Chapter 11
Economic Analysis of Banking Regulation

Multiple Choice

1) 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
   Question Status: Previous Edition

2) 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
   Question Status: Previous Edition

3) 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) no depositor can withdraw funds during a crisis.
   (e) banks randomly select the depositors who will receive all of their funds.
   Answer: C
   Question Status: New

4) 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.
   (e) first-come, last-served constraint.
   Answer: B
   Question Status: New
5) The fact that depositors cannot distinguish good from bad banks is a(n)
   (a) adverse selection problem.
   (b) moral hazard problem.
   (c) asymmetric information problem.
   (d) too-big-to-fail problem.
   (e) none of the above.
   Answer: C
   Question Status: New

6) 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.
   (e) sequential service constraint.
   Answer: D
   Question Status: New

7) The contagion effect refers to the fact that
   (a) some banks are too big to fail.
   (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.
   (e) deposit insurance has eliminated the problem of bank failures.
   Answer: D
   Question Status: New

8) A system of deposit insurance
   (a) attracts risk-taking entrepreneurs into the banking industry.
   (b) encourages bank managers to assume increased risk.
   (c) increases the incentives of depositors to monitor the riskiness of their bank’s asset portfolio.
   (d) does all of the above.
   (e) does only (a) and (b) of the above.
   Answer: E
   Question Status: Study Guide
9) The primary difference between the “payoff” and the “purchase and assumption” methods of handling failed banks is
   (a) that the FDIC guarantees all deposits, not just those under the $100,000 limit, when it uses the “payoff” method.
   (b) that the FDIC guarantees all deposits, not just those under the $100,000 limit, 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) both (a) and (b) of the above.
   (e) both (b) and (c) of the above.
   Answer: B
   Question Status: Previous Edition

10) The primary difference between the “payoff” and the “purchase and assumption” methods of handling failed banks is
   (a) that the FDIC guarantees all deposits, not just those under the $100,000 limit, when it uses the “payoff” method.
   (b) that the FDIC guarantees all deposits, not just those under the $100,000 limit, when it uses the “purchase and assumption” method.
   (c) that the FDIC is less 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) both (a) and (b) of the above.
   (e) both (b) and (c) of the above.
   Answer: E
   Question Status: Previous Edition

11) The primary difference between the “payoff” and the “purchase and assumption” methods of handling failed banks is
   (a) that the FDIC guarantees all deposits, not just those under the $100,000 limit, when it uses the “purchase and assumption” method.
   (b) that the FDIC is more likely to use the “purchase and assumption” method when the bank is large and it fears that depositor losses may spur business bankruptcies and other bank failures.
   (c) that the FDIC guarantees all deposits, not just those under the $100,000 limit, when it uses the “payoff” method.
   (d) both (a) and (b) of the above.
   (e) both (b) and (c) of the above.
   Answer: D
   Question Status: Previous Edition

12) 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
   Question Status: Previous Edition
13) Moral hazard is an important feature 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) both (a) and (b) of the above.
(e) both (b) and (c) of the above.
Answer: A
Question Status: Previous Edition

14) 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

15) 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
Question Status: Previous Edition

16) 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
Question Status: Previous Edition

17) Deposit insurance
(a) attracts risk-prone entrepreneurs to the banking industry.
(b) encourages bank managers to take on greater risks than they otherwise would.
(c) reduces the incentives of depositors to monitor the riskiness of their banks’ asset portfolios.
(d) does all of the above.
(e) does only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition
18) Deposit insurance works well in countries with
   (a) a tradition of the rule of law.
   (b) effective supervision of the financial system.
   (c) honest governments.
   (d) all of the above.
   (e) both (a) and (b) of the above.
   Answer: D
   Question Status: New

19) The spread of deposit insurance throughout the world provides evidence that
    (a) deposit insurance always prevents moral hazard problems.
    (b) deposit insurance always prevents adverse selection problems.
    (c) deposit insurance works well only with a strong institutional environment.
    (d) all of the above.
    (e) both (a) and (b) of the above.
    Answer: C
    Question Status: New

20) 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) all of the above.
    (e) both (a) and (b) of the above.
    Answer: A
    Question Status: New

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
    Question Status: Previous Edition

