ch13

Student: ____

1. Off-balance-sheet items can generate cash flows that immediately impact the bank's financial performance.
   True False

2. Off-balance-sheet activities are an important source of fee income for many FIs.
   True False

3. Off-balance sheet activities can have both positive and negative effects on the risk of the FI.
   True False

4. Off-balance-sheet activities generally have risk-reducing attributes, but seldom have risk-increasing attributes.
   True False

5. Off-balance sheet positions are risky because they may yield negative future cash flows.
   True False

6. Off-balance-sheet items often are called contingent assets and liabilities because they may, or may not, affect the balance sheet in the future.
   True False

7. Even though an FI has off-balance-sheet activities, the true net worth is equal to on-balance sheet assets minus on-balance sheet liabilities.
   True False

8. All off-balance-sheet items will eventually move on to the balance sheet at some point in time.
   True False

9. An FI can protect itself against insolvency resulting from off-balance sheet activities by purchasing insurance.
   True False

10. The delta of an option is the sensitivity of an option's value to a unit change in the value of the underlying asset.
    True False

11. All call options are eventually exercised and the underlying asset must be delivered.
    True False

12. The present value of an off-balance-sheet item is its notional value.
    True False

13. A default option is exercised when the holder requests a draw on the loan commitment.
    True False

14. If an FI enters into a loan commitment, it is essentially entering into a forward contract.
    True False

15. The current market value of an off-balance-sheet item is determined by finding the current market value of the underlying item.
    True False

16. The Federal Reserve requires banks to complete schedule L with their quarterly call reports to list the notional size and variety of off-balance-sheet activities.
True False

17. The use of an up-front fee by a bank eliminates the contingent risk on a loan commitment.
True False

18. The current market value or contingent claim value of OBS items overestimates their notional value.
True False

19. The extremely high growth of OBS activities since the early 1990s has caused regulators to recognize the potential risk exposure to FIs from their use.
True False

20. Interest rate risk is part of the loan commitment contingent risk because of the uncertainty of changes in interest rates before the borrower exercises his option to borrow.
True False

21. One way to completely protect the lender against interest rate risk on a loan commitment is for the lender to price the loan at a variable rate against some index.
True False

22. An up-front fee on a loan commitment rewards the FI for its willingness to stand ready to lend the commitment amount during some agreed upon time period.
True False

23. Basis risk occurs on a loan commitment because the spread of a pricing index over the cost of funds may vary.
True False

24. The aggregate commitment funding risk can increase the cost of funds above normal levels.
True False

25. Loan commitment activities increase the insolvency exposure of FIs that engage in such activities.
True False

26. Derivative products used in managing contingent credit risk can only be acquired as over-the-counter arrangements.
True False

27. The ability to provide loan commitments is a signal to borrowers that the FI has a lower risk portfolio.
True False

28. Commercial letters of credit are guarantees that are issued to cover contingencies that are potentially more severe and less predictable than those covered by standby letters of credit.
True False

29. Commercial letters of credit are used only in international trade.
True False

30. In the U.S., commercial banks are the only issuers of standby letters of credit.
True False

31. As compared to LCs, SLCs typically are used to cover contingencies that potentially are more severe and which may not be trade related.
True False

32. Standby letters of credit perform an insurance function similar to that of commercial and trade letters of credit.
True False

33. In many ways, SLCs perform similar functions for a borrower as do loan commitments.
True False

34. The use of LCs and SLCs may result in an FI having a higher concentration ratio than desired for a particular industry.
True False

35. Contingent credit risk occurs with the use of derivative products and involves the potential default by a counterparty.
True False

36. Contingent credit risk on derivative contracts is more serious for futures contracts than for forward contracts.
True False

37. One way to minimize contingent credit risk is to use derivative products sold on organized exchanges.
True False

38. Contingent credit risk is more serious for futures contracts than forward contracts because the over-the-counter arrangements necessary to replicate the guarantees at a later date.
True False

39. If an FI is a counterparty to a swap arrangement, it must record the notational value of the swap as the market value.
True False

40. If a commercial bank engages in OBS activities, there are no additional capital requirements imposed by regulators.
True False

41. Credit derivatives allow FIs to hedge credit risk on individual assets, but not on portfolios of assets.
True False

42. More FIs fail as a result of credit risk exposures than either interest rate or FX risk exposure.
True False

43. When-issued trading involves the commitment to buy and sell securities before they are issued.
True False

44. Loans sold with no recourse have contingent liability off-balance-sheet implications for the FI that sells the loan.
True False

