

# CHAPTER 1

## TRUE/FALSE QUESTIONS

- (T) 1. The purpose of the financial system is to bring savers and borrowers together.
- (F) 2. Businesses are never deficit spending units (DSUs).
- (T) 3. A financial claim is an “IOU” from a deficit spending unit.
- (T) 4. Investment bankers help deficit spending units (DSUs) bring new primary security issues to market.
- (F) 5. Deposits in a credit union by a household are an example of direct finance.
- (F) 6. When a surplus spending units (SSU) owns a financial claim created by financial intermediation, its residual claim is against a deficit spending units (DSU).
- (F) 7. Assets of financial intermediaries include direct financial claims only.
- (F) 8. Finance companies take small consumer deposits and make large consumer loans.
- (T) 9. Liabilities of financial intermediaries are indirect financial claims.
- (T) 10. Direct finance requires a more or less exact match of preferences.
- (F) 11. There must be an equal number of DSUs and surplus spending units (SSUs) in a period.
- (T) 12. Every financial claim appears on two balance sheets.
- (T) 13. Without a financial sector, real investment must be financed internally by the deficit spending unit.
- (T) 14. Depository intermediaries issue claims that are for the most part highly liquid.
- (T) 15. A household is a surplus spending units when income for the period exceeds spending.
- (F) 16. A surplus spending units surplus spending unit (SSU) must hold a claim until its scheduled maturity.
- (T) 17. Financial claims or securities are written for the mutual benefit of both SSU and DSU.
- (F) 18. Deficit spending units (DSUs) and surplus spending units (SSUs) always have some contact with each other in financial markets.
- (T) 19. Commercial banks lend to businesses in direct financial markets.
- (F) 20. “Futures contract” and “forward contract” are interchangeable terms.
- (T) 21. Mortgages are capital market debt securities.

- (T) 22. Households are the major source of funds to the financial system.
- (F) 23. Secondary markets are important because they provide funds directly to deficit spending units (DSUs).
- (F) 24. Primary markets offer liquidity and ways for investors to alter the risk of their portfolios.
- (T) 25. The New York Stock Exchange is an example of an organized exchange.
- (T) 26. The money market provides short-term liquidity; the capital market finances long-term corporate growth.
- (T) 27. Private placements are the simplest form of direct finance.
- (T) 28. Competition among financial intermediaries tends to force interest rates downward.
- (T) 29. Money markets have a greater variety of investors than borrowers.
- (F) 30. Every asset is someone else's liability, but not every liability is someone else's asset.
- (T) 31. All money market instruments are short-term debt.
- (T) 33. The money market is a dealer market, not an exchange, and has no specific location.
- (T) 34. Money market borrowers are small in number compared to money market lenders.
- (T) 35. The money market is a market where liquidity is bought and sold.
- (T) 36. Commercial banks are the major issuer and investor of money market securities.
- (F) 37. Federal funds are the funds provided by the Federal Government for domestic corporations for long-term growth.
- (F) 38. Dealers bring buyer and seller together; brokers make a market.
- (F) 39. OTC markets are not very important any more.
- (T) 40. When a stock is listed on an exchange, members may trade it on the floor of the exchange.
- (T) 41. Primary markets are markets where users of funds raise cash by selling securities to funds suppliers.
- (F) 42. Privately placed securities are usually sold to one or more investment bankers and then resold to the general public.
- (T) 43. Financial institutions such as commercial banks typically have assets that are riskier than their liabilities.