22) One problem of the too-big-to-fail policy is that it
    (a) reduces the incentives for moral hazard by big banks.
    (b) increases the incentives for moral hazard by big banks.
    (c) reduces the incentives for adverse selection by big banks.
    (d) increases the incentives for adverse selection by big banks.
    Answer: B
    Question Status: Previous Edition
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

Question Status: Previous Edition

24) The result of the too-big-to-fail policy is that big banks will take on _____ risks, making bank failures _____ likely.
   (a) fewer; less
   (b) greater; less
   (c) fewer; more
   (d) greater; more
   Answer: D

Question Status: Previous Edition

25) 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) eliminates; moral hazard
   (d) increases; adverse selection
   (e) decreases; adverse selection
   Answer: A

Question Status: Study Guide

26) The too-big-to-fail policy
   (a) exacerbates moral hazard problems.
   (b) puts small 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) does all of the above.
   Answer: D

Question Status: Previous Edition

27) The too-big-to-fail policy
   (a) puts small banks at a competitive disadvantage in attracting large deposits.
   (b) treats large depositors of small banks inequitably when compared to depositors of large banks.
   (c) exacerbates moral hazard problems.
   (d) does all of the above.
   (e) does only (a) and (b) of the above.
   Answer: D

Question Status: Previous Edition
28) The too-big-to-fail policy
   (a) exacerbates 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) does only (a) and (c) of the above.
   Answer: D
   Question Status: Previous Edition

29) The too-big-to-fail policy
   (a) puts small banks at a competitive disadvantage relative to large banks in attracting large deposits.
   (b) treats large depositors of small banks inequitably when compared to depositors of large banks.
   (c) ameliorates the moral hazard problem.
   (d) does all of the above.
   (e) does only (a) and (b) of the above.
   Answer: E
   Question Status: Study Guide

30) 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) all of the above.
   Answer: C
   Question Status: Previous Edition

31) When Continental Illinois became insolvent in 1984, the FDIC guaranteed all deposits, even those exceeding $100,000. The Comptroller of the Currency defended this action, arguing that
   (a) the deposits of only the largest eleven banks should not be fully guaranteed.
   (b) the deposits of only the largest twenty banks should not be fully guaranteed.
   (c) the largest eleven banks were too big to fail.
   (d) the largest twenty banks were too big to fail.
   Answer: C
   Question Status: Previous Edition

32) The view that some banks are too big to fail explains
   (a) why the FDIC uses the “payoff” method for dealing with failed banks that are large.
   (b) why the FDIC uses the “purchase and assumption” method for dealing with failed banks that are large.
   (c) why the FDIC is reluctant to use the “purchase and assumption” method for dealing with failed banks that are large.
   (d) none of the above.
   Answer: B
   Question Status: Previous Edition
33) Federal deposit insurance covers deposits up to $100,000, 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
Question Status: Revised

34) In cases when the FDIC determines that a bank is “too-big-to-fail,” it uses the
(a) payoff method, effectively covering all deposits—even those exceeding the $100,000 ceiling.
(b) payoff method, covering only those deposits that do not exceed the $100,000 ceiling.
(c) purchase and assumption method, effectively covering all deposits—even those that exceed the $100,000 ceiling.
(d) purchase and assumption method, covering only those deposits that do not exceed the $100,000 ceiling.
(e) regulatory forbearance method, effectively covering all deposits, even those exceeding $100,000.
Answer: C
Question Status: Study Guide

35) Although most bank failures do not involve institutions that the government judges too big to fail, uninsured deposits are protected when large banks fail because
(a) the FDIC arranges for a healthy bank to purchase the failed bank and assume all the deposits.
(b) the FDIC believes that it would be inequitable to limit pay outs to $100,000.
(c) of both (a) and (b) of the above.
(d) of neither (a) nor (b) of the above.
Answer: A
Question Status: Revised

36) Financial consolidation poses challenges to banking regulation because
(a) it increases the number of banks that are too big to fail.
(b) it extends the government safety net to new activities.
(c) it extends deposit insurance to stock brokers.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New
37) Because the _____ costs of bank failure are greater than bank’s _____ costs, banks may hold assets that are too risky.
   (a) social; social
   (b) social; private
   (c) private; social
   (d) private; private
   Answer: B
   Question Status: Previous Edition

38) 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) prohibiting banks from holding risky assets such as common stocks.
   (c) establishing a minimum interest rate floor that banks can earn on certain assets.
   (d) doing all of the above.
   (e) doing only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition

39) Banks do not want to hold too much capital because
   (a) they do not bear fully the costs of bank failures.
   (b) higher returns on equity are earned when bank capital is smaller.
   (c) higher capital levels attract the scrutiny of regulators.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition

40) 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

41) 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 more excess reserves.
   (d) a bank has more bank capital.
   Answer: D
   Question Status: Previous Edition
42) 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.
(e) capital divided by its earnings.
Answer: C
Question Status: New

43) A bank’s regulatory capital requirements include
(a) a bank’s leverage ratio.
(b) risk-based capital requirements.
(c) a bank’s own models of risk exposure.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: D
Question Status: New

44) A well-capitalized bank 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
(e) nothing; more
Answer: B
Question Status: Study Guide

45) 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) reduce a bank’s income and risk.
(e) generate fee income and reduce risk.
Answer: C
Question Status: New

46) Bank capital requirements take three forms. The first type is
(a) based on the so-called leverage ratio, the amount of capital divided by the bank’s total assets.
(b) a risk-based capital requirement that is linked to off-balance-sheet activities.
(c) a capital requirement to cover risk in trading activities.
(d) none of the above.
Answer: A
Question Status: Previous Edition
47) Bank capital requirements take three forms. The second type is
   (a) based on the so-called leverage ratio, the amount of capital divided by the bank’s total assets.
   (b) a risk-based capital requirement that is linked to off-balance-sheet activities.
   (c) a capital requirement to cover risk in trading activities.
   (d) none of the above.
   Answer: B
   Question Status: Previous Edition

48) Bank capital requirements take three forms. The third type is
   (a) based on the so-called leverage ratio, the amount of capital divided by the bank’s total assets.
   (b) a risk-based capital requirement that is linked to off-balance-sheet activities.
   (c) a capital requirement to cover risk in trading activities.
   (d) none of the above.
   Answer: C
   Question Status: Previous Edition

49) The 1988 Basel Accord has resulted in
   (a) increased risk taking.
   (b) reduced risk taking.
   (c) no change in risk taking.
   (d) a prohibition against off-balance-sheet lending.
   (e) capital requirements that are not related to asset risk.
   Answer: A
   Question Status: New

50) The increased integration of financial markets across countries and the need to make the playing
    field equal for banks from different countries led to the Basel agreement in June 1988 to
    (a) standardize bank capital requirements internationally.
    (b) reduce, across the board, bank capital requirements in all countries.
    (c) sever the link between risk and capital requirements.
    (d) do all of the above.
    Answer: A
    Question Status: Previous Edition

51) The stated purposes of the Basel Plan include:
    (a) coordinating supervisory definitions of capital, risk assessments, and standards for capital
        adequacy across countries.
    (b) linking a bank’s capital requirements systematically to the riskiness of its activities.
    (c) devising monitoring mechanisms to prevent collusion among banks in international markets.
    (d) all of the above.
    (e) only (a) and (b) of the above.
    Answer: E
    Question Status: Previous Edition
52) Which of the following was not a stated purpose for bringing banking officials from 12 countries together in Basel, Switzerland in June 1988?
(a) Coordinating supervisory definitions of capital, risk assessments, and standards for capital adequacy across countries
(b) Linking a bank’s capital requirements systematically to the riskiness of its activities
(c) Devising monitoring mechanisms to prevent collusion among banks in international markets
(d) All of the above
(e) Only (a) and (b) of the above
Answer: C
Question Status: Previous Edition

53) Under the Basel Plan,
(a) assets and off-balance-sheet activities are assigned to different categories to reflect the degree of credit risk.
(b) a bank’s “core” capital must equal or exceed 10 percent of total risk-adjusted assets.
(c) a bank’s total capital must equal or exceed 8 percent of total risk-adjusted assets.
(d) all of the above.
(e) only (a) and (c) of the above.
Answer: E
Question Status: Revised

54) Of the following assets, the one that has the highest capital requirement under the Basel Accord is
(a) municipal bonds.
(b) residential mortgages.
(c) commercial paper.
(d) securities issued by government agencies.
Answer: C
Question Status: Previous Edition

55) Of the following assets, the one that has the lowest capital requirement under the Basel Accord is
(a) municipal bonds.
(b) residential mortgages.
(c) commercial paper.
(d) securities issued by government agencies.
Answer: D
Question Status: Previous Edition

