***Financial Markets and Institutions, 7e* (Saunders)**

**Chapter 21 Managing Liquidity Risk on the Balance Sheet**

1) If a bank meets a net deposit drain by borrowing money in the Fed funds market, it is using purchased liquidity.

Answer: TRUE

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

2) A corporation informs the bank that it will immediately draw down the maximum amount on its credit line. This is an example of liability side risk.

Answer: FALSE

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

3) If a bank's brokered deposits increase $3 million and their savings accounts decrease $1 million, then core deposits decreased.

Answer: TRUE

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-01 Identify the causes of liquidity risk.

Accessibility: Keyboard Navigation

4) A bank's financing gap is calculated as average loans minus average deposits plus liquid assets.

Answer: FALSE

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

5) Repos and Fed funds borrowed are examples of stored liquidity.

Answer: FALSE

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

6) When money market interest rates are higher than deposit rates, using purchased liquidity to replace deposit drains can reduce a bank's profit margin.

Answer: TRUE

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

7) Using stored liquidity to offset a deposit drain will reduce the size of the bank, but using purchased liquidity to offset the drain will not.

Answer: TRUE

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

8) Property and casualty insurers have a greater need for liquidity than life insurers.

Answer: TRUE

Difficulty: 2 Medium

Topic: Liquidity Risk and Insurance Companies

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-06 Consider the extent to which insurance companies are exposed to liquidity risk.

Accessibility: Keyboard Navigation

9) Relying on purchased liquidity is more risky than relying on stored liquidity.

Answer: TRUE

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

10) Closed-end mutual funds have less need to maintain liquid asset holdings than open-end mutual funds.

Answer: TRUE

Difficulty: 2 Medium

Topic: Liquidity Risk and Investment Funds

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-07 Clarify the extent to which investment funds are exposed to liquidity risk.

Accessibility: Keyboard Navigation

11) The financing gap is defined as average core deposits minus average borrowed funds.

Answer: FALSE

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

12) The greater the discount required to sell assets quickly, the higher the value of the bank's liquidity index.

Answer: FALSE

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

13) The fear that liquidity problems at one bank may cause depositors to worry about the solvency of other banks is called the disease effect.

Answer: FALSE

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

14) Stored liquidity management occurs when a DI uses its reserves held at the Federal Reserve to meet the net deposit drain.

Answer: TRUE

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

15) A DI has highly liquid assets if there is a large price difference between immediate fire-sale asset prices and fair market prices of assets.

Answer: FALSE

Difficulty: 1 Easy

Topic: Measuring a DIs Liquidity Exposure

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

16) A widely accepted method measuring liquidity risk exposure of a DI is core deposits over total assets ratio.

Answer: FALSE

Difficulty: 2 Medium

Topic: Measuring a DIs Liquidity Exposure

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

17) Liquidity planning is the only viable method that eliminates liquidity risk from DIs that currently exists.

Answer: FALSE

Difficulty: 1 Easy

Topic: Liquidity Planning

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-04 Examine the components of a liquidity plan.

Accessibility: Keyboard Navigation

18) Contagion effect occurs when a failure of one DI leads to concerns among depositors about the solvency risk of the other DIs.

Answer: TRUE

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

19) Life insurers and property and casualty insurers have federal guarantee programs similar to DIs deposit insurance.

Answer: FALSE

Difficulty: 2 Medium

Topic: Liquidity Risk and Insurance Companies

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-06 Consider the extent to which insurance companies are exposed to liquidity risk.

Accessibility: Keyboard Navigation

20) When investment funds experience dramatic liquidity needs, the liquidated assets are distributed to fund's shareholders on first-come, first-served basis.

