ch07

Student: ____

1. Because the economies of the U.S. and other overseas countries have become more integrated, the risks of financial intermediation have decreased.
   True False

2. Interest rate risk stems from the impact of both anticipated and unanticipated changes in interest rates on FI profitability.
   True False

3. An FI is short-funded when the maturity of its liabilities is less than the maturity of its assets.
   True False

4. An FI is exposed to reinvestment risk by holding longer-term assets relative to liabilities.
   True False

5. An FI that is short-funded faces the risk that the return of reinvesting assets could exceed the cost of funding those assets.
   True False

6. Exactly matching the maturities of assets and liabilities will provide a perfect hedge against interest rate risk for an FI.
   True False

7. Matching the maturities of assets and liabilities supports the asset transformation function of FIs.
   True False

8. Funding a portion of assets with equity capital means that hedging risk does not require perfect matching of the assets and liabilities.
   True False

9. Active trading of assets and liabilities creates market risk.
   True False

10. FIs typically are concerned about the value at risk of their trading portfolios.
    True False

11. Market risk is present whenever an FI takes an open position and prices change in a direction opposite to that expected.
    True False

12. FIs that make loans or buy bonds with long maturity liabilities are more exposed to interest rate risk than FIs that make loans or buy bonds with short maturity liabilities.
    True False

13. The relationship of a limited or fixed upside return with a high probability and the potential large downside loss with a small probability is an example of an asset's credit risk to an FI.
    True False

14. Credit risk stems from non-repayment or delays in repayment of either principal or interest on FI assets.
    True False

15. Credit risk exposes the lender to the uncertainty that only interest payments may not be received.
    True False

16. In the case where a borrower defaults on a loan, the FI may lose only a portion of the interest payments and a portion of the principal that was loaned.
True False

17. Historically credit card loans have had very low rates of default or credit risk when compared to other assets that an FI may hold.
True False

18. One method of guarding against credit risk is to assess a risk premium based on the estimate of default risk exposure that a borrower carries.
True False

19. Managerial monitoring efficiency and credit risk management strategies affect the shape of the risk of the loan return distribution.
True False

20. Individuals have an advantage over FIs in that individuals more easily can diversify away some of the credit risk of their asset portfolios.
True False

21. Similar to loans, non-government bonds expose a lender to principal payment default risk.
True False

22. Effective use of diversification principles allows an FI to reduce the total default risk in a portfolio.
True False

23. Firm-specific credit risk can be eliminated by diversification.
True False

24. Systematic credit risk can be reduced significantly by diversification.
True False

25. An off-balance-sheet activity does not appear on the current balance sheet because it does not involve holding a current primary claim or the issuance of a current secondary claim.
True False

26. Off-balance-sheet risk occurs because of activities that do not appear on the balance sheet.
True False

27. Off-balance-sheet activities often affect the shape of an FI's current balance sheet through the creation of contingent claims.
True False

28. Contingent claims are assets and liabilities that will come into existence at a future time often at the insistence of a customer or second party.
True False

29. Off-balance-sheet activities have become an important source of fee income, even though losses on these activities can cause a financial institution to fail.
True False

30. The objective of technological expansion is to achieve economies of scale at the expense of diseconomies of scope.
True False

31. Technology risk is the uncertainty that economies of scale or scope will be realized from the investment in new technologies.
True False

32. The mergers of Citicorp with Travelers Insurance is an example of an attempt to exploit economies of scope.
True False

33. Economies of scope involve the ability to lower the average cost of operations by expanding the output of financial services.
True False

34. Employee fraud is a type of operational risk to a financial institution.
True False

35. The risk that a computer system may malfunction during the processing of data is an example of operational risk.
True False

36. Direct foreign investment and foreign portfolio investment both can be beneficial to an FI because of imperfectly correlated returns with domestic investments.
True False

37. Returns from domestic and foreign investments may not be perfectly correlated because of different economic infrastructures and growth rates.
True False

38. Foreign exchange risk is that the value of assets and liabilities may change because of changes in the foreign exchange rate between two countries.
True False

39. Foreign exchange risk is that the value of assets and liabilities may change because of changes in the level of interest rates.
True False