56) Of the following assets, the one that has the lowest capital requirement under the Basel Accord is
(a) commercial paper.
(b) government securities.
(c) municipal bonds.
(d) residential mortgages.
Answer: B
Question Status: Previous Edition
57) 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 duel banking system.
(e) cooking the books.
Answer: C
Question Status: New

58) 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) selling risky assets to arbitrageurs.
(d) buying risky assets from arbitrageurs.
(e) hiding risky assets from regulators.
Answer: A
Question Status: New

59) 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.
(e) both (a) and (b) of the above.
Answer: D
Question Status: New

60) 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
Question Status: Previous Edition
61) The chartering process is especially designed to deal with the _____ problem, and restrictions on asset holdings 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
   Question Status: Previous Edition

62) Examinations of banks are conducted by
   (a) the Office of the Comptroller of the Currency.
   (b) the Federal Reserve System.
   (c) the FDIC.
   (d) all of the above.
   (e) both (a) and (b) of the above.
   Answer: D
   Question Status: New

63) The federal agencies that examine banks include
   (a) the Federal Reserve System.
   (b) the Internal Revenue Service.
   (c) the Office of the Comptroller of the Currency.
   (d) all of the above.
   (e) both (a) and (c) of the above.
   Answer: E
   Question Status: New

64) 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
   Question Status: Previous Edition
65) Regular bank examinations and restrictions on asset holdings help to indirectly _____ the adverse selection problem because, given fewer opportunities to take on risk, risk-prone entrepreneurs will be _____ from entering the banking industry.
(a) increase; encouraged
(b) increase; discouraged
(c) reduce; encouraged
(d) reduce; discouraged
Answer: D
Question Status: Previous Edition

66) The __________ problem is reduced by regular bank examinations, and examination also indirectly helps reduce the _______________ because risk taking entrepreneurs will be discouraged from entering the banking industry.
(a) adverse selection; adverse selection
(b) adverse selection; moral hazard.
(c) moral hazard; adverse selection
(d) moral hazard; moral hazard
(e) adverse selection; disintermediation
Answer: C
Question Status: Study Guide

67) Ways in which bank regulations reduce the adverse selection and moral hazard problems in banking include
(a) a chartering process designed to prevent crooks from getting control of a bank.
(b) restrictions that prevent banks from acquiring certain risky assets, such as common stocks.
(c) high bank capital requirements to increase the cost of bank failure to the owners.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

68) Bank regulators attempt to align the incentives of banks and their depositors by requiring banks to
(a) maintain a relatively high amount of equity capital.
(b) diversify its loan portfolio.
(c) submit to regular examinations.
(d) do all of the above.
Answer: D
Question Status: Previous Edition
69) One way for bank regulators to assure depositors that banks are not taking on too much risk is to require that banks
(a) diversify their loan portfolios.
(b) reduce their equity capitals.
(c) reduce the size of their loan portfolios.
(d) do both (a) and (b) of the above.
(e) do both (b) and (c) of the above.
Answer: A
Question Status: Previous Edition

70) 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) all of the above.
(e) both (b) and (c) of the above.
Answer: C
Question Status: New

71) Competition between banks
(a) encourages greater risk taking.
(b) encourages conservative bank management.
(c) increases bank profitability.
(d) all of the above.
(e) both (a) and (c) of the above.
Answer: A
Question Status: New

72) Regulations that reduce competition between banks include
(a) branching restrictions.
(b) prohibitions preventing nonbank institutions from engaging in banking activities.
(c) the dual system of granting bank charters.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New

73) The main motive behind the forces that have shaped the development of the current regulatory system has been the
(a) desire to prevent monopolistic practices.
(b) desire to ensure a sound banking system.
(c) desire to create an interstate banking system.
(d) desire to foster a highly competitive banking system.
Answer: B
Question Status: Previous Edition
74) The Act that required separation of commercial and investment banking was
   (a) the Federal Reserve Act.
   (b) the Glass-Steagall Act.
   (c) the Bank Holding Company Act.
   (d) the Monetary Control Act.
   (e) FIRREA.
   Answer: B
   Question Status: Revised

75) The Depository Institutions Deregulation and Monetary Control Act of 1980
   (a) approved NOW accounts nationwide.
   (b) restricted the use of ATS accounts.
   (c) imposed restrictive usury ceilings on large agricultural loans.
   (d) did all of the above.
   Answer: A
   Question Status: Previous Edition

