11.1 Asymmetric Information and Financial Regulation

1) Depositors lack of information about the quality of bank assets can lead to
A) bank panics.
B) bank booms.
C) sequencing.
D) asset transformation.
Answer: A
Ques Status: Previous Edition
AACSB: Analytic skills

2) The fact that banks operate on a "sequential service constraint" means that
A) all depositors share equally in the bank's funds during a crisis.
B) depositors arriving last are just as likely to receive their funds as those arriving first.
C) depositors arriving first have the best chance of withdrawing their funds.
D) banks randomly select the depositors who will receive all of their funds.
Answer: C
Ques Status: Previous Edition
AACSB: Reflective thinking skills

3) Depositors have a strong incentive to show up first to withdraw their funds during a bank crisis because banks operate on a
A) last-in, first-out constraint.
B) sequential service constraint.
C) double-coincidence of wants constraint.
D) everyone-shares-equally constraint.
Answer: B
Ques Status: Previous Edition
AACSB: Reflective thinking skills

4) Because of asymmetric information, the failure of one bank can lead to runs on other banks. This is the
A) too-big-to-fail effect.
B) moral hazard problem.
C) adverse selection problem.
D) contagion effect.
Answer: D
Ques Status: Previous Edition
AACSB: Analytic skills
5) The contagion effect refers to the fact that
A) deposit insurance has eliminated the problem of bank failures.
B) bank runs involve only sound banks.
C) bank runs involve only insolvent banks.
D) the failure of one bank can hasten the failure of other banks.
Answer: D

Ques Status: Previous Edition

AACSB: Reflective thinking skills

6) During the boom years of the 1920s, bank failures were quite
A) uncommon, averaging less than 30 per year.
B) uncommon, averaging less than 100 per year.
C) common, averaging about 600 per year.
D) common, averaging about 1000 per year.
Answer: C

Ques Status: Previous Edition

7) To prevent bank runs and the consequent bank failures, the United States established the ________ in 1934 to provide deposit insurance.
A) FDIC
B) SEC
C) Federal Reserve
D) ATM
Answer: A

Ques Status: Previous Edition

8) The primary difference between the "payoff" and the "purchase and assumption" methods of handling failed banks is
A) that the FDIC guarantees all deposits when it uses the "payoff" method.
B) that the FDIC guarantees all deposits when it uses the "purchase and assumption" method.
C) that the FDIC is more likely to use the "payoff" method when the bank is large and it fears that depositor losses may spur business bankruptcies and other bank failures.
D) that the FDIC is more likely to use the purchase and assumption method for small institutions because it will be easier to find a purchaser for them compared to large institutions.
Answer: B

Ques Status: Previous Edition

AACSB: Reflective thinking skills

9) Deposit insurance has not worked well in countries with
A) a weak institutional environment.
B) strong supervision and regulation.
C) a tradition of the rule of law.
D) few opportunities for corruption.
Answer: A

Ques Status: Previous Edition

AACSB: Reflective thinking skills
10) When one party to a transaction has incentives to engage in activities detrimental to the other party, there exists a problem of
A) moral hazard.
B) split incentives.
C) ex ante shirking.
D) pre-contractual opportunism.
Answer: A
Ques Status: Previous Edition
AACSB: Ethical understanding and reasoning abilities

11) Moral hazard is an important concern of insurance arrangements because the existence of insurance
A) provides increased incentives for risk taking.
B) is a hindrance to efficient risk taking.
C) causes the private cost of the insured activity to increase.
D) creates an adverse selection problem but no moral hazard problem.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

12) When bad drivers line up to purchase collision insurance, automobile insurers are subject to the
A) moral hazard problem.
B) adverse selection problem.
C) assigned risk problem.
D) ill queue problem.
Answer: B
Ques Status: Previous Edition
AACSB: Reflective thinking skills

13) Deposit insurance is only one type of government safety net. All of the following are types of government support for troubled financial institutions except
A) forgiving tax debt.
B) lending from the central bank.
C) lending directly from the government's treasury department.
D) nationalizing and guaranteeing that all creditors will be repaid their loans in full.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills
14) 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.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

15) A system of deposit insurance
A) attracts risk-taking entrepreneurs into the banking industry.
B) encourages bank managers to decrease risk.
C) increases the incentives of depositors to monitor the riskiness of their bank's asset portfolio.
D) increases the likelihood of bank runs.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

