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

**Chapter 12 Commercial Banks' Financial Statements and Analysis**

1) A wholesale bank is one that focuses its business activities on commercial banking relationships.

Answer: TRUE

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

2) Composite rating 5 is the rating for the soundest financial institutions.

Answer: FALSE

Difficulty: 2 Medium

Topic: Why Evaluate the Performance of Commercial Banks? Chapter Overview

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

3) Banks have higher leverage than most manufacturing firms.

Answer: TRUE

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

4) Loans to consumers and to individuals are jointly termed C&I loans on a bank's balance sheet.

Answer: FALSE

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

5) MMDAs are a type of savings account that has some limited checking features. These accounts were designed to help banks compete with MMMFs.

Answer: TRUE

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

6) C&I loans are loans to businesses used to finance capital needs, equipment purchases, and plant expansions.

Answer: TRUE

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

7) The provision for loan loss account is actual loan losses less loan recoveries in a given time period.

Answer: FALSE

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-04 Describe the major categories on a commercial banks income statement.

Accessibility: Keyboard Navigation

8) The allowance for loan and lease losses is bank management's estimate of the amount of gross loans and leases that will not be repaid to the bank.

Answer: TRUE

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-04 Describe the major categories on a commercial banks income statement.

Accessibility: Keyboard Navigation

9) In ratio analysis, the profit margin times the asset utilization ratio equals return on assets.

Answer: TRUE

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

10) Loans are the major asset on a bank's balance sheet, and they generate the largest amount of revenue.

Answer: TRUE

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

11) Both retail and wholesale CDs are negotiable instruments despite their different denominations.

Answer: FALSE

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

12) Banks generally pay higher interest rates on NOW accounts than on MMDAs.

Answer: FALSE

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

13) Wholesale CDs obtained from an investment house rather than directly from a customer are referred to as brokered deposits.

Answer: TRUE

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

14) At almost all banks noninterest expense is greater than noninterest income; hence, the overhead efficiency ratio is usually greater than 100 percent.

Answer: FALSE

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

15) Rate-sensitive funding sources at a bank are termed core deposits.

Answer: FALSE

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

16) Core deposits are deposits that are

A) at the bank solely for the interest rate earned.

B) very stable funds sources.

C) typically for larger denominations than hot money sources.

D) very frequently turned over.

Answer: B

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

17) A construction firm cannot obtain the necessary permits to begin building a shopping mall until it can show it either has or will have the necessary funding to complete the project. The firm may ask a bank for which of the following to allow it to obtain the permits?

I. Commercial letter of credit

II. Loan commitment

III. Credit line

IV. Repurchase agreement

A) I or II

B) II or III

C) II or IV

D) III or IV

E) I or IV

Answer: B

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 12-03 Identify off-balance-sheet activities that commercial banks undertake.

Accessibility: Keyboard Navigation

18) Which one of the following is the definition of the NIM?

A) (Net interest income − Net noninterest income)/Earning assets

B) Net interest income/Interest-bearing liabilities

C) (Interest income − Interest expense)/Earning assets

D) (Interest income − Interest expense)/Interest-bearing liabilities

E) (Interest income/Earning assets) − (Interest expense/Interest-bearing liabilities)

Answer: C

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

19) Uniform principles, standards, and report forms for depository institutions are prescribed by the

A) FDIC.

B) Federal Reserve.

C) Federal Financial Institutions Examination Council.

D) Office of Comptroller of Currency.

Answer: C

Difficulty: 2 Medium

Topic: Why Evaluate the Performance of Commercial Banks? Chapter Overview

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

20) Bank A has a higher ROA than Bank B. Both banks have similar interest income to asset ratios and noninterest income to asset ratios. We know that

I. Bank A has a higher profit margin than Bank B.

II. Bank A has a higher AU ratio than Bank B.

III. Bank A must have a higher PLL/OI ratio.

A) I only

B) II only

C) I and II only

D) III only

E) I, II, and III

Answer: A

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

21) Fernando Bank has interest expense of $150 million, earning assets of $1,400 million and a NIM of 5.00 percent. The bank also has interest-bearing liabilities of $1,100 million. Fernando Bank's spread is

A) 1.10 percent.

B) 1.65 percent.

C) 1.94 percent.

D) 2.08 percent.

E) 2.16 percent.

Answer: D

Explanation: [(0.05 × 1,400) + 150]/1,400 − (150/1,100) = 2.08%

Difficulty: 3 Hard

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

22) Cash in the process of collection is

A) a deposit at another financial institution.

