ch19

Student: ____

1. Contagious runs on bank deposits are directed at FIs, whether they are failing or healthy.
True False

2. A run on a bank is not necessarily a bad occurrence.
True False

3. The adverse effects of a contagious run include the restrictions on the ability of individuals to transfer wealth through time and a negative impact on the level or rate of savings.
True False

4. The Federal safety net to protect the integrity of the payments system consists of deposit insurance and social welfare.
True False

5. The number of bank failures in the period of 1933-79 was less than the number of failures from 1980-1989.
True False

6. The average cost to the FDIC of each bank failure during the decade of the 1980s was larger than the total cost of all bank failures during the period 1933-79.
True False

7. During the financial crisis of 2008-2009, deposit balances at DIs increased.
True False

8. Since its inception, the FDIC deposit insurance fund has never fallen to a negative balance.
True False

9. After nearly failing, the FDIC's Bank Insurance Fund (BIF) achieved record levels of reserves during the 1990s.
True False

10. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) restructured the savings association deposit insurance fund and transferred its management to the FDIC.
True False

11. As a result of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), the deposit insurance fund for the savings and loan industry has been combined with the deposit insurance fund for the commercial banking industry.
True False

12. A major cause of the FSLIC insolvency in the 1980s was the dramatic rise in interest rates in 1979-82 that created extensive duration mismatches of assets and liabilities in the savings and loan industry.
True False

13. A major reason for the deterioration of the deposit insurance funds in the 1980s was the downturn in the technology, manufacturing, and real estate industries.
True False

14. Deposit insurance is often blamed for the deterioration in depositor discipline that allowed FIs to accept more risk in the asset selection process.
True False

15. Moral hazard encourages the FI to take on more, rather than less, risk.
True False

16. The risk of moral hazard increases when capital levels are low.
True False

17. If regulators provide more protection against bank runs, the incidence of moral hazard is likely to increase.
True False

18. Explicit deposit insurance premiums applied by regulators can involve restricting and more closely monitoring the risky activities of banks.
True False

19. Moral hazard provides an incentive for bank owners to accept greater asset risks because they have less to lose, and potentially more to gain.
True False

20. Pricing insurance premiums in an actuarially fair manner involves assessing the risk-taking profile of the financial institution.
True False

21. Because deposit insurance premiums were not priced in an actuarially fair manner during the period from 1933-1980s, instability was created in the credit and monetary system.
True False

22. Currently in the U.S., deposit insurance premiums increase with the amount of risk of the institution.
True False

23. Pricing deposit insurance premiums to reflect increases in risk-taking by financial institutions is one method to reduce incentives to take risks.
True False

24. The use of the option pricing model to determine the actuarially fair premium for deposit insurance indicates that the cost of the insurance should rely on both the asset quality and level of leverage of the DI.
True False

25. The use of the option pricing model to determine the actuarially fair premium is difficult to apply in practice because the asset values and risks are difficult to determine.
True False

26. The cost of insolvency of an FI to the FDIC is offset in part by the deposit insurance premiums paid by the bank.
True False

27. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) required the FDIC to establish risk-based premiums for deposit insurance coverage at banks.
True False

28. The initial risk-based deposit insurance program implemented on January 1, 1993 was based on capital adequacy and supervisory judgments involving asset quality, loan underwriting standards and other operating risks.
True False

29. The improved financial health of the FDIC during the 1990s resulted in a considerable reduction in deposit insurance premiums.
True False

30. The Designated Reserve Ratio is a rule that stipulates that highly-rated DIs would not pay deposit insurance premiums if this ratio was above 1.25 percent.
True False

31. Statistical credit scoring models have been suggested for use in measuring the risk of DIs for the purpose of assigning deposit insurance premiums.
True False

32. Requiring higher capital ratios often is proposed as method to reduce the incentive to take excessive risk because the moral-hazard risk-taking incentives are thought to decrease as the amount of net worth increases.
True False

