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

**Chapter 20 Managing Credit Risk on the Balance Sheet**

1) Provision for loan losses, net charge-offs, and the percentage of nonperforming loans all increased dramatically in 2007.

Answer: TRUE

Difficulty: 1 Easy

Topic: Credit Risk Management: Chapter Overview

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-01 Examine trends in nonperforming loans at commercial banks.

Accessibility: Keyboard Navigation

2) Gross debt service usually must be greater than 30 percent before a residential mortgage will be approved.

Answer: FALSE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-02 Understand the processes financial institutions use to evaluate a mortgage loan application.

Accessibility: Keyboard Navigation

3) Individuals with higher levels of income must have higher GDS and TDS ratios to qualify for a loan.

Answer: FALSE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-02 Understand the processes financial institutions use to evaluate a mortgage loan application.

Accessibility: Keyboard Navigation

4) Collateral on a mortgage is normally only considered if the applicant has enough income to service the loan.

Answer: TRUE

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-03 Use a credit-scoring model.

Accessibility: Keyboard Navigation

5) The five Cs of credit are financial capacity, collateral, conditions, connections with the bank, and capital.

Answer: FALSE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

6) Credit analysis of a mid-market corporate borrower differs from the analysis of a small business in that the analysis of the mid-market borrower is more focused on the business itself and less on the business owners.

Answer: TRUE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

7) As long as overall cash flow growth is positive, a bank loan officer would not be concerned if cash flow from operations was projected to be negative over the term of the loan.

Answer: FALSE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

8) A rising sales to working capital ratio may indicate a potential borrower is using its net current assets more efficiently.

Answer: TRUE

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

9) The more variable a borrower's cash flows are, the lower the fixed charge coverage ratio should be to limit risk.

Answer: FALSE

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

10) Issuance of short-term debt would result in an increase in cash flow from operations on the statement of cash flows.

Answer: FALSE

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

11) If you were a loan officer evaluating a small business credit application for a loan secured by working capital, you would generally want to see a higher (rather than lower) number of days in inventory and number of days' sales in receivables.

Answer: FALSE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

12) If you are a lender evaluating a loan application and you calculate the following ratio: (EBIT + Lease Payments)/[Interest + Lease Payments + (Sinking Fund/(1 − T))], then you are calculating a debt service ratio and it should be less than one in order to approve the loan.

Answer: FALSE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

13) A firm's cash account grew by $300 over the year when the firm had cash flow from financing of −$150 and cash flow from investing of $100. The firm's operating cash flow must have been +$250.

Answer: FALSE

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

14) Asset management ratios are used in credit analysis to help understand the borrower's ability to generate sales from the amount invested in some asset category.

Answer: TRUE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

15) The risk-adjusted return on capital (RAROC) model calculates the actual or promised annual cash flow on a loan as a percentage of the amount lent.

Answer: FALSE

Difficulty: 1 Easy

Topic: Calculating the Return on a Loan

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-06 Calculate the return on a loan.

Accessibility: Keyboard Navigation

16) Junk bonds usually yield lower returns than investment-grade bonds due to their speculative feature.

Answer: FALSE

Difficulty: 1 Easy

Topic: Credit Quality Problems

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-01 Examine trends in nonperforming loans at commercial banks.

Accessibility: Keyboard Navigation

17) Management of credit risk is achieved through diversification effect by combining numerous loans in a portfolio.

Answer: TRUE

Difficulty: 1 Easy

Topic: Credit Quality Problems

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-01 Examine trends in nonperforming loans at commercial banks.

Accessibility: Keyboard Navigation

18) Residential mortgage loan applications have the most diverse application processes that differ from one institution to the other.

Answer: FALSE

Difficulty: 2 Medium

Topic: Real Estate Lending

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-02 Understand the processes financial institutions use to evaluate a mortgage loan application.

Accessibility: Keyboard Navigation

19) Credit scoring models are probabilistic models based on economic and financial borrower characteristics aiming to determining the likelihood of default of a borrower.

Answer: TRUE

Difficulty: 1 Easy

Topic: Credit Scoring System

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-03 Use a credit-scoring model.

Accessibility: Keyboard Navigation

20) Analysis of the statement of cash flows involves assessment of operating, financing and investing cash flows and analysis of the resulting net income.

Answer: FALSE

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

21) Nonperforming loans are loans that are past due \_\_\_\_\_\_\_\_ that are not accruing interest.

A) 30 days

B) 60 days

C) 90 days

D) 120 days

E) 180 days

Answer: C

Difficulty: 3 Hard

Topic: Credit Quality Problems

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-01 Examine trends in nonperforming loans at commercial banks.

Accessibility: Keyboard Navigation

22) \_\_\_\_\_\_\_\_ is the process of taking possession of the mortgaged property to satisfy the debt in the event of failure to repay the mortgage and foregoing claim to any deficiency.