76) The Depository Institutions Deregulation and Monetary Control Act of 1980
   (a) approved NOW accounts nationwide.
   (b) imposed uniform reserve requirements.
   (c) mandated the phase out of interest rate ceilings on deposits.
   (d) did all of the above.
   (e) did only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

77) As a way of stemming the decline in the number of savings and loans and mutual savings banks, the
    Garn-St. Germain Act of 1982 allowed
   (a) MMCs.
   (b) MMMFs.
   (c) MMDAs.
   (d) NOWs.
   Answer: C
   Question Status: Previous Edition

78) An impact of the Garn-St. Germain Act of 1982 has been to
   (a) put savings and loans at a competitive disadvantage.
   (b) make the banking system more competitive.
   (c) give money market mutual funds a competitive advantage.
   (d) do both (a) and (b) of the above.
   (e) do both (a) and (c) of the above.
   Answer: B
   Question Status: Previous Edition
79) 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  
(e) twenty  

Answer: D  
Question Status: Previous Edition

80) Moral hazard and adverse selection problems increased in prominence in the 1980s

(a) as deregulation opened up more avenues to savings and loans and mutual savings banks to take on more risk.  
(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 an increase in federal deposit insurance from $40,000 to $100,000. 
(d) all of the above.  
(e) only (a) and (b) of the above.  

Answer: D  
Question Status: Previous Edition

81) Moral hazard and adverse selection problems increased in prominence in the 1980s

(a) as deregulation opened up more avenues to savings and loans and mutual savings banks to take on more risk.  
(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) all of the above.  
(e) only (a) and (b) of the above.  

Answer: E  
Question Status: Previous Edition

82) In the 1980s, high-rolling banks and S&Ls were aided in their quest for rapid growth by

(a) legislation that raised federal deposit insurance from $40,000 to $100,000. 
(b) legislation that phased out Regulation Q deposit rate ceilings.  
(c) a financial innovation that widened the scope for risk taking.  
(d) all of the above.  
(e) only (a) and (b) of the above.  

Answer: D  
Question Status: Revised
83) In the early stages of the 1980s banking crisis, financial institutions were especially hurt by
   (a) the sharp increases in interest rates from late 1979 until 1981.
   (b) the severe recession in 1981-82.
   (c) the sharp decline in the price level from mid 1980 to early 1983.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition

84) 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) all of the above.
   Answer: B
   Question Status: Previous Edition

85) Although as many as half of the S&Ls in the U.S. had a negative net worth and were thus insolvent
   by the end of 1982, regulators adopted a policy of _____, which amounted to _____ capital
   requirements.
   (a) regulatory forbearance; raising
   (b) regulatory forbearance; lowering
   (c) regulatory agnosticism; raising
   (d) regulatory agnosticism; lowering
   Answer: B
   Question Status: Previous Edition

86) Which of the following reasons explain why federal regulators adopted a policy of regulatory
   forbearance toward insolvent financial institutions in the early 1980s?
   (a) The FSLIC lacked sufficient funds to cover insured deposits in the insolvent S&Ls.
   (b) The regulators were reluctant to close the firms that justified their regulatory existence.
   (c) The Federal Home Loan Bank Board and the FSLIC were reluctant to admit that they were in
      over their heads with problems.
   (d) All of the above.
   (e) Only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

87) 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
   Question Status: Previous Edition
88) The policy of regulatory forbearance
(a) meant delaying the closing of “zombie S&Ls” as their losses mounted during the 1980s.
(b) benefited “zombie S&Ls” at the expense of healthy S&Ls, as healthy institutions lost deposits to insolvent institutions.
(c) contributed to declining profitability in the S&L industry and an increase in the number of “zombie S&Ls”.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

89) The policy of regulatory forbearance
(a) meant delaying the closing of “zombie S&Ls” as their losses mounted during the 1980s.
(b) benefited “zombie S&Ls” at the expense of healthy S&Ls, as healthy institutions lost deposits to insolvent institutions.
(c) had the advantage that it benefited healthy S&Ls by giving them the opportunity to attract deposits that began to leave the “zombie S&Ls”.
(d) both (a) and (b) of the above.
(e) both (a) and (c) of the above.
Answer: D
Question Status: Previous Edition