B) a Fed funds transaction.

C) checks the bank owes other institutions that have not yet been paid.

D) checks that the bank is owed but has not yet collected.

E) equity capital.

Answer: D

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

23) Blue Ridge Bank has a PM of 12 percent, an interest income to total assets ratio of 6.00 percent, and a noninterest income to assets ratio of 1.50 percent. Blue Ridge also has $9 in assets per dollar in equity capital. Blue Ridge's ROE is

A) 7.50 percent.

B) 9.00 percent.

C) 8.10 percent.

D) 6.48 percent.

E) 5.75 percent.

Answer: C

Explanation: 0.12 × (0.06 + 0.0150) × 9 = 8.10%

Difficulty: 3 Hard

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

24) Interest-bearing retail accounts with limited checking features designed to compete with money market mutual fund investments are called \_\_\_\_\_\_\_\_.

A) NOWs

B) retail CDs

C) MMDAs

D) special savings deposits

E) negotiable CDs

Answer: C

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

25) Oceanside Bank converts a dollar of equity into 10 cents of net income and has $9.50 in assets per dollar of equity capital. Oceanside also has a profit margin of 15 percent. What is Oceanside's AU ratio?

A) 1.05 percent

B) 3.55 percent

C) 5.56 percent

D) 6.45 percent

E) 7.02 percent

Answer: E

Explanation: (0.10/9.5)/0.15 = 7.02%

Difficulty: 3 Hard

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

26) Purchased funds include all but which one of the following?

A) Brokered deposits

B) Wholesale CDs

C) Fed funds purchased

D) Repurchase agreements

E) Demand deposits

Answer: E

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.; 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

27) Core deposits typically include all except which one of the following?

A) Demand deposits

B) NOW accounts

C) MMDAs

D) Eurodollar deposits

E) Passbook savings accounts

Answer: D

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

28) A bank has interest income to total assets ratio of 5.45 percent and has noninterest income of $45 million and total assets of $700 million. What is the bank's asset utilization ratio?

A) 5.45 percent

B) 6.43 percent

C) 9.67 percent

D) 15.02 percent

E) 11.88 percent

Answer: E

Explanation: 0.0545 + (45 million / 700 million) = 11.88%

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

29) The lower the interest expense ratio, the provision for loan loss ratio, the noninterest expense ratio, and the tax ratio the \_\_\_\_\_\_\_\_ the \_\_\_\_\_\_\_\_.

A) lower; PM

B) higher; PM

C) lower; AU

D) higher; AU

E) lower; EM

Answer: B

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Understand; Analyze

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

30) Plains National Bank has interest income of $250 million and interest expense of $110 million, noninterest income of $40 million and noninterest expense of $65 million on earning assets of $3,900 million. What is Plains' overhead efficiency ratio?

A) 61.54 percent

B) 44.00 percent

C) 9.23 percent

D) 42.45 percent

E) 37.46 percent

Answer: A

Explanation: 40/65 = 61.54%

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

31) The largest source of income at a typical bank is

A) interest income on securities held for sale.

B) interest income on securities held for investment.

C) interest income on loans and leases.

D) noninterest income.

E) dividends or stock.

Answer: C

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-04 Describe the major categories on a commercial banks income statement.

Accessibility: Keyboard Navigation

32) A municipal bond is paying a 6 percent annual yield. An equivalent risk corporate bond is paying 7 percent. Investors with a tax rate of \_\_\_\_\_\_\_\_ or higher would prefer the municipal bond.

A) 65.13 percent

B) 14.28 percent

C) 25.00 percent

D) 80.75 percent

E) 25.75 percent

Answer: B

Explanation: 1 − (0.0600/0.0700) = 14.28%

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-04 Describe the major categories on a commercial banks income statement.

Accessibility: Keyboard Navigation

33) The First Bank of the Ozarks generates $0.0155 dollars of net income per dollar of assets and it has a profit margin of 12.25 percent. How much operating income per dollar of total assets does First Bank generate?