A) Perfecting collateral

B) Foreclosure

C) Power of sale

D) Conditions precedent

E) Lien enforcement

Answer: B

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-03 Use a credit-scoring model.

Accessibility: Keyboard Navigation

23) Which one of the following is usually the better predictor of default?

A) Standard & Poor's credit rating

B) Moody's credit rating

C) Altman Z-score

D) Moody's Analytics EDF

E) All of these choices are correct.

Answer: D

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

24) The base loan rate accounts for

I. the FI's weighted average cost of capital.

II. the FI's marginal cost of funds.

III. the credit risk of the loan.

A) I only

B) I and II only

C) II and III only

D) I and III only

E) I, II, and III

Answer: B

Difficulty: 2 Medium

Topic: Calculating the Return on a Loan

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-06 Calculate the return on a loan.

Accessibility: Keyboard Navigation

25) Which one of the following five Cs of credit is *NOT* correctly defined?

A) Capacity—Whether the borrower has enough other credit available to pay off the loan in the event of cash flow problems.

B) Capital—The borrower's equity.

C) Character—A measure of the borrower's intention/willingness to repay the loan.

D) Conditions—Assessing how economic conditions could affect the borrower's ability to repay the loan.

E) Collateral—An asset of the borrower that the lender may seize in the event of default on the loan.

Answer: A

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

26) A corporate customer obtains a $1.5 million loan from a bank. The customer agrees to pay a 6.25 percent interest rate and agrees to make compensating balances of 4 percent of the loan amount. These will be held in noninterest-bearing transactions deposits at the bank for one year. The bank charges a 1 percent loan origination fee on the amount borrowed. Reserve requirements are 10 percent. What is the expected rate of return to the bank (k) (to the nearest basis point)?

A) 6.95 percent

B) 7.52 percent

C) 7.99 percent

D) 8.01 percent

E) 8.45 percent

Answer: B

Explanation: (1% + 6.25%)/(1 − (4%(1 − 10%))) = 7.52%

Difficulty: 3 Hard

Topic: Calculating the Return on a Loan

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 20-06 Calculate the return on a loan.

Accessibility: Keyboard Navigation

27)

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| Mortgage  Applicant | Annual Gross  Income | | | Projected Monthly  Mortgage Payment | | | Annual  Property Taxes | | | Other Monthly  Debt Payments | | |
| Joe | $ | 100,000 |  | $ | 2,100 |  | $ | 3,000 |  | $ | 600 |  |
| Bill | $ | 45,000 |  | $ | 1,000 |  | $ | 1,400 |  | $ | 150 |  |

GDS cutoff: 30 percent

TDS  cutoff: 35 percent

Using only the GDS criteria, which one of the following statements is true?

A) Joe gets the loan, but Bill does not.

B) Bill gets the loan, but Joe does not.

C) Both get the loan.

D) Neither gets the loan.

E) The bank does not have money to make the loan.

Answer: C

Explanation: Joe: GDS = ((2,100 × 12) + 3,000)/100,000 = 28.20%; Bill: GDS = ((1,000 × 12) + 1,400)/45,000 = 29.78%; both are under the max of 30%.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand; Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 20-02 Understand the processes financial institutions use to evaluate a mortgage loan application.

Accessibility: Keyboard Navigation

28)

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| Mortgage  Applicant | Annual Gross  Income | | | Projected Monthly  Mortgage Payment | | | | Annual  Property Taxes | | | | Other Monthly  Debt Payments | | | |
| Joe | $ | 100,000 |  | | $ | 2,100 |  | | $ | 3,000 |  | | $ | 600 |  | |
| Bill | $ | 45,000 |  | | $ | 1,000 |  | | $ | 1,400 |  | | $ | 150 |  | |

GDS cutoff: 30 percent

TDS  cutoff: 35 percent

Using only the TDS criteria, which one of the following statements is true?

A) Joe gets the loan, but Bill does not.

B) Bill gets the loan, but Joe does not.

C) Both get the loan.

D) Neither gets the loan.

E) The bank does not have money to make the loan.

Answer: C

Explanation: Joe: TDS = ((2,700 × 12) + 3,000)/100,000 = 35.40%; Bill: TDS = ((1,150 × 12) + 1,400)/45,000 = 33.78%; The maximum TDS is between 35% and 40% so both loans are acceptable.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand; Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 20-02 Understand the processes financial institutions use to evaluate a mortgage loan application.

Accessibility: Keyboard Navigation

29) Individual credit-scoring models typically include all of the following information except

A) income.

B) length of time in residence.

C) credit history.

D) age.

E) ethnic background.

Answer: E

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-03 Use a credit-scoring model.