33. The regulatory practice of excessive capital forbearance is a method of reducing the short-run and long-run costs to deposit insurance funds.
True False

34. The policy of forbearance practiced by the FSLIC in the late 1980s allowed many commercial banks to remain open even in the face of continuing losses and insolvency.
True False

35. Risk-based capital supports risk-based deposit insurance premiums by increasing the cost of risk taking for DI stockholders.
True False

36. The prompt corrective action program of the FDIC Improvement Act allows a bank or thrift to be placed into receivership when the book value of capital to assets falls below 2 percent.
True False

37. The ability of the FDIC to place a bank into receivership even though the book value of capital remains positive is an attempt to institute increased stockholder discipline.
True False

38. The use of subordinated debt as a replacement for common stock has been proposed as a method of increasing stockholder discipline.
True False

39. One of the overall objectives in using subordinated debt in addition to common stock for a DI's capital base is to improve market discipline of a DI's risk structure.
True False

40. Critics of the current FDIC insurance programs often argue that only uninsured depositors have any incentive to discipline riskier banks.
True False

41. Insured depositors can be covered for more than $250,000 at any given FI under current FDIC regulations.
True False

42. The employment of deposit brokers allows individual depositors to receive deposit insurance coverage on total asset balances well in excess of $250,000 at any given bank.
True False

43. During the 1980s, a high proportion of brokered deposits at a DI became an early warning signal of its risk for failure.
True False

44. The FIRREA prohibited all insured financial institutions from accepting brokered deposits or paying interest rates that are significantly higher than existing market rates.
True False

45. The "too big to fail" policy doctrine prevalent through the 1980s and most of the 1990s is remised on the separation of small depositors who would receive deposit insurance and large depositors who would not receive the benefits of deposit insurance.
True False

46. The 1993 Depositor Protection legislation gives equal claim to the value of liquidated assets less the amount of insured deposits to foreign uninsured depositors, domestic uninsured depositors, and the FDIC.
True False

47. The insured depositor transfer method of least-cost bank failure resolution requires the FDIC to employ the method that imposes the highest amount of failure costs on uninsured depositors.
True False

48. FDICIA imposed additional regulatory discipline as a substitute for increased stockholder and depositor discipline.
True False

49. The introduction of prompt corrective action capital zones by FDICIA was an attempt to place greater decision-making power at the discretion of regulators rather than on objective, measurable rules.
True False

50. The discount window at the Federal Reserve is a suitable substitute for deposit insurance and a possible method of preventing bank runs.
True False

51. Interest rates charged to healthy banks that use the Federal Reserve discount window are typically set one percent below the fed funds target interest rate.
True False

52. By decreasing the use of the discount window as a source of funding for a DI, the Federal Reserve hopes to reduce volatility in the fed funds market.
True False

53. State guaranty funds for insurance companies are sponsored by state insurance regulators rather than by a federal agency such as the FDIC.
True False

54. The required contribution from surviving insurers to protect policyholders of failed insurance companies usually is on a pro rata amount based on the relative asset size of the surviving company.
True False

55. The FDIC deposit insurance program is also available to credit unions.
True False

56. The National Credit Union Administration (NCUA) is an independent federal agency that insures credit union deposits.
True False

57. The deposit insurance programs of the National Credit Union Administration (NCUA) is modeled after the programs offered by the FDIC.
True False

58. The Pension Benefit Guaranty Corporation (PBGC) insures pension benefits against the under-funding of pension plans by corporations.
True False

59. The deficit realized by the PBGC in 1992 was a result of risk-taking by fund administrators.
True False

60. Which of the following is NOT a social welfare effect of bank runs?
    A. Discipline of incompetent managers.
    B. Negatively affecting the payments function of DIs.
    C. Reduced availability of credit.
    D. Potential decrease in the money supply.
    E. Inability to perform intergenerational wealth transfers.