16) The government safety net creates _______ problem because risk-loving entrepreneurs
might find banking an attractive industry.
A) an adverse selection
B) a moral hazard
C) a lemons
D) a revenue
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

17) Since depositors, like any lender, only receive fixed payments while the bank keeps any
surplus profits, they face the _______ problem that banks may take on too _______ risk.
A) adverse selection; little
B) adverse selection; much
C) moral hazard; little
D) moral hazard; much
Answer: D
Ques Status: Previous Edition
AACSB: Reflective thinking skills

18) Acquiring information on a bank's activities in order to determine a bank's risk is difficult for
depositors and is another argument for government
A) regulation.
B) ownership.
C) recall.
D) forbearance.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills
19) The existence of deposit insurance can increase the likelihood that depositors will need deposit protection, as banks with deposit insurance
   A) are likely to take on greater risks than they otherwise would.
   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 placed at a competitive disadvantage in acquiring funds.
   Answer: A
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

20) In May 1991, the FDIC announced that it would sell the government's final 26% stake in Continental Illinois, ending government ownership of the bank that it had rescued in 1984. The FDIC took control of the bank, rather than liquidate it, because it believed that Continental Illinois
   A) was a good investment opportunity for the government.
   B) could be the Chicago branch of a new governmentally-owned interstate banking system.
   C) was too big to fail.
   D) would become the center of the new midwest region central bank system.
   Answer: C
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

21) If the FDIC decides that a bank is too big to fail, it will use the ________ method, effectively ensuring that ________ depositors will suffer losses.
   A) payoff; large
   B) payoff; no
   C) purchase and assumption; large
   D) purchase and assumption; no
   Answer: D
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

22) Federal deposit insurance covers deposits up to $250,000, but as part of a doctrine called "too-big-to-fail" the FDIC sometimes ends up covering all deposits to avoid disrupting the financial system. When the FDIC does this, it uses the
   A) "payoff" method.
   B) "purchase and assumption" method.
   C) "inequity" method.
   D) "Basel" method.
   Answer: B
   Ques Status: Revised
23) The result of the too-big-to-fail policy is that ________ banks will take on ________ risks, making bank failures more likely.
   A) small; fewer
   B) small; greater
   C) big; fewer
   D) big; greater
   Answer: D
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

24) A problem with the too-big-to-fail policy is that it ________ the incentives for ________ by big banks.
   A) increases; moral hazard
   B) decreases; moral hazard
   C) decreases; adverse selection
   D) increases; adverse selection
   Answer: A
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

25) The too-big-to-fail policy
   A) reduces 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) allows small banks to take on more risk than large banks.
   Answer: C
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

26) Regulators attempt to reduce the riskiness of banks' asset portfolios by
   A) limiting the amount of loans in particular categories or to individual borrowers.
   B) encouraging banks to hold risky assets such as common stocks.
   C) establishing a minimum interest rate floor that banks can earn on certain assets.
   D) requiring collateral for all loans.
   Answer: A
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills
27) A well-capitalized financial institution has ________ to lose if it fails and thus is ________ likely to pursue risky activities.
A) more; more
B) more; less
C) less; more
D) less; less
Answer: B
Ques Status: Previous Edition
AACSB: Reflective thinking skills

28) 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.
Answer: D
Ques Status: Previous Edition
AACSB: Reflective thinking skills

29) The leverage ratio is the ratio of a bank's
A) assets divided by its liabilities.
B) income divided by its assets.
C) capital divided by its total assets.
D) capital divided by its total liabilities.
Answer: C
Ques Status: Previous Edition

30) To be considered well capitalized, a bank’s leverage ratio must exceed
A) 10%.
B) 8%.
C) 5%.
D) 3%.
Answer: C
Ques Status: Previous Edition

31) The FDIC must take steps to close down banks whose equity capital is less than ________ of assets.
A) 4%
B) 3%
C) 2%
D) 1%
Answer: C
Ques Status: New
32) Off-balance-sheet activities
A) generate fee income with no increase in risk.
B) increase bank risk but do not increase income.
C) generate fee income but increase a bank's risk.
D) generate fee income and reduce risk.
Answer: C
Ques Status: Previous Edition
AACSBS: Reflective thinking skills

