

ch20

Student: _____

1. Capital is the primary protection for an FI against the risk of insolvency and failure.
True False
2. The primary role of capital for an FI is to assure the highest possible return on equity for its shareholders.
True False
3. Protecting FI insurance funds in the event of an FI failure is the responsibility of taxpayers.
True False
4. One function of bank capital is to protect uninsured depositors, bondholders, and creditors in the event of insolvency and liquidation.
True False
5. The book value of bank equity is the present value of assets minus the present value of liabilities.
True False
6. One function of capital is to provide funding for real assets, such as branches and technology, that are necessary to provide financial services.
True False
7. The function of capital to serve as a source of funds is critical to regulators in setting risk-based deposit insurance premiums.
True False
8. The economic definition of the value of an FI's equity is the book value of assets minus the market value of liabilities.
True False
9. Market value of equity is better than book value of equity at reflecting changes in the credit risk and interest rate risk of an FI.
True False
10. If the value of equity is less than zero on a mark-to-market accounting basis, liquidation of the FI would result in losses to the shareholders.
True False
11. If the value of equity is less than zero on a mark-to-market accounting basis, liquidation of the FI may result in losses to the depositors or creditors.
True False
12. The market value of capital is equal to market value of assets minus the market value of liabilities.
True False
13. The book value of equity is seldom equal to the market value of equity.
True False
14. An FI may be insolvent in market value terms even if the book value of equity is positive.
True False
15. Equity holders absorb credit losses on the asset portfolio because liability holders are senior claimants.
True False

16. If an FI were closed by regulators before its economic net worth became zero, neither liability holders nor those regulators guaranteeing the claims of liability holders would stand to lose.
True False
17. The book value of bonds and loans reflects the market value of those assets when they were placed on the books of an FI.
True False
18. Except in cases of extreme credit risk shocks or interest rate risk shocks, the book value of equity is equal to the economic or market value of equity.
True False
19. Under Generally Accepted Accounting Principles, FIs have flexible rules in recognizing the amount and timing of loan losses.
True False
20. When a substandard loan is identified by a regulator, it is required that the loan immediately be charged off by the bank.
True False
21. Book value accounting systems recognize the impact of credit risk problems sooner than interest rate risk problems.
True False
22. It is likely that the discrepancy between book value of equity and market value of equity will increase as volatility in interest rates increases.
True False
23. More frequent regulatory examinations and stricter regulator standards will cause greater discrepancies in book value of equity and the market value of equity.
True False
24. A market to book ratio greater than one indicates that the book value of equity is overstated.
True False
25. Market value accounting often is criticized because the error in market valuation of nontraded assets likely will be greater than the error using the original book valuation.
True False
26. Market value accounting often is said to be difficult to implement because of the amounts of nontraded assets.
True False
27. Market value accounting is likely to increase the variability of earnings of an FI.
True False
28. The implementation of true market value accounting for FIs may have adverse effects on small business finance and economic growth because of the hesitancy of FIs to invest in long-term assets.
True False
29. The SEC requires securities firms to follow capital rules that utilize market value accounting.
True False
30. FDICIA required that banks and thrifts adopt the same capital requirements.
True False
31. The greater is the leverage ratio, the more highly leveraged is the bank.
True False
32. The leverage ratio measures the amount of an FI's core capital relative to total assets.
True False

33. Under FDICIA, the ability for regulators to show forbearance is limited by a set of mandatory actions for each level of capital that an FI achieved as measured by the leverage ratio.
True False
34. Under FDICIA, regulators are required to take prompt corrective action steps when a DI falls outside of Zone 1.
True False
35. The leverage ratio specified under FDICIA protects the depositors and the insurance fund from the effects of risk that may cause the market value of assets to be negative.
True False
36. The leverage ratio specified under FDICIA does not account for the risks of off-balance- sheet activities.
True False
37. Basel I requires banks in the member countries of the Bank for International Settlements to utilize risk-based capital ratios.
True False
38. Under Basel II, total capital is equal to Tier I capital plus Tier II capital.
True False
39. Under Basel II, the credit risk and interest rate risk of assets on the balance sheet as well as off the balance sheet are differentiated.
True False
40. Under Basel II, Tier I capital measures the market value of common equity plus the amount of perpetual preferred stock plus minority equity interest held by the bank in subsidiaries minus goodwill.
True False
41. Under Basel II, banks must hold a total capital to credit risk-adjusted assets equal to 8 percent to be adequately capitalized.
True False
42. Under Basel II, regulatory minimum capital requirements for credit, market, and operational risks are covered in the first pillar of the regulation.
True False
43. Under Basel II, banks are allowed to use their internal estimates of borrower creditworthiness to assess credit risk subject to strict disclosure standards.
True False
44. Under Basel II, operational risk can be measured by four different approaches.
True False
45. In addition to establishing minimum capital requirements, Basel II proposed procedures to ensure that sound internal processes are used to assess capital adequacy and to set targets that are commensurate with the risk profile and environment.
True False
46. Basel II attempts to encourage market discipline by having banks disclose capital structure, risk exposures, and capital adequacy in a systematic manner.
True False
47. The use of risk-based capital measures under Basel I effectively mark-to-market the bank's on- and off-balance-sheet for the purpose of reflecting credit and market risk.
True False