61. All of the following are associated with contagious runs EXCEPT
    A. liability holders not distinguishing between good and bad FIs.
    B. liability holders seeking to quickly turn their liabilities into cash or safe securities.
    C. a contractionary effect on the supply of credit.
    D. negative social welfare effects.
    E. an expansionary effect on the regional money supply.

62. The contagion effect
    A. stems from the positive correlation in FI returns.
    B. results when interest rate risk increases credit risk and liquidity risk exposures.
    C. occurs when liquidity risk problems at bad banks damages well-run banks.
    D. occurs when a computer virus infects the computerized electronics payments systems Fedwire and CHIPS.
    E. is completely eliminated by government provided deposit insurance against bank runs.

63. What is the benefit of a regulatory guarantee or insurance program for liability holders of FIs?
    A. It decreases the likelihood contagious runs.
    B. It increases concerns about the asset quality of FI.
    C. It increases concerns about solvency of an FI.
    D. It provides incentives to liability holders to engage in runs.
    E. It provides preference to those who are first in line to withdraw funds over those last in line.

64. What was the objective of the FDIC Improvement Act (FDICIA) of 1991?
    A. Returning the banking industry to record profit levels.
    B. Restructure the savings association deposit insurance fund and transfer its management to FDIC.
    C. To deny deposit insurance coverage to funds obtained through deposit brokers.
    D. To restructure the bank deposit insurance fund and prevent its potential insolvency.
    E. To enforce the capital standards on insured depository institutions.

65. Which of the following contributed the least to the collapse of the FSLIC/FDIC deposit insurance funds?

    A. An increase in interest rate volatility.
    B. Enhanced investment powers granted to thrifts.
    C. Fraudulent behavior induced by the greed of the decade of the 80s.
    D. Fraudulent behavior induced by ineffective regulatory incentives.
    E. The extension of deposit insurance to uninsured depositors.

66. To address the decreasing balance of the FDIC deposit insurance fund during the financial crisis of 2007-2008
    A. deposit insurance programs were suspended for a period of three months.
    B. the FDIC increased individual depositor insurance coverage from $100,000 to $250,000.
    C. the FDIC announced that it would no longer honor deposit insurance coverage of some failing DIs.
    D. two special assessments were levied on institutions participating in the FDIC insurance programs.
    E. the U.S. Treasury had to take over management of the FDIC.

67. Which of the following methods was NOT a method used to replenish the FDIC's deposit insurance reserve fund during the most recent financial crisis?
    A. A special assessment was imposed on participating FIs in early 2009.
    B. Individual depositor insurance coverage was increased to $250,000.
    C. Deposit insurance premiums were increased.
    D. Participating institutions were required to pre-pay insurance premiums.
    E. A special assessment was imposed on participating FIs during the fall of 2009.

68. From January 2008 to December 2009, there were a total of ____ FDIC insured bank failures, which cost the FDIC approximately ____ billion to resolve.
   A. 26; $17
   B. 140; $39
   C. 166; $56
   D. 211; $69
   E. 234; $72

69. Moral hazard at FIs may
   A. result when actions and consequences are separated.
   B. occur when interest rates are very high and volatile.
   C. occur when commodity prices are very high and volatile.
   D. be a consequence of strict regulatory supervision.
   E. be a consequence of an erosion of family values.

70. How can the regulators reduce the effects of moral hazard in the absence of depositor discipline?
   A. By allowing DIs to undertake high-risk high-return asset investments.
   B. By basing deposit insurance premiums on a DI's deposit size.
   C. By charging explicit deposit insurance premiums and implicit premiums on DIs.
   D. By exhibiting excessive capital forbearance.
   E. By implementing prompt corrective action capital zones based on rules rather than discretion.

71. Which of the following refers to the regulators' policy of allowing an FI to continue operating even when its capital funds are fully depleted?
   A. Capital forbearance.
   B. Prompt corrective action.
   C. Risk-based deposit insurance.
   D. Too-big-to-fail.
   E. Regulatory oversight.