Answer: FALSE

Difficulty: 2 Medium

Topic: Liquidity Risk and Investment Funds

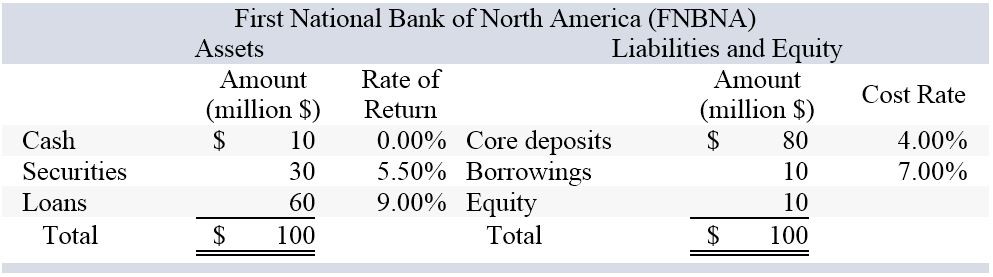
Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-07 Clarify the extent to which investment funds are exposed to liquidity risk.

Accessibility: Keyboard Navigation

21)



If FNBNA is expecting a $10 million net deposit drain and the securities liquidity index is 0.97, by how much will pretax net income change if the drain is funded entirely through securities sales?

A) −$306,122

B) −$150,000

C) −$375,339

D) −$476,289

E) −$474,490

Answer: D

Explanation: Liquidate securities totaling 10m/0.97 = 10,309,278, lose interest income = 5.5% × 10,309,278 = 567,010, lose $309,278 on the fire sale. This is offset by the decrease in interest expense of 4% × 10 million core deposits = 400,000. The e total net loss is $476,289.

Difficulty: 3 Hard

Topic: Liquidity Risk and Depository Institutions

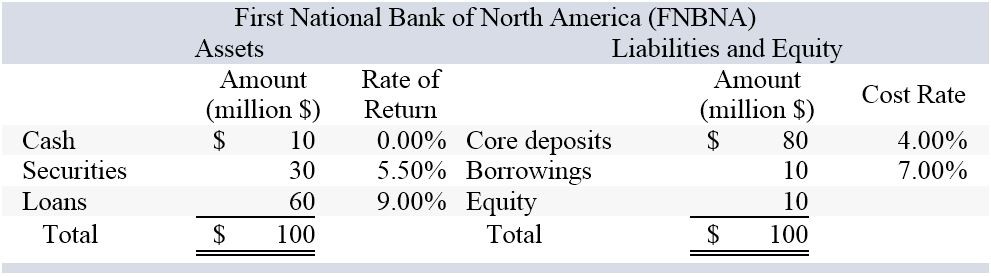
Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.; 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

22)



If FNBNA is expecting a $15 million net deposit drain and the securities liquidity index is 0.98, how many securities would have to be liquidated if the bank used only its securities to fund the expected deposit drain?

A) $15,000,000

B) $16,444,331

C) $15,600,000

D) $15,306,122

E) $16,772,345

Answer: D

Explanation: 15 million/0.98 = $15,306,122

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

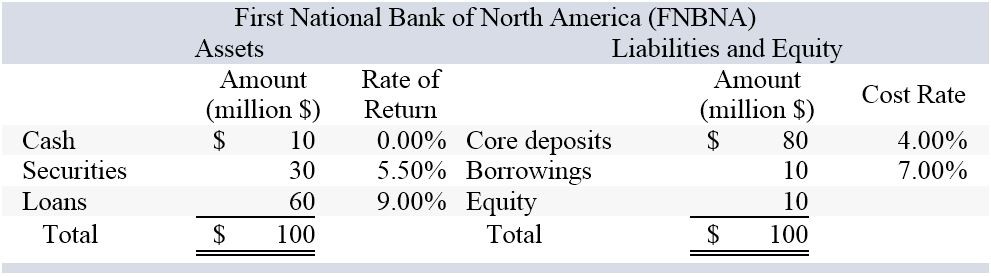
Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

23)



If FNBNA is expecting a $20 million net deposit drain and the bank wishes to fund the drain by borrowing more money, how much will pretax net income change if the borrowing cost is the same as on its existing borrowed funds?

A) $600,000

B) −$312,000

C) −$2,000,000

D) −$600,000

E) $312,000

Answer: D

Explanation: 20 million × (4% − 7%) = −$600,000

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

24) Which one of the following situations creates the most liquidity risk?

