

Note: Submit your answers using Blackboard Learn. Notice that the order in which the answers appear [i.e., A), B), C), and D)] are different in this PDF file and in Blackboard Learn.

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

- 1) Financial innovations occur because of financial institutions search for _____. 1) _____
A) fame B) stability C) recognition D) profits
- 2) In the generalized dividend model, if the expected sales price is in the distant future 2) _____
A) it is less important than dividends but still affects the current stock price.
B) it does not affect the current stock price.
C) it is equally important with dividends in determining the current stock price.
D) it is more important than dividends in determining the current stock price.
- 3) If bad credit risks are the ones who most actively seek loans then financial intermediaries face the 3) _____
problem of
A) adverse selection. B) costly state verification.
C) moral hazard. D) free-riding.
- 4) To prevent bank runs and the consequent bank failures, the United States established the _____ 4) _____
in 1934 to provide deposit insurance.
A) Federal Reserve B) FDIC
C) ATM D) SEC
- 5) With a 10% reserve requirement ratio, a \$100 deposit into New Bank means that the maximum 5) _____
amount New Bank could lend is
A) \$10. B) \$90. C) \$100. D) \$110.
- 6) If expectations of the future inflation rate are formed solely on the basis of a weighted average of 6) _____
past inflation rates, then economics would say that expectation formation is
A) adaptive. B) rational. C) irrational. D) reasonable.
- 7) Which of the following statements are true? 7) _____
A) Checkable deposits are payable on demand.
B) Demand deposits are checkable deposits that pay interest.
C) Checkable deposits are the primary source of bank funds.
D) Checkable deposits do not include NOW accounts.
- 8) Information plays an important role in asset pricing because it allows the buyer to more accurately 8) _____
judge _____.
A) capital B) policy C) liquidity D) risk
- 9) Regulation of the financial system 9) _____
A) ensures the stability of the financial system.
B) protects the wealth of owners of financial institutions.
C) protects the jobs of employees of financial institutions.
D) occurs only in the United States.

- 10) Long-term customer relationships _____ the cost of information collection and make it easier to _____ credit risks. 10) _____
 A) reduce; increase B) increase; screen
 C) increase; increase D) reduce; screen
- 11) Because of the adverse selection problem, 11) _____
 A) lenders are reluctant to make loans that are not secured by collateral.
 B) lenders will write debt contracts that restrict certain activities of borrowers.
 C) lenders may refuse loans to individuals with high net worth, because of their greater proclivity to "skip town."
 D) good credit risks are more likely to seek loans causing lenders to make a disproportionate amount of loans to good credit risks.
- 12) One of the concerns of increased bank consolidation is the reduction in community banks which could result in 12) _____
 A) more bank regulation. B) less lending to small businesses.
 C) higher interest rates. D) loss of cultural identity.
- 13) Bank's make their profits primarily by issuing _____. 13) _____
 A) NOW accounts B) negotiable CDs C) loans D) equity
- 14) Deposit insurance has not worked well in countries with 14) _____
 A) a tradition of the rule of law. B) few opportunities for corruption.
 C) a weak institutional environment. D) strong supervision and regulation.
- 15) Depositors have a strong incentive to show up first to withdraw their funds during a bank crisis because banks operate on a 15) _____
 A) double-coincidence of wants constraint. B) sequential service constraint.
 C) last-in, first-out constraint. D) everyone-shares-equally constraint.
- 16) Bank capital is listed on the _____ side of the bank's balance sheet because it represents a _____ of funds. 16) _____
 A) asset; source B) liability; source C) asset; use D) liability; use
- 17) The most important category of assets on a bank's balance sheet is 17) _____
 A) cash items in the process of collection. B) discount loans.
 C) loans. D) securities.
- 18) A _____ is a provision that restricts or specifies certain activities that a borrower can engage in. 18) _____
 A) restrictive covenant B) restrictive barrier
 C) residual claimant D) risk hedge
- 19) The most important source of the changes in supply conditions that stimulate financial innovation has been the 19) _____
 A) improvement in computer and telecommunications technology.
 B) dramatic increase in competition from foreign banks.
 C) dramatic increase in the volatility of interest rates.
 D) deregulation of financial institutions.