40. Foreign exchange risk includes interest rate risk and credit risk as well as changes in the foreign exchange rate between two countries.
True False

41. An FI can hold assets denominated in a foreign country, but it cannot issue foreign liabilities.
True False

42. An FI is net long in foreign assets if it holds more foreign liabilities than foreign assets.
True False

43. For an FI to exactly hedge the foreign investment risk, the foreign currency assets must equal the foreign currency liabilities.
True False

44. To be immunized against foreign currency and foreign interest rate risk, an FI should match both the size and maturities of its foreign assets and foreign liabilities.
True False

45. Sovereign risk involves the inability of a foreign corporation to repay the principal or interest on a loan because of stipulations by the foreign government that are out of the control of the foreign corporation.
True False

46. Control of the future supply of funds available to a foreign country is one method to ensure the repayment of an existing debt.
True False

47. Unanticipated withdrawals by liability holders are a major part of liquidity risk.
True False

48. A natural consequence of the effects of realized liquidity risk across several institutions is the ability to recognize capital gains on the sale of assets in the attempt to generate cash.
True False

49. During a liquidity crisis assets normally must be sold at a loss because of the rising interest rates caused by financial institutions attempting to raise funds.
True False

50. A lower level of equity capital increases the risk of insolvency to a financial institution.
True False

51. Many of the various risks faced by an FI often are interrelated with each other.
True False

52. Event risks often cause sudden and unanticipated changes in financial market conditions.
True False

53. General macroeconomic risks may affect all risks of a financial institution.
True False

54. Foreign exchange rate risk occurs because foreign exchange rates are volatile and can impact banks with exposed foreign assets and/or liabilities.
True False

55. Holding corporate bonds with fixed interest rates involves
A. default risk only.
B. interest rate risk only.
C. liquidity risk and interest rate risk only.
D. default risk and interest rate risk.
E. default and liquidity risk only.

56. Regulation limits FI investment in non-investment grade bonds (rated below Baa or non-rated).What kind of risk is this designed to limit?
A. Liquidity risk.
B. Interest rate risk.
C. Credit risk.
D. Foreign exchange rate risk.
E. Off-balance sheet risk.

57. What type of risk focuses upon mismatched asset and liability maturities and durations?
A. Liquidity risk.
B. Interest rate risk.
C. Credit risk.
D. Foreign exchange rate risk.
E. Off-balance sheet risk.

58. The asset transformation function potentially exposes the FI to
A. foreign exchange risk.
B. technology risk
C. operational risk
D. trading risk
E. interest rate risk.

59. Which function of an FI involves buying primary securities and issuing secondary securities?
A. Brokerage.
B. Asset transformation.
C. Investment research.
D. Self-regulator.
E. Trading.

60. What type of risk focuses upon mismatched currency positions?
A. Liquidity risk.
B. Interest rate risk.
C. Credit risk.
D. Foreign exchange rate risk.
E. Off-balance sheet risk.

61. What type of risk focuses upon future contingencies?
A. Liquidity risk.
B. Interest rate risk.
C. Credit risk.
D. Foreign exchange rate risk.
E. Off-balance sheet risk.

62. If the loans in the bank's portfolio are all negatively correlated, what will be the impact on the bank's credit risk exposure?
A. The loans' negative correlations will decrease the bank's credit risk exposure because lower than expected returns on some loans will be offset by higher than expected returns on other loans.
B. The loans' negative correlations will increase the bank's credit risk exposure because lower than expected returns on some loans will be offset by higher than expected returns on other loans.
C. The loans' negative correlations will increase the bank's credit risk exposure because higher returns on less risky loans will be offset by lower returns on riskier loans.
D. The loans' negative correlations will decrease the bank's credit risk exposure because higher returns on less risky loans will be offset by lower returns on riskier loans.
E. There is no impact on the bank's credit risk exposure.

63. A mortgage loan officer is found to have provided false documentation that resulted in a lower interest rate on a loan approved for one of her friends. The loan was subsequently added to a loan pool, securitized and sold. Which of the following risks applies to the false documentation by the employee?

A. Market risk.
B. Credit risk.
C. Operational risk.
D. Technological risk.
E. Sovereign risk.

64. A small local bank failed because a housing market collapse following the departure of the areas largest employer. What type of risk applies to the failure of the institution?
A. Firm-specific risk.
B. Technological risk.
C. Operational risk.
D. Sovereign risk.
E. Insolvency risk.

