ECON UN3265: Money and Banking

Summer 2026 — Practice Quiz

Chapter 9 — Practice Quiz

How to use this quiz. These multiple-choice questions are based on the Chapter 9 practice questions and applied problems on banking and management of financial institutions. The answer key is on the last page.

Questions

1. Why do small banks hold deposits in larger banks?

- **A)** To avoid all reserve requirements and operate without regulation.
- **B)** To earn capital gains on the larger bank's stock.
- **C)** To obtain correspondent banking services such as check clearing, payments, liquidity management, and other services that are costly to provide on their own.
- **D)** Because deposits held at larger banks are counted as bank capital rather than assets.

2. Rank the following bank assets from most liquid to least liquid: commercial loans, securities, reserves, and physical capital.

- **A)** Reserves, securities, commercial loans, physical capital.
- **B)** Commercial loans, reserves, securities, physical capital.
- **C)** Securities, physical capital, reserves, commercial loans.
- **D)** Physical capital, commercial loans, securities, reserves.

3. A bank initially has reserves of $75 million, loans of $525 million, deposits of $500 million, and bank capital of $100 million. If deposits fall by $50 million and the required reserve ratio is 10%, what should the bank do?

- **A)** It needs no action because reserves are still above required reserves after the outflow.
- **B)** It should reduce its bank capital by $50 million because capital must match deposits.
- **C)** It should obtain about $20 million in reserves, for example by borrowing, selling securities, or reducing loans, because reserves fall to $25 million while required reserves are $45 million.
- **D)** It should increase loans by $20 million because loan growth automatically creates required reserves.

4. If a $50 million deposit outflow occurs, which initial balance sheet would a bank prefer: the Question 3 balance sheet with $75 million in reserves and $525 million in loans, or one with $100 million in reserves and $500 million in loans? Why?

- **A)** The Question 3 balance sheet, because fewer reserves always raise liquidity.
- **B)** The balance sheet with $100 million in reserves and $500 million in loans, because after the outflow the bank still has enough reserves to meet the 10% reserve requirement.
- **C)** The two balance sheets are identical because loans and reserves have the same liquidity.
- **D)** The Question 3 balance sheet, because after the outflow it has more reserves than required.

5. If no decent lending opportunity arises and the central bank pays an interest rate on reserves similar to other low-risk investments, should banks be willing to hold large amounts of excess reserves?

- **A)** No, because excess reserves are illegal whenever lending opportunities are weak.
- **B)** No, because reserves always pay exactly zero interest.
- **C)** Yes, because excess reserves can be an attractive low-risk asset when their return is close to other safe alternatives and loan opportunities are poor.

D) Only if banks have negative bank capital.

6. If a bank's ROE is too low because it has too much bank capital, what can it do to raise ROE?

A) Increase capital further, because more capital always raises ROE.
B) Hold only reserves and stop making loans.
C) Reduce capital relative to assets, for example through dividends or stock repurchases, or increase assets and earnings so that the equity multiplier rises.
D) Lower its equity multiplier to zero.

7. Banca Intesa Sanpaolo is told by its regulator that it must increase capital by €5,000,000 and has already planned not to pay dividends this year. What can it do to rectify the situation?

A) It can issue new equity or retain earnings until capital rises by the required amount.
B) It can reduce deposits by €5,000,000, because deposits are bank capital.
C) It can make additional risky loans, because riskier loans automatically count as capital.
D) It can ignore the regulator because dividend policy does not affect capital.

8. Why do equity holders usually care more about ROE than ROA?

A) Because ROA measures only liabilities, while ROE measures only reserves.
B) Because ROE measures the return on the owners' invested equity, which is the return shareholders directly receive.
C) Because ROE is always lower than ROA and therefore more conservative.
D) Because ROA is unrelated to bank profitability.

9. If a bank doubles the amount of its capital while ROA stays constant, what happens to ROE?

A) ROE rises because the equity multiplier doubles.
B) ROE stays exactly the same because ROA and ROE are identical.
C) ROE becomes infinite because capital is larger.
D) ROE falls, roughly by half, because the equity multiplier falls when assets are financed with more equity.

