Econ 353 Money, Banking and Financial Markets
Summer 2008
Exam 3

Name ____________________________       ID # ___________________________

Note:

Questions 1-20 worth 4 points each;
Questions 21 worth 20 points;

Write your answers on the exam paper. You are encouraged to write comments on the exam paper as well.

If you have any questions, please ask the instructor and/or comment at the margin of the exam paper.

Work on your own and {good luck}!
Questions 1-20: Choose the correct answer

1. Which of the following statements about a bank’s balance sheet is wrong?
   A) A bank's assets are its uses of funds.
   B) A bank’s liabilities are its sources of funds.
   C) Bank capital is the bank’s net worth.
   D) The amount of a bank’s assets equals to the amount of the bank’s liabilities which also equals to the amount of bank capital.

2. Bank loans from the Federal Reserve are called _______ and represent a _______ of funds, is a _____ of the bank
   A) discount loans; source; liability
   B) fed funds; source; bank capital
   C) fed funds; source; liability
   D) discount loans; use; asset

3. Banks that actively manage liabilities will most likely meet a reserve shortfall by
   A) calling in loans.
   B) borrowing from the Fed.
   C) printing money
   D) sell off loans.

4. Which of the following statements about risk management is correct?
   A) If a bank has more rate-sensitive liabilities than assets, a rise in interest rates will reduce bank profit.
   B) Gap analysis and duration analysis are methods to measure credit risks.
   C) Credit rationing means that the lender refuses to make a loan because the interest rate is too low.
   D) Banks need not to manage risks associated with off-balance-sheet activities because these activities do not affect both assets and liability terms in bank’s balance sheet.

5. The regulatory system that has evolved in the United States that banks supervised by the federal government and banks supervised by the state coexist, is known as:
   A) bilateral regulatory system.
   B) tiered regulatory system.
   C) two-tiered regulatory system.
   D) dual banking system.
6. The Glass-Steagall Act, before its repeal in 1999, was the legislation that
   __________
   A) created the Federal Reserve System.
   B) separated investment banking from commercial banking
   C) prohibited banks from branching across state lines.
   D) raised deposit insurance premiums.

7. The process that financial institutions try to get around regulations in seek of profit is called
   A) regulatory forbearance.
   B) loophole mining.
   C) disintermediation.
   D) lobbying.

8. The presence of so many small commercial banks in the United States is most likely the result of
   A) consumers' strong desire for dealing with only local banks.
   B) adverse selection and moral hazard problems that give local banks a competitive advantage over larger banks.
   C) prior regulations that restrict the ability of these financial institutions to open branches.
   D) consumers' preference for state banks.

9. Depositors lack of information about the quality of bank assets can lead to
   __________
   A) bank panics
   B) bank booms
   C) efficiency
   D) asset transformation

10. A financial innovation that developed as a result of banks' avoidance of bank branching restrictions was ________.
    A) money market mutual funds
    B) commercial paper
    C) junk bonds
    D) bank holding companies
11. Advantages result from bank consolidation does not include _________
   A) economics of scale
   B) diversification
   C) comparative advantage in serving small local business
   D) economics of scope

12. Although the FDIC was created to prevent bank failures, its existence encourages banks to _______
   A) take too much risk.
   B) hold too much capital.
   C) open too many branches.
   D) buy too much stock.

13. A bank failure is less likely to occur when
   A) a bank holds less U.S. government securities.
   B) a bank suffers large deposit outflows.
   C) a bank holds fewer excess reserves.
   D) a bank has more bank capital.

14. The chartering process – screening banks is especially designed to deal with the _______ problem, and regular bank examinations help to reduce the _______ problem.
   A) adverse selection; adverse selection
   B) adverse selection; moral hazard
   C) moral hazard; adverse selection
   D) moral hazard; moral hazard

15. Regulatory forbearance
   A) meant delaying the closing of "zombie S&Ls" as their losses mounted during the 1980s.
   B) had the advantage of benefiting healthy S&Ls at the expense of "zombie S&Ls", as insolvent institutions lost deposits to health institutions.
   C) had the advantage of permitting many insolvent S&Ls the opportunity to return to profitability, saving the FSLIC billions of dollars.
   D) is the proper way to regulate S&Ls.
16. Which of the following statements about the Federal Reserve System (the Fed) is wrong?
   A) The Fed is an elaborated system of checks and balances
   B) The Fed is more decentralized than central banks in other countries
   C) Structure of the Fed is designed in an attempt to diffuse power along regional lines, between the private sector and the government.
   D) In U.S. history, the idea of establishing a central bank like the Fed was always supported by the public.

