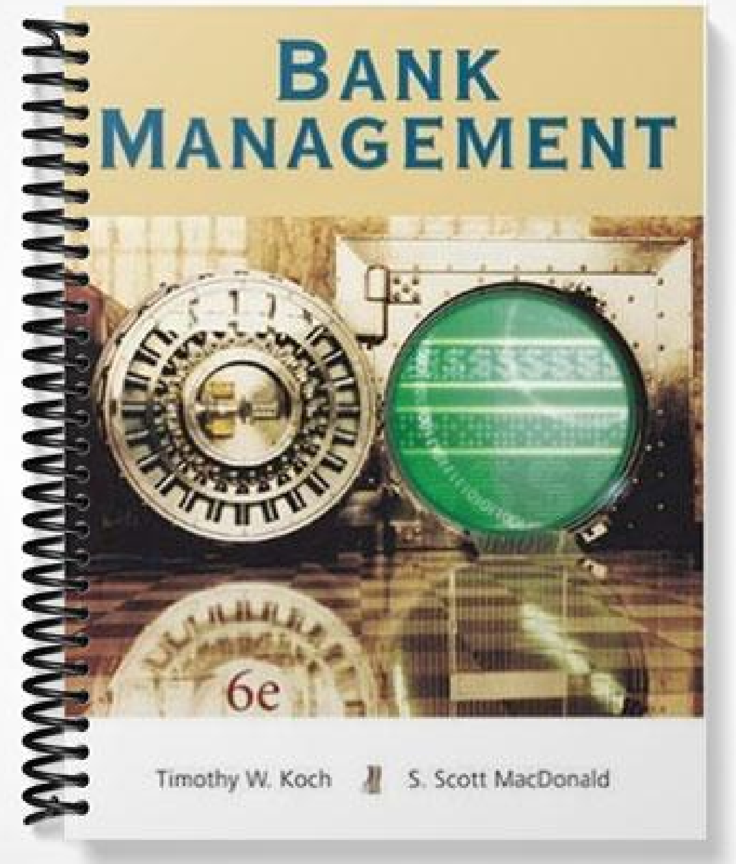
TEST BANK



Chapter 2

Analyzing Bank Performance

1. Which of the following is <u>not</u> a characteristic of a typical commercial bank?
   a. Most banks own few fixed assets.
   b. Most banks have a high degree of operating leverage.
   c. Most banks have few fixed costs.
   d. Many bank liabilities are payable on demand.
   e. Banks generally operate with less equity capital than non-financial firms.

Answer: b

2. Bank assets fall into each of the following categories <u>except</u>:
   a. loans.
   b. investment securities.
   c. demand deposits.
   d. noninterest cash and due from banks.
   e. other assets.

Answer: c

3. Typically, "Call loans" are:
   a. residential mortgages.
   b. farm loans.
   c. demand deposits.
   d. payable on demand.
   e. automobile loans.

Answer: d

4. A loan to an individual to purchase a home would be considered to be a:
   a. consumer loan.
   b. commercial loan.
   c. agricultural loan.
   d. construction loan.
   e. real estate loan.

Answer: e

5. Which of the following would <u>not</u> be considered a commercial loan?
   a. An interim construction loan
   b. A working capital loan
   c. A loans to another financial institution
   d. A loan to purchase a piece of industrial equipment
   e. A loan to the State of Illinois

Answer: a

6. Banks generate their largest portion of income from:
   a. loans.
   b. short-term investment.
   c. demand deposits.
   d. long-term investments.
   e. certificates of deposit.

Answer: a

7. Loans typically fall into each of the following categories <u>except</u>:
   a. real estate.
   b. individual.
   c. commercial.
   d. agricultural.
   e. municipal.

Answer: e

8. Which of the following adjustments are made to gross loans and leases to obtain net loans and leases?
   a. The loan and lease loss allowance is subtracted from gross loans
   b. Unearned income is subtracted from gross interest received
   c. Investment income is added to gross interest received
   d. a. and b.
   e. a. and c.

Answer: d

9. An example of a contra-asset account is:
   a. the loan and lease loss allowance.
   b. unearned income.
   c. buildings and equipment.
   d. revenue bonds.
   e. the provision for loan loss.