- 20) If a bank has excess reserves greater than the amount of a deposit outflow, the outflow will result in equal reductions in _____ 20) _____
 A) deposits and reserves. B) deposits and loans.
 C) capital and loans. D) capital and reserves.
- 21) The result of the too-big-to-fail policy is that _____ banks will take on _____ risks, making bank failures more likely. 21) _____
 A) big; greater B) big; fewer C) small; fewer D) small; greater
- 22) Which of the following statements are true? 22) _____
 A) A bank's balance sheet shows that total assets equal total liabilities plus equity capital.
 B) A bank's liabilities are its uses of funds.
 C) A bank's assets are its sources of funds.
 D) A bank's balance sheet indicates whether or not the bank is profitable.
- 23) Credit risk management tools include 23) _____
 A) duration analysis. B) collateral.
 C) deductibles. D) interest rate swaps.
- 24) The presence of _____ in financial markets leads to adverse selection and moral hazard problems that interfere with the efficient functioning of financial markets. 24) _____
 A) costly state verification B) noncollateralized risk
 C) free-riding D) asymmetric information
- 25) Periodic payments of net earnings to shareholders are known as 25) _____
 A) profits. B) dividends. C) interest. D) capital gains.
- 26) When housing prices began to decline after their peak in 2006, many subprime borrowers found that their mortgages were "underwater." This meant that 26) _____
 A) the amount that they owed on their mortgage was less than the value of their house.
 B) the value of the house fell below the amount of the mortgage.
 C) the basement flooded since they could not afford to fix the leaky plumbing.
 D) the roof leaked during a rainstorm.
- 27) A substantial decrease in the aggregate price level that reduces firms' net worth may stall a recovery from a recession. This process is called 27) _____
 A) illiquidity. B) debt deflation. C) insolvency. D) moral hazard.
- 28) Conditions that likely contributed to a credit crunch in 2008 include: 28) _____
 A) increases in reserve requirements.
 B) falling interest rates that raised interest rate risk, causing banks to choose to hold more capital.
 C) capital shortfalls caused in part by falling real estate prices.
 D) regulated hikes in bank capital requirements.
- 29) A major disruption in financial markets characterized by sharp declines in asset prices and firm failures is called a 29) _____
 A) "lemons" problem. B) fiscal imbalance.
 C) financial crisis. D) free-rider problem.

- 30) An example of the _____ problem would be if Karen borrowed money from Paul in order to pay for school and instead took a trip to South Padre Island using those funds. 30) _____
 A) agency B) adverse selection
 C) moral hazard D) costly state verification
- 31) Using the Gordon growth formula, if D_1 is \$2.00, k_e is 12% or 0.12, and g is 10% or 0.10, then the current stock price is 31) _____
 A) \$20. B) \$50. C) \$100. D) \$150.
- 32) Using the one-period valuation model, assuming a year-end dividend of \$1.00, an expected sales price of \$100, and a required rate of return of 5%, the current price of the stock would be 32) _____
 A) \$110.00. B) \$101.00. C) \$100.00. D) \$96.19.
- 33) Banks face the problem of _____ in loan markets because bad credit risks are the ones most likely to seek bank loans. 33) _____
 A) intentional fraud B) adverse selection
 C) moral hazard D) moral suasion
- 34) A credit boom can lead to a(n) _____ such as the one we saw recently in the housing market. 34) _____
 A) liability war B) decline in lending
 C) price bubble D) decrease in moral hazard
- 35) Banks acquire the funds that they use to purchase income-earning assets from such sources as 35) _____
 A) cash items in the process of collection B) deposits at other banks.
 C) reserves. D) savings accounts.
- 36) The goals of bank asset management include 36) _____
 A) minimizing liquidity.
 B) lending at high interest rates regardless of risk.
 C) purchasing securities with high returns and low risk.
 D) maximizing risk.
- 37) Government regulations require publicly traded firms to provide information, reducing 37) _____
 A) economies of scale. B) the adverse selection problem.
 C) the need for diversification. D) transactions costs.
- 38) New information that might lead to a decrease in an asset's price might be 38) _____
 A) an expected decrease in the level of future dividends.
 B) an expected increase in the dividend growth rate.
 C) an expected increase in the future sales price.
 D) a decrease in the required rate of return.
- 39) _____ may antagonize customers and thus can be a very costly way of acquiring funds to meet an unexpected deposit outflow. 39) _____
 A) Selling loans B) Calling in loans
 C) Selling securities D) Selling negotiable CDs

