Foundations of Financial Markets and Institutions, 4e **(Fabozzi/Modigliani/Jones)**
Chapter 2 Financial Institutions, Financial Intermediaries, and Asset Management Firms

Multiple Choice Questions

1 Financial Institutions

1) Financial enterprises, more popularly referred to as financial institutions, provide a variety of services. Which of the below is NOT one of these?
A) Transform financial assets acquired through the market and constituting them into a different, and more widely preferable, type of asset–which becomes their liability.
B) Exchange financial assets on behalf of customers but not for their own accounts.
C) Manage the portfolios of other market participants.
D) Assist in the creation of financial assets for their customers, and then sell those financial assets to other market participants.
Answer: B
Comment: Financial enterprises exchange financial assets both on behalf of customers **and for their own accounts**.
Diff: 2
Topic: 2.1 Financial Institutions
Objective: 2.1 the business of financial institutions

2) Financial intermediaries include ________ that acquire the bulk of their funds by offering their liabilities to the public mostly in the form of deposits; insurance companies, pension funds, and finance companies.
A) depository institutions
B) utilities
C) initial public offerings
D) preferred equity instrument.
Answer: A
Diff: 1
Topic: 2.1 Financial Institutions
Objective: 2.1 the business of financial institutions

3) Some nonfinancial enterprises have subsidiaries that provide financial services. These financial institutions are called ________.
A) free finance companies.
B) captive finance companies.
C) captive investment companies.
D) captive finance shares.
Answer: B
Comment: Some nonfinancial enterprises have subsidiaries that provide financial services. For example, many large manufacturing firms have subsidiaries that provide financing for the parent company's customer. These financial institutions are called **captive finance companies**. Examples include General Motors Acceptance Corporation (a subsidiary of General Motors) and General Electric Credit Corporation (a subsidiary of General Electric).
Diff: 2
Topic: 2.1 Financial Institutions
Objective: 2.1 the business of financial institutions

4) Depository institutions include ________.
A) commercial banks.
B) savings and loan associations.
C) savings banks and credit unions.
D) All of these
Answer: D
Diff: 1
Topic: 2.1 Financial Institutions
Objective: 2.1 the business of financial institutions

2 Role of Financial Intermediaries

1) Financial intermediaries get funds by issuing financial claims against themselves to market participants, and then investing those funds. The investments made by financial intermediaries can be in ________.
A) loans but not in securities.
B) securities but not in loans.
C) loans and/or securities.
D) only equity.
Answer: C
Diff: 1
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.2 the role of financial intermediaries

2) Financial intermediaries play the basic role of transforming financial assets that are less desirable for a large part of the public into other financial assets (their own liabilities) which are more widely preferred by the public. This transformation involves at least one of four economic functions. Which of the below is NOT one of these functions?
A) providing maturity intermediation
B) enhancing risk via diversification
C) reducing the costs of contracting and information processing
D) providing a payments mechanism
Answer: B
Comment: Financial intermediaries play the basic role of transforming financial assets that are less desirable for a large part of the public into other financial assets (their own liabilities) which are more widely preferred by the public. This transformation involves at least one of four economic functions: (1) providing maturity intermediation, (2) **reducing** risk via diversification, (3) reducing the costs of contracting and information processing, and (4) providing a payments mechanism.
Diff: 2
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.2 the role of financial intermediaries

3) The commercial bank by issuing its own financial claims transforms a longer-term asset into a shorter-term one by giving the borrower a loan for the length of time sought and the investor/depositor a financial asset for the desired investment horizon. This function of a financial intermediary is called ________.
A) diversification.
B) maturity intermediation.
C) information processing costs.
D) providing payment mechanisms.
Answer: B
Diff: 2
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.4 how financial intermediaries transform the maturity of liabilities and give both short-term depositors and longer-term, final borrowers what they want

4) The economic function of financial intermediaries that transforms more risky assets into less risky ones is called ________.
A) diversification.
B) maturity intermediation.
C) information processing costs.
D) providing payment mechanisms.
Answer: A
Diff: 1
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.5 how financial intermediaries offer investors diversification and so reduce the risks of their investments

5) The costs of writing loan contracts are referred to as ________.
A) asset costs.
B) loan costs.
C) information processing costs.
D) contracting costs.
Answer: D
Comment: The costs of writing loan contracts are referred to as **contracting costs**. There is also another dimension to contracting costs, the cost of enforcing the terms of the loan agreement.
Diff: 2
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.6 the way financial intermediaries reduce the costs of acquiring information and entering into contracts with final borrowers of funds

