Midterm Exam #2
Economics 252 Financial Markets
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There are two parts to this exam. In each of the two parts, answer any seven of the ten questions, four minutes each. For the entire exam, you must answer 14 questions total, 56 minutes total. You have 75 minutes to do the exam. Exam is *not* open book. Use two bluebooks, and put Part I and Part II in separate bluebooks, your name on both bluebooks (as they will be separated and graded separately).

Part I. Answer seven of the ten questions, 4 minutes each.

1. Under Basel I, can a bank remedy a capital deficiency by a. issuing preferred stock? b. issuing common stock?, or c. selling some of its riskier assets and using the proceeds to buy less risky assets in the same asset class? Explain.

2. What inequality relations, if any, are there, between the federal funds rate, the primary discount rate, the secondary discount rate, and the repo rate? Explain.

3. A firm has an investment opportunity that requires it raise $100 million. The firm is convinced that it is essential that it have the whole $100 million to invest. It asks an investment bank to underwrite an issue of shares. Should it ask for a bought deal or a best efforts underwriting? Explain.

4. In investment banking, what is a “tombstone” and why do underwriters do them?

5. What is the difference between a savings bank, a saving and loan, and a credit union?

6. What is home equity insurance, and what are the advantages of settling policies based on home price indices rather than on the selling price of the home?

7. Describe the Lintner model of the dividend-setting behavior of firms. Why did Lintner think firms act this way in deciding on dividends?

8. What is leverage (in the context of the debt on a firm’s balance sheet) and what does it have to do with the probability of bankruptcy of the firm?

9. What is overcollateralization in CMOs?

10. What is Regulation Q and what is its relevance today?

Part II. Answer seven of the following ten questions, 4 minutes each, in a separate bluebook

11. The Oddball mortgage company offers unusual mortgages. One kind is a zero interest rate 30-year mortgage. What is the monthly payment on a $1000 mortgage? Another is a two-month mortgage with an annual interest rate of 1200%. Its first payment is one month from now, its second and last payment is two months from now. What is the monthly payment on a $1000 mortgage? Explain.

12 Companies A and B differ only in their capital structure. A is financed 50 percent debt and 50 percent equity. B is financed 25 percent debt and 75 percent equity. The debt of both companies is risk free. An investor owns 3 percent of the common stock of A. What other investment package, involving only company B, would produce identical cash flows for the investor? Explain.

13. What was Andrew Redleaf's business plan for Sun Country Airlines, and how does this plan relate to principles of behavioral finance?

14. What was the gold standard, and what happened to it and when?

15. What is the difference between an exchange-traded and OTC security?

16. What is "due diligence" in securities underwriting and why is it important?

17. What are reserve requirements and what determines the requirement?

18. What is the difference between a numeraire and a medium of exchange?

19. How is it decided whether a mortgage is "conforming" and why does it matter?

20. What is a closed-end home equity loan?