A) 12.50 percent

B) 12.65 percent

C) 12.75 percent

D) 12.85 percent

E) 12.95 percent

Answer: B

Explanation: 0.0155/0.1225 = 12.65%

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

34)

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| Bank A (Dollars in Millions) | | | | | | | |
| Assets | | |  | Liability and Equity | | | | |
| Cash | $ | 850 |  | Deposits | $ | 6,475 |  | | |
| Securities |  | 1,925 |  | Other Borrowing |  | 1,645 |  | | |
| Loans |  | 5,400 |  | Equity |  | 1,030 |  | | |
| Others |  | 975 |  | Total | $ | 9,150 |  | | |
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| --- | --- | --- | --- |
| Income Statement | | | |
| Interest income on loans | $ | 450 |  | |
| Interest income on securities |  | 95 |  | |
| Interest expense |  | 246 |  | |
| Noninterest income |  | 78 |  | |
| Nonincome expense |  | 112 |  | |
| Provision for loan loss |  | 35 |  | |
| Taxes |  | 115 |  | |
| NI | $ | 115 |  | |

The bank's ROA is

A) 1.31 percent.

B) 1.78 percent.

C) 1.26 percent.

D) 0.89 percent.

E) None of these choices are correct.

Answer: C

Explanation: 115/9,150 = 1.26%

Difficulty: 1 Easy

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

35)

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| --- | --- | --- | --- | --- | --- | --- | --- |
| Bank A (Dollars in Millions) | | | | | | | |
| Assets | | |  | Liability and Equity | | | | |
| Cash | $ | 850 |  | Deposits | $ | 6,475 |  | | |
| Securities |  | 1,925 |  | Other Borrowing |  | 1,645 |  | | |
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The bank's ROE is

A) 15.65 percent.

B) 13.21 percent.

C) 19.55 percent.

D) 11.17 percent.

E) 12.67 percent.

Answer: D

Explanation: 115/1,030 = 11.17%

Difficulty: 1 Easy

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

36)

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| NI | $ | 115 |  | |

The bank's profit margin is

A) 27.27 percent.

B) 23.08 percent.

C) 21.31 percent.

D) 18.46 percent.

E) None of these choices are correct.

Answer: D

Explanation: 115/(450 + 95 + 78) = 18.46%

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

37)

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| Nonincome expenses |  | 112 |  | |
| Provision for loan loss |  | 35 |  | |
| Taxes |  | 115 |  | |
| NI | $ | 115 |  | |

The bank's asset utilization ratio is

A) 58.04 percent.

B) 6.12 percent.

C) 5.46 percent.

D) 4.29 percent.

E) 6.81 percent.

Answer: E

Explanation: (450 + 95 + 78)/9,150 = 6.81%

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

38)

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| Others |  | 975 |  | Total | $ | 9,150 |  | | |
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If the average net interest margin for this type of bank is 4.65 percent, then, ceteris paribus, this particular bank is performing

A) the same as average because this bank has a NIM of 4.65 percent.

B) better than average because this bank has a NIM of 6.55 percent.

C) poorer than average because this bank has a NIM of 4.08 percent.

D) better than average because this bank has a NIM of 5.23 percent.

E) One can't determine with the information given.

Answer: C

Explanation: NIM = (450 + 95 − 246)/(1,925 + 5,400) = 4.08%

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply; Evaluate

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

39)

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| Nonincome expenses |  | 112 |  | |
| Provision for loan loss |  | 35 |  | |
| Taxes |  | 115 |  | |
| NI | $ | 115 |  | |

If the typical bank of this type has an overhead efficiency ratio of 0.65, then this particular bank \_\_\_\_\_\_\_\_ than the typical bank, ceteris paribus.

A) is doing a poorer job generating profitable off-balance-sheet activities

B) is doing a better job time managing noninterest income and expenses

C) is paying higher taxes

D) has fewer loan losses

E) None of these choices are correct.

Answer: B

Explanation: Overhead efficiency ratio = 78/112 = 69.64%

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply; Evaluate

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

40) If a bank has more purchased funds than the average bank, you would not be surprised to see a higher than average \_\_\_\_\_\_\_\_ ratio.

A) provision for loan loss

B) tax

C) noninterest expense

D) interest expense

E) None of these choices are correct.

Answer: D

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks; Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.; 12-05 Examine ratios that can be used to analyze a commercial bank.; 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

41) The AU ratio measures the bank's ability to \_\_\_\_\_\_\_\_ and the PM ratio measures the bank's ability to \_\_\_\_\_\_\_\_.

A) control expenses; generate income from assets

B) generate income from assets; control expenses

C) maximize interest revenue; minimize interest expense

D) control leverage; minimize physical plant

E) None of these choices are correct.