A) Long-term assets funded by long-term liabilities

B) Short-term assets funded by short-term liabilities

C) Long-term assets funded by short-term liabilities

D) Short-term assets funded by long-term liabilities

E) Long-term liabilities funded by short-term assets

Answer: C

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

25) Which of the following results in a net liquidity drain?

A) Demand deposits increase $100; loans increase $50.

B) Demand deposits decrease $100; loan repayments are $150.

C) Repurchase agreements increase $100; demand deposits decrease $50.

D) Reverse repurchase agreements increase $50; demand deposits decrease $50.

E) None of these choices are correct.

Answer: D

Difficulty: 3 Hard

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

26) A bank meets a deposit withdrawal with one of the following alternatives. Which one of the following is an example of using stored liquidity to meet a deposit withdrawal?

A) Increasing Eurodollar deposits

B) Contacting an investment banker to find new corporate deposits

C) Increasing Fed funds borrowed

D) Issuance of a negotiable CD

E) Selling the bank's holdings of T-bills

Answer: E

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

27)

|  |  |  |  |
| --- | --- | --- | --- |
| Second National Bank (SNB) (million $) | | | |
| Funds borrowed | $ | 6,500 |  | |
| Maximum amount SNB can still borrow | $ | 8,500 |  | |
| Cash-type assets | $ | 3,700 |  | |
| Excess cash reserves | $ | 80 |  | |
| Federal Reserve borrowings | $ | 20 |  | |

What are Second National Bank's total sources of liquidity?

A) $6,520

B) $13,500

C) $14,200

D) $12,280

E) $5,760

Answer: D

Explanation: Cash assets + Max can borrow + Excess cash = 3,700 + 8,500 + 80 = $12,280

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

28)

|  |  |  |  |
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| Excess cash reserves | $ | 80 |  | |
| Federal Reserve borrowings | $ | 20 |  | |

What are Second National Bank's total uses of liquidity?

A) $6,520

B) $13,500

C) $14,200

D) $12,280

E) $5,760

Answer: A

Explanation: Funds borrowed + Fed borrowing = 6,500 + 20 = $6,520

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

29)

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| Excess cash reserves | $ | 80 |  | |
| Federal Reserve borrowings | $ | 20 |  | |

What is Second National Bank's total net liquidity?

A) $6,520

B) $13,500

C) $14,200

D) $12,280

E) $5,760

Answer: E

Explanation: Sources − Uses = 3,700 + 8,500 + 80 − (6,500 + 20) = $5,760

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

30) If a bank relies solely on purchased liquidity, the bank will likely

A) maintain large amounts of liquid assets.

B) fund its loan commitments with asset sales.

C) be required to borrow money at short notice.

D) be required to raise equity capital quickly.

E) be forced to liquidate liabilities at fire-sale prices.

Answer: C

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

31) Which one of the following is a source of liquidity risk for a bank?

A) Predicted increase in net deposit drain before Christmas

B) Maturation of notes payable

C) Corporation calling in a bond the bank is holding

D) A natural disaster in the bank's community

E) None of these choices are correct.

Answer: D

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

32) Bank A has a loan-to-deposit ratio of 110 percent, core deposits equal 55 percent of total assets, and borrowed funds are 25 percent of assets. Bank B has a loan-to-deposit ratio of 80 percent. Core deposits are 65 percent of assets and borrowed funds are 5 percent of assets. Which bank has more liquidity risk? Ceteris paribus, which bank will probably be more profitable when interest rates are low?

A) Bank A; Bank A

B) Bank A; Bank B

C) Bank B; Bank A

D) Bank B; Bank B

E) You can't tell.

Answer: A

Difficulty: 3 Hard

Topic: Liquidity Risk and Depository Institutions

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.; 21-01 Identify the causes of liquidity risk.

Accessibility: Keyboard Navigation

33) Core deposits include all but which of the following?

A) Retail demand deposits

B) NOW accounts

C) MMDAs

D) Savings accounts

E) Negotiable CDs

Answer: E

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-01 Identify the causes of liquidity risk.

