) None of the above
Answer: D

90. A bank that wants to examine the operating efficiency of a borrower would most likely examine which of the following ratios?
A) Cost of Goods Sold/ Average Inventory
B) Income Before Interest and Taxes/ Interest Payments
C) Cost of Goods Sold/ Net Sales
D) Current Assets/ Current Liabilities
E) All of the Above
Answer: A

91. A bank that wants to examine the liquidity of a borrower would most likely examine which of the following ratios?
A) Costs of Goods Sold/ Average inventory
B) Income Before Interest and Taxes/ Interest Payments
C) Cost of Goods Sold/ Net Sales
D) Current Assets/ Current Liabilities
E) All of the Above
Answer: D

92. A bank wants to examine whether the borrower can raise cash in a timely fashion to pay bills that are coming due. This bank would most likely examine which of the following categories of ratios?
A) Customer's Control over Expenses
B) Customer's Liquidity
C) Customer's Operating Efficiency
D) Customer's Profitability
E) None of the Above
Answer: B

93. A government security dealer requires credit to add new government securities to his security portfolio. What type of loan is this?
A) Self-liquidating inventory loan
B) Working capital loan
C) Security dealer financing
D) Revolving line of credit
E) None of the above
Answer: C

94. Credit is extended to a company up to one year to purchase raw materials and cover a seasonal peak need for cash. What type of loan is this?
A) Self-liquidating inventory loan
B) Working capital loan
C) Security dealer financing
D) Revolving line of credit
E) None of the above
Answer: B

95. The term of an inventory loan is being set to match the exact length of time needed to generate sufficient cash to repay the loan. What type of loan is this?
A) Self-liquidating inventory loan
B) Working capital loan
C) Security dealer financing
D) Revolving line of credit
E) None of the above
Answer: A

96. A business receives a three year line of credit against which it can borrow, repay and borrow again if necessary during the loan's three year term. What type of loan is this?
A) Self-liquidating inventory loan
B) Working capital loan
C) Security dealer financing
D) Revolving line of credit
E) None of the above
Answer: D

97. A loan or line of credit extended to a business by a group of lending institutions in order to reduce the risk exposure is known as:
A) An LBO
B) A revolving line of credit
C) A working capital loan
D) A syndicated loan
E) None of the above
Answer: D

98. A bank that is examining the ratio of total liabilities to total assets is examining which category of ratios?
A) Expense Control Measures
B) Operating Efficiency Measures
C) Coverage Measures
D) Liquidity Measures
E) Leverage Measures
Answer: E

99. A bank that is examining the ratio of costs of goods sold to inventory is examining which category of ratios?
A) Expense Control Measures
B) Operating Efficiency Measures
C) Coverage Measures
D) Liquidity Measures
E) Leverage Measures
Answer: B

100. A bank that is examining the ratio of overhead expenses to net sales is examining which category of ratios?
A) Expense Control Measures
B) Operating Efficiency Measures
C) Coverage Measures
D) Liquidity Measures
E) Leverage Measures
Answer: A

101. Which dimension of a business firm's financial and operating performance would unfunded pension liabilities fit best?
A) Profitability measure
B) Market indicator
C) Contingent liability
D) Marketability of the product or service
E) None of the above
Answer: C

102. Which dimension of a business firm's financial and operating performance would the percentage change in the firm's stock price fit best?
A) Profitability measure
B) Market indicator
C) Contingent liability
D) Marketability of the product or service
E) None of the above
Answer: B

103. Which dimension of a business firm's financial and operating performance would the gross profit margin fit best?
A) Liquidity measure
B) Market indicator
C) Contingent liability
D) Marketability of the product or service
E) None of the above
Answer: D

104. According to the cost-plus model for pricing loans, factors that should be considered in pricing a loan include:
A) The marginal cost of raising loanable funds to support the loan request
B) Nonfunds operating costs
C) An appropriate margin to compensate the bank for default risk.
D) The bank's desired profit margin
E) All of the above
Answer: E

105. The business loan pricing method that includes the nonfunds operating costs of making a loan plus the bank's desired profit margin is:
A) The Cost-Plus Loan-Pricing Method
B) The Price Leadership Model
C) The Markup Model
D) Customer Profitability Analysis
E) None of the above
Answer: A

106. The business loan pricing method that estimates the total revenues a loan will generate, the net amount of loanable funds the bank must turn over to the borrower, and the before-tax yield expected from the loan is the:
A) The Cost-Plus Loan-Pricing Method
B) The Price Leadership Model
C) The Below Prime Rate Pricing Model
D) Customer Profitability Analysis
E) None of the above

Answer: D

107. Suppose a business borrower is quoted a loan rate of two percentage points above the prevailing prime interest rate posted by leading U.S. banks. This is an example of the:
A) Times-prime pricing method.
B) Market-based pricing method.
C) Cost-plus loan-pricing method.
D) Prime-plus pricing method.
E) Customer profitability analysis pricing method.
Answer: D

108. The method of pricing a business loan that contends that a bank should take the whole customer relationship into account when pricing each loan request is the:
A) Cost-Plus Loan-Pricing Method
B) Price Leadership Model
C) Below Prime Rate Pricing Model
D) Customer Profitability Analysis
E) None of the above.
Answer: D

109. The business loan pricing method that bases a loan rate on a relatively low money market interest rate (such as the federal funds rate) plus a small margin to cover risk exposure, other operating costs, and a profit margin is known as the:
A) Price Leadership Model
B) Below Prime Rate Pricing Model
C) Cost-Plus Loan Pricing Method
D) Customer Profitability Analysis
E) None of the above.
Answer: B

110. Which of the following is a strength of the cost-plus loan pricing method?
A) It considers the competition from other lenders
B) It allows the bank to compete more aggressively with the commercial paper market
C) It considers the cost of loanable funds and the operating costs of running the bank
D) It takes the whole customer relationship into account
E) None of the above
Answer: C

111. Which of the following is a weakness of the price leadership loan pricing method?
A) It does not consider the marginal cost of raising funds
B) It does not give much regard for the competition from other lenders
C) The bank must know what their costs are in order to make correctly price loans
D) The bank must consider the revenues and expenses from all of the bank's dealings with the customer
E) None of the above

Answer: A

112. Which of the following is a strength of the markup (or below prime market) loan pricing method?
A) It considers the competition from other lenders
B) It allows the bank to compete more aggressively with the commercial paper market
C) It considers the cost of loanable funds and the operating costs of running the bank
D) It takes the whole customer relationship into account
E) None of the above
Answer: B

113. Which of the following is a weakness of the cost-plus loan pricing method?
A) It does not consider the marginal cost of raising funds
B) It does not give much regard for the competition from other lenders
C) The bank must know what their costs are in order to make correctly price loans
D) B and C above
E) All of the above
Answer: D

114. Which of the following is a strength of the price leadership loan pricing method?
A) It considers the competition from other lenders
B) It allows the bank to compete more aggressively with the commercial paper market
C) It considers the cost of loanable funds and the operating costs of running the bank
D) It takes the whole customer relationship into account
E) None of the above
Answer: A

115. Which of the following is a strength of the customer profitability analysis method for pricing loans?
A) It considers the competition from other lenders
B) It allows the bank to compete more aggressively with the commercial paper market
C) It considers the cost of loanable funds and the operating costs of running the bank
D) It takes the whole customer relationship into account
E) None of the above
Answer: D

116. The business loan pricing method which starts with a base rate such as the bank's prime rate and adds a markup for default and term risk is known as:
A) The Cost-Plus Loan-Pricing Method
B) The Price Leadership Model
C) The Below Prime Rate Pricing Model
D) Customer Profitability Analysis
E) None of the above
Answer: B

117. A bank has determined that its marginal cost of raising funds is 4.5 percent and that its nonfunds costs to the bank are .5 percent. It has also determined that its margin to compensate the bank for default risk for a particular customer is .30 percent. It has also determined that it wants to have a profit margin of .3 percent. If this customer wants to borrow $10,000,000, how much in total interest costs will this customer pay in one year?
A) $450,000
B) $480,000
C) $510,000
D) $560,000
E) None of the above
Answer: D

118. A bank has determined that its marginal cost of raising funds is 4.5 percent and that its nonfunds costs to the bank are .5 percent. It has also determined that its margin to compensate the bank for default risk for a particular customer is .30 percent. It has also determined that it wants to have a profit margin of .3 percent. What business loan model is this bank using to price the loan for this customer?
A) The Cost-Plus Loan-Pricing Method
B) The Price Leadership Model
C) The Below Prime Rate Pricing Model
D) Customer Profitability Analysis
E) None of the above
Answer: A

119. A bank has a prime rate of 6 percent for its best customers. It has determined that the default risk premium for a particular customer is .4% and the term-risk premium for this loan is .25 percent. If this customer wants to borrow $5.0 million from the bank, how much in interest will this customer pay in one year?
A) $332,500
B) $665,000
C) $300,000
D) $320,000
E) None of the above
Answer: A

120. The bank has determined the information below for one of its customers. This customer wants to borrow $1,000,000 but will maintain an average deposit balance in its account of $200,000. What is the expected net rate of return on this loan?

Expected Revenues		Expected Costs	
Interest Revenues	$1,000,000	Deposit Interest	$30,000
Commitment Fee	$15,000	Cost of Other Funds Raised	$890,000
Deposit Service Fees	$5,000	Loan Processing Costs	$8000
Agency Fees	$6000	Activity and Record Keeping Costs	$16,000

A) 10.00 percent

B) 8.20 percent
C) 10.25 percent
D) 13.75 percent
E) None of the above
Answer: C

121. The bank has determined the information below for one of its customers. This customer wants to borrow $1,000,000 but will maintain an average deposit balance in its account of $200,000. What is the interest rate the bank is charging the customer on the funds they have borrowed?

Expected Revenues		Expected Costs	
Interest Revenues	$1,000,000	Deposit Interest	$30,000
Commitment Fee	$15,000	Cost of Other Funds Raised	$890,000
Deposit Service Fees	$5,000	Loan Processing Costs	$8000
Agency Fees	$6000	Activity and Record Keeping Costs	$16,000

A) 10.00 percent
B) 12.50 percent
C) 10.25 percent
D) 13.75 percent
E) None of the above
Answer: A

122. SNCs are also known as:
A) Working capital loans
B) Asset-backed loans
C) Syndicated loans
D) Construction loans
E) Inventory loans
Answer: C

123. Small business lending by banks is
A) Declining
B) Rising
C) Relatively constant
D) One with no pattern
E) One with an unknown pattern
Answer: A

124. The most common type of loan foreign banks make in the U.S. are:
A) Commercial loans
B) Retail loans
C) Real estate loans
D) Credit card loans
E) None of the above
Answer: A

125. Which of the following is an example of a captive finance company?
A) Bank of America
B) GMAC
C) Toyota Motors
D) Koch Industries
E) All of the above
Answer: B

126. Lloyd Blenman is building a shopping center in Charlotte and needs to get a loan until the shopping center is finished and he can get a mortgage on the property. What type of loan does he need?
A) Self-liquidating inventory loan
B) Working capital loan
C) Interim construction financing
D) Security dealer financing
E) Retailer and equipment financing
Answer: C

127. Dick Dowen needs a loan to buy plants and fertilizer for his nursery for the spring planting season. This loan will automatically be paid off as the plants and fertilizer are sold to his customers. What type of loan does Dick need?
A) Self-liquidating inventory loan
B) Working capital loan
C) Interim construction financing
D) Security dealer financing
E) Retailer and equipment financing
Answer: A

128. Randal Ice needs a loan to purchase pet food and other pet supplies for his local pet store over the next six months. He has estimated that the maximum amount of inventory he will need in the next six months is $200,000 and he knows that he will have to use accounts receivables and the inventory he purchases as collateral for the loan. At the end of six months, he hopes he can get the loan renewed. What type of loan does Randal need?
A) Self-liquidating inventory loan
B) Working capital loan
C) Interim construction financing
D) Security dealer financing
E) Retailer and equipment financing
Answer: B