45. The Clearing House Interbank Payments System (CHIPS) is an international wire transfer system owned by the participating banks in the countries in which it is used.
True False

46. Funds transferred on Fedwire are settled at the end of the day.
True False

47. Funds transferred on CHIPS are settled immediately.
True False

48. Settlement risk on wire transfers involves intraday credit risk.
True False

49. To be an affiliate of a holding company, the parent must own at least 50 percent of the shares of the affiliate company.
True False

50. The source of strength doctrine involving failed FIs in multibank holding company corporate structures has been widely accepted by the courts.
True False

51. Fees from derivative products are an increasing component of noninterest income for many FIs.
True False

52. The estoppel argument used in bank failures is based on the concept of financial unsophistication.
True False

53. The ability to form financial holding companies for the purpose of creating full-service financial institutions has caused an increase in affiliate risk.
True False

54. The amount of regulations that have been proposed because of the increased use of risk-reducing OBS derivatives is increasing.
True False

55. Where are the contingent items disclosed in the financial statements?
A. On the assets side of the balance sheet.
B. On the liabilities side of the balance sheet.
C. As footnotes to financial statements.
D. In the income statement.
E. In the director's report.

56. Loan commitments are classified as
A. on-balance-sheet assets.
B. off-balance-sheet assets.
C. off-balance-sheet liabilities.
D. on-balance-sheet liabilities.
E. equity capital.

57. Standby letters of credit are classified as
A. on-balance-sheet assets.
B. off-balance-sheet assets.
C. off-balance-sheet liabilities.
D. on-balance-sheet liabilities.
E. equity capital.

58. Rediscounted bankers' acceptances are classified as
A. on-balance-sheet assets.
B. off-balance-sheet assets.
C. off-balance-sheet liabilities.
D. on-balance-sheet liabilities.
E. equity capital.

59. Loan loss reserves are classified as
A. on-balance-sheet assets.
B. off-balance-sheet assets.
C. off-balance-sheet liabilities.
D. on-balance-sheet liabilities.
E. equity capital.

60. When an FI pre-commits to lending at a fixed rate, it is exposed to
A. credit risk.
B. interest rate risk.
C. takedown risk.
D. funding risk.
E. exchange rate risk.

61. Up-front fees are charged as a certain percentage of
    A. commitment size.
    B. loan taken down.
    C. utilized portion of commitment size.
    D. unused portion of commitment size.
    E. interest payable on the loan commitment.

62. Back-end fees are charged as a certain percentage of
    A. commitment size.
    B. loan taken down.
    C. utilized portion of commitment size.
    D. unused portion of commitment size.
    E. interest payable on the loan commitment.

63. This refers to the fee charged on the unused balance of a loan commitment.
    A. Up-front fee.
    B. Facility fee.
    C. Compensating balance.
    D. Commitment fee.
    E. Closing costs.

64. The quantity risk exposure of a loan commitment is
    A. credit risk.
    B. interest rate risk.
    C. takedown risk.
    D. funding risk.
    E. exchange rate risk.

65. Takedown risk in a loan commitment exposes the FI to
    A. immediate liquidity risk.
    B. basis risk.
    C. spread risk.
    D. externality effects.
    E. future liquidity risk.

66. Which of the following is true of an ‘adverse material change in conditions clause' used in a loan commitment?
    A. It allows the FI to cancel or reprice a loan commitment.
    B. It protects the lender against takedown risk.
    C. It protects the lender against basis risk.
    D. Exercise of the clause helps defaulted borrowers.
    E. It is exercised frequently by most FIs.

67. An Adverse material changes in conditions clause is included in loan commitments to protect the FI against
    A. credit risk.
    B. interest rate risk.
    C. takedown risk.
    D. funding risk.
    E. exchange rate risk.

68. If a future credit crunch is possible, a loan commitment may expose the FI to
    A. credit risk.
    B. interest rate risk.
    C. sovereign country risk.
    D. funding risk.
    E. exchange rate risk.

69. What is seen as a possible reason behind restricted supply of spot loans to borrowers during a credit crunch?
    A. Expansionary monetary policy actions of the Federal Reserve.
    B. FI's increased aversion toward lending.
    C. Shift to the right in the loan supply function at all interest rates.
    D. Low aggregate demand from borrowers to take down loan commitments.
    E. Decrease in cost of funds.

