

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 1) Investment banks and stock brokerages have traditionally been regulated by the: 1) _____
A) Internal Revenue Service (IRS).
B) Federal Reserve System (FED).
C) Federal Deposit Insurance Corporation (FDIC).
D) Securities and Exchange Commission (SEC).
- 2) The Glass-Steagall Act of 1933: 2) _____
A) created the Federal Reserve System.
B) separated commercial banking activities from investment banking activities.
C) developed the system of commercial bank deposit insurance.
D) all of the above
- 3) Which of the following is NOT another term for a prime mortgage loan? 3) _____
A) conventional loan
B) conforming loan
C) top-quality loan
D) All of the above are suitable terms for a prime mortgage loan.
- 4) The process of turning an illiquid asset into a liquid saleable asset is called: 4) _____
A) creationism. B) wrapping. C) swapping. D) securitization.
- 5) Asset-backed securities (ABSs) may be securitized based on: 5) _____
A) auto loans. B) credit card receivables.
C) home-equity loans. D) all of the above
- 6) A _____ is a financial intermediation device that allowed the participant to borrow short and lend long. 6) _____
A) non-conforming loan B) structured investment vehicle
C) sub-prime loan D) all of the above
- 7) A _____ is a securitized financial instrument that is sold to the market in tranches representing different levels of default risk. 7) _____
A) collateralized debt obligation (CDO) B) guaranteed security asset (GSA)
C) mortgaged backed security (MBS) D) credit default swap (CDS)

- 8) Which of the following statements concerning credit default swaps is FALSE? 8) _____
- A) In order to be a party to a CDO, at least one of either the buyer or seller must own the underlying asset.
 - B) As of year-end 2008, CDSs are completely outside of regulatory boundaries.
 - C) CDSs allow banks to sever their links to their borrowers, thereby reducing their incentive to screen and monitor the ability of borrowers to repay.
 - D) A CDS is a derivative security that may be used for hedging risk or for speculative purposes.
- 9) _____ is the method of making investments more attractive to prospective buyers by reducing their perceived risk. 9) _____
- A) Deregulation
 - B) Subordination
 - C) Credit enhancement
 - D) Derivation

TRUE/FALSE. Write 'T' if the statement is true and 'F' if the statement is false.

- 10) Mortgage loans in the U.S. are classified by risk into one of three types: prime, alt-A, and sub-prime. 10) _____
- 11) Alt-A mortgage loans are NOT eligible for sale to GSEs such as Fannie Mae or Freddie Mac. 11) _____
- 12) The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 explicitly allowed corporate combinations of commercial banks with other types of financial institutions such as insurance companies and investment banking firms. 12) _____
- 13) Subprime mortgages did not exceed 8% of all outstanding mortgage obligations by 2007, but by the end of 2008 they were the source of 65% of bankruptcy filings by homeowners in the United States. 13) _____
- 14) Even though household debt as a percentage of disposable income rose rapidly in the United States in early 2000s, the rate was even greater in Britain, topping out at over 170% in 2008. 14) _____
- 15) From 1990 through 2007, the amount of securitized loans outstanding dropped from over \$25 trillion to less than \$5 trillion and was a key element in the loss of market liquidity. 15) _____
- 16) It is pretty clear after reading this chapter that securitization in and of itself is a poor financial idea. 16) _____
- 17) Securitization may degrade credit quality because the process severs the link of lending and repayment (risk and reward) between the originator of the loan and the borrower. 17) _____
- 18) The authors make it clear that the main source of market failure with collateralized debt obligations lay almost exclusively with the rating agencies. 18) _____

19) Credit Default Swaps are highly regulated financial instruments as a result of the Commodity Futures Modernization Act of 2000. 19) _____

SHORT ANSWER. Write the word or phrase that best completes each statement or answers the question.

20) What is a Collateralized Debt Obligation (CDO)? In your answer explain how CDOs are generally separated into one of three tranches. What types of mistakes were made by security rating agencies that contributed to the collapse of the CDO market? 20) _____

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21) Which of the following is NOT identified by the authors as a "safe-haven" currency? 21) _____
A) the Japanese yen B) the British pound
C) the U.S. dollar D) the euro

22) The accounting procedure whereby assets are revalued to market value basis on a daily basis is known as: 22) _____
A) marked-to-market. B) FASB rule 62.
C) market value accounting. D) none of the above

23) The typical TED spread, the difference between the LIBOR and the interest rate swap index, is typically about _____ basis points. 23) _____
A) 180 B) 80 C) 350 D) 120

24) The three stages of the global credit crisis of 2009-2009 were: 24) _____
A) 1. The failure of commercial and investment financial institutions, 2. a credit-induced global recession, 3. the failure of specific mortgage-backed securities credit-induced global recession.
B) 1. The failure of specific mortgage-backed securities, 2. a credit-induced global recession, 3. failure of commercial and investment financial institutions.
C) 1. The failure of specific mortgage-backed securities, 2. the failure of commercial and investment financial institutions, and 3. a credit-induced global recession.
D) 1. The failure of commercial and investment financial institutions, 2. the failure of specific mortgage-backed securities, 3. a credit-induced global recession.

25) The British Bankers Association (BBA) estimates that LIBOR was used in the pricing of more than _____ in assets globally. 25) _____
A) \$360 trillion B) \$100 billion C) \$100 trillion D) \$360 billion

- 26) Which of the following pieces of U.S. legislation was developed and passed in response to the 2008-2009 international credit crisis? 26) _____
- A) Gramm-Leach-Bliley Financial Services Modernization Act
 - B) The Glass-Steagall Act
 - C) Depository Institutions Deregulation and Monetary Control Act
 - D) Dodd-Frank Wall Street Reform and Consumer Protection Act

TRUE/FALSE. Write 'T' if the statement is true and 'F' if the statement is false.