33) The Basel Accord, an international agreement, requires banks to hold capital based on
A) risk-weighted assets.
B) the total value of assets.
C) liabilities.
D) deposits.
Answer: A
Ques Status: Previous Edition

34) The Basel Accord requires banks to hold as capital an amount that is at least ________ of their risk-weighted assets.
A) 10%
B) 8%
C) 5%
D) 3%
Answer: B
Ques Status: Previous Edition

35) Under the Basel Accord, assets and off-balance sheet activities were sorted according to ________ categories with each category assigned a different weight to reflect the amount of ________.
A) 2; adverse selection
B) 2; credit risk
C) 4; adverse selection
D) 4; credit risk
Answer: D
Ques Status: Previous Edition

36) The practice of keeping high-risk assets on a bank's books while removing low-risk assets with the same capital requirement is known as
A) competition in laxity.
B) depositor supervision.
C) regulatory arbitrage.
D) a dual banking system.
Answer: C
Ques Status: Previous Edition
37) Banks engage in regulatory arbitrage by
A) keeping high-risk assets on their books while removing low-risk assets with the same capital requirement.
B) keeping low-risk assets on their books while removing high-risk assets with the same capital requirement.
C) hiding risky assets from regulators.
D) buying risky assets from arbitragers.
Answer: A

38) Because banks engage in regulatory arbitrage, the Basel Accord on risk-based capital requirements may result in
A) reduced risk taking by banks.
B) reduced supervision of banks by regulators.
C) increased fraudulent behavior by banks.
D) increased risk taking by banks.
Answer: D

39) One of the criticisms of Basel 2 is that it is procyclical. That means that
A) banks may be required to hold more capital during times when capital is short.
B) banks may become professional at a cyclical response to economic conditions.
C) banks may be required to hold less capital during times when capital is short.
D) banks will not be required to hold capital during an expansion.
Answer: A

40) Overseeing who operates banks and how they are operated is called
A) prudential supervision.
B) hazard insurance.
C) regulatory interference.
D) loan loss reserves.
Answer: A

41) The chartering process 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
Answer: B
42) The chartering process is similar to _________ potential borrowers and the restriction of risk assets by regulators is similar to ________ in private financial markets.
A) screening; restrictive covenants
B) screening; branching restrictions
C) identifying; branching restrictions
D) identifying; credit rationing
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

43) Banks will be examined at least once a year and given a CAMELS rating by examiners. The L stands for
A) liabilities.
B) liquidity.
C) loans.
D) leverage.
Answer: B
Ques Status: Previous Edition

44) The federal agencies that examine banks include
A) the Federal Reserve System.
B) the Internal Revenue Service.
C) the SEC.
D) the U.S. Treasury.
Answer: A
Ques Status: Previous Edition

45) Banks are required to file _________ usually quarterly that list information on the bank's assets and liabilities, income and dividends, and so forth.
A) call reports
B) balance reports
C) regulatory sheets
D) examiner updates
Answer: A
Ques Status: Previous Edition

46) Regular bank examinations and restrictions on asset holdings help to indirectly reduce the _________ problem because, given fewer opportunities to take on risk, risk-prone entrepreneurs will be discouraged from entering the banking industry.
A) moral hazard
B) adverse selection
C) ex post shirking
D) post-contractual opportunism
Answer: B
Ques Status: Previous Edition
AACSB: Reflective thinking skills
47) The current supervisory practice toward risk management
A) focuses on the quality of a bank's balance sheet.
B) determines whether capital requirements have been met.
C) evaluates the soundness of a bank's risk-management process.
D) focuses on eliminating all risk.
Answer: C
Ques Status: Previous Edition
AACSB: Reflective thinking skills

48) Regulations designed to provide information to the marketplace so that investors can make informed decisions are called
A) disclosure requirements.
B) efficient market requirements.
C) asset restrictions.
D) capital requirements.
Answer: A
Ques Status: Previous Edition

49) With _______, firms value assets on their balance sheet at what they would sell for in the market.
A) mark-to-market accounting
B) book-value accounting
C) historical-cost accounting
D) off-balance sheet accounting
Answer: A
Ques Status: Previous Edition