129. Barbara Miller is a small dealer who specializes in healthcare stocks. She needs a loan so that she can sustain her portfolio of stocks until customer buy orders catch up with what she has already purchased from the market. She only expects to need this loan for a week. What type of loan

does Barbara need?
A) Self-liquidating inventory loan
B) Working capital loan
C) Interim construction financing
D) Security dealer financing
E) Retailer and equipment financing
Answer: D

130. Sight n' Sound is a retail store that sells refrigerators, washers, dryers and other consumer appliances. They need a loan so they can place an order with Whirlpool. The appliances will be the collateral for the loan and as an appliance is sold, the money will be passed on to the lender. An employee of the lender will periodically check to make sure what has sold and what remains in the store. What type of loan does Sight n' Sound need?
A) Self-liquidating inventory loan
B) Working capital loan
C) Interim construction financing
D) Security dealer financing
E) Retailer and equipment financing
Answer: E

131. Mary Williams needs to purchase a new bulldozer and excavator for her construction business and wants to repay the loan over the next three years in regularly scheduled payments. What type of loan does Mary need?
A) Term business loan
B) Revolving credit financing
C) Long term project loan
D) LBO loan
E) Syndicated loan
Answer: A

132. The Ford Motor Company needs to borrow \$50 million. The First National Bank creates a packaged loan with several other banks to lend to Ford Motor Company. This loan package can be sold on the secondary market and carries a rate that is 500 basis points above LIBOR. The First National Bank expects this loan package to ultimately be held by a finance company looking for a good return on their money? What type of loan is this mostly likely to be?
A) Term business loan
B) Revolving credit financing
C) Long term project loan
D) LBO loan
E) Syndicated loan
Answer: E

133. The Wabash Washing Machine Company has arranged to get a loan from their bank over the next five years. They can borrow up to a pre-specified limit and repay it as many times as they need until the loan matures. The Wabash Washing Machine Company has not pledged any specific

collateral for this loan. What type of loan is this mostly likely to be?
A) Term business loan
B) Revolving credit financing
C) Long term project loan
D) LBO loan
E) Syndicated loan
Answer: B

134. The Jung Company and the Nguyen Company have combined to build a new container ship docking facility in Charleston Harbor. The facility is expected to take two years to complete and cost $3 billion to construct. These companies want to borrow money in order to build this facility. What type of loan is this most likely to be?
A) Term business loan
B) Revolving credit financing
C) Long term project loan
D) LBO loan
E) Syndicated loan
Answer: C

135. The management of the Frickel Frontier Freight Company wants to take the company private by borrowing money and using the proceeds of the loan to purchase the shares of the company in the market. Management believes they can increase revenues enough to be able to pay off the loan. What type of loan is management getting?
A) Term business loan
B) Revolving credit financing
C) Long term project loan
D) LBO loan
E) Syndicated loan
Answer: D

136. A bank wants to examine how well customer controls their expenses. They are most likely to look at which of the following ratios?
A) Wages and Salaries/Net Sales
B) Accounts Receivables/(Annual credit sales/360)
C) Net income after taxes/Net Sales
D) Income before interest and taxes/Interest payments
E) (Current assets – Inventory)/Current liabilities
Answer: A

137. A bank wants to examine how well a customer uses assets to generate sales. They are most likely to look at which of the following ratios?
A) Wages and Salaries/Net Sales
B) Accounts Receivables/(Annual credit sales/360)
C) Net income after taxes/Net Sales
D) Income before interest and taxes/Interest payments
E) (Current assets – Inventory)/Current liabilities
Answer: B

138. A bank wants to examine how well a customer markets their goods and services. They are most likely to look at which of the following ratios?
A) Wages and Salaries/Net Sales
B) Accounts Receivables/(Annual credit sales/360)
C) Net income after taxes/Net Sales
D) Income before interest and taxes/Interest payments
E) (Current assets – Inventory)/Current liabilities
Answer: C

139. A bank wants to examine the adequacy of a business customer's earnings based on the coverage ratios. They are most likely to look at which of the following ratios?
A) Wages and Salaries/Net Sales
B) Accounts Receivables/(Annual credit sales/360)
C) Net income after taxes/Net Sales
D) Income before interest and taxes/Interest payments
E) (Current assets – Inventory)/Current liabilities
Answer: D

140. A bank wants to know whether a customer can raise cash in a timely fashion at a reasonable cost. They are mostly likely to look at which of the following ratios?
A) Wages and Salaries/Net Sales
B) Accounts Receivables/(Annual credit sales/360)
C) Net income after taxes/Net Sales
D) Income before interest and taxes/Interest payments
E) (Current assets – Inventory)/Current liabilities
Answer: E

141. A bank has a concern about the Wilson Company's debt level. They feel that it is too high. What ratio are they most likely to examine to answer this question?
A) Selling and administrative expenses/Net sales
B) Net sales/Total assets
C) Current assets-Current liabilities
D) Net income/Total assets
E) Long term debt/(Long term debt + Net worth)
Answer: E

142. A bank has a concern because they feel that a firm has an excessive amount of assets. They do not feel that the firm is efficient in generating sales from their current level of assets. What ratio are they most likely to examine to answer this question?
A) Selling and administrative expenses/Net sales
B) Net sales/Total assets
C) Current assets-Current liabilities
D) Net income/Total assets

E) Long term debt/(Long term debt + Net worth)
Answer: B

143. A bank feels that a firm has expenses that are too high. What ratio are they most likely to examine to address this concern?
A) Selling and administrative expenses/Net sales
B) Net sales/Total assets
C) Current assets-Current liabilities
D) Net income/Total assets
E) Long term debt/(Long term debt + Net worth)
Answer: A

144. A bank is concerned because they feel that a firm will not be able to raise enough cash to pay bills that are due within the next year. What ratio are they most likely to examine to address this concern?
A) Selling and administrative expenses/Net sales
B) Net sales/Total assets
C) Current assets-Current liabilities
D) Net income/Total assets
E) Long term debt/(Long term debt + Net worth)
Answer: C

145. A bank wants to examine the financial success of a company by examining the profits of a company. What ratio will help the bank examine this issue?
A) Selling and administrative expenses/Net sales
B) Net sales/Total assets
C) Current assets-Current liabilities
D) Net income/Total assets
E) Long term debt/(Long term debt + Net worth)
Answer: D

146. A firm submits their financial records to a bank. Upon examination, the bank discovers that this firm has $500 in cash, $2500 in accounts receivables, $1000 in inventory, $5000 in plant and equipment and that their assets totaled $9000. In addition this bank discovered that the firm had $2000 in current liabilities, $2500 in long term debt and $4500 in net worth. Finally this bank discovered that this firm had $20,000 in net sales and $2000 in net income. What is this firm's net profit margin?
A) 10.00%
B) 22.22%
C) 44.44%
D) 50%
E) None of the above
Answer: A

147. A firm submits their financial records to a bank. Upon examination, the bank discovers that this firm has $500 in cash, $2500 in accounts receivables, $1000 in inventory, $5000 in plant and

equipment and that their assets totaled $9000. In addition this bank discovered that the firm had $2000 in current liabilities, $2500 in long term debt and $4500 in net worth. Finally this bank discovered that this firm had $20,000 in net sales (all of which are on credit and $2000 in net income. What is this firm's average collection period?

A) 18 days
B) 45 days
C) 72 days
D) 162 days
E) None of the above
Answer: B

148. A firm submits their financial records to a bank. Upon examination, the bank discovers that this firm has $500 in cash, $2500 in accounts receivables, $1000 in inventory, $5000 in plant and equipment and that their assets totaled $9000. In addition this bank discovered that the firm had $2000 in current liabilities, $2500 in long term debt and $4500 in net worth. Finally this bank discovered that this firm had $20,000 in net sales and $2000 in net income. What is this firm's net working capital?

A) $9000
B) $4500
C) $4000
D) $2000
E) None of the above
Answer: D

149. A firm submits their financial records to a bank. Upon examination, the bank discovers that this firm has $500 in cash, $2500 in accounts receivables, $1000 in inventory, $5000 in plant and equipment and that their assets totaled $9000. In addition this bank discovered that the firm had $2000 in current liabilities, $2500 in long term debt and $4500 in net worth. Finally this bank discovered that this firm had $20,000 in net sales and $2000 in net income. What is this firm's leverage ratio?

A) 22.50%
B) 44.44%
C) 50.00%
D) 88.89%
E) None of the above
Answer: C

150. A firm submits their financial records to a bank. Upon examination, the bank discovers that this firm has $500 in cash, $2500 in accounts receivables, $1000 in inventory, $5000 in plant and equipment and that their assets totaled $9000. In addition this bank discovered that the firm had $2000 in current liabilities, $2500 in long term debt and $4500 in net worth. Finally this bank discovered that this firm had $20,000 in net sales and $2000 in net income. What is this firm's acid test ratio?

A) 1.00
B) 2.00
C) 0.33
D) 3.00

E) 1.50
Answer: E

151. Banks need to be able to compare the firm they are examining to its industry. One company that provides information to banks about the industries their customers are in is:
A) Standard and Poors
B) Moody's
C) Dun and Bradstreet
D) Morgan Stanley
E) None of the above
Answer: C

152. A firm has net sales of $25,000, costs of goods sold of $10,000, selling, general and administrative expenses of $8000 (of which $2000 are depreciation expenses) and taxes (in cash) of $3000. What is this firm's operating cash flow (using the traditional or direct method)?
A) $4,000
B) $15,000
C) $5,000
D) $8,000
E) None of the above
Answer: C

153. A bank wants to estimate a firm's future financial condition. Which of the following is something that allows a bank to do this?
A) Statement of cash flows
B) Pro forma statement
C) Balance sheet
D) Income statement
E) None of the above
Answer: B

154. A bank has a listed prime rate of 7%. They have estimated that the marginal cost of raising funds is 5%, their default risk premium on a loan is 1.5% and that they want a profit margin of 2%. They have also estimated that the term risk premium is .5%. What is the interest rate this bank will charge if they use the cost plus pricing model?
A) 8.5%
B) 9%
C) 12%
D) 9.5%
E) None of the above
Answer: A

155. A bank has a listed prime rate of 7%. They have estimated that the marginal cost of raising funds is 5%, their default risk premium on a loan is 1.5% and that they want a profit margin of 2%. They have also estimated that the term risk premium is .5%. What is the interest rate this bank

will charge if they use the price leadership model (and the prime rate as their base rate)?
A) 8.5%
B) 9%
C) 12%
D) 9.5%
E) None of the above
Answer: B

Chapter 18
Consumer Loans, Credit Cards, and Real Estate Lending

Fill in the Blank Questions

1. The purchase of a house or a multifamily dwelling such as a duplex, triplex or apartment building is usually financed through the use of a______________________ loan.
   Answer: residential mortgage

2. A(n)______________________ loan is a short- or medium-term loan repayable in two or more consecutive payments, usually monthly or quarterly.
   Answer: installment

3. Household borrowings tend to be ______________________. Consumers are more concerned about the size of the debt repayments than the interest rate charged.
   Answer: interest inelastic

4. The fact that a consumer feels a strong moral and ethical responsibility to repay a loan on time refers to the ______________________ of that individual. The loan officer must be assured that the borrower is serious about repaying the loan before they are willing to make a loan.
   Answer: character

5. When a borrower receives a loan at one lending institution to repay another it is called ________ ___________________
   Answer: pyramiding of debt

6. The______________________ allows a bank to call a loan that is in default and seize any checking or savings deposits the customer may hold with the bank in order to recover its funds.
   Answer: right of offset

7. ______________________ is a method to evaluate a large volume of consumer loans quickly with minimum labor. This method is a statistical model which predicts whether the consumer will repay the loan or not.
   Answer: Credit scoring

8. A(n)____ is where the customer can use the difference between some percentage of the appraised value of their home and the mortgage remaining to secure a loan. This loan can be used to fund a college education, pay for a vacation or pay for home improvements.
   Answer: home equity loan

9. The law that requires the full disclosure of credit terms and which promotes the informed use of credit is the ______________________. This law requires the bank to report the APR of the loan, the dollar amount of all finance charges and, where appropriate, all fees.
Answer: Truth in Lending Act

10. The law that limits how far a creditor or credit collection agency can go in pressing a customer to pay a past due debt is the ______________________. It does not allow a debt collector to "harass" a debtor.
Answer: Fair Debt Collection Practices Act

