ECON UN3265: Money and Banking

Summer 2026 — Practice Quiz

Chapter 10 — Practice Quiz

How to use this quiz. These multiple-choice questions are based on the Chapter 10 practice questions and applied problems on economic analysis of financial regulation. The answer key is on the last page.

Questions

1. What was the main reason the EU Bank Recovery and Resolution Directive (BRRD) was introduced after the financial crisis?

- **A)** To eliminate all capital requirements for European banks.
- **B)** To create a framework for resolving failing banks, including bail-ins, while reducing taxpayer-funded bailouts and protecting financial stability.
- **C)** To require all European banks to hold only government bonds.
- **D)** To replace deposit insurance with unlimited shareholder guarantees.

2. Would eliminating or sharply limiting deposit insurance necessarily be a good idea?

- **A)** Yes, because deposit insurance only creates benefits for risky banks and no benefits for depositors.
- **B)** Yes, because financial markets can never suffer from bank runs without deposit insurance.
- **C)** Not necessarily: limiting insurance can reduce moral hazard, but eliminating too much protection can increase bank runs and financial instability.
- **D)** No, because deposit insurance has no effect on bank risk taking.

3. How could higher deposit insurance premiums for banks with riskier assets benefit the economy?

- **A)** They can reduce moral hazard by making risky banks internalize more of the cost of the risk they impose on the insurance fund.
- **B)** They encourage all banks to hold more risky assets because the government pays the premium.
- **C)** They remove the need for capital requirements because premiums always prevent insolvency.
- **D)** They reduce the cost of funding only for the riskiest banks.

4. What are the main costs and benefits of a too-big-to-fail policy?

- **A)** It has no costs because large banks never take excessive risks.
- **B)** It may prevent systemic crises and contagion, but it can also create moral hazard, unfair advantages for large banks, and possible taxpayer costs.
- **C)** It eliminates the need for deposit insurance and bank supervision.
- **D)** It is useful only for small banks and never applies to large financial institutions.

5. Altin has 500,000 ALL in deposits at an insolvent Albanian bank, while deposit insurance covers up to 250,000 ALL. Which resolution method would he prefer? What if his deposits were 200,000 ALL?

- **A)** With 500,000 ALL, he would prefer the payoff method; with 200,000 ALL, he would prefer purchase and assumption.
- **B)** With 500,000 ALL, he would prefer purchase and assumption if all deposits are assumed; with 200,000 ALL, he would be roughly indifferent because both methods should protect him fully.
- **C)** He would always prefer the payoff method because it guarantees unlimited reimbursement.
- **D)** He would always lose his full deposit under both methods.

6. If a country has weak institutions and prevalent corruption, is deposit insurance automatically a good idea?

- **A)** Yes, because deposit insurance removes the need for bank supervision.

B) Yes, because corruption cannot affect a deposit insurance agency.
C) Not automatically: it can protect depositors, but weak supervision and corruption can worsen moral hazard and make the system costly or fragile.
D) No, because deposit insurance can never help depositors in developing economies.

7. During the financial crisis, why might the Irish government have injected capital into commercial banks?

A) To prevent bank failures, restore confidence, avoid contagion, and keep credit flowing through the economy.
B) To force banks to stop lending permanently.
C) To eliminate all private ownership of banks as the main objective.
D) To reduce capital ratios and increase insolvency risk.

8. What special problem do off-balance-sheet activities present to bank regulators, and what have regulators done about it?

A) They can hide or shift risk outside the traditional balance sheet, so regulators have required more disclosure and capital treatment for many off-balance-sheet exposures.
B) They make banks less risky, so regulators ignore them entirely.
C) They affect only shareholders, so they cannot affect depositors or the insurance fund.
D) They are illegal in all modern banking systems.

9. How does the government safety net create both adverse selection and moral hazard problems?

A) Riskier banks may be more attracted to insured funding, and once protected they may take greater risks because depositors have less incentive to monitor them.
B) It makes only safe banks enter the market and forces all risky banks to close.
C) It causes depositors to monitor banks more carefully than they otherwise would.
D) It eliminates all incentives for bank managers to take risk.

10. Why has bank supervision moved away from relying only on capital requirements toward a stronger focus on risk management?

A) Because capital ratios perfectly capture every possible bank risk.
B) Because risks can change quickly and arise from complex or off-balance-sheet activities, so supervisors also evaluate banks' internal controls and risk-management systems.
C) Because risk management is unrelated to bank solvency.
D) Because supervisors no longer care about bank capital.

11. Why might a government bail out commercial banks by injecting capital during a crisis?

A) To stabilize systemically important banks, protect the payments system, reduce panic, and prevent a collapse in lending.
B) To make bank runs more likely.
C) To guarantee that shareholders never suffer any losses.
D) To remove all regulation from the banking system.

12. Why might more competition in financial markets be a bad idea, and would restrictions on competition be clearly better?

A) More competition is always bad, so strict restrictions always improve efficiency.
B) More competition can reduce franchise value and encourage risk taking, but restrictions can also reduce efficiency and raise costs for consumers, so there is a tradeoff.
C) Competition has no effect on risk taking or bank profits.
D) Restrictions on competition eliminate moral hazard completely.

13. How might consumer protection regulations negatively and positively affect a financial intermediary's profits?

A) They can never affect profits because regulation applies only to consumers.
B) They may reduce fee income and raise compliance costs, but they may also increase trust, customer retention, and demand for financial services.
C) They always raise profits by eliminating all losses.
D) They always lower profits and never produce any benefit for intermediaries.

14. Oldhat Financial starts with $11 million in capital, $120 million in checkable deposits, $30 million in commercial loans, and $40 million in mortgages. Required reserves are 8%. What does the initial balance sheet imply about capitalization and risk-weighted capital?

A) Assets are $131 million; required reserves are $9.6 million; excess reserves are $51.4 million; the capital-to-asset ratio is about 8.4%, and the risk-weighted capital ratio is about 22% if commercial loans receive 100% weight and mortgages 50%.
B) Assets are $120 million; required reserves are zero; the capital-to-asset ratio is exactly 20%.
C) Assets are $70 million; the bank has no reserves and is immediately insolvent.
D) The bank's risk-weighted capital ratio is negative even before any shock.

15. The next day Oldhat invests $35 million of excess reserves in commercial loans. Mortgage rates then jump, reducing each of its 200 mortgages to a fair value of $99,838. What is the effect on the balance sheet and capital position?

A) The bank gains about $20 million and becomes better capitalized.
B) The mortgages fall to about $19.97 million in total, creating a loss of about $20.03 million; capital becomes about -$9.03 million, so the bank is insolvent.
C) Only deposits change; capital is unaffected by marking mortgages to market.
D) The bank remains fully capitalized because higher interest rates always increase fixed-rate mortgage values.

Answer Key

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