Accessibility: Keyboard Navigation

30) A corporate loan applicant has cash of $40, receivables of $50, and inventory of $20. The applicant also has current debts of $65. If the bank's policy requires a current ratio of 1.75 or better and an acid test ratio of 1.25 or better, would the applicant receive the loan?

A) Yes, because the applicant's current ratio and acid test ratios are acceptable.

B) No, because the applicant's current ratio and acid test ratios are both unacceptable.

C) No, because although the applicant's current ratio is acceptable, its acid test ratio is not.

D) No, because although the applicant's acid test ratio is acceptable, its current ratio is not.

E) Yes, because the bank will make the loan regardless of the results.

Answer: D

Explanation: Current ratio = (40 + 50 + 20)/65 = 1.69, Not acceptable; Acid Test (40 + 50)/65 = 1.38, Acceptable

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

31)

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| BALANCE SHEET BIG VALLEY ENTERPRISES | | | | | | | | | | | | | |
| *Assets* | | | | *Liabilities and Equity* | | | | | *Income Statement* | | | | |
| Cash | $ | 10 |  | | Current Liabilities | $ | 160 |  | | Cash Sales | $ | 275 |  | |
| Accounts receivable |  | 80 |  | | Long-Term Debt |  | 230 |  | | Credit sales |  | 500 |  | |
| Inventory |  | 115 |  | | Common Stock |  | 75 |  | | Operating Expenses |  | 560 |  | |
| Fixed Assets |  | 400 |  | | Retained Earnings |  | 140 |  | | Depreciation |  | 100 |  | |
| Total | $ | 605 |  | | Total | $ | 605 |  | | Interest |  | 55 |  | |
|  |  |  |  | |  |  |  |  | | Taxes |  | 30 |  | |
|  |  |  |  | |  |  |  |  | | Net Income |  | ? |  | |

Interest is Big Valley's only fixed cash charge.

Big Valley's market value of equity to book value of debt ratio = 1.5.

|  |  |  |
| --- | --- | --- |
| Peer Average Ratios | | |
| Current Ratio | 1.35 |  |
| Quick Ratio | 0.5 |  |
| Days Sales in Receivables | 50 |  |
| Sales to Working Capital | 14 |  |
| Sales to Fixed Assets | 1.8 |  |
| Times Interest Earned | 4 |  |
| Debt to Asset Ratio | 50 | % |
| Return on equity | 15 | % |

Big Valley's current ratio indicates that Big Valley is \_\_\_\_\_\_\_\_ liquid than the typical firm in the industry, and Big Valley's quick ratio indicates that Big Valley is \_\_\_\_\_\_\_\_ liquid than the typical firm.

A) more; more

B) more; less

C) less; less

D) less; more

E) similar; similar

Answer: D

Explanation: Current = (10 + 80 + 115)/160 = 1.28, Peer = 1.35; Quick = (10 + 80)/160 = 0.56, Peer = 0.5

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

32)

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| BALANCE SHEET BIG VALLEY ENTERPRISES | | | | | | | | | | | | | |
| *Assets* | | | | *Liabilities and Equity* | | | | | *Income Statement* | | | | |
| Cash | $ | 10 |  | | Current Liabilities | $ | 160 |  | | Cash Sales | $ | 275 |  | |
| Accounts receivable |  | 80 |  | | Long-Term Debt |  | 230 |  | | Credit sales |  | 500 |  | |
| Inventory |  | 115 |  | | Common Stock |  | 75 |  | | Operating Expenses |  | 560 |  | |
| Fixed Assets |  | 400 |  | | Retained Earnings |  | 140 |  | | Depreciation |  | 100 |  | |
| Total | $ | 605 |  | | Total | $ | 605 |  | | Interest |  | 55 |  | |
|  |  |  |  | |  |  |  |  | | Taxes |  | 30 |  | |
|  |  |  |  | |  |  |  |  | | Net Income |  | ? |  | |

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| --- | --- | --- |
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| Days Sales in Receivables | 50 |  |
| Sales to Working Capital | 14 |  |
| Sales to Fixed Assets | 1.8 |  |
| Times Interest Earned | 4 |  |
| Debt to Asset Ratio | 50 | % |
| Return on equity | 15 | % |

Big Valley's return on equity indicates that the firm generates a \_\_\_\_\_\_\_\_ return to their shareholders than their peers.