72. Which of the following refers to mandatory actions that have to be taken by regulators as a DI's capital ratio falls?
   A. Capital forbearance.
   B. Prompt corrective action.
   C. Risk-based deposit insurance.
   D. Too-big-to-fail.
   E. Regulatory oversight.

73. Bank risk taking can be controlled by increasing
   A. stockholder discipline by charging stockholders a surcharge.
   B. stockholder discipline by setting risk adjusted deposit insurance premiums.
   C. depositor discipline by increasing the ceiling for deposit insurance coverage.
   D. regulatory discipline by increasing the budgets of the regulatory agencies.
   E. depositor discipline by expanding the doctrine of "too big to fail."

74. The provision of deposit insurance by the FDIC is similar to having the FDIC ________ on the assets of the bank that buys the deposit insurance.
   A. write a call option
   B. buy a call option
   C. write a put option
   D. having a secondary lien
   E. enter into a swap agreement

75. The insured depositor transfer method of failure resolution
   A. results in the closure of the failed bank.
   B. results in the merger of the failed bank into a stronger entity.
   C. keeps the failed bank operating for a short period of time.
   D. minimizes the FDIC's out of pocket costs of resolving a failed DI.
   E. forces insured depositors to bear some losses.

76. Subordinate debt (SD) has been proposed as a means of increasing the degree of overall market discipline at a depository institution. Which of the following objectives is considered to be achievable when attempting to increase market discipline?
   A. Issuing SD might increase the size of the DI's capital cushion.
   B. The expected cost of issuing SD should decrease as the risk of the DI increased.
   C. Mandatory SD would reduce transparency at DIs.
   D. SD would further emphasize the use of capital forbearance.
   E. Secondary market yields on the SD would be inversely related to an increase in the risk of the DI.

77. What does a high proportion of brokered deposits indicate?
   A. Total risk-based capital ratio of the DI is less than10 percent.
   B. Above average risk, and thus an increased potential for failure.
   C. Less informed savers are protected against a reduction in wealth.
   D. Reduced insolvency risk as brokered deposits are covered under deposit insurance.
   E. Lower levels of credit risk.

78. The system of flat deposit insurance premium formerly used in the U.S.
   A. enhances bank safety and soundness because it discourages bank risk taking.
   B. reduces bank safety and soundness because it encourages bank risk taking.
   C. has no impact on bank safety and soundness.
   D. places banks that are considered "too big to fail" at a disadvantage.
   E. provides unfair advantage to small community banks.

79. Which of the following is a drawback of charging flat deposit insurance premiums?
   A. The FDIC acts more like a private property-casualty insurer when charging flat premiums.
   B. It discourages banks from taking risks.
   C. Both high risk and low risk banks are charged the same premium rate.
   D. High risk banks will be charged an unreasonably high premium rate.
   E. Premiums reflect the expected private costs or losses to the insurer from the provision of deposit insurance.

80. When risk-taking is not actuarially fairly priced into deposit insurance premiums
   A. depositors are required to pay the shortfall in funds collected.
   B. there is an increase in the incentives for owners of DIs to take additional risk.
   C. deposit insurance premiums are more costly than economically justified.
   D. depositors will be unprotected should the DI become insolvent and fail.
   E. the insurance provider is forced to find other sources of funds to continue coverage for the institution.

81. The least cost resolution strategy of FDICIA requires failure resolution alternatives for all banks to be evaluated on a
   A. historical cost basis.
   B. opportunity cost basis.
   C. market value basis.
   D. present value basis.
   E. replacement cost basis.

