Chapter 9
The Banking Firm and the Management of Financial Institutions

■ Multiple Choice

1) A bank's balance sheet
   (a) shows that total assets equals total liabilities plus equity capital.
   (b) lists sources and uses of bank funds.
   (c) indicates whether or not the bank is profitable.
   (d) does all of the above.
   (e) does only (a) and (b) of the above.

   Answer: E
   Question Status: Previous Edition

2) A bank's balance sheet
   (a) shows that total assets equals total liabilities plus equity capital.
   (b) lists sources and uses of bank funds.
   (c) indicates whether or not the bank is solvent.
   (d) does all of the above.
   (e) does only (a) and (b) of the above.

   Answer: D
   Question Status: Previous Edition

3) Which of the following statements are true?
   (a) A bank's assets are its sources of funds.
   (b) A bank's liabilities are its uses of funds.
   (c) A bank's balance sheet shows that total assets equal total liabilities plus equity capital.
   (d) Each of the above.

   Answer: C
   Question Status: Previous Edition

4) Which of the following statements are true?
(a) A bank's assets are its uses of funds.
(b) A bank's liabilities are its sources of funds.
(c) A bank's balance sheet has the property that total assets equal the sum of total liabilities and equity capital.
(d) Each of the above are true.
(e) Only (a) and (b) of the above are true.
Answer: D
Question Status: Previous Edition

5) Which of the following statements is true?
(a) A bank's assets are its uses of funds.
(b) A bank's assets are its sources of funds.
(c) A bank's liabilities are its uses of funds.
(d) Only (b) and (c) of the above are true.
Answer: A
Question Status: Previous Edition

6) Which of the following statements is false?
(a) A bank's assets are its uses of funds.
(b) A bank issues liabilities to acquire funds.
(c) The bank's assets provide the bank with income.
(d) Bank capital is an asset in the bank balance sheet.
Answer: D
Question Status: Previous Edition

7) Which of the following are reported as liabilities on a bank's balance sheet?
(a) Reserves
(b) Checkable deposits
(c) Loans
(d) Deposits with other banks
Answer: B
Question Status: Previous Edition

8) Which of the following are reported as liabilities on a bank's balance sheet?
(a) Discount loans
(b) Checkable deposits
(c) U.S. Treasury securities
(d) Only (a) and (b) of the above
Answer: D
Question Status: Previous Edition

9) Which of the following are reported as liabilities on a bank's balance sheet?
(a) Reserves
(b) Small denomination time deposits
(c) Loans
(d) Deposits with other banks

Answer: B
Question Status: Previous Edition

10) Which of the following are reported as liabilities on a bank's balance sheet?
(a) Nontransaction deposits
(b) Bank capital
(c) Loans
(d) Only (a) and (b) of the above
(e) Only (b) and (c) of the above

Answer: D
Question Status: Previous Edition

11) Which of the following are reported as liabilities on a bank's balance sheet?
(a) Discount loans
(b) Cash items in the process of collection
(c) State government securities
(d) All of the above
(e) Only (a) and (b) of the above

Answer: A
Question Status: Previous Edition

12) Which of the following are reported as liabilities on a bank's balance sheet?
(a) Bank capital
(b) Loans
(c) Reserves
(d) All of the above
(e) Only (a) and (b) of the above

Answer: A
Question Status: Study Guide

13) The share of checkable deposits in total bank liabilities has
(a) expanded moderately over time.
(b) expanded dramatically over time.
(c) shrunk over time.
(d) remained virtually unchanged since 1960.

Answer: C
Question Status: Previous Edition

14) Checkable deposits and money market deposit accounts are
(a) payable on demand.
(b) liabilities of the banks.
(c) assets of the banks.
(d) only (a) and (b) of the above.
(e) only (a) and (c) of the above.
Answer: D
Question Status: Previous Edition

15) Which of the following statements is false?
(a) Checkable deposits are usually the lowest cost source of bank funds.
(b) Checkable deposits are the primary source of bank funds.
(c) Checkable deposits are payable on demand.
(d) Checkable deposits include NOW accounts.
Answer: B
Question Status: Previous Edition

16) In recent years the interest paid on checkable and time deposits has accounted for around _____ of total bank operating expenses, while the costs involved in servicing accounts have been approximately _____ of operating expenses.
(a) 45 percent; 55 percent
(b) 55 percent; 4 percent
(c) 30 percent; 50 percent
(d) 50 percent; 30 percent
Answer: C
Question Status: Previous Edition

17) In recent years the interest paid on checkable and time deposits has accounted for around
(a) 60 percent of total bank operating expenses.
(b) 45 percent of total bank operating expenses.
(c) 30 percent of total bank operating expenses.
(d) 20 percent of total bank operating expenses.
Answer: C
Question Status: Previous Edition

18) In recent years the costs involved in servicing checkable and time deposit accounts have been approximately
(a) 65 percent of total bank operating expenses.
(b) 75 percent of total bank operating expenses.
(c) 50 percent of total bank operating expenses.
(d) 25 percent of total bank operating expenses.
Answer: C
Question Status: Previous Edition

19) Which of the following statements is false?

(a) The expenses involved in servicing accounts (salaries, building rent, etc.) make up over half the costs of running a bank.
(b) Nontransaction deposits are the primary source of bank funds.
(c) Demand deposits are checkable deposits that pay no interest.
(d) Technically, savings deposits are not payable on demand.

Answer: A
Question Status: Previous Edition

20) Which of the following statements are true?

(a) Checkable deposits are usually the lowest cost source of bank funds.
(b) Checkable deposits are payable on demand.
(c) Checkable deposits include NOW accounts.
(d) All of the above are true.

Answer: D
Question Status: Previous Edition

21) Which of the following statements are true?

(a) Checkable deposits are payable on demand.
(b) Checkable deposits include NOW accounts.
(c) Checkable deposits are the primary source of bank funds.
(d) All of the above are true.
(e) Only (a) and (b) of the above are true.

Answer: E
Question Status: Previous Edition

22) Which of the following statements are true?

(a) Nontransaction deposits are the primary source of bank funds.
(b) Demand deposits are checkable deposits that pay no interest.
(c) Technically, savings deposits are not payable on demand.
(d) All of the above are true.
(e) Only (a) and (b) of the above are true.

Answer: D
Question Status: Previous Edition

23) Which of the following statements are true?

(a) Demand deposits are the primary source of bank funds.
(b) Demand deposits are checkable deposits that pay no interest.
(c) The expenses involved in servicing accounts (salaries, building rent, etc.) make up over half the costs of running a bank.
(d) Only (a) and (b) of the above are true.

Answer: B
Question Status: Previous Edition

24) Which of the following are transaction deposits?
(a) Savings accounts
(b) Small-denomination time deposits
(c) Negotiable order of withdraw accounts
(d) Certificates of deposit

Answer: C
Question Status: Previous Edition

25) Which of the following are not nontransaction deposits?
(a) Savings accounts
(b) Small-denomination time deposits
(c) Negotiable order of withdraw accounts
(d) Certificates of deposit

Answer: C
Question Status: Previous Edition

26) Which of the following are nontransaction deposits?
(a) Savings accounts
(b) Small-denomination time deposits
(c) Certificates of deposit
(d) All of the above
(e) Only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

27) Which of the following are nontransaction deposits?
(a) Savings accounts
(b) Small-denomination time deposits
(c) Negotiable order of withdraw accounts
(d) All of the above
(e) Only (a) and (b) of the above

Answer: E
Question Status: Previous Edition

28) Large-denomination CDs are _____, so that like a bond they can be resold in a _____ market before they mature.
(a) nonnegotiable; secondary
(b) nonnegotiable; primary
(c) negotiable; secondary
(d) negotiable; primary

Answer: C
Question Status: Previous Edition

29) Because checking accounts are _____ liquid for the depositor than passbook savings, they earn _____ interest rates.

(a) less; higher
(b) less; lower
(c) more; higher
(d) more; lower

Answer: D
Question Status: Previous Edition

30) Because passbook savings are _____ liquid for the depositor than checking accounts, they earn _____ interest rates.

(a) less; higher
(b) less; lower
(c) more; higher
(d) more; lower

Answer: A
Question Status: Previous Edition

31) Because _____ are less liquid for the depositor than _____, they earn higher interest rates.