A) 2.04 percent higher

B) 3.02 percent higher

C) 15.25 percent higher

D) 5.75 percent lower

E) 1.05 percent lower

Answer: E

Explanation: NI/Equity = (275 + 500 − 560 − 100 − 55 − 30)/(75 + 140) = 13.95%; industry = 15%

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

33)

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| BALANCE SHEET BIG VALLEY ENTERPRISES | | | | | | | | | | | | | |
| *Assets* | | | | *Liabilities and Equity* | | | | | *Income Statement* | | | | |
| Cash | $ | 10 |  | | Current Liabilities | $ | 160 |  | | Cash Sales | $ | 275 |  | |
| Accounts receivable |  | 80 |  | | Long-Term Debt |  | 230 |  | | Credit sales |  | 500 |  | |
| Inventory |  | 115 |  | | Common Stock |  | 75 |  | | Operating Expenses |  | 560 |  | |
| Fixed Assets |  | 400 |  | | Retained Earnings |  | 140 |  | | Depreciation |  | 100 |  | |
| Total | $ | 605 |  | | Total | $ | 605 |  | | Interest |  | 55 |  | |
|  |  |  |  | |  |  |  |  | | Taxes |  | 30 |  | |
|  |  |  |  | |  |  |  |  | | Net Income |  | ? |  | |

Interest is Big Valley's only fixed cash charge.

Big Valley's market value of equity to book value of debt ratio = 1.5.

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| --- | --- | --- |
| Peer Average Ratios | | |
| Current Ratio | 1.35 |  |
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| Days Sales in Receivables | 50 |  |
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| Sales to Fixed Assets | 1.8 |  |
| Times Interest Earned | 4 |  |
| Debt to Asset Ratio | 50 | % |
| Return on equity | 15 | % |

Big Valley has a times interest earned ratio that is \_\_\_\_\_\_\_\_, which indicates that Big Valley has \_\_\_\_\_\_\_\_ long-term insolvency risk than the typical firm in the industry.

A) 4; the same

B) 3.91; less

C) 3.91; more

D) 4.58; more

E) 4.58; less

Answer: C

Explanation: [(275 + 500 − 560)/55] = 3.91; more

Difficulty: 3 Hard

Topic: Credit Analysis

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

34)

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| BALANCE SHEET BIG VALLEY ENTERPRISES | | | | | | | | | | | | | |
| *Assets* | | | | *Liabilities and Equity* | | | | | *Income Statement* | | | | |
| Cash | $ | 10 |  | | Current Liabilities | $ | 160 |  | | Cash Sales | $ | 275 |  | |
| Accounts receivable |  | 80 |  | | Long-Term Debt |  | 230 |  | | Credit sales |  | 500 |  | |
| Inventory |  | 115 |  | | Common Stock |  | 75 |  | | Operating Expenses |  | 560 |  | |
| Fixed Assets |  | 400 |  | | Retained Earnings |  | 140 |  | | Depreciation |  | 100 |  | |
| Total | $ | 605 |  | | Total | $ | 605 |  | | Interest |  | 55 |  | |
|  |  |  |  | |  |  |  |  | | Taxes |  | 30 |  | |
|  |  |  |  | |  |  |  |  | | Net Income |  | ? |  | |

Interest is Big Valley's only fixed cash charge.

Big Valley's market value of equity to book value of debt ratio = 1.5.

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| --- | --- | --- |
| Peer Average Ratios | | |
| Current Ratio | 1.35 |  |
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| Sales to Working Capital | 14 |  |
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| Times Interest Earned | 4 |  |
| Debt to Asset Ratio | 50 | % |
| Return on equity | 15 | % |

Altman's Z-score model is Z = 1.2X1 + 1.4X2 + 3.3X3 + 0.6X4 + 1.0X5.

X1 = Working Capital/Total Assets

X2 = Retained Earnings/Total Assets

X3 = EBIT/Total Assets

X4 = Market Value Equity/Book Value Long-Term Debt

X5 = Sales/Total Assets

Using the Altman's Z model, Big Valley's Z-score is

A) 3.22.

B) 2.88.

C) 2.65.

D) 2.11.

E) 1.85.

Answer: A

Explanation: WC/TA = 7.44%; RE/TA = 23.14%; EBIT/TA = 19.01%; MVE/BVLTD = 1.50; S/TA = 1.28;

These numbers give a Z-score of 3.22, which indicates low default risk.

Difficulty: 3 Hard

Topic: Credit Analysis

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

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| BALANCE SHEET BIG VALLEY ENTERPRISES | | | | | | | | | | | | | |
| *Assets* | | | | *Liabilities and Equity* | | | | | *Income Statement* | | | | |
| Cash | $ | 10 |  | | Current Liabilities | $ | 160 |  | | Cash Sales | $ | 275 |  | |
| Accounts receivable |  | 80 |  | | Long-Term Debt |  | 230 |  | | Credit sales |  | 500 |  | |
| Inventory |  | 115 |  | | Common Stock |  | 75 |  | | Operating Expenses |  | 560 |  | |
| Fixed Assets |  | 400 |  | | Retained Earnings |  | 140 |  | | Depreciation |  | 100 |  | |
| Total | $ | 605 |  | | Total | $ | 605 |  | | Interest |  | 55 |  | |
|  |  |  |  | |  |  |  |  | | Taxes |  | 30 |  | |
|  |  |  |  | |  |  |  |  | | Net Income |  | ? |  | |

Interest is Big Valley's only fixed cash charge.