90) Regulatory forbearance
(a) meant delaying the closing of “zombie S&Ls” as their losses mounted during the 1980s.
(b) had the advantage of benefiting healthy S&Ls at the expense of “zombie S&Ls”, as insolvent institutions lost deposits to health institutions.
(c) had the advantage of permitting many insolvent S&Ls the opportunity to return to profitability, saving the FSLIC billions of dollars.
(d) means all of the above.
(e) means (a) and (c) of the above.
Answer: A
Question Status: Study Guide

91) In 1987, Far West Savings & Loan Association, with a negative net worth of $290 million, persuaded the Federal Home Loan Bank of Seattle to lend the thrift more than $1 billion. This regulatory response to insolvency is an example of
(a) loophole mining.
(b) regulatory forbearance.
(c) securitization.
(d) none of the above.
Answer: B
Question Status: Previous Edition
(a) provided insufficient funds to the FSLIC to close down insolvent S&Ls.
(b) actually directed S&L regulators to continue to pursue regulatory forbearance, further delaying
the closing of insolvent S&Ls.
(c) created a new agency, the Resolution Trust Corporation, to manage insolvent thrifts.
(d) did all of the above.
(e) did only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

93) 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) all of the above.
(e) only (a) and (b) of the above.
Answer: C
Question Status: Previous Edition

94) The major provisions of the Competitive Equality Banking Act of 1987 include
(a) the abolishment of the Federal Home Loan Bank Board and the FSLIC.
(b) transferring the regulatory role of the Federal Home Loan Bank Board to the Office of Thrift
Supervision, a bureau within the U.S. Treasury Department.
(c) the establishment of the Resolution Trust Corporation to manage and resolve insolvent thrifts
placed in conservatorship or receivership.
(d) all of the above.
(e) none of the above.
Answer: E
Question Status: Previous Edition

95) Provisions of the 1987 Competitive Equality Banking Act included
(a) provision of an additional $10.8 billion to the FSLIC.
(b) directing the Federal Home Loan Bank Board to hasten the closing of insolvent S&Ls.
(c) transferring the regulatory responsibility of the FSLIC to the FDIC.
(d) all of the above.
(e) both (b) and (c) of the above.
Answer: A
Question Status: Study Guide
96) Responsibility for the high cost of the savings and loan bailout rests with
   (a) thrift regulators.
   (b) depositors.
   (c) politicians.
   (d) thrift officials.
   Answer: C
   Question Status: Revised

97) “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) none of the above.
   Answer: C
   Question Status: Previous Edition

98) That taxpayers were poorly served by thrift regulators in the 1980s is now quite clear. This poor performance is 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 unwillingness to appropriate sufficient funds to permit regulators to examine the many thrift institutions that needed monitoring.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Revised

99) 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 nations savings and loans.
   (d) any of the above.
   Answer: C
   Question Status: Revised
100) An analysis of the political economy of the savings and loan crisis helps one to understand
   (a) why politicians hampered the efforts of thrift regulators, cutting regulatory appropriations and
       encouraging regulatory forbearance.
   (b) why thrift regulators were so reluctant to admit that any problem even existed in the thrift
       industry.
   (c) why thrift regulators willingly acceded to pressures placed upon them by members of Congress.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

101) 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) all of the above.
   Answer: C
   Question Status: Previous Edition

102) 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) the strong S&L lobby which contributed heavily to members of Congress and asked Congress to
       encourage regulatory forbearance.
   (c) prohibitions against onerous regulatory restrictions against S&Ls as mandated in the
       Competitive Banking Equality Act.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition

103) 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) prohibitions against onerous regulatory restrictions against S&Ls as mandated in the
       Competitive Banking Equality Act.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: A
   Question Status: Previous Edition
104) 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 who received generous campaign contributions from the savings and loan industry, like regulators, hoped that the problems in the industry would ease over time.
   (c) Congress encouraged, and thrift regulators acceded to, a policy of regulatory forbearance.
   (d) of all of the above.
   (e) of only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

105) 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 who received generous campaign contributions from the savings and loan industry, like regulators, hoped that the problems in the industry would ease over time.
   (c) of only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition

106) Prior to August 1989, the agency that regulated the nation’s savings and loan associations was the
   (a) Federal Home Loan Bank Board.
   (b) Office of Thrift Supervision.
   (c) Resolution Trust Corporation.
   (d) Comptroller of the Currency.
   Answer: A
   Question Status: Previous Edition

107) 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.
   (d) Office of the Comptroller of the Currency.
   Answer: B
   Question Status: Previous Edition
108) The major provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 include
   (a) the abolishment of the Federal Home Loan Bank Board and the FSLIC.
   (b) transferring the regulatory role of the Federal Home Loan Bank Board to the Office of Thrift
       Supervision, a bureau within the U.S. Treasury Department.
   (c) expanding the responsibilities of the FDIC, which is now the sole administrator of the federal
       deposit insurance system.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

109) The major provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 include
   (a) the abolishment of the Federal Home Loan Bank Board and the FSLIC.
   (b) transferring the regulatory role of the Federal Home Loan Bank Board to the Office of Thrift
       Supervision, a bureau within the U.S. Treasury Department.
   (c) the establishment of the Resolution Trust Corporation to manage and resolve insolvent thrifts
       placed in conservatorship or receivership.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

110) The major provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 include
   (a) transferring the regulatory role of the Federal Home Loan Bank Board to the Office of Thrift
       Supervision, a bureau within the U.S. Treasury Department.
   (b) expanding the responsibilities of the FDIC, which is now the sole administrator of the federal
       deposit insurance system.
   (c) the establishment of the Resolution Trust Corporation to manage and resolve insolvent thrifts
       placed in conservatorship or receivership.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition
111) The major provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 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) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

112) The major provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 include
(a) reducing the regulatory responsibilities of the FDIC.
(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) all of the above.
(e) only (a) and (b) of the above.
Answer: B
Question Status: Previous Edition

113) The 1989 Financial Institutions Reform, Recovery and Enforcement Act
(a) transferred the regulatory role of the Office of Thrift Supervision to the Federal Home Loan Bank Board.
(b) significantly reduced the responsibilities of the FDIC, which no longer administers the federal deposit insurance system.
(c) established the Resolution Trust Corporation to manage and resolve insolvent thrifts placed into conservatorship or receivership.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: C
Question Status: Study Guide

114) Many economists are mildly critical of FIRREA because
(a) it reduces the efficiency of financial intermediation in the United States.
(b) it does little to deal with the underlying adverse selection and moral hazard problems created by deposit insurance.
(c) it significantly reduces the powers of thrift regulators and makes it more difficult to remove incompetent thrift managers.
(d) of all of the above.
(e) of only (a) and (b) of the above.
Answer: B
Question Status: Previous Edition
115) 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) reduced the scope of deposit insurance in several ways.
   (c) eliminated governmentally-administered deposit insurance.
   (d) did only (a) and (b) of the above.
   Answer: D
Question Status: Previous Edition

116) The Federal Deposit Insurance Corporation Improvement Act of 1991
   (a) reduced the scope of deposit insurance in several ways.
   (b) eliminated restrictions on nationwide banking.
   (c) allowed well-capitalized banks to have to do some securities underwriting.
   (d) did only (a) and (b) of the above.
   (e) did only (a) and (c) of the above.
   Answer: E
Question Status: Previous Edition

117) The Federal Deposit Insurance Corporation Improvement Act of 1991
   (a) reduced the scope of deposit insurance in several ways.
   (b) limited the FDIC’s ability to use the “too-big-to-fail” policy.
   (c) requires the FDIC to intervene earlier when a bank gets into trouble.
   (d) did all of the above.
   Answer: D
Question Status: Previous Edition

118) The Federal Deposit Insurance Corporation Improvement Act of 1991
   (a) instructed the FDIC to come up with risk-based deposit insurance premiums.
   (b) expanded the FDIC’s ability to use the “too-big-to-fail” policy.
   (c) instructed the FDIC to wait longer before intervening when a bank gets into trouble.
   (d) did all of the above.
   Answer: A
Question Status: Previous Edition

119) An examination of banking crises in the Scandinavian countries Norway, Sweden, and Finland
indicates that, as in the U.S., an important factor in the crises was the
   (a) decline in real interest rates that occurred in the 1980s.
   (b) financial liberalization that occurred in the 1980s.
   (c) high inflation that occurred in the 1980s.
   (d) sluggish economic growth that occurred in the 1980s.
   Answer: B
Question Status: Previous Edition
120) 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
   Question Status: Previous Edition

