Exam 3 (Final)

Please answer each question. For short answer questions, show the formulas and calculations needed where appropriate. You have two hours (2:00). Good luck!

Multiple Choice. (Sixteen problems, 3 points each, 48 points total)

1) Mutual funds
   A) take in deposits from savers and make loans to borrowers.
   B) take in deposits from savers and purchase assets with the funds.
   C) sell shares to savers and purchase assets with the funds.
   D) bring together small savers and small borrowers.

2) Money market mutual funds
   A) hold only U.S. Treasury securities.
   B) hold portfolios of stocks.
   C) are always load funds.
   D) hold portfolios of short-term assets.

3) The difference between a savings deposit and a time deposit is
   A) savings deposits have specified maturities.
   B) savings deposits pay no interest.
   C) time deposits have specified maturities.
   D) time deposits pay no interest.

4) Loans by the Federal Reserve to banks are known as
   A) Federal funds.
   B) discount loans.
   C) cash items in the process of collection.
   D) repurchase agreements.

5) When bank loan officers screen loan applicants to eliminate potentially bad risks, they are attempting to mitigate the problem of
   A) adverse selection.
   B) illiquidity.
   C) moral hazard.
   D) interest rate risk.

6) Collateral is
   A) the interest rate that banks charge high-quality borrowers.
   B) the difference between the value of a bank's assets and the value of a bank's liabilities.
   C) required reserves minus excess reserves.
   D) assets pledged to the bank in the event the borrower defaults.

7) Banks experience interest rate risk
   A) on any investment that has high information costs.
   B) if moral hazard problems are particularly severe.
   C) if changes in interest rates cause bank profits to fluctuate.
   D) if adverse selection problems are particularly severe.

8) The Fed pays interest on
   A) neither required nor excess reserves.
   B) required reserves, but not excess reserves.
   C) excess reserves, but not required reserves.
   D) both required and excess reserves.

9) Most of the earnings that the Fed receives on interest from government securities are
   A) shared by members of the Board of Governors.
   B) retained for future open market operations.
   C) returned to the Treasury.
   D) reinvested in new government securities.
10) Open market operations involve
   A) the Fed buying and selling U.S. government securities.
   B) private investors buying and selling securities directly on exchanges, rather than through brokers.
   C) the Fed buying and selling common stock in order to affect the liquidity of the stock market.
   D) the Fed making discount loans to depository institutions.

11) Which of the following is a depository institution?
   A) The New York Stock Exchange
   B) Greater Illinois Savings and Loan
   C) Fidelity Magellan Mutual Fund
   D) Prudential Insurance Company

12) Investment banks
   A) assist business firms in raising new capital in primary markets.
   B) acquire deposits from savers and lend them to borrowers.
   C) aid the government to raise funds to cover the budget deficit.
   D) lease machinery and equipment to business firms.

13) What do many analysts see finance companies as having an advantage in?
   A) In charging consumers particularly low interest rates
   B) In selling long-term securities
   C) In monitoring the value of collateral
   D) In purchasing commercial paper

14) Charging drivers with good records lower premiums than drivers with bad records is an example of an attempt by insurance companies to deal with the problem of
   A) adverse selection.
   B) moral hazard.
   C) failure of policyholders to keep paying their premiums.
   D) drunk driving.

15) The use of deductibles and coinsurance are examples of attempts by insurance companies to deal with the problem of
   A) failure of policyholders to keep paying their premiums.
   B) excessive government regulation.
   C) moral hazard.
   D) adverse selection.

16) Property and casualty insurers hold
   A) more short-term assets than do life insurance companies.
   B) only long-term assets.
   C) fewer short-term assets than do life insurance companies.
   D) roughly the same amount of short-term assets as do life insurance companies.

17) The largest institutional participants in capital markets are
   A) business finance companies.
   B) consumer finance companies.
   C) pension funds.
   D) insurance companies.
18) A defined benefits plan
   A) is always fully funded.
   B) may be underfunded but cannot be overfunded.
   C) may be either underfunded or overfunded.
   D) may be overfunded but cannot be underfunded.

19) To deal with difficulties in administering pension funds, Congress in 1974 passed the
   A) Social Security Act.
   C) Corrupt Pension Fund Reform Act.

20) Savings institutions originated as
   A) building and loan societies.
   B) commercial banks.
   C) consumer cooperatives.
   D) farm cooperatives.

21) Credit unions have invested primarily in
   A) corporate stock.
   B) mortgages.
   C) commercial paper.
   D) corporate bonds.

22) The greatest difficulty with federal loan guarantees is that
   A) they interfere with the smooth working of the market system.
   B) they have largely driven out private lending in the market for small business loans.
   C) they have largely driven out private lending in the mortgage market.
   D) moral hazard problems have led to excessive defaults.