Answer: B

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

42) Investment securities plus \_\_\_\_\_\_\_\_ is equal to a bank's earning assets.

A) net loans and leases

B) gross loans and leases

C) property, plant, and equipment

D) securities held for trading

E) purchased accounts

Answer: A

Difficulty: 2 Medium

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

43) Net loans and leases plus \_\_\_\_\_\_\_\_ plus \_\_\_\_\_\_\_\_ equals gross loans and leases.

A) earned income; provision for loan and lease losses

B) unearned income; the allowance for loan and lease losses

C) net charge-offs; provision for loan and lease losses

D) provision for loan and lease losses; allowance for loan and lease losses

E) None of these choices are correct.

Answer: B

Difficulty: 3 Hard

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

44) The largest market available for purchased funds is the \_\_\_\_\_\_\_\_.

A) wholesale CD market

B) Eurodollar deposit market

C) banker's acceptances market

D) discount window purchases

E) Fed funds market

Answer: E

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.; 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

45) A(n) \_\_\_\_\_\_\_\_ is a contra asset account.

A) loan commitment

B) provision for loan and lease losses

C) allowance for loan and lease losses

D) net charge-off

Answer: C

Difficulty: 3 Hard

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

46) All but which one of the following is an example of noninterest income or noninterest expense?

A) Income from service charges on deposits

B) Income from trust services

C) Gains and losses from trading account assets

D) Earnings on securities held for investment

E) Salaries and benefits paid to employees

Answer: D

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-04 Describe the major categories on a commercial banks income statement.

Accessibility: Keyboard Navigation

47) Which of the following is not an off-balance sheet activity?

A) Commercial letter of credit

B) Standby letter of credit

C) Swap transaction

D) Futures contract

E) Consumer loans

Answer: E

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 12-03 Identify off-balance-sheet activities that commercial banks undertake.

Accessibility: Keyboard Navigation

48) A bank can raise capital by:

A) Offering long-term CDs

B) Issuing Stock

C) Retaining earnings

D) Both issuing stocks and offering long-term CDs

E) Both issuing stocks and retaining earnings

Answer: E

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

49) What is the largest operating expense for a bank?

A) Employee salaries

B) Interest paid on loans from Federal Reserve

C) Interest paid on deposits

D) Interest paid on loans borrowed from other banks

E) Employee benefits

Answer: C

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-04 Describe the major categories on a commercial banks income statement.

Accessibility: Keyboard Navigation

50) Which of the following assets are used to increase a bank's liquidity position?

A) Commercial loans

B) Treasury securities

C) Personal loans

D) Mortgage loans

E) Corporate bonds

Answer: B

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

51)

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Assets | Amount | | | Interest rate  of return | | | | | Liab. & Equity | | Amount | | | | Interest  Cost | | | | |
| Securities | $ | 475 |  | |  | 4.5 | % |  | | Liabilities | | $ | 1,175 |  | |  | 3.0 | % |  | |
| Loans |  | 725 |  | |  | 7.5 | % |  | | Equity | |  | 125 |  | |  |  |  |  | |
| Non-earning |  | 100 |  | |  | 0.0 | % |  | | Total | | $ | 1,300 |  | |  |  |  |  | |
| Total | $ | 1,300 |  | |  |  |  |  | |  | |  |  |  | |  |  |  |  | |

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| --- | --- | --- | --- | --- |
| *First National Bank* | | | | |
| *ROE* |  | *12* | *%* |  |
| *Tax rate* |  | *34* | *%* |  |
| *Noninterest Expense* | *$* | *30* |  |  |
| *PLL* | *$* | *3* |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| Industry Average | | | |
| NIM | 3.54 | % |  |
| Overhead Efficiency | 0.85 |  |  |
| Average Loan Rate (ALR) | 7.5 | % |  |

What is the bank's NIM? Is the bank performing better or worse than average? In what area is the bank performing better or worse than average? How could the bank improve if necessary?

NIM = (Interest revenue − Interest expense)/(Securities + Loans)

[(475 × .045) + (725 × .075) − (1,175 × .03)]/(475 + 725) = 3.383%

Answer: The bank is performing more poorly than the average bank in generating a large enough spread between interest income and interest expense. The bank may need to increase loan rates, shift to more profitable loans, or seek lower-cost deposits.