(a) money market deposit accounts; time deposits
(b) checkable deposits; passbook savings
(c) passbook savings; checkable deposits
(d) passbook savings; time deposits

Answer: C
Question Status: Previous Edition

32) Because time deposits are _____ liquid for the depositor than passbook savings, they earn _____ interest rates.

(a) less; higher
(b) less; lower
(c) more; higher
(d) more; lower

Answer: A
Question Status: Previous Edition

33) Because _____ are less liquid for the depositor than _____, they earn higher interest rates.

(a) passbook savings; time deposits
(b) money market deposit accounts; time deposits
(c) money market deposit accounts; passbook savings
(d) time deposits; passbook savings

Answer: D
Question Status: Previous Edition

34) Bank capital is listed on the _____ side of the bank's balance sheet because it represents a _____ of funds.
(a) liability; use
(b) liability; source
(c) asset; use
(d) asset; source
Answer: B
Question Status: Previous Edition

35) Banks acquire funds from such sources as
(a) checkable deposits.
(b) savings accounts.
(c) reserves.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

36) Banks acquire funds from such sources as
(a) bank capital.
(b) cash items in the process of collection.
(c) reserves.
(d) only (a) and (b) of the above.
Answer: A
Question Status: Previous Edition

37) Banks acquire the funds that they use to purchase income-earning assets from such sources as
(a) checkable deposits.
(b) savings accounts.
(c) reserves.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

38) Banks acquire the funds that they use to purchase income-earning assets from such sources as
(a) bank capital.
(b) cash items in the process of collection.
(c) reserves.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: A
Question Status: Previous Edition

39) Bank loans from the Federal Reserve are called _____ and represent a _____ of funds.
(a) discount loans; use
(b) discount loans; source
(c) fed funds; use
(d) fed funds; source
Answer: B
Question Status: Previous Edition

40) Bank reserves
(a) equal bank deposits at the Fed.
(b) include holdings of U.S. government securities.
(c) can be divided up into required and excess reserves.
(d) all of the above.
(e) both (a) and (c) of the above.
Answer: C
Question Status: Study Guide

41) Bank reserves include
(a) deposits at the Fed.
(b) vault cash.
(c) short-term Treasury securities.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New

42) Bank reserves include
(a) deposits at the Fed and short-term treasury securities.
(b) vault cash and short-term Treasury securities.
(c) short-term Treasury securities and municipal securities.
(d) deposits at other banks and deposits at the Fed.
(e) vault cash and deposits at the Fed.
Answer: E
Question Status: New

43) The fraction of checkable deposits that banks are required by regulation to hold are
(a) excess reserves.
(b) required reserves.
(c) vault cash.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: B
Question Status: New

44) The sum of reserves, cash items in the process of collection, and deposits in other banks are know as
(a) secondary reserves.
(b) cash items.
(c) liquid items.
(d) compensating balances.
(e) correspondent balances.
Answer: B
Question Status: Study Guide

45) Which of the following are reported as assets on a bank's balance sheet?
(a) U.S. Treasury securities
(b) Loans
(c) Discount loans from the Fed
(d) Only (a) and (b) of the above
Answer: D
Question Status: Previous Edition

46) Which of the following are reported as assets on a bank's balance sheet?
(a) Discount loans from the Fed
(b) Loans
(c) Borrowings
(d) Only (a) and (b) of the above
Answer: B
Question Status: Previous Edition

47) Which of the following are reported as assets on a bank's balance sheet?
(a) Cash items in the process of collection
(b) Loans
(c) Borrowings
(d) Only (a) and (b) of the above
Answer: D
Question Status: Previous Edition

48) Which of the following are reported as assets on a bank's balance sheet?
(a) Cash items in the process of collection
(b) Checkable deposits
(c) Borrowings
(d) Bank capital
Answer: A
Question Status: Previous Edition

49) Which of the following are reported as assets on a bank's balance sheet?
(a) Cash items in the process of collection
(b) Deposits with other banks
(c) Checkable deposits
(d) Bank capital
(e) Only (a) and (b) of the above

Answer: E
Question Status: Previous Edition

50) Which of the following are reported as assets on a bank's balance sheet?
(a) U.S. Treasury securities
(b) Reserves
(c) Loans
(d) All of the above
(e) Only (a) and (b) of the above

Answer: D
Question Status: Previous Edition

51) Which of the following are reported as assets on a bank's balance sheet?
(a) Discount loans from the Fed
(b) Loans
(c) Reserves
(d) Only (a) and (b) of the above
(e) Only (b) and (c) of the above

Answer: E
Question Status: Previous Edition

52) Which of the following are reported as assets on a bank's balance sheet?
(a) Borrowings
(b) Reserves
(c) Savings deposits
(d) Bank capital
(e) Only (a) and (b) of the above

Answer: B
Question Status: Previous Edition

53) Which of the following are reported as assets on a bank's balance sheet?
(a) Reserves
(b) Checkable deposits
(c) Borrowings
(d) Bank capital

Answer: A
Question Status: Previous Edition

54) Which of the following are reported as assets on a bank's balance sheet?
(a) Cash items in the process of collection
(b) Deposits with other banks
(c) U.S. Treasury securities
(d) All of the above

Answer: D
Question Status: Previous Edition

55) Which of the following are not reported as assets on a bank's balance sheet?
(a) Cash items in the process of collection
(b) Deposits with other banks
(c) U.S. Treasury securities
(d) Checkable deposits

Answer: D
Question Status: Previous Edition

56) Which of the following are not reported as assets on a bank's balance sheet?
(a) Cash items in the process of collection
(b) Borrowings
(c) U.S. Treasury securities
(d) Reserves

Answer: B
Question Status: Previous Edition

57) Which of the following are not reported as assets on a bank's balance sheet?
(a) Discount loans from the Fed
(b) Loans
(c) Reserves
(d) Only (a) and (b) of the above

Answer: A
Question Status: Previous Edition

58) Which of the following are not reported as assets on a bank's balance sheet?
(a) Borrowings
(b) Savings deposits
(c) Reserves
(d) Only (a) and (b) of the above

Answer: D
Question Status: Previous Edition

59) Through correspondent banking, large banks provide services to small banks, including
(a) check collection.
(b) foreign exchange transactions.
(c) issuing stock.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New

60) Through correspondent banking, large banks provide services to small banks, including
(a) check collection.
(b) foreign exchange transactions.
(c) help with security purchases.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: D
Question Status: New

61) Banks' holdings of securities consist primarily of
(a) Treasury and government agency securities.
(b) tax-exempt municipal securities.
(c) state and local government securities.
(d) corporate securities.
Answer: A
Question Status: Previous Edition

62) Which of the following bank assets is the most liquid?
(a) Consumer loans
(b) Reserves
(c) Cash items in process of collection
(d) U.S. government securities
Answer: B
Question Status: Previous Edition

63) Of the following bank assets, the most liquid is
(a) consumer loans.
(b) state and local government securities.
(c) physical capital.
(d) U.S. government securities.
(e) commercial loans.
Answer: D
Question Status: Study Guide

64) The most important category of assets on a bank's balance sheet is
(a) discount loans.
(b) securities.
(c) gold.
(d) cash items in the process of collection.
(e) none of the above.
Answer: E
Question Status: Previous Edition

65) The most important category of assets on a bank's balance sheet is
(a) discount loans.
(b) securities.
(c) loans.
(d) cash items in the process of collection.
Answer: C
Question Status: Previous Edition

66) Which of the following bank assets is the least liquid?
(a) Reserves
(b) Secondary reserves
(c) Deposits with other banks
(d) Cash items in process of collection
Answer: B
Question Status: Previous Edition

67) Secondary reserves include
(a) deposits at Federal Reserve Banks.
(b) deposits at other large banks.
(c) short-term Treasury securities.
(d) state and local government securities.
(e) all of the above.
Answer: C
Question Status: New

68) Because of their _____ liquidity, _____ U.S. government securities are called secondary reserves.
(a) low; short-term
(b) low; long-term
(c) high; short-term
(d) high; long-term
Answer: C
Question Status: Previous Edition

69) Secondary reserves are so called because
(a) they can be converted into cash with low transactions costs.
(b) they are not easily converted into cash, and are, therefore, of secondary importance to banking firms.
(c) 50% of these assets count toward meeting required reserves.
(d) of none of the above.