6) Which of the below statements is FALSE?
A) Investors purchasing financial assets should take the time to develop skills necessary to understand how to evaluate an investment and then apply these skills to the analysis of specific financial assets that are candidates for purchase (or subsequent sale).
B) Investors who want to make a loan to a consumer or business will need to write the loan contract (or hire an attorney to do so). Although there are some people who enjoy devoting leisure time to this task, most prefer to use that time for just that–leisure.
C) In addition to the opportunity cost of the time to process the information about the financial asset and its issuer, there is the cost of acquiring that information. All these costs are called contracting costs.
D) One dimension to contracting costs involves the cost of enforcing the terms of the loan agreement.
Answer: C
Comment: In addition to the opportunity cost of the time to process the information about the financial asset and its issuer, there is the cost of acquiring that information. All these costs are called **information processing costs**.
Diff: 3
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.6 the way financial intermediaries reduce the costs of acquiring information and entering into contracts with final borrowers of funds

3 Overview of Asset/Liability Management for Financial Institutions

1) To understand the reasons managers of financial institutions invest in particular types of financial assets and the types of investment strategies they use, it is necessary to have a general understanding of the ________ that they face.
A) investment/employee problem
B) risk management /dividend problem
C) shot-term/long-term asset problem
D) asset/liability problem
Answer: D
Diff: 3
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.8 the nature of the management of assets and liabilities by financial intermediaries

2) The objective of a ________ is to earn a positive spread between the assets it invests in (what it has sold the money for) and the costs of its funds (what it has purchased the money for).
A) limited partnership
B) corporation
C) life insurance company
D) depository institution
Answer: D
Diff: 2
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.8 the nature of the management of assets and liabilities by financial intermediaries

3) Which of the below statements is FALSE?
A) The nature of the liabilities dictates the investment strategy a financial institution will pursue.
B) The objective of a depository institution is to earn a positive spread between the assets it invests in (what it has sold the money for) and the costs of its funds (what it has purchased the money for).
C) Life insurance companies and, to a certain extent, property and casualty insurance companies are in the spread business.
D) Pension funds are in the spread business in that they do not raise funds themselves in the market.
Answer: D
Comment: Pension funds are **not** in the spread business in that they do not raise funds themselves in the market.
Diff: 1
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.8 the nature of the management of assets and liabilities by financial intermediaries

4) Which of the below statements is TRUE?
A) For Type-II Liabilities**,** both the amount and the timing of the liabilities are known with certainty
B) By the liabilities of a financial institution, we mean the amount and timing of the cash outlays that must be made to satisfy the contractual terms of the obligations issued.
C) When we refer to a cash outlay as being uncertain, we mean that it cannot be predicted.
D) Type-I Liabilities, the amount of cash outlay is known, but the timing of the cash outlay is uncertain.
Answer: B
Comment: **For Type-I Liabilities**, both the amount and the timing of the liabilities are known with certainty. **Type-II Liabilities**, the amount of cash outlay is known, but the timing of the cash outlay is uncertain. When we refer to a cash outlay as being uncertain, we do **not mean** that it cannot be predicted.
Diff: 3
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.9 how different financial institutions have differing degrees of knowledge and certainty about the amount and timing of the cash outlay of their liabilities

5) With this type of liability, the timing of the cash outlay is known, but the amount is uncertain.
A) Type-I Liabilities
B) Type-II Liabilities
C) Type-III Liabilities
D) Type-IV Liabilities
Answer: C
Diff: 2
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.9 how different financial institutions have differing degrees of knowledge and certainty about the amount and timing of the cash outlay of their liabilities

4 Concerns of Regulators

1) ________ is a broadly used term to describe several types of risk.
A) Credit risk
B) Settlement risk
C) Counterparty risk
D) Market risk
Answer: A
Diff: 2
Topic: 2.4 Concerns of Regulators
Objective: 2.11 concerns regulators have with financial institutions

2) ________ is the risk that a counterparty in a trade fails to satisfy its obligation.
A) Liquidity risk
B) Settlement risk
C) Counterparty risk
D) Market risk
Answer: C
Diff: 2
Topic: 2.4 Concerns of Regulators
Objective: 2.11 concerns regulators have with financial institutions