48. The determination of risk-adjusted on-balance-sheet assets under Basel II requires the segregation of assets into five categories of credit risk exposure.
True False
49. Under Basel II, the credit risk-adjusted value of the bank's on-balance-sheet assets can be found by adding the products of the risk weights for each asset times the market value of each asset.
True False
50. As compared to Basel I, the standardized approach of Basel II is designed to produce capital ratios that are more in line with the actual economic risks that the DIs are facing.
True False
51. Similar to Basel I, Basel II will require banks to assign on-balance-sheet assets to one of four categories of credit risk exposure.
True False
52. Under the 2008-2009 TARP Capital Purchase Program, senior preferred shares of stock purchased by the U.S. Treasury are classified as Tier II Capital.
True False
53. The evaluation of credit risk of off-balance-sheet assets under Basel II requires that the notional amount of OBS items be converted to credit equivalent amounts of on-balance-sheet items.
True False
54. Under Basel II, OBS contingent guaranty contracts are assigned the same risk weights as on-balance-sheet principal items to determine their risk-adjusted asset values.
True False
55. In determining the risk-adjusted value of the on-balance-sheet credit equivalent amounts of the contingent guaranty contracts, the risk weights are determined by the credit rating of the underlying counterparty of the off-balance-sheet activity.
True False
56. Basel II guidelines for determining credit risk-adjusted on-balance-sheet assets relies more heavily on credit agency ratings than did Basel I.
True False
57. Counterparty credit risk is the risk that the other party of a contract will default on contract obligations.
True False
58. Counterparty credit risk is more prevalent for exchange-traded derivatives than over-the-counter (OTC) contracts because the bank has more control of its OTC contracts.
True False
59. The risk-adjusted asset values of OBS market contracts or derivative instruments are determined in a manner similar to the risk-adjusted asset values of contingent guarantee claims.
True False
60. Determining risk-adjusted asset values for OBS market contracts requires multiplying the notional values by the appropriate risk weights.
True False
61. In evaluating the risk-adjusted asset value of foreign exchange forward contracts, the value of the current exposure can be either positive or zero.
True False
62. A deficiency of the risk-based capital ratio is that it measures the ability of a bank to meet both the on- and off-balance-sheet credit risk, but not the interest rate or market risks.
True False

63. Operational risk has increased to a point that the BIS will require DIs to account for it in the capital adequacy standards under Basel II.
True False
64. The Basic Indicator Approach in calculating capital to cover operational risk requires banks to hold 12 percent of total assets in capital to cover operational risk exposure.
True False
65. The Standardized Approach in calculating capital to cover operational risk requires DIs to separate activities into business units from which a capital charge is determined based on the amount of operational risk in each unit.
True False
66. The risk-based capital ratio fails to take into account the effects of diversification in the credit portfolio.
True False
67. The risk-based capital ratio does account for loans made to companies with different credit ratings.
True False
68. The capital requirements for broker-dealers include a net worth market value to assets ratio of at least 2 percent.
True False
69. Broker-dealers make very few adjustments to the book value net worth to reach an approximate market value net worth.
True False
70. The risk-based capital model in the life insurance industry includes asset risk, business risk, insurance risk, and interest rate risk.
True False
71. In the life insurance model, morbidity risk differs from mortality risk by the circumstances surrounding the actual death event.
True False
72. In the life insurance model, the ratio of total surplus and capital to the risk-based capital calculation must be greater than or equal to 1.0 for the insurance company to be satisfactorily capitalized.
True False
73. In the property-casualty insurance model, risk-based capital is a function of six different risk categories.
True False
74. The difference between the market value of assets and liabilities is the definition of the
A. accounting value of capital.
B. regulatory value of capital.
C. economic value of capital.
D. book value of net worth.
E. adjusted book value of net worth.
75. Regulatory-defined capital and required leverage ratios are based in whole or in part on
A. market value accounting concepts.
B. book value accounting concepts.
C. the net worth concept.
D. the economic meaning of capital.
E. None of the above.

