ch25

Student: ____

1. The growth of the commercial paper market as well as the increased ability of banks to underwrite commercial paper has reduced the importance of short-term segment of the loan sales market.
   True False

2. Banks began selling short-term loans only since the passage of the Financial Services Modernization Act in 1999.
   True False

3. Historically, correspondent banking relationships have been important in the sale of bank loans.
   True False

4. When a portion of a loan is sold from a large bank to a small bank, it is often called a participation.
   True False

5. When an FI sells a loan without recourse, the credit risk of the loan is completely eliminated.
   True False

6. In the sale of a loan in an investor/buyer, there are fewer agency costs associated with loan participation contracts than with loan assignment contracts.
   True False

7. A bank loan sale occurs when an FI originates a loan and sells the loan without recourse to an outside buyer.
   True False

8. The loan sales market in which an FI originates and sells a short-term loan of a corporation can be considered a close substitute to the issuance of commercial paper.
   True False

9. Most loans originated and sold in the short-term market are secured loans to below investment grade entities.
   True False

10. HLT loans typically are used to finance new fixed assets of an ongoing firm.
    True False

11. Highly leveraged transaction (HLT) loans are typically unsecured, short term and have fixed rates.
    True False

12. The definition of a highly leveraged transaction is any transaction that involves a buyout, acquisition or recapitalization.
    True False

13. Most HLT loans are very heterogeneous with respect to the size of the issue, the interest payment date, interest indexing, and prepayment features.
    True False

14. The buyer of a loan participation benefits because the only risk exposure is to the borrower.
    True False

15. Floating-rate loan assignments typically occur on the loan repricing date as an effort to minimize confusion regarding the calculation and transfer of accrued interest.
    True False

16. Assignments of fixed-rate loans typically do not have difficulties in the calculation and transfer of accrued interest.
True False

17. Investment banks are the predominant buyers of HLT loans because they are more informed agents in this market than other investors.
True False

18. The traditional interbank loan sale market has been growing rapidly due to an increase in the number of mergers and acquisitions.
True False

19. Loans originated by domestic U.S. banks cannot be sold to foreign banks.
True False

20. Insurance companies and pension funds are important buyers of long-maturity loans.
True False

21. Credit derivatives allow FIs to reduce credit risks without removing loan assets from their balance sheet.
True False

22. Closed-end bank loan mutual funds are restricted to investing in loans only through the loan resale or secondary market.
True False

23. The primary sellers of domestic loans are medium-sized regional banks.
True False

24. Because a bad-bank has a difficult time gaining deposits for funding, it also has a difficult time devising an optimal strategy to manage and dispose of bad assets.
True False

25. Selling loans without recourse is a way for FIs to remove loans from their balance sheet for the purpose of reducing the cost associated with reserve requirements.
True False

26. One way to boost the capital to assets ratio of an FI is through loan sales.
True False

27. Some corporate customers that rely on bank loans may see the sale of one of its loan by the bank as an adverse event in the customer-bank relationship.
True False

28. A loan credit rating is the same as bond credit rating in that it is based solely on the financial soundness of the underlying corporation.
True False

29. The move by regulators toward market value accounting of the loan portfolios likely will have an encouraging effect on the secondary loan sale markets.
True False

30. An originate-to-sell model when dealing with below investment grade companies is considered an attractive alternative for FIs, which have specialized credit monitoring skills, as compared with keeping the loans in their portfolio.
True False

31. Mutual funds are prohibited from purchasing/participating in the FI loan sales market by the SEC.
True False

32. Most vulture funds are formed by the mutual fund industry as a way around SEC restrictions from participating in the FI-originated loan sales market.
True False

33. Research has shown that current-year income for an FI is rarely affected by the decision to sell loans from their balance sheet.
True False

34. Although a loan sale strategy for an FI may reduce or eliminate credit risk, the strategy does not affect the FI's liquidity risk.
True False

35. The Resolution Trust Corporation (RTC), a government agency formed to manage failed S&Ls in the early 1990s, followed a Good Bank/Bad Bank concept in the sale of loans.
True False

36. As of 2010, the Department of Housing and Urban Development (HUD) no longer sells loans that were used to purchase multifamily apartment properties.
True False

37. As FIs consolidate and expand their range of financial services, customer relationships with commercial entities are likely to become more important.
True False

38. Besides reducing credit risks, an FI has an incentive to sell loans it originates for all of the following reasons EXCEPT to:
A. geographically diversify.
B. decrease core deposits.
C. lower reserve requirements.
D. lower capital requirements.
E. generate reinvestment income.