Answer: A
Question Status: Previous Edition

70) Banks' holdings of securities consist primarily of
(a) Treasury and government agency securities.
(b) tax-exempt municipal securities.
(c) state and local government securities.
(d) corporate securities.

Answer: A
Question Status: Previous Edition

71) Banks' asset portfolios include state and local government securities because
(a) their interest payments are tax deductible for federal income taxes.
(b) banks consider them helpful in attracting state and local government accounts.
(c) the Federal Reserve requires member banks to buy securities from state and local governments located within their respective Federal Reserve districts.
(d) of all of the above.
(e) of only (a) and (b) of the above.

Answer: E
Question Status: Previous Edition

72) Loans
(a) are the largest category of bank assets.
(b) provide most of the bank's revenues.
(c) earn the highest return of all bank assets.
(d) do each of the above.
(e) do only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

73) The benefits to a bank from making loans include
(a) liquidity.
(b) safety.
(c) high returns.
(d) all of the above.
(e) both (a) and (c) of the above.

Answer: C
Question Status: New

74) Banks earn profits by selling ______ with attractive combinations of liquidity, risk, and return, and using the proceeds to buy _____ with a different set of characteristics.

(a) loans; deposits
(b) securities; deposits
(c) liabilities; assets
(d) assets; liabilities

Answer: C
Question Status: Previous Edition

75) In general, banks make profits by selling _____ liabilities and buying _____ assets.

(a) long-term; shorter-term
(b) short-term; longer-term
(c) illiquid; liquid
(d) risky; risk-free

Answer: B
Question Status: Previous Edition

76) Asset transformation can be described as

(a) borrowing long and lending short.
(b) borrowing short and lending long.
(c) borrowing and lending only for the short term.
(d) borrowing and lending for the long term.
(e) making only high-interest loans.

Answer: B
Question Status: New

77) When a new depositor opens a checking account at the First National Bank, the bank's assets _____ and its liabilities _____.

(a) increase; increase
(b) increase; decrease
(c) decrease; increase
(d) decrease; decrease

Answer: A
Question Status: Previous Edition

78) When Jane Brown writes a $100 check to her nephew (who lives in another state), Ms. Brown's bank _____ assets of $100 and _____ liabilities of $100.

(a) gains; gains
(b) gains; loses
(c) loses; gains
(d) loses; loses

Answer: D
Question Status: Previous Edition

79) When you deposit a $50 bill in the Security Pacific National Bank,
(a) its liabilities increase by $50.
(b) its assets increase by $50.
(c) its reserves increase by $50.
(d) all of the above occur.
(e) only (b) and (c) of the above occur.

Answer: D
Question Status: Previous Edition

80) When you deposit a $50 bill in the Security Pacific National Bank,
(a) its liabilities decrease by $50.
(b) its assets increase by $50.
(c) its reserves increase by $50.
(d) only (b) and (c) of the above occur.

Answer: D
Question Status: Previous Edition

81) When you deposit a $50 bill in the Security Pacific National Bank,
(a) its liabilities decrease by $50.
(b) its assets increase by $50.
(c) its reserves decrease by $50.
(d) only (b) and (c) of the above occur.

Answer: B
Question Status: Previous Edition

82) When you deposit $50 in currency at Old National Bank,
(a) its assets increase by $50.
(b) its reserves increase by $50.
(c) its liabilities increase by $50.
(d) each of the above occurs.
(e) only (a) and (b) of the above occur.

Answer: D
Question Status: Previous Edition

83) When you deposit $50 in currency at Old National Bank,
(a) its assets increase by $50.
(b) its reserves increase by less than $50 because of reserve requirements.
(c) its liabilities decrease by $50.
(d) only (a) and (b) of the above occur.

Answer: A
Question Status: Previous Edition

84) When you deposit $50 in currency at Old National Bank,
(a) its assets increase by less than $50 because of reserve requirements.
(b) its reserves increase by less than $50 because of reserve requirements.
(c) its liabilities increase by $50.
(d) only (a) and (b) of the above occur.
Answer: C
Question Status: Previous Edition

85) Holding all else constant, when a bank receives the funds for a deposited check,
(a) cash items in the process of collection fall by the amount of the check.
(b) bank assets increase by the amount of the check.
(c) bank liabilities decrease by the amount of the check.
(d) all of the above.
Answer: A
Question Status: Previous Edition

86) Holding all else constant, when a bank receives the funds for a deposited check,
(a) cash items in the process of collection fall by the amount of the check.
(b) bank assets remain unchanged.
(c) bank liabilities remain unchanged.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

87) Holding all else constant, when a bank receives the funds for a deposited check,
(a) cash items in the process of collection fall by the amount of the check.
(b) bank assets remain unchanged.
(c) bank liabilities decrease by the amount of the check.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

88) When a $10 check written on the First National Bank of Chicago is deposited in an account at Citibank, then
(a) the liabilities of the First National Bank increase by $10.
(b) the reserves of the First National Bank increase by $10.
(c) the liabilities of Citibank fall by $10.
(d) the assets of Citibank fall by $10.
(e) none of the above occurs.
Answer: E
Question Status: Previous Edition

89) When a $10 check written on the First National Bank of Chicago is deposited in an account at Citibank, then
(a) the liabilities of the First National Bank increase by $10.
(b) the reserves of the First National Bank increase by $10.
(c) the liabilities of Citibank increase by $10.
(d) the assets of Citibank fall by $10.
Answer: C
Question Status: Previous Edition

90) When a $10 check written on the First National Bank of Chicago is deposited in an account at Citibank, then
(a) the liabilities of the First National Bank decrease by $10.
(b) the reserves of the First National Bank increase by $10.
(c) the liabilities of Citibank decrease by $10.
(d) the assets of Citibank decrease by $10.
Answer: A
Question Status: Previous Edition

91) When a $10 check written on the First National Bank of Chicago is deposited in an account at Citibank, then
(a) the liabilities of the First National Bank decrease by $10.
(b) the liabilities of Citibank increase by $10.
(c) the reserves of the First National Bank increase by $10.
(d) all of the above occur.
(e) only (a) and (b) of the above occur.
Answer: E
Question Status: Previous Edition

92) When a $10 check written on the First National Bank of Chicago is deposited in an account at Citibank, then
(a) the liabilities of the First National Bank decrease by $10.
(b) the liabilities of Citibank increase by $10.
(c) the reserves of the First National Bank decrease by $10.
(d) all of the above occur.
(e) only (a) and (b) of the above occur.
Answer: D
Question Status: Previous Edition

93) 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 assets of First National rise by $50.
(b) the assets of Chemical Bank rise by $50.
(c) the reserves at First National fall by $50.
(d) the liabilities at Chemical Bank rise by $50.
Answer: C
Question Status: Previous Edition

94) 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 liabilities of First National decrease by $50.
(b) the reserves at First National fall by $50.
(c) the liabilities at Chemical Bank rise by $50.
(d) all of the above occur.
(e) only (a) and (b) of the above occur.

Answer: E
Question Status: Previous Edition

95) 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 liabilities of First National decrease by $50.
(b) the reserves at First National decrease by $50.
(c) the liabilities at Chemical Bank rise by $100.
(d) all of the above occur.
(e) only (a) and (b) of the above occur.

Answer: D
Question Status: Previous Edition

96) 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 liabilities of First National decrease by $50.
(b) the reserves at First National increase by $50.
(c) the liabilities at Chemical Bank increase by $50.
(d) only (a) and (b) of the above occur.

Answer: A
Question Status: Previous Edition

97) When $1 million is deposited at a bank, the required reserve ratio is 20 percent, and the bank chooses not to hold any excess reserves but makes loans instead, then, in the bank's final balance sheet,

(a) the assets at the bank increase by $200,000.
(b) the liabilities of the bank increase by $200,000.
(c) reserves increase by $200,000.
(d) each of the above occurs.
(e) both (a) and (b) of the above occur.

Answer: C
Question Status: Revised

98) When $1 million is deposited at a bank, the required reserve ratio is 20 percent, and the bank chooses not to hold any excess reserves but makes loans instead, then, in the bank's final balance sheet,

(a) the assets at the bank increase by $1,000,000.
(b) the liabilities of the bank increase by $1,000,000.
(c) reserves increase by $200,000.
(d) each of the above occurs.
(e) both (a) and (b) of the above occur.