11. Short-term credit to finance the building of homes or other dwellings is called ______________________.
Answer: construction loans

12. A(n)______________________ is a credit-rating agency that keeps records of borrowers' loan payment histories.
Answer: credit bureau

13. The____ permits consumers to dispute billing errors with a merchant or credit card company and receive a prompt investigation into any billing errors.
Answer: Fair Credit Billing Act

14. The____ prevents redlining out certain neighborhoods and refusing to provide loans and other services in those areas.
Answer: Community Reinvestment Act

15. ____ is the granting of loans to weaker borrowers and charging them excessive fees and interest rates, increasing their risk of default
Answer: Predatory lending

16. The______________________ is the internal rate of return that equates present value of the payments with the amount of the loan. It is the rate required to be reported under the Truth in Lending Act.
Answer: annual percentage rate (APR)

17. The interest rate method which requires the interest on the loan to be paid in advance is called the______________________ method.
Answer: discount rate

18. The interest rate method that adds the interest owed to the principal is called the __________ method.
Answer: add-on

19. A rule of thumb used to determine how much interest income a bank is allowed to accrue at any point in time from a consumer loan paid off in monthly installments is called the _____________.
Answer: Rule of 78s

20. A(n)____ is an agreement drawn up by the bank that gives the bank control of the property if the loan cannot be repaid as planned.
Answer: chattel mortgage

21. The interest rate on most consumer loans is based on the cost of loanable funds to the bank plus nonfunding cost plus premiums for default and time to maturity and also includes the desired profit margin on the loan. This method of pricing loans is known as______________________ .
Answer: cost plus pricing

22. ______________________ is a basic method for calculating the interest owed on a loan that adjusts for declining balances and the time remaining on the loan.
Answer: Simple interest

23. A variable rate loan on a residential mortgage is called a(n)______________________.
Answer: adjustable rate mortgage or ARM

24. Many home mortgage agreements include______________________ which is an additional charge up front. Generally, each of these corresponds to one percent of the face value of the amount borrowed.
Answer: points

25. A popular prepaid card used like a credit card, especially in Europe, is the _________ card.
Answer: smart

26. A popular credit scoring system developed and sold by Fair Issac Corporation is known as ____________.
Answer: FICO

27. Traditional home equity loans are usually priced using ________-term interest rates while home equity lines of credit are priced using __________-term interest rates.
Answer: longer, shorter

28. ________________________ are loans that families and individuals can draw upon for immediate cash needs that are repayable in one lump sum. These loans often cover the cost of a vacation, medical care, the purchase of a home appliance or home repairs.
Answer: Noninstallment loans

29. Credit cards are the best example of a __________________ that offer consumers convenience and flexibility. Consumers can access them whenever the need arises.
Answer: revolving lines of credit (revolving credit loans)

30. _____________ are plastic cards that can be used to pay for goods and services but where credit is not extended. They are a convenient way to make deposits into and withdrawals from an ATM.
Answer: Debit cards

31. Consumer loans tend to be ______________________. They tend to rise in periods of economic expansion and tend to fall in periods of economic downturn.
Answer: cyclically sensitive

32. In the case of a borrower without a credit record or a very poor track record, a ________ may be requested to support repayment. Technically if the borrower defaults on the payment, they are obligated to repay the loan.
Answer: cosigner

33. A bank generally prefers the borrower report _____________ rather than gross salary.
Answer: net income (or take-home pay)

34. One of the three biggest credit bureaus includes _________________.
Answer: Experian (Equifax, Transunion)

35. The ______________________ prohibits lenders from asking certain questions of a customer, such as a customer's age or race.
Answer: Equal Credit Opportunity Act

36. The fastest rising financial crime against individuals today is ____________. This is the deliberate attempt to take unauthorized use of someone else's personal information in order to fraudulently obtain money, credit or other property.
Answer: identity theft

37. The __________________ Act provides consumers with the opportunity to order one free credit report annually from each of the three nationwide credit bureaus.
Answer: Fair and Accurate Credit Transactions (FACT)

38. __________________ is the granting of loans to borrowers with below-average credit records. These loans tend to go to borrowers with a record of delinquent payments, previously charged-off loans, bankruptcies or court judgments.
Answer: Subprime lending

39. In real estate lending, the property must be ______________. The value and condition of the property are determined by an independent party. These must conform to industry and government standards.
Answer: appraised

40. One new type of mortgage where no principal payments are made is called a(n) ___________.
Interest-only mortgage

True/False Questions

T F 41. The dominant lender in the United States to households is the finance company with commercial banks ranked second as consumer lenders.
Answer: False

T F 42. Nonresidential consumer loans include credit to finance the purchase of home appliances.
Answer: True

T F 43. Credit cards offer convenience to customers plus a revolving line of credit.
Answer: True

T F 44. Consumer loans appear to have virtually no sensitivity to the business cycle, staying relatively level through both recessions and expansions.
Answer: False

T F 45. Households tend to be interest-inelastic borrowers.
Answer: True

T F 46. Lenders in the consumer loan field prefer to measure a borrowing customer's income by the amount of take-home pay.
Answer: True

T F 47. The "right of offset" allows a bank to sell a customer's property to the highest bidder to repay a customer's loan if the loan is in default.
Answer: False

T F 48. "Pyramiding of debt" refers to borrowing from one lender to repay another lender.
Answer: True

T F 49. Credit-scoring systems tend to be valid over long periods of time (usually several years) and need not be periodically retested.
Answer: False

T F 50. The Truth-in-Lending Act of 1968 gave consumers access to the information from their credit files kept at local and regional credit bureaus.
Answer: False

T F 51. Small business owners with gross annual revenues of $1 million or less who apply for credit have the right to receive a written notice if their loan request is turned down by a bank.
Answer: True

T F 52. The symbol "SN" indicates that a bank has been judged to be an outstanding performer under the terms of the Community Reinvestment Act.
Answer: False

T F 53. Banks awarded top CRA marks usually get strong commitments from their boards of directors and senior management to promote community involvement.
Answer: True

T F 54. FNMA will buy home mortgages provided the borrower's monthly house payment does not exceed 35 percent of monthly gross income.
Answer: False

T F 55. Under FNMA rules for buying home mortgages FNMA will not usually purchase a borrower's mortgage if the borrower's credit report is more than 45 days old.
Answer: False

T F 56. An installment loan is a loan in which the customer repays the loan in two or more consecutive payments. These payments are often monthly or quarterly.
Answer: True

T F 57. The Equal Credit Opportunity Act authorizes individuals and families to review their credit file for accuracy and to demand an investigation and correction of any apparent inaccuracies.
Answer: False

T F 58. The burden of proof is on the bank to demonstrate that its credit scoring system successfully identifies quality loan applications at a statistically significant level.
Answer: True

T F 59. Real estate loans are smaller in size and shorter in maturity than most other types of bank loans.
Answer: False

T F 60. The Community Reinvestment Act is designed to prevent a lender from arbitrarily marking out certain neighborhoods as undesirable and refusing to lend to people who live in those neighborhoods.
Answer: True

T F 61. There is usually a positive relationship between the interest rate a consumer is asked to pay and the amount of deposits the consumer is willing to keep with the bank.
Answer: False

T F 62. Competition for consumer loans tends to drive the interest rates on these loans down closer to loan production costs.
Answer: True

T F 63. Shorter term cash loans to consumers are normally secured, but longer-term consumer loans are usually unsecured.
Answer: False

T F 64. An auto loan usually carries with it a chattel mortgage, giving the bank a claim against the property covered by the loan.
Answer: True

T F 65. Most consumer loans are priced off some base or cost rate.
Answer: True

T F 66. The APR is the internal rate of return on a loan that equates total payments with the amount of the loan.
Answer: True

T F 67. The quotation to customers of the APR on the loan they are requesting usually discourages consumers from shopping around according to recent research findings.
Answer: False

T F 68. Unlike the APR method for calculating consumer loan rates, the simple interest approach adjusts for the length of time a borrower actually has use of credit.
Answer: False

T F 69. Under the simple interest method the customer saves on interest as an installment loan approaches maturity.
Answer: True

T F 70. With the discount rate method interest is deducted first before the customer has use of the proceeds of a loan.
Answer: True

T F 71. The majority of installment and lump-sum payment loans to families and individuals are made with floating interest rates.
Answer: False

T F 72. Points on a home mortgage loan result in a lender earning a higher effective interest rate on the loan than just the loan rate quoted to the borrower.
Answer: True

T F 73. According to the table presented in the book personal loans tend to have lower rates than automobile loans.
Answer: False

T F 74. According to the table presented in the book credit card loans tend to have the highest interest rates of all consumer loans.
Answer: True

T F 75. According to the table presented in the book new car loans have a lower interest rate than used car loans.
Answer: True

T F 76. There are very little economies of scale (cost savings) in the credit card business.
Answer: False

T F 77. Currently the debit card market is almost as large as the credit card market.
Answer: False

T F 78. One of the elements used in the FICO credit scoring system is the borrower's employment history and salary.
Answer: False

T F 79. The most important factor used in the FICO credit score is the borrower's payment history.
Answer: True

T F 80. Home mortgage real estate loans soared to record levels at the beginning of the 21st century.
Answer: True

Multiple Choice Questions

81. Short-term to medium-term loans repayable in two or more consecutive payments are known as:
A) Noninstallment loans
B) Installment loans
C) Residential mortgage loans
D) Nonresidential cash loans
E) None of the above
Answer: B

82. Loans to individuals and families to finance the purchase of new homes are known as:
A) Noninstallment loans
B) Installment loans
C) Residential mortgage loans
D) Nonresidential cash loans
E) None of the above
Answer: C

83. Short-term loans drawn upon by individuals and families for immediate cash needs and repayable in a lump sum when the borrower's note matures are known as:
A) Noninstallment loans
B) Installment loans
C) Residential mortgage loans
D) Nonresidential cash loans
E) None of the above
Answer: A

84. The federal law that requires banks to notify their credit customers in writing when a loan request is denied is known as the:
A) Equal Credit Opportunity Act
B) Competitive Equality in Banking Act
C) Truth-in-Lending Act
D) Community Reinvestment Act
E) None of the above.
Answer: A

85. Major laws and regulations which must be complied with in the mortgage lending area include which of the following?
A) National Affordable Housing Act
B) Community Reinvestment Act
C) Financial Institution Reform Recovery and Enforcement Act
D) All of the above
E) B and C only
Answer: D

86. Which of the following factors have proven most important in credit scoring models?
A) Credit Bureau ratings
B) Income bracket
C) Number of loans the customer has had
D) All of the above
E) A and B only
Answer: E

87. The requirement that banks must provide their consumer loan customers with a statement of the APR for the proposed loan was established by:
A) The Fair Credit Reporting Act.
B) The Equal Credit Opportunity Act.
C) The Truth-in-Lending Act.
D) The Community Reinvestment Act.
E) None of the above
Answer: C

88. Which of the following consumer loans has grown in popularity as a result of the passage of the Tax Reform Act of 1986?
A) Credit card loans
B) Home equity loans
C) Long-term, noninstallment loans
D) Short-term, installment loans
E) All of the above
Answer: B

89. A bank that is judged by examiners as needing to improve under the performance requirements of the Community Reinvestment Act will receive an examiner rating of:
A) 0
B) S
C) N
D) SN
E) None of the above
Answer: C

90. In order to be eligible for purchase by FNMA a home mortgage cannot have a maturity of less than 10 years nor more than:
A) 25 years
B) 30 years
C) 35 years
D) 40 years
E) None of the above
Answer: B

91. FNMA will <u>not</u> purchase home mortgages in the secondary market if the borrower's monthly debt repayments (including housing costs) exceed _________ percent of the borrower's monthly gross income. The correct percentage figure to complete the sentence above is:
A) 28
B) 30
C) 36
D) 40
E) None of the above
Answer: C

92. How did the Tax Reform Act of 1986 increase the appeal of home equity loans?
A) It allowed customers to borrow up to 100 percent of the value of their home
B) It eliminated bank income taxes from this type of loan
C) It protected homes under Chapter 13 bankruptcy
D) It eliminated individuals' tax deduction for interest payments on other types of loans
E) It required banks to lend on homes in the geographic area of their deposits
Answer: D