- 40) If uncertainty about banks' health causes depositors to begin to withdraw their funds from banks, the country experiences a(n) _____ 40) _____
 A) reduction of the adverse selection and moral hazard problems.
 B) banking crisis.
 C) financial recovery.
 D) increase in information available to investors.
- 41) The process of transforming otherwise illiquid financial assets into marketable capital market instruments is known as _____ 41) _____
 A) arbitrage. B) program trading.
 C) securitization. D) internationalization.
- 42) A common element in all of the banking crisis episodes in different countries is _____ 42) _____
 A) increased regulation. B) the existence of a government safety net.
 C) lack of competition. D) deposit insurance.
- 43) Uncertainty about interest-rate movements and returns is called _____. 43) _____
 A) interest-rate risk B) market potential
 C) financial creativity D) interest-rate irregularities
- 44) If a forecast is made using all available information, then economists say that the expectation formation is _____ 44) _____
 A) rational. B) reasonable. C) adaptive. D) irrational.
- 45) _____ and _____ may provide an explanation for stock market bubbles. 45) _____
 A) Overconfidence; social contagion B) Underconfidence; social isolationism
 C) Underconfidence; social contagion D) Overconfidence; social isolationism
- 46) When a new depositor opens a checking account at McAllen National Bank, the bank's assets _____ and its liabilities _____. 46) _____
 A) increase; decrease B) decrease; decrease
 C) decrease; increase D) increase; increase
- 47) A sharp decline in the stock market means that the _____ of corporations has fallen making lenders _____ willing to lend. 47) _____
 A) net worth; more B) liability; more
 C) liability; less D) net worth; less
- 48) A financial crisis occurs when an increase in asymmetric information from a disruption in the financial system _____ 48) _____
 A) reduces uncertainty in the economy and increases market efficiency.
 B) causes severe adverse selection and moral hazard problems that make financial markets incapable of channeling funds efficiently.
 C) allows for a more efficient use of funds.
 D) increases economic activity.
- 49) Professional athletes often have contract clauses prohibiting risky activities such as skiing and motorcycle riding. These clauses are _____ 49) _____
 A) risk insurance. B) illegal.
 C) restrictive covenants. D) limited-liability clauses.