50) During times of financial crisis, mark-to-market accounting
A) requires that a financial firms' assets be marked down in value which can worsen the lending crisis.
B) leads to an increase in the financial firms' balance sheets since they can now get assets at bargain prices.
C) leads to an increase in financial firms' lending.
D) results in financial firms' assets increasing in value.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

51) Consumer protection legislation includes legislation to
A) reduce discrimination in credit markets.
B) require banks to make loans to everyone who applies.
C) reduce the amount of interest that bank's can charge on loans.
D) require banks to make periodic reports to the Better Business Bureau.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills
52) An important factor in producing the subprime mortgage crisis was
A) lax consumer protection regulation.
B) onerous rules placed on mortgage originators.
C) weak incentives for mortgage brokers to use complicated mortgage products.
D) strong incentives for the mortgage brokers to verify income information.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

53) Competition between banks
A) encourages greater risk taking.
B) encourages conservative bank management.
C) increases bank profitability.
D) eliminates the need for government regulation.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

54) Regulations that reduced competition between banks included
A) branching restrictions.
B) bank reserve requirements.
C) the dual system of granting bank charters.
D) interest-rate ceilings.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

55) The ________ that required separation of commercial and investment banking was repealed
in 1999.
A) the Federal Reserve Act.
B) the Glass-Steagall Act.
C) the Bank Holding Company Act.
D) the Monetary Control Act.
Answer: B
Ques Status: Previous Edition

56) Microprudential supervision focuses on the safety and soundness of
A) individual financial institutions.
B) the financial system as a whole.
C) the shadow banking system.
D) government credit agencies.
Answer: A
Ques Status: New
57) Microprudential supervision does all of the following except
A) checking capital ratios of a bank.
B) checking a bank's compliance with disclosure requirements.
C) assessing the riskiness of an individual bank's activities.
D) focusing on financial system liquidity.
Answer: D
Ques Status: New
AACSB: Reflective thinking skills

58) Macroprudential supervision policies try to prevent a leverage cycle by changing capital requirements so that they ________ during an expansion and ________ during a downturn.
A) increase; decrease
B) increase; increase
C) decrease; increase
D) decrease; decrease
Answer: A
Ques Status: New
AACSB: Reflective thinking skills

59) Which of the following is not a reason financial regulation and supervision is difficult in real life?
A) Financial institutions have strong incentives to avoid existing regulations.
B) Unintended consequences may happen if details in the regulations are not precise.
C) Regulated firms lobby politicians to lean on regulators to ease the rules.
D) Financial institutions are not required to follow the rules.
Answer: D
Ques Status: Previous Edition
AACSB: Reflective thinking skills

60) Who has regulatory responsibility when a bank operates branches in many countries?
A) It is not always clear.
B) The WTO.
C) The U.S. Federal Reserve System.
D) The first country to submit an application.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills
61) The collapse of the Bank of Credit and Commerce International, BCCI, showed the difficulty of international banking regulation. BCCI operated in more than ________ countries and was supervised by the small country of ________.
A) 70, Luxembourg
B) 100, Monaco
C) 70, Monaco
D) 100, Luxembourg
Answer: A
Ques Status: Previous Edition
AACSB: Dynamics of the global economy

62) Agreements such as the ________ are attempts to standardize international banking regulations.
A) Basel Accord
B) UN Bank Accord
C) GATT Accord
D) WTO Accord
Answer: A
Ques Status: Previous Edition
AACSB: Dynamics of the global economy

63) The Basel Committee ruled that regulators in other countries can ________ the operations of a foreign bank if they believe that it lacks effective oversight.
A) restrict
B) encourage
C) renegotiate
D) enhance
Answer: A
Ques Status: Previous Edition
AACSB: Dynamics of the global economy

64) The government safety net creates both an adverse selection problem and a moral hazard problem. Explain.
Answer: The adverse selection problem occurs because risk-loving individuals might view the banking system as a wonderful opportunity to use other peoples' funds knowing that those funds are protected. The moral hazard problem comes about because depositors will not impose discipline on the banks since their funds are protected and the banks knowing this will be tempted to take on more risk than they would otherwise.
Ques Status: Previous Edition
AACSB: Reflective thinking skills
11.2 The 1980s Savings and Loan and Banking Crisis

