Standbys, and Credit Derivatives

Fill in the Blank Questions

1. When a bank sets aside a group of income-earning assets and then sells securities based upon those assets it is _____ those assets.

   Answer: securitizing

2. Often when loans are securitized they are passed on to a _____ who pools the loans and sells securities.

   Answer: special purpose entity

3. A(n) _____ allows a homeowner to borrow against the residual value of their residence.

   Answer: home equity loan

4. _____ allow the bank to generate fee income after they have sold a loan. The bank continues to collect interest and principal from the borrowers and passes these collections to the loan buyers.

   Answer: Servicing rights

5. In a _____ an outsider purchases part of a loan from the selling financial institution. Generally the purchaser has no influence over the terms of the loan contract.

   Answer: participation loan

6. A(n) _____ is a contingent claim of the bank that issues it. The issuing bank, in return for a fee, guarantees the repayment of a loan received by its customer or the fulfillment of

a contract made by its customer to a third party.

Answer: standby credit agreement

7. A(n) _____ occurs when two banks agree to exchange a portion or all of the loan repayments of their customers.

   Answer: credit swap

8. A(n) _____ guards against the losses in the value of a credit asset. It would pay off if the asset declines significantly in value or if it completely turns bad.

   Answer: credit option.

9. A(n) _____ combines a normal debt instrument with a credit option. It allows the issuer of the debt instrument to lower its loan repayments if some significant factor changes.
   Answer: credit linked note
10. The _____ of a standby letter of credit is a bank or other investor who is concerned about the safety of funds committed to the recipient of the standby letter of credit.
   Answer: beneficiary
11. A(n) _____ guarantees the s a specific rate of return on their credit asset. Bank A may agree to pay the total return on the loan to Bank B plus any appreciation in the market value of the loan. In return Bank A will often get LIBOR plus a fixed spread plus any depreciation in the value of the loan.
   Answer: total return swap
12. The _____ is the party that is requesting a standby letter of credit.
   Answer: account party
13. The _____ is the bank or financial institution which guarantees the payment of the loan in a standby letter of credit.
   Answer: issuer
14. A(n) _____ is a loan sale where ownership of the loan is transferred to the buyer of the loan, who then has a direct claim against the borrower.
   Answer: assignment
15. Another type of loan sale is a(n) _____ which is a short dated piece of a longer maturity loan, entitling the

purchaser to a fraction of the expected loan income.

Answer: loan strip

16. A relatively new type of credit derivative is a which stands for _____.

Answer: collateralized debt obligation

17. Insurance companies are a prime _____ of credit derivatives.

Answer: seller

18. A(n) _____ is an over-the-counter agreement offering protection against loss when default occurs on a loan or other debt instrument.

Answer: credit derivative

19. A(n) _____ is related to the credit option and is usually aimed at lenders able to handle comparatively limited declines in value but wants insurance against serious losses.

Answer: credit default swap

20. There has been an explosion in _____ in recent years. These instruments rest on pools of credit derivatives that mainly insure against defaults on corporate bonds. The creators of these instruments do not have to buy and pool actual bonds but can create these instruments and generate revenues from selling and trading in them.

Answer: synthetic CDOs (Collateralized debt obligations)

21. A _____ rates the securities to be sold from a pool of securitized loans so that investors have a better idea of what the new securities are likely to be worth.

Answer: credit rating agency

will be repaid in the event of the default of the underlying loans in a securitization. These can be internal or external to the securitization process and lower the risk of the securities.

Answer: credit enhancement

23. When the FHLMC creates CMOs they often use different _____ which each promise a different coupon rate and which have different maturity and risk characteristics.

24. Lenders can set aside a group of loans on their balance sheet, issue bonds and pledge the loans as collateral against the bonds in _____. These usually stay on the bank's balance sheet as liabilities.

25. FNMA (Fannie Mae) and FHLMC (Freddie Mac) are examples of _____. They appear to have the unofficial _____ backing of the federal government in the event of default.

Answer: government sponsored enterprises (GSEs)

T F 26. Securitization is designed to turn illiquid loans into liquid assets in the form of securities sold in the open market.

Answer: True

T F 27. Securitization has the added advantage of generating fee income for banks.

Answer: True

T F 28. Securitized assets cannot be removed from a bank's balance sheet until they mature.

Answer: False

T F 29. Securitization raises the level of competition for the best-quality loans among banks.

Answer: True

T F 30. Servicing rights on loans sold consist of the collection of interest and principal payments from borrowers and monitoring borrower compliance with loan terms.

Answer: True

T F 31. A loan sold by a bank to another investor with recourse means the bank has given the investor a call option on the loan.

Answer: False

T F 32. An account party will seek a bank's standby credit guarantee if the bank's fee for issuing the guarantee is less than the value assigned the guarantee by its beneficiary.

Answer: True

T F 33. Securitization tends to lengthen the maturity of a bank's assets.

Answer: False

T F 34. Securitized assets as a source of bank funds are subject to reserve requirements set by the Federal Reserve Board.

Answer: False

T F 35. Securitizations of commercial loans usually carry the same regulatory capital requirements for a bank as the original loans themselves.

Answer: True

T F 36. Most loans that banks sell off their balance sheets have

Answer: True

T F 37. Most loans that banks sell off their balance sheets carry interest rates that usually are connected to long-term interest rates (such as the 30-year Treasury bond rate).