Big Valley's market value of equity to book value of debt ratio = 1.5.

|  |  |  |
| --- | --- | --- |
| Peer Average Ratios | | |
| Current Ratio | 1.35 |  |
| Quick Ratio | 0.5 |  |
| Days Sales in Receivables | 50 |  |
| Sales to Working Capital | 14 |  |
| Sales to Fixed Assets | 1.8 |  |
| Times Interest Earned | 4 |  |
| Debt to Asset Ratio | 50 | % |
| Return on equity | 15 | % |

Big Valley's fixed asset efficiency score is \_\_\_\_\_\_\_\_ which is \_\_\_\_\_\_\_\_that of the typical firm in the industry.

A) 1.8; the same as

B) 1.54; lower than

C) 1.94; higher than

D) 2.15; higher than

E) 1.32; lower than

Answer: C

Explanation: S/FA = (275 + 500)/400 = 1.9375; Peer S/FA = 1.8

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

36)

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| BALANCE SHEET BIG VALLEY ENTERPRISES | | | | | | | | | | | | | |
| *Assets* | | | | *Liabilities and Equity* | | | | | *Income Statement* | | | | |
| Cash | $ | 10 |  | | Current Liabilities | $ | 160 |  | | Cash Sales | $ | 275 |  | |
| Accounts receivable |  | 80 |  | | Long-Term Debt |  | 230 |  | | Credit sales |  | 500 |  | |
| Inventory |  | 115 |  | | Common Stock |  | 75 |  | | Operating Expenses |  | 560 |  | |
| Fixed Assets |  | 400 |  | | Retained Earnings |  | 140 |  | | Depreciation |  | 100 |  | |
| Total | $ | 605 |  | | Total | $ | 605 |  | | Interest |  | 55 |  | |
|  |  |  |  | |  |  |  |  | | Taxes |  | 30 |  | |
|  |  |  |  | |  |  |  |  | | Net Income |  | ? |  | |

Interest is Big Valley's only fixed cash charge.

Big Valley's market value of equity to book value of debt ratio = 1.5.

|  |  |  |
| --- | --- | --- |
| Peer Average Ratios | | |
| Current Ratio | 1.35 |  |
| Quick Ratio | 0.5 |  |
| Days Sales in Receivables | 50 |  |
| Sales to Working Capital | 14 |  |
| Sales to Fixed Assets | 1.8 |  |
| Times Interest Earned | 4 |  |
| Debt to Asset Ratio | 50 | % |
| Return on equity | 15 | % |

Big Valley is collecting their receivables about \_\_\_\_\_\_\_\_ than the typical firm.

A) 22 percent more quickly

B) 12 percent more quickly

C) 17 percent more slowly

D) 12 percent more slowly

E) 16 percent more quickly

Answer: C

Explanation: BV's Days' sales in receivables = (80 × 365)/500 = 58.4 days; 58.4/50 − 1 = 16.8%

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

37)

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| BALANCE SHEET BIG VALLEY ENTERPRISES | | | | | | | | | | | | | |
| *Assets* | | | | *Liabilities and Equity* | | | | | *Income Statement* | | | | |
| Cash | $ | 10 |  | | Current Liabilities | $ | 160 |  | | Cash Sales | $ | 275 |  | |
| Accounts receivable |  | 80 |  | | Long-Term Debt |  | 230 |  | | Credit sales |  | 500 |  | |
| Inventory |  | 115 |  | | Common Stock |  | 75 |  | | Operating Expenses |  | 560 |  | |
| Fixed Assets |  | 400 |  | | Retained Earnings |  | 140 |  | | Depreciation |  | 100 |  | |
| Total | $ | 605 |  | | Total | $ | 605 |  | | Interest |  | 55 |  | |
|  |  |  |  | |  |  |  |  | | Taxes |  | 30 |  | |
|  |  |  |  | |  |  |  |  | | Net Income |  | ? |  | |

Interest is Big Valley's only fixed cash charge.

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| Times Interest Earned | 4 |  |
| Debt to Asset Ratio | 50 | % |
| Return on equity | 15 | % |

Big Valley's use of debt to finance assets indicates that Big Valley has \_\_\_\_\_\_\_\_ the typical firm in the industry.

A) more long-term solvency risk than

B) the same long-term solvency risk as

C) less interest expense than

D) less long-term solvency risk than

E) a lower market value of equity to book value of equity ratio than

Answer: A

Explanation: BV's Debt/TA = (160 + 230)/605 = 64.4%; Peer Debt/TA = 50%

Difficulty: 3 Hard

Topic: Credit Analysis

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

38) Mid-market commercial lending may be typically defined as borrowers

I. with sales revenue between $5 million and $100 million.

II. with a recognizable corporate structure.

III. with ready access to deep and liquid capital markets.

A) I only

B) II only

C) III only

D) I and II only

E) I, II, and III

Answer: D

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-03 Use a credit-scoring model.