Accessibility: Keyboard Navigation

34) BIS' Basel Committee on Banking Supervision provides regulatory standards for liquidity risk supervision. Which of the following are among the new ratios required to be maintained by large DIs?

I. Liquidity coverage ratio

II. Net stable funds ratio

III. Financing gap over total asset ratio

IV. Core deposits over financing gap ratio

A) I only

B) II and III

C) I and II only

D) II and III only

E) I, II, III, and IV

Answer: C

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

35) A financial intermediary has two assets in its investment portfolio. It has 35 percent of its security portfolio invested in one-month Treasury bills and 65 percent in real estate loans. If it liquidated the bills today, the bank would receive $98 per hundred of face value. If the real estate loans were sold today, they would be worth $85 per 100 of face value. In one month, the real estate loans could be liquidated at $94 per 100 of face value. What is the intermediary's one-month liquidity index?

A) 0.93

B) 0.92

C) 0.91

D) 0.90

E) 0.89

Answer: A

Explanation: [(0.35 × 0.98) + (0.65 × 0.85)]/[(0.35 × 1.00) + (0.65 × 0.94)] = 0.93

Difficulty: 3 Hard

Topic: Liquidity Risk and Depository Institutions

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

36) When calculating the liquidity index, the larger the discount from fair value, the \_\_\_\_\_\_\_\_ the liquidity index; and the \_\_\_\_\_\_\_\_ the liquidity risk the FI faces.

A) larger; greater

B) smaller; greater

C) larger; lower

D) smaller; lower

Answer: B

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

37) An increasingly positive financing gap can indicate \_\_\_\_\_\_\_\_ liquidity risk because it may indicate \_\_\_\_\_\_\_\_ deposits and/or rising loan commitments.

A) increasing; increasing

B) decreasing; decreasing

C) increasing; decreasing

D) decreasing; increasing

Answer: C

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

38) Insurance industry guarantee funds do not eliminate runs on insurers because

I. the funds are not backed by the federal government.

II. the funds lack permanent reserves to back policies.

III. the size of the required contributions differs widely from state to state.

A) I only

B) II only

C) III only

D) I and III only

E) I, II, and III

Answer: E

Difficulty: 2 Medium

Topic: Liquidity Risk and Insurance Companies

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-06 Consider the extent to which insurance companies are exposed to liquidity risk.

Accessibility: Keyboard Navigation

39) A married couple each has an IRA and deposits at a bank. The couple also has one child. If they had the money, what is the total amount of their accounts that could be insured at one bank?

A) $250,000

B) $750,000

C) $1,250,000

D) $1,500,000

E) $2,000,000

Answer: D

Explanation: $750,000 for a couple (two separate accounts and one joint account), $250,000 child's account held in trust by parents, and $250,000 for each IRA for a total of $1,500,000.

Difficulty: 3 Hard

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand; Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

40) Which of the following can create liquidity risk for a life insurer?

I. Unexpectedly high number of policy surrenders

II. Unexpectedly low number of new policies sold

III. Unexpectedly high insurance claims filed by policyholders

A) I only

B) II only

C) I and II only

D) II and III only

E) I, II, and III

Answer: E

Difficulty: 1 Easy

Topic: Liquidity Risk and Insurance Companies

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-06 Consider the extent to which insurance companies are exposed to liquidity risk.

Accessibility: Keyboard Navigation

41) Runs on insurance firms are more likely to occur than runs on banks even in states with guaranty funds for insurers because these funds generally

A) lack a permanent reserve fund.

B) do not repay insurance policyholders immediately.

C) lack federal government backing.

D) All of these choices are correct.

E) None of these choices are correct.

Answer: D

Difficulty: 1 Easy

Topic: Liquidity Risk and Insurance Companies

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-06 Consider the extent to which insurance companies are exposed to liquidity risk.

Accessibility: Keyboard Navigation

42) The two main reasons why runs on U.S. banks no longer occur are

A) reserve requirements and higher bank liquidity ratios.

B) a required positive financing gap and bank use of purchased liquidity.