Difficulty: 3 Hard

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply; Evaluate; Create

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

52)

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Assets | Amount | | | Interest rate  of return | | | | | Liab. & Equity | | Amount | | | | Interest  Cost | | | | |
| Securities | $ | 475 |  | |  | 4.5 | % |  | | Liabilities | | $ | 1,175 |  | |  | 3.0 | % |  | |
| Loans |  | 725 |  | |  | 7.5 | % |  | | Equity | |  | 125 |  | |  |  |  |  | |
| Non-earning |  | 100 |  | |  | 0.0 | % |  | | Total | | $ | 1,300 |  | |  |  |  |  | |
| Total | $ | 1,300 |  | |  |  |  |  | |  | |  |  |  | |  |  |  |  | |

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| *First National Bank* | | | | |
| *ROE* |  | *12* | *%* |  |
| *Tax rate* |  | *34* | *%* |  |
| *Noninterest Expense* | *$* | *30* |  |  |
| *PLL* | *$* | *3* |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| Industry Average | | | |
| NIM | 3.54 | % |  |
| Overhead Efficiency | 0.85 |  |  |
| Average Loan Rate (ALR) | 7.5 | % |  |

What must net noninterest income (net of noninterest expense) be in order for FNB to have a 12 percent ROE? Based on your answer, must FNB be performing better or worse than the industry average in this area? Explain.

Answer: NI/Equity = 0.12; NI/$125 = 0.12, so required NI = $15.00

Interest Revenue = ($475 × 0.045) + ($725 × 0.075) = $75.75

Interest Expense = $1,175 × 0.03 = $35.25

NI = {Interest revenue − Interest expense + Net noninterest income − PLL} (1 − Tax rate)

$15.00 = {$75.75 − $35.25 + Net noninterest income − $3} × (1 − 0.34)

Net noninterest income must be = −$14.77 (millions)

Noninterest Expense = $30, so noninterest income must be $30 + (−$14.77) = $15.23

FNB Overhead Efficiency Ratio = $15.23/$30 = 0.5076, industry average = 0.85. Thus, FNB must be doing a poorer job of generating noninterest income while controlling noninterest expense than the industry average.

Difficulty: 3 Hard

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply; Evaluate

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

53)

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Assets | Amount | | | Interest rate  of return | | | | | Liab. & Equity | | Amount | | | | Interest  Cost | | | | |
| Securities | $ | 475 |  | |  | 4.5 | % |  | | Liabilities | | $ | 1,175 |  | |  | 3.0 | % |  | |
| Loans |  | 725 |  | |  | 7.5 | % |  | | Equity | |  | 125 |  | |  |  |  |  | |
| Non-earning |  | 100 |  | |  | 0.0 | % |  | | Total | | $ | 1,300 |  | |  |  |  |  | |
| Total | $ | 1,300 |  | |  |  |  |  | |  | |  |  |  | |  |  |  |  | |

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| --- | --- | --- | --- | --- |
| *First National Bank* | | | | |
| *ROE* |  | *12* | *%* |  |
| *Tax rate* |  | *34* | *%* |  |
| *Noninterest Expense* | *$* | *30* |  |  |
| *PLL* | *$* | *3* |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| Industry Average | | | |
| NIM | 3.54 | % |  |
| Overhead Efficiency | 0.85 |  |  |
| Average Loan Rate (ALR) | 7.5 | % |  |

If the net noninterest income were to increase to −$16, what would the average loan rate (ALR) have to be to generate a 12 percent ROE? Compared to the industry, does this ALR appear feasible? If not, what options does FNB have?

Answer: NI/Equity = 0.12; NI/$125 = 0.12 so NI = $15.00

NI = {Interest revenue - Interest expense + Net noninterest income − PLL} (1 − Tax rate)

$15 = [(475 × 0.045) + (725 × ALR) − (1,175 × 0.030) + − 16 − 3] x (1 − 0.34)

ALR = 7.67%

The required ALR is probably not feasible since the industry average is only 7.5 percent. FNB may attempt to shift toward more profitable loans but probably also needs to generate more noninterest income per dollar of noninterest expense. They need to either seek more profitable off-balance-sheet activities or reprice those activities. The managers should examine salary expense, as this is usually a major component of noninterest expense. FNB may also wish to consider increasing fees on checking, another large source of noninterest expense.

Difficulty: 3 Hard

Topic: Financial Statement Analysis Using a Return on Equity Framework

Bloom's: Analyze; Apply; Evaluate; Create

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-05 Examine ratios that can be used to analyze a commercial bank.