39. Which of the following is NOT a contractual mechanism used by FIs to control credit risks?
A. Diversifying across different types of risky borrowers.
B. Requiring higher interest rate spreads for higher risk borrowers.
C. Requiring more collateral for the bank over the assets of more risky borrowers.
D. Making lending decisions only in centralized locations.
E. Placing more restrictive covenants on the actions of more risky borrowers.

40. A loan made to finance a merger and acquisition that usually results in a high leverage ratio for the borrower is a
A. loan sold without recourse.
B. highly leveraged transaction loan.
C. loan sold with recourse.
D. loan assignment transaction.
E. loan participation transaction.

41. Which of the following is NOT a reason for a FI to sell loans with recourse?
A. To reduce capital requirements.
B. To avoid credit risk exposure.
C. To control interest rate risk exposure.
D. To avoid regulatory scrutiny.
E. To make it possible to lend large amounts to an individual borrower.

42. Which of the following is NOT true of a loan that is sold without recourse?
A. The loan is removed from the FI's balance sheet.
B. The FI has no explicit liability if the loan eventually goes bad.
C. The FI that originated the loan bears all the credit risk.
D. The buyer can put the loan back to the selling FI.
E. All of the above.

43. Which of the following is true concerning loans sold with recourse?
A. Most loans are sold in this manner.
B. The buyer cannot put the loan back to the selling FI.
C. The FI has no explicit liability if the loan eventually goes bad.
D. The FI that originated the loan retains a contingent credit risk liability.
E. The loan sale is technically removed from the balance sheet.

44. Which of the following observations is NOT correct?
A. Most loans are sold with recourse.
B. Loan sales are a primitive substitute for securitization.
C. Selling of a loan creates a secondary market for loans.
D. Ownership of the loan is always transferred to the loan purchaser.
E. Loan sales do not involve the creation of new types of securities.

45. Which of the following refers to a period when a borrower is unable to meet a payment obligation to lenders and other creditors?
A. Window.
B. Financial distress.
C. Foreclosure.
D. Recession.
E. Basis.

46. Which of the following is NOT a key characteristic of loans sold in the short-term loan sale market?
A. Issued as a secured loan.
B. Loans to investment grade borrowers or better.
C. Issued with a fixed rate.
D. Sold in units of $1 million and up.
E. Issued for 90 days or less.

47. What are the two basic types of loan sale contracts or mechanisms by which loans can be transferred between seller and buyer?
A. Participations and assignments.
B. Participations and originations.
C. Syndications and originations.
D. Transfers and assignments.
E. Exercise and transfers.

48. Currently, this basic type of loan sale contracts comprises the bulk of loan sales trading.
A. Participations.
B. Originations.
C. Syndications.
D. Assignments.
E. Transfers.

49. Loan participations
A. are riskier than loan assignments.
B. are less risky than loan assignments.
C. are always sold without recourse.
D. are always sold with partial recourse.
E. are made in smaller denominations than are loan assignments.

50. In a loan participation
    A. the holder (buyer) is not a party to the underlying credit agreement, so the initial contract between the loan seller and the borrower remains in place after the sale
    B. the holder (buyer) is a party to the underlying credit agreement, so the initial contract between the loan seller and the borrower remains in place after the sale
    C. the holder (buyer) can vote only on material changes to the loan contract such as changes in interest rate or collateral backing
    D. Answers A and C only.
    E. Answers B and C only.

51. Loan participations are typically sold to correspondent banks because
    A. they are insiders and can be trusted.
    B. they offer the best prices.
    C. the ongoing relationship offers the greatest monitoring opportunities.
    D. this is a regulatory requirement.
    E. correspondent banks are captive customers.

52. A buyer of a loan participation is exposed to
    A. risk exposure to the original borrower defaulting.
    B. risk exposure to the failure of the selling bank.
    C. moral hazard problems because the borrower is no longer monitored by the seller.
    D. Answers A and B only.
    E. Answers A and C only.

53. The definition of an HLT loan as adopted by U.S. bank regulators in 1989 includes
    A. doubling the borrower's liabilities which results in a leverage ratio higher than 50 percent.
    B. involving a buyout, acquisition, or recapitalization.
    C. results in a leverage ratio higher than 75 percent.
    D. All of the above.
    E. Only two of the above.