3) Because of uncertainty about the timing and/or the amount of the cash outlays, a financial institution must be prepared ________.
A) to have sufficient cash to satisfy its obligations.
B) to have sufficient projects to satisfy its capital budget constraints.
C) to have sufficient risk to satisfy its obligations.
D) to have sufficient risk to satisfy its conservative investors.
Answer: A
Diff: 1
Topic: 2.4 Concerns of Regulators
Objective: 2.10 why financial institutions have liquidity concerns

4) ________ is the risk to a financial institution's economic well-being that results from an adverse movement in the market price of assets it owns.
A) Credit risk
B) Settlement risk
C) Funding liquidity risk
D) Market risk
Answer: D
Diff: 2
Topic: 2.4 Concerns of Regulators
Objective: 2.5 how financial intermediaries offer investors diversification and so reduce the risks of their investments

5) ________ is the risk that the financial institution will be unable to obtain funding to obtain cash flow necessary to satisfy its obligations.
A) Funding liquidity risk
B) Credit risk
C) Settlement risk
D) Market risk
Answer: A
Diff: 2
Topic: 2.4 Concerns of Regulators
Objective: 2.10 why financial institutions have liquidity concerns

5 Asset Management Firms

1) Which of the following statements is FALSE?
A) Asset management firms manage the funds of individuals, businesses, endowments and foundations, and state and local governments.
B) Asset management firms are ranked semi-annually by *Pension & Investments* with the ranking based on the number of liabilities under management.
C) Asset management firms are either affiliated with some financial institution (such as a commercial bank, insurance company, or investment bank) or are independent companies.
D) Larger institutional clients seeking the services of an asset management firm typically do not allocate all of their assets to one asset management firm.
Answer: B
Comment: Asset management firms are ranked **annually** by *Pension & Investments* with the ranking based on the number of **assets** under management.
Diff: 2
Topic: 2.5 Asset Management Firms
Objective: 2.12 the general characteristics of asset management firms

2) ________ seeking the services of an asset management firm typically do not allocate all of their assets to one asset management firm firm.
A) Smaller institutional clients
B) Larger institutional clients
C) Depository institutions
D) GIC institutions
Answer: B
Diff: 1
Topic: 2.5 Asset Management Firms
Objective: 2.12 the general characteristics of asset management firms

3) Asset management firms receive their compensation ________ from management fees charged based on the market value of the assets managed for clients.
A) primarily
B) secondarily
C) totally
D) to a minor extent
Answer: A
Diff: 2
Topic: 2.5 Asset Management Firms
Objective: 2.12 the general characteristics of asset management firms

4) Which of the below is NOT one of the types of funds managed by asset management firms?
A) Deregulated investment companies
B) Insurance company funds
C) Separately managed accounts for individuals and institutional investors
D) Pension and hedge funds.
Answer: A
Comment: Types of funds managed by asset management firms include: **regulated** investment companies; insurance company funds; separately managed accounts for individuals and institutional investors; pension funds; and hedge funds.
Diff: 2
Topic: 2.5 Asset Management Firms
Objective: 2.13 the types of funds that asset management firms manage

5) There is no universally accepted definition to describe the 9,000 privately pooled investment entities in the United States called ________ that invest more than $1.3 trillion in assets.
A) derivative funds
B) option funds
C) hedge funds
D) asset/liability funds
Answer: C
Diff: 2
Topic: 2.5 Asset Management Firms
Objective: 2.14 what a hedge fund is and the different types of hedge funds

6) The term hedge fund is associated with common characteristics. Which of the below is NOT one of these common characteristics?
A) organized as private investment partnerships or offshore investment corporations
B) use a wide variety of trading strategies involving position-taking in a range of markets
C) employ an assortment of trading techniques and instruments, often including short-selling, derivatives and leverage
D) pay performance fees to their managers; and have an investor base comprising modest-income individuals
Answer: D
Comment: Usually, hedge funds: are associated with the following characteristics: organized as private investment partnerships or offshore investment corporations; use a wide variety of trading strategies involving position-taking in a range of markets; employ an assortment of trading techniques and instruments, often including short-selling, derivatives and leverage; pay performance fees to their managers; and have an investor base comprising **wealthy** individuals and institutions and a relatively high minimum investment limit (set at U.S. $100,000 or higher for most funds).
Diff: 2
Topic: 2.5 Asset Management Firms
Objective: 2.14 what a hedge fund is and the different types of hedge funds