Accessibility: Keyboard Navigation

54) What are the major sources of purchased funds? Can using purchased funds change a bank's profitability? Its risk level? Explain.

Answer: The major sources of purchased funds are brokered deposits, wholesale CDs, deposits at foreign offices, Fed funds purchased, RPs, and subordinated notes and debentures. These funds sources tend to be more expensive than core deposits and more volatile. However, if a bank can count on obtaining these funds when needed, the bank can hold fewer low-earning liquid securities and increase the percentage of loans on the balance sheet. Hence, using purchased funds can increase profitability, but usually at the expense of increasing the interest sensitivity of profits and increasing the probability of liquidity problems if the purchased funds become unavailable due to bank or market problems.

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Remember; Understand

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.; 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

55) What is the difference between net charge-offs (NCOs, sometimes called write-offs) and the provision for loan loss (PLL)? What is the purpose of the PLL account?

Answer: The PLL account is forward looking; it is management's estimate of the loans that will default in the upcoming period. NCOs are records of actual loans that defaulted. The PLL is used to reduce current earnings estimates so that interest income (accrual based) more accurately reflects the actual cash that is likely to be received. The allowance account on the balance sheet provides a cushion against equity write-downs if loans default.

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.; 12-03 Identify off-balance-sheet activities that commercial banks undertake.

Accessibility: Keyboard Navigation

56) How has the negotiable feature of wholesale CDs improved banks' ability to manage their liquidity?

Answer: Time deposits carry a substantial interest penalty for early withdrawals (usually forfeiting all current period interest). This penalty would make them unsuitable investments for corporations that are unsure whether the funds will be needed prior to maturity. The bank can also withhold the funds prior to maturity if the bank cannot immediately provide the funds. The ability to resell the CD to a third party without any interest penalty encourages corporate use of wholesale CDs, giving banks another source of funds that can be tapped via a deposit broker if needed.

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 12-01 Describe the four major categories of assets on a commercial banks balance sheet.

Accessibility: Keyboard Navigation

57) At the start of the quarter a bank has $55 million (gross) in its loan portfolio, and has $1 million in its allowance for loan loss account. During the quarter, loan audits indicate that an additional $300,000 of loans will not be paid as promised. These loans have not yet been written off as uncollectible, however. What are the starting and ending gross and net loan amounts and the provision for loan loss account, and what is the effect on the bank's quarterly earnings?

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Beginning of  quarter | | | End of quarter | | |
| Gross Loans | $ | 55,000,000 |  | $ | 55,000,000 |  |
| Less: Allowance loan losses | $ | 1,000,000 |  | $ | 1,300,000 |  |
| Net Loans | $ | 54,000,000 |  | $ | 53,700,000 |  |

Answer: The provision for loan loss (PLL) will be increased by $300,000. This will be a charge against (i.e., reduce) earnings for the quarter.

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Analyze; Apply

AACSB: Reflective Thinking; Analytical Thinking

Learning Goal: 12-04 Describe the major categories on a commercial banks income statement.

Accessibility: Keyboard Navigation

58) What are the differences between purchased funds and core deposits?

Answer: Purchased funds are very sensitive to the interest rate earned. They are usually high denomination ($100,000 and over) and have high turnover, particularly as other investment opportunities become more attractive. Core deposits are usually retail deposits made primarily by individuals. They are usually low-denomination, low-turnover accounts that are not very interest-sensitive and are at the bank for convenience reasons. They are normally a less-volatile, low-interest cost source of funds to the bank. Transaction accounts can be quite expensive to the bank; many banks now pass on these costs to the customer via fees.

Difficulty: 1 Easy

Topic: Financial Statements of Commercial Banks

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 12-02 Distinguish between core deposits and purchased funds.

Accessibility: Keyboard Navigation

59) What is the difference between a loan commitment and a letter of credit?

Answer: A loan commitment is a promise made by a bank that allows a customer to borrow up to a specified maximum for the remaining time of the commitment. The bank normally charges a commitment fee and a fee for any unused portion of the commitment. It is expected that the customer will borrow (draw down) at least a portion of the commitment.

Letters of credit are insurance policies sold for a fee that state that the bank will pay in event of nonpayment by the party that draws the line of credit. It is not expected that bank funds will be necessary to cover the letter except in unusual circumstances.

Difficulty: 2 Medium

Topic: Financial Statements of Commercial Banks

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 12-03 Identify off-balance-sheet activities that commercial banks undertake.

Accessibility: Keyboard Navigation