Accessibility: Keyboard Navigation

39) In analyzing credit risk for a loan to a major diversified corporation, the bank typically has which of the following advantages?

I. Market-based models to analyze credit risk

II. Greater negotiating power due to the size of the loan required

III. Ratings agency measures of default risk

A) I only

B) I and II only

C) II and III only

D) I and III only

E) I, II, and III

Answer: D

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

40) A firm with a low Z-score has high

A) insolvency risk.

B) interest rate risk.

C) liquidity risk.

D) international risk.

E) None of these options are correct.

Answer: A

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

41) Business credit-scoring models suffer from several weaknesses. These include which of the following?

I. Credit-score models are not statistically sound tools to use in making a lending decision.

I. The appropriate weights on a credit-score model are likely to change unpredictably over time.

II. These models ignore non-quantifiable behavioral factors, such as a relationship with the bank and reputation.

IV. Credit-scoring models discriminate against minorities.

A) I and II only

B) II and III only

C) II, III, and IV only

D) I, II, and III only

E) I, II, III, and IV

Answer: B

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

42) The conditions specified in a credit agreement that must be fulfilled before a drawdown is allowed are called

A) collateral perfection.

B) power of sale conditions.

C) conditions precedent.

D) foreclosure agreements.

E) audit review terms.

Answer: C

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

43) Based on an option valuation method, the EDF model:

A) determine if the equity is mispriced.

B) calculate the market value of the lender's investment.

C) estimates the probability that a firm will default over a specified period of time.

D) estimate the likelihood that the Z-score model is correct.

E) estimates the probability that the firm's rating will change over a period of time.

Answer: C

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

44) A bank charges a commercial borrower a 6.55 percent interest rate on a one-year loan. The bank also charges a 0.5 percent origination fee and requires compensating balances of 7 percent in the form of demand deposits. Reserve requirements are 10 percent. What is the promised gross rate of return on the loan?

A) 8.45 percent

B) 7.89 percent

C) 9.10 percent

D) 7.52 percent

E) 6.95 percent

Answer: D

Explanation: (0.005 + 0.0655)/[1 − (0.07 × (1 − 0.10))] = 7.52%

Difficulty: 2 Medium

Topic: Calculating the Return on a Loan

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 20-06 Calculate the return on a loan.

Accessibility: Keyboard Navigation

45) If you were a loan officer evaluating a small business credit application for a loan and you wanted to ensure that the applicant had more than sufficient cash flow to pay off its existing debt, the applicant's cash-flow-to-debt ratio would have to be greater than

A) one.

B) zero.

C) the TIE ratio.

D) the interest rate on the debt.

E) peer average ratio.

Answer: D

Difficulty: 3 Hard

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-03 Use a credit-scoring model.; 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

46) In concept, the RAROC measure indicates a loan is acceptable if the RAROC is greater than the

A) borrower's ROE.

B) lender's ROA.

C) borrower's ROA.

D) lender's ROE.

E) NCO rate.

Answer: D

Difficulty: 1 Easy

Topic: Calculating the Return on a Loan

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-06 Calculate the return on a loan.

Accessibility: Keyboard Navigation

47) As a business lender, you would prefer that the borrower have stable or growing cash flows resulting from which part of the statement of cash flows?

A) Financing cash flows

B) Cash flows from investment

C) Operating cash flows

D) Dividends

E) Common Stock

Answer: C

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

48) A bank is using the RAROC to evaluate large business loans. The benchmark rate of return is 7.55 percent. The one-year loan interest rate is 8.00 percent and the bank must pay 7.40 percent to raise the funds. The cost to service the loan is 0.3 percent. If the loan defaults, 92 percent of the money lent will be lost. Based on historical default rates, the extreme worst-case loss scenario is about 5 percent. Should the bank make the loan? Why or why not?

A) Yes, because the RAROC is 7.11 percent.

B) No, because the RAROC is 7.11 percent.

C) Yes, because the RAROC is 6.52 percent.

D) No, because the RAROC is 6.52 percent.

E) No, because the RAROC is more than 7.55 percent.

Answer: D

Explanation: (0.080 − 0.074 − 0.003)/(0.05 × 0.92) = 6.52%, but this is below the benchmark of 7.55%.

Difficulty: 3 Hard

Topic: Calculating the Return on a Loan

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-06 Calculate the return on a loan.