65. The risk that a German investor who purchases British bonds will lose money when trying to convert bond interest payments made in pounds sterling into euros is called
A. liquidity risk.
B. interest rate risk.
C. credit risk.
D. foreign exchange rate risk.
E. off-balance-sheet risk.

66. An FI that finances long-term fixed rate mortgages with short-term deposits is exposed to
A. increases in net interest income and decreases in the market value of equity when interest rates fall.
B. decreases in net interest income and decreases in the market value of equity when interest rates fall.
C. decreases in net interest income and decreases in the market value of equity when interest rates rise.
D. increases in net interest income and decreases in the market value of equity when interest rates rise.
E. increases in net interest income and increases in the market value of equity when interest rates rise.

67. The risk that an investor will be forced to place earnings from a loan or security into a lower yielding investment is known as
A. liquidity risk.
B. reinvestment risk.
C. credit risk.
D. foreign exchange risk.
E. off-balance-sheet risk.

68. Matching the book is intended to protect the FI from
A. liquidity risk.
B. interest rate risk.
C. credit risk.
D. foreign exchange risk.
E. off-balance-sheet risk.

69. When the assets and liabilities of an FI are not equal in size, efficient hedging of interest rate risk can be achieved by
A. increasing the duration of assets and increasing the duration of equity.
B. issuing more equity and reducing the amount of borrowed funds.
C. not exactly matching the maturities of assets and liabilities.
D. issuing more equity and investing the funds in higher-yielding assets.
E. efficient hedging cannot be achieved without the use of derivative securities.

70. Unanticipated diseconomies of scope are a result of
A. technology risk.
B. interest rate risk.
C. credit risk.
D. foreign exchange risk.
E. off-balance-sheet risk.

71. An FI that finances a euro loan with U.S. dollar deposits is exposed to
A. technology risk.
B. interest rate risk.
C. credit risk.
D. foreign exchange risk.
E. off-balance-sheet risk.

72. Matching the foreign currency book does not protect the FI from
A. sovereign country risk.
B. interest rate risk.
C. liquidity risk.
D. foreign exchange risk.
E. off-balance-sheet risk.

73. The potential exercise of unanticipated contingencies can result in
A. technology risk.
B. interest rate risk.
C. credit risk.
D. foreign exchange risk.
E. off-balance-sheet risk.

74. The asymmetric return distribution on risky debt exposes the FI to
A. technology risk.
B. interest rate risk.
C. credit risk.
D. foreign exchange risk.
E. off-balance-sheet risk.

75. The major source of risk exposure resulting from issuance of standby letters of credit is
   - A. technology risk.
   - B. interest rate risk.
   - C. credit risk.
   - D. foreign exchange risk.
   - E. off-balance-sheet risk.

76. Politically motivated limitations on payments of foreign currency may expose an FI to
   - A. sovereign country risk.
   - B. interest rate risk.
   - C. credit risk.
   - D. foreign exchange risk.
   - E. off-balance-sheet risk.

77. The risk that a debt security's price will fall, subjecting the investor to a potential capital loss is
   - A. credit risk.
   - B. political risk.
   - C. currency risk.
   - D. liquidity risk.
   - E. market risk.

78. The risk that interest income will increase at a slower rate than interest expense is
   - A. credit risk.
   - B. political risk.
   - C. currency risk.
   - D. liquidity risk.
   - E. interest rate risk.

79. The risk that borrowers are unable to repay their loans on time is
   - A. credit risk.
   - B. sovereign risk.
   - C. currency risk.
   - D. liquidity risk.
   - E. interest rate risk.

80. The risk that many borrowers in a particular country fail to repay their loans is
   - A. credit risk.
   - B. sovereign risk.
   - C. currency risk.
   - D. liquidity risk.
   - E. interest rate risk.

81. The risk that many depositors withdraw their funds at once is
   - A. credit risk.
   - B. sovereign risk.
   - C. currency risk.
   - D. liquidity risk.
   - E. interest rate risk.