7) There are various ways to categorize the different types of hedge funds. Mark Anson uses the four broad categories. Which of the below is NOT one of these?
A) divergence buying
B) market directional
C) corporate restructuring
D) opportunistic
Answer: A
Comment: There are various ways to categorize the different types of hedge funds. Mark Anson uses the following four broad categories: market directional, corporate restructuring, **convergence trading**, and opportunistic.
Diff: 2
Topic: 2.5 Asset Management Firms
Objective: 2.13 the types of funds that asset management firms manage

True/False Questions

1 Financial Institutions

1) Business entities include nonfinancial and financial enterprises. Nonfinancial enterprises manufacture products (e.g., cars, steel, computers) and/or provide nonfinancial services (e.g., transportation, utilities, computer programming).
Answer: TRUE
Diff: 1
Topic: 2.1 Financial Institutions
Objective: 2.1 the business of financial institutions

2) A financial institution that provides an underwriting service will only on occasion also provide a brokerage and/or dealer service.
Answer: FALSE
Comment: A financial institution that provides an underwriting service **will also typically provide** a brokerage and/or dealer service.
Diff: 1
Topic: 2.1 Financial Institutions
Objective: 2.1 the business of financial institutions

3) Many large manufacturing firms have subsidiaries that provide financing for the parent company's customer. These financial institutions are called captive finance companies.
Answer: TRUE
Diff: 1
Topic: 2.1 Financial Institutions
Objective: 2.1 the business of financial institutions

2 Role of Financial Intermediaries

1) People who work for financial intermediaries (such as a commercial bank and an investment company) include investment professionals who are trained to analyze financial assets and manage them.
Answer: TRUE
Diff: 2
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.2 the role of financial intermediaries

2) Most transactions made today are done with cash more so than payments mechanisms that use checks, credit cards, debit cards, and electronic transfers of funds.
Answer: FALSE
Comment: Most transactions made today are **not done** with cash. Instead, payments are made using checks, credit cards, debit cards, and electronic transfers of funds. These methods for making payments, called **payment mechanisms**, are provided by certain financial intermediaries.
Diff: 1
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.2 the role of financial intermediaries

3) Many large manufacturing firms have subsidiaries that provide financing for the parent company's customer. These financial institutions are called free investment companies.
Answer: FALSE
Comment: Many large manufacturing firms have subsidiaries that provide financing for the parent company''s customer. These financial institutions are called **captive finance companies**.
Diff: 1
Topic: 2.2 Role of Financial Intermediaries
Objective: 2.1 the business of financial institutions

3 Overview of Asset/Liability Management for Financial Institutions

1) In addition to uncertainty about the timing and amount of the cash outlays, and the potential for the depositor or policyholder to withdraw cash early or borrow against a policy, a financial institution has to be concerned with possible reduction in cash inflows.
Answer: TRUE
Diff: 1
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.9 how different financial institutions have differing degrees of knowledge and certainty about the amount and timing of the cash outlay of their liabilities

2) Very few regulations and tax considerations influence the investment policies that financial institutions pursue.
Answer: FALSE
Comment: **Numerous** regulations and tax considerations influence the investment policies that financial institutions pursue.
Diff: 1
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.1 the business of financial institutions

3) For Type-IV Liabilities, both the amount and the timing of the liabilities are known with certainty.
Answer: FALSE
Comment: For Type-I Liabilities, both the amount and the timing of the liabilities are known with certainty.
Diff: 1
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.8 the nature of the management of assets and liabilities by financial intermediaries

4) In regards to Type-IV Liabilities, there are numerous insurance products and pension obligations that present uncertainty as to both the amount and the timing of the cash outlay.
Answer: TRUE
Diff: 1
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.8 the nature of the management of assets and liabilities by financial intermediaries

4   Concerns of Regulators

1) Funding liquidity risk is the risk that the financial institution will be unable to obtain funding to obtain cash flow necessary to satisfy its obligations.
Answer: TRUE
Diff: 1
Topic: 2.4 Concerns of Regulators
Objective: 2.11 concerns regulators have with financial institutions

2) Liquidity risk is the risk that a counterparty in a trade fails to satisfy its obligation.
Answer: FALSE
Comment: **Counterparty risk** is the risk that a counterparty in a trade fails to satisfy its obligation.
Diff: 1
Topic: 2.4 Concerns of Regulators
Objective: 2.11 concerns regulators have with financial institutions

3) An important risk that is often overlooked but has been the cause of the demise of some major financial institutions is value-at risk.
Answer: FALSE
Comment: An important risk that is often overlooked but has been the cause of the demise of some major financial institutions is **operational risk**.