76. Each of the following is a function of capital EXCEPT
- A. funding the branch and other real investments to provide financial services.
 - B. protecting the insurance fund and the taxpayers.
 - C. assuring the highest possible return on equity for the shareholders.
 - D. protecting uninsured depositors in the event of insolvency and liquidation.
 - E. absorbing losses in a manner that allows the FI to continue as a going concern.
77. Under market value accounting methods, FIs
- A. must write down the value of their assets to fully reflect market values.
 - B. have a great deal of discretion in timing the write downs of problem loans.
 - C. must conform to regulatory write-down schedules.
 - D. have an incentive to fully reflect problem assets as they become known.
 - E. are required to invest in expensive computerized bookkeeping systems.
78. Losses in asset values due to adverse changes in interest rates are borne initially by the
- A. equity holders of an FI.
 - B. liability holders of an FI.
 - C. regulatory authorities.
 - D. taxpayers.
 - E. insured depositors.
79. Through August 2009, approximately which of the following indicates the amount of funds paid back to the U.S. Treasury as part of the TARP Capital Purchase Program?
- A. \$192 billion.
 - B. \$120 billion.
 - C. \$72 billion.
 - D. \$26 billion.
 - E. \$19 billion.
80. Through August 2009, approximately which of the following indicates the amount of dividends and assessments that the U.S. Treasury has received from entities participating in the TARP Capital Purchase Program?
- A. \$2.1 billion.
 - B. \$1.2 billion.
 - C. \$12.2 billion.
 - D. \$16.0 billion.
 - E. \$9.5 billion.
81. What is the impact on economic capital of a 25 basis point decrease in interest rates if the FI is holding a 20-year, fixed-rate, 11 percent annual coupon bond selling at a par value of \$100,000?
- A. A decrease of \$250.
 - B. An increase of \$250.
 - C. An increase of \$2,024.
 - D. A decrease of \$1,959.
 - E. No impact on capital since the book value is unchanged.
82. From a regulatory perspective, what is the impact on book value capital of a 25 basis point decrease in interest rates if the FI is holding a year, fixed-rate, 11 percent annual coupon \$100,000 par value bond?
- A. A decrease of \$250.
 - B. An increase of \$250.
 - C. An increase of \$2,023.
 - D. A decrease of \$1,959.
 - E. No impact on capital since the book value is unchanged.

83. Which of the following statements is true?
- A. The book value of equity always equals the market value of equity.
 - B. The book value of equity always equals the market value of equity minus surplus value.
 - C. The book value of equity equals par value plus surplus value plus retained earnings plus the loan loss reserve.
 - D. The book value of equity equals par value plus surplus value plus the loan loss reserve.
 - E. The book value of equity equals the market value of equity plus par value plus surplus value plus retained earnings.
84. Which of the following is not a component of the book value of capital for an FI?
- A. Net worth.
 - B. Common stock at par value.
 - C. Paid in surplus in excess of par.
 - D. Retained earnings.
 - E. Loan loss reserves.
85. The par value of shares is
- A. the face or stated value of shares issued upon establishment of the FI.
 - B. the difference between the market price at the time of issue and the face value of the shares.
 - C. the value of the shares if interest rates are constant.
 - D. the book value of the shares outstanding.
 - E. the face value of the shares plus accumulated past earnings.
86. The surplus value of shares is
- A. the face value of shares issued upon establishment of the FI.
 - B. the difference between the market price at the time of issue and the face value of the shares.
 - C. the value of the shares if interest rates are constant.
 - D. the book value of the shares outstanding.
 - E. the face value of the shares plus accumulated past earnings.
87. Retained earnings
- A. are not included in equity because they are accumulations of past earnings.
 - B. are included in equity because they could have been paid out in the form of dividends.
 - C. are included in equity since they are a special set-aside that adjusts with adjustments in the market value of assets.
 - D. are not included in equity since they are a special set-aside that adjusts with adjustments in the market value of liabilities.
 - E. are not included in equity since they are a contra-asset entry to the balance sheet.
88. Loan loss reserves are
- A. not included in equity because they are accumulations of past earnings.
 - B. included in equity because they were not paid out in the form of dividends.
 - C. included in equity since they are a special set-aside that adjusts with adjustments in the market value of assets.
 - D. not included in equity since they are a special set-aside that adjusts with adjustments in the market value of liabilities.
 - E. not included in equity since they are a contra-asset entry to the balance sheet.
89. Under historical accounting methods, FIs
- A. must write down the value of their assets to fully reflect market values.
 - B. have a great deal of discretion in timing the write downs of problem loans.
 - C. must conform to regulatory write-down schedules.
 - D. have an incentive to fully reflect problems in the asset portfolio as they become known.
 - E. invest in expensive computerized bookkeeping systems.