Answer: D
Question Status: Revised

99) When $1 million is deposited at a bank, the required reserve ratio is 20 percent, and the bank chooses not to hold any excess reserves but makes loans instead, then, in the bank's final balance sheet,

(a) the assets at the bank increase by $800,000.
(b) the liabilities of the bank increase by $1,000,000.
(c) the liabilities of the bank increase by $800,000.
(d) reserves increase by $160,000.

Answer: B
Question Status: Previous Edition

100) When $1 million is deposited at a bank, the required reserve ratio is 20 percent, and the bank chooses not to make any loans but to hold excess reserves instead, then, in the bank's final balance sheet,

(a) the assets at the bank increase by $1 million.
(b) the liabilities of the bank increase by $1 million.
(c) reserves increase by $200,000.
(d) each of the above occurs.
(e) only (a) and (b) of the above occurs.

Answer: E
Question Status: Previous Edition

101) When $1 million is deposited at a bank, the required reserve ratio is 20 percent, and the bank chooses not to make any loans but to hold excess reserves instead, then, in the bank's final balance sheet,

(a) the assets at the bank increase by $1 million.
(b) the liabilities of the bank increase by $1 million.
(c) required reserves increase by $200,000.
(d) each of the above occurs.
(e) only (a) and (b) of the above occurs.

Answer: D
Question Status: Previous Edition

102) A banker has the following concerns:
(a) to acquire funds at low cost.
(b) to minimize risk by diversifying asset holdings.
(c) to have enough ready cash to meet deposit outflows.
(d) to acquire and maintain adequate capital.
(e) each of the above.
Answer: E
Question Status: Revised

103) Which of the following are primary concerns of the bank manager?
(a) Maintaining sufficient reserves to minimize the cost to the bank of deposit outflows
(b) Extending loans to borrowers who will pay high interest rates, but who are also good credit risks
(c) Acquiring funds at a relatively low cost, so that profitable lending opportunities can be realized
(d) All of the above
Answer: D
Question Status: Previous Edition

104) If a bank has $100,000 of deposits, a required reserve ratio of 20 percent, and it holds $30,000 in reserves, then it has enough reserves to support a deposit outflow of
(a) $20,000.
(b) $11,000.
(c) $5,000.
(d) either (a) or (b) of the above.
(e) either (b) or (c) of the above.
Answer: E
Question Status: Previous Edition

105) If a bank has $100,000 of deposits, a required reserve ratio of 20 percent, and it holds $30,000 in reserves, then it need not rearrange its balance sheet if there is a deposit outflow of
(a) $20,000.
(b) $8,000.
(c) $5,000.
(d) either (a) or (b) of the above.
(e) either (b) or (c) of the above.
Answer: E
Question Status: Previous Edition

106) If a bank has $1 million of deposits, a required reserve ratio of 20 percent, and it holds $300,000 in reserves, it need not rearrange its balance sheet if there is a deposit outflow of
(a) $50,000.
(b) $100,000.
(c) $150,000.
(d) any of the above
(e) either (a) or (b) of the above.
Answer: E
Question Status: Previous Edition

107) If a bank has $1 million of deposits, a required reserve ratio of 20 percent, and it holds $300,000 in reserves, it need not rearrange its balance sheet if there is a deposit outflow of

(a) $50,000.
(b) $75,000.
(c) $150,000.
(d) either (a) or (b) of the above.

Answer: D
Question Status: Previous Edition

108) If a bank has $100,000 of deposits, a required reserve ratio of 20 percent, and it holds $40,000 in reserves, then the maximum deposit outflow it can sustain without altering its balance sheet is

(a) $30,000.
(b) $25,000.
(c) $20,000.
(d) $10,000.

Answer: B
Question Status: Previous Edition

109) If a bank has $200,000 of deposits, a required reserve ratio of 20 percent, and it holds $80,000 in reserves, then the maximum deposit outflow it can sustain without altering its balance sheet is

(a) $50,000.
(b) $40,000.
(c) $30,000.
(d) $25,000.

Answer: A
Question Status: Previous Edition

110) If a bank has $10 million of deposits, a required reserve ratio of 10 percent, and it holds $2 million in reserves, then it will not have enough reserves to support a deposit outflow of

(a) $1.2 million.
(b) $1.1 million.
(c) $1 million.
(d) either (a) or (b) of the above.

Answer: A
Question Status: Previous Edition

111) If a bank has excess reserves greater than the amount of a deposit outflow, the outflow will result in

(a) equal reductions in deposits and reserves.
(b) equal reductions in deposits and loans.
(c) equal reductions in deposits and securities.
(d) equal reductions in capital and loans.
(e) equal reductions in capital and reserves.

Answer: A
Question Status: New

112) A $5 million deposit outflow from a bank has the immediate effect of
(a) reducing deposits and reserves by $5 million.
(b) reducing deposits and loans by $5 million.
(c) reducing deposits and securities by $5 million.
(d) reducing reserves and increasing loans by $5 million.
(e) reducing deposits and capital by $5 million.
Answer: A
Question Status: New

113) If, after a deposit outflow, a bank has a reserve deficiency of $3 million, it can meet its reserve requirements by
(a) reducing deposits by $3 million.
(b) increasing loans by $3 million.
(c) selling $3 million of securities.
(d) reducing its capital by $3 million
(e) repay its discount loans from the Fed.
Answer: C
Question Status: New

114) Banks protect themselves from the disruption of deposit outflows by
(a) holding excess reserves.
(b) selling securities.
(c) "calling in" loans.
(d) doing all of the above.
(e) doing only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

115) A bank facing a reserve deficiency will first
(a) call in loans.
(b) borrow from the Fed.
(c) sell securities.
(d) borrow from other banks.
(e) all of the above.
Answer: D
Question Status: Study Guide

116) A bank can reduce its total amount of loans outstanding by
(a) "calling in" loans—that is, by not renewing some loans when they come due.
(b) selling them to other banks.
(c) selling them to the Federal Reserve.
(d) doing all of the above.
(e) doing only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

117) In general, banks would prefer to meet deposit outflows by _____ rather than _____.
(a) selling loans; selling securities
(b) selling loans; borrowing from the Fed
(c) borrowing from the Fed; selling loans
(d) “calling in” loans; selling securities
Answer: C
Question Status: Previous Edition

118) Bankers’ concerns regarding the optimal mix of excess reserves, secondary reserves, borrowings from the Fed, and borrowings from other banks to deal with deposit outflows is an example of
(a) liability management.
(b) liquidity management.
(c) managing interest rate risk.
(d) none of the above.
Answer: B
Question Status: Previous Edition

119) Banks hold excess and secondary reserves to
(a) prevent bank failures.
(b) meet deposit outflows.
(c) satisfy reserve requirements.
(d) do all of the above.
(e) do only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

120) Banks hold excess and secondary reserves to
(a) satisfy reserve requirements.
(b) provide for deposit outflows.
(c) satisfy margin requirements.
(d) do all of the above.
(e) do only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

121) Banks hold excess and secondary reserves to
(a) satisfy customer expectations.
(b) provide for deposit outflows.
(c) satisfy margin requirements.
(d) do only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

122) A bank will want to hold more excess reserves (everything else equal) when
(a) it expects to have deposit inflows in the near future.
(b) brokerage commissions on selling bonds falls.
(c) the cost of selling off loans falls.
(d) all of the above situations occur.
(e) none of the above situations occur.

Answer: E
Question Status: Previous Edition

123) Everything else equal, a bank will hold less excess reserves when
(a) it expects to have a deposit inflow in the near future.
(b) brokerage commissions on selling bonds rise.
(c) the cost of selling off loans rises.
(d) all of the above occur.
(e) none of the above occur.

Answer: A
Question Status: Study Guide

124) A bank will want to hold more excess reserves (everything else equal) when
(a) it expects to have deposit inflows in the near future.
(b) brokerage commissions on selling bonds increase.
(c) the cost of selling loans falls.
(d) all of the above situations occur.