70. Which of the following situations is similar to the externality effect?
    A. Exercising an adverse material change in conditions clause as a last resort, thereby canceling or repricing a loan commitment.
    B. Increase in the cost of funds above normal levels while many FIs scramble for funds to meet their commitments to customers during a credit crunch.
    C. In a loan commitment, the borrower takes down only part of the funds over the specified time-period.
    D. The buyer of a commercial letter of credit fails to perform as promised under a contractual obligation.
    E. All of the above.

71. An exporter demands a letter of credit in order to
    A. guarantee safe delivery of goods to the importer.
    B. guarantee receipt of payment from the importer upon receipt of the goods.
    C. protect against adverse changes in foreign exchange rates.
    D. protect against adverse changes in international interest rates.
    E. ascertain the creditworthiness of the importer.

72. FIs are competing directly with loan commitments, one of their own OBS products, when they also offer:
    A. Futures contracts.
    B. Swaps.
    C. Standby letters of credit.
    D. Forward contracts.
    E. When-issued trading.

73. Off-balance-sheet items are
    A. items omitted from the short form balance sheet.
    B. contingent assets and liabilities.
    C. risk-free assets and liabilities.
    D. exceptionally risky assets and liabilities.
    E. foreign (off shore) assets and liabilities.

74. As of June 2009, the vast majority of OBS activities of commercial banks was
    A. future and forward contracts.
    B. credit derivatives.
    C. commitments to buy FX.
    D. swap contracts.
    E. loans sold with recourse.

75. Which of the following statements best describes a derivative contract?
    A. Contractual commitments to make a loan up to a stated amount at a given interest rate in the future.
    B. Contingent guarantees sold by an FI to underwrite the performance of the buyer of the guaranty.
    C. Agreement between two parties to exchange a standard quantity of an asset at a predetermined price at a specified date in the future.
    D. Trading in securities prior to their actual issue.
    E. Loans originated by an FI and then sold to other investors with recourse.

76. As of 2009, the top 25 U.S. commercial banks accounted for ________ percent of OBS derivative contracts among FDIC-insured institutions.
A. 100
B. 99.8
C. 92.6
D. 81.9
E. 60.7

77. The effect to an FI of default by the counterparty to a derivative contract is LEAST serious with
A. options contracts.
B. futures contracts.
C. swap agreements.
D. forward contracts.
E. loan commitments.

78. Which of the following is the newest addition to the derivative securities markets?
A. Options contracts.
B. Futures contracts.
C. Swap agreements.
D. Forward contracts.
E. Credit derivatives.

79. Which of the following is true of the market price of a futures contract over time?
A. It is set at time 0.
B. It is fixed over the life of the contract.
C. It changes based on the market value of the underlying asset.
D. It decreases with time to expiration.
E. It is based on supply and demand.

80. Which of the following is true of the market price of an options contract over time?
A. It is set at time 0.
B. It is fixed over the life of the contract.
C. It changes based on the market value of the underlying asset.
D. It increases with time to expiration.
E. It is based on supply and demand.

81. What is a swap?
A. An agreement between two parties to exchange assets or a series of cash flows for a specific period of time at a specified interval.
B. An agreement between a buyer and a seller at time 0 to exchange a nonstandardized asset for cash at some future date.
C. A contract that gives the holder the right, but not the obligation to buy or sell the underlying asset at a specified price within a specified period of time.
D. Trading in securities prior to their actual issue.
E. Contractual commitment to make a loan up to a stated amount at a given interest rate in the future.

82. Which of the following ratios do FIs and regulators often use as a simple measure of solvency?
A. Current ratio.
B. Capital to assets.
C. Earnings before interest and taxes to total assets.
D. Quick ratio.
E. Asset turnover ratio.

83. What are commercial letters of credit?
   A. They are contractual commitments to make a loan up to a stated amount at a given interest rate in the future.
   B. They are contracts that give the holder the right, but not the obligation, to buy or sell an underlying asset at a prespecified price for a specified time period.
   C. They are nonstandard contracts between two parties to deliver and pay for an asset in the future.
   D. They are standardized contract guaranteed by organized exchanges to deliver and pay for an asset in the future.
   E. They are contingent guarantees sold by an FI to underwrite the trade or commercial performance of the buyer of the guaranty.

84. In economic terms, the LCs and SLCs sold by an FI
   A. are contractual commitments to make a loan up to a stated amount at a given interest rate in the future.
   B. are insurance against the frequency or severity of some particular future occurrence.
   C. are nonstandard contracts between two parties to deliver and pay for an asset in the future.
   D. are standardized contract guaranteed by organized exchanges to deliver and pay for an asset in the future.
   E. Answers C and D only.