23) The payments system refers to
   A) the system that credit card companies use to collect their payments.
   B) the type of medium of exchange used in the economy.
   C) the means of clearing and settling transactions in the economy.
   D) the means by which the government collects taxes.

24) Which of the following is NOT a bank liability?
   A) Borrowings from the Federal Reserve
   B) CDs
   C) Checkable deposits
   D) Mortgage loans

25) Which of the following statements about checkable deposits is correct?
   A) Checkable deposits are a larger fraction of banks' funds today than in 1960.
   B) All checkable deposits pay interest.
   C) No checkable deposits pay interest.
   D) Checkable deposits are a smaller fraction of banks' funds today than in 1960.

26) A cash item in the process of collection is
   A) a U.S. Treasury bill that has matured, but for which the bank has not yet received payment.
   B) a check drawn against another bank, from whom the funds have not yet been collected.
   C) a car loan payment that is due but not yet received by the bank.
   D) currency that has been deposited in the bank, but not yet formally counted and entered into the bank's balance sheet.

27) Which asset is sometimes referred to as a bank's secondary reserves?
   A) Vault cash
   B) U.S. government securities
   C) Federal funds
   D) Repurchase agreements
28) If you have a checking account at First National Bank, the account is
   A) an asset to both you and First National.       B) an asset to you and a liability to First National.
   C) a liability to both you and First National.   D) an asset to First National and a liability to you.

29) If you deposit a $50 check in the bank, before the check has cleared the change in your bank's balance sheet will be a
   A) $50 increase in cash and a $50 increase in checkable deposits.
   B) $50 increase in cash items in the process of collection and a $50 increase in reserves.
   C) $50 increase in cash items in the process of collection and a $50 increase in checkable deposits.
   D) $50 increase in reserves and a $50 increase in checkable deposits.

30) Credit risk is the risk that
   A) an insufficient number of borrowers will apply for loans or credit.
   B) interest rates will rise after a loan has been granted.
   C) borrowers might default on their loans.
   D) interest rates will fall after a loan has been granted.

31) A bank's net worth will decline following an increase in interest rates if the value of its
   A) fixed-rate assets is greater than the value of its variable-rate assets.
   B) fixed-rate assets is greater than the value of its fixed-rate liabilities.
   C) fixed-rate liabilities is greater than the value of its variable-rate liabilities.
   D) fixed-rate assets is less than the value of its fixed-rate liabilities.

32) Securitization refers to
   A) selling directly to investors loans or securities that were formerly held by financial intermediaries.
   B) banks insisting that collateral be supplied on previously unsecured loans.
   C) changing the mix in a financial portfolio away from stocks and toward bonds.
   D) reducing the exposure of a bank's portfolio to interest rate risk.

33) Reserve deposits are
   A) liabilities for financial institutions, but assets for the Fed.
   B) assets for financial institutions, but liabilities for the Fed.
   C) assets for both financial institutions and the Fed.
   D) liabilities for both financial institutions and the Fed.

34) Which of the following decreased its share of the percentage of total assets of financial intermediaries between 1960 and 2006?
   A) State and local government retirement funds      B) Commercial banks
   C) Private pension funds                             D) Life insurance companies

35) About what percentage of bank assets is made up of cash items in 2006?
   A) 3%       B) 21%       C) 50%       D) 37%

Short Answer. (Six problems, 52 points total.)

36) Explain why checking deposits have decreased in importance as a source of funds for banks since 1960.

37) Suppose First National Bank has $190 million of assets and $38 million of equity capital. If First National has a 5% return on assets (ROA), what is its return on equity (ROE)? Suppose First National's equity capital declines to $30 million, while its assets and ROA are unchanged. What is First National's ROE now?
38) State four ways that banks can increase their liquidity positions. For each draw a T-account to describe how a bank’s balance sheet is affected.

39) What changes have occurred that make problems like those that affected savings and loans in the 1980s less likely? Explain.

40) What factors determine the quantity of reserves a bank chooses to hold?

41) What service do banks offer borrowers that financial markets cannot? Explain how this is valuable from the point of view of the economy as a whole.
Answer Key
Testname: ECON380-FALL09-EXAM3-ROUGH

1) C
2) D
3) C
4) B
5) A
6) D
7) C
8) A
9) C
10) A
11) B
12) A
13) C
14) A
15) C
16) A
17) C
18) C
19) B
20) A
21) B
22) D
23) C
24) D
25) D
26) B
27) B
28) B
29) C
30) C
31) B
32) A
33) B
34) B
35) A

36) Money market mutual funds are attractive because they are invested in instruments with short maturities whose asset values do not fluctuate much. These funds provide savers with liquid accounts that pay interest and against which checks are usually allowed to be written.

37) ROE = ROA \times \frac{\text{Bank assets}}{\text{Bank equity capital}}; \text{ROE} = 2\% \times \frac{200}{20} = 20\%. \text{ROE} = 2\% \times \frac{200}{10} = 40\%.

38)
39)
40)
41)