Answer: False

T F 38. In a participation loan the purchaser is an outsider to the loan contract between the financial institution selling the loan and the borrower.

Answer: True

T F 39. The buyer of a loan participation must watch both the borrower and the seller bank closely.

Answer: True

T F 40. Under an assignment ownership of a loan is transferred to the buyer, though the buyer still holds only an indirect claim against the borrower.

Answer: False

T F 41. Loan sales are generally viewed as risk-reducing for the selling financial institution.

Answer: True

T F 42. In a CMO, the different tiers (or tranches) of security purchasers face the same prepayment risk.

Answer: False

T F 43. A standby letter of credit substantially reduces the issuing bank's interest rate risk and liquidity risk.

Answer: False

T F 44. Securitization of loans can easily be applied to business loans since these loans tend to have similar cash flow schedules and comparable risk structures.

Answer: False

T F 45. The advantage of a credit s that it allows each bank in the s broaden its market area and spread out its credit risk on its loans.

Answer: True

T F 46. Bank use of credit derivatives is dominated by the largest banks.

Answer: True

T F 47. The credit derivatives market has grown nine-fold during the recent years.

Answer: True

T F 48. Banks are the principal sellers of credit derivatives.

Answer: False

T F 49. Banks are one of the principal buyers of credit derivatives.

Answer: True

T F 50. Insurance companies are one of the principal sellers of credit derivatives.

Answer: True

51. Securitized assets carry a unique form of risk called:

A) Default risk

B) Inflation risk

C) Interest-rate risk

D) Prepayment risk

E) None of the above

Answer: D

52. Short-dated pieces of a longer-term loan, usually maturing in a few days or weeks, are called:

A) Loan participations

B) Servicing rights

C) Loan strips

D) Shared credits

E) None of the above

Answer: C

53. The party for whom a standby credit letter is issued by a bank is known as the:

A) Account party

B) Beneficiary

C) Representative

D) Credit Guarantor

E) None of the above

Answer: A

54. When a bank issues a standby credit guarantee on behalf of one of its customers, the party receiving the guarantee is known as the:

A) Account party

B) Beneficiary

C) Obligator

D) Servicing agent

E) None of the above

Answer: B

55. Securitization had its origin in the selling of securities backed by _____

A) Credit card receivables

B) Residential mortgage loans

C) Computer leases

D) Automobile loans

E) Truck leases

Answer: B

56. Loan-backed securities, which closely resemble traditional bonds, carry various forms of credit enhancements, which may include all of the following, EXCEPT:

A) Credit letter guaranteeing repayment of the securities.

B) Set aside of a cash reserve.

C) Division into different risk classes.

D) Early payment clauses.

E) None of the above.

Answer: D

57. In some instances, a bank will sell loans and agree to give the loan purchaser recourse to the seller for all or a portion of those loans that become delinquent. In this case, the purchaser, in effect, gets a:

A) Call option.

B) Put option.

C) Forward contract.

D) Futures contract

E) None of the above.

Answer: B

58. The key advantages of issuing standby letters of credit include which of the following:

A) Letters of credit generate fee income for the bank.

B) Letters of credit typically reduce the borrower's cost of borrowing.

C) Letters of credit can usually be issued for a relatively low cost.

D) The probability is low that the issuer of the letter of credit will be called upon to pay.

E) All of the above.

Answer: E

59. Banks that issue standby letters of credit may face which of the following types of risk?

A) Prepayment risk.

B) Interest-rate risk.

C) Liquidity risk.

D) All of the above.

E) B and C only.

Answer: E

59. By agreeing to service any assets that are packaged together in the securitization process a bank can:

A) Ensure the assets that are packaged and securitized remain in the package and are not sold off.

B) Choose the best loans to go through the securitization

process.

C) Earn added fee income.

D) Liquidate any assets it chooses.

E) None of the above.

Answer: C

60. The difference in interest rates between securitized loans themselves and the securities issued against the loans is referred to as:

A) The funding gap

B) Residual income.

C) Service returns

D) Security income

E) None of the above

Answer: B

61. If a credit letter is issued to backstop payments on loan-backed securities, the credit letter is a form of:

A) Collateralized asset

B) Residual income

C) Direct loan obligation

D) Credit enhancement

E) None of the above

Answer: D

62. Loan sales by banks are generally of two types: (a) participation loans; and (b)_____. The term that correctly fills in the blank above is:

A) Assignments

B) Recourse loans

C) Direct loans

D) Subscription loans

E) None of the above.

Answer: A

63. A standby credit letter is a (or an):

A) Securitized strip

B) Loan strip

C) Contingent obligation

D) Indirect loan

E) None of the above.

Answer: C

64. A bank that wants to protect itself from higher credit costs due to a decrease in its credit rating might purchase _____ .

A) A credit risk option

B) A standby letter of credit

C) A credit linked note

D) A credit swap

E) None of the above

Answer: A

65. When two banks simply agree to exchange a portion of their customers' loan repayments, they are using:

A) A credit option

B) A standby letter of credit

C) A credit linked note

D) A credit swap

E) None of the above

Answer: D

66. A debt instrument which allows the issuer to lower its coupon payments if some significant factor changes is called:

A) A credit option

B) A standby letter of credit

C) A credit linked note

D) A credit swap

E) None of the above

Answer: C

67. Which of the following is a risk of using credit derivatives?

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