82. How is the cost of a systemic risk exemption to the least-cost resolution of bank failures shared among banks?
   A. It is shared equally among all other insured banks.
   B. Additional deposit insurance premiums are imposed on FIs based on their size as measured by their total deposits and borrowed funds excluding subordinated debt.
   C. Additional deposit insurance premiums are imposed on FI based on their size as measured by their total deposits and borrowed funds including subordinated debt.
   D. It is shared equally among all other insured banks based on the profits earned by the FI during the year.
   E. The cost is borne by the bank whose run was responsible for the contagion.

83. Discount window loans from the Federal Reserve are used as
   A. Non-permanent short-term funds.
   B. Funds to meet seasonal liquidity needs.
   C. Funds to meet unexpected deposit drain.
   D. Funds to meet reserve requirement.
   E. All of the above.

84. Access to the discount window of the Federal Reserve is unlikely to deter bank runs because
   A. discount loans are meant to provide temporary liquidity for inherently solvent banks.
   B. borrowing is not automatic, that is, banks gain access only on a "need to borrow" basis.
   C. a bank needs high-quality liquid assets to pledge as collateral.
   D. discount window advances to undercapitalized banks that eventually fail requires the Federal Reserve to compensate the FDIC for incremental losses caused by keeping the bank open for an additional period of time.
   E. All of the above.

85. The federal safety net to minimize bank failures includes all of the following EXCEPT
   A. deposit insurance.
   B. reserve requirements.
   C. contagious runs.
   D. minimum capital requirements.
   E. the discount window of the Federal Reserve Bank.

86. The insolvency of the FSLIC occurred because of
   A. declining real estate values.
   B. risky lending.
   C. asset liability mismatch.
   D. insider lending.
   E. All of the above.

87. The FDICIA of 1991 strengthened the role of regulators to monitor bank asset quality by the following measures EXCEPT
   A. requiring improved accounting standards for banks.
   B. giving private accountants an increased role in monitoring bank performances.
   C. requiring an annual on-site examination by regulators.
   D. requiring banks to work on achieving market value accounting.
   E. disallowing independent audits.

88. Which of the following is not a Least-Cost Resolution (LCR) requirement under FDICIA?
   A. Consider and evaluate all possible resolution alternatives by computing and comparing their costs on a present value basis, using realistic discount rates.
   B. Place a bank or thrift into receivership as soon as its capital falls below some positive book value level.
   C. Document the evaluation and the assumption on which it is based.
   D. Retain documentation for at least five years.
   E. Select the least costly alternative based on the evaluation.

89. During the 1980s, which of the following was NOT a change in the financial environment that had an inverse impact on U.S. banks and thrifts?
   A. The effects of significant interest rate changes.
   B. The failure of the FSLIC.
   C. The deterioration of real estate prices.
   D. The collapse of the energy industry.
   E. Significant deterioration in the agricultural economy.

90. Deposit insurance contracts can be structured to reduce moral hazard behavior by
   A. increasing depositor discipline.
   B. increasing stockholder discipline.
   C. increasing regulator discipline.
   D. reducing owner incentives to take risks.
   E. All of the above.

91. The FDIC establishes risk-based deposit insurance premiums by considering all of the following EXCEPT
   A. the deposit insurer's revenue needs.
   B. different categories and concentrations of assets.
   C. the frequency of examinations.
   D. different categories and concentrations of liabilities.
   E. other factors that affect the probability of loss.

92. Under the option pricing model of deposit insurance, the cost of the insurance
   A. decreases as the insured deposit base increases.
   B. decreases as the period over which the insurance coverage extends is increased.
   C. increases with the level of risk of the assets held by the DI increase.
   D. decreases with market interest rates.
   E. increase as the level of leverage used by the DI decreases.

93. Which of the following considerations was not imposed by FDICIA in an attempt to increase regulatory discipline?
   A. The act required improved accounting standards for banks.
   B. The act forbids the use of brokered deposits.
   C. The act required an annual on-site examination of every bank.
   D. The act gave private accountants a greater role in monitoring a bank's performance.
   E. The act produced prompt corrective action capital zones based on observable rules rather than discretion of examiners.