93. The federal law that permits consumers to dispute billing errors with a merchant or credit card company and receive a prompt investigation of any billing disputes is the:
A) Fair Credit Reporting Act
B) Fair Credit Billing Act
C) Fair Debt Collection Practices Act
D) Truth in Lending Act
E) None of the above
Answer: B

94. The bank's real estate loan officer should consider which of the following aspects of the customer's loan application carefully when making a home mortgage?
A) The amount and stability of the borrower's income
B) The borrower's available savings and where the down payment is coming from
C) The borrower's track record in caring for and managing property.
D) The outlook for real estate sales in the local market area
E) All of the above are things that need to be looked at carefully
Answer: E

95. An abusive practice is which lenders grant loans to weak borrowers and charge them high fees and interest rates which may cause the borrower to default on the loan is known as:
A) Installment loans
B) Credit card loans
C) Predatory lending
D) Herbivore lending
E) None of the above
Answer: C

96. The law which was passed to reduce predatory lending is known as:
A) Community Reinvestment Act
B) Home Ownership and Equity Protection Act
C) Equal Credit Opportunity Act
D) Fair Debt Collection Practices Act
E) None of the above
Answer: B

97. Which of the following is true regarding credit card loans?
A) There is evidence that considerable economies of scale exist
B) Credit cards cannot act as installment loans
C) Credit cards are very inconvenient for consumers
D) Credit cards are very inflexible for consumers
E) All of the above are true
Answer: A

98. A loan officer asks a customer what race she belongs to. Which law prohibits the loan officer from asking that question?
A) Truth in Lending Act
B) Equal Credit Opportunity Act
C) Community Reinvestment Act
D) Fair Debt Collection Practices Act
E) None of the above
Answer: B

99. Which of the following is not part of the evaluation of an installment loan?
A) The borrower's track record in caring for and maintaining property
B) Evidence of stable employment
C) Evidence of residence stability
D) Evidence of income stability
E) All of the above are part of the evaluation of an installment loan
Answer: A

100. Which of the following is an advantage of a credit scoring model?
A) Credit scoring models rely on the evaluation of an experienced credit officer
B) Credit scoring models are immune from charges of discrimination
C) Credit scoring models never make mistakes
D) Credit scoring models can handle a large volume of applications in a short period of time
E) All of the above are advantages of credit scoring models
Answer: D

101. When interest owed on a loan is added to the principal amount of the loan to determine a borrowing customer's required installment payments, this is known as the _________method for figuring a customer's loan rate. Fill in the blank with an appropriate response below.
A) Simple interest
B) APR
C) Discount
D) Add-on
E) None of the above
Answer: D

102. The symbols ARM in lending means:
A) Automatic rate modulation
B) Amortization rate method
C) Adjustable rate mortgage
D) Adaptable readjusted mortgage
E) None of the above.
Answer: C

103. The charge on a home mortgage loan that a borrower may be asked to pay up front is referred to as:
A) Loan Interest Owed
B) Points
C) Loading
D) Tax equity
E) None of the above.
Answer: B

104. Which of the following has the highest interest rate according to the book?
A) New automobile loan
B) Used automobile loan
C) Personal loan
D) Credit card loan
E) All of these have the same interest rate
Answer: D

105. Which of the following has the lowest interest rate according to the book?
A) New automobile loan
B) Used automobile loan
C) Personal loan
D) Credit card loan
E) All of these have the same interest rate
Answer: A

106. A customer seeks a $150,000 home mortgage. The bank requires the customer to pay 1 ¾ points up front. How much of the loan is actually available to the customer?
A) $150,000
B) $152,625
C) $147,375
D) $148,000
E) None of the above
Answer: C

107. A customer wants to borrow $1200 from Edmond State Bank. Edmond State Bank has an add-on loan with an interest rate of 12 percent and monthly payments for one year. What are the monthly payments this customer will need to make on this loan?
A) $100 per month
B) $112 per month
C) $107 per month
D) $88 per month
E) None of the above
Answer: B

108. A customer wants to borrower $25,000 for one year. TRC State Bank has a discount loan with an interest rate of 15 percent. How much of the loan will be available to the customer?
A) $25,000
B) $28,750
C) $22,500
D) $21,250
E) None of the above
Answer: D

109. A customer wants to borrow $125,000 to purchase a new home. The APR on this loan is 10 percent and it is a 30-year mortgage with monthly payments. What monthly payment will this customer face on this loan?
A) $1097
B) $55
C) $12,500
D) $13,260
E) None of the above
Answer: A

110. Mark Brown receives a $2000 loan with the intention of repaying the loan in 12 months. However, at the end of one month, Mr. Brown discovers he can repay the loan in full. What percentage of the interest charge is Mr. Brown entitled to receive as a rebate?
A) 36.67 percent
B) 50.00 percent
C) 91.67 percent
D) 63.33 percent
E) None of the above
Answer: D

111. Paul Carter requests an automobile loan of $15,000 that will be repaid over the next four years in monthly repayments. The First National Bank tells Mr. Carter that his total finance charges will be $4675.20. What is the APR on this loan?
A) 16 percent
B) 1 percent
C) 14 percent
D) 7 percent
E) None of the above
Answer: C

112. Jane Smith has asked for a 30 year mortgage to purchase a home in Oklahoma City, Oklahoma. The purchase price of the home is $150,000 of which $125,000 must be borrowed. If the APR on this loan is 8 percent, how much will Jane's total financing charges be?
A) $246,233
B) $205,194
C) $180,194
D) $165,097
E) None of the above
Answer: B

113. Beverly Frickerson asks for a $15,000 loan for one year. The bank tells her that they will give her $13,050 immediately and deduct $1950 in interest up front. What is the effective rate of interest on this loan?
A) 14.94 percent
B) 13.00 percent
C) 19.50 percent
D) 11.50 percent
E) None of the above
Answer: A

114. The largest credit card lender (as a group) in the U.S. are:
A) Thrifts
B) Insurance companies
C) Finance companies
D) Oil companies
Answer: C

115. Prepaid cards which compete with credit cards and debit cards are:
A) Smart cards
B) Deposit cards
C) Match cards
D) All of the above
E) None of the above
Answer: A

116. The first major bank within the U.S. to establish a separate department for granting household loans was:
A) First National City Bank of New York
B) BankAmerica
C) Bank One
D) State Street Bank
E) Bank of New York
Answer: A

117. The fastest growing consumer loan category is:
A) Credit card loans
B) Auto loans
C) Home mortgages
D) Personal loans
E) Education loans
Answer: C

118. The very popular FICO credit scoring system provides credit scores in the range:
A) 0 to 10
B) 0 to 1000
C) 100 to 1000
D) 300 to 850
E) 20 to 80
Answer: D

119. The most important factor used in the FICO credit scoring system is:
A) The borrower's payment history
B) The amount of money owed
C) Marital status
D) Employment history and salary
E) Age
Answer: A

120. Jeremiah Uselton needs a loan to purchase a condo in Sarasota, Florida. What type of loan does Jeremiah need?
A) Residential mortgage loan
B) Installment loan
C) Noninstallment loan
D) Revolving line of credit
E) None of the above
Answer: A

121. Tammy Payne wants to buy a used car and wants a loan that she will pay off over the next three years with monthly payments. What type of loan does Tammy want?
A) Residential mortgage loan
B) Installment loan
C) Noninstallment loan
D) Revolving line of credit
E) None of the above
Answer: B

122. Emily Barnes has gone to the First State Bank and gotten a loan of $5000 so she can go on vacation. She plans on paying the loan back in one payment in three months. What type of loan has Emily gotten?
A) Residential mortgage loan
B) Installment loan
C) Noninstallment loan
D) Revolving line of credit
E) None of the above
Answer: C

123. Bill Wells uses his Discover card to buy new furniture for his apartment. The interest rate on this card is 18% and the minimum payment that is due is $100. What type of loan has Bill gotten?
A) Residential mortgage loan
B) Installment loan
C) Noninstallment loan
D) Revolving line of credit
E) None of the above
Answer: D

124. Jerry McGuire uses his Visa card to buy a new washer and dryer and a new refrigerator for his home. He plans on paying off the credit card over the next two years. How is Jerry using his credit card?
A) As an installment loan
B) As a noninstallment loan
C) As a lump sum payer
D) As a debit card
E) None of the above
Answer: A

125. The most profitable credit card customers for a bank are those that:
A) Use their credit card frequently
B) Pay off any charges incurred within a few days
C) Charge at least $10,000 per year
D) Use their credit card as a source of installment loans
E) None of the above
Answer: D

126. Alexis Downs uses her credit card to buy furniture but pays off the credit card at the end of the month before she incurs any interest costs. How is Alexis using her credit card?
A) As an installment loan
B) As a noninstallment loan
C) As a lump sum payer
D) As a debit card
E) None of the above
Answer: B

127. Donna Carlon is using her plastic card to buy groceries. The money is taken from her checking account immediately to pay for her groceries. How is Donna using her card?
A) As an installment loan
B) As a noninstallment loan
C) As a lump sum payer
D) As a debit card
E) None of the above
Answer: D

128. A bank is considering making a loan to Alice Granger. The bank is looking at her credit report from Equifax and also examining the reason Alice has put on the loan application for needing the loan? What aspect of evaluating a consumer loan application is the bank looking at?
A) Character and purpose
B) Income level
C) Deposit balance
D) Employment and residential stability
E) Pyramiding of debt
Answer: A

129. A bank is considering making a loan to Ron Weasley. Ron has a gross salary per month of $4000 but has take-home pay of $2800 per month. What aspect of evaluating a consumer loan application is this fact most concerned with?
A) Character and purpose
B) Income level
C) Deposit balance
D) Employment and residential stability
E) Pyramiding of debt
Answer: B

130. A bank is considering making a loan to Sean Finnigan. Sean owns his own home and has lived there for the past four years. What aspect of evaluating a consumer loan application is this fact most concerned with?
A) Character and purpose
B) Income level
C) Deposit balance
D) Employment and residential stability
E) Pyramiding of debt
Answer: D

131. A bank is considering making a loan to Sam Snape. Mr. Snape has $1000 in the bank right now but generally keeps a balance of $4500 most of the year. What aspect of evaluating a consumer loan application is this fact concerned with?
A) Character and purpose
B) Income level
C) Deposit balance
D) Employment and residential stability
E) Pyramiding of debt
Answer: C

132. A bank is considering making a loan to Neville Langdon. Neville has bounced three checks in the last year and already has $10,000 on a credit card and an automobile loan with a large balance. What aspect of evaluating a consumer loan application is this fact concerned with?
A) Character and purpose
B) Income level
C) Deposit balance
D) Employment and residential stability
E) Pyramiding of debt
Answer: E

133. A bank is considering making a loan to John Carter. John is a commissioned sales broker. Some months he earns as much as $10,000 and in other months he earns virtually nothing. Which aspect of evaluating a consumer loan would this be concerned with?
A) Character and purpose
B) Income level
C) Deposit balance
D) Employment and residential stability
E) Pyramiding of debt
Answer: B

134. Which of the following is a challenge of making a consumer loan?
A) Audited financial statements are provided by consumers quarterly
B) Consumers must disclose publicly any changes in their health that would affect the loan
C) Consumers can more easily hide pertinent information
D) Consumers can more easily adjust to financial setbacks than can businesses
E) All of the above are challenges of making a consumer loan
Answer: C

135. Mark Green is considering buying a new Honda Accord. The purchase price of the car is $21,000 but Mark has a trade-in worth $4500. Mark needs a loan to buy the car and knows that his local bank requires him to put down 10% of the purchase price after the value of the trade-in is considered. Mark also knows that bank will charge 8% for the loan and require monthly payments over the next 4 years. What is the minimum down payment that Mark can make?
A) $2,100
B) $450
C) $1,650
D) $2,550
E) None of the above
Answer: C

136. Mark Green is considering buying a new Honda Accord. The purchase price of the car is $21,000 but Mark has a trade-in worth $4500. Mark needs a loan to buy the car and knows that his local bank requires him to put down 10% of the purchase price after the value of the trade-in is considered. Mark also knows that bank will charge 8% for the loan and require monthly payments over the next 4 years. If Mark makes the minimum down payment on the car, what is the amount of the loan that Mark will receive?
A) $18,900
B) $14,850
C) $16,500
D) $14,400
E) None of the above
Answer: B