## MULTIPLE CHOICE QUESTIONS

- (b) 1. A surplus spending unit's
- income and expenditures for the period are equal.
  - income for the period exceeds expenditures.
  - expenditures for the period exceed receipts.
  - spending is entirely financed by credit cards
- (c) 2. Which of the following is an example of indirect financing?
- a surplus spending unit (SSU) purchasing a financial claim from a deficit spending unit (SSU) spending unit (DSU)
  - a surplus spending unit (SSU) purchasing a financial claim from a dealer
  - a surplus spending unit (SSU) purchasing a financial claim from a commercial bank
  - a surplus spending unit (SSU) purchasing a financial claim from an underwriter
- (d) 3. Which of the following does not take deposits?
- commercial banks.
  - savings and loan associations.
  - credit unions.
  - finance companies.
- (c) 4. When the financial system has achieved a high degree of efficiency,
- Borrowers are able to finance at the highest possible cost.
  - Surplus spending units are able to receive the lowest return on their savings.
  - Transaction and intermediation costs are low.
  - Lenders will have a limited choice of financial investments.
- (c) 5. An efficient financial system
- eliminates search and transactions costs
  - is a mere theoretical possibility
  - promotes economic growth and social progress
  - depends on high volumes of "direct" transactions
- (a) 6. Pension funds tend to invest in
- higher-yielding long-term securities
  - money market securities exclusively
  - government securities exclusively
  - none of the above
- (d) 7. Financial institutions facilitate the flow of investment funds
- from savers to borrowers
  - from Surplus spending units (SSUs) to deficit spending units (DSUs)
  - from the household sector to the business sector
  - any of the above
- (d) 8. Which sector has been most consistently in a surplus budget position?
- Business
  - Government
  - Foreign
  - Household

- (d) 9. Which of the following are “economic units”?
- households
  - businesses
  - governments
  - all of the above
- (b) 10. Which of the following best describes the "two faces of debt" concept?
- Deficit spending units (DSUs) are sometimes Surplus spending units (SSUs).
  - Every financial asset is someone else’s liability.
  - Intermediaries may own both direct and indirect financial assets.
  - The government is unable to control its federal spending.
- (a) 11. A dealer offers to buy shares of IBM at \$116 and sell to investors at \$118. The “bid” is
- \$116
  - \$118
  - \$2
  - none of the preceding
- (d) 12. Most financial intermediaries:
- issue direct claims and purchase direct financial assets.
  - issue indirect claims and purchase indirect financial assets.
  - purchase large amounts of real, tangible assets.
  - purchase direct financial claims and issue indirect securities.
- (a) 13. Profitability of financial intermediaries derives from all of the following except
- government regulation of interest rates
  - economies of scale
  - ability to manage credit risk
  - control of transactions costs
- (c) 14. Denomination intermediation is best exemplified by
- issuing insured deposits and making risky business loans.
  - bringing together investors of different religions
  - issuing five \$3,000 CDs and making one \$15,000 loan.
  - promising liquidity to surplus spending units (SSUs) while investing the funds long-term
- (a) 15. All but one of the following is comparative advantage of financial intermediaries:
- ability to finance businesses and governments.
  - ability to achieve economies of scale.
  - ability to reduce transaction costs.
  - ability to find confidential information.
- (a) 16. Which of the following would tend to hold corporate bonds in significant amounts?
- life insurance company
  - credit union
  - mutual savings bank
  - commercial bank
- (d) 17. All but one of the following is a standard characteristic of financial claims:
- They are recognized on two balance sheets.
  - They are intangible assets.
  - They are IOU's traded for funds.

- d. They represent ownership of real assets.
- (a) 18. Money market mutual funds are a strong competitor for
- depository institutions.
  - contractual savings institutions.
  - finance companies.
  - the real estate market.
- (d) 19. All of the following are terms for or examples of financial claims except
- bonds.
  - money.
  - loans.
  - commodities.
- (c) 20. Direct finance is best exemplified by
- the purchase of mutual fund shares.
  - depositing in a credit union.
  - borrowing from a friend or relative.
  - employee contributions to a pension fund.
- (a) 21. Surplus spending units (SSUs) are also called
- lenders.
  - borrowers.
  - sellers of securities.
  - balanced budget units.
- (c) 22. During 2008, Bob and Nancy Gutierrez expect total income of about \$225,000 and are budgeting total expenditures of about \$180,000. For this budget period, the Gutierrez family is most specifically a(n)
- deficit spending unit (DSU)
  - business
  - surplus spending unit (SSU)
  - household
- (c) 23. The ease with which a financial claim can be resold is its
- quality.
  - risk.
  - marketability.
  - perpetuity.
- (c) 24. The flow of funds from saving to investment through direct financing involves
- the saver holding the lender's IOU.
  - two separate contracts.
  - the lender holding the borrower's IOU.
  - several different financial institutions.
- (a) 25. Intermediation, or \_\_\_\_ financing, involves \_\_\_\_ financial claim(s) linking surplus spending unit (SSU) and deficit spending unit (DSU) .
- indirect; two
  - direct; two
  - indirect; one

