Chapter One
Why Are Financial Institutions Special?

True/False

1-1 Prior to the financial crisis of 2007-2008, J.P. Morgan Chase was the largest bank holding company in the world and operations in 60 countries.
Answer: F

1-2 As of 2009, U.S. FIs held assets totaling over $35 trillion
Answer: T

1-3 Financial institutions act as intermediaries between suppliers and demanders of money.
Answer: T

1-4 If a household invests in corporate securities and does not supervise how the funds are invested or used by the corporation, the risk of not earning the desired return or not having the funds returned increase.
Answer: T

1-5 If not done by FIs, the process of monitoring the actions of borrowers would reduce the attractiveness and increase the risk of investing in corporate debt and equity by individuals.
Answer: T

1-6 Failure to monitor the actions of firms in a timely and complete fashion after purchasing securities in that firm exposes the investor to agency costs.
Answer: T

1-7 The risk that the sale price of an asset will be less than the purchase price of an asset is called liquidity risk.
Answer: F

1-8 Because bank loans have a shorter maturity than most debt contracts, FIs typically exercise less monitoring power and control over the borrower.
Answer: F

1-9 FIs typically provide secondary claims to household savers that have inferior liquidity than primary securities of corporations such as equity and bonds.
Answer: F

1-10 Because the average maturity of assets and the average maturity of liabilities are often different on an FIs balance sheet, the FI is exposed to liquidity risk.
Answer: F

1-11 When an FI functions as a broker, they are selling a financial asset that they have created and will continue to hold on their balance sheet.
Answer: F

1-12 An FI acting as an agent in matching savers and borrowers of funds can attain economies of scale and provide this service more efficiently than either the saver or borrower could on their own.
Answer: T

1-13 Financial institutions are subject to economies of scale in the collection of information.
Answer: T

1-14 As an asset transformer, the FI issues financial claims that are more attractive to household savers than the claims directly issued by corporations.
Answer: T

1-15 The asset transformation function of an FI is to issue primary financial claims to corporations while purchasing primary claims issued by households and other investors.
Answer: F

1-16 Secondary securities are securities that serve as collateral for primary securities.
Answer: F

1-17 FIs are independent market entities that create financial assets whose value is the transformation of financial risk.
Answer: T

1-18 The more costly it is to supervise the use of funds by a borrower, the less likely a saver will encounter agency costs.
Answer: F

1-19 As a delegated monitor, an FI’s actions reduce agency costs.
Answer: T

1-20 The ability of diversification to eliminate much of the risk from the asset side of the balance sheet of an FI is the result of choosing assets that are less than perfectly positively correlated.
Answer: T

1-21 Research shows that there is a significant reduction in risk achieved by investing in as few as 8 different securities.
Answer: F

1-22 Depository institutions serve as the primary conduit through which monetary policy actions impact the economy.
Answer: T

1-23 The liabilities of depository institutions are significant components of the money supply.
Answer: T

1-24 The goal of credit allocation is the encouragement of FIs to diversity the composition of their assets.
Answer: F

1-25 Credit allocation regulations are typically designed to benefit customers as well as the financial institution that must implement the guidelines.
Answer: F

1-26 The qualified thrift lender test is utilized to determine whether an institution can serve as an FI.
Answer: F

1-27 Commercial banks and finance companies have traditionally served the needs of the residential real estate market.
Answer: F

1-28 The Federal Reserve mandates reserve requirements for depository institutions so that the DIs may provide payment services for the U.S. economy.
Answer: F

1-29 The ability of savers to transfer wealth between youth and old age and across generations is called maturity intermediation.
Answer: F

1-30 Time intermediation involves the investment of small amounts by investors into mutual funds that invest in long-term securities such as stocks and bonds.
Answer: F

1-31 The efficiency with which FIs provide payment services directly benefits the economy.
Answer: T

1-32 The adverse effects on the economy that can occur because of major disturbances to the special functions or services provided by financial institutions are negative externalities.
Answer: T

1-33 Unfairly excluding some potential financial service consumers from the financial services marketplace is a reason why FIs must absorb net regulatory burden.