137. Mark Green is considering buying a new Honda Accord. The purchase price of the car is $21,000 but Mark has a trade-in worth $4500. Mark needs a loan to buy the car and knows that his local bank requires him to put down 10% of the purchase price after the value of the trade-in is considered. Mark also knows that bank will charge 8% for the loan and require monthly payments over the next 4 years. What is the size of Mark's monthly payments if he makes the minimum down payment on the car?
A) $353.50
B) $301.67
C) $512.67
D) $402.81
E) None of the above
Answer: A

138. Mark Green is considering buying a new Honda Accord. The purchase price of the car is $21,000 but Mark has a trade-in worth $4500. Mark needs a loan to buy the car and knows that his local bank requires him to put down 10% of the purchase price after the value of the trade-in is considered. Mark also knows that bank will charge 8% for the loan and require monthly payments over the next 4 years. Mark's monthly payments are 353.50 per month. What is Mark's total finance charge if he takes the full 4 years to pay off the loan?
A) $468
B) $4,032
C) $4,500
D) $2,488
E) None of the above
Answer: D

139. The Equal Credit Opportunity Act requires that:
A) A bank make loans to all minority applicants
B) A bank only make loans to white male applicants
C) A bank give reasons in writing for denying the loan
D) A bank deny loans if the borrower has only been employed for three months
E) None of the above
Answer: C

140. Credit reports provided by credit bureaus provide lenders:
A) With personal identifying data
B) With personal credit histories derived from data submitted by lenders
C) With public information that may bear on a borrower's honesty and stability
D) With the volume of inquiries from lenders about the borrower
E) All of the above
Answer: E

141. Which regulation requires out-of-state-banks that acquire local banks to commit to continued lending in the area and not use the acquired banks simply as deposit gatherers?
A) Equal Credit Opportunity Act
B) National Bank Act
C) Federal Lending Act
D) Fair Credit Reporting Act
E) Community Reinvestment Act
Answer: E

142. A bank customer is granted credit for a $2,000 loan at 10% to be repaid in 12 equal installments. If the loan is a discount loan, what is the monthly payment?
A) 200.00
B) $192.35
C) $184.20
D) $173.12
E) $166.67
Answer: E

143. A bank customer is granted credit for a $2,000 loan at 10% to be repaid in 12 equal installments. If the loan quoted has an add-on rate, what are the net proceeds of the loan?
A) $2,200
B) $2,100
C) $2,000
D) $1.800
E) Cannot be determined
Answer: c

144. A bank customer is granted credit for a $2,000 loan at 10% to be repaid in 12 equal installments. If the loan quoted has an add-on rate, what is the approximate annual percentage rate (APR) on the loan?
A) 20%
B) 18%
C) 14%
D) 12%
E) 10%

Answer: B

145. As part of the new regulations of the mortgage market, the Federal Reserve Board moved to tighten the rules on mortgage lending in 2008. All of the following would improve transparency of the market except for:
A) Lenders must verify the borrower's reported income
B) Lenders cannot rely on a home's current market value to judge a borrower's creditworthiness
C) Lenders must rely on a borrower's stated income
D) Lenders must disclose more about the actual terms of a home mortgage loan to a borrower
E) All of the above are included in the new rules
Answer: C

Chapter 19
Acquisitions and Mergers in Financial-Services Management

Fill in the Blank Questions

1. The_______________________________________ is the law that requires each merging bank to seek approval from its principal federal regulating agency before a merger can take place.
   Answer: Bank Merger Act

2. Under the terms of Bank Merger Act, the federal regulating agencies must give top priority to the______________________ of the proposed merger.
   Answer: competitive effects

3. In the______________________ method of acquiring a bank, the bank purchases all or a portion of another bank's assets.
   Answer: purchase of assets

4. In the_______________________________________ method of acquiring a bank, the bank assumes all of the assets and liabilities of the other bank which ceases to exist.
   Answer: purchase of stock

5. If the earning per share of the merged firm has declined then the shareholders have suffered a problem known as_______________________________________ .
   Answer: dilution of earnings

6. The______________________ tells how may shares of stock the shareholders of the acquired firm will receive from the acquiring firm.
   Answer: exchange ratio

7. The_______________________________________ is the amount over the current stock price shareholders of the acquired firm will receive from the acquiring bank in a merger.
   Answer: merger premium

8. The_______________________________________ is a measure of the market concentration of a given market area. The larger this number is the more concentrated the market.
   Answer: Herfindahl-Hirschman Index (HHI)

9. A large metropolitan or money center bank is often called a(n)______________________ .
Answer: wholesale bank

10. A(n)______________________ takeover is a merger which is resisted by the existing management and stockholders.
Answer: hostile

11. If a bank can show that the merger has____ it may be able to overcome anticompetitive problems of the merger. This is the impact the merger has upon the convenience and service needs of the community.
Answer: public benefits

12. To most authorities, the recent upsurge in mergers reflects the expectation of the stockholders that the____ will increase once the merger is completed. This allows the merged bank to maximize future earnings.
Answer: profit potential

13. One reason banks pursue mergers is for______________________. This allows the bank to reduce fluctuations in revenues and net income.
Answer: risk reduction

14. One reason banks pursue mergers is for______________________. This allows the bank to enter new markets and find new sources of revenue.
Answer: market positioning benefits

15. When the existing ownership of the bank experiences a loss in their share of the company due to an increased number of shares going to new stockholders it is known as ______________________.
Answer: dilution of ownership

16. "Intangible synergies" is a relatively new name for _____________.
Answer: goodwill

17. One of the reasons for a merger is _________________. This where the merger is encouraged by the FDIC as a way to conserve scarce federal deposit insurance resources.
Answer: because of failing institutions

18. Many mergers arise from expected _________________. This takes place particularly when the acquired firm has earnings losses that can be used offset taxable profits of the acquirer.
Answer: tax benefits

19. A bank may increase future earnings by ____________________. The bank can achieve greater efficiency by consolidating operations and unnecessary duplication.
Answer: improving operating efficiency

20. When a bank expands the number of service options it offers after acquiring another financial firm they have practiced ______________________________.
Answer: product line diversification

21. When a bank enters into a new market area as the result of a merger with another financial institution they have practiced ___________________________.
Answer: geographic diversification

22. When a national bank wants to acquire another bank they must apply to the _________ for approval.
Answer: Comptroller of the Currency

23. The degree of ____________________ in a market is measured by the proportion of assets controlled by the largest institutions serving that market. In banking this is measured but the Herfindahl-Hirschman Index.
Answer: concentration

24. The executive body of the EU has emerged as a key arbiter if mergers involving European businesses and uses the doctrine of _________________________.
Answer: collective dominance

25. When a merger takes place some banks have been asked to _______________ themselves of some of their branches. Many of these are sold to third parties.
Answer: divest

True/False Questions

T F 26. In recent years banking has ranked in the top five of all U.S. industries in the number of reported merger transactions.
Answer: True

T F 27. If a bank with a higher stock-price-to-earnings ratio acquires a bank with a lower price-earnings ratio, earnings per share of the combined organization will increase even if combined earnings fall after the merger.
Answer: False

T F 28. In recent years in the United States bank merger premiums have commonly ranged from 150 to 250 percent.
Answer: True

T F 29. According to the textbook the financial success of a bank merger depends heavily upon the comparative dollar amounts of earnings reported by the two banking organizations and their relative price-earnings ratios.
Answer: True

T F 30. A proposed merger between two or more banks must be ratified by the board of directors of each bank involved and by the management of each of the banks and then the merger can proceed once regulators' approval is received.
Answer: False

T F 31. Under the terms of the Bank Merger Act each federal agency must give top priority to the competitive effects of a proposed merger.
Answer: True

T F 32. Mergers with anticompetitive effects can only be approved at the federal level if one of the banks involved is failing.
Answer: False

T F 33. A market area served by one bank which is the only provider of financial services in that market would have an HHI of 100 percent.
Answer: False

T F 34. A market served by just two banks, equal to each other in size, would have an HHI of 5,000.
Answer: True

T F 35. According to a recent survey, many European bank mergers in the 1980s and 1990s were motivated by the search for cost savings (economies of scale).
Answer: True

T F 36. The acquisition of First City Bancorporation of Texas by Chemical Bank of New York was motivated by both banks seeking market-positioning benefits.
Answer: False

T F 37. The merger of Bank of America and Security Pacific in 1992 resulted in an expansion of branch offices at both banks.
Answer: False

T F 38. Under the purchase-of-stock method the acquired bank ceases to exist as a separate corporation.
Answer: True

T F 39. Bank executives identify the most important factor in choosing a merger target as the ability of the merged bank to better accommodate their corporate customers.
Answer: False

T F 40. One of the major motives behind the rapid growth of mergers in recent years is that stockholders expect the profit potential will increase once the merger is completed.
Answer: True

T F 41. Some merger partners anticipate reduced earnings risk as a result of the merger. One reason for this may be that the merger opens up new markets with different economic characteristics.
Answer: True

T F 42. If one of the banks is in financial difficulty a merger is not allowed to take place.
Answer: False

T F 43. The passage of the Garn-St. Germain Depository Institutions Act allowed bank holding companies to acquire failing banks and thrifts in other states.
Answer: True

T F 44. The most important goal of any merger should be to increase the market value of the surviving firm.
Answer: True

T F 45. Mergers with anticompetitive effects cannot go unchallenged by federal authorities unless the banks can show that the resultant bank would have significant public benefits.
Answer: True

T F 46. As a result of many bank mergers, research indicates that goodwill on many bank balance sheets has exploded in recent years.
Answer: True

T F 47. According to FASB, goodwill must now be amortized over its useful life.
Answer: False

T F 48. In order to get regulatory approval for a merger, many times banks have been required to open up a number of new branch offices.
Answer: False

T F 49. A 2002 study by the Federal Reserve indicates that there are economies of scale (cost savings) resulting from small mergers among banks and insurance companies.
Answer: True

T F 50. There is no evidence for cost savings resulting from large financial institution mergers.
Answer: True

T F 51. Recent research indicates that some merger activity may actually stimulate "de novo" bank entry into the marketplace.
Answer: True

T F 52. The 2007 credit crunch resulted in numerous banks experiencing financial distress for which mergers and acquisitions were often the only option.
Answer: True

T F 53. The agency problem described in the textbook is referred to the idea of bank managers driven primarily by their own interest to increase salaries and benefits at the expense of company stockholders.
Answer: True

T F 54. One of the most common motives for large banks to acquire smaller banks is to gain access to capable new management which is always in short supply at larger institutions.
Answer: False

T F 55. Bank regulators may challenge the merger between two institutions but can never require banks to divest themselves of some of their offices in order to secure regulators' approval.
Answer: False

Multiple Choice Questions

56. According to the literature on bank mergers these mergers are often motivated by:
A) Their profit potential

B) Expected reduction in the risk of fluctuations in cash flow and earnings
C) Expected tax benefits
D) All of the above.
E) None of the above.
Answer: D

57. According to the research literature, the principal beneficiaries of most bank mergers appear to be:
A) The stockholders of the bank acquired
B) The stockholders of the acquiring bank
C) The public (in the form of new services offered and lower service fees)
D) The staff of the acquired bank
E) None of the above.
Answer: A

58. According to the research literature, the lackadaisical profit performance surrounding a merger may be explained by the following:
A) Managerial hubris
B) The sizeable merger premium that acquirers have to pay to shareholders of the acquired firms
C) Accounting irregularities when reporting earnings of the combined entity
D) All of the above
E) A and B only
Answer: E

59. The ratio of the acquired bank's current stock price per share plus the additional amount paid by the acquirer for each share of the acquired bank's stock divided by the acquired bank's current stock price is the:
A) Price-earnings ratio
B) Merger premium
C) Exchange rate (of a merger transaction)
D) Combined stock price of the merging banks
E) None of the above.
Answer: B

60. The danger faced by the stockholders of an acquiring firm in a merger if an excessive number of new shares are issued relative to the value of their old shares is known as:
A) More volatile earnings
B) Reduction of the exchange ratio
C) Dilution of ownership
D) Increased risk of bankruptcy
E) None of the above
Answer: C