85. Which of the following are contracts that give the holder the right, but not the obligation, to buy or sell an underlying asset at a prespecified price for a specified time period?
   A. Options.
   B. Futures.
   C. Forwards.
   D. Swaps.
   E. All of the above.

86. Which of the following is true of the delta of an option?
   A. It lies between 0 and 0.5.
   B. It is always negative.
   C. It lies between 0 and 1.
   D. It is greater than 1.
   E. It is always equal to 1.

87. If an option's price increases 1.4 percent for every 2 percent change in the price of the underlying security, what is the value of the option's delta?
   A. 0.60.
   B. 1.40.
   C. 0.70.
   D. 2.00.
   E. 3.00.

88. The delta of an option is
   A. a measure of the option's price volatility.
   B. calculated by dividing the price of the underlying security by the change in the option's price.
   C. equal to the option premium.
   D. calculated by multiplying the change in the price of the underlying security by the change in the option's price.
   E. usually negative.

89. Which of the following is an out-of-the-money counterparty?
   A. Counterparty in a loan commitment contract.
   B. FI that trades in securities prior to their actual issue.
   C. Counterparty that is currently at an advantage in terms of cash flows.
   D. FI that guarantees to underwrite the performance of the buyer of the guaranty.
   E. Counterparty that is currently at a disadvantage in terms of cash flows.

90. In the early 1980s
    A. banks increased their off-balance-sheet activities to avoid regulatory costs.
    B. banks decreased their off-balance-sheet activities to avoid regulatory taxes.
    C. banks decreased their off-balance-sheet activities to avoid competition from nonbank banks.
    D. banks increased their off-balance-sheet activities to avoid competition from nonbank banks.
    E. banks increased their off-balance-sheet activities to avoid interest rate risk exposure.

91. Why is the default risk much more serious for forward contracts than for futures contracts?
    A. Because forward contracts are nonstandard contracts.
    B. Forward contracts are entered into bilaterally by negotiating parties.
    C. For forwards, all cash flows are required to be paid at one time on contract maturity.
    D. Forwards are essentially OTC arrangements with no external guarantees in case of default.
    E. All of the above.

92. Which of the following is a non-schedule L off-balance-sheet risk?
    A. Settlement risk.
    B. Takedown risk.
    C. Aggregate funding risk.
    D. When-issued trading.
    E. Credit risk with derivative securities.

93. Which of the following observations is NOT true?
    A. The settlement risk that an FI is exposed to within-day appears on its balance sheet.
    B. Settlement Risk is a form of OBS risk that FIs participating on private wholesale wire transfer system networks face.
    C. A holding company is a corporation that owns more than 25 percent of the shares of other corporations.
    D. Failure of an affiliated firm or bank imposes affiliate risk on another bank in a holding company structure in a number of ways.
    E. Investors do not distinguish between the failing corporation and its surviving affiliate because of name similarity.

A $200 million loan commitment has an up-front fee of 20 basis points and a back-end fee of 25 basis points on the unused portion.

94. The up-front fee is
    A. $250,000.
    B. $4,000,000.
    C. $400,000.
    D. $775,000.
    E. $375,000.

95. If 50 percent of the commitment is taken down, the back-end fee is
    A. $250,000.
    B. $4,000,000.
    C. $400,000.
    D. $775,000.
    E. $375,000.

96. If 25 percent of the commitment is taken down, the total fees are
    A. $250,000.
    B. $4,000,000.
    C. $400,000.
    D. $775,000.
    E. $375,000.

An FI has assets of $800 million and liabilities of $740 million.

97. What is the balance sheet capital?
  A. -$60 million.
  B. $60 million.
  C. $740 million.
  D. $800 million.
  E. This question cannot be answered without information about off-balance sheet assets and liabilities.

98. If the FI bought call options on bonds with a face value of $50 million, what is the minimum amount of the stockholder's true net worth?
  A. $10 million.
  B. $70 million.
  C. $110 million.
  D. $790 million.
  E. $850 million.

99. If the FI had contingent assets of $40 million and contingent liabilities of $160 million, calculate the stockholder's true net worth.
  A. -$60 million.
  B. $60 million.
  C. $70 million.
  D. -$160 million.
  E. $190 million.

Sun Bank has issued a one-year $5 million loan commitment to a customer for an up-front fee of 15 basis points and at a fixed rate of 12 percent. The back-end fee for non-usage of the commitment is 5 basis points. The bank requires a 10 percent compensating balance in demand deposits. Reserve requirements on demand deposits are 10 percent.

