MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) Advocates of Fed independence fear that subjecting the Fed to direct presidential or congressional control would
   A) force monetary authorities to sacrifice the long-run objective of price stability.
   B) impart an inflationary bias to monetary policy.
   C) make the so-called political business cycle less pronounced.
   D) do all of the above.
   E) do only (a) and (b) of the above.

2) To prevent the moral hazard problem, health and life insurance companies may write policies
   A) containing provisions which either reduce or eliminate benefits to persons who contract pre-specified illnesses.
   B) for which premiums increase dramatically once the policyholder is discovered to have contracted an illness.
   C) limiting the amount the companies will pay in the event that claims are submitted by policyholders.
   D) with all of the above provisions.
   E) with only (a) and (b) of the above provisions.
3) Because young males have a much higher rate of accidents on average than young females, automobile insurers will be likely to
   A) encourage young males to purchase collision insurance policies with relatively high deductibles.
   B) charge young males higher insurance premiums than young females, all else equal.
   C) encourage young females to purchase collision insurance policies with no deductibles.
   D) all of the above.
   E) only (a) and (b) of the above.

4) Bank loans from the Federal Reserve are called _____ and represent a _____ of funds.
   A) fed funds; use
   B) discount loans; source
   C) fed funds; source
   D) discount loans; use

5) A bank’s balance sheet
   A) lists sources and uses of bank funds.
   B) shows that total assets equals total liabilities plus equity capital.
   C) indicates whether or not the bank is profitable.
   D) does all of the above.
   E) does only (a) and (b) of the above.

6) Because of the adverse selection problem,
   A) lenders may refuse loans to individuals with high net worth, because of their greater proclivity to "skip town."
   B) good credit risks are more likely to seek loans causing lenders to make a disproportionate amount of loans to good credit risks.
   C) in the light of recent accounting scandals related with Enron and other big firms, lenders are now reluctant to buy new issues in the commercial paper market.
   D) all of the above.

7) Which of the following statements most accurately describes the task of bank asset management?
   A) Banks seek to prevent bank failure at all cost; since a failed bank earns no profit, liquidity needs supersede the desire for profits.
   B) Banks seek to have the highest liquidity possible subject to earning a positive rate of return on their operations.
   C) Banks seek the highest returns possible subject to minimizing risk and making adequate provisions for liquidity.
   D) None of the above accurately describes the task of asset management.
8) The too-big-to-fail policy
   A) exacerbates moral hazard problems.
   B) puts large banks at a competitive disadvantage in attracting large deposits.
   C) treats large depositors of small banks inequitably when compared to depositors of large banks.
   D) does only (a) and (c) of the above.

9) Financial intermediaries and, particularly, banks have the ability to avoid the free-rider problem as long as they primarily
   A) acquire a diversified portfolio of stocks.
   B) make private loans.
   C) buy junk bonds.
   D) do a balanced combination of (a) and (b) of the above.

10) The policy of regulatory forbearance
   A) meant delaying the closing of "zombie S&Ls" as their losses mounted during the 1980s.
   B) benefited "zombie S&Ls" at the expense of healthy S&Ls, as healthy institutions lost deposits to insolvent institutions.
   C) had the advantage that it benefited healthy S&Ls by giving them the opportunity to attract deposits that began to leave the "zombie S&Ls".
   D) both (a) and (b) of the above.
   E) both (a) and (c) of the above.

11) Financial intermediaries, particularly banks,
   A) overcome the free-rider problem by primarily making private loans, rather than purchasing securities that are traded in the open market.
   B) are experts in the production of information about firms so that it can sort good risks from bad ones.
   C) play a greater role in moving funds to corporations than do securities markets.
   D) all of the above.
   E) only (a) and (b) of the above.

12) A major controversy involving the banking industry in its early years was
   A) whether banks should be allowed to issue their own bank notes.
   B) what percent of deposits banks should hold as fractional reserves.
   C) whether the federal government or the states should charter banks.
   D) whether banks should both accept deposits and make loans or whether these functions should be separated into different institutions.
13) To prevent adverse selection, health and life insurance companies
   A) charge the same premiums to all policyholders.
   B) always charge the same premiums to people regardless of certain pre-existing health
      conditions.
   C) require potential policyholders to submit medical records, and may refuse to sell
      policies to people with certain pre-existing health conditions.
   D) will do both (a) and (b) of the above.

14) Of the following financial intermediaries, which holds the least liquid assets?
   A) Money market mutual funds
   B) Commercial banks
   C) Life insurance companies
   D) Property and casualty insurance companies

15) Solutions to the moral hazard problem include
   A) greater reliance on debt contracts and less on equity contracts.
   B) monitoring and enforcement of restrictive covenants.
   C) high net worth.
   D) all of the above.
   E) only (a) and (b) of the above.

16) Because of their _____ liquidity, _____ U.S. government securities are called secondary
    reserves.
   A) high; short-term  B) low; long-term
   C) high; long-term  D) low; short-term

17) Which of the following do banks hold as insurance against the high cost of deposit
    outflows?
   A) Secondary reserves
   B) Excess reserves
   C) Bank equity capital
   D) Each of the above
   E) Only (a) and (b) of the above

18) The spectacular growth in international banking can be explained by
   A) the desire for U.S. banks to expand.
   B) only (a) and (e).
   C) the desire for U.S. banks to escape burdensome domestic regulations.
   D) all.
   E) the rapid growth in international trade.
19) The president from which Federal Reserve Bank always has a vote in the Federal Open Market Committee?
   A) Boston  B) San Francisco  C) Philadelphia  D) New York

20) The existence of deposit insurance can increase the likelihood that depositors will need deposit protection, as banks with deposit insurance
   A) are placed at a competitive disadvantage in acquiring funds.
   B) are likely to be too conservative, reducing the probability of turning a profit.
   C) are likely to regard deposits as an unattractive source of funds due to depositors' demands for safety.
   D) are likely to take on greater risks than they otherwise would.