61. The federal law that requires each U.S. merging bank to notify its principal federal regulatory agency and request approval before a merger can take place is the:

A) Bank Merger Act
B) Glass-Steagall Act
C) Depository Institutions Deregulation and Monetary Control Act
D) Garn-St Germain Depository Institutions Act
E) Gramm-Leach-Bliley Act
Answer: A

62. A merger may increase the bank's expected future earnings or reduce its level of risk exposure by:
A) Improved operating efficiency.
B) Improved earnings per share.
C) Geographic or product diversification.
D) All of the above.
E) A and B, only.
Answer: D

63. The Herfindahl-Hirschman Index is a measure of:
A) Market concentration.
B) Merger premium.
C) Synergy gained from a merger.
D) All of the above.
E) None of the above.
Answer: A

64. There are three banks in East Panhandle. First National Bank currently has 40 percent of the deposits, while Second State Bank currently has 30 percent, as does New State Bank and Trust. What is the Herfindahl-Hirschman Index for East Panhandle?
A) 100.
B) 1200.
C) 3400.
D) 2400.
E) None of the above
Answer: C

65. There are three banks in East Panhandle. First State Bank currently has 25 percent of the deposits, while Second State Bank currently has 40 percent. What is the Herfindahl-Hirschman Index for East Panhandle (compute the share of Third State Bank first)?
A) 100.
B) 2200.
C) 3450.
D) 3640.
E) None of the above
Answer: C

66. There are three banks in East Panhandle. First State Bank currently has 25 percent of the deposits, while Second State Bank currently has 40 percent. Compute the share of the Third State Bank in the market and use the Department of Justice Guidelines to identify this market as:
A) Unconcentrated
B) Mildly concentrated
C) Moderately concentrated
D) Concentrated
E) Excessively concentrated
Answer: D

67. There are three banks in East Panhandle. First State Bank currently has 25 percent of the deposits, while Second State Bank currently has 40 percent. Compute the share of the Third State Bank in the market. Suppose First State and Third State propose to merge in order to compete with Second State Bank. According to the Department of Justice Guidelines, would this merger be allowed?
A) Yes
B) Yes but with certain regulatory restrictions
C) No
D) Not enough information to make the determination
E) None of the above
Answer: C

68. First National Bank's stock is currently selling at $40 per share and the bank recently reported earnings per share of $4.50 for its 200,000 shares. Second National Bank has 150,000 shares outstanding, with a current market price of $30 per share. Second National just reported its earnings per share of $5. If First National acquires Second National in a stock purchase, with the two banks agreeing to exchange stock at the current market prices, and post-merger earnings are expected to be $1,800,000, what will the post-merger EPS be?
A) $4.36
B) $5.76
C) $5.28
D) $5.14
E) None of the above
Answer: B

69. Recent research on interstate bank mergers suggests that:
A) Earnings increased
B) Employee productivity improved
C) Faster growth ensued
D) All of the above.
E) None of the above.
Answer: D

70. Suppose Bank A's stock price is $75 and Bank B's stock price is $25. Bank A is planning on purchasing Bank B and plans on paying Bank B shareholders a bonus of $10 per share. What is the merger premium that Bank B shareholders will receive?

A) 110 percent
B) 46.6 percent
C) 200 percent
D) 140 percent
E) None of the above
Answer: D

71. Suppose Bank A's stock price is $75 and Bank B's stock price is $25. Bank A is planning on purchasing Bank B and plans on paying Bank B shareholders a bonus of $10 per share. If Bank B has 100,000 shares outstanding, how many shares of Bank A will the shareholders of Bank B receive?
A) 100,000 shares
B) 33,333 shares
C) 46,667 shares
D) 214,286 shares
E) None of the above
Answer: C

72. The most important goal of any merger should be to:
A) Increase the market value of the surviving firm
B) Reduce the risk of the surviving firm through geographic diversification
C) Increase managerial compensation
D) Increase the efficiency of the target firm
E) None of the above
Answer: A

73. Which of the following are reasons that bank mergers do not work?
A) Ill-prepared management
B) A mismatch of corporate cultures
C) Excessive prices paid by the acquirer for the acquired bank
D) A failure to take into account customers' feelings and concerns
E) All of the above are reasons bank mergers do not work
Answer: E

74. Andover Bank is thinking about purchasing Berkley Bank. The current market value of Andover's stock is $55 per share. The current market value of Berkley's stock is $15 per share and Andover is planning on paying Berkley's stockholders a $5 bonus per share. Currently, Andover has 100,000 shares outstanding and earnings per share of $12. Currently, Berkley has 50,000 shares outstanding and earnings per share of $5. What is the market premium that Andover is paying on Berkley's shares?
A) 367 percent
B) 275 percent
C) 133 percent
D) 100 percent
E) None of the above

Answer: C

75. Andover Bank is thinking about purchasing Berkley Bank. The current market value of Andover's stock is $55 per share. The current market value of Berkley's stock is $15 per share and Andover is planning on paying Berkley's stockholders a $5 bonus per share. Currently, Andover has 100,000 shares outstanding and earnings per share of $12. Currently, Berkley has 50,000 shares outstanding and earnings per share of $5. What is the exchange ratio for this transaction?
A) 3:11
B) 4:3
C) 5:2
D) 4:11
E) None of the above
Answer: D

76. Andover Bank is thinking about purchasing Berkley Bank. The current market value of Andover's stock is $55 per share. The current market value of Berkley's stock is $15 per share and Andover is planning on paying Berkley's stockholders a $5 bonus per share. Currently, Andover has 100,000 shares outstanding and earnings per share of $12. Currently, Berkley has 50,000 shares outstanding and earnings per share of $5. What should the total number of shares outstanding be in the new bank?
A) 118,182 shares
B) 150,000 shares
C) 166,667 shares
D) 200,000 shares
E) None of the above
Answer: A

77. Andover Bank is thinking about purchasing Berkley Bank. The current market value of Andover's stock is $55 per share. The current market value of Berkley's stock is $15 per share and Andover is planning on paying Berkley's stockholders a $5 bonus per share. Currently, Andover has 100,000 shares outstanding and earnings per share of $12. Currently, Berkley has 50,000 shares outstanding and earnings per share of $5. Suppose that the earnings of the new bank are $1,600,000 and the combined bank will have 118,182 shares outstanding. What will the earnings per share of the new bank be?
A) $17.00 per share
B) $13.54 per share
C) $9.67 per share
D) $12.27 per share
E) None of the above
Answer: B

78. Andover Bank is thinking about purchasing Berkley Bank. The current market value of Andover's stock is $55 per share. The current market value of Berkley's stock is $15 per share and Andover is planning on paying Berkley's stockholders a $5 bonus per share. Currently, Andover has 100,000 shares outstanding and earnings per share of $12. Currently, Berkley has 50,000 shares outstanding and earnings per share of $5. Suppose the earnings of the combined bank do not increase over the total earnings of the two banks before the merger. In addition assume that the new bank will have 118,182 shares outstanding. What will the earnings per share of the new bank be?
A) $17.00 per share
B) $13.54 per share
C) $9.67 per share
D) $12.27 per share
E) None of the above
Answer: D

79. Suppose there are four banks in a local community. Each of these banks has 25 percent of the deposits in this community. What is the Herfindahl-Hirschman Index (HHI) for this community?
A) 10,000
B) 100
C) 2500
D) 625
E) None of the above
Answer: C

80. Suppose there are four banks in a local community. Each of these banks has 25 percent of the deposits in this community. This market is:
A) Unconcentrated
B) Mildly concentrated
C) Moderately concentrated
D) Concentrated
E) None of the above
Answer: D

81. Suppose there are four banks in a local community. Each of these banks has 25 percent of the deposits in this community. Calculate the change in the Herfindahl-Hirschman Index (HHI) if two of these banks merge.
A) 625
B) 1000
C) 1150
D) 1200
E) 1250
Answer: E

82. In the United States, most bank mergers have occurred in the following geographic region of the country:
A) Southeastern U.S.
B) Northeastern U.S.
C) The West
D) The Midwest
E) Southwestern U.S.
Answer: A

83. Research indicates economies of scale (cost savings) for financial institution mergers which are:
A) Small
B) Large
C) Medium
D) All sizes
E) No economies of scale have been found
Answer: A

84. Dorchester County has the following five banks in its market area.

Bank	**Total Assets**
First National Bank, NA	$1,500 million
Dorchester County Bank	$750 million
First State Bank	$500 million
Summerfield Bank	$250 million
Charlestown Bank	$250 million
All Banks	$3,250 million

Using this information, what is the market share of the First National Bank?
A) 100.00%
B) 75.00%
C) 46.15%
D) 15.38%
E) None of the above
Answer: C

85. Dorchester County has the following five banks in its market area.

Bank	**Total Assets**
First National Bank, NA	$1,500 million
Dorchester County Bank	$750 million
First State Bank	$500 million
Summerfield Bank	$250 million
Charlestown Bank	$250 million
All Banks	$3,250 million

Using this information, what is the Hirfindahl-Hirschman Index for this market area?
A) 3017
B) 5000
C) 10,000
D) 3,187,000
E) None of the above
Answer: A

86. Dorchester County has the following five banks in its market area.

Bank	**Total Assets**
First National Bank, NA	$1,500 million
Dorchester County Bank	$750 million
First State Bank	$500 million
Summerfield Bank	$250 million
Charlestown Bank	$250 million
All Banks	$3,250 million

If the Summerfield and Charlestown banks merge, what would be the Hirfindahl-Hirschmann Index after the merger?
A) 3017
B) 3136
C) 5000
D) 10,000
E) None of the above
Answer: B

87. There are 10 banks in a particular market area all with a market share of 10%. What is the Hirfindahl-Hirschmann Index for this market area?
A) 10,000
B) 5000
C) 1000
D) 0
E) None of the above
Answer: C

88. There are 10 banks in a particular market area all with a market share of 10%. Two of the banks plan to merge. What would the Hirfindahl-Hirschmann Index be after the merger?
A) 5000
B) 1200
C) 1000
D) 0
E) None of the above
Answer: B

89. There are 10 banks in a particular market area, all with a market share of 10%. Two of the banks plan to merger and the Hirfindahl-Hirschmann Index moves from 1000 to 1200. Would the Justice Department likely bring suit against the merger?
A) Yes
B) No
C) Only if the banks divest themselves of half of their branches
D) Cannot be determined from the information given
Answer: B

90. What caused there to be a wave of mergers in Europe?
A) Passage of the Riegle-Neal Interstate Banking Act
B) Passage of the Gramm-Leach-Bliley Act
C) Passage of the Bank Merger Act
D) Formation of the European Union
E) A, B and C above
Answer: D

91. The First State Bank of Wyoming wants to acquire the First State Bank of Oklahoma. The management of the bank feels that this geographic diversification will increase earnings as new markets will be exploited and new services are offered to all of their bank customers. Which motive for a merger does this most likely reflect?
A) Profit Potential
B) Risk Reduction
C) Rescue of Failing Institution
D) Tax and Market-Positioning
E) Maximizing Management Welfare
Answer: A

92. The First State Bank of Wyoming wants to acquire the Second National Bank of South Carolina. They want to do this because management feels that South Carolina faces very different economic conditions than does Wyoming and that this acquisition will reduce variability in earnings in the future. What motive for a merger does this most likely reflect?
A) Profit Potential
B) Risk Reduction
C) Rescue of Failing Institution
D) Tax and Market Positioning
E) Maximizing Management Welfare
Answer: B

93. The First National Bank of Edmond wants to acquire the First State Bank of Oklahoma City. Management believes that this merger will enhance their reputation in the labor market because the new firm will be twice as big as what they are managing now. In addition, the First National Bank of Edmond has promised to pay $10,000,000 in compensation to the top managers of the First State Bank of Oklahoma City and help them cover any resulting tax liability. What motive for a merger does this most likely reflect?
A) Profit Potential

B) Risk Reduction
C) Rescue of Failing Institution
D) Tax and Market Positioning
E) Maximizing Management Welfare
Answer: E

