##### Solutions for End-of-Chapter Questions and Problems: Chapter Twenty Five

6.1. What is the difference between loans sold with recourse and loans sold without recourse from the perspective of both sellers and buyers?

6.2. A bank has made a three-year $10 million loan that pays annual interest of 8 percent. The principal is due at the end of the third year.

a. The bank is willing to sell this loan with recourse at an interest rate of 8.5 percent. What price should it receive for this loan?

b. The bank has the option to sell this loan without recourse at a discount rate of 8.75 percent. What price should it receive for this loan?

c. If the bank expects a 0.5 percent probability of default on this loan, is it better to sell this loan with or without recourse? It expects to receive no interest payments or principal if the loan is defaulted.

6.3. What are some of the key features of short-term loan sales?

6.4. Why are yields higher on loan sales than on commercial paper issues with similar maturity and issue size?

6.5. What are highly leveraged transactions? What constitutes the federal regulatory definition of an HLT?

6.6. How do the characteristics of an HLT loan differ from those of a short-term loan that is sold?

6.7. What is a possible reason why the spreads on HLT loans perform differently than do the spreads on junk bonds?

6.8. City Bank has made a 10-year, $2 million loan that pays annual interest of 10 percent. The principal is expected to be paid at maturity.

a. What should City Bank expect to receive from the sale of this loan if the current market interest rate on loans of this risk is 12 percent?

b. The price of loans of this risk is currently being quoted in the secondary market at bid-offer prices of 88-89 cents (on each dollar). Translate these quotes into actual prices for the above loan.

c. Do these prices reflect a distressed or nondistressed loan? Explain.

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6.9. What is the difference between loan participations and loan assignments?

6.10. What are the difficulties in completing a loan assignment?

6.11. Who are the buyers of U.S. loans and why do they participate in this activity?

a. What are vulture funds?

b. What are three reasons the interbank market has been shrinking?

c. What are reasons a small bank would be interested in participating in a loan syndication?

6.12. Who are the sellers of U.S. loans and why do they participate in this activity?

a. What is the purpose of a bad bank?

b. What are the reasons why loan sales through a bad bank will be value enhancing?

c. What impact has the 1996 Federal Debt Improvement Act had on the loan sale market?

6.13. In addition to managing credit risk, what are some other reasons for the sale of loans by FIs?

The reasons for an increase in loan sales, apart from hedging credit risk, include:

6.14. What are factors that may deter the growth of the loan sale market in the future? Discuss.

6.15. An FI is planning the purchase of a $5 million loan to raise the existing average duration of its assets from 3.5 years to 5 years. It currently has total assets worth $20 million, $5 million in cash (0 duration) and $15 million in loans. All the loans are fairly priced.

a. Assuming it uses the cash to purchase the loan, should the FI purchase the loan if its duration is seven years?

b. What asset duration loans should it purchase in order to raise its average duration to five years?

6.16. In addition to hedging credit risk, what are five factors that are expected to encourage loan sales in the future? Discuss the impact of each factor.