1) In the ten year period 1981-1990, 1202 commercial banks were closed, with a peak of 206 failures in 1989. This rate of failures was approximately ________ times greater than that in the period from 1934 to 1980.
   A) two
   B) three
   C) five
   D) ten
   Answer:  D
   Ques Status:  Previous Edition

2) During the 1960s, 1970s, and early 1980s, traditional bank profitability declined because of
   A) financial innovation that increased competition from new financial institutions.
   B) a decrease in interest rates to fight the inflation problem.
   C) a decrease in deposit insurance.
   D) increased regulation that prohibited banks from making risky real estate loans.
   Answer:  A
   Ques Status:  Previous Edition
   AACSB:  Reflective thinking skills

3) Moral hazard problems increased in prominence in the 1980s
   A) as deregulation required savings and loans and mutual savings banks to be more cautious.
   B) following a burst of financial innovation in the 1970s and early 1980s that produced new financial instruments and markets, thereby widening the scope for risk taking.
   C) following a decrease in federal deposit insurance from $100,000 to $40,000.
   D) as interest rates were sharply decreased to bring down inflation.
   Answer:  B
   Ques Status:  Previous Edition
   AACSB:  Reflective thinking skills

4) Prior to the 1980s, S&Ls and mutual savings banks were restricted almost entirely to
   A) commercial real estate loans.
   B) home mortgages.
   C) education loans.
   D) vacation loans.
   Answer:  B
   Ques Status:  New

5) The Depository Institutions Deregulation and Monetary Control Act of 1980
   A) restricted thrift institutions to making loans for home mortgages.
   B) restricted the use of ATS accounts.
   C) imposed restrictive interest-rate ceilings on large agricultural loans.
   D) increased deposit insurance from $40,000 to $100,000.
   Answer:  D
   Ques Status:  Previous Edition
6) How did the increase in the interest rates in the early 80s contribute to the S&L crisis?
Answer: The S&Ls suffered from an interest-rate risk problem. They had many fixed-rate mortgages with low interest rates. As interest rates in the economy began to climb, S&Ls began to lose profitability. Because of deregulation and financial innovation, it became possible for the S&Ls to undertake more risky ventures to try to regain their profitability. Many of them lacked expertise in judging credit risk in the new loan areas resulting in large losses.

11.3 Banking Crises Throughout the World

1) The evidence from banking crises in other countries indicates that
A) deposit insurance is to blame in each country.
B) a government safety net for depositors need not increase moral hazard.
C) regulatory forbearance never leads to problems.
D) deregulation combined with poor regulatory supervision raises moral hazard incentives.
Answer: D

2) All of the following are common to banking crises in different countries except
A) financial liberalization or innovation.
B) weak bank regulatory systems.
C) a government safety net.
D) a dual banking system.
Answer: D

3) A common element in all of the banking crisis episodes in different countries is
A) the existence of a government safety net.
B) deposit insurance.
C) increased regulation.
D) lack of competition.
Answer: A

4) Banking crises have occurred throughout the world. What similarities do we find when we look at the different countries?
Answer: Financial deregulation with inadequate supervision can lead to increased moral hazard as banks take on more risk. Although deposit insurance was not necessarily a major factor in every country's bank crisis, there was always some kind of government safety net. The presence of the government safety net also leads to increased risk-taking from the banks.

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11.4 The Dodd-Frank Bill and Future Regulation

1) In order to ensure that borrowers have an ability to repay residential mortgages, the new consumer protection legislation requires lenders to do all of the following except
   A) verify the income of the borrower.
   B) verify the borrower's job status.
   C) check the credit history of the borrower.
   D) verify that the borrower can read and understand a loan contract.
   Answer: D
   Ques Status: New
   AACSB: Reflective thinking skills

2) The new Consumer Financial Protection Bureau is an independent agency but is funded and housed within
   A) the Treasury Department.
   B) the Federal Reserve.
   C) the SEC.
   D) the IRS.
   Answer: B
   Ques Status: New

3) The Dodd-Frank legislation of 2010 permanently increased the federal deposit insurance to
   A) $40,000.
   B) $100,000.
   C) $200,000.
   D) $250,000.
   Answer: D
   Ques Status: New