Answer: T

1-34 Regulation of FIs is an attempt to enhance the social welfare benefits and mitigate the social costs of providing FI services.
Answer: T

1-35 In an attempt to enhance the net social welfare benefits of the services provided by financial intermediaries, safety and soundness regulation requires a DI to hold a minimum level of cash reserves against deposits.
Answer: F

1-36 Because of changes in regulatory barriers, technology, and financial innovation, a single financial service firm may now be able to offer a full set of financial services.
Answer: T

1-37 Small investors in mutual funds are often able to realize larger returns than they would receive from bank deposits.
Answer: T

1-38 The purpose of guaranty funds in safety and soundness regulation is to protect claim-holders when an FI collapses or fails.
Answer: T

1-39 In most countries, cash is required to be held in reserve against deposits.
Answer: T

1-40 The passage of legislation to prevent discrimination in lending is an example of regulation to protect investors.
Answer: F

1-41 The passage of legislation to ensure that FIs are meeting the needs of their local communities is an example of entry regulation.
Answer: F

1-42 Firms in industries that have low costs of entry tend to enjoy larger profits than firms in industries with high costs of entry.
Answer: F

1-43 In recent years, the proportion of savings and demand deposits have decreased and the proportion of pension funds have increased in the financial assets held by U.S. households.
Answer: T

1-44 The proportion of financial assets controlled by depository institutions has been increasing in recent years.
Answer: F

1-45 One reason for the increasing proportion of total financial assets controlled by pension funds and investment companies is that these intermediaries exploit the comparative advantages of size and diversification.
Answer: T

1-46 Pension and mutual funds have a lower correlation between the maturities of their assets and liabilities than do commercial banks and thrifts.
Answer: F

1-47 Savers increasingly favor investments that closely imitate diversified investments in the direct securities markets over the transformed financial claims offered by traditional FIs.
Answer: T

1-48 The standardization of many FI products is evidence of the inefficient institutionalization by financial markets and the mechanisms through which these products trade.
Answer: F

1-49 The Internet has allowed individual investors to purchase securities while benefiting from decreased transactions costs.
Answer: T

1-50 Services provided by depository institutions have become relatively less significant as a portion of all services provided by FIs.
Answer: T

Multiple-Choice

1-51 Economic collapse during the 1930s, the banking system in the U.S> performed directly or indirectly all financial services. Those functions included all of the following EXCEPT
- a. commercial banking.
- b. money market funds.
- c. investment banking.
- d. stock investing.
- e. insurance services.

Answer: B

1-52 Depository financial institutions include all of the following EXCEPT
- a. commercial banks.

b. savings banks
c. investment banks.
d. credit unions.
e. all of the above are depository institutions.

Answer: C

1-53 Nondepository financial institutions are represented by all of the following EXCEPT
a. insurance companies.
b. mutual funds.
c. finance companies.
d. credit unions.
e. securities firms.

Answer: D

1-54 Which of the following statements is FALSE?
a. A financial intermediary specializes in the production of information.
b. A financial intermediary reduces its risk exposure by pooling its assets.
c. A financial intermediary benefits society by providing a mechanism for payments.
d. A financial intermediary may act as a broker to bring together funds deficit and funds surplus units.
e. A financial intermediary acts as a lender of last resort.

Answer: E

1-55 Which function of an FI reduces transaction and information costs between a corporation and individual which may encourage a higher rate of savings?
a. Brokerage services.
b. Asset transformation services.
c. Information production services.
d. Money supply management.
e. Administration of the payments mechanism.

Answer: A

1-56 In its role as a delegated monitor, an FI
a. keeps track of required interest and principal payments on loans it originates.
b. works with financially distressed borrowers in danger of defaulting on their loans.
c. holds portfolios of loans that they continue to service.
d. maintains contact with borrowers to ensure that loan proceeds are utilized for intended purposes.
e. All of the above.