Answer: B
Question Status: Previous Edition

125) Which of the following do banks hold as insurance against the high cost of deposit outflows?
(a) Excess reserves
(b) Secondary reserves
(c) Bank equity capital
(d) Each of the above
(e) Only (a) and (b) of the above

Answer: D
Question Status: Previous Edition

126) The _____ are the costs associated with deposit outflows, the _____ excess reserves banks will want to hold.
(a) lower; more
(b) higher; less
(c) higher; more
(d) None of the above, since deposit outflows cannot be anticipated.

Answer: C
Question Status: Previous Edition

127) Banks hold excess reserves, secondary reserves, and _____ because they all provide insurance against the highest cost of a deposit outflow—bank failure.
(a) deposits
(b) securities
(c) loans
(d) bank capital
Answer: D
Question Status: Previous Edition

128) Which of the following would a bank not hold as insurance against the highest cost of deposit outflow—bank failure?
(a) excess reserves
(b) secondary reserves
(c) bank capital
(d) mortgages
Answer: D
Question Status: Previous Edition

129) A bank holding insufficient reserves can meet its reserve requirements by
(a) borrowing federal funds.
(b) borrowing from the Fed.
(c) selling secondary reserves.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: D
Question Status: New

130) A bank holding insufficient reserves can meet its reserve requirements by
(a) borrowing federal funds.
(b) borrowing from other banks.
(c) selling secondary reserves.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: D
Question Status: New

131) A bank with insufficient reserves can increase its reserves by
(a) lending federal funds.
(b) calling in loans.
(c) buying short-term Treasury securities.
(d) buying municipal bonds.
(e) all of the above.
Answer: B
Question Status: New

132) The First National Bank gains reserves when
(a) a check written on an account at another bank is deposited in First National.
(b) it receives a discount loan from the Federal Reserve.
(c) it pays back a discount loan from the Federal Reserve.
(d) both (a) and (b) of the above occur.
(e) both (a) and (c) of the above occur.

Answer: D
Question Status: Previous Edition

133) Which of the following statements most accurately describes the task of bank asset management?
(a) Banks seek the highest returns possible subject to minimizing risk and making adequate provisions for liquidity.
(b) Banks seek to have the highest liquidity possible subject to earning a positive rate of return on their operations.
(c) Banks seek to prevent bank failure at all cost; since a failed bank earns no profit, liquidity needs supersede the desire for profits.
(d) None of the above accurately describes the task of asset management.

Answer: A
Question Status: Previous Edition

134) The First National Bank gains reserves when
(a) a check written on an account at another bank is deposited in First National.
(b) it borrows federal funds from other banks.
(c) it lends federal funds to other banks.
(d) both (a) and (b) of the above occur.
(e) both (a) and (c) of the above occur.

Answer: D
Question Status: New

135) The goals of bank asset management include
(a) maximizing risk.
(b) minimizing liquidity
(c) lending at high interest rates regardless of risk.
(d) purchasing securities with high returns and low risk.
(e) all of the above.

Answer: D
Question Status: New

136) Banks that suffered significant losses in the 1980s made the mistake of
(a) holding too many liquid assets.
(b) minimizing default risk.
(c) failing to diversify their loan portfolio.
(d) holding only safe securities.
(e) all of the above.

Answer: C
Question Status: New

137) Which of the following has not resulted from more active liability management on the part of banks?
(a) Increased bank holdings of cash items
(b) Aggressive targeting of goals for asset growth by banks
(c) Increased use of negotiable CDs to raise funds
(d) An increased proportion of bank assets held in loans
Answer: A
Question Status: Previous Edition

138) Which of the following have resulted from more active liability management on the part of banks?
(a) Checking deposits have become a less important source of bank funds.
(b) Banks have increased loans.
(c) Banks make more active use of the federal funds market.
(d) Each of the above.
(e) Only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

139) Which of the following statements are accurate descriptions of modern liability management?
(a) Greater flexibility in liability management has allowed banks to increase the proportion of their assets held in loans.
(b) New financial instruments enable banks to acquire funds quickly.
(c) The introduction of negotiable CDs has significantly reduced the percentage of funds that banks borrow from one another to finance loans.
(d) All of the above have occurred since 1960.
(e) Only (a) and (b) of the above have occurred since 1960.
Answer: E
Question Status: Previous Edition

140) Banks that actively manage liabilities will most likely meet a reserve shortfall by
(a) calling in loans.
(b) borrowing federal funds.
(c) selling municipal bonds.
(d) seeking new deposits.
(e) reducing sales of negotiable certificates of deposit.
Answer: B
Question Status: New

141) Modern liability management has resulted in
(a) increased sales of certificates of deposits to raise funds.
(b) increase importance of deposits as a source of funds.
(c) reduced borrowing by banks in the overnight loan market.
(d) failure by banks to coordinate management of assets and liabilities.
(e) all of the above.
Answer: A
Question Status: New

142) A bank is insolvent when
(a) its liabilities exceed its assets.
(b) its assets exceed its liabilities.
(c) its capital account increases.
(d) its assets increase in value.
(e) its capital exceeds its liabilities.

Answer: A
Question Status: New

143) When a bank's _____ exceed it ______, it is ______.
(a) assets; liabilities; illiquid
(b) assets; capital; illiquid
(c) capital; assets; insolvent
(d) liabilities; assets; illiquid
(e) liabilities; assets; insolvent

Answer: E
Question Status: New

144) Banks fail when the value of bank _____ falls below the value of its _____, causing the bank to become insolvent.
(a) reserves; required reserves
(b) loans; secondary reserves
(c) securities; deposit liabilities
(d) assets; liabilities

Answer: D
Question Status: Previous Edition

145) Banks fail
(a) when the value of bank reserves falls below the value of its required reserves, causing the bank to become insolvent.
(b) when the value of bank loans falls below the value of its secondary reserves, causing the bank to become insolvent.
(c) when the value of bank assets falls below the value of its liabilities, causing the bank to become insolvent.
(d) when all of the above occur.

Answer: C
Question Status: Previous Edition

146) A bank failure occurs whenever
(a) a bank cannot satisfy its obligations to pay its depositors and have enough reserves to meet its reserve requirements.
(b) a bank suffers a large deposit outflow.
(c) a bank has to call in a large volume of loans.
(d) a bank is not allowed to borrow from the Fed.

Answer: A
Question Status: Previous Edition

147) Holding large amounts of bank capital helps prevent bank failures because
(a) it means that the bank has a higher income.
(b) it makes loans easier to sell.
(c) it can be used to absorb the losses resulting from a deposit outflow.
(d) it makes it easier to call in loans.
Answer: C
Question Status: Previous Edition

148) A bank failure is less likely to occur when
(a) a bank holds fewer U.S. government securities.
(b) a bank suffers large deposit outflows.
(c) a bank holds more excess reserves.
(d) a bank has less bank capital.
Answer: C
Question Status: Previous Edition

149) A bank failure is more likely to occur when
(a) a bank holds fewer U.S. government securities.
(b) a bank suffers large deposit outflows.
(c) a bank holds less equity capital.
(d) each of the above occur.
(e) only (a) and (b) of the above occur.
Answer: D
Question Status: Previous Edition

150) The likelihood of bank failure increases when
(a) a bank holds more U.S. government securities.
(b) a bank suffers large deposit outflows.
(c) a bank holds more excess reserves.
(d) a bank has more capital.
(e) all of the above.
Answer: B
Question Status: Study Guide

151) Bank capital
(a) acts as a cushion against a drop in the value of assets.
(b) acts to reassure uninsured depositors that the bank is sound.
(c) acts to reassure loan customers that the bank is not likely to fail due to a few bad loans.
(d) does each of the above.
(e) does only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

152) Depositors want banks to have _____ net worth to help ensure that banks do not _____ in the production of information about borrowers.

(a) low; over-invest
(b) low; under-invest
(c) high; over-invest
(d) high; under-invest

Answer: D
Question Status: Previous Edition

153) When compared to banks with high net worth, banks with low net worth have _____ incentives to engage in activities that _____ profitability.

(a) fewer; increase
(b) fewer; reduce
(c) greater; increase
(d) greater; maintain

Answer: A
Question Status: Previous Edition

154) When compared to banks with _____ net worth, banks with _____ net worth have fewer incentives to engage in activities that ensure profitability.

