1. What are three characteristics of perfect markets that we do not expect to find in financial markets?
   - Buyers and sellers interact without cost
   - Securities are infinitely divisible
   - Buyers/sellers know true quality of financial instruments

2. A. What two basic types of contracts are sold to financial intermediaries? Give examples of both.
   - Traded = Treasury bills
   - Nontraded = loans

   B. Is the purchase of either type of contract part of a process of “direct finance”?
   - Yes, direct finance = traded contracts
   - ≠ nontraded contracts

3. Would financial intermediaries be necessary if there were no transactions costs? Why?
   - No, financial intermediaries exist to lower transaction costs associated with buying/selling financial instruments. If those costs didn’t exist, then neither would financial intermediaries.

   - Changing one’s behavior as a result of a transaction
   - EX: bungee-jumping now that one has health insurance

   B. Define adverse selection. Give an example.
   - Lenders can’t differentiate between high and low quality borrowers, only those who need money seek loans – how risky are they?
   - EX: high health insurance premiums push only the desperate into the market

5. True/False: When interest rates rise, a bank can justifiably place a higher value on the financial assets that it holds.
   - True

   - Transactions deposits
   - Nontransactions deposits
   - Foreign deposits
   - Borrowed funds
   - Miscellaneous liabilities
   - Equity capital

7. A bank’s sources of funds represent its liabilities and a bank’s uses of funds represent its assets.
8. List the four “miscellaneous” liabilities discussed as a source of bank funds that have grown in importance over the past 25 years.

- Borrowing from the Fed
- Borrowing in the federal funds market
- Borrowing by banks from their foreign branches, parent holding companies, subsidiaries/affiliates
- Repurchase agreements