Answer: E

1-57 Which of the following is NOT a major function of financial intermediaries?
a. Brokerage services.
b. Asset transformation services.
c. Information production.

d. Management of the nation's money supply.
e. Administration of the payments mechanism.
Answer: D

1-58 Advantages of depositing funds into a typical bank account instead of directly buying corporate securities include all of the following EXCEPT
a. monitoring done by the bank on your behalf.
b. increased liquidity if funds are needed quickly.
c. increased transactions costs.
d. less price risk when funds are needed.
e. better diversification of deposited funds.
Answer: C

1-59 Many households place funds with financial institutions because many FI accounts provide
a. lower denominations than other securities.
b. flexible maturities verses other interest-earning securities.
c. better liquidity than directly negotiated debt contracts.
d. less price risk if interest rates change.
e. All of the above.
Answer: E

1-60 The reason FIs can offer highly liquid, low price-risk contracts to savers while investing in relatively illiquid and higher risk assets is
a. because diversification allows an FI to predict more accurately the expected returns on its asset portfolio.
b. significant amounts of portfolio risk are diversified away by investing in assets that have correlations between returns that are less than perfectly positive.
c. because individual savers cannot benefit from risk diversification.
d. because FIs have a cost advantage in monitoring their portfolios.
e. All of the above.
Answer: E

1-61 The federal government has traditionally extended safety nets to DIs consisting of
a. deposit insurance, discount window borrowing, and reserve requirements.
b. deposit insurance and discount window borrowing.
c. deposit insurance, unemployment insurance, and discount window borrowing.
d. deposit insurance, open market operations, and discount window borrowing.
e. deposit insurance protection.
Answer: B

1-62 The asset transformation function of FIs typically involves
a. receipt of securities through electronic payments systems.

b. altering the liquidity and maturity features of funds sources used to finance the FI's asset portfolio.
c. granting loans to transform funds deficit units into funds surplus units.
d. investing short-term funds in off-balance sheet activities.
e. transferring of funds from one generation to another.

Answer: B

1-63 Which of the following refers to the possibility that a firm’s owners or managers will take actions contrary to the promises contained in the covenants of the securities the firm issues to raise funds?
a. Liquidity risk.
b. Price risk.
c. Credit risk.
d. Intermediation.
e. Agency costs.

Answer: E

1-64 Which of the following refers to the term "maturity intermediation"?
a. Creation of a secondary market mature enough to withstand volatility.
b. Overcoming constraints to buying assets imposed by large minimum denomination size.
c. Mismatching the maturities of assets and liabilities.
d. Reducing information costs or imperfections between households and corporations.
e. The transfer of wealth from one generation to the next.

Answer: C

1-65 Traditionally, regulation of FIs in the U.S. has been
a. minimal, as evidenced by the recent financial crisis.
b. extensive, as a result of the importance of FI to the economy.
c. minimal, because the free market is allowed to allocate financial resources.
d. extensive, because banks have monopoly power.
e. no different from regulation of nonfinancial firms.

Answer: B

1-66 Depository institutions (DIs) play an important role in the transmission of monetary policy from the Federal Reserve to the rest of the economy primarily because
a. loans to corporations are part of the money supply.
b. bank loans are highly regulated.
c. savings institutions provide a large amount of credit to finance residential real estate.
d. DI deposits are a major portion of the money supply.
e. U.S. DIs compete with foreign financial institutions.

Answer: D

1-67 Which of the following measures the difference between the private costs of regulations and the private benefits of those regulations for the producers of financial services?
a. Capital adequacy.
b. Agency costs.
c. Net regulatory burden.
d. Charter value.
e. Liquidity risk.
Answer: C

1-68 What is globalization?
a. The process that causes an FI to focus more intensely on their own domestic market.
b. Acceptance of the Federal Reserve as the regulator of the world financial system.
c. Usually refers to the initiation of GLOBEX, a new international financial communications and trading system.
d. The evolution of markets and institutions so that geographic boundaries do not restrict financial transactions.
e. Joint ownership of international electronic payments systems.
Answer: D

1-69 Negative externalities exist in the depository sector when
a. the fear of DI insolvency leads to bank deposit runs.
b. lending activity is impaired or constrained.
c. there are delays in disbursements from insolvent DIs.
d. banks that are healthy suffer when another bank nears insolvency.
e. All of the above.
Answer: E

1-70 Which of the following is the term used when a banker refuses to make loans to residents living within certain geographic boundaries?
a. Credit allocation.
b. Redlining.
c. Intermediation.
d. Externalization.
e. Spinning.
Answer: B

1-71 Why is the failure of a large bank more detrimental to the economy than the failure of a large steel manufacturer?
a. The bank failure usually leads to a government bailout.
b. There are fewer steel manufacturers than there are banks.
c. The large bank failure reduces credit availability throughout the economy.

d. Since the steel company's assets are tangible, they are more easily reallocated than the intangible bank assets.
e. Everyone needs money, but not everyone needs steel.