C) the FDIC and the discount window.

D) insurance funds operated by individual states and tighter bank regulations.

E) None of these choices are correct.

Answer: C

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

43) In the absence of deposit insurance, a deposit is a \_\_\_\_\_\_\_\_ to the bank's assets.

A) pro rata claim

B) first-come/first-serve claim

C) full pay or no pay claim

D) pro rata claim and first come/first serve claim

E) first come/first serve claim and full pay or no pay claim

Answer: E

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

44) How does reliance on purchased liquidity rather than core deposits affect a bank?

I. Increases the risk of a liquidity crisis

II. Allows the bank to adjust to deposit drains without affecting bank size

III. Increases overall interest sensitivity of the bank's profits to interest rates

A) I only

B) II only

C) I and II only

D) II and III only

E) I, II, and III

Answer: E

Difficulty: 3 Hard

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

45) Which of the following statements, if any, is (are) true?

I. Mutual funds never have runs.

II. Funds invested with insurers are as safe as deposits at a bank.

III. Pension funds generally have less liquidity risk than banks.

A) All three are true.

B) Only I is true.

C) Only II and III are true.

D) Only III is true.

E) None of these choices are correct.

Answer: D

Difficulty: 3 Hard

Topic: Liquidity Risk and Investment Funds

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-07 Clarify the extent to which investment funds are exposed to liquidity risk.

Accessibility: Keyboard Navigation

46) Discount window borrowing is available to

I. banks.

II. thrifts.

III. investment banks.

IV. nonfinancial corporations.

A) I and II only

B) I and III only

C) I, II, and III only

D) II, III, and IV only

E) I, II, III, and IV

Answer: C

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

47) The amount that a policyholder receives when he or she cashes in an insurance policy is called the

A) cash value.

B) surrender value.

C) face value.

D) policy value.

E) fair market value.

Answer: B

Difficulty: 1 Easy

Topic: Liquidity Risk and Insurance Companies

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-06 Consider the extent to which insurance companies are exposed to liquidity risk.

Accessibility: Keyboard Navigation

48) The greater the \_\_\_\_\_\_\_\_ ratio, the more liquid is the institution, ceteris paribus.

A) borrowed funds to total assets

B) core deposits to total assets

C) loans to deposits

D) unused commitments to lend to total assets

E) unused commitments to lend to liquid assets

Answer: B

Difficulty: 1 Easy

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-01 Identify the causes of liquidity risk.

Accessibility: Keyboard Navigation

49) The BIS guidelines for monitoring intraday liquidity risk at internationally active banks include which of the following:

I. Measure expected daily gross liquidity inflows and outflows, anticipate the intraday timing of these flows where possible, and forecast the range of potential net funding shortfalls that might arise at different points during the day.

II. Monitor intraday liquidity positions against expected activities and available resources.

III. Arrange to acquire sufficient intraday funding to meet intraday objectives.

IV. Have the ability to maintain a collateral-to-asset ratio above the minimum required by BIS.

A) I and II only

B) II and III only

C) I, II, and IV only

D) I, II, and III only

E) I, II, III, and IV

Answer: D

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

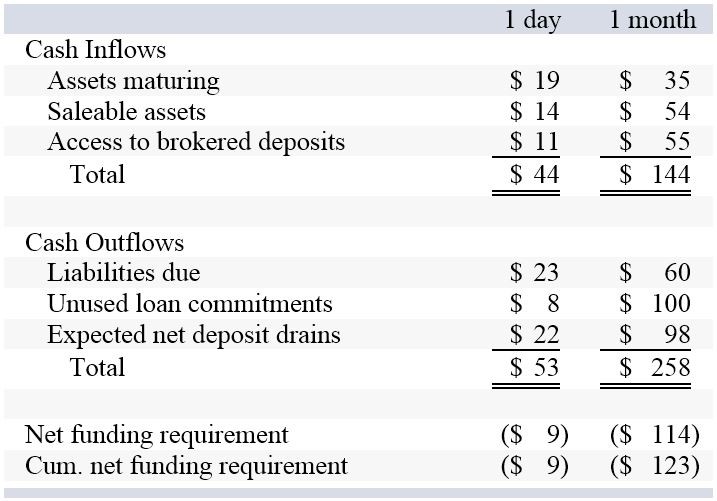
Accessibility: Keyboard Navigation

50) You have the following data for a bank (million $):