(a) high; high
(b) high; low
(c) low; high
(d) low; low

Answer: B
Question Status: Previous Edition

155) 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
Question Status: Previous Edition

156) One way for a bank to assure depositors that it is not taking on too much risk, and so obtain their deposits, is for it to

(a) diversify its loan portfolio.
(b) reduce its equity capital.
(c) lengthen the maturity of its assets.
(d) shorten the maturity of its liabilities.

Answer: A
Question Status: Previous Edition

157) One way for a bank to assure depositors that it is not taking on too much risk, and so obtain their deposits, is for it to
(a) diversify its loan portfolio.
(b) increase its equity capital.
(c) lengthen the maturity of its assets.
(d) do both (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

158) A bank can signal its depositors that its incentives are compatible with theirs by
(a) maintaining a high amount of equity capital.
(b) diversifying its loan portfolio.
(c) shortening the maturity of its liabilities.
(d) doing all of the above.
(e) doing both (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

159) In the absence of regulation, banks would probably hold
(a) too much capital, reducing the efficiency of the payments system.
(b) too much capital, reducing the profitability of banks.
(c) too little capital.
(d) none of the above.
Answer: C
Question Status: Previous Edition

160) Which of the following is an argument in support of a regulated minimum capital requirement?
(a) Banks that hold too little capital are too profitable.
(b) Banks that hold too little capital impose costs on other banks because they are more likely to fail.
(c) Banks that hold too little capital have an unfair competitive advantage over savings and loans.
(d) All of the above.
Answer: B
Question Status: Previous Edition

161) Net profit after taxes per dollar of equity capital is a basic measure of bank profitability called
(a) return on assets.
(b) return on capital.
(c) return on equity.
(d) return on investment.
Answer: C
Question Status: Previous Edition

162) Net profit after taxes per dollar of assets is a basic measure of bank profitability called
(a) return on assets.
(b) return on capital.
(c) return on equity.
(d) return on investment.
Answer: A
Question Status: Previous Edition

163) The amount of assets per dollar of equity capital is called the
(a) asset ratio.
(b) equity ratio.
(c) equity multiplier.
(d) asset multiplier.
(e) return on equity.
Answer: C
Question Status: Previous Edition

164) Given the return on _____, the return to the owners of the bank is _____ for a _____ amount of bank capital.
(a) liabilities; lower; lower
(b) assets; higher; lower
(c) assets; higher; higher
(d) liabilities; higher; lower
(e) assets; lower; lower
Answer: B
Question Status: Study Guide

165) For a given return on assets,
(a) the lower is bank capital, the lower is the return for the owners of the bank.
(b) the lower is bank capital, the higher is the return for the owners of the bank.
(c) the lower is bank capital, the lower is the credit risk for the owners of the bank.
(d) both (a) and (c) of the above.
Answer: B
Question Status: Previous Edition

166) For a given return on assets,
(a) the lower is bank capital, the higher is the return for the owners of the bank.
(b) the lower is bank capital, the higher is the credit risk for the owners of the bank.
(c) the higher is the return for the owners of the bank, the lower is bank capital.
(d) both (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

167) Conditions that likely contributed to a credit crunch in 1990-92 include:
(a) a decline in bank capital caused by loan losses due to falling real estate prices.
(b) regulated hikes in bank capital requirements.
(c) falling interest rates that raised interest rate risk, causing banks to choose to hold more capital.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: E
Question Status: Previous Edition

168) Conditions that likely contributed to a credit crunch in 1990-92 include:
(a) a decrease in the equity multiplier caused by loan losses due to falling real estate prices.
(b) regulated hikes in bank capital requirements.
(c) falling interest rates that raised interest rate risk, causing banks to choose to hold more capital.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: B
Question Status: Revised

169) Banks face the problem of _____ in loan markets because bad credit risks are the ones most likely to seek bank loans.
(a) adverse selection
(b) moral hazard
(c) moral suasion
(d) intentional fraud

Answer: A
Question Status: Previous Edition

170) If borrowers with the most risky investment projects seek bank loans in higher proportion to those borrowers with the safest investment projects, banks are said to face the problem of
(a) adverse credit risk.
(b) adverse selection.
(c) moral hazard.
(d) lemon lenders.

Answer: B
Question Status: Previous Edition

171) Because borrowers, once they have a loan, are more likely to invest in high-risk investment projects, banks face the
(a) adverse selection problem.
(b) lemon problem.
(c) adverse credit risk problem.
(d) moral hazard problem.

Answer: D
Question Status: Previous Edition

172) Banks' attempts to solve adverse selection and moral hazard problems help explain loan management principles such as:
(a) screening and monitoring of loan applicants.
(b) collateral and compensating balances.
(c) credit rationing.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

173) Banks attempt to screen out the good credit risks from the bad credit risks to reduce the incidence of loan defaults. To do this, banks
(a) specialize in lending to certain industries or regions.
(b) write restrictive covenants into loan contracts.
(c) expend resources to acquire accurate credit histories of their potential loan customers.
(d) do all of the above.
Answer: D
Question Status: Previous Edition

174) In one sense _____ appears surprising since it means that the bank is not _____ its portfolio of loans and thus is exposing itself to more risk.
(a) specialization in lending; diversifying
(b) specialization in lending; rationing
(c) credit rationing; diversifying
(d) screening; rationing
Answer: A
Question Status: Previous Edition

175) From the standpoint of _____, specialization in lending is surprising but makes perfect sense when one considers the _____ problem.
(a) moral hazard; diversification
(b) diversification; moral hazard
(c) adverse selection; diversification
(d) diversification; adverse selection
Answer: D
Question Status: Previous Edition

176) Provisions in loan contracts that prohibit borrowers from engaging in specified risky activities are called
(a) proscription bonds.
(b) restrictive covenants.
(c) due-on-sale clauses.
(d) liens.
Answer: B
Question Status: Previous Edition

177) A bank's commitment (for a specified future period of time) to provide a firm with loans up to a given amount at an interest rate that is tied to a market interest rate is called
(a) credit rationing.
(b) loan commitment.
(c) continuous dealings.
(d) none of the above.
Answer: B
Question Status: Revised

178) Long-term relationships between banks and their customers, and loan commitments
(a) reduce the costs of information collection.
(b) make it easier for banks to screen good from bad risks.
(c) enable banks to deal with moral hazard contingencies that are neither anticipated nor specified in restrictive covenants.
(d) do all of the above.
(e) do only (a) and (b) of the above.
Answer: D
Question Status: Revised

179) Long-term relationships between banks and their customers, and loan commitments
(a) increase the costs of information collection.
(b) make it easier for banks to screen good from bad risks.
(c) enable banks to deal with moral hazard contingencies that are neither anticipated nor specified in restrictive covenants.
(d) do only (a) and (b) of the above.
(e) do only (b) and (c) of the above.
Answer: E
Question Status: Revised

180) A bank's commitment to provide a firm with loans up to pre-specified limit at an interest rate that is tied to a market interest rate is called
(a) an adjustable gap loan.
(b) an adjustable portfolio loan.
(c) loan commitment.
(d) pre-credit loan line.
Answer: C
Question Status: Previous Edition

181) Compensating balances
(a) are a particular form of collateral commonly required on commercial loans.
(b) are a required minimum amount of funds that a borrower (i.e., a firm receiving a loan) must keep in a checking account at the bank.
(c) allow banks to monitor firms' check payment practices which can yield information about their borrowers' financial conditions.
(d) all of the above.
Answer: D
Question Status: Previous Edition

182) A bank that wants to monitor the check payment practices of its commercial borrowers, so that moral hazard can be prevented, will require borrowers to

(a) place a bank officer on their board of directors.
(b) place a corporate officer on the bank's board of directors.
(c) keep compensating balances in a checking account at the bank.
(d) do all of the above.
(e) do only (a) and (b) of the above.

Answer: C
Question Status: Previous Edition

183) Of the following methods that banks might use to reduce moral hazard problems, the one not legally permitted in the United States is the

(a) requirement that firms keep compensating balances at the banks from which they obtain their loans.
(b) requirement that firms place on their board of directors an officer from the bank.
(c) inclusion of restrictive covenants in loan contracts.
(d) requirement that individuals provide detailed credit histories to bank loan officers.