Answer: C

1-72 Why do households prefer to use FIs as intermediaries to invest their surplus funds?

a. Transaction costs are low to the household since FIs are more efficient in monitoring and gathering investment information.
b. To receive the benefits of diversification that households may not be able to achieve on their own.
c. The FI has can benefit from combining funds and negotiating lower asset prices and transactions costs.
d. The FI can provide insurance at relatively low cost that will protect funds under management.
e. All of the above.

Answer: E

1-73 Financial intermediaries are

a. funds surplus units, because they exist to make money.
b. funds deficit units, because they must pay heavy regulatory fees and taxes.
c. funds surplus units, because they hold large portfolios of financial securities.
d. funds deficit units, because they must comply with minimum capital requirements.
e. neither funds surplus nor deficit units.

Answer: E

1-74 Which of the following observations is true?

a. Central bank directly controls both inside and outside money.
b. Outside money is that part of the money supply produced by the private banking system.
c. Inside money refers to the quantity of notes and coin in the economy.
d. Bulk of the money supply consists of inside money.
e. Central banks cannot vary the quantity of outside money.

Answer: D

1-75 Net regulatory burden for FIs is higher because regulators may require the FI to

a. to hold more capital than what would be held without regulation.
b. to produce less information than would be produced without regulation.
c. to hold more debt than what would be held without regulation.
d. hold fewer reserves than they would without regulation.
e. All of the above.

Answer: A

1-76 What distinguishes financial intermediaries from industrial firms?

a. FI balance sheets are almost totally comprised of financial assets while commercial firms hold substantial amounts of real assets.
b. Industrial firms are the customers of FIs, but FIs cannot be customers of industrial firms.
c. FIs deal exclusively in primary securities, but industrial firms specialize in secondary securities.
d. Industrial firms produce real goods or services while FIs only produce money.
e. Industrial firms are unregulated while FIs are heavily regulated.

Answer: A

1-77 The origination of a home mortgage loan is considered to be a
a. primary security, because this is the FI's primary source of business.
b. secondary security, because mortgages are typically resold in the secondary market.
c. primary security, because the mortgage note is a newly created security.
d. secondary security if the sale is for an existing home and a primary security if it is for a new home.
e. derivative security because the value of the mortgage note depends on the underlying value of the home.

Answer: C

1-78 How have the innovations of global financial networks and computerized money and information transfer systems changed financial intermediation?
a. Financial intermediation has become riskier because it is more difficult to stay informed about worldwide events.
b. Financial intermediation has become more costly because it is necessary to invest in high cost technology.
c. Financial intermediation has been unaffected.
d. Financial intermediation has become more costly as global firms exploit economies of scale and scope.
e. Financial intermediation has become less risky as firms become adept at maintaining zero gap positions.

Answer: B

1-79 The charter values of FIs will be higher if regulators
a. increase the cost of entry by requiring more capital.
b. restrict the number of activities permitted by FIs, thereby increasing potential profits.
c. restrict the number of FIs that can operate in a given market.
d. Answers A and B.
e. Answers A and C.

Answer: E

1-80 In a world without FIs, households will be less willing to invest in corporate securities because they
- a. are not able to monitor the activities of the corporation more closely than FIs.
- b. tend to prefer shorter, more liquid securities.
- c. are subject to price risk when corporate securities are sold.
- d. may not have enough funds to purchase corporate securities.
- e. All of the above.

Answer: E

1-81 FIs perform their intermediary function in two ways
- a. they specialize as brokers between savers and users.
- b. they serve as asset transformers by purchasing primary securities and issuing secondary securities.
- c. they serve as asset transformers by purchasing secondary securities and issuing primary securities.
- d. Answers A and B.
- e. Answers A and C.

Answer: D

1-82 Which of the following is true of secondary securities?
- a. They include equities, bonds, and other debt claims.
- b. They are backed by the real assets of corporations issuing them.
- c. They are securities that back primary securities.
- d. They are securities issued by FIs.
- e. They must be placed in a separate account on order for primary securities to be offered.