82. The risk that foreign governments may devalue their exchange rates is:
   - A. credit risk.
   - B. sovereign risk.
   - C. currency risk.
   - D. liquidity risk.
   - E. interest rate risk.

83. As commercial banks move from their traditional banking activities of deposit taking and lending and shift more of their activities to trading, they are more subject to
A. credit risk.
B. market risk.
C. political risk.
D. sovereign risk.
E. liquidity risk.

84. An advantage FIs have over individual household investors is that they are able to diversify away credit risk by holding a large portfolio of loans to different entities. This reduces
A. firm-specific credit risk.
B. systematic credit risk.
C. interest rate risk.
D. market risk.
E. political risk.

85. A U.S. bank has €40 million in assets and €50 million in CDs. All other assets and liabilities are in U.S. dollars. This bank is
A. net long €10 million.
B. net short €10 million.
C. neither short nor long in €.
D. net long -€10 million.
E. net short -€10 million.

86. Risk management for financial intermediaries deals with
A. controlling the overall size of the institution.
B. controlling the scope of the institution's activities.
C. limiting the geographic spread of the institution's offices.
D. limiting the mismatches on the institution's balance sheet.
E. complying scrupulously with all government regulations.

87. The U.S. dollar's decline against European currencies is
A. potentially harmful for European banks only.
B. potentially harmful for U.S. banks only.
C. potentially harmful for those banks that have financed U.S. dollar assets with liabilities denominated in European currencies.
D. potentially harmful for those banks that have financed European currency assets with U.S. dollar liabilities.
E. irrelevant for global banks.

88. In which of the following situations would an FI be considered net long in foreign assets if it has ×100 million in loans?
A. ×120 million in liabilities.
B. ×80 million in liabilities.
C. ×100 million in liabilities.
D. ×110 million in liabilities.
E. Answers A and D only.

89. With regard to market value risk, rising interest rates
A. increase the value of fixed rate liabilities.
B. increase the value of fixed rate assets.
C. increase the value of variable-rate assets.
D. decrease the value of fixed rate liabilities.
E. decrease the value of variable-rate assets.

90. Which of the following situations pose a refinancing risk for an FI?
A. An FI issues $10 million of liabilities of one-year maturity to finance the purchase of $10 million of assets with a two-year maturity.
B. An FI issues $10 million of liabilities of two-year maturity to finance the purchase of $10 million of assets with a two-year maturity.
C. An FI issues $10 million of liabilities of three-year maturity to finance the purchase of $10 million of assets with a two-year maturity.
D. An FI matches the maturity of its assets and liabilities.
E. All of the above.

91. Which term refers to the risk that the cost of rolling over or re-borrowing funds will rise above the returns being earned on asset investments?
A. Reinvestment risk.
B. Credit risk.
C. Refinancing risk.
D. Liquidity risk.
E. Sovereign risk.

92. Which term refers to the risk that interest income will decrease as maturing assets are replaced with new, more current assets?
A. Credit risk.
B. Refinancing risk.
C. Reinvestment risk.
D. Liquidity risk.
E. Sovereign risk.

93. Which of the following would you typically find in the trading portfolio of an FI?
A. Cash, loans, and deposits.
B. Premises and equipment.
C. Relatively illiquid assets.
D. Assets held for long holding periods.
E. Bonds, equities, and derivatives.

94. The increased opportunity for a bank to securitize loans into liquid and tradable assets is likely to affect which type of risk?
A. Sovereign risk.
B. Market risk.
C. Insolvency risk.
D. Technological risk.
E. Interest rate risk.

95. This risk of default is associated with general economy-wide or macro conditions affecting all borrowers.
A. Systematic credit risk.
B. Firm-specific credit risk.
C. Refinancing risk.
D. Liquidity risk.
E. Sovereign risk.

96. Which of the following observations is NOT true of a letter of credit?
A. It is a credit guarantee.
B. It is issued by an FI.
C. It is issued for a fee.
D. Payment on the letter is contingent on some future event occurring.
E. It appears on the FI's current balance sheet.

97. The BIS definition: "the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events," encompasses which of the following risks?
A. Credit risk and liquidity risk
B. Operational risk and technology risk
C. Credit risk and market risk
D. Technology risk and liquidity risk
E. Sovereign risk and credit risk

98. Which of the following refers to an FI's ability to generate cost synergies by producing more than one output with the same inputs?
A. Market intermediation.
B. Economies of scope.
C. Break-even point.
D. Economies of scale.
E. Business continuity plan.

