***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.

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

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

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

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

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.

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.

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

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

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

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.

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.

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.

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.

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.

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

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

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

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

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

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

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

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.

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

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.

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

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.

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.

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.

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.

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

32)

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| 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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| 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

33)

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| 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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| 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

34)

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| 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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|  |  |  |
| --- | --- | --- |
| Peer Average Ratios | | |
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| 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 | % |

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.

35)

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| 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 |  |
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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 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

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

37)

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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 |  |
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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 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

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

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

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.

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

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.

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.

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

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.

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.

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

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.

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

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

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?

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

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

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

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?

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

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

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?

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

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.

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.

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?

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?