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | 1 day | | |  | | 1 month | | | |
| Liabilities due | $ | 23 |  | |  | | $ | 60 |  | |
| Assets maturing | $ | 19 |  | |  | | $ | 35 |  | |
| Saleable assets | $ | 14 |  | |  | | $ | 54 |  | |
| Unused loan commitments | $ | 8 |  | |  | | $ | 100 |  | |
| Access to brokered deposits | $ | 11 |  | |  | | $ | 55 |  | |
| Expected net deposit drains | $ | 12 |  | |  | | $ | 98 |  | |

Calculate the net funding requirement for each period and the cumulative net funding requirement over the month. What does the plan reveal?

Answer:



The liquidity plan indicates that the bank will need to obtain an additional $9 million in funding immediately and should plan on an additional $114 million over the next month.

Difficulty: 3 Hard

Topic: Liquidity Risk and Depository Institutions

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

51) Explain how liquidity risk can lead to insolvency risk.

Answer: If an FI has to sell non liquid assets to meet cash requirements, it may have to sell them at less than face value (indeed at less than market value) as a result of the need for a speedy sale. If the asset write-downs are large enough, equity value is reduced. Once equity is reduced to zero, the institution is insolvent.

Difficulty: 1 Easy

Topic: Causes of Liquidity Risk

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-01 Identify the causes of liquidity risk.

Accessibility: Keyboard Navigation

52) What are the major sources of liquidity risk for a bank? For a life insurer?

Answer: For a bank: Unanticipated net deposit drains; unanticipated loan demand; unanticipated exercise of loan commitments.

For an insurer: Unanticipated policy surrenders; unanticipated poor investment returns; and fewer new policies than expected.

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions; Liquidity Risk and Insurance Companies

Bloom's: Remember

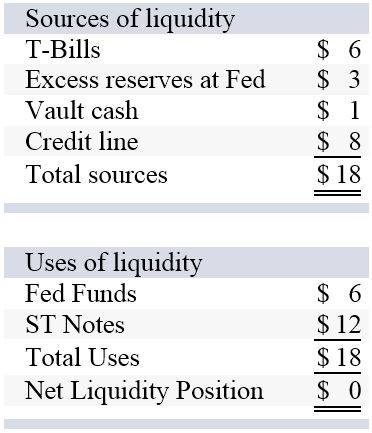
AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.; 21-06 Consider the extent to which insurance companies are exposed to liquidity risk.

Accessibility: Keyboard Navigation

53) A bank has $6 million in Treasury bills, $3 million in excess reserves at the Fed, $1 million in vault cash, and an $8 million line of credit on the repo market. The bank has borrowed $6 million in Fed funds and $12 million in short-term notes borrowed to finance loans. What is the net liquidity position of the bank and what can you conclude from it?

Answer:



The net liquidity position reveals it is zero. While the bank has all expected liquidity needs covered, it has no contingency funds and it should have a plan prepared detailing how additional funds can be raised at short notice if needed.

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

54) Explain the relationship between each of the following ratios and liquidity risk.

(a) Loan-to-deposit ratio

(b) Borrowed funds to total assets

(c) Loan commitments to total assets

Answer: (a) Loan-to-deposit ratio: The higher the ratio, the lower the amount of liquid assets to cover possible deposit withdrawals, and hence, liquidity risk is higher. (b) Borrowed funds to total assets: The higher the ratio, the more the bank is relying on the ability to purchase funds to raise money for loans, a relatively illiquid asset, and hence, liquidity risk is higher. (c) Loan commitments to total assets: The higher the ratio, the greater the possibility the bank will need additional liquidity in the near future, and this would require either additional liquid assets or borrowing capacity.

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.; 21-01 Identify the causes of liquidity risk.