54. Which of the following transactions meets the legal definition of a highly leveraged transaction (HLT)?

    A. A buyout that increases debt from $100 million to $150 million resulting in a 25 percent leverage ratio.
    B. An investment project that increases debt from $100 million to $250 million resulting in a 55 percent leverage ratio.
    C. An acquisition that increases debt from $100 million to $250 million resulting in a 5 percent leverage ratio.
    D. An acquisition that increases debt from $100 million to $150 million resulting in a 70 percent leverage ratio.
    E. An investment project that results in an 80 percent leverage ratio.

55. Which of the following transactions does not meet the legal definition of a highly leveraged transaction (HLT)?
    A. A buyout that increases debt from $100 million to $150 million resulting in a 55 percent leverage ratio.
    B. A recapitalization that increases debt from $100 million to $250 million resulting in a 55 percent leverage ratio.
    C. An acquisition that increases debt from $100 million to $250 million resulting in a 55 percent leverage ratio.
    D. An acquisition that increases debt from $100 million to $150 million resulting in an 80 percent leverage ratio.
    E. An acquisition that results in an 80 percent leverage ratio.

56. Why do spreads on HLT loans behave more like investment-grade bonds than like high- yield bonds?
    A. They tend to be more junior in bankruptcy.
    B. They tend to have greater collateral backing than do high-yield bonds.
    C. Because no bank makes a market in this debt.
    D. Because securities firms do not make a market in this debt.
    E. They tend to have no covenant protection.

57. HLT loans typically have all of the following characteristics except which of the following?
    A. They have a short maturity of less than three months.
    B. They are secured by assets of the borrowing firm.
    C. They have floating rates tied to LIBOR or some other short-term index.
    D. They have strong covenant protection.
    E. They are term loans.

58. Loan assignments make up more than 90 percent of the U.S. domestic loan sale market because
    A. they have lower capital requirements than other types of loan sales.
    B. they are riskier than are other types of loan sales.
    C. monitoring costs are reduced since all rights are transferred upon sale.
    D. regulators prefer these transactions to loan participations.
    E. there is no secondary market in loan participations.

59. What is NOT true of loan assignments?
    A. All rights are transferred on sale.
    B. The loan buyer holds a direct claim on the borrower.
    C. Transfer of U.S. domestic loans is normally associated with a Uniform Commercial Code filing.
    D. Ownership rights are generally much clearer in a loan sale by assignment.
    E. Contract terms are unrestrictive from the seller's perspective.

60. Assignments
    A. are common in loan syndications.
    B. do not have buyer restrictions.
    C. comprise less than 30 percent of the U.S. loan sales market.
    D. involve extremely high monitoring costs.
    E. expose the buyer to a double risk and involve double monitoring costs.

61. Identify the correct observation.
    A. Most loan sales are completed in less than a month.
    B. Up to 50 percent of loan sales eventually fail to be completed at all.
    C. There is no incentive to renege on a loan sales contract.
    D. The tendency to renege on a loan sales contract decrease as market prices move
    E. away from those originally agreed.
    F. Contractual problems, trading frictions, and costs rarely affect loan sales.

62. A type of FI company that predominantly buys HLT loans because these loans require the kinds of investment analysis skills used in other parts of the FI's business is
    A. a bank loan mutual fund.
    B. a domestic bank.
    C. a foreign bank.
    D. an investment bank.
    E. a vulture fund.

63. A type of company that recently has moved from only purchasing loans on the secondary market into primary loan syndication is
    A. a bank loan mutual fund.
    B. a domestic bank.
    C. a foreign bank.
    D. an investment bank.
    E. a vulture fund.

64. A type of company that specializes in distressed loans is
    A. a bank loan mutual fund.
    B. a domestic bank.
    C. a foreign bank.
    D. an investment bank.
    E. a vulture fund.

65. Which observation is true of vulture funds?
    A. Their decisions based on developing and maintaining long-term relationships.
    B. Their sole agenda is to helping the distressed firm to survive.
    C. Their investments are always passive.
    D. They are relationship based, not transaction driven.
    E. In a restructuring, they are looking for a return on capital invested.

66. Which of the following rely on nondistressed HLT loan purchases as a means of diversifying without the high cost of developing costly nationwide banking networks?
    A. Bank loan mutual funds.
    B. Credit unions.
    C. Foreign banks.
    D. Investment banks.
    E. Vulture funds.