121) 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
   Question Status: Previous Edition

122) When comparing the banking crisis in the United States to the crises in Mexico and Venezuela, the cost to the taxpayers of the government bailouts was
   (a) higher in Mexico and the United States than in Venezuela.
   (b) higher in Mexico and Venezuela than in the United States.
   (c) higher in Venezuela and the United States than in Mexico.
   (d) higher in the United States than in Mexico and Venezuela.
   Answer:  B
   Question Status: Previous Edition

123) In the recent banking crises in Venezuela, the cost to the taxpayers of the government bailouts could exceed ______ percent of GDP.
   (a) 50
   (b) 30
   (c) 10
   (d) 5
   Answer: A
   Question Status: Revised

124) Common to all the recent banking crises in the United States, Scandinavia, Latin America, Japan, Russia, and Eastern Europe was the
   (a) the financial liberalization that occurred in the 1980s.
   (b) the banks’ lack of expertise in screening borrowers and monitoring loans.
   (c) the regulators’ lack of expertise in monitoring banking activities.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition
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125) 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) expertise in screening borrowers cannot prevent loan losses.
(d) deregulation combined with poor regulatory supervision raises moral hazard incentives.
(e) regulatory forbearance never leads to problems.
Answer: D
Question Status: Study Guide

**Internet Appendix**

126) A system of coinsurance would
(a) eliminate deposit insurance.
(b) reduce deposit insurance to $40,000.
(c) Increase deposit insurance to $130,000.
(d) provide 100% deposit insurance for all deposits.
(e) limit deposit insurance to only a percentage of a deposit.
Answer: E
Question Status: New

127) Eliminating or reducing deposit insurance may fail to provide the desired discipline because
(a) depositors may be incapable of monitoring banks.
(b) banks would be subject to runs and a large number of failures.
(c) such an action increases banks’ incentives to assume high risk.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New

128) Big banks are not subject to enough discipline from uninsured depositors because of
(a) regulatory forbearance.
(b) bureaucratic gambling.
(c) the too-big-to-fail policy.
(d) the principal-agent problem.
(e) prudential supervision.
Answer: C
Question Status: New

129) Risk-based deposit insurance premiums
(a) reduce moral hazard incentives.
(b) encourage banks to hold more capital.
(c) reduce the adverse selection problem for regulators.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New
130) Market-value accounting has a number of advantages over historical-cost accounting, including
(a) giving regulators the ability to close a bank before its net worth falls to zero.
(b) reducing the incidence in the number of banks that “bet-the-bank” by taking excessive risks in 
hopes of staying in operation.
(c) making it more difficult for bank officials to hide insolvencies.
(d) making it more difficult for regulators and politicians to hide insolvencies.
(e) all of the above
Answer: E

Essay Questions

1) The government safety net is considered a mixed blessing. Discuss the pros and cons of the safety 
net.
Answer: The main advantages are that the safety net protects depositors and thus has avoided major 
bank panics, even during periods of increased failures. The cons include the incentives for 
moral hazard and adverse selection, the problems created by the too-big-to-fail policy, and 
the extension of the safety net to other activities due to financial consolidation.

2) What factors account for the banking crisis of the 1980s?
Answer: Innovations increased competition, leading to greater risk taking by banks. Innovation also 
resulted in new financial assets increasing the scope for risk taking. Deregulation also 
stimulated risk taking, and allowed S&Ls to move into lines of business for which they 
lacked the requisite expertise. The rise in interest rates and the recession of the early 1980s 
also hurt the S&Ls. The existence of deposit insurance created a moral hazard problem, 
supporting the increase in risky behavior, and the amount of insurance was increased to 
$100,000. Regulatory forbearance and failure of Congress to address the problems allowed 
the crisis to grow.

3) Banking regulation suffers from the principal-agent problem. Describe how this problem relates to 
regulators and politicians.
Answer: Taxpayers are the principals, and regulators and politicians are the agents. Regulators want 
to escape blame for poor performance, so they have incentives to loosen capital 
requirements and practice forbearance, the opposite of what they should do. Regulators 
must also please politicians, who in turn receive contributions from the banks being 
regulated. Thus, politicians may pressure regulators to practice forbearance, and fail to 
address problems if resolving problems conflicts with their personal interests.