90. Which ratio shows degree of discrepancy between the market value of an FI's equity capital as perceived by investors in the stock market and the book value of capital on its balance sheet?
- A. Total risk-based capital ratio.
 - B. Core capital ratio.
 - C. Market to book ratio.
 - D. Book value of capital to assets ratio.
 - E. Current ratio.
91. **91. Simulate Bank has 2 million shares of stock that currently are trading at \$40 per share. The shares have a par value of \$2.00, and the bank's balance sheet shows a surplus value of \$36,000,000, retained earnings of \$56,000,000, and loans loss reserve of \$9,000,000. What is the value of the bank's market to book ratio?**
- A. 2.00.
 - B. 0.83.
 - C. 1.31.
 - D. 0.76.
 - E. 1.20.
92. According to FDICIA, a bank's leverage ratio must be greater than _____ to be considered well-capitalized.
- A. 8 percent
 - B. 2 percent
 - C. 3 percent
 - D. 12 percent
 - E. 5 percent
93. Which of the following is NOT a typical argument against market value accounting?
- A. Market value accounting introduces an unnecessary degree of variability into an FI's earnings.
 - B. The use of market value accounting may reduce the willingness of FIs to invest in longer-term assets.
 - C. FIs are increasingly trading, selling, and securitizing assets.
 - D. Market value accounting is difficult to implement.
 - E. Market value accounting may interfere with an FI's special functions as lenders and monitors of credit.
94. The U.S. banking industry built up record levels of capital in the early 2000s because
- A. the economy went through a downturn.
 - B. problem loans increased.
 - C. the regulators required higher amounts of equity sales.
 - D. of record high levels of profitability.
 - E. of mergers between large banks.
95. Bank regulators set minimum capital standards to
- A. inhibit rapid growth rate of bank assets.
 - B. protect shareholders from managerial fraud or incompetence.
 - C. protect creditors from decreases in asset values.
 - D. force banks to follow socially desirable policies.
 - E. make work for regulators.
96. The concept of prompt corrective action refers to the requirement
- A. that bank managers must address problems in the loan portfolio when they are first identified.
 - B. that regulators must take specific actions when bank capital levels fall outside the well-capitalized category.
 - C. that a receiver must be appointed when a bank's book value of capital to assets falls below 2 percent.
 - D. that b and c above are correct.
 - E. that all of the above are correct.

97. Which of the following is NOT a criticism of the leverage ratio as a measure of capital?
- A. Capital is not required to be held to meet the risks of off-balance-sheet activities.
 - B. The ratio sends a definitive signal of the level of capital adequacy according to FDICIA.
 - C. The ratio fails to take into account the different degrees of credit and interest rate risk of the assets.
 - D. A positive leverage ratio could occur even with a negative economic value of net worth.
 - E. Answers A and C only.
98. The Basel capital requirements differ from previous capital standards in all except one of the following ways?
- A. More stringent capital standards for large banks than for small banks.
 - B. Inclusion of off balance sheet assets in the asset base.
 - C. Restrictions on the amount of goodwill that can be counted towards primary or tier I capital.
 - D. Risk weighting of assets on the basis of credit risk exposure.
 - E. Risk weighting of off balance sheet contingencies.
99. The Basle capital requirements are based upon the premise that
- A. banks with riskier assets should have higher capital ratios.
 - B. banks with riskier assets should have lower capital ratios.
 - C. banks with riskier assets should have lower absolute amounts of capital.
 - D. banks with riskier assets should have higher absolute amounts of capital.
 - E. there is no relationship between asset risk and capital.
100. The Basel I capital requirements as currently implemented include
- A. different credit risks of on-balance-sheet assets.
 - B. different credit risks of off-balance-sheet assets.
 - C. the consideration of market risk in 1998.
 - D. All of the above.
 - E. Only two of the above.
101. The Basel II Accord effective at year-end 2007 in the United States
- A. includes provisions covering minimum capital requirements for credit, market, and interest rate risk.
 - B. stresses the regulatory supervisory process by requiring regulators to be more involved in evaluating . the bank's specific risk profile and environment.
 - C. requires only banks on the regulatory problem bank list to disclose publicly the degree and depth of . problem issues as well as their capital adequacy.
 - D. All of the above.
 - E. Answers B and C only.
102. The measurement of credit risk under the Basel II Accord allows banks to choose between
- A. a standardized approach similar to that used under Basel I.
 - B. a basic indicator approach that will cause banks to hold an additional 12 percent of capital.
 - C. an internal rating system in which they must adhere to strict methodological and disclosure standards.
 - D. All of the above.
 - E. Answers A and C only.
103. The bank is considering changing its asset mix by moving \$100 million of commercial loans into Treasury securities. If it does change the asset mix and capital remains the same, the risk-based capital ratio
- A. will not change because the total assets have not changed.
 - B. will decrease because the earnings rate on Treasuries is less than on loans.
 - C. will increase by 16.67 percent.
 - D. will increase because the assets will have less risk.
 - E. will change, but the direction can not be determined with the information given.