- d. direct; one
- (d) 26. In direct financing the lender
  - a. trades a financial claim for money.
  - b. trades money for a financial claim issued by a financial institution.
  - c. trades money with a broker who owns the financial claims of a borrower.
  - d. trades money for the financial claim of the borrower.
- (c) 27. All but one is associated with direct financing:
  - a. single financial instrument.
  - b. a broker, dealer or investment banker.
  - c. small denominations.
  - d. dominance of governments and businesses as borrowers.
- (b) 28. A sale of an entire security issue to one investor or a small group of investors is
  - a. a dealer arrangement.
  - b. a private placement.
  - c. an underwriting.
  - d. intermediation financing.
- (c) 29. Brokers and dealers work in direct financial markets to
  - a. make commissions.
  - b. minimize the bid-ask spread.
  - c. bring sellers and buyers together.
  - d. underwrite new issues of securities.
- (d) 30. \_\_\_\_\_ merely execute buy or sell orders for their clients; \_\_\_\_\_ “make markets”.
  - a. dealers; brokers
  - b. brokers; investment bankers
  - c. dealers; financial institutions
  - d. brokers; dealers
- (a) 31. Hammond Securities holds an inventory of ABC Corp. stock, buying at \$65.00 and selling at \$67.50. The bid is \_\_\_\_\_; the bid-ask spread is \_\_\_\_\_.
  - a. \$65.00; \$2.50
  - b. \$67.50; \$2.50
  - c. lower than the ask price; higher than the bid price
  - d. higher than the ask price; \$2.50
- (d) 32. The \_\_\_\_\_ price is the highest price offered by the dealer to purchase a given security.
  - a. market
  - b. ask
  - c. offering
  - d. bid
- (c) 33. Acting as matchmaker and earning a commission, the \_\_\_\_\_ is an important component in direct financial markets.
  - a. dealer
  - b. investment banker
  - c. broker
  - d. seller

- (d) 34. All but one describes a dealer involved in direct financial market:
- a. provides liquidity to sellers
  - b. buys and sells from inventory
  - c. earns return from bid-ask spread
  - d. transforms claims
- (a) 35. All but one of the following is associated with investment banking:
- a. Taking deposits.
  - b. Marketing new issues of securities.
  - c. Underwriting securities.
  - d. Completing regulatory paperwork and rendering advice.
- (b) 36. Hollon Securities is underwriting an issue of Llamas Unlimited, Inc. common stock. Hollon will pay LU \$45.00 a share and offer the stock to the public at \$48.00. The direct cost of underwriting the issue is \$1.00 per share. The underwriting spread is
- a. \$4.00 per share.
  - b. \$3.00 per share.
  - c. \$2.00 per share.
  - d. not ascertainable from the information above.
- (a) 37. Most of the financial claims issued by U.S. financial intermediaries are purchased by
- a. the household sector.
  - b. the business sector.
  - c. the government sector.
  - d. the foreign sector
- (d) 38. The best synonym for “financial intermediation” is
- a. direct finance
  - b. investment banking
  - c. market making
  - d. transformation of claims
- (b) 39. An S&L taking short-term deposits and financing local land development is engaging in
- a. speculation.
  - b. maturity intermediation.
  - c. denomination intermediation.
  - d. currency transformation
- (c) 40. Credit risk diversification occurs when
- a. adding loans to the portfolio increases the variability of the loan portfolio.
  - b. loans from similar borrowers are combined in a portfolio.
  - c. adding loans to the portfolio decreases the variability of the loan portfolio.
  - d. combining loans with similar payment patterns in a single portfolio.
- (c) 41. Currency transformation is an important service because
- a. most Surplus spending units (SSUs) want to invest in more than one currency
  - b. all financial institutions operate internationally
  - c. few ordinary investors care to hold claims denominated in foreign currency
  - d. Deficit spending units (DSUs) can’t export unless they borrow in the currency of the importing country