Answer: a

10. Which of the following bank assets is the most liquid?
    a. Long-term investments
    b. Short-term investments
    c. Loans
    d. Demand deposits
    e. Unearned income

Answer: b

11. Which of the following would a bank generally classify as a short-term investment?
    a. Demand deposits
    b. Deposits at the Federal Reserve
    c. Repurchase agreements
    d. Fed Funds purchased
    e. Vault cash

Answer: c

12. All other things constant, securities that are extremely liquid:
    a. earn higher rates of return than securities that are less liquid.
    b. have a longer maturity than less liquid securities.
    c. have lower risk than less liquid securities.
    d. a. and b.
    e. b. and c.

Answer: c

13. Which of the following would a bank generally classify as a long-term investment?
    a. Treasury bill
    b. Vault cash
    c. Cash items in process of collection
    d. Municipal bond
    e. Repurchase agreements

Answer: d

14. Securities that are "held-to-maturity" are:
    a. trading account securities.
    b. recorded on the balance sheet at amortized cost.
    c. marked-to-market.
    d. a. and b.
    e. a. and c.

Answer: b

15. Securities that require unrealized gains or losses to be recorded as a change in stockholder's equity are called:
    a. held-to-maturity securities.
    b. trading account securities.
    c. available-for-sale securities.
    d. revenue securities.
    e. repurchase agreements

Answer: c

16. Securities that require unrealized gains or losses to be recorded on the income statement are called:
    a. held-to-maturity securities.
    b. trading account securities.
    c. available-for-sale securities.
    d. revenue securities.
    e. repurchase agreements

Answer: b

17. The largest component of “non- interest cash and due from banks” is:
    a. cash items in process of collection.
    b. deposits held at other financial institutions.
    c. federal funds sold.
    d. vault cash.
    e. loans from the Federal Reserve.

Answer: a

18. The volume of net deferred credit is commonly referred to as:
    a. the burden.
    b. NOW balances.
    c. reserve requirements.
    d. equity.
    e. float.

Answer: e

19. __________ own(s) the bulk of demand deposit accounts.
    a. Consumers
    b. Businesses
    c. State governments
    d. The federal government
    e. Non-profits

Answer: b

20. Which of the following is are only available to non-commercial customers?
    a. Money Market Demand Accounts
    b. Demand deposit accounts
    c. Mortgage loans
    d. Negotiable Orders of Withdrawal (NOW) accounts
    e. Auto leases

Answer: d

21. Checking accounts with unlimited check-writing and pay interest are known as:
    a. demand deposit accounts.
    b. money market deposit accounts.
    c. NOW accounts.
    d. certificates of deposit.
    e. time deposits.

Answer: e

22. Jumbo CDs that a bank obtains from a third-party broker are called:
    a. money market demand accounts.
    b. time deposit accounts.
    c. mortgage loans.
    d. brokered deposits.
    e. core deposits.

Answer: d

23. Jumbo certificates of deposit (CDs) typically:
    a. have maturities greater than 10 years..
    b. are negotiable.
    c. are $1 million in size.
    d. All of the above
    e. b. and c.

Answer: e

24. Unsecured liabilities created from the exchange of immediately available funds are known as:
    a. federal funds purchased.
    b. repurchase agreements.
    c. federal funds sold.
    d. pledged securities.
    e. brokered deposits.

Answer: a

25. A bank's core deposits are:
    a. vault cash.
    b. stable deposits that are not typically withdrawn over short periods of time.
    c. the bank's deposits at the Federal Reserve.
    d. the most interest rate sensitive liabilities of a bank.
    e. deposits held in foreign offices.

Answer: b

26. Core deposits consist of all of the following except:
   a. demand deposits.
   b. NOW accounts.
   c. jumbo certificates of deposit.
   d. savings accounts.
   e. money market demand accounts.

Answer: c

27. Which of the following is <u>not</u> considered a volatile liability?
   a. Jumbo CDs
   b. Deposits in foreign offices
   c. Repurchase agreements
   d. Federal funds sold
   e. All of the above are considered volatile liabilities

Answer: d

28. Which of the following would be the <u>least</u> sensitive to changes in interest rates?
   a. Demand deposits
   b. Repurchase agreements
   c. Federal funds purchased
   d. Eurodollar liabilities
   e. Jumbo CDs

Answer: a

29. The "provision for loan and lease losses":
   a. are the realized losses from the previous accounting period.
   b. represents management's estimate of potential lost revenue from bad loans.
   c. determined by the Federal Reserve for all banks.
   d. does not affect net income.
   e. is another name for a bank's "burden."