NOTE. **Market risk** is the risk to a financial institution's economic well-being that results from an adverse movement in the market price of assets (debt obligations, equities, commodities, currencies) it owns or the level or the volatility of market prices. There are measures that can be used to gauge this risk. One such measure endorsed by bank regulators is **value-at-risk**, a measure of the potential loss in a financial institution's financial position associated with an adverse price movement of a given probability over a specified time horizon.
Diff: 2
Topic: 2.4 Concerns of Regulators
Objective: 2.11 concerns regulators have with financial institutions

4) Liquidity risk in the context of settlement risk means that the counterparty can eventually meet its obligation, but not at the due date.
Answer: TRUE
Diff: 2
Topic: 2.4 Concerns of Regulators
Objective: 2.10 why financial institutions have liquidity concerns

5 Asset Management Firms

1) A market directional hedge fund is one in which the asset manager retains some exposure to "systematic risk."
Answer: TRUE
Diff: 1
Topic: 2.5 Asset Management Firms
Objective: 2.14 what a hedge fund is and the different types of hedge funds

2) A convergence trading hedge fund is one in which the asset manager positions the portfolio to capitalize on the anticipated impact of a significant corporate event.
Answer: FALSE
Comment: A **corporate restructuring** hedge fund is one in which the asset manager positions the portfolio to capitalize on the anticipated impact of a significant corporate event.
Diff: 1
Topic: 2.5 Asset Management Firms
Objective: 2.14 what a hedge fund is and the different types of hedge funds

3) Risk-arbitrage hedge funds have the broadest mandate of all of the four hedge fund categories.
Answer: FALSE
Comment: **Opportunistic** hedge funds have the broadest mandate of all of the four hedge fund categories.
Diff: 1
Topic: 2.5 Asset Management Firms
Objective: 2.14 what a hedge fund is and the different types of hedge funds

4) Hedge funds use a wide range of trading strategies and techniques in an attempt to earn superior returns.
Answer: TRUE
Diff: 1
Topic: 2.5 Asset Management Firms
Objective: 2.14 what a hedge fund is and the different types of hedge funds

Essay Questions

1 Financial Institutions

1) Describe three of the services that can be provided by financial enterprises.
Answer: Financial enterprises, more popularly referred to as **financial institutions**, provide services related to one or more of the following: **1.** Transforming financial assets acquired through the market and constituting them into a different, and more widely preferable, type of asset–which becomes their liability. This is the function performed by **financial intermediaries**, the most important type of financial institution. **2.** Exchanging of financial assets on behalf of customers. **3.** Exchanging of financial assets for their own accounts. **4.** Assisting in the creation of financial assets for their customers, and then selling those financial assets to other market participants. **5.** Providing investment advice to other market participants. **6.** Managing the portfolios of other market participants.
Diff: 3
Topic: 2.1 Financial Institutions
Objective: 2.1 the business of financial institutions

2 Role of Financial Intermediaries

1) Describe the difference between direct and indirect investments. Cite an example of how an investor in a financial intermediaries makes an indirect investment in an actual entity or company.

Answer: Financial intermediaries obtain funds by issuing financial claims against themselves to market participants, and then investing those funds. The investments made by financial intermediaries–their assets–can be in loans and/or securities. These investments are referred to as **direct investments**. Market participants who hold the financial claims issued by financial intermediaries are said to have made **indirect investments**.

As a first example, consider commercial banks that accept deposits and may use the proceeds to lend funds to consumers and businesses. The deposits represent the IOU of the commercial bank and a financial asset owned by the depositor. The loan represents an IOU of the borrowing entity and a financial asset of the commercial bank. The commercial bank has made a direct investment in the borrowing entity; the depositor (or investor) effectively has made an indirect investment in that borrowing entity.

As a second example, consider an **investment company**, which is a financial intermediary that pools the funds of market participants and uses those funds to buy a portfolio of securities such as stocks and bonds. Investment companies are more commonly referred to as "mutual funds." Investors providing funds to the investment company receive an equity claim that entitles the investor to a pro rata share of the outcome of the portfolio. The equity claim is issued by the investment company. The **portfolio** of financial assets acquired by the investment company represents a direct investment that it has made. By owning an equity claim against the investment company, those who invest in the investment company have made an indirect investment in stocks and bonds of actual companies.