104. Which of the following statements best describes the treatment of adjusting for credit risk of off-balance-sheet activities?
- A. All OBS activities are treated equally in making credit-risk adjustments.
 - B. Standby letter of credit guarantees issued by banks to back commercial paper have a 50 percent conversion factor.
 - C. The credit or default risk of over-the-counter contracts is approximately zero.
 - D. The current exposure component of the credit equivalent amount of OBS
 - E. derivative contracts reflects the credit risk if the contract counterparty defaults.
 - F. The treatment of interest rate forward, option, and swap contracts differs from the treatment of contingent or guarantee contracts.
105. Broker-dealers must calculate a market value for their net worth on a day-to-day basis and ensure that their net worth-assets ratio
- A. exceeds 1 percent.
 - B. is at least 2 percent.
 - C. exceeds 5 percent.
 - D. is less than 1 percent.
 - E. is greater than or equal to 1 percent.
106. A criticism of the Basel I risk-based capital ratio is
- A. the incorporation of off-balance-sheet risk exposures.
 - B. the application of a similar capital requirement across major banks in international banking centers across the world.
 - C. the more systematic accounting of credit risk differences.
 - D. the lack of appropriate consideration of the portfolio diversification effects of credit risk.
 - E. Answers B and C only.
107. Which of the following is NOT a criticism of the Basel I risk-based capital ratio?
- A. All commercial loans are given equal weight regardless of the credit risk of the borrower.
 - B. The ratio incorporates off-balance-sheet risk exposures.
 - C. Grouping assets into different risk categories may encourage balance sheet asset allocation games.
 - D. The treatment does not include interest rate or foreign exchange risk.
 - E. The weights in the four risk categories imply a cardinal measurement of relevant risk between each category.
108. The primary difference between Basel I and the proposed Basel II in calculating risk-adjusted assets is
- A. that Basel II considers OBS assets.
 - B. the use of only three weight classes rather than four classes.
 - C. a heavier reliance on the use of ratings by external credit rating agencies for the assignment of assets to weight classes.
 - D. All of the above.
 - E. Answers A and C only.
109. The primary difference between Basel I and the proposed Basel II in converting OBS values to on-balance-sheet credit equivalent amounts is
- A. the use of credit ratings in Basel II to assign credit risk weights on the OBS activities.
 - B. the use of six weight classes by Basel II rather than four classes.
 - C. the use of the underlying counterparty activity in Basel II to assign credit risk weights on the OBS activities.
 - D. All of the above.
 - E. Answers A and C only.