Answer: b

30. A bank's "burden" is defined as:
   a. net interest income minus non-interest income.
   b. non-interest income minus non-interest expense.
   c. non-interest expense minus non-interest income.
   d. net interest income plus non-interest income.
   e. interest expense plus non-interest expense.

Answer: c

31. Everything else the same, a bank's "burden" would most likely increase given:
    a. a decrease in overhead expenses.
    b. an increase in interest rates.
    c. a decrease in interest rates.
    d. an increase in executive salaries.
    e. an increase in service charges collected by the bank.

Answer: d

32. Interest income includes:
    a. interest earned on all of the bank's assets.
    b. fees earned on all of the bank's assets.
    c. fees earned on all of the bank's deposit accounts.
    d. all of the above.
    e. a. and b. only

Answer: e

33. A bank currently owns a municipal bond paying a tax-exempt rate of 5%. If the banks marginal tax rate is 35%, what is the taxable equivalent yield?
    a. 7.69%
    b. 3.25%
    c. 6.75%
    d. 3.70%
    e. 9.32%

Answer: a
Municipal Interest Income (Tax Equivalent) = Municipal Interest Income/(1-Tax Rate)
.05/(1-.35) = .0769

34. A bank currently owns a municipal bond paying a tax-exempt rate of 6.5%. If the banks marginal tax rate is 40%, what is the taxable equivalent yield?
    a. 3.90%
    b. 10.83%
    c. 9.10%
    d. 4.64%
    e. 9.32%

Answer: B
Municipal Interest Income (Tax Equivalent) = Municipal Interest Income/(1-Tax Rate)
.065/(1-.40) = .1083

35. A bank currently owns a municipal bond paying a tax-exempt rate of 8%. If the banks marginal tax rate is 39%, what is the taxable equivalent yield?
   a. 11.12%
   b. 4.88%
   c. 13.11%
   d. 5.76%
   e. 9.32%

Answer: c

Municipal Interest Income (Tax Equivalent) = Municipal Interest Income/(1-Tax Rate)

.08/(1-.39) = .1311

36. Net interest income is the difference between:
   a. gross interest income and net interest expense.
   b. gross interest income and non-interest income.
   c. the burden and realized gains or losses.
   d. non-interest income and net interest expense.
   e. gross interest income and gross interest expense.

Answer: e

37. Non-interest income includes all of the following <u>except:</u>
   a. checking account fees.
   b. insufficient funds service charges.
   c. trust income.
   d. personnel expenses.
   e. all of the above are considered non-interest income.

Answer: d

38. Non-interest income includes all of the following <u>except</u>:
   a. monthly fee income on checking accounts.
   b. late fees on loans.
   c. trust income.
   d. insufficient funds service charges.
   e. all of the above are considered non-interest income.

Answer: b

39. Non-interest expenses includes all of the following <u>except</u>:
   a. occupancy expenses.
   b. goodwill impairment.
   c. insufficient funds service charges.
   d. personnel expenses.
   e. all of the above are considered non-interest expense.

Answer: c

40. Which of the following would be considered an extraordinary item on an income statement of a bank?
    a. Revenue from the sale of the bank's office building.
    b. Interest income when the spread is greater than 10%.
    c. Realized security gains.
    d. Collection on loans already charged off.
    e. All of the above would be considered extraordinary items.

Answer: a

41. Net income is defined as:
    a. Net interest income – burden + provision for loan loss + securities gains or losses – taxes.
    b. Net interest income + burden + provision for loan loss + securities gains or losses – taxes.
    c. Net interest income – burden – provision for loan loss + securities gains or losses – taxes.
    d. Net interest income – burden – provision for loan loss + securities gains or losses + taxes.
    e. Net interest income + burden – provision for loan loss + securities gains or losses – taxes.