Diff: 3

Topic: 2.2 Role of Financial Intermediaries

Objective: 2.3 the difference between direct and indirect investments

3 Overview of Asset/Liability Management for Financial Institutions

1) By the liabilities of a financial institution, we mean the **amount** and **timing** of the cash outlays that must be made to satisfy the contractual terms of the obligations issued. The liabilities of any financial institution can be categorized according to **four types** where the categorization assumes that the entity that must be paid the obligation will not cancel the financial institution's obligation prior to any actual or projected payout date. Using a table format, name and describe these four types.

Answer:

Liability Type	Amount of Cash Outlay	Timing of Cash Outlay
Type I	Known	Known
Type II	Known	Uncertain
Type III	Uncertain	Known
Type IV	Uncertain	Uncertain

Diff: 3
Topic: 2.3 Overview of Asset/Liability Management for Financial Institutions
Objective: 2.9 how different financial institutions have differing degrees of knowledge and certainty about the amount and timing of the cash outlay of their liabilities

4 Concerns of Regulators

1) The Global Association of Risk Professional (GARP) suggests classifying the major categories of operational risk into five categories according to the cause of the loss event. Name and describe two of these categories.
Answer: The Global Association of Risk Professional (GARP) suggests classifying the major categories of operational risk into five categories according to the cause of the loss event. They are: **1.** Employee: loss events resulting from the actions or inactions of a person who works for a firm. **2.** Business Process: loss events arising from a firm's execution of business operations. **3.** Relationships: loss events caused by the connection or contact that a firm has with clients, regulators, or third parties. This category focuses on the interaction between a firm and other entities; relationship risks involve both parties. **4.** Technology: loss events due to piracy, theft, failure, breakdown, or other disruption in technology, data or information; this category also includes technology that fails to meet the intended business needs. **5.** External: loss events caused by people or entities outside a firm; the firm cannot control their actions." The five categories above apply to nonfinancial entities as well as financial institutions.
Diff: 3
Topic: 2.4 Concerns of Regulators
Objective: 2.11 concerns regulators have with financial institutions

5 Asset Management Firms

1) There is considerable debate on the role of hedge funds in financial markets because of their size and their impact on financial markets that result from their investment strategies. On the positive side, it has been argued that they provide liquidity to the market.Nonetheless, there is a major concern. Identify and discuss this major concern.
Answer: The major concern is the risk of a severe financial crisis (i.e., systemic risk) due to the activities and investment strategies of hedge funds, most notably the employment of excess leverage. The best-known example is the collapse of Long-Term Capital Management (LTCM) in September 1998. Studies of LTCM indicate that it used leverage of 50. This means that for every $1 million of capital provided by investors, LTCM was able to borrow $50 million. The reason why LTCM was able to borrow such a large amount was because lenders did not understand or ignored the huge risks associated with that hedge fund"s investment strategies. The loss of LTCM because of bad bets is not a concern *per se* since the investors in that hedge fund were sophisticated investors who took their chances in the hopes of reaping substantial returns. Rather, the problem was that the real losers of that hedge fund's activities were major commercial banks and investment banking firms that loaned funds to LTCM. In the view of the Federal Reserve, there were potential dire consequences from the potential failure of LTCM and it reacted by organizing a rescue plan for that hedge fund. More recently, in June 2007, there was the collapse of the two hedge funds sponsored by the investment banking firm Bear Stearns: the High-Grade Structured Credit Strategies Enhanced Leverage Fund and the High-Grade Structured Credit Strategies Fund. This required the sponsor, Bear Stearns, to bail out the hedge fund. As a result of the LTCM failure, the President's Working Group on Financial Markets made several recommendations for improving the functioning of hedge funds in financial markets. The major recommendation was that commercial banks and investment banks that lend to hedge funds improve their credit risk management practices.
Diff: 3
Topic: 2.5 Asset Management Firms
Objective: 2.14 what a hedge fund is and the different types of hedge funds

2) Name three of the five types of funds managed by asset management firms.
Answer: Types of funds managed by asset management firms include: regulated investment companies; insurance company funds; separately managed accounts for individuals and institutional investors; pension funds; and hedge funds.
Diff: 2
Topic: 2.5 Asset Management Firms
Objective: 2.13 the types of funds that asset management firms manage