94. The First National Bank of Edmond had decided to purchase The First National Bank of Plano in Texas. The bank is interested in this purchase because The First National Bank of Plano is in financial distress and the First National Bank of Edmond thinks this is a cheap way to get a start in the large Texas market. The FDIC supports this acquisition because they won't have to make any insurance payouts. What motive for a merger does this most likely reflect?
A) Profit Potential
B) Risk Reduction
C) Rescue of Failing Institution
D) Tax and Market Positioning
E) Maximizing Management Welfare
Answer: C

95. The State Bank of Stillwater has had record profits this year. They are interested in purchasing the National Bank of Durant because they have had losses this year. The State Bank of Stillwater feels that they can turn around the National Bank of Durant and in the meantime they can enjoy a reduced tax burden after this acquisition. What motive for a merger does this most likely reflect?
A) Profit Potential
B) Risk Reduction
C) Rescue of Failing Institution
D) Tax and Market Positioning
E) Maximizing Management Welfare
Answer: D

Chapter 20
International Banking and the Future of Banking and Financial-Services

Fill in the Blank Questions

1. A(n)____ is the simplest organizational form for an international bank. This is a limited service office that markets the services provided by the home office and identifies new customers but does not take deposits or book loans.
   Answer: representative office

2. A(n)_______________________ is a more complete organizational form for international banks than a representative office which does not generally take deposits from the public but does take commitments to make or purchase loans among other things.
   Answer: agency office

3. A(n)_______________________ is the most common organizational form for an international bank. It offers the bank's full range of services but is not a separate legal entity.
   Answer: branch office

4. When an international bank acquires majority ownership of a separate, legally incorporated foreign bank, this foreign bank is called a(n)_______________________ of the international bank.
   Answer: subsidiary

5. ____ are separate domestic U.S. companies owned by U.S. or foreign banks located outside the home state of the bank that owns them. These organizations are limited primarily to international or foreign business transactions.
   Answer: Edge Act Corporations

6. A(n)_______________________ branch is a special foreign office which merely records the receipt of deposits and other international transactions. Often these are little more than a desk and a telephone and are used as a way around regulations.
   Answer: shell

7. A(n)____ is an organization which has over half its income from activities associated with exporting goods and services from the U.S. They can offer export insurance coverage, transportation, warehousing and other services for exporting goods and services.
   Answer: Export Trading Company (ETC)

8. The____ is the first major federal law regulating foreign bank activity in the U.S. It required foreign banks accepting deposits to meet reserve requirements and allowed foreign banks to be eligible for federal deposit insurance.
Answer: International Banking Act of 1978

9. A(n)____ is a receipt issued by a U.S. bank which makes it easier for a foreign business borrower to sell securities in the U.S.
Answer: American Depository Receipt

10. A(n)______________________ is where a customer anticipating a future need for a foreign currency will negotiate with another party, with the help of their bank, a contract for the delivery of the currency at a set price on a set date.
Answer: forward contract

11. A(n)____ is where computerized records of transactions involving banks and their international customers are kept separate from the rest of the domestic accounts. These are more lightly regulated than regular bank offices.
Answer: international banking facility (IBF)

12. The____ requires regulators to determine if foreign banks selling their services in the U.S. are adequately regulated by their home governments and to close those not adequately supervised or in violation of U.S. law.
Answer: Foreign Bank Supervision Enhancement Act

13. The____ is an agreement between the U.S., Japan, Canada and several other nations of Western Europe to adopt common capital requirements for all of their banks.
Answer: Basel Agreement

14. ____ refers to the market for foreign currency or trading one currency for another.
Answer: FOREX

15. ____ is the risk that has to do with the fluctuations in currency prices.
Answer: Currency risk

16. A(n)____ grants the buyer the right to deliver or take delivery of a specified currency at a specified price until it expires.
Answer: currency option

17. A(n)____ is the exchange of different national currencies between two parties who need foreign currencies to repay loans or cover other expenses.
Answer: currency swap

18. The____ is an international market for long-term debt denominated in foreign currency units.
Answer: Eurobond market

19. A(n)____ is a contractual agreement between two parties to exchange interest payments in order to hedge against interest rate risk.
Answer: interest rate swap

20. A(n)____ is a device used to satisfy creditors by giving them stock in place of paying off any remaining debt.
Answer: debt for equity swap

21. A device which aids customers in selling goods abroad is known by the acronym _________ and which was originally developed by the Japanese.
Answer: ETC

22. When dealers speculate on trends in the price of selected currencies it is called ___________.
Answer: proprietary trading

23. _______________ are primarily medium term credit agreements between international banks and their larger corporate an government customers. The customer is authorized to periodically offer short term notes that come due in 90 to 180 days over a stipulated period.
Answer: Note issuance facilities (NIFs)

24. A(n) __________________ is a draft for payment due and payable upon presentation to the bank.
Answer: sight draft

25. A(n) ___________________ is a draft for payment due and payable only on a specific future date.
Answer: time draft

26. When a loan is made thousands of miles away and where the court system and bankruptcy laws needed to support the enforcement of contracts and loans is missing, it causes a special type of risk called ________________.
Answer: country risk

27. When a foreign government takes actions that interfere with the repayment of an international loan, it causes a special type of risk called ________________.
Answer: sovereign risk

28. An international loan risk evaluation system that lists economic and political factors believed to be correlated with loan risk is called the _____________. It may apply comparative weights to each factor or consider each factor equally.
Answer: checklist approach

29. An international loan risk evaluation system that uses expert opinion is the ______________.
Answer: Delphi Method

30. One of the most comprehensive country-risk indicators is provided by _________. This guide supplies political, economic and financial risk ratings and an overall composite rating for about 140 countries monthly.
Answer: International Country Risk Guide (ICRG)

True/False Questions

T F 31. The barriers between securities dealers and international banks are falling in many countries, making it harder for the public to see real differences between financial institutions.
Answer: True

T F 32. Under U.S. regulations no one U.S. bank can invest more than 50 percent of its consolidated capital and surplus in an export trading company.
Answer: False

T F 33. Under U.S. regulations Edge Act subsidiaries must devote at least 50 percent of their business to assisting customers with export-import trade and international credit.
Answer: False

T F 34. The International Banking Act of 1978 prohibited foreign-owned banks from crossing state lines unless the state or states involved allow cross-border entry.
Answer: True

T F 35. Foreign banks taking retail deposits in the U.S. can qualify for federal deposit insurance.
Answer: True

T F 36. The International Lending and Supervision Act requires federal regulators to supervise the U.S. banks under their jurisdiction more closely but to give banks and the private marketplace more freedom in deciding what their capital requirements should be.
Answer: False

T F 37. The Basel Agreement on international capital standards does not cover Japanese banks but does cover major banks in the U.S. and Western Europe.
Answer: False

T F 38. Long hedges in currency futures are designed to protect a bank or its customer from increases in the price of the currency it must eventually acquire.
Answer: True

T F 39. Currency options give their buyer the right, but not the obligation, to deliver or take delivery of a foreign currency or currency futures contract.
Answer: True

T F 40. ADRs are issued by foreign banks operating outside the U.S. and sold to investors in the Eurodollar market.
Answer: False

T F 41. The Federal Reserve Board can terminate the operations of a foreign bank in the United States if it finds the bank is not being operated in a manner consistent with the public interest.
Answer: True

T F 42. Under the terms of the International Lending and Supervision Act the loan rescheduling fees U.S. banks can charge international borrowers are restricted.
Answer: True

T F 43. An international bank with a positive net exposure in a given foreign currency is said to be in a net short position in that particular currency.
Answer: False

T F 44. An international bank's net position in a foreign currency is measured by the difference between the volume of that currency purchased less the volume of that currency sold.
Answer: True

T F 45. If an international bank has gone net long in a particular currency it will score a positive gain if the value of that currency declines.
Answer: False

T F 46. If an international bank has adopted a <u>net</u> <u>short</u> position in a particular currency and that currency's exchange value increases the bank will achieve a profit from trading the currency.
Answer: False

T F 47. A bank's net foreign currency-denominated assets in a given currency are equal to the volume of its assets denominated in that currency less any liabilities the bank has taken on that are denominated in the same currency.
Answer: True

T F 48. <u>Short hedges</u> in currency futures contracts are used to protect a bank or bank customer against rising currency prices.
Answer: False

T F 49. A <u>put</u> option on currency futures is often used to protect against a rise in currency prices.
Answer: False

T F 50. A <u>call</u> option is often employed to protect a bank or bank customer against losses from falling currency prices.
Answer: False

T F 51. A foreign currency swap does not fully hedge the borrower against exchange risk.
Answer: False

T F 52. In a foreign currency swap a customer who needs to borrow a foreign currency receives the domestic currency today and swaps it back for the foreign currency just in time to repay the loan in the foreign currency.
Answer: True

T F 53. A sight draft is a payment for purchase of goods and services across national borders which is payable only on a future date.
Answer: False

T F 54. A time draft is a payment for purchase of goods and services across national borders which is payable upon presentation to the bank.
Answer: False

T F 55. One way to determine the soundness of an international loan is to use the Delphi method which uses the consensus opinion of a panel of experts to develop a measure of a country's risk exposure.
Answer: True

T F 56. The top trading firms in the global currency markets are all banks.
Answer: False

T F 57. Internet banks are not allowed in some countries such as Japan.
Answer: False

T F 58. The currency swap market is in decline following the introduction of the euro.
Answer: False

T F 59. China is an attractive market for banks because there is limited domestic competition and a general lack of expertise in banking.
Answer: True

T F 60. An ETC is a device which aids customers in selling goods abroad.
Answer: True

T F 61. The Eurobond market provides a firm with access to funds outside its home country.
Answer: True

Multiple Choice Questions

62. A limited service facility that can market services supplied by the home office of an international bank and identify new customers is known as a:
A) Branch office
B) Agency office
C) Subsidiary
D) Representative office
E) None of the above
Answer: D

63. Separate corporate entities affiliated either with a U.S. bank or with a foreign bank operating in the U.S. that can cross state lines, but must devote the majority of their accounts to international activities are known as:
A) Joint ventures
B) Representative offices
C) Subsidiaries
D) Edge Act Corporations
E) None of the above
Answer: D

64. An organizational form used by international banks that was created by U.S. regulations enforced by the Federal Reserve Board and consists of computerized account records is known as:
A) International Banking Facility (IBF)
B) Export Trading Company (ETC)
C) Edge Acts
D) Agencies
E) None of the above
Answer: A

65. These specialized firms can be operated by U.S. banking companies and Edge Act Corporations and must receive over half their income from their roles in assisting exporting activities from the U.S. are called:
A) International Banking Facility (IBF)
B) Export Trading Company (ETC)
C) Shell Branches
D) Subsidiaries
E) None of the above
Answer: B

66. Organizational devices used by international banks to take deposits offshore and avoid regulations (such as deposit insurance assessments) are known as:
A) International Banking Facility (IBF)
B) Export Trading Company (ETC)
C) Shell branches
D) Subsidiaries
E) None of the above
Answer: C

67. International banking activities are regulated for many of the same reasons that shape domestic banking regulation. These common reasons for regulation include:
A) Restricting bank risk exposure.
B) Limiting non-banking business activity.
C) Promoting stable growth in money and credit.
D) Specifying minimum amounts of owners' equity capital.
E) All of the above.
Answer: E

68. International banking regulations that do not apply to most domestic banking activity include:
A) Foreign exchange controls.
B) Restricting the outflow of scarce capital.
C) Protecting domestic financial institutions and markets from foreign competition.
D) All of the above.
E) B and C only.
Answer: D

69. The key components of the International Banking Act (IBA) of 1978 include which of the following:
A) Required foreign banks to follow the same branching laws as U.S. banks.
B) Required legal reserves against deposits accepted at U.S. branch or agency offices of foreign banks with consolidated assets of $1 billion or more.
C) Required U.S. branches of foreign banks to obtain deposit insurance.
D) All of the above.
E) A and B only.
Answer: E

70. The Foreign Bank Supervision Enhancement Act of 1991 places the responsibility for supervising U.S. branches of foreign banks with the:
A) Office of the Comptroller of the Currency.
B) Federal Reserve Board.
C) Federal Deposit Insurance Corporation.
D) Secretary of Commerce.
E) None of the above.
Answer: B