Answer: c

42. Total operating income is comparable to __________ for a non-financial firm.
    a. sales
    b. cost of goods sold
    c. gross profit
    d. earnings before interest and taxes
    e. net income

Answer: a

43. Total operating expense is comparable to __________ for a non-financial firm.
    a. sales
    b. cost of goods sold + other operating expenses
    c. interest expense
    d. earnings before taxes
    e. net income

Answer: b

44. A change in net interest income would occur when:
    a. the composition of the assets of the bank change.
    b. the average asset yield changes.
    c. the volume of the assets of the bank change.
    d. the average interest expense changes.
    e. All of the above

Answer: e

45. A bank that deals primarily with commercial customers is called:
   a. an Edge Act bank.
   b. a retail bank.
   c. a wholesale bank.
   d. a uniform bank.
   e. a liability bank.

Answer: c

46. Relative to retail banks, wholesale banks:
   a. deal primarily with consumers.
   b. operate with fewer commercial deposits.
   c. purchase more non-core liabilities.
   d. hold proportionally more consumer loans.
   e. All of the above.

Answer: c

47. Relative to wholesale banks, retail banks:
   a. focus on individual consumer banking relationships.
   b. operate with fewer consumer deposits.
   c. purchase more non-core liabilities.
   d. hold proportionally more business loans to large firms.
   e. All of the above.

Answer: a

48. A bank's equity multiplier measures the bank's:
   a. financial leverage.
   b. operating leverage.
   c. credit leverage.
   d. interest rate exposure.
   e. duration gap.

Answer: a

49. Return on equity can be decomposed into:
   a. the sum of return on assets and the equity multiplier.
   b. the product of return on assets and the equity multiplier.
   c. the product of the profit margin and the equity multiplier.
   d. the sum of the profit margin and the equity multiplier.
   e. the sum of the profit margin, equity multiplier, and the interest ratio.

Answer: b

50. Return on assets can be calculated as:
   a. return on equity plus the equity multiplier.
   b. net interest income divided by earning assets.
   c. asset utilization minus the expense ratio and the tax ratio.
   d. interest income minus interest expense.
   e. earning assets divided by average total assets.

Answer: c

51. What is the return on equity for a bank that has an equity multiplier of 14, an interest expense ratio of 4%, and a return on assets of .9%?
   a. 1.3%
   b. 4.0%
   c. 9.0%
   d. 12.6%
   e. 8.6%

Answer: d

ROE = ROA * EM = 0.9% * 14 = 12.6%

52. What is the return on equity for a bank that has an equity multiplier of 9, an interest expense ratio of 6%, and a return on assets of 1.2%?
   a. 10.8%
   b. 6.0%
   c. 8.0%
   d. 4.8%
   e. 0.65%

Answer: a

ROE = ROA * EM = 1.2% * 9 = 10.8%

53. What is the return on equity for a bank that has an equity multiplier of 12, an interest expense ratio of 5%, and a return on assets of 1.1%?
   a. 5.0%
   b. 13.2%
   c. 8.2%
   d. 26.4%
   e. 0.66%

Answer: b

ROE = ROA * EM = 1.1% * 12 = 13.2%

54. Everything else the same, financial leverage works to a bank’s advantage when:
   a. the return on assets is positive.
   b. the return on assets is negative.
   c. fixed assets are high.
   d. fixed assets are low.
   e. a. and d.

Answer: a

55. What is the equity multiplier for a bank where equity is equal to 8% of total assets?

a. 1.08
b. 8.00
c. 0.92
d. 12.5
e. 1.25

Answer: d
Total Assets/Total Equity = 100%/8% = 12.5x

56. What is the equity multiplier for a bank where equity is equal to 10% of total assets?

f. 90.00
g. 10.00
h. 1.10
i. 110.00
j. 1.00

Answer: b
Total Assets/Total Equity = 100%/10% = 10.0x

57. What is the equity multiplier for a bank where equity is equal to 12% of total assets?

a. 83.33
b. 1.12
c. 0.88
d. 12.00
e. 8.33

Answer: e
Total Assets/Total Equity = 100%/12% = 8.33x

58. Net income is calculated as:

a. total revenue – total operating expenses.
b. total revenue – total operating expenses – taxes.
c. asset utilization – expense ratio.
d. asset utilization – expense ratio – tax ratio.
e. interest expense ratio – non-interest expense ratio – provision for loan loss ratio.

Answer: b

59. The expense ratio is calculated as:

a. total revenue – total operating expenses.
b. total revenue – total operating expenses – taxes.
c. interest expense ratio – non-interest expense ratio – provision for loan loss ratio.
d. asset utilization – expense ratio – tax ratio.
e. interest expense ratio + non-interest expense ratio + provision for loan loss ratio.