100. What is expected return on the loan to the bank if 50 percent of the loan is drawn? Do not take future values of fee or interest income received.
  A. 13.45 percent.
  B. 13.57 percent.
  C. 13.60 percent.
  D. 13.72 percent.
  E. 13.90 percent.

101. What is the expected return on the loan at the end of the year if 50 percent of the loan is drawn? Estimate using future values of fee and interest income received, that is, return is defined as all fee and interest income earned at year-end as a percentage of funds used. Assume the cost of funds to the bank is 8 percent.
  A. 13.45 percent.
  B. 13.57 percent.
  C. 13.60 percent.
  D. 13.72 percent.
  E. 13.90 percent.

102. What is the expected return on the loan to the bank if 50 percent of the loan is drawn and there are no reserve requirements on demand deposits? Do not take future values of fees or interest income received.
  A. 13.45 percent.
  B. 13.57 percent.
  C. 13.60 percent.
  D. 13.72 percent.
  E. 13.90 percent.

103. What is the expected return on the loan to the bank if 50 percent of the loan is drawn using discounted cash flows? That is, the return has to be estimated at the beginning of the loan period using present values. Assume there are reserve requirements of 10 percent on demand deposits.
A. 12.00 percent.
B. 12.26 percent.
C. 12.59 percent.
D. 13.01 percent.
E. 13.26 percent.

104. Assume 50 percent of the loan is drawn and that there are reserve requirements of 10 percent on demand deposits. What should the bank charge as back-end fees if they require an expected return of 13.63 percent? Do not take future values of fees or interest income received.
A. 5 basis points.
B. 10 basis points.
C. 15 basis points.
D. 20 basis points.
E. 25 basis points.

A corporation is planning to issue $10 million worth of 180-day commercial paper. In order to reduce the interest rates by 25 basis points (per annum), it plans to back this issue with a standby letter of credit or a loan commitment. The standby letter of credit is available for 20 basis points to be paid up-front. The loan commitment for $10 million is available for an up-front fee of 15 basis points and a 5 basis points back-end fee.

105. What are the savings to the corporation if it obtains a standby letter of credit to back its $10 million issue of commercial paper?
A. $1,250.
B. $2,500.
C. $3,750.
D. $5,000.
E. $6,250.

106. What are the savings to the corporation if it obtains a loan commitment to back its $10 million issue of commercial paper?
A. $1,250.
B. $2,500.
C. $3,750.
D. $5,000.
E. $6,250

107. Which method is preferable, between the loan commitment and the standby letter of credit?
A. The loan commitment is preferable because the savings are greater.
B. The standby letter of credit is preferable because the savings are greater.
C. The loan commitment is preferable it has a lower risk of default.
D. The standby letter of credit is preferable because it has a lower risk of default.
E. The loan commitment is preferable because the back-end fee is payable at the end of the year.

ch13 Key

1. TRUE

2. TRUE

3. TRUE

4. FALSE

5. TRUE

6. TRUE

7. FALSE

8. FALSE

9. FALSE

10. TRUE

11. FALSE

12. FALSE

13. FALSE

14. FALSE

15. TRUE

16. TRUE

17. FALSE

18. FALSE

19. FALSE

20. TRUE

21. FALSE

22. TRUE

23. TRUE

24. TRUE

25. TRUE

26. FALSE

27. TRUE

28. FALSE

29. FALSE

30. FALSE

31. TRUE

32. TRUE

33. TRUE

34. TRUE

35. TRUE

36. FALSE

37. TRUE

38. FALSE

39. FALSE

40. FALSE

41. FALSE

42. TRUE

43. TRUE

44. FALSE

45. TRUE

46. FALSE

47. FALSE

48. TRUE

49. FALSE

50. FALSE

51. TRUE

52. TRUE

53. TRUE

54. TRUE

55. C

56. B

57. C

58. D

59. E

60. B

61. A

62. D

63. D

64. C

65. E

66. A

67. A

68. D

69. B

70. B

71. B

72. C

73. B

74. D

75. C

76. B

77. B

78. E

79. C

80. C

81. A

82. B

83. E

84. B

85. A

86. C

87. C

88. A

89. E

90. A

91. E

92. A

93. A

94. C

95. A

96. D

97. B

98. C

99. A

100. B

101. C

102. D

103. C

104. B

105. B

106. B

107. E

ch13 Summary

Category	*# of Questions*
Saunders - Chapter 13	111