4) Firms that are designated as systemically important financial institutions (SIFIs) are subject to all of the following additional Federal Reserve regulations except
   A) higher capital standards.
   B) stricter liquidity requirements.
   C) providing a plan for orderly liquidation if necessary.
   D) interest rate ceilings on time deposits.
   Answer: D
   Ques Status: New
   AACSB: Reflective thinking skills

5) The Volcker Rule addresses the off-balance-sheet problem involving
   A) trading risks.
   B) selling loans.
   C) loan guarantees.
   D) interest rate risks.
   Answer: A
   Ques Status: New
   AACSB: Analytic skills
6) Higher capital requirements will reduce the problems incurred when troubled ________ which had been off-balance sheet activities come back on the balance sheet.
A) structured investment vehicles (SIVs)
B) negotiable CDs
C) Eurodollars
D) Federal funds
Answer: A
Ques Status: Previous Edition
AACSB: Analytic skills

7) Currently, Fannie Mae and Freddie Mac are
A) privately owned government-sponsored enterprises.
B) privately owned enterprises with no government sponsorship.
C) government agencies.
D) government departments.
Answer: A
Ques Status: Previous Edition

8) The inaccurate ratings provided by credit-rating agencies
A) meant that investors did not have the information they needed to make informed choices about their investments.
B) were irrelevant since no one pays any attention to them anyway.
C) meant that investors actually took on less risk.
D) will not be a problem when determining capital requirements under Basel 2.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

9) The global financial crisis showed the need for increased financial regulation, however, too much or poorly designed regulation could
A) choke off financial innovation.
B) increase the efficiency of the financial system.
C) increase economic growth.
D) increase international financial integration.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills
11.5 Web Appendix 1: The Savings and Loan Crisis and Its Aftermath

1) Moral hazard and adverse selection problems increased in prominence in the 1980s
   A) as deregulation required savings and loans and mutual savings banks to be more cautious.
   B) following a burst of financial innovation in the 1970s and early 1980s that produced new
      financial instruments and markets, thereby widening the scope for risk taking.
   C) following a decrease in federal deposit insurance from $100,000 to $40,000.
   D) as interest rates were sharply decreased to bring down inflation.
   Answer: B
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

2) The Depository Institutions Deregulation and Monetary Control Act of 1980
   A) separated investment banks and commercial banks.
   B) restricted the use of ATS accounts.
   C) imposed restrictive usury ceilings on large agricultural loans.
   D) increased deposit insurance from $40,000 to $100,000.
   Answer: D
   Ques Status: Previous Edition

3) One of the problems experienced by the savings and loan industry during the 1980s was
   A) managers lack of expertise to manage risk in new lines of business.
   B) heavy regulations in the new areas open to S&Ls.
   C) slow growth in lending.
   D) close monitoring by the FSLIC.
   Answer: A
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

4) In the early stages of the 1980s banking crisis, financial institutions were especially harmed by
   A) declining interest rates from late 1979 until 1981.
   B) the severe recession in 1981-82.
   C) the disinflation from mid 1980 to early 1983.
   D) the increase in energy prices in the early 80s.
   Answer: B
   Ques Status: Previous Edition
   AACSB: Reflective thinking skills

5) When regulators chose to allow insolvent S&Ls to continue to operate rather than to close
   them, they were pursuing a policy of
   A) regulatory forbearance.
   B) regulatory kindness.
   C) ostrich reasoning.
   D) ignorance reasoning.
   Answer: A
   Ques Status: Previous Edition
6) Savings and loan regulators allowed S&Ls to include in their capital calculations a high value for intangible capital called
A) goodwill.
B) salvation.
C) kindness.
D) retribution.
Answer: A
Ques Status: Previous Edition

7) Reasons regulators chose to follow regulatory forbearance rather than to close the insolvent S&Ls include all of the following except
A) they had insufficient funds to close all of the insolvent S&Ls.
B) they were friends with the S&L owners.
C) they hoped the problem would go away.
D) they did not have the authority to close the insolvent S&Ls.
Answer: D
Ques Status: Previous Edition
AACSB: Reflective thinking skills

8) The policy of _______ exacerbated _______ problems as savings and loans took on increasingly huge levels of risk on the slim chance of returning to solvency.
A) regulatory forbearance; moral hazard
B) regulatory forbearance; adverse hazard
C) regulatory agnosticism; moral hazard
D) regulatory agnosticism; adverse hazard
Answer: A
Ques Status: Previous Edition