99. The risk that an FI may not have enough capital to offset a sudden decline in the value of its assets relative to its liabilities is referred to as
A. currency risk.
B. sovereign risk.
C. insolvency risk.
D. liquidity risk.
E. interest rate risk.

100. Which of the following may occur when a sufficient number of borrowers are unable to repay interest and principal on loans, thus causing an FI's equity to approach zero?
A. Insolvency risk.
B. Sovereign risk.
C. Currency risk.
D. Liquidity risk.
E. Interest rate risk.

101. For an FI investing in risky loans or bonds, the probability is relatively less for which of the following occurrences?
A. Repayment of principal and promised interest in full.
B. Partial default on interest payments.
C. Complete default on interest payments.
D. Partial default of the principal remaining on a loan.
E. Complete default on principal and interest.

102. Economies of scale refer to an FI's ability to
A. lower its average costs of operations by expanding its output of financial services.
B. generate cost synergies by producing more than one output with the same inputs.
C. understand each risk and its interaction with other risks.
D. finance its assets completely with borrowed funds.
E. moderate the long-tailed downside risk of the return distribution.

A bank has liabilities of $4 million with an average maturity of two years paying interest rates of 4 percent annually. It has assets of $5 million with an average maturity of 5 years earning interest rates of 6 percent annually.

103. To what risk is the bank exposed?
A. Reinvestment risk.
B. Refinancing risk.
C. Interest rate risk.
D. Answers A and C only.
E. Answers B and C only.

104. What is the bank's net interest income for the current year?
A. $300,000.
B. $140,000.
C. $160,000.
D. $280,000.
E. $80,000.

105. What is the bank's net interest income in dollars in year 3, after it refinances all of its liabilities at a rate of 6 percent?
A. -$60,000.
B. -$140,000.
C. +$140,000.
D. +$60,000.
E. +$800,000.

106. What is the bank's net interest income in dollars in year 3, after it refinances all of its liabilities at a rate of 8 percent?
A. -$20,000.
B. -$10,000.
C. -$15,000.
D. +$20,000.
E. +$10,000.

107. What is the maximum interest rate that it can refinance its $4 million liability and still break even on its net interest income in dollars?
A. 6.5 percent.
B. 7.0 percent.
C. 7.5 percent.
D. 8.0 percent.
E. 8.5 percent.

A bank has 10 million British pounds (≤) in one-year assets and ≤8 million in one-year liabilities. In addition, it has one-year liabilities of 4 million euros (€). Assets are earning 8 percent and both liabilities are being paid at a rate of 8 percent. All interest and principal will be paid at the end of the year.

108. What is the net interest income in dollars if the spot prices at the end of the year are $1.50/≤ and €1.65/$?
A. $46,060.61.
B. $320,000.
C. $1,200,000.
D. $266,666.67.
E. $720,000.

109. What is the net interest income in dollars if the spot prices at the end of the year are $1.35/≤ and €1.35/$ and the liabilities instead cost 7 percent instead of 8 percent?
A. $1,080,000.
B. $116,592.59.
C. $100,567.45.
D. $112,677.94.
E. $120,009.76.

110. What is the maximum that the € can appreciate and the bank still maintain a zero profit?

A. €1.30/$.

B. €1.33/$.

C. €1.35/$.

D. €1.50/$.

E. €1.60/$.

ch07 Key

1. FALSE

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56. C

57. B

58. E

59. B

60. D

61. E

62. A

63. C

64. E

65. D

66. C

67. B

68. B

69. C

70. A

71. D

72. A

73. E

74. C

75. E

76. A

77. E

78. E

79. A

80. B

81. D

82. C

83. B

84. A

85. B

86. D

87. C

88. B

89. D

90. A

91. C

92. C

93. E

94. B

95. A

96. E

97. B

98. B

99. C

100. A

101. E

102. A

103. E

104. B

105. D

106. A

107. C

108. A

109. B

110. B

ch07 Summary

Category	*# of Questions*
Saunders - Chapter 07	112