67. The traditional interbank loan sale market has been shrinking for which of the following reasons?
    A. The barriers to nationwide banking have been largely removed through legislation.
    B. Concerns about counterparty risk and moral hazard have increased.
    C. The traditional correspondent banking relationships are slowly breaking down.
    D. All of the above.
    E. Only two of the above.

68. Vulture funds are
    A. management consulting firms that employ turn-around specialists.
    B. portfolios consisting of stakes in distressed companies.
    C. mutual funds that grow by acquiring their competitors.
    D. mutual funds that invest only in highly-leveraged transactions.
    E. companies offering burial insurance contracts.

69. The major buyers of U.S. domestic loans of non-distressed companies include all of the following EXCEPT
    A. domestic banks.
    B. foreign banks.
    C. the Resolution Trust Corporation.
    D. non-financial companies.
    E. closed-end bank loan mutual funds.

70. The sellers of domestic loans and HLT loans include all of the following EXCEPT
    A. major money center banks.
    B. foreign banks.
    C. U.S. government and its agencies.
    D. non-financial companies.
    E. investment banks.

71. If an FI embraces the concept of good bank/bad bank,
    A. bad bank assets are passed on to the institutions correspondent bank that is required to accept the assets.
    B. good bank assets are organized into a closed end mutual fund which then sells shares to raise funds for the bad bank.
    C. the bad bank is a special purpose vehicle (SPV) that is organized to liquidate non-performing loans.
    D. the bad bank assets are funded by FDIC insured deposits.
    E. the bad bank is placed under the supervision of the Resolution Trust Corporation.

72. The principal objective in the creation of _____ is to maximize asset values by separating good loans from bad loans.
   A. hedge funds
   B. bad banks
   C. vulture funds
   D. structured banks
   E. correspondent banks

73. Which of the following is NOT a reason for using a bad bank as a vehicle to add value in the loan sale process?
   A. Contracts for managers can be created to maximize the incentives to generate enhanced values from loan sales.
   B. The bad bank enables bad assets to be managed by loan workout specialists.
   C. The bad bank does not need to be concerned about liquidity needs since it does not have any deposits.
   D. Moving the bad loans off the balance sheet of the good bank will improve the markets perception, and thus performance, of the good bank.
   E. The good bank-bad bank structure increases information asymmetries regarding the value of the good bank's assets.

74. Which legislation authorizes federal agencies to sell delinquent and defaulted loan assets?
   A. Federal Debt Collection Improvements Act.
   B. Financial Services Modernization Act.
   C. The Bank Holding Company Act.
   D. Depository Institutions Deregulation and Monetary Control Act.
   E. Financial Institutions Reform Recovery and Enforcement Act.

75. Which of the following is NOT a reason for FIs to sell loans?
   A. Loan diversification.
   B. To reduce required reserves.
   C. To reduce required capital.
   D. To reduce costs of credit risk assessment.
   E. To provide liquidity.

76. The implementation of BIS capital requirements may be expected to
   A. increase the downward trend in loan sales because of higher required capital levels.
   B. increase the downward trend in loan sales because of the use of risk adjusted assets.
   C. decrease the downward trend in loan sales because of the use of risk adjusted assets.
   D. decrease the downward trend in loan sales because of higher required capital levels.
   E. Answers C and D only.

77. Loan sales do not completely protect the lending FI from credit risk exposure because
   A. defaults may reduce the ability of the lending bank to sell loans in the future.
   B. a loan sale contains an implicit quality guarantee by the lending FI.
   C. loans are always sold with recourse.
   D. regulators require the lending FI to make restitution for defaulted loans.
   E. loan sales force the FI to mark its loans to market.

78. The growth of the commercial paper market has hurt the market for loan sales by
   A. offering some borrowers alternatives to bank loans.
   B. underpricing the banks that sell loans.
   C. fostering the credit crunch.
   D. adding another regulatory layer since the SEC requires shelf registration of new
   E. issues.
   F. increasing moral hazard concerns in the market.

79. Loan sales by foreign banks
   A. are forbidden in the U.S. domestic market.
   B. must be of a certain size to be purchased by a domestic FI.
   C. are allowed to be purchased by domestic FIs if the loan is to a highly-rated company.
   D. must be of a certain duration, and be sold without recourse in order to be purchased by a domestic FI.
   E. have no restrictions placed on them.