Accessibility: Keyboard Navigation

49) The ratio that measures the firm's efficiency in utilizing its assets to generate revenue is:

A) Current ratio

B) Debt ratio

C) Time interest earned ratio

D) Total Assets turnover ratio

E) Cash-flow-to-debt ratio

Answer: D

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

50) Which ratio measures the firm's ability to pay current interest and lease payments?

A) Current ratio

B) Debt ratio

C) Time interest earned ratio

D) Total Assets turnover ratio

E) Cash-flow-to-debt ratio

Answer: C

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

51) Before allowing the borrower to actually acquire the funds for a mid-market collateralized loan, what must the lender ensure? What type of monitoring occurs by the lender after the loan is granted?

Answer: The lender must perfect the security interest in the collateral. This process includes confirming that the collateral does not have a preexisting lien that would prevent foreclosure and sale, ensuring that back taxes are not owed, and in certain cases, obtaining an independent assessment of the collateral value. Following the draw down, the lender must monitor the condition of the collateral periodically and reassess the borrower's ability to continue to service the loan. This review normally takes place annually.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 20-03 Use a credit-scoring model.

Accessibility: Keyboard Navigation

52) Explain how the Moody's Analytics Model predicts bankruptcy probability.

Answer: The Moody's Analytics Model calculates the expected default frequency (EDF).  The database contains 30 years of information for 6,000 public and 220,000 private corporate default events.  This represents 60,000 public and 2.8 million private companies, healthy and distressed, from across the globe. The data are used to generate a score that reflects the probability of default and has been shown to be a better predictor of financial distress or failure than accounting-based models and S&P rating changes.

Difficulty: 3 Hard

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

53) Explain the purpose/benefits in adding a credit-scoring model to evaluate a loan application.

Answer: Credit-scoring models allow the loan officer to quickly make a decision about a loan. The idea behind a credit-scoring model is to identify how characteristics of past borrowers that repaid their loan on time differ from borrowers that defaulted. The differences are then weighted with a point system and new loan applicants are then scored to see if they fall into the sound or default category.

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

54) For most business loans, growing earnings are not a sufficient reason to grant a loan. Why?

Answer: Collateral is still important because economic conditions can change over the life of the loan and the bank would like to be able to limit its losses in the event the borrower's earnings are not sufficient to repay the loan. The lender must also evaluate how sensitive the borrower's earnings are to economic conditions and how much the economy might change over the period of the loan. Finally, earnings are not cash; cash is required to repay the loan and the lender will be more concerned about sources and uses of cash than about earnings.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

55) A $40,000 one-year loan with a 1 percent origination fee and a 7.50 percent interest rate is funded with money on which the bank owes 3 percent. What is the expected pretax dollar spread on the loan? If the bank needs to net at least 3.5 percent on the funds lent to make its ROE, how many dollars can the bank spend on credit investigation, loan servicing, and so forth? Would the bank be able to spend more if the loan amount was greater? What does this example suggest about credit analysis?

Answer: Gross Revenue = (7.50% − 3.00% + 1.00%) × $40,000 = $2,200

Minimum Revenue = 7.50% − 3.00% + 1.00% − 3.50% = 2.00% of $40,000 = $800

The bank would be able to spend more money for a larger loan amount. This indicates the need for the lender to employ credit scoring and other quick, low-cost methods of evaluating small loan amounts to maintain profitability on these transactions.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-03 Use a credit-scoring model.

Accessibility: Keyboard Navigation

56) Describe the credit analysis process for a mid-market corporate loan applicant.

Answer: The account officer gathers information about the loan applicant's business. This may include meeting the client's existing customers, checking referrals, and cold calling new business prospects. The account officer analyzes the risk of the applicant by applying the five Cs of credit. If the account officer decides to pursue the loan application, the loan is submitted for review and approval by senior lending officials and/or a loan review committee.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 20-03 Use a credit-scoring model.; 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

57) What are the five Cs of credit? Briefly describe each.

Answer: Character: Character of applicant; applicant's willingness to work hard to repay the loan.

Capacity: Borrower's ability to generate enough cash to repay the loan.

Condition: How changing economic and other conditions will affect the borrower's ability to repay.

Capital: How much capital (protection from insolvency) the borrower has.

Collateral: The value of assets pledged against the loan.

Difficulty: 1 Easy

Topic: Credit Analysis

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

58) A corporate loan applicant has had a growing cash account for the last three years, but cash flow from operations has been negative in every year. Would this concern you if you were the loan officer charged with approving the loan? If so, why? If not, why not?

Answer: This would be a concern because it indicates cash growth is being generated by borrowing, new equity issued, or by selling assets. None of these are sustainable sources of financing. Moreover, the applicant is not generating cash flow from its operations. This may be acceptable if the firm is in a growth period and has good collateral, but the loan officer would normally desire to have positive cash flow from operations.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

59) Why won't a loan officer usually approve a loan solely on the basis of collateral?