21) When you deposit $50 in your account at First National Bank and a $100 check you have written on this account is cashed at Chemical Bank, then
   A) the reserves at First National increase by $50.
   B) the liabilities of First National decrease by $50.
   C) the liabilities at Chemical Bank increase by $50.
   D) only (a) and (b) of the above occur.

22) The large number of banks in the United States is an indication of
   A) only efficient banks operating within the United States.
   B) lack of competition within the banking industry.
   C) vigorous competition within the banking industry.
   D) none of the above.

23) The Federal Open Market Committee consists of
   A) the seven members of the Board of Governors and seven presidents of the regional Fed banks.
   B) the twelve regional Fed bank presidents and the chairman of the Board of Governors.
   C) the seven members of the Board of Governors and five presidents of the regional Fed banks.
   D) the five senior members of the seven-member Board of Governors.

24) What country is given credit for the birth of the Eurodollar market?
   A) The Soviet Union  B) The United States
   C) England  D) Japan
Answer Key
Multiple Choice

1) Answer: E
2) Answer: D
3) Answer: E
4) Answer: B
5) Answer: E
6) Answer: C
7) Answer: C
8) Answer: D
9) Answer: B
10) Answer: D
11) Answer: D
12) Answer: C
13) Answer: C
14) Answer: C
15) Answer: D
16) Answer: A
17) Answer: D
18) Answer: B, D
19) Answer: D
20) Answer: D
21) Answer: B
22) Answer: B
23) Answer: C
24) Answer: A
25. (a) (Bonus Question: 5 points) The news story “Firms Repeatedly Dodged Efforts To Rein In Off-the-Books Deals” highlights that the regulators in this case faced a lot of opposition from the firms who would have been affected by the proposed new measures. Who are the regulators?

Compare this with the Savings and Loans banking crisis in the 80s. How is the problem of regulators in the present case different than that in the Savings and Loans crisis?

Ans. The regulators in question are the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC). In the Savings and Loans case, regulators were restrained by politicians. This does not seem to be the case in the present story.
26. (a) (6 points) The bank you own has the following balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserves $50 million</td>
<td>Deposits $500 million</td>
</tr>
<tr>
<td>Loans $500 million</td>
<td>Bank capital $50 million</td>
</tr>
</tbody>
</table>

The bank your friend Amy owns has the following balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserves $50 million</td>
<td>Deposits $450 million</td>
</tr>
<tr>
<td>Loans $500 million</td>
<td>Bank capital $100 million</td>
</tr>
</tbody>
</table>

Suppose that both banks obtain 1\% net profit (return) on their assets. Which one of you has a higher return on equity? Show your work.

**Ans.** The net amount of profit = $550 \times 0.01 = $5.5 million. The return on equity for your bank is $5.5/50 = 11\%$, while for Amy’s bank it is $5.5/100 = 5.5\%$.

(b) (4 points) Now suppose that both banks suffer from loan defaults of $60 million each. What will be the new net worth (bank capital) of the each? Which situation you would like to be in now?

**Ans.** Your bank’s capital after the loss will be $50 - 60 = -10$ million $. Your bank is bankrupt. On the other hand Amy’s bank’s capital will be $100 - 60 = $40 million. Hence, her bank will survive. I guess you would like to be in this situation now.
27. (a) (6 points) The Glass-Steagall Act of 1933 separated commercial banking from the securities industry. Legislation in 1999, however, repealed the Glass-Steagall Act, removing the separation of these industries. What are the arguments in the favor and against of separation?

**Ans.** The main argument in the favor of separation is that banks may otherwise have excessive exposure to risky assets such as stocks. Thus, in case stock prices decline the depositors will suffer losses. A large portion of risky assets may also lead to bank panics and runs. On the other hand, consolidation brings economies of scale and makes domestic banks more competitive with foreign banks that already deal in both activities.

(b) (4 points) It is being alleged that some big banks had both traditional banking as well as investment banking (security underwriting etc.) with Enron. What kind of conflict of interest it can lead to? What measure(s) will you propose to handle this problem?

**Ans.** The banks may not have adequately screened loan proposals from Enron under the apprehension that it may adversely affect their business relationship and they may lose their highly profitable securities business with Enron. More disclosure requirements is one solution: if investors know that these banks are making substandard loans, it will reflect in banks’ share prices. Also, large depositors will be hesitant to do business with these banks.
28. (a) (5 points) Some proposals for reforming the banking regulatory system include elimination of deposit insurance, lower limits on the amount of deposit insurance, and outright elimination of the too-big-to-fail policy. What are the arguments in favor and against each of these?

**Ans.** All these measures have been introduced to ensure financial stability. On the other hand, they all lead to the problems related with moral hazard: the insured take excessive risks. A balance has to be maintained. If somehow regulators could ensure that in case of failures only the genuine will be protected - but that’s easier said than done!

(b) (3 points) The Wall Street Journal editorial “Fannie Mae Enron?” has criticized the risk management practices of the two ‘government sponsored enterprises’ Fannie Mae and Freddie Mac. What could potentially be the information problem behind the alleged excessive risk taking by these agencies? Why should it be a matter of concern for the taxpayers and investors?

**Ans.** Moral hazard due to government guarantees could potentially be the reason behind excessive risk taking. In case these institutions fail, the taxpayers will end up paying for financial losses as in the Savings and Loans crisis.