International Certificate in Banking Risk and Regulation (ICBRR)

1. Which one of the following four statements correctly defines credit risk?

A. Credit risk is the risk that complements market and liquidity risks.

B. Credit risk is a form of performance risk in contractual relationship.

C. Credit risk is the risk arising from execution of a company's strategy.

D. Credit risk is the risk that summarizes the exposures a company or firm assumes when it attempts to operate within a given field or industry.

Answer(s): B

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2. A credit analyst wants to determine a good pricing strategy to compensate for credit decisions that might have been made incorrectly.
When analyzing her credit portfolio, the analyst focuses on the spreads in each loan to determine if they are sufficient to compensate the bank for all of the following costs and risks EXCEPT.

A. The marginal cost of funds provided.

B. The overhead cost of maintaining the loan and the account.

C. The inherent risk of lending to this borrower while providing a return on the risk capital used to the support the loan.

D. The opportunity cost of risk-adjusted marginal cost of capital.

Answer(s): D

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3. To estimate the interest charges on the loan, an analyst should use one of the following four formulas:

A. Loan interest = Risk-free rate - Probability of default x Loss given default + Spread

B. Loan interest = Risk-free rate + Probability of default x Loss given default + Spread

C. Loan interest = Risk-free rate - Probability of default x Loss given default - Spread

D. Loan interest = Risk-free rate + Probability of default x Loss given default - Spread

Answer(s): B

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4. Alpha Bank determined that Delta Industrial Machinery Corporation has 2% change of default on a one-year no-payment of USD $1 million, including interest and principal repayment. The bank charges 3% interest rate spread to firms in the machinery industry, and the risk-free interest rate is 6%. Alpha Bank receives both interest and principal payments once at the end the year. Delta can only default at the end of the year. If Delta defaults, the bank expects to lose 50% of its promised payment. Hence, the loss rate in this case will be

A. 1%

B. 3%

C. 5%

D. 10%

Answer(s): A

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5. Alpha Bank determined that Delta Industrial Machinery Corporation has 2% change of default on a one-year no-payment of USD $1 million, including interest and principal repayment. The bank charges 3% interest rate spread to firms in the machinery industry, and the risk-free interest rate is 6%. Alpha Bank receives both interest and principal payments once at the end the year. Delta can only default at the end of the year. If Delta defaults, the bank expects to lose 50% of its promised payment.
What interest rate should Alpha Bank charge on the no-payment loan to Delta Industrial Machinery Corporation?

A. 8%

B. 9%

C. 10%

D. 12%

Answer(s): C

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6. Alpha Bank determined that Delta Industrial Machinery Corporation has 2% change of default on a one-year no-payment of USD $1 million, including interest and principal repayment. The bank charges 3% interest rate spread to firms in the machinery industry, and the risk-free interest rate is 6%. Alpha Bank receives both interest and principal payments once at the end the year. Delta can only default at the end of the year. If Delta defaults, the bank expects to lose 50% of its promised payment.
What may happen to the Delta's initial credit parameter and the value of its loan if the machinery industry experiences adverse structural changes?

A. Probability of default and loss at default may decrease simultaneously, while duration rises causing the loan value to decrease.

B. Probability of default and loss at default may decrease simultaneously, while duration falls causing the loan value to decrease.

C. Probability of default and loss at default may increase simultaneously, while duration rises causing the loan value to decrease.

D. Probability of default and loss at default may increase simultaneously, while duration falls causing the loan value to decrease.

Answer(s): D

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7. Alpha Bank determined that Delta Industrial Machinery Corporation has 2% change of default on a one-year no-payment of USD $1 million, including interest and principal repayment. The bank charges 3% interest rate spread to firms in the machinery industry, and the risk-free interest rate is 6%. Alpha Bank receives both interest and principal payments once at the end the year. Delta can only default at the end of the year. If Delta defaults, the bank expects to lose 50% of its promised payment. Six months after Alpha Bank provides USD $1 million loan to the Delta Industrial Machinery Corporation, a new competitor enters the machinery industry, causing Delta to adjust its prices and mark down the value of its inventory. Hence, the probability of default

increases from 2% to 10% and the loss given default increases from 50% to 75%. If Alpha Bank can reprice the loan, what should the new rate be?

