

## Module Quiz 27.1 - Answers

### Question 1

The minimum level of capital a bank needs to maintain, according to its own estimates, models, and risk assessments, is best described as its:

- A) equity capital.
- B) financial capital.
- C) **economic capital.** ✓
- D) regulatory capital.

#### Explanation

Economic capital refers to a bank's own assessment of the minimum level of capital it needs to maintain. Economic capital is often less than regulatory capital, which is the minimum level a bank must maintain to comply with capital adequacy regulations. (LO 27.b)

### Question 2

Which of the following actions in the banking system is most likely intended to address the problem of moral hazard?

- A) **Deposit insurers charge risk-based premiums.** ✓
- B) Banks increase loans to higher-risk borrowers.
- C) Governments implement deposit insurance programs.
- D) Banks increase the interest rates they offer to depositors.

#### Explanation

Charging risk-based premiums is a measure intended to address the problem of moral hazard, which exists when insured parties take greater risks than they would take in the absence of insurance. (LO 27.d)

### Question 3

An investment bank is most likely to earn a trading profit from buying and selling securities if it arranges a:

- A) Dutch auction.
- B) private placement.
- C) best-efforts offering.
- D) **firm commitment offering.** ✓

#### Explanation

With a firm commitment offering, an investment bank buys an entire issue of securities from the issuer and attempts to sell them to the public at a higher price. In a private placement or a best-efforts offering, an investment bank earns fee income rather than trading income. A Dutch auction is a method of price discovery for an initial public offering that does not involve buying and reselling shares. (LO 27.e)

### Question 4

The purpose of a Chinese wall in banking is to:

- A) prevent a bank failure from endangering other banks.
- B) **prevent a bank's departments from sharing information.** ✓
- C) restrict companies from offering both banking and securities services.
- D) restrict companies from engaging in both commercial and investment banking.

#### Explanation

Chinese walls are internal controls to prevent a banking company's commercial banking, securities, and investment banking operations from sharing information. (LO 27.f)

### Question 5

A drawback of the originate-to-distribute banking model is that it has led to:

- A) too little liquidity in certain sectors.
- B) too much liquidity in certain sectors.
- C) **looser credit standards in certain sectors. ✓**
- D) tighter credit standards in certain sectors.

#### Explanation

One drawback to the originate-to-distribute model is that it has led to looser credit standards in certain sectors, such as residential mortgages. A benefit of the model is that it has increased liquidity in certain sectors. (LO 27.h)