- 50) The reduction in transactions costs per dollar of investment as the size of transactions increases is 50) _____
 A) diversification. B) economies of trade.
 C) economies of scale. D) discounting.
- 51) According to rational expectations theory, forecast errors of expectations 51) _____
 A) are unpredictable.
 B) are more likely to be negative than positive.
 C) are more likely to be positive than negative.
 D) tend to be persistently high or low.
- 52) Regulations that reduced competition between banks included 52) _____
 A) the dual system of granting bank charters.
 B) interest-rate ceilings.
 C) branching restrictions.
 D) bank reserve requirements.
- 53) A borrower who takes out a loan usually has better information about the potential returns and risk 53) _____
 of the investment projects he plans to undertake than does the lender. This inequality of
 information is called
 A) adverse selection. B) asymmetric information.
 C) moral hazard. D) noncollateralized risk.
- 54) In the one-period valuation model, the current stock price increases if 54) _____
 A) dividends are cut. B) the expected sales price increases.
 C) the expected sales price falls. D) the required return increases.
- 55) Reasons for holding Eurodollars include 55) _____
 A) the fact that Eurodollar deposits are heavily regulated.
 B) the fact that Eurodollar deposits are insured by the FDIC.
 C) the fact that dollars are widely used to conduct international transactions.
 D) the fact that minimum transaction sizes are very low, making Eurodollars an attractive
 savings instrument for consumers.
- 56) The fraction of checkable deposits that banks are required by regulation to hold are 56) _____
 A) vault cash. B) total reserves.
 C) required reserves. D) excess reserves.
- 57) _____ is the field of study that applies concepts from social sciences such as psychology and 57) _____
 sociology to help understand the behavior of securities prices.
 A) Procedural finance B) Strategical finance
 C) Behavioral finance D) Methodical finance
- 58) Of the following sources of external finance for American nonfinancial businesses, the least 58) _____
 important is
 A) bonds and commercial paper. B) loans from other financial intermediaries.
 C) loans from banks. D) stocks.
- 59) A bank with insufficient reserves can increase its reserves by 59) _____
 A) buying municipal bonds. B) calling in loans.
 C) lending federal funds. D) buying short-term Treasury securities.

- 60) According to the efficient markets hypothesis, the current price of a financial security 60) _____
 A) is the discounted net present value of future interest payments.
 B) is a result of none of the above.
 C) fully reflects all available relevant information.
 D) is determined by the highest successful bidder.
- 61) Holding large amounts of bank capital helps prevent bank failures because 61) _____
 A) it makes loans easier to sell.
 B) it can be used to absorb the losses resulting from bad loans.
 C) it makes it easier to call in loans.
 D) it means that the bank has a higher income.
- 62) _____ is creating a marketable capital market instrument by bundling a portfolio of mortgage or 62) _____
 auto loans.
 A) diversification. B) computerization.
 C) securitization. D) arbitrage.
- 63) When bad drivers line up to purchase collision insurance, automobile insurers are subject to the 63) _____
 A) adverse selection problem. B) assigned risk problem.
 C) ill queue problem. D) moral hazard problem.
- 64) Solutions to the moral hazard problem include 64) _____
 A) low net worth.
 B) greater reliance on equity contracts and less on debt contracts.
 C) monitoring and enforcement of restrictive covenants.
 D) greater reliance on debt contracts than financial intermediaries.
- 65) Which of the following bank assets is the most liquid? 65) _____
 A) Reserves B) U.S. government securities
 C) Cash items in process of collection D) Consumer loans
- 66) Which of the following are not reported as assets on a bank's balance sheet? 66) _____
 A) U.S. Treasury securities B) Checkable deposits
 C) Deposits with other banks D) Cash items in the process of collection
- 67) To reduce moral hazard problems, banks include restrictive covenants in loan contracts. In order 67) _____
 for these restrictive covenants to be effective, banks must also
 A) trust the borrower to do the right thing.
 B) monitor and enforce them.
 C) be prepared to extend the deadline when the borrower needs more time to comply.
 D) be willing to rewrite the contract if the borrower cannot comply with the restrictions.
- 68) The efficient markets hypothesis indicates that investors 68) _____
 A) do better if they purchase loaded mutual funds.
 B) can use the advice of technical analysts to outperform the market.
 C) do better on average if they adopt a "buy and hold" strategy.
 D) let too many unexploited profit opportunities go by if they adopt a "buy and hold" strategy.

69) American businesses get their external funds primarily from

69) _____

- A) loans from nonbank financial intermediaries.
- B) bank loans.
- C) bonds and commercial paper issues.
- D) stock issues.

70) The subprime financial crisis lead to a decline in stock prices because

70) _____

- A) higher current dividends.
- B) of a lowered required return on investment in equity.
- C) of a lowered expected dividend growth rate.
- D) higher expected future stock prices.