80. The move toward market value accounting
   A. increases banks' incentives to sell loans to avoid reporting capital losses.
   B. decreases banks' incentives to sell loans to avoid reporting capital losses.
   C. increases banks' incentives to sell loans since all assets will automatically be marked to market.
   D. decreases banks' incentives to sell loans since all assets will automatically be marked to market.
   E. has no impact on the banks' incentives to sell loans.

81. Banks that sell many of their loans
   A. utilize more of a dealer intermediation approach.
   B. utilize more of a broker intermediation approach.
   C. utilize more of a trader intermediation approach.
   D. utilize more of a market maker intermediation approach.
   E. relinquish some of their roles as financial intermediaries.

82. Banks and other FIs sell loans because of all of the following EXCEPT
   A. loan diversification benefits.
   B. reduction in reserve requirements.
   C. lowering of capital costs.
   D. reduction of liquid assets of the institution.
   E. increase in fee income through brokerage functions.

83. Which of the following aided in allowing Federal Government Agencies (such as the FDIC) to sell loans of institutions for which the agency has become responsible?
   A. National Banking Act.
   B. Financial Services Modernization Act.
   C. Savings Institutions Reform Act.
   D. Glass-Steagall Act.
   E. Federal Debt Collection Improvement Act.

84. Which of the following is NOT a factor that may tend to increase loan sales in the future?
   A. There is an increased trend to apply credit ratings to loans offered for sale, increasing the attractiveness to secondary market purchasers.
   B. The federal government takeover of Fannie Mae and Freddie Mac means that the loans held by these agencies can never be sold to other entities.
   C. Because of their special credit monitoring skills, FIs have a comparative advantage in making loans to below-investment grade companies and then selling the loan.
   D. The trend toward marked-to-market accounting for assets makes bank loans more like securities so they may be easier to sell.
   E. The risk-based capital requirements of the Bank for International Settlements give banks a strong incentive to sell commercial loans to decrease their amount of risky assets.

85. Which of the following is a reason for an FI to sell a residential real estate loan rather than securitize it through GNMA?
   A. The loan is too large to meet securitization standards.
   B. The loan is not insured by FHA or guaranteed by the VA.
   C. The loan recipient's income cannot be verified.
   D. The loan carries a non-standard adjustable interest rate.
   E. All of the above.

Good Bank:				
	Cash	$200	Deposits	$1,000
	Good loans	$1,000	Purchased funds	$300
	Bad Loans	$380	Equity	$280
	Totals	$1,580		$1,580
Bad Bank:				
	Cash	$240	Bonds	$120
	Loans	0	Preferred stock	$40
			Common stock	$80
	Totals	$240		$240

Bad Bank buys the bad loans for $232. The proceeds of the loan sale are used by Good Bank to pay off purchased funds.

86. What will be the total assets of Good Bank after the sale of the loans?
    A. $1,200.
    B. $232.
    C. $132.
    D. $68.
    E. $0.

87. What will be the amount of equity on the balance sheet of Good Bank after the sale of the loans?
    A. $1,200.
    B. $232.
    C. $132.
    D. $68.
    E. $0.

88. If the proceeds of the loan sale are used to pay off purchased funds, what will be the balance of the purchased funds for Good Bank after the transaction?
    A. $1,200.
    B. $232.
    C. $132.
    D. $68.
    E. $0.

ch25 Key

1. TRUE

2. FALSE

3. TRUE

4. TRUE

5. TRUE

6. FALSE

7. TRUE

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10. FALSE

11. FALSE

12. FALSE

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25. TRUE

26. TRUE

27. TRUE

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30. TRUE

31. FALSE

32. FALSE

33. FALSE

34. FALSE

35. FALSE

36. FALSE

37. TRUE

38. B

39. D

40. B

41. B

42. C

43. D

44. A

45. B

46. C

47. A

48. D

49. A

50. D

51. C

52. D

53. D

54. C

55. A

56. B

57. A

58. C

59. E

60. A

61. B

62. D

63. A

64. E

65. E

66. C

67. D

68. B

69. C

70. D

71. C

72. B

73. E

74. A

75. D

76. E

77. B

78. A

79. A

80. C

81. B

82. D

83. E

84. B

85. E

86. A

87. C

88. D

ch25 Summary

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