Answer: There are two reasons why a loan officer will not typically grant a loan if the borrower has insufficient cash flow but good collateral. First, the lender's rate of return is usually reduced if the lender has to seize collateral and incur storage and sale costs, because seizing and disposing of collateral is very costly. Borrowers also may not maintain collateral in the best condition if they believe it will be seized and the borrower's future business will also probably be lost for good. Second, it is unethical to grant a loan that the loan officer knows or strongly believes cannot be repaid. Old western TV shows notwithstanding, making a loan to seize the collateral at a good price is bad business.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Understand; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-03 Use a credit-scoring model.; 20-04 Appreciate the analysis that is involved in mid-market commercial and industrial lending.

Accessibility: Keyboard Navigation

60) Explain what each ratio in the Altman credit model measures and explain why higher values of each of the variables predict lower default probability.

Answer: The variables and their explanations are:

|  |  |
| --- | --- |
|  | |
| X1 = Working capital/Total assets | The higher the ratio, the more liquid assets (%) the firm has. Greater liquidity implies a stronger ability to pay off debts in the short run. |
| X2 = Retained earnings/Total assets | The higher retained earnings are to total assets, the greater the firm's ability to generate and keep profits. This should indicate a greater ability to pay off debt. |
| X3 = EBIT/Total assets | A higher value for this ratio indicates a greater ability to generate profits off the given assets and should indicate a stronger ability to pay off debt. |
| X4 = Market value of equity/Book value of long-term debt | When this ratio is higher, it signals that the market believes that the firm's ability to generate cash through time is strong relative to the principal owed on the debt, thus indicating that the equity investors believe the firm's prospects are good. |
| X5 = Sales/Total assets | This ratio measures the firm's ability to turn dollars invested in assets into sales revenue. The higher the ratio, the more efficiently managers are using assets to generate sales. Sales are a cornerstone of profitability and the ability to pay off debts. |

Difficulty: 3 Hard

Topic: Credit Analysis

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation

61) A bank has a base loan rate of 4.75 percent and for the loan under consideration it would apply a 2 percent risk premium. The bank also requires compensating balances (noninterest-bearing) equal to 5 percent of the loan amount. The bank's reserve requirements are 10 percent. The bank charges 1 percent of the loan amount as an origination fee. The borrower is asking for a $500,000 loan. Calculate the ROA on the loan.

Answer: Loan ROA = (0.01 + 0.0475 + 0.02)/[1 − (0.05 × (1 − 0.10))] = 8.115%

Difficulty: 2 Medium

Topic: Calculating the Return on a Loan

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 20-06 Calculate the return on a loan.

Accessibility: Keyboard Navigation

62) A bank can charge a corporate borrower 6.25 percent on a loan. The borrower is asking for a $600,000 loan. The extreme loss rate on this loan type is 4.0 percent and, when default occurs, about 15 percent of the loan amount is recovered. The interest and noninterest cost of the loan is 5.85 percent. What is the RAROC of the loan? Under what circumstances should the bank make the loan?

Answer: RAROC = Net first-year $ income on the Loan/Value of loan at risk

Net first-year $ income on the loan = (0.0625 − 0.0585) × $600,000 = $2,400

Value of loan at risk = Dollar value of loan × Unexpected (extreme) default rate × Loss given default = $600,000 × 0.040 × (1 − 0.15) = $20,400

RAROC = $2,400/$20,400 = 11.76%

The bank should make the loan if the bank's ROE is less than the RAROC of 11.76%.

Difficulty: 3 Hard

Topic: Calculating the Return on a Loan

Bloom's: Analyze; Apply; Evaluate

AACSB: Analytical Thinking

Learning Goal: 20-06 Calculate the return on a loan.

Accessibility: Keyboard Navigation

63) Why is bank lending to large corporations more difficult than making loans to small or mid-size firms? What additional factors are involved? Do banks have some additional tools to help in assessing credit risk of large firms? What are some examples?

Answer:

\*Banks have reduced bargaining power on terms with large corporations. This means they may not be able to set profitable terms, and it implies that banks may have to consider what would happen to other aspects of the business relationship, such as consulting, if a loan is refused. These other relationships represent a conflict of interest with the lending function.

\*Large corporate borrowers tend to be involved in many different lines of business, making industry comparisons and risk assessment difficult.

\*If the borrower is a holding company that has no assets other than the separate firms, the bank's loan to the holding company will be subordinated to direct claims of the subsidiaries.

Banks have some additional tools to help with loans to large corporations. The Altman Z-score model, the ratings from Moody's and Standard & Poor's, and the Moody's Analytics Model are examples. These tools can help the bank assess the risk of loan default.

Difficulty: 2 Medium

Topic: Credit Analysis

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 20-05 Analyze large commercial and industrial loans.

Accessibility: Keyboard Navigation