Answer: C

1-83 Each of the following is a special function performed by FIs at a macro level EXCEPT
- a. transmission of monetary policy.
- b. credit allocation.
- c. intergenerational wealth transfers or time intermediation.
- d. denomination intermediation.
- e. interbank lending and investing.

Answer: E

1-84 Which of the following is closely associated with credit allocation regulation?
- a. Support the FI’s lending to socially important sectors.
- b. Transmission of monetary policy from the Federal Reserve to the economy.
- c. Ensure the safety and soundness of the FI.
- d. Prevent discrimination in lending on the basis of age, race, sex, or income.
- e. Protect investors against abuses.

Answer: A

1-85 Verifying the minimum level of capital or equity that must be held to fund the operations of an FI is part of the goal of

a. investor protection regulation.
b. safety and soundness regulation.
c. entry regulation.
d. credit allocation regulation.
e. consumer protection regulation.

Answer: B

1-86 The Community Reinvestment Act and the Home Mortgage Disclosure Act were both passed to provide incentives to comply with

a. entry regulation.
b. credit allocation regulation.
c. consumer protection regulation.
d. safety and soundness regulation.
e. investor protection regulation.

Answer: C

1-87 Price and quantity restrictions in regulation are usually aimed at determining whether an FI is meeting certain

a. consumer protection guidelines.
b. credit allocation guidelines.
c. investor protection guidelines.
d. safety and soundness guidelines.
e. entry regulation guidelines.

Answer: B

1-88 The following are protective mechanisms that have been developed by regulators to promote the safety and soundness of the banking system EXCEPT

a. encouraging banks to rely more on deposits rather than debt or capital as a cushion against failure.
b. encouraging banks to limit lending to a single customer to no more than 10% of capital.
c. the provision of deposit insurance.
d. the periodic monitoring of banks.
e. encouraging banks to produce timely accounting statements and reports.

Answer: A

1-89 Safety and soundness regulations include all of the following layers of protection EXCEPT

a. the provision of guaranty funds.
b. requirements encouraging diversification of assets.
c. the creation of money for those FIs in financial trouble.
d. requiring minimum levels of capital.
e. monitoring and surveillance.

Answer: C

1-90 Which of the following groups of FIs have experienced the highest percentage growth in assets in the U.S. financial services industry during the past sixty years?
a. Commercial banks.
b. Thrifts.
c. Life insurance companies.
d. Investment companies.
e. Finance companies.
Answer: D

1-91 Which of the following repealed the 1933 Glass-Steagall barriers between commercial banking, insurance, and investment banking?
a. Financial Institutions Reform Recovery and Enforcement Act (1989).
b. Financial Services Modernization Act (1999).
c. Competitive Equality in Banking Act (1987).
d. The Bank Holding Company Act (1956).
e. Garn–St. Germain Depository Institutions Act (1982).
Answer: B

1-92 A significant recent trend in the provision of financial services is that households increasingly prefer denomination intermediation and information services provided by
a. mutual funds.
b. commercial banks.
c. insurance companies.
d. hedge funds.
e. investment banks
Answer: A

1-93 When a DI makes a shift from an "originate-to-hold" banking model to an "originate-to-sell" model, the change is likely to result in
a. increased operating costs.
b. increased interest rate risk.
c. increased liquidity risk.
d. decreased monitoring costs.
e. decreased fee income.
Answer: D

1-94 As DIs made a shift from an "originate-to-hold" banking model to an "originate-to-sell" model over the last decade,
a. banks became more financially stable.
b. it became easier to measure the riskiness of individual loans.

c. there was a dramatic increase in systematic risk of the financial system.
d. the Federal Reserve decreased the number of services that banks could provide.

e. it became more difficult for households to obtain credit.

Answer: D

1-95 The recent financial crisis highlighted, in retrospect, how heavily households and businesses had come to rely on FIs to act as specialists in

a. generating profits and lowering costs.
b. risk measurement and management.
c. investment advice and brokerage services.
d. time intermediation and denomination mediation.
e. derivative securities and interbank borrowing.

Answer: B

1-96 Of the ten largest banks in the world at the beginning of 2009, how many were U.S. banks?

a. 0.
b. 2.
c. 4.
d. 7.
e. 10.

Answer: B