Answer: B
Question Status: Previous Edition

184) When a lender refuses to make a loan, although borrowers are willing to pay the stated interest rate or even a higher rate, the bank is said to engage in

(a) coercive bargaining.
(b) strategic holding out.
(c) credit rationing.
(d) collusive behavior.

Answer: C
Question Status: Previous Edition

185) When a lender refuses to make a loan, even though borrowers are willing to pay the stated interest rate or even a higher rate, the bank is said to engage in

(a) coercive bargaining.
(b) strategic holding out.
(c) coercive behavior.
(d) none of the above.

Answer: D
Question Status: Previous Edition

186) Credit rationing occurs when a bank

(a) refuses to make a loan of any amount to a borrower, even when she is willing to pay a higher interest rate.
(b) restricts the size of the loan to less than the borrower would like.
(c) does either (a) or (b) of the above.
(d) does neither (a) nor (b) of the above.

Answer: C
Question Status: Previous Edition

187) A Federal Reserve survey of bankers done in early 1991 revealed that depressed conditions in commercial real estate markets had prompted many banks simply to stop lending. This response to potential adverse selection problems is referred to as

(a) screening.
(b) monitoring.
(c) specialized lending.
(d) credit rationing.

Answer: D
Question Status: Previous Edition

188) Because larger loans create greater incentives for borrowers to engage in undesirable activities that make it less likely they will repay the loans, banks

(a) ration credit, granting borrowers smaller loans than they have requested.
(b) ration credit, charging higher interest rates to borrowers who want large loans than to those who want small loans.
(c) ration credit, charging higher fees as a percentage of the loan to borrowers who want large loans than to those who want small loans.
(d) do none of the above.

Answer: A
Question Status: Previous Edition

189) When banks offer borrowers smaller loans than they have requested, banks are said to

(a) shave credit.
(b) rediscount the loan.
(c) raze credit.
(d) ration credit.

Answer: D
Question Status: Previous Edition

190) Credit risk management tools include:

(a) compensating balances.
(b) collateral.
(c) restrictive covenants.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

191) Credit risk management tools include:

(a) credit rationing.
(b) collateral.
(c) interest rate swaps.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: E
Question Status: Previous Edition

192) Risk that is related to the uncertainty about interest rate movements is called
(a) default risk.
(b) interest-rate risk.
(c) the problem of moral hazard.
(d) security risk.
Answer: B
Question Status: Previous Edition

193) All else the same, if a bank has more rate-sensitive liabilities than assets, then a(n) _____ in interest rates will _____ bank profits.
(a) increase; increase
(b) increase; reduce
(c) decline; reduce
(d) decline; not affect
Answer: B
Question Status: Previous Edition

194) All else the same, if a bank's liabilities are more sensitive to interest rate fluctuations than are its assets, then a(n) _____ in interest rates will _____ bank profits.
(a) increase; increase
(b) increase; reduce
(c) decline; reduce
(d) decline; not affect
Answer: B
Question Status: Previous Edition

195) If a bank has more rate-sensitive assets than liabilities, then a(n) _____ in interest rates will _____ bank profits.
(a) increase; increase
(b) increase; reduce
(c) decline; increase
(d) decline; not affect
Answer: A
Question Status: Previous Edition

196) If a bank has _____ rate-sensitive assets than liabilities, then a(n) _____ in interest rates will increase bank profits.
(a) more; decline
(b) more; increase
(c) less; increase
(d) fewer; surge
Answer: B
Question Status: Previous Edition

197) If a bank has _____ rate-sensitive liabilities than assets, a _____ in interest rates will reduce bank profits, while a _____ in interest rates will raise bank profits.

(a) more; rise; decline
(b) more; decline; rise
(c) fewer; rise; decline
(d) fewer; rise; rise

Answer: A
Question Status: Previous Edition

198) If a bank has _____ rate-sensitive assets than liabilities, a _____ in interest rates will reduce bank profits, while a _____ in interest rates will raise bank profits.

(a) more; rise; decline
(b) more; decline; rise
(c) fewer; decline; decline
(d) fewer; rise; rise

Answer: B
Question Status: Previous Edition

199) The difference of rate-sensitive liabilities and rate-sensitive assets is known as the

(a) duration.
(b) interest-sensitivity index.
(c) rate-risk index.
(d) gap.

Answer: D
Question Status: Previous Edition

200) If the First State Bank has a gap equal to a positive $20 million, then a 5 percentage point drop in interest rates will cause profits to

(a) increase by $10 million.
(b) increase by $1.0 million.
(c) decline by $10 million.
(d) decline by $1.0 million.

Answer: D
Question Status: Previous Edition

201) If the First State Bank has a gap equal to a positive $20 million, then a 5 percentage point increase in interest rates will cause profits to

(a) increase by $1 million.
(b) decrease by $1 million.
(c) increase by $10 million.
(d) decrease by $10 million.
(e) remain unchanged.

Answer: A
Question Status: Study Guide

202) If the First National Bank has a gap equal to a negative $30 million, then a 5 percentage point increase in interest rates will cause profits to
(a) increase by $15 million.
(b) increase by $1.5 million.
(c) decline by $15 million.
(d) decline by $1.5 million.
Answer: D
Question Status: Previous Edition

203) Measuring the sensitivity of bank profits to changes in interest rates by multiplying the gap times the change in the interest rate is called
(a) basic duration analysis.
(b) basic gap analysis.
(c) interest-exposure analysis.
(d) gap-exposure analysis.
Answer: B
Question Status: Previous Edition

204) Measuring the sensitivity of bank profits to changes in interest rates by multiplying the gap for several maturity subintervals times the change in the interest rate is called
(a) basic gap analysis.
(b) the maturity bucket approach to gap analysis.
(c) the segmented maturity approach to gap analysis.
(d) the segmented maturity approach to interest-exposure analysis.
(e) none of the above.
Answer: B
Question Status: Previous Edition

First National Bank

	Assets	**Liabilities**
Rate-sensitive	$20 million	$50 million
Fixed-rate	$80 million	$50 million

205) If interest rates rise by 5 percentage points, say, from 10 to 15%, bank profits (measured using gap analysis) will
(a) decline by $0.5 million.
(b) decline by $1.5 million.
(c) decline by $2.5 million.
(d) increase by $1.5 million.
Answer: B
Question Status: Previous Edition

206) Assuming that the average duration of its assets is five years, while the average duration of its liabilities is three years, then a 5 percentage point increase in interest rates will cause the net worth of First National to _____ by _____ of the total original asset value.

(a) decline; 5 percent
(b) decline; 10 percent
(c) decline; 15 percent
(d) decline; 25 percent

Answer: B
Question Status: Previous Edition

First National Bank

	Assets	**Liabilities**
Rate-sensitive	$40 million	$50 million
Fixed-rate	$60 million	$50 million

207) If interest rates rise by 5 percentage points, say from 10 to 15%, bank profits (measured using gap analysis) will

(a) decline by $0.5 million.
(b) decline by $1.5 million.
(c) decline by $2.5 million.
(d) increase by $2.0 million.

Answer: A
Question Status: Previous Edition

208) Assuming that the average duration of its assets is four years, while the average duration of its liabilities is three years, then a 5 percentage point increase in interest rates will cause the net worth of First National to _____ by _____ of the total original asset value.

(a) decline; 5 percent
(b) decline; 10 percent
(c) decline; 15 percent
(d) increase; 20 percent

Answer: A
Question Status: Previous Edition

209) Duration analysis involves comparing the average duration of the bank's _____ to the average duration of its _____.

(a) securities portfolio; non-deposit liabilities
(b) loan portfolio; non-deposit liabilities
(c) loan portfolio; deposit liabilities
(d) assets; deposit liabilities
(e) assets; liabilities

Answer: E
Question Status: Previous Edition

210) When interest rates are expected to rise in the future, a banker is likely to
   (a) make short-term rather than long-term loans.
   (b) buy short-term rather than long-term bonds.
   (c) buy long-term rather than short-term bonds.
   (d) do (a) and (b) of the above.

   Answer: D
   Question Status: Previous Edition

211) When interest rates are expected to fall in the future, a bank manager is likely to
   (a) make short-term rather long-term loans.
   (b) buy short-term rather than long-term bonds.
   (c) buy long-term rather than short-term bonds.
   (d) do both (a) and (b).