71. A call currency option:
A) Obligates the holder to purchase currency or currency futures contracts at a fixed price any time before the option expires.
B) Gives the holder the right to purchase currency or currency futures contracts at a fixed price any time before the option expires.
C) Obligates the holder to sell currency or currency futures contracts at a fixed price any time before the option expires.
D) Gives the holder the right to sell currency or currency futures contracts at a fixed price any time before the option expires.
E) None of the above.
Answer: B

72. Business Corporations that are subsidiaries of a bank organized under Section 25 of the Federal Reserve Act and that must devote the bulk of their activities to serving international customers and carrying out international transactions are known as:
A) IBFs
B) Shell Branches
C) ITCs
D) Agreement Corporations
E) None of the above
Answer: D

73. Often used to protect a nation against loss of its foreign currency reserves, which might damage its prospects for repaying international loans and purchasing goods and services abroad, are:
A) Export loan rate restrictions
B) Foreign exchange reserves
C) Minimum capitalization requirements for domestic banks
D) Examination and supervision regulations for local branch offices
E) None of the above.
Answer: B

74. Which U.S. federal law required branches and agency offices of foreign banks to secure federal licenses for their U.S. operations for the first time?
A) The International Banking Act
B) International Lending and Supervision Act
C) Bank Holding Company Act
D) International Bank Supervision and Examination Procedures Act
E) None of the above.
Answer: A

75. Under current U.S. law the Federal Reserve Board must be notified a minimum of __________ days in advance if a foreign bank wishes to close any of its U.S. offices.
A) 30
B) 60
C) 90
D) 180
E) None of the above
Answer: A

76. A foreign currency contract that obligates the holder of the contract to take delivery of a foreign currency some time in the future is called a(n):
A) Call currency option
B) Put currency option
C) Long hedge currency futures contract
D) Short hedge currency futures contract
E) None of the above
Answer: C

77. A foreign currency contract that obligates the holder of the contract to make delivery of a foreign currency some time in the future is called a(n):
A) Call currency option
B) Put currency option
C) Long hedge currency futures contract
D) Short hedge currency futures contract
E) None of the above
Answer: D

78. A foreign currency contract that gives the holder of the contract the right to purchase a foreign currency is called a(n):
A) Call currency option
B) Put currency option
C) Long hedge currency futures contract
D) Short hedge currency futures contract
E) None of the above
Answer: A

79. A foreign currency contract that give the holder of the contract the right to sell a foreign currency is called a(n):
A) Call currency option
B) Put currency option
C) Long hedge currency futures contract
D) Short hedge currency futures contract
E) None of the above
Answer: B

80. A foreign currency contract where one party trades currencies with another and trades it back at the end of the contract is called a(n):
A) Currency option contract
B) Currency forward contract
C) Currency swap contract
D) Currency futures contract
E) None of the above
Answer: C

81. Banks have been heavily involved in selling their services across national boundaries since:
A) The industry's very beginnings
B) The 1950s
C) The 1980s
D) The turn of the century
E) None of the above
Answer: A

82. A full-service facility operated by a bank away from its home office but offering many of the same services as the home office is known as a(n):
A) Branch office
B) Agency office
C) Subsidiary
D) Representative office
E) None of the above
Answer: A

83. Which of the following is one of the customer services supplied by banks in international markets?
A) Underwriting notes and bond issues in the U.S. bond market
B) Helping customer market their products in the domestic market
C) Helping customers hedge against foreign currency risk
D) Making loans to domestic customers
E) All of the above are customer services offered by banks in the international market
Answer: C

84. Which of the following is a risk evaluation system in international lending today?
A) The Seat of the Pants Method
B) The Discrimination Method
C) The Delphi Method
D) The State-Risk Indicator Method
E) None of the above
Answer: C

85. The Hagard Mercantile Company has made a $30 million investment in a mill in Germany and fears a substantial decline in the mark's current spot rate from $0.63 to $0.56 lowering the value of the company's investment in the mill. Which of the following currency contracts can help Hagard solve this problem?
A) Call currency option
B) Put currency option
C) Long currency futures contract
D) Currency swap contract
E) None of the above
Answer: B

86. The Goudge Grilling Company has just ordered a shipment of grills from Frankfurt. Payment for the grills must be in euros when the grills are delivered. Euros have changed in value in the last 30 days. They have gone from $1.42 to $1.40. If this trend continues which of the following currency contracts can help the Goudge Grilling Company hedge their currency risk?
A) Put currency option
B) Short currency futures contract
C) Long currency futures contract
D) Currency swap contract
E) None of the above
Answer: C

87. As the text suggests all of the following areas of the world have significant opportunities for foreign banks except:
A) Asia
B) China
C) Russia
D) Japan
E) South Korea
Answer: D

88. The primary source for international bank statistics is:
A) The FDIC
B) The OCC
C) The BIS
D) The World Bank
E) The United Nations
Answer: C

89. The market for banking in China exhibits all of the following except:
A) Limited domestic competition
B) Lack of expertise
C) A large percentage of troubled loans
D) A general lack of access from outside the country
E) A growing economy
Answer: D

90. The biggest problem for international banks at the beginning of the 21st century is:
A) The internet
B) Interest rate risk
C) Foreign exchange risk
D) Nonperforming loans
E) None of the above
Answer: D

91. The First National Bank of Summerville has opened an office in Turkey. This is a limited service office that can market services of the home office to Turkey and can identify Turkish customers but does not take deposits or book loans. What type of office did the First National Bank of Summerville open in Turkey?
A) A Representative Office
B) An Agency Office
C) A Branch Office
D) A Subsidiary
E) An Export Trading Company
Answer: A

92. The Third State Bank of Laramie has opened an office in Morocco. This office does not take deposits but makes commitments to make loans, issues letters of credit and provides technical assistance to companies in Morocco. What type of office did the Third State Bank of Laramie open in Morocco?
A) A Representative Office
B) An Agency Office
C) A Branch Office
D) A Subsidiary
E) An Export Trading Company
Answer: B

93. The Second National Bank of Guthrie has opened an office in Chile. This office offers a full line of services and is not a separate legal entity from the Second National Bank of Guthrie. What type of office did the Second National Bank of Guthrie open in Chile?
A) A Representative Office
B) An Agency Office
C) A Branch Office
D) A Subsidiary
E) An Export Trading Company
Answer: C

94. The State Bank of Virginia owns 55% of the shares of the Bank of Budapest. What type of arrangement is this?
A) A Representative Office
B) An Agency Office
C) A Branch Office
D) A Subsidiary
E) An Export Trading Company
Answer: D

95. The State Bank of Nebraska owns a company that has more than half of its income from activities associated with exporting goods and services from the U.S. This company offers export insurance, transportation and warehousing in Europe, trade financing and other services. What type of company does the State Bank of Nebraska own?
A) A Representative Office
B) An Agency Office
C) A Branch Office
D) A Subsidiary
E) An Export Trading Company
Answer: E

96. If Denmark requires that all foreign banks operating in Denmark have at least ten percent capital, what reason for regulating international banks is this most likely in support of?
A) Protecting the safety of depositor funds
B) Promoting stable growth in money and credit
C) Providing foreign currency controls
D) Protecting domestic financial institutions
E) Restricting the outflow of scarce capital
Answer: A

97. Suppose banks operating in Venezuela have to meet the same legal reserve requirements as domestic banks. This would be in support of which reason for regulating international banks?
A) Protecting the safety of depositor funds
B) Promoting stable growth in money and credit
C) Providing foreign currency controls
D) Protecting domestic financial institutions
E) Restricting the outflow of scarce capital
Answer: B

98. Suppose Brazil decides to restrict the export of the real by international banks so that the real does not leave the country and reduce currency reserves for repayment of Brazilian debt. This would be in support of which reason for regulating international banks?
A) Protecting the safety of depositor funds
B) Promoting stable growth in money and credit
C) Providing foreign currency controls
D) Protecting domestic financial institutions
E) Restricting the outflow of scarce capital
Answer: C

99. Suppose India restricts entry into India by foreign banks until the end of the decade. This would be in support of which reason for regulating international banks?
A) Protecting the safety of depositor funds
B) Promoting stable growth in money and credit
C) Providing foreign currency controls
D) Protecting domestic financial institutions
E) Restricting the outflow of scarce capital
Answer: D

100. Suppose South Korea limits the amount of deposits made in South Korea that can be used to make loans in other countries. This would be in support of which reason for regulating international banks?
A) Protecting the safety of depositor funds
B) Promoting stable growth in money and credit
C) Providing foreign currency controls
D) Protecting domestic financial institutions
E) Restricting the outflow of scarce capital
Answer: E

101. Suppose Bank of America holds assets denominated in yen of 150 million and liabilities denominated in yen of 90 million. They also have yen purchases of 70 million and yen sales of 50 million. What is Bank of America's net exposure to currency risk?
A) +150 million yen
B) +60 million yen
C) +80 million yen
D) -80 million yen
E) -60 million yen
Answer: C

102. Suppose Bank of America holds assets denominated in yen of 150 million and liabilities denominated in yen of 90 million. They also have yen purchases of 70 million and yen sales of 50 million. When would Bank of America experience a loss in the currency market?
A) When the yen declines in value relative to U.S. dollars
B) When the yen increases in value relative to U.S. dollars
C) When U.S. dollar declines in value relative to the yen
D) When the euro declines in value
E) None of the above
Answer: A

103. Suppose Citibank holds assets denominated in euros of 120 million and liabilities denominated in euros of 180 million. They also have euro purchases of 40 million and euro sales of 70 million. What is Citibank's net exposure to currency risk?
A) +120 million euros
B) -90 million euros
C) +90 million euros
D) -60 million euros
E) +60 million euros
Answer: B

104. Suppose Citibank holds assets denominated in euros of 120 million and liabilities denominated in euros of 180 million. They also have euro purchases of 40 million and euro sales of 70 million. When would Citibank experience a loss in the currency market?
A) When the euro declines in value relative to the dollar
B) When the dollar increases in value relative to the euro
C) When the yen increases in value
D) When the euro increases in value relative to the dollar
E) None of the above
Answer: D

105. Suppose a U.S. bank borrows money in London while a British company borrows money in New York. At the end of the loan period the U.S. company needs pounds to repay their loan and the British company needs dollars to repay their loan. Which of the following might be a good tool for these companies to reduce their currency risk?
A) Currency futures contract
B) Currency option contract
C) Interest rate futures contract
D) Interest rate swap contract
E) Currency swap contract
Answer: E

106. Which of the following is a reason for the growth of the currency swap market in recent years?
A) It has helped thousands of businesses and governments hedge currency risk
B) It has provided central banks with a new instrument to trade
C) It has helped shape money and credit conditions in various countries
D) It has helped strengthen home nations' economies
E) All of the above are reasons for the growth of the currency swap market in recent years
Answer: E

107. A multinational company issues short-term credit through London's financial district. They are most likely using:
A) Eurrocommercial paper (ECP)
B) Depository receipt (DR)
C) Note Issuance Facility
D) Currency Swap
E) None of the above
Answer: A

108. Suppose Bank of America provides a 5 year credit guarantee for Dillard's Department Stores. Dillard's Department Stores periodically issues short term notes with due dates 90 days after they are issued in the international market. Bank of American has most likely provided a(n):
A) Eurrocommercial paper (ECP)
B) Depository receipt (DR)
C) Note Issuance Facility
D) Currency Swap
E) None of the above
Answer: C

109. A broker has purchased stock in Sony Corporation and has asked to Citibank act as a custodian of this stock. Citibank has issued a negotiable instrument representing ownership interest in the stock. These negotiable instruments are denominated in dollars and not in yen. This is an example of a(n):

A) Eurrocommercial paper (ECP)
B) Depository receipt (DR)
C) Note Issuance Facility
D) Currency Swap
E) None of the above
Answer: B

110. Which of the following is a way a bank can deal with a troubled international loan?

A) The loan can be restructured generally with a lower interest rate and longer time to repay
B) The loan can be sold in the secondary market
C) The bank can write off all or part of the loan
D) The bank can accept exit bonds in lieu of loan repayment
E) All of the above are ways to deal with a troubled international loan
Answer: E