10. What are the benefits and costs to a bank of increasing its bank capital?

A) Benefit: it reduces the chance of insolvency and provides a cushion against losses; cost: it lowers leverage and can reduce ROE.
B) Benefit: it eliminates all default risk; cost: it makes lending illegal.
C) Benefit: it raises ROE mechanically; cost: it eliminates all reserves.
D) Benefit: it increases deposit insurance coverage; cost: it removes the need for supervision.

11. 'Because diversification is desirable for avoiding risk, it never makes sense for a bank to specialize in making specific types of loans.' Is this statement true, false, or uncertain?

A) True, because specialization has no benefit for screening or monitoring.
B) False, because although diversification reduces risk, specialization can create expertise that improves screening and monitoring; banks face a tradeoff.
C) True, because all loan types have exactly the same expected return and risk.
D) False only if the bank holds no capital.

12. Parameshwar's boss believes interest rates will rise and asks whether the bank should make more short-term or long-term loans. What should Parameshwar suggest?

A) Make more short-term or rate-sensitive loans, because they can be repriced upward when interest rates rise.
B) Make only long-term fixed-rate loans, because rising rates increase the value of old fixed-rate loans.
C) Make no loans, because rising rates make all bank lending impossible.

D) Make long-term loans only if they have no collateral.

13. 'Bank managers should always seek the lowest risk possible on their assets.' Is this statement true, false, or uncertain?

A) True, because bank managers should ignore expected returns.
B) False, because managers should balance risk and expected return rather than simply choose the lowest-risk assets.
C) True, because the lowest-risk asset always has the highest return.
D) Uncertain, because risk applies only to liabilities, not assets.

14. When Giancarlo writes a €3,000 check on Intesa Sanpaolo to Alessandra, who deposits it at Unicredit, what happens to the T-accounts after the check clears?

A) Intesa loses €3,000 of reserves and €3,000 of deposits; Unicredit gains €3,000 of reserves and €3,000 of deposits.
B) Both banks gain €3,000 of reserves and deposits.
C) Intesa gains €3,000 of reserves while Unicredit loses €3,000 of deposits.
D) Only bank capital changes; reserves and deposits are unaffected.

15. What happens to reserves at Banca Mediolanum if one person withdraws €1,000 in cash and another person deposits €500 in cash?

A) Reserves rise by €1,500 and deposits rise by €1,500.
B) Reserves fall by €500 and deposits fall by €500 in net terms.
C) Reserves fall by €1,000 but deposits rise by €500, so net deposits are unchanged.
D) There is no effect on reserves because cash is not part of a bank's balance sheet.

16. Victory Bank reports an equity multiplier of 25, while Batovi Bank reports an equity multiplier of 14. Which bank is better prepared to withstand large loan losses?

A) Victory Bank, because a higher equity multiplier means more capital per dollar of assets.
B) Batovi Bank, because a lower equity multiplier means more capital relative to assets and a larger loss cushion.
C) Both are equally prepared because the equity multiplier is unrelated to capital.
D) Neither bank, because an equity multiplier below 30 means insolvency.

17. Barclays has £150 million of fixed-rate assets, £300 million of rate-sensitive assets, £250 million of fixed-rate liabilities, and £200 million of rate-sensitive liabilities. What does gap analysis predict if rates rise by 2 percentage points, and how can the bank reduce interest-rate risk?

A) The gap is -£100 million, so profits fall by £2 million; the bank should increase rate-sensitive assets.
B) The gap is +£100 million, so profits rise by £2 million; the bank can reduce risk by shrinking the gap, such as reducing rate-sensitive assets or increasing rate-sensitive liabilities.
C) The gap is +£500 million, so profits rise by £10 million; no risk remains.
D) The gap is zero, so profits do not change.

Answer Key

1. C 2. A 3. C 4. B 5. C 6. C 7. A 8. B 9. D 10. A 11. B 12. A 13. B 14. A 15. B 16. B 17. B