110. Counter party credit risk in OBS contracts
- A. is the risk that the counterparty will likely default when he is in the money on a contract position.
 - B. refers to the risk that a counterparty will default when suffering large actual or potential losses on its position.
 - C. requires the counterparty to return to the market and replace contracts at less favorable terms.
 - D. All of the above.
 - E. None of the above.
111. The potential exposure component of the credit equivalent amount of OBS derivative items reflects
- A. the probability of an adverse price movement in contracts.
 - B. the cost of replacing a contract if a counterparty defaults today.
 - C. the probability today of a counterparty contract default in the future.
 - D. the maximum price loss for any given position.
 - E. Answers A and D only.
112. The current exposure component of the credit equivalent amount of OBS derivative items reflects
- A. the probability of an adverse price movement in contracts.
 - B. the cost of replacing a contract if a counterparty defaults today.
 - C. the probability today of a counterparty contract default in the future.
 - D. the maximum price loss for any given position.
 - E. future volatility of the underlying.
113. The calculation of the risk-adjusted asset values of OBS market contracts
- A. nearly always equals zero because the exchange over which the contract initially traded assumes all of the risk.
 - B. requires multiplication of the credit equivalent amounts by the appropriate risk weights.
 - C. requires the calculation of a conversion factor to create credit equivalent amounts.
 - D. All of the above.
 - E. Answers B and C only.
114. Calculation of the "add-on" to the risk-based capital ratio to measure market risk
- A. may be done using the Basic Indicator Approach.
 - B. may be done using the standardized model proposed by regulators.
 - C. may be done using the DI's own internal market risk model.
 - D. Answers A and B only.
 - E. Answers B and C only.
115. Calculation of the "add-on" to the risk-based capital ratio to measure operational risk
- A. may be done using the Basic Indicator Approach.
 - B. may be done using the Standardized Approach.
 - C. may be done using the Advanced Measurement Approaches.
 - D. All of the above.
 - E. Answers A and B only.
116. Which approach used in calculating capital to cover operational risk allow banks to rely on internal data for the calculation of regulatory capital requirements?
- A. Standardized approach.
 - B. Advanced measurement approach.
 - C. Basic indicator approach.
 - D. Internal ratings-based approach.
 - E. All of the above.

117. In calculating the net capital for a securities firm, which of the following is NOT an adjustment to the book value of net worth?
- A. The market value of net worth is calculated on a day-to-day basis.
 - B. A series of adjustments are made to reflect unrealized profits and losses, subordinated liabilities, deferred taxes, options, and futures.
 - C. The amount of securities that cannot be publicly sold are subtracted.
 - D. All assets not readily converted into cash are subtracted.
 - E. Haircuts to reflect potential market value fluctuations in asset values are deducted.
118. Which of the following risk categories is NOT covered by the risk-based model for the life insurance industry?
- A. Interest rate risk.
 - B. Business risk.
 - C. Asset risk.
 - D. Foreign exchange risk.
 - E. Insurance risk.
119. In the NAIC model for life insurance companies, which risk covers the amount of capital necessary to meet the maximum contribution that an insurance company may need to make to the state guarantee fund?
- A. Interest rate risk.
 - B. Business risk.
 - C. Asset risk.
 - D. Foreign exchange risk.
 - E. Insurance risk.
120. In the NAIC model for life insurance companies, which risk captures the risk of adverse changes in mortality risk and morbidity risk?
- A. Interest rate risk.
 - B. Business risk.
 - C. Asset risk.
 - D. Foreign exchange risk.
 - E. Insurance risk.
121. In the NAIC model for life insurance companies, this risk measures the liquidity of liabilities for given rate changes.
- A. Interest rate risk
 - B. Business risk
 - C. Asset risk
 - D. Foreign exchange risk
 - E. Insurance risk

122. The risk-based capital requirements have received several types of criticism. Please match the criticism headings below (as stated in the text) with the appropriate criticism explanations in questions 122 to 130.

- | | |
|---|--|
| 1. Because rating agencies often lag rather than lead the business cycle, risk weights based on a loan's credit rating may not accurately measure the relative risk exposure of individual borrowers | Risk weights
_ |
| 2. The benefits may not support the significant cost of developing and implementing new risk management systems | Risk weights
based on
external credit
rating agencies _ |
| 3. Banks in the U.S. likely would need additional capital to meet the new minimum standards | Portfolio
aspects _ |
| 4. Because DIs may have little incentive to make high risk commercial loans, one important aspect of intermediation may be somewhat curtailed | DI
specialness _ |
| 5. The four (five) risk weight categories in Basel I (Basel II) may not reflect the true credit risk | Excessive
complexity _ |
| 6. The BIS plans largely ignore the covariance among asset risks between different parties | Other risks
_ |
| 7. Interest rate and liquidity risks are not yet included in the proposed Basel II plan | Impact
on capital
requirements _ |
| 8. Regulators may not be trained or willing to make the necessary decisions that may rely heavily on judgment | Competition
_ |
| 9. Because of different tax, accounting, and safety-net rules and the application of the new Basel II rules to different industries, a level playing field across banks in different countries will not occur | Pillar 2 may
ask too much of
regulators _ |