Answer: e

60. Interest expense varies between banks because of:
   a. rate effects.
   b. composition effects.
   c. volume effects.
   d. all of the above.
   e. a. and c.

Answer: d

Use the following information for questions 61 – 65.

1st State Bank
Balance Sheet
Assets

Cash and Due from Banks	$	50
Investments	$	300
Federal Funds	$	10
Loans	$	350
Premises	$	90
Average Total Assets	$	800

Liabilities & Equity

Demand Deposits	$	100
Time Deposits	$	300
Federal Funds	$	300
Equity	$	100
Average Total Liabilities & Equity	$	800

Income Statement

Interest Income	$	100
Interest Expense	$	75
Non-Interest Income	$	5
Non-Interest Expense	$	25
Net Income	$	5

61. What is 1st State's return on equity?
   a. 0.6%
   b. 3.8%
   c. 5.0%
   d. 8.2%
   e. 9.8%

Answer: c

ROE = Net Income/Total Equity

ROE = $5/$100 = 5%

62. What is 1st State's net interest margin?
a. 0.6%
b. 3.8%
c. 5.0%
d. 8.2%
e. 9.8%

Answer: b
Net Interest Margin = Net Interest Income/Earning Assets
Net Interest Income = Interest Income – Interest Expense
Net Interest Income = $100 - $75 = $25
Earning Assets = Investments + Federal Funds + Loans
Earning Assets = $300 + $10 + $350 = $660
Net Interest Margin = $25/$660 = 3.8%

63. What is the earnings base at 1st State?
a. 12.5%
b. 17.5%
c. 58.5%
d. 75.5%
e. 82.5%

Answer: e
Earnings Base = Earning Assets/Total Assets
Earning Assets = Investments + Federal Funds + Loans
Earning Assets = $300 + $10 + $350 = $660
Earnings Base = $660/$800 = 82.5%

64. What is 1st State's burden?
a. 2.5%
b. 17.5%
c. 25.0%
d. 75.5%
e. 82.5%

Answer: a
Burden = (Non-Interest Expense – Non-Interest Income)/Average Total Assets
Burden = ($25 - $5)/$800 = 2.50%

65. What is 1st State's efficiency ratio?

a. 2.53%
b. 17.51%
c. 0.83%
d. 0.45%
e. 83.3%

Answer: e

Efficiency Ratio = Non-Interest Expense/(Net Interest Income + Non-Interest Income)

Net Interest Income = Interest Income – Interest Expense

Net Interest Income = $100 - $75= $25

Efficiency Ratio = $25/($25 + $5) =83.3%

Use the following information for questions 66 – 70.

1st National Bank

Balance Sheet

Assets		
Cash and Due from Banks	$	75
Investments	$	400
Federal Funds	$	18
Loans	$	402
Premises	$	105
Average Total Assets	$	1,000

Liabilities & Equity		
Demand Deposits	$	150
Time Deposits	$	325
Federal Funds	$	425
Equity	$	100
Average Total Liabilities & Equity	$	1,000

Income Statement		
Interest Income	$	150
Interest Expense	$	110
Non-Interest Income	$	11
Non-Interest Expense	$	38
Net Income	$	13

66. What is 1st State's return on equity?

a. 0.6%
b. 3.8%
c. 5.0%
d. 8.2%
e. 13.0%

Answer: e

ROE = Net Income/Total Equity

ROE = $13/$100 = 13%

67. What is 1st State's net interest margin?

a. 0.6%
b. 3.8%
c. 4.9%
d. 8.2%
e. 9.8%

Answer: c

Net Interest Margin = Net Interest Income/Earning Assets
Net Interest Income = Interest Income – Interest Expense
Net Interest Income = $150- $110 = $40
Earning Assets = Investments + Federal Funds + Loans
Earning Assets = $400 + $18 + $402 = $820
Net Interest Margin = $40/$820 = 4.9%

68. What is the earnings base at 1st State?

a. 12.5%
b. 17.0%
c. 58.5%
d. 75.5%
e. 82.0%

Answer: e

Earnings Base = Earning Assets/Total Assets
Earning Assets = Investments + Federal Funds + Loans
Earning Assets = $400 + $18 + $402 = $820
Earnings Base = $820/$1,000 = 82.0%