94. Which of the following is NOT a differentiation between deposit insurance and state guaranty funds for the insurance industry?
   A. The required contributions provided by surviving insurers differs widely across states.
   B. The annual pro rata contributions often are legally capped for each insurer as a percent of premium income.
   C. A permanent guaranty fund does not exist for the insurance industry.
   D. Contributions by surviving firms into the guaranty fund occur before an insurance company has failed.
   E. The programs that are sponsored by state insurance regulators are administered by private insurance companies.

95. The costs to the bank of borrowing at the discount window do NOT include
   A. an explicit rate of interest on the borrowings.
   B. the market value of collateral to be pledged against the loans.
   C. the negative signal the use of such borrowings sends to regulators about the insurer's financial condition.
   D. the negative signal the use of such borrowings sends to the market about the bank's financial condition.
   E. the possibility of greater regulatory scrutiny and examination.

96. The changes implemented by the Fed in January 2003 to its discount window lending
   A. decreased the cost of borrowing.
   B. eased the terms of borrowing.
   C. terms of borrowing became less flexible.
   D. resulted in reduction of outstanding discount loan volumes.
   E. None of the above.

97. Why are credit unions less affected by financial crises experienced by other thrifts such as savings associations?
A. They hold almost 30 percent of their assets in government securities.
B. They hold relatively high amounts of residential mortgages.
C. Less than 10 percent of their assets are in small consumer loans.
D. They are more diversified than other DIs.
E. Their customers have no other options for their banking needs.

The following market value balance sheet of a failed bank ($ millions)

Assets	$400	Insured Deposits	$200
		Uninsured Deposits	$100

98. What is the market value of capital?
A. $200 million.
B. -$200 million.
C. $0.
D. $400 million.
E. $600 million.

99. If the insured depositor transfer resolution method is utilized, what is the cost to insured depositors of bank failure resolution?
A. $0.
B. -$200 million.
C. $67 million.
D. $133 million.
E. $200 million.

100. If the insured depositor transfer resolution method is utilized, what is the cost to uninsured depositors of bank failure resolution?
A. $0.
B. -$200 million.
C. $67 million.
D. $133 million.
E. $200 million.

101. If the insured depositor transfer resolution method is utilized, what is the cost to the FDIC of bank failure resolution?
A. $0.
B. -$200 million.
C. $67 million.
D. $133 million.
E. $200 million.

As a result of loan write-offs, Bank A has to be liquidated by the regulators. The book value of the assets and liabilities of the bank is presented below (in millions of dollars). The market value of the loans has been estimated at $240 million.

Loans (book value)	$340	Insured Deposits	$200
		Uninsured Deposits	$100
		Equity	$ 40

102. What is the current net worth (market value) of the bank?
A. +$40 million.
B. $0 million.
C. -$40 million.
D. -$60 million.
E. -$100 million.

103. What is the cost to the insured depositors if the insured depositor transfer resolution method is used by the regulators to resolve the bank failure?

A. $0.
B. $30 million.
C. $40 million.
D. $60 million.

104. What is the cost to the uninsured depositors if the insured depositor transfer resolution method is used by the regulators to resolve the bank failure?

A. $0.
B. $20 million.
C. $30 million.
D. $40 million.
E. $60 million.

105. What is the cost to the FDIC if the insured depositor transfer resolution method is used by the regulators to resolve the bank failure?

A. $0.
B. $20 million.
C. $30 million.
D. $40 million.
E. $60 million.

ch19 Key

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73. B

74. C

75. D

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78. B

79. C

80. B

81. D

82. B

83. E

84. E

85. C

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87. E

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89. B

90. E

91. C

92. C

93. B

94. D

95. D

96. B

97. A

98. B

99. A

100. E

101. A

102. D

103. A

104. E

105. A

ch19 Summary

Category	*# of Questions*
Saunders - Chapter 19	107