Securities (at par)	\$250	Deposits	\$975
Loans (at par)	\$760	Capital	\$ 35

123. How would regulators characterize this FI based on the leverage ratio zones of FDICIA?
- Well capitalized.
 - Undercapitalized.
 - Severely undercapitalized.
 - Overcapitalized.
 - Insolvent.
124. If problem loans reduce the market value of the loan portfolio by 25 percent, what is the value of regulatory defined (book value) capital?
- \$35 million.
 - \$155 million.
 - \$7 million.
 - \$7 million.
 - \$0.
125. If problem loans reduce the market value of the loan portfolio by 25 percent, what is the market value of capital?
- \$35 million.
 - \$155 million.
 - \$7 million.
 - \$7 million.
 - \$0.
126. Given that 25 percent of the loans have been identified as problem loans, and if historical cost accounting methods allow the bank to write down only 10 percent of the problem loans, what will be the book value of capital?
- \$35 million.
 - \$155 million.
 - \$16 million.
 - \$7 million.
 - \$0.
127. If the loan portfolio consists of a five-year, 10 percent annual coupon loan selling at par, what is the market, or economic, value of capital if interest rates increase 1 percent?
- \$35 million.
 - \$155 million.
 - \$7 million.
 - \$7 million.
 - \$0.
128. If the loan portfolio consists of five-year, 10 percent annual coupon par value loans, what is the market, or economic, value of capital if interest rates decrease 2 percent?
- \$35 million.
 - \$96 million.
 - \$60 million.
 - \$7 million.
 - \$0.

Cash and Treasury securities	\$100 million
Fed Funds Sold	\$100 million
Residential Mortgages 1–4 family	\$200 million
Commercial Loans, BB + rated	\$600 million

129.If the bank has capital of \$50 million, what is the leverage ratio?

- A. 5.00 percent.
- B. 8.33 percent.
- C. 25.0 percent.
- D. 50.0 percent.
- E. None of the above.

130.What is the amount of risk-adjusted assets?

- A. \$1,000 million.
- B. \$720 million.
- C. \$900 million.
- D. \$600 million.
- E. \$700 million.

131.What is the ratio of capital to risk-adjusted assets, if the bank has capital of \$50 million?

- A. 5.00 percent.
- B. 5.56 percent.
- C. 7.14 percent.
- D. 8.33 percent.
- E. 6.25 percent.

Sigma Bank has the following balance sheet in millions of dollars. The risk weights as specified by the Basel capital standards are given in parentheses. Unless mentioned otherwise, all assets are held by corporate customers in millions of dollars.

Cash	(0 percent)	\$40	Deposits	\$370
Municipal General Obligation Bonds	(20 percent)	\$60		
Residential Mortgages 1-4 family	(50 percent)	\$100	Perpetual Preferred Stock (Nonqualifying)	\$20
Commercial loans BB + rated	(100 percent)	\$200	Equity	\$10
Total Assets		\$400		\$400

Off balance Sheet

\$40 million Direct-credit substitute standby letters of credit issued to a BBB + -rated U.S. corporation.
(credit conversion factor = 100 percent)

\$40 million commercial letters of credit issued to a BBB - -rated U.S. corporation
(credit conversion factor = 20 percent)

Off-balance sheet derivatives

\$200 million 10-year interest rate swaps
(credit conversion factor for potential exposure = 1.5%)

\$100 million 2-year forward DM contracts
(credit conversion factor for potential exposure = 5%)

132.What is the bank's risk-adjusted assets as defined by the Basel standards for its on- balance-sheet assets only?

- A. \$400 million.
- B. \$360 million.
- C. \$310 million.
- D. \$262 million.
- E. \$236 million.

133.What is the required Tier I and Tier II capital for the on-balance-sheet assets?

- A. \$8 million; \$8 million.
- B. \$16 million; \$16 million.
- C. \$10.48 million; \$10.48 million.
- D. \$8 million; \$16 million.
- E. \$10.8 million; \$8 million.