9) 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 healthy institutions.
C) had the advantage of permitting many insolvent S&Ls the opportunity to return to profitability, saving the FSLIC billions of dollars.
D) increased adverse selection dramatically.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills
10) The major provisions of the Competitive Equality Banking Act of 1987 include
A) expanding the responsibilities of the FDIC, which is now the sole administrator of the federal
deposit insurance system.
B) the establishment of the Resolution Trust Corporation to manage and resolve insolvent thrifts
placed in conservatorship or receivership.
C) directing the Federal Home Loan Bank Board to continue to pursue regulatory forbearance.
D) prompt corrective action when a bank gets in trouble.
Answer:  C
Ques Status:  Previous Edition

11) The S&L Crisis can be analyzed as a principal-agent problem. The agents in this case, the
_______, did not have the same incentive to minimize cost to the economy as the principals, the
_______.
A) politicians/regulators; taxpayers
B) taxpayers; politician/regulators
C) taxpayers; bank managers
D) bank managers; politicians/regulators
Answer:  A
Ques Status:  Previous Edition

12) "Bureaucratic gambling" refers to
A) the strategy of thrift managers that they would not be audited by thrift regulators in the 1980s
due to the relatively weak bureaucratic power of thrift regulators.
B) the risk that thrift regulators took in publicizing the plight of the S&L industry in the early
1980s.
C) the strategy adopted by thrift regulators of lowering capital requirements and pursuing
regulatory forbearance in the 1980s in the hope that conditions in the S&L industry would
improve.
D) the risk that regulators took in going to Congress to ask for additional funds.
Answer:  C
Ques Status:  Previous Edition

13) That several hundred S&Ls were not even examined once in the period January 1984
through June 1986 can be explained by
A) Congress's unwillingness to allocate the necessary funds to thrift regulators.
B) regulators' reluctance to find the specific problem thrifts that they knew existed.
C) slower growth in lending meant that less regulation was needed.
D) Congress's unwillingness to listen to campaign contributors.
Answer:  A
Ques Status:  Previous Edition
14) The bailout of the savings and loan industry was much delayed and, therefore, much more costly to taxpayers because
A) of regulators' initial attempts to downplay the seriousness of problems within the thrift industry.
B) politicians listened to the taxpayers rather than the S&L lobbyists.
C) Congress did not wait long enough for many of the problems in the thrift industry to correct themselves.
D) regulators could not be fired, therefore, they didn't care if they did a good job or not.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

15) An analysis of the political economy of the savings and loan crisis helps one to understand
A) why politicians aided the efforts of thrift regulators, raising regulatory appropriations and encouraging closing of insolvent thrifts.
B) why thrift regulators were so quick to inform Congress of the problems that existed in the thrift industry.
C) why thrift regulators willingly acceded to pressures placed upon them by members of Congress.
D) why politicians listened so closely to the taxpayers they represented.
Answer: C
Ques Status: Previous Edition
AACSB: Reflective thinking skills

16) Taxpayers were served poorly by thrift regulators in the 1980s. This poor performance cannot be explained by
A) regulators' desire to escape blame for poor performance, leading to a perverse strategy of "bureaucratic gambling."
B) regulators' incentives to accede to pressures imposed by politicians, who sought to keep regulators from imposing tough regulations on institutions that were major campaign contributors.
C) Congress's dogged determination to protect taxpayers from the unsound banking practices of managers at many of the nation’s savings and loans.
D) politicians strong incentives to act in their own interests rather than the interests of the taxpayers.
Answer: C
Ques Status: Previous Edition
AACSB: Reflective thinking skills

17) The Federal Home Loan Bank Board and the FSLIC, both of which failed in their regulatory tasks, were abolished by the
C) Office of Thrift Supervision.
Answer: B
Ques Status: Previous Edition
18) The Resolution Trust Corporation was created by the FIRREA in order to
A) manage and resolve insolvent S&Ls.
B) build up trust in government regulation.
C) regulate the S&L industry.
D) purchase large amounts of government debt.
Answer: A
Ques Status: Previous Edition

