

## Answer Outline - Multiple Choice Answers at End

ECONOMICS 353

L. Tesfatsion/Fall 2010

EXERCISE 10: 6 Questions (8 Points Total) DUE: Thursday, Dec. 9, 2010, 2:10pm

**\*\*IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT BE ACCEPTED  
– NO EXCEPTIONS\*\***

### EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353 Exercise 10** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to questions Q1 through Q5, below, which are all in multiple choice format.
- (3) Separately complete and turn in an answer sheet for Q6. Be sure to include your name and **353 Exercise 10** on your Q6 answer sheet.
- (4) Each question Q1 through Q5 is worth 1 point, and Q6 is worth 3 points.

**Q1 (1 Point).** A key DISTINCTION between the lending policies of microcredit banks (e.g., the Grameen Bank) and the lending policies of traditional banks is that

- A. loans are forgiven if a borrower runs into financial difficulty.
- B. loans are typically made over long periods of time.
- C. borrowers are not required to put up collateral.
- D. no behavioral restrictions are imposed on borrowers.

**Q2 (1 point).** A major DISTINCTION between the U.S. banking sector and the banking sectors of many of the U.S.'s major trading partners is that

- A. foreign branch banking is not permitted in the U.S.
- B. the U.S. banking sector is less concentrated.
- C. the U.S. central bank is less politically independent of the executive branch.
- D. all of the above.
- E. only B and C.

**Q3 (1 Point).** A CENTRAL BANKING SYSTEM was not firmly established in the U.S. until the \_\_\_\_ due to \_\_\_\_.

- A. 1982 Depository Institutions Act; the efficiency of free banking.
- B. the National Banking Act of 1863; domination by northern states.
- C. 1933 Glass-Steagall Act; persistent concerns about states' rights.
- D. 1913 Federal Reserve Act; persistent hostility to centralized authority.

**Q4 (1 Point).** From 1933 through 1994, key characteristics of the U.S. banking system included

- A. the centralization of regulatory oversight within a single agency.
- B. the prohibition of bank branching across state lines
- C. the required separation of commercial banking and securities activities.
- D. only B and C of the above.

**Q5 ( 1 Point).** The regulatory system that has evolved in the United States whereby banks are chartered either at the state level or the national level is known as a

- A. dual banking system
- B. discretionary banking system
- C. two-tiered regulatory system
- D. none of the above

**Q6 ( 3 Points).** *In your own words*, provide a summary discussion (maximum one page) of the **Dodd-Frank Wall Street Reform and Consumer Protection Act**. Be sure to explain in your discussion:

1. Part A: The *purpose* of the act;
2. Part B: A brief discussion of at least *three key provisions* of the act;
3. Part C: A brief discussion comparing and contrasting the Dodd-Frank Act with the Sarbanes-Oxley (SOX) Act of 2002.

## Answer Outline for Q6:

### *Q6.A Purpose of the Dodd-Frank Act:*

As stated in Ref.[1], the purpose of the Dodd-Frank Act of 2010 is to “create a sound economic foundation to grow jobs, protect consumers, rein in Wall Street and big bonuses, end bailouts and too big to fail, and prevent another financial crisis.”

### *Q6.B Three Key Dodd-Frank Act Provisions:*

According to Ref.[1], three key provisions of the Dodd-Frank Act of 2010 are as follows:

- 1. Consumer Protection:** Create a new independent watchdog, housed at the Fed, with authority to ensure American consumers receive clear, accurate financial information.
- 2. End Too Big to Fail Bailouts** End the possibility that taxpayers will be asked to write a check to bail out financial firms that threaten the economy by: creating a safe way to liquidate failed financial firms; imposing tough new capital and leverage requirements that make it undesirable to get too big; updating the Fed’s authority to allow system-wide support but no longer prop up individual firms; and establishing rigorous standards and supervision to protect the economy and American consumers, investors, and businesses.
- 3. Advance Warning System** Create a council to identify and address systemic risks posed by large, complex companies, products, and activities before they threaten the stability of the economy.

### *Q6.C Comparison/Contrast with SOX Act of 2002:*

Both the SOX Act of 2002 and the Dodd-Frank Act of 2010 were enacted in direct response to a financial crisis. However, the financial crisis preceding the SOX Act was the Enron scandal [2]. The SOX Act was meant to close various loopholes in corporate governance, accounting practices, and market trading rules that had permitted Enron to game the California electric power market design through exploitation of principal-agent (moral hazard) problems arising from the separation of ownership and control of assets. In particular, these loopholes had permitted Enron executives (for a while) to make very high returns through highly risky (and in some cases illegal) activities hidden from their shareholders and from the Securities and Exchange Commission (SEC). Consequently, most of the provisions of the SOX Act involve requirements placed on the corporate executives of an individual company in an attempt to ensure more transparent operations and better risk management practices for that individual company.

In contrast, the Dodd-Frank Act of 2010 was developed in response to the financial crisis of 2007-2010. A key factor triggering this crisis was the build up of “systemic risk” in the financial system through the (legal) financial practices carried out by numerous individual financial companies. By *systemic risk* is meant risk that affects an entire financial market or system and not just specific individual participants. In consequence, the scope of the Dodd-Frank Act is much broader and far-reaching than the SOX Act, encompassing protections for consumers, investors, and businesses. In particular [Q6.B], the Dodd-Frank Act attempts to bring transparency to financial system operations as a whole, permitting regulators to obtain warnings in advance concerning the build-up of systemic risk and giving these regulators tools to help prevent this build-up.

### **References:**

- 1** U.S. Senate Banking Committee, “Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act,” [http://banking.senate.gov/public/\\_files/070110\\_Dodd\\_Frank\\_Wall\\_Street\\_Reform\\_comprehensive\\_summary\\_Final.pdf](http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf)
- 2** L. Tesfatsion, “The Enron Scandal and Moral Hazard,” on-line  
<http://www.econ.iastate.edu/classes/econ353/tesfatsion/enron.pdf>
- 3** L. Tesfatsion, “Notes on Mishkin Chapters 11/12:Part A,” on-line,  
html version ([www.econ.iastate.edu/classes/econ353/tesfatsion/Mish1112a.htm](http://www.econ.iastate.edu/classes/econ353/tesfatsion/Mish1112a.htm)) and  
ppt version ([www.econ.iastate.edu/classes/econ353/tesfatsion/Mish1112a.pdf](http://www.econ.iastate.edu/classes/econ353/tesfatsion/Mish1112a.pdf)).

### **Multiple Choice Answers for Q1-Q5:**

Q1-C, Q2-B, Q3-D, Q4-D, Q5-A