69. What is 1st State's burden?

a. 2.7%
b. 17.5%
c. 25.0%
d. 75.5%
e. 82.5%

Answer: a

Burden = (Non-Interest Expense – Non-Interest Income)/Average Total Assets
Burden = ($38 - $11)/$1,000 = 2.70%

70. What is 1st State's efficiency ratio?

a. 2.5%
b. 17.5%
c. 25.0%
d. 74.5%
e. 82.5%

Answer: d

Efficiency Ratio = Non-Interest Expense/(Net Interest Income + Non-Interest Income)
Net Interest Income = Interest Income – Interest Expense
Net Interest Income = $150 - $110= $40
Efficiency Ratio = $38/($40 + $11) =74.5%

71. The efficiency ratio measures:

a. a bank's ability to control interest expense.
b. a bank's ability to control non-interest expense.
c. a bank's spread.
d. a bank's burden.
e. a bank's operating leverage.

Answer: b

72. Which of the following would not be considered an earning asset?

a. Cash due from banks
b. Municipal securities
c. Treasury bills
d. Repurchase agreements
e. Mortgages

Answer: a

73. The goal of a bank manager should be:

a. to maximize earnings.
b. to minimize taxes.
c. to minimize risk.
d. to maximize shareholder wealth.
e. to maximize net interest income.

Answer: d

74. Which of the following is not one of the risks identified by the Federal Reserve Board?

a. Credit Risk
b. Market Risk
c. Ownership Risk
d. Reputation Risk
e. Legal Risk

Answer: c

75. Which type of risk is the most difficult to quantify?
    a. Credit risk
    b. Liquidity risk
    c. Legal risk
    d. Operating risk
    e. Market risk

Answer: c

76. A savings and loan that sold off their junk bond holdings and issued consumer auto loans with the proceed would most likely be:
    a. decreasing their market risk.
    b. increasing their capital risk.
    c. decreasing their legal risk.
    d. increasing their operating risk.
    e. reducing their credit risk.

Answer: e

77. Recoveries refer to:
    a. the dollar value of loans actually written off as uncollectible.
    b. the dollar amount of loans that were previously charged-off but now collected.
    c. net charge-offs.
    d. loans not currently accruing interest.
    e. loans that regulators have required the bank to "recover".

Answer: b

78. Classified loans:
    a. still accrue interest.
    b. have not had a principle or interest payment made in 90 days.
    c. exactly offset gross charge-offs.
    d. are loans in which regulators have forced management to set aside reserves.
    e. all of the above

Answer: d

79. The risk that a bank cannot meet payment obligations in a timely and cost-effective manner is known as:
    a. credit risk.
    b. capital risk.
    c. market risk.
    d. operating risk.
    e. liquidity risk.

Answer: e

80. All of the following are examples of operational risk <u>except</u>:
   a. fraud.
   b. compromised security data.
   c. theft.
   d. business interruptions.
   e. default on a loan.

Answer: e

81. Which of the following is <u>not</u> part of the CAMELS ratings?
   a. Capital adequacy.
   b. Asset quality.
   c. Earnings quality.
   d. Liabilities quality.
   e. Sensitivity to market risk.

Answer: d

True/False

82. Subordinated bank debt is federally insured.
Answer: False

83. Total revenue is the same as total operating income.
Answer: True

84. Retail banks deal primarily with commercial customers.
Answer: False

85. When constructing ratios, average balance sheet data should be used.
Answer: True

86. Balance sheet items are considered stock variables.
Answer: True

87. Regarding interest expense, volume effects suggest that the mix of liabilities among banks may differ.
Answer: False

88. Banks that use preferred stock understate their ROE relative to banks that do not use preferred stock.
Answer: False

89. Eliminating borrowing from the Federal Reserve at the end of fiscal year is an example or "window dressing."
Answer: True

90. Smaller banks generally employee fewer people per dollar of assets than larger banks.
Answer: False

91. Regarding interest expense, volume effects suggest that the mix of liabilities among banks may differ.
Answer: False

Essay Questions

92. What are the principal sources of risk facing a bank manager?

93. What are some of the advantages and disadvantages of using ratio analysis to examine the financial performance of a bank?

94. From a financial statement perspective, discuss how banks differ from non-financial companies.

95. What are some key differences in the financial ratios for small banks versus large banks?