Accessibility: Keyboard Navigation

55) Does a positive or a negative financing gap indicate greater liquidity risk? Explain.

Answer: A positive financing gap indicates that average loans are greater than average core deposits. This implies that stable deposit funds have been used to fund relatively illiquid asset loans resulting in greater liquidity risk. If the gap is negative, then some deposits have been used to fund liquid assets and there is less likelihood that the bank will need to purchase liquidity i.e., less liquidity risk.

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-03 Describe how depository institutions measure liquidity risk.

Accessibility: Keyboard Navigation

56) Describe the major components of a liquidity plan.

Answer: 1. Assign responsibility to manage liquidity to key personnel. 2. Construct a list of withdrawal patterns and fund providers that are most likely to withdraw funds. 3. Identify potential size of fund withdrawals over given time intervals and identify sources of funds. 4. Set internal limits on borrowing and bounds on rates paid in each market. 5. Design a plan for disposal of assets in a specified sequence if necessary to meet liquidity needs.

Difficulty: 2 Medium

Topic: Liquidity Planning

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-04 Examine the components of a liquidity plan.

Accessibility: Keyboard Navigation

57) We rarely see bank runs since the advent of Federal Deposit Insurance, but runs on life insurers and mutual funds do occur even though claimants have pro rata claims in the event of default. Why do these runs still occur?

Answer: Life insurers: State guarantee funds, if they exist, do not guarantee timely payment to policyholders. Rational policyholders would seek to cash out first (while they can still receive the full surrender value of the policy) rather than face an uncertain payout received at an uncertain time in the future.

Mutual funds: Runs on mutual funds do not occur because of fear of default. Runs occur in periods of falling asset values when MF investors seek to cash out prior to facing large losses on the value of their fund holdings. Redemptions can deplete the fund's cash reserves and force the fund to sell assets at depressed prices.

Difficulty: 3 Hard

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

58) What are the trade-offs involved between storing liquidity and purchasing liquidity as needed for a bank?

Answer: Storing liquidity is the conservative approach. It requires maintaining substantial stocks of cash and near-cash assets that earn zero or low rates of return. Carrying costs will be high and are likely to constitute a drag on profitability and ROE. If the bank relies on its ability to purchase liquidity as needed, it may improve profitability since fewer low-earning assets need to be held, but the bank will probably face greater variability in funds costs. Purchased funds tend to be interest-sensitive and the bank that uses them will face greater costs in higher interest rate environments. Moreover, a bank relying on purchased funds faces higher risk in abnormal conditions when the bank's ability to acquire reasonable cost borrowings at short notice may be impaired due to poor bank or market conditions.

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-02 Define the two methods financial institutions use to manage liquidity risk.

Accessibility: Keyboard Navigation

59) Why might a bank face abnormal deposit drains?

Answer: If depositors believe the bank is facing insolvency, large depositors with amounts over the insurance limits are likely to withdraw their funds from the bank. Similarly, the failure of a related bank, perhaps another bank in the holding company or simply another bank with related business, may cause fears of a bank failure resulting in deposit withdrawals. Changes in rates of return between bank deposits and competing nonbank accounts can cause interest-sensitive bank customers to withdraw their funds from banks.

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

Accessibility: Keyboard Navigation

60) The Fed now operates the discount window differently than it used to. What are the major changes?

Answer: The Fed used to keep the discount rate below the target Fed funds rate and give limited access to the discount window for emergency lending to institutions that could not find private credit sources. The Fed changed this policy several years ago. All sound member institutions can borrow from the discount window through its primary credit program. The discount rate is normally kept above the FOMC target Fed funds rate. Secondary credit is available for troubled institutions at a rate of 50 basis points above the primary credit rate. A longer-term seasonal lending program is also available for banks that can demonstrate seasonal funding needs. More recently, to help in the subprime crisis, the Fed has extended discount window borrowing to nonbanks and expanded the acceptable collateral on these loans.

Difficulty: 2 Medium

Topic: Liquidity Risk and Depository Institutions

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 21-05 Explain why abnormal deposit drains occur.

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