   Answer: C
   Question Status: Previous Edition

212) Because of an expected fall in interest rates in the future, a banker will likely
   (a) make short-term rather than long-term loans.
   (b) buy short-term rather than long-term bonds.
   (c) buy long-term rather than short-term bonds.
   (d) none of the above.
   (e) do both (a) and (b) of the above.

   Answer: C
   Question Status: Study Guide

213) Because of an expected rise in interest rates in the future, a banker will likely
   (a) make long-term rather than short-term loans.
   (b) buy short-term rather than long-term bonds.
   (c) buy long-term rather than short-term bonds.
   (d) none of the above.
   (e) do both (a) and (b) of the above.

   Answer: B
   Question Status: New

214) If a banker expects interest rates to rise in the future, the her best strategy for the present is
   (a) to make long-term loans.
   (b) to buy long-term bonds.
   (c) to sell long-term certificates of deposit.
   (d) to increase the duration of the bank's assets.
   (e) to shorten the duration of the bank's liabilities.

   Answer: C
   Question Status: New

215) If a banker expects interest rates to fall in the future, the her best strategy for the present is

(a) to make short-term loans.
(b) to buy short-term bonds.
(c) to sell long-term certificates of deposit.
(d) to increase the duration of the bank's assets.
(e) to increase the duration of the bank's liabilities.

Answer: D
Question Status: New

216) Bruce the Bank Manager can reduce interest rate risk by _____ the duration of the bank's assets to increase their rate sensitivity or, alternatively, _____ the duration of the bank's liabilities.

(a) shortening; lengthening
(b) shortening; shortening
(c) lengthening; lengthening
(d) lengthening; shortening

Answer: A
Question Status: Previous Edition

217) Bruce the Bank Manager can reduce interest rate risk by shortening the duration of the bank's _____, to increase their rate sensitivity or, alternatively, lengthening the duration of the bank's _____.

(a) rate-sensitive liabilities; rate-sensitive assets
(b) rate-sensitive deposits; rate-sensitive loans
(c) liabilities; assets
(d) assets; liabilities

Answer: D
Question Status: Previous Edition

218) Which of the following help financial institutions reduce interest-rate risk?

(a) Interest-rate swaps
(b) Financial futures
(c) Options for debt instruments
(d) All of the above
(e) Only (a) and (b) of the above

Answer: D
Question Status: Previous Edition

219) Examples of off-balance–sheet activities include

(a) loan sales.
(b) foreign exchange market transactions.
(c) trading in financial futures.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

220) Examples of off-balance-sheet activities include
(a) loan sales.
(b) extending loans to depositors.
(c) borrowing from other banks.
(d) all of the above.
Answer: A
Question Status: Previous Edition

221) When a bank sells all or part of the cash stream from a specific loan,
(a) it thereby removes the loan from its balance sheet.
(b) it usually does so at a loss.
(c) it usually does so at a profit.
(d) both (a) and (b) of the above.
(e) both (a) and (c) of the above.
Answer: E
Question Status: Previous Edition

222) Banks that engage in off-balance-sheet activities may
(a) increase profits.
(b) reduce risk.
(c) increase risk.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: D
Question Status: New

223) Traders working for banks are subject to the
(a) principal-agent problem.
(b) free-rider problem.
(c) double-jeopardy problem.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: A
Question Status: New

224) When banks involved in trading activities attempt to outguess markets, they are
(a) forecasting.
(b) diversifying.
(c) speculating.
(d) engaging in riskless arbitrage.
(e) satisfying regulators.
Answer: C
Question Status: New

225) A reason why rogue traders have bankrupt their banks is due to
(a) a failure of regulation.
(b) stringent supervision of trading activities by bank management.
(c) accounting errors.
(d) a failure to maintain proper internal controls.
(e) the separation of trading activities from the bookkeepers.
Answer: D
Question Status: New

226) The principal-agent problem that exists for bank trading activities can be reduced through
(a) creation of internal controls that combine trading activities with bookkeeping.
(b) creation of internal controls that separate trading activities from bookkeeping.
(c) elimination of regulation of banking.
(d) elimination of internal controls.
(e) increased freedom for traders from managerial supervision.
Answer: B
Question Status: New

227) Banks develop statistical models to calculate their maximum loss over a given time period. This approach is known as the
(a) stress-testing approach.
(b) value-at-risk approach.
(c) probabilistic approach.
(d) doomsday approach.
(e) trading-loss approach.
Answer: B
Question Status: New

Appendix 1

228) Assume a bank has $200 million of assets with a duration of 2.5, and $190 million of liabilities with a duration of 1.05. If interest rates increase from 5 percent to 6 percent, the net worth of the bank falls by
(a) $1 million.
(b) $2.4 million.
(c) $3.6 million.
(d) $4.8 million.
(e) cannot be determined.
Answer: D
Question Status: New

229) Assume a bank has $200 million of assets with a duration of 2.5, and $190 million of liabilities with a duration of 1.05. The duration gap for this bank is

(a) 0.5 year.
(b) 1 year.
(c) 1.5 years.
(d) 2 years.
(e) 2.4 years.

Answer: C
Question Status: New

230) If interest rates increase from 9 percent to 10 percent, a bank with a duration gap of 2 years would experience a decrease in its net worth of

(a) 0.9 percent of its assets.
(b) 0.9 percent of its liabilities.
(c) 1.8 percent of its capital.
(d) 1.8 percent of its assets.
(e) 1.8 percent of its liabilities.

Answer: D
Question Status: New

Appendix 2

231) When a bank suspects that a $1 million loan might prove to be bad debt that will have to be written off in the future the bank

(a) can set aside $1 million of its earnings in its loan loss reserves account.
(b) reduces its reported earnings by $1, even though it has not yet actually lost the $1 million.
(c) reduces its assets immediately by $1 million, even though it has not yet lost the $1 million.
(d) does all of the above
(e) does only (a) and (b) of the above.

Answer: E
Question Status: Revised

232) For banks,

(a) return on assets exceeds return on equity.
(b) return on assets equals return on equity.
(c) return on equity exceeds return on assets.
(d) return on equity is another name for net interest margin.
(e) return on assets is another name for net interest margin.

Answer: C
Question Status: New

233) The quantity interest income minus interest expenses divided by assets is a measure of bank performance known as
(a) operating income.
(b) net interest margin.
(c) return on assets.
(d) return on equity.
(e) total income.
Answer: B
Question Status: New

■ Essay Questions

1) Assume that a customer deposits $1000 in her bank. Show in a T-account the effect of this deposit. If the bank is subject to reserve requirements, show in a second T-account the banks balance sheet indicating required and excess reserve. In a third T-account, show the change in the bank's balance sheet when the bank makes loans with the excess reserves.

Answer:

Reserves	$1000	Checkable deposits	$1000

Required reserves	$100	Checkable deposits	$1000
Excess reserves	$900		

Required reserves	$100	Checkable deposits	$1000
Loans			$900

2) Explain the relationship between return on assets and return on equity. What incentives does this relationship give a bank manager? Is this the desired outcome preferred by regulators? Discuss.

Answer: For a given return on assets, the greater the amount of capital, the lower is the return on equity. Bank managers who seek to increase the return on equity must increase the asset base, purchase riskier assets, or reduce the amount of capital by paying dividends or buying back stock.

Regulators (and depositors) prefer higher capital for bank safety. Managers typically prefer lower equity than regulators, resulting in regulatory bank capital requirements.

3) Assume the following balance sheet for the First National Bank:

Assets		**Liabilities**	
Rate-sensitive assets	$40 million	Rate-sensitive liabilities	$80 million
Fixed-rate assets	$60 million	Fixed-rate liabilities	$20 million

Using gap analysis, what is the effect of a 4 percent increase in interest rates? What is the effect of a 3 percent decrease in rates? Why is knowledge of interest-rate risk important? How might banks respond if rates are expected to change unfavorably?

Answer: The gap is –$40 million. A 4 percent rate increase reduces profits by $1.6 million, while a 3 percent rate decrease increases profits by $1.2 million. Obviously, knowledge of interest-rate risk is important for understanding the impact of interest rate changes on bank profits. If an adverse change in interest rates is expect, banks can change their assets and liability mix to reduce or eliminate unfavorable gaps.