- 27) Bear-Stearns is the largest single bankruptcy in U.S. history. 27) _____
- 28) The international credit crisis began in full force in September 2008. 28) _____
- 29) Near the end of the U.S. housing boom, many of the mortgages classified as Alt-A were in fact sub-prime. 29) _____
- 30) LIBOR stand for the London Interbank Offered Rate. 30) _____
- 31) The credit crisis was worsened by the destabilizing effects of speculators, in a variety of different institutions, betting that particular instruments or markets or securities would fail. 31) _____

ESSAY. Write your answer in the space provided or on a separate sheet of paper.

- 32) What is TARP? Provide an argument for why TARP was necessary and successful.

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 33) Portfolio theory relies on combining assets with _____ return correlation exclusively to reduce risk. 33) _____
- A) low
 - B) highly positive
 - C) zero
 - D) none of the above
- 34) Future financial market regulation must include all of the following EXCEPT: 34) _____
- A) greater transparency in pricing and valuation.
 - B) increased reporting.
 - C) renewed regulatory requirements.
 - D) Regulation must include all of the above.
- 35) In finance, a liquid asset: 35) _____
- A) sells at or near its market value.
 - B) sells quickly.
 - C) both A and B
 - D) none of the above

- 36) Debt issued by the national government is called: 36) _____
 A) debenture debt. B) sovereign debt.
 C) municipal debt. D) none of the above
- 37) The member nations of the European Union have relative freedom to set their own fiscal policies EXCEPT for which of the following? 37) _____
 A) government taxation
 B) government spending
 C) government printing of the euro currency
 D) government surpluses or deficits
- 38) When the EU moved to a single currency with the adoption of the euro, its member states agreed to each of the following EXCEPT: 38) _____
 A) free movement of capital in and out of their economies.
 B) a single currency.
 C) control of their own money supply.
 D) In fact, the member states agreed to ALL of the above.
- 39) As of 2011, the European countries with the highest debt/GDP ratio were, in order: 39) _____
 A) Greece, Italy, France, and Germany.
 B) Greece, Italy, Great Britain, and Portugal.
 C) Greece, Italy, Portugal, and Slovenia.
 D) Greece, Italy, Ireland, and Portugal.
- 40) In October 2009, the new government of Greece estimated the size of the 2009 government budget deficit as 12.7% of GDP rather than the previously published: 40) _____
 A) 6.7%. B) 3.4%. C) 10.2%. D) 8.6%.

TRUE/FALSE. Write 'T' if the statement is true and 'F' if the statement is false.

- 41) The authors conclude the chapter with a specific road map for future financial regulation. 41) _____
- 42) Baring the (hopefully temporary setback of 2008) capital is more mobile today than ever before. 42) _____
- 43) Securitization is likely to be declared illegal in the U.S. though it may still exist elsewhere in the world. 43) _____
- 44) Every EU member nation has the right to simply print more euros. 44) _____
- 45) The members of the EU's eurozone (euro participants) do NOT have the ability to conduct independent *monetary policy*. 45) _____
- 46) The European Financial Stability Facility (EFSF) has a mandate to safeguard financial stability in Europe by providing financial assistance to euro area Member States. 46) _____

47) Ireland and Greece had the same issues lead to their financial crises in 2009. In each case, the previous government had dramatically understated the size of their federal budget deficit as a percentage of GDP.

47) _____

Answer Key

Testname: UNTITLED4

- 1) D
- 2) B
- 3) C
- 4) D
- 5) D
- 6) B
- 7) A
- 8) A
- 9) C
- 10) TRUE
- 11) FALSE
- 12) TRUE
- 13) TRUE
- 14) TRUE
- 15) FALSE
- 16) FALSE
- 17) TRUE
- 18) FALSE
- 19) FALSE
- 20) Financial institutions create and then package similar types of debt instruments (mortgage or corporate loans for example). Once packaged, the bank transfers the packaged loans to a special purpose vehicle so that they can be sold into the market through underwriters. The CDOs are rated as senior tranches, or those of AAA rated quality, followed by mezzanine ratings, and finally the lowest rated equity tranches.
Rating agencies were unable to keep up with the demand for CDOs and were too optimistic in their ratings of the securities. This was confounded by a misuse of portfolio theory when groups of securities with similar ratings on their own were given higher ratings when combined into a CDO tranche.
- 21) B
- 22) A
- 23) B
- 24) C
- 25) A
- 26) D
- 27) FALSE
- 28) TRUE
- 29) TRUE
- 30) TRUE
- 31) TRUE

Answer Key

Testname: UNTITLED4

- 32) TARP is the Troubled Asset Recovery Program and was a \$700 billion U.S. federal program designed rescue or "bail out" U.S. banks and their insurers deemed "too big to fail." The basic premise was if these banks and their insurers failed this would lead to the failure of many other financial institutions and ultimately several non-financial institutions.

In times of greatest financial stress the federal government can provide the capital and safety net to stem a financial meltdown. One could argue that most of the \$700 billion has been recovered by the federal government and that the U.S. banking system seems to have recovered more quickly and effectively than other countries allowing markets to move on from the financial crisis of 2008-2009.

- 33) A
- 34) D
- 35) C
- 36) B
- 37) C
- 38) C
- 39) D
- 40) A
- 41) FALSE
- 42) TRUE
- 43) FALSE
- 44) FALSE
- 45) TRUE
- 46) TRUE
- 47) FALSE