Prep Questions for Exam #2
ECON 4673
Dr. Keen

1. Briefly explain the difference between adverse selection and moral hazard. How does the government help reduce the adverse selection and moral hazard problems for publicly-traded companies? How do financial intermediaries reduce the adverse selection problem without generating a free-rider problem?

2. What are collateral and restrictive covenants, and how do they reduce the moral hazard problem in debt contracts?

3. Consider a bank with the following balance sheet (in millions of $). You may assume the required reserves ratio is 10% and the bank's net profits after taxes are $5 million.

Assets		Liabilities/Equity	
Reserves	30	Checkable deposits	160
Business loans	240	Nontransaction deposits	200
Residential mortgages	75	Borrowings (other banks)	15
U.S. Treasury securities	55	Borrowings (the Fed)	5
		Bank equity	20

   a. Calculate the equity multiplier for this bank.
   b. Calculate the return on equity for this bank.
   c. Calculate the return on assets for this bank.
   d. Calculate the leverage ratio for this bank.
   e. Calculate the Basal Accord's risk-weight measure of assets for this bank.
   f. Use a T-account to show how the balance sheet changes when $1 million is deposited into checkable deposits.
   g. Use a T-account to show how the balance sheet changes when the bank makes a $3 million business loan.
   h. Use a T-account to show how the balance sheet changes when the bank writes off $5 million in residential mortgages.
   i. Suppose reserves and U.S. Treasury Securities are short-term assets, while checkable deposits and borrowings from the Fed and other banks are short-term liabilities. If the interest rate rises by 2%, how much do bank profits change?
   j. If the average duration of a bank's assets is 4 years and the average duration of the bank's liabilities is 2 years, how much does the bank's market value change when the interest rate rises by 2%.

4. Name and briefly describe the two key financial innovations in the 1960s that led banks to place more emphasis on liability management.

5. Discuss compensating balances and how they are a form of collateral.

6. Name and briefly describe the two ways the Federal Deposit Insurance Corporation (FDIC) can respond to an insolvent bank. How does FDIC insurance impact the adverse selection and moral hazard problems of a financial institution? If the insolvent bank is “too big to fail,” which of the two methods does the FDIC use?

7. What is meant when a financial firm is “too big to fail?” Briefly discuss how the designation of being a “too big to fail” firm affects the incentive structure of the firm’s management. What are the three approaches to solving the “too big to fail” problem? Briefly discuss.

8. Briefly discuss the dual banking system in the U.S. What role did the National Banking Act of 1863 play in the development of the dual banking system in the U.S.?

9. What did the Glass-Steagall Act of 1933 do? What legislation repealed the Glass-Steagall Act, and in what year was the repeal enacted?

10. What is securitization? Name and briefly describe the four steps of the securitization process.

11. What is a financial crisis? Briefly discuss the role of the credit boom and bust and the asset price boom and bust in a financial crisis. How can those stages of a financial crisis precipitate a banking crisis? Briefly discuss the three causes of the 2008 Financial Crisis. Discuss three ways the government responded to the 2008 Financial Crisis.

12. What are two possible causes of a credit boom?

13. Name the legislation that was enacted to modernize regulations of the financial industry after the 2008 Financial Crisis? What are the major features of that legislation?