134. Is the bank adequately capitalized for its on-balance-sheet assets based on the Basel standards?
- A. Yes, because both Tier I and Tier II capital each exceed the required minimum.
 - B. Yes, because both the Tier I and Tier II combined exceeds the required minimum.
 - C. No, because both Tier I and Tier II capital each are below the required minimum.
 - D. No, because Tier I is below the required minimum while Tier II exceeds the required minimum.
 - E. No, because Tier I is above the required minimum while Tier II is below the required minimum.
135. What is the credit equivalent amount of the off-balance-sheet letters of credit, both standby and commercial?
- A. \$9.6 million.
 - B. \$16.0 million.
 - C. \$48 million.
 - D. \$72 million.
 - E. \$80 million.
136. What is the minimum total capital (Tier I + Tier II) required for the off-balance-sheet letters of credit under the Basel II standards?
- A. \$3.84 million.
 - B. \$3.68 million.
 - C. \$3.20 million.
 - D. \$4.80 million.
 - E. \$6.40 million.
137. What is the credit equivalent amount of the off-balance-sheet interest rate swaps if it is in-the-money by \$1 million?
- A. \$1.0 million.
 - B. \$2.0 million.
 - C. \$3.0 million.
 - D. \$4.0 million.
 - E. \$5.0 million.
138. What is the credit equivalent amount of the off-balance-sheet foreign exchange contracts if it is out-of-the-money by \$4 million?
- A. \$1.0 million.
 - B. \$2.0 million.
 - C. \$5.0 million.
 - D. \$6.0 million.
 - E. \$9.0 million.
139. What is the minimum total capital (Tier I + Tier II) required for the off-balance sheet derivative contracts (both interest rate swaps and foreign exchange forwards) under Basel II?
- A. \$0.24 million.
 - B. \$0.36 million.
 - C. \$0.72 million.
 - D. \$0.60 million.
 - E. \$0.48 million.

A property-casualty (P-C) insurance firm has estimated the following risk-based capital charge for its individual risk classes:

Risk Description RBC Charge

R0 Affiliated P-C \$6.0 million

R1 Fixed income assets \$2.0 million

R2 Common Stock \$1.0 million

R3 Reinsurance \$3.0 million

R4 Loss Adjustment expense \$1.0 million

R5 Written premiums \$2.0 million

Total \$15.0 million

140. Using the model recommended by the National Association of Insurance Commissioners (NAIC), what is the total risk-based capital charge for the P-C firm?
- A. \$4.36 million.
 - B. \$10.00 million.
 - C. \$10.36 million.
 - D. \$12.50 million.
 - E. \$15.00 million.
141. Is the firm adequately capitalized if it has total capital and surplus of \$10 million?
- A. No, its total risk-based capital charge is higher than \$10 million.
 - B. No, its total risk-based capital charge is lower than \$10 million.
 - C. Yes, its total risk-based capital charge is higher than \$10 million.
 - D. Yes, its total risk-based capital charge is lower than \$10 million.
 - E. No, its total risk-based capital charge is greater than 0.

ch20 Key

1. TRUE
2. FALSE
3. FALSE
4. TRUE
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74. C

75. B
76. C
77. A
78. A
79. C
80. E
81. C
82. E
83. C
84. A
85. A
86. B
87. B
88. C
89. B
90. C
91. D
92. E
93. C
94. D
95. C
96. D
97. B
98. A
99. D
100. D
101. B
102. E
103. D
104. F
105. B
106. D
107. B
108. C
109. A
110. B
111. C
112. B

- 113. E
- 114. E
- 115. D
- 116. B
- 117. A
- 118. D
- 119. B
- 120. E
- 121. A

122. The four (five) risk weight categories in Basel I (Basel II) may not reflect the true credit risk :: Risk weights *and* Because rating agencies often lag rather than lead the business cycle, risk weights based on a loan's credit rating may not accurately measure the relative risk exposure of individual borrowers :: Risk weights based on external credit rating agencies *and* The BIS plans largely ignore the covariance among asset risks between different parties :: Portfolio aspects *and* Because DIs may have little incentive to make high risk commercial loans, one important aspect of intermediation may be somewhat curtailed :: DI specialness *and* The benefits may not support the significant cost of developing and implementing new risk management systems :: Excessive complexity *and* Interest rate and liquidity risks are not yet included in the proposed Basel II plan :: Other risks *and* Banks in the U.S. likely would need additional capital to meet the new minimum standards :: Impact on capital requirements *and* Because of different tax, accounting, and safety-net rules and the application of the new Basel II rules to different industries, a level playing field across banks in different countries will not occur :: Competition *and* Regulators may not be trained or willing to make the necessary decisions that may rely heavily on judgment :: Pillar 2 may ask too much of regulators

- 123. B
- 124. A
- 125. B
- 126. C
- 127. C
- 128. B
- 129. A
- 130. E
- 131. C
- 132. D
- 133. C
- 134. D
- 135. C
- 136. A
- 137. D
- 138. C
- 139. C
- 140. C
- 141. A

ch20 Summary

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