A. 10%

B. 13%

C. 16.5%

D. 20.5%

Answer(s): D

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8. Which one of the following four model types would assign an obligor to an obligor class based on the risk characteristics of the borrower at the time the loan was originated and estimate the default probability based on the past default rate of the members of that particular class?

A. Dynamic models

B. Causal models

C. Historical frequency models

D. Credit rating models

Answer(s): C

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9. Which one of the following four models is typically used to grade the obligations of small- and medium-size enterprises?

A. Causal models

B. Historical frequency models

C. Credit scoring models

D. Credit rating models

Answer(s): C

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10. A credit associate extending a loan to an obligor suspects that the obligor may change his behavior after the loan has been originated. The obligor in this case may use the loan proceeds for purposes not sanctioned by the lender, thereby increasing the risk of default. Hence, the credit associate must estimate the probability of default based on the assumptions about the applicability of the following tendency to this lending situation:

A. Speculation

B. Short bias

C. Moral hazard

D. Adverse selection

Answer(s): C

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11. A bank customer chooses a mortgage with low initial payments and payments that increase over time because the customer knows that she will have trouble making payments in the early years of the loan. The bank makes this type of mortgage with the same default assumptions uses for ordinary mortgages, thus underestimating the risk of default and becoming exposed to:

A. Moral hazard

B. Adverse selection

C. Banking speculation

D. Sampling bias

Answer(s): B

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12. The potential failure of a manufacturer to honor a warranty might be called ____, whereas the potential failure of a borrower to fulfill its payment requirements, which include both the repayment of the amount borrowed, the principal and the contractual interest payments, would be called ___.

A. Credit risk; market risk

B. Market risk; credit risk

C. Credit risk; performance risk

D. Performance risk; credit risk

Answer(s): D

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13. Which one of the following four options does NOT represent a benefit of compensating balances to the bank?

A. Compensating balances allow the bank to net some of the exposure they may have in case of default, by taking funds from these specific deposit account one the borrower defaults.

B. Since the compensating balances cannot be withdrawn at short notice, if at all, they are not considered transaction accounts and are able to provide a stable funding to the bank, reducing its reliance on more volatile external inter-bank based funding sources.

C. Compensation balances influence the expected loss rate of the bank given the default obligor and improve capital structure by controlling obligor type and avoiding payment delays.

D. Since the compensating balances reduce the next amount lent to the borrower, the earned return on the loan is increased, further widening the bank's interest rate margin and profitability.

Answer(s): C

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14. According to a Moody's study, the most important drivers of the loss given default historically have been all of the following EXCEPT:
I) Debt type and seniority
II) Macroeconomic environment
III) Obligor asset type
IV) Recourse

A. I

B. II

C. I, II

D. III, IV

Answer(s): D

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15. A credit rating analyst wants to determine the expected duration of the default time for a new three-year loan, which has a 2% likelihood of defaulting in the first year, a 3% likelihood of defaulting in the second year, and a 5% likelihood of defaulting the third year.
What is the expected duration for this three-year loan?

A. 1.5 years

B. 2.1 years

C. 2.3 years

D. 3.7 years

Answer(s): C

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16. Of all the risk factors in loan pricing, which one of the following four choices is likely to be the least significant?

A. Probability of default

B. Duration of default

C. Loss given default

D. Exposure at default

Answer(s): B

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17. By lowering the spread on lower credit quality borrowers, the bank will typically achieve all of the following outcomes EXCEPT:

A. Aggressively courting of new business

B. Lower probability of default

C. Rapid growth

D. Higher losses in case of default

Answer(s): B

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18. In the United States, Which one of the following four options represents the largest component of securitized debt?

A. Education loans

B. Credit card loans

C. Real estate loans

D. Lines of credit

Answer(s): C

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19. From the bank's point of view, repricing the retail debt portfolio will introduce risks of fluctuations in:
I) Duration
II) Loss given default
III) Interest rates
IV) Bank spreads

A. I

B. II

C. I, II

D. III, IV

Answer(s): D

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20. Altman's Z-score incorporates all the following variables that are predictive of bankruptcy EXCEPT:

A. Return on total assets

B. Sales to total assets

C. Equity to debt

D. Return on equity

Answer(s): D