19) FIRREA increased the core-capital leverage requirement for thrift institutions from 3% to
A) 8%.
B) 5%
C) 10%
D) 25%
Answer: A
Ques Status: Previous Edition

20) The Federal Deposit Insurance Corporation Improvement Act of 1991
A) increased the FDIC's ability to borrow from the Treasury to deal with failed banks.
B) increased the FDIC's ability to use the too-big-to-fail doctrine.
C) eliminated governmentally-administered deposit insurance.
D) eliminated restrictions on nationwide banking.
Answer: A
Ques Status: Previous Edition

21) The ability to use the too-big-to-fail policy was curtailed by the passage of the FDICIA. To use this action today, the FDIC must get approval of a two-thirds majority of both the Board of Governors of the Federal Reserve and the directors of the FDIC and also the approval of the
A) Secretary of the Treasury.
B) Senate Finance Committee Chairperson.
C) President of the United States.
D) Governor of the state in which the failed bank is located.
Answer: A
Ques Status: Previous Edition

22) The directive of prompt corrective action means that
A) the FDIC will intervene earlier and more vigorously when a bank gets into trouble.
B) the banks must take actions quickly to resolve reserve disputes.
C) bank failures cannot occur.
D) there must be an immediate response to an increase in interest rates.
Answer: A
Ques Status: Previous Edition

AACSB: Reflective thinking skills
23) FDICIA ________ incentives for banks to hold capital and ________ incentives to take on excessive risk.
A) increased; decreased 
B) increased; increased 
C) decreased; decreased 
D) decreased; increased 
Answer: A 
Ques Status: Previous Edition

11.6   Web Appendix 2: Banking Crises Throughout the World

1) As in the United States, an important factor in the banking crises in Norway, Sweden, and Finland was the 
A) financial liberalization that occurred in the 1980s. 
B) decline in real interest rates that occurred in the 1980s. 
C) high inflation that occurred in the 1980s. 
D) sluggish economic growth that occurred in the 1980s. 
Answer: A 
Ques Status: Previous Edition 
AACSB: Dynamics of the global economy

2) As in the United States, an important factor in the banking crises in Latin America was the 
A) financial liberalization that occurred in the 1980s. 
B) decline in real interest rates that occurred in the 1980s. 
C) high inflation that occurred in the 1980s. 
D) sluggish economic growth that occurred in the 1980s. 
Answer: A 
Ques Status: Previous Edition 
AACSB: Dynamics of the global economy

3) The Argentine banking crisis of 2001 resulted from Argentina's banks being required to 
A) purchase large amounts of government debt. 
B) pay back the value of failed loans. 
C) make risky real estate loans. 
D) make loans to only state-owned businesses. 
Answer: A 
Ques Status: Previous Edition 
AACSB: Dynamics of the global economy
4) When comparing the banking crisis in the United States to the crises in Latin America, cost to the taxpayers of the government bailouts was
A) higher in Latin American than in the United States.
B) higher in the United States than in Latin America.
C) about the same in both Latin America and the United States.
D) positive in Latin America but negative in the United States.
Answer: A
Ques Status: Previous Edition
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5) The Japanese banking system went through a cycle of ________ in the 1990s similar to the one that occurred in the U.S. in the 1980s.
A) regulatory forbearance
B) policy antagonism
C) regulatory ignorance
D) policy renewal
Answer: A
Ques Status: Previous Edition
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6) China is trying to move its banking system from being strictly ________ owned by having them issue shares overseas.
A) state
B) domestic investor
C) depositor
D) domestic corporate
Answer: A
Ques Status: Previous Edition
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7) The evidence from banking crises in other countries indicates that
A) deposit insurance is to blame in each country.
B) a government safety net for depositors need not increase moral hazard.
C) regulatory forbearance never leads to problems.
D) deregulation combined with poor regulatory supervision raises moral hazard incentives.
Answer: D
Ques Status: Previous Edition
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8) Banking crises have occurred throughout the world. What similarities do we find when we look at the different countries?
Answer: Financial deregulation with inadequate supervision can lead to increased moral hazard as banks take on more risk. Although deposit insurance was not necessarily a major factor in every country's bank crisis, there was always some kind of government safety net. The presence of the government safety net also leads to increased risk-taking from the banks.
Ques Status: Previous Edition
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