***Economics of Money, Banking, and Fin. Markets,* (Mishkin)**

**Chapter 9 Banking and the Management of Financial Institutions**

9.1 The Bank Balance Sheet

1) 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) A bank's balance sheet indicates whether or not the bank is profitable.

Answer: C

2) 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

3) Which of the following statements are true?

A) Checkable deposits are payable on demand.

B) Checkable deposits do not include NOW accounts.

C) Checkable deposits are the primary source of bank funds.

D) Demand deposits are checkable deposits that pay interest.

Answer: A

**Basically, demand deposit accounts (DDA’s) are synonymous with checkable deposits. The primary differences:**

**1. Whether interest is paid on the account (i.e., business checking accounts generally do not pay interest (this explicit ban on interest was lifted in 2010 with Dodd-Frank legislation); and**

**2. The amount of notice a depositor has to give a bank before a withdrawal. For example,** [**Negotiable**](http://www.investopedia.com/terms/n/negotiable.asp)**Order of Withdrawal (NOW) accounts are essentially checking accounts where you earn interest on the money you have deposited. Also, the bank has the right to require at least seven days written notice of a withdrawal; however, this is rare.**

**From Chapter 2 Table 1 - definition of M1 as separated in the text: M1 (money supply) includes:**

**-Demand deposit accounts to include business checking accounts that do not pay interest as well as traveler’s checks issued by banks;**

**-Other checkable deposits items include all other checkable deposits, to include interest bearing accounts held by households, NOW (negotiated order of withdrawal), and ATS (automatic transfer from savings).**

4) 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

5) 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

6) 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

7) Bank capital is equal to \_\_\_\_\_\_\_\_ minus \_\_\_\_\_\_\_\_.

A) total assets; total liabilities

B) total liabilities; total assets

C) total assets; total reserves

D) total liabilities; total borrowings

Answer: A

8) Bank reserves include

A) deposits at the Fed and short-term treasury securities.

B) vault cash and short-term Treasury securities.

C) vault cash and deposits at the Fed.

D) deposits at other banks and deposits at the Fed.

Answer: C

9) The largest percentage of banks' holdings of securities consist of

A) Treasury and government agency securities.

B) tax-exempt municipal securities.

C) state and local government securities.

D) corporate securities.

Answer: A

10) 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.

Answer: C

11) Bank's make their profits primarily by issuing

A) equity.

B) negotiable CDs.

C) loans.

D) NOW accounts.

Answer: C

9.2 Basic Banking

12) Banks earn profits by **converting** \_\_\_\_\_\_\_\_ with attractive combinations of liquidity, risk and return, **into** \_\_\_\_\_\_\_\_ with a different set of characteristics.

A) loans; deposits

B) securities; deposits

C) liabilities; assets

D) assets; liabilities

13) 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

14) 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) its cash items in the process of collection increase by $50.

Answer: B

15) 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**

9.3 General Principles of Bank Management

16) If a bank has $100,000 of checkable 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



17) 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 deposits and capital by $5 million.

Answer: A

18) 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.

Answer: D

19) 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) the discount rate decreases.

Answer: B

20) 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

21) 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

22) A bank is insolvent when

A) its liabilities exceed its assets.

B) its assets exceed its liabilities.

C) its capital exceeds its liabilities.

D) its assets increase in value.

Answer: A

23) 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 bad loans.

D) it makes it easier to call in loans.

Answer: C

24) The amount of assets per dollar of equity capital is called the

A) asset ratio.

B) equity ratio.

C) equity multiplier.

D) asset multiplier.

Answer: C

25) 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) too much capital, making it more difficult to obtain loans.

Answer: C

9.4 Managing Credit Risk

26) 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

27) **Unanticipated** moral hazard contingencies can be reduced by

A) screening.

B) long-term customer relationships.

C) specialization in lending.

D) credit rationing.

Answer: B

28) 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

29) 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) purchase the bank's CDs.

Answer: C

9.5 Managing Interest-Rate Risk

30) All else the same, if a bank's liabilities are more sensitive to interest rate fluctuations than are its assets, then \_\_\_\_\_\_\_\_ in interest rates will \_\_\_\_\_\_\_\_ bank profits.

A) an increase; increase

B) an increase; reduce

C) a decline; reduce

D) a decline; not affect

Answer: B

31) 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

*First National Bank*

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

32) 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**

**Basic gap analysis: (Rate sensitive assets - rate sensitive liabilities) X  interest rates =  in bank profit (20-50) X 0.05= -1.5**

**33)** 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 decline by \_\_\_\_\_\_\_\_ of the total original asset value.

A) 5 percent

B) 10 percent

C) 15 percent

D) 25 percent **Answer: B**

**Duration analysis**

% in market value of security **≈** **-** percentage point  in interest rate X duration in yrs.

**A**ssets: -.05 X 5= -.25

**L**iabilities: -.05 X 3= -.15

**N**et: -.25- - .15 = -.10

**The interest rate is rising but locked-in on the asset side for a longer period than on the liability side - resulting in lower net worth.**

34) Duration analysis involves comparing the average duration of the bank's \_\_\_\_\_\_\_\_ to the average duration of its \_\_\_\_\_\_\_\_.

A) securities portfolio; non-deposit liabilities

B) assets; liabilities

C) loan portfolio; deposit liabilities

D) assets; deposit liabilities

Answer: B

9.6 Off-Balance-Sheet Activities

35) Examples of off-balance-sheet activities include

A) loan sales.

B) extending loans to depositors.

C) borrowing from other banks.

D) issuing negotiable CDs.

**Answer: A.**

36) Which of the following is not an example of a backup line of credit?

A) loan commitments

B) overdraft privileges

C) standby letters of credit

D) mortgages

Answer: D

37) 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) trading-loss approach.

D) doomsday approach.

Answer: B

38) When banks calculate the losses the institution would incur if an unusual combination of bad events happened, the bank is using the \_\_\_\_\_\_\_\_ approach.

A) stress-test

B) value-at-risk

C) trading-loss

D) maximum value

Answer: A