17. The Federal Reserve Bank of ______ plays a special role in the Federal Reserve System, it houses the open market desk and its district contains the largest banks in the country
   A) Chicago  
   B) New York  
   C) San Francisco  
   D) Boston

18. The Federal Reserve entity that makes decisions regarding the conduct of open market operations is the
   A) Board of Governors.  
   B) chairman of the Board of Governors.  
   C) Federal Open Market Committee.  
   D) Open Market Advisory Council

19. The theory of bureaucratic behavior suggests that the objective of a bureaucracy is to maximize
   A) the public's welfare.  
   B) profits.  
   C) its own welfare.  
   D) conflict with the executive and legislative branches of government.

20. Which of the following topics was not presented in class last Friday?
   A) commodity futures  
   B) corporate finance  
   C) gold standard  
   D) behavioral finance
21. Open-ended Essay Question: Choose any ONE of the following five topics. And answer all questions that belong to the topic you choose.

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**Topic A: Financial Innovations**

(1) What do you think are some of the reasons to explain financial innovations? (Hint: such as changing conditions in demand and supply, in response to regulation …)

(2) We learnt some financial innovations such as adjustable-rate mortgages, junk bonds, money market mutual funds, commercial paper, bank holding companies, ATM. Choose any one of these financial innovations and tell me what you know about it.

(3) Do you think sometimes newly invented financial instruments like sub-prime mortgage could cause trouble for consumers and the bank or even the economy as a whole? (Hint: you could say something about risk and asymmetric information about newly invented financial instruments in general. Or, you could say something about some of the new features of the sub-prime mortgage contract, some of the adverse effects of sub-prime mortgage crisis on consumers, financial institutions and the U.S. economy.)

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**Topic B: Bank Risk Management**

(1) Why do you think risk management is so important for banks? (Hint: think about the asymmetric information problem between banks and depositors; how about bank failure and bank panics? who would loose if banks take on too much risks?)

(2) We talked about credit risk management, interest rate risk management and managing risks in off-balance-sheet activities in class. Choose one of the three and tell me what you know about it.

(3) What’s your opinion about principal-agent problem and internal control in managing risks in off-balance-sheet activities? Use the example of Barings bank failure to assist your reasoning.
**Topic C: Bank consolidation**

(1) Branching restrictions or bank consolidation, which one of the two do you think would lead to more efficiency? List your reasons.

(2) What have you learnt about benefits and costs of bank consolidation?

(3) We talked about Merges and Acquisitions (M&A) in the banking industry. If you were a banker, what issues would you consider to decide whether to buy another bank or to buy which bank? Why do you think regulators sometimes would rather see banks merging with each other than opening new banks?

**Topic D: Banking crisis**

(1) Why do you think banks are the most tightly regulated institutions? 
(Hint: asymmetric information between banks and depositors; bank run and bank failure)

(2) We talked about regulations such as government safety net, bank supervision, disclosure requirements, consumer protection, etc. Choose any one of these regulations and tell me what you know about it.
(Hint: you could explain what was the intention and content of the regulation? Did the regulation cause any new problems?)

(3) In banking crisis of the 1980s (failure of S&Ls) or current banking crisis (troublesome Bear Stern and many others), do you think that regulators did the right thing? 
(Hint: what about regulatory forbearance in 1980s? what are some of the complexities today? Other useful key words are moral hazard and principal-agent problem.)

**Topic E: The Fed and its chairman**

(1) Do you think the Federal Reserve System (the Fed) is independent and why?

(2) We learnt that three main components of the Federal Reserve System are the Federal Reserve Banks, Board of Governors and FOMC. Choose one of the three and tell me what you know about it.
(Hint: you could describe its structure, features, and functions)

(3) What do you think are some of the functions of the chairman of the Fed (currently Ben Bernanke) and his limitations in dealing with current economic issues in the U.S.?