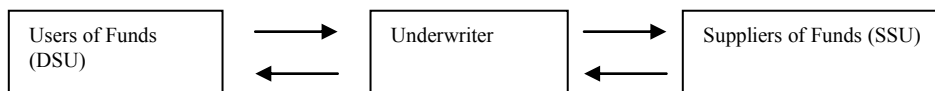
- (d) 42. A commercial bank provides liquidity when it
- pays the check written by a deposit customer.
  - redeems a savings deposit upon demand.
  - makes a loan fulfilling a loan commitment.
  - All of the above.
- (c) 43. Disintermediation is best exemplified by
- purchase of securities.
  - sale of securities.
  - writing a broker a check to pay for a purchase of IBM stock.
  - depositing an insurance settlement with a credit union.
- (b) 44. The only “deposit-type” institutions that do not operate for profit are
- thrift institutions
  - credit unions
  - pension funds
  - commercial banks
- (a) 45. Credit unions are \_\_\_\_\_ institutions; pension funds are \_\_\_\_\_ institutions.
- depository; contractual
  - contractual; depository
  - federal ; investment
  - depository; depository
- (b) 46. The financial institution that is the largest issuer of commercial paper is
- commercial banks.
  - finance companies.
  - property-casualty insurance companies.
  - pension funds.
- (d) 47. Which of the following is not a debt security?
- corporate bonds.
  - U.S. Government securities.
  - federal agency securities.
  - common stock.
- (c) 48. Federal agencies issue high quality securities and invest primarily in claims issued by
- businesses that are “too big to fail”.
  - the U.S. Treasury to finance government deficits.
  - agricultural or housing-related sectors which have limited access to private credit.
  - foreign governments
- (a) 49. Money market instruments and capital market instruments differ appreciably in
- maturity
  - liquidity
  - availability to ordinary individual investors
  - all of the above
- (d) 50. Potential effects of yield fluctuations on security prices and reinvestment income represent
- credit risk.
  - liquidity risk.
  - foreign exchange risk.



- d. interest rate risk.
- (c) 51. Which of the following is NOT an example of capital market securities?
- a. common stocks
  - b. convertible bonds
  - c. commercial paper
  - d. mortgages
- (d) 52. Secondary capital markets have promoted economic growth in the U.S. because
- a. they have increased marketability of stocks and bonds.
  - b. they have increased the public's access to investment.
  - c. they have helped investors diversify.
  - d. all of the above
- (b) 53. Security exchanges provide a valuable function in that they
- a. create interest in stocks.
  - b. increase the marketability of securities.
  - c. provide a legal way to gamble.
  - d. supply money to deficit spending units.
- (d) 54. The difference between “capital spending” and “real investment” is chiefly a difference in
- a. essential nature and purpose of the assets created or acquired
  - b. relative cost of the assets created or acquired
  - c. susceptibility of the assets created or acquired to amortization or depreciation
  - d. semantics
- (a) 55. Primary capital markets are most likely to finance
- a. plant and equipment
  - b. inventory
  - c. operating expenses
  - d. none of the above
- (d) 56. The household sector is the largest surplus sector and invests in the capital market
- a. directly by purchasing stocks and bonds.
  - b. indirectly through mutual funds.
  - c. indirectly through pension funds
  - d. all of the above
- (d) 57. If Boeing splits its outstanding common stock 2-for-1, that is an example of
- a. “primary market” activity
  - b. “secondary market” activity
  - c. “money market” activity
  - d. financial intermediation
- (c) 58. A standardized, exchange-backed contract to deliver assets 3 months from today is a:
- a. forward contract.
  - b. securitized asset.
  - c. futures contract.
  - d. option contract.
- (d) 59. A conditional contract granting its holder the right to buy assets in the future is a:
- a. put.
  - b. forward contract.

- c. futures contract.
  - d. call.
- (c) 60. Money markets are associated with \_\_\_\_; capital markets are associated with
- a. liquidity; marketability.
  - b. spot; future.
  - c. liquidity; economic investment.
  - d. primary; secondary.
- (d) 61. The deficit spending unit (DSU) receives the funds in the primary market; the surplus spending unit (SSU) sells the claim in the
- a. intermediation market.
  - b. direct financial market.
  - c. federal funds market.
  - d. secondary market.
- (b) 62. Which of the following is not a characteristic of money market instruments?
- a. short-term to maturity
  - b. small denomination
  - c. low default risk
  - d. high marketability
- (d) 63. Small investors are likely to invest in the money market \_\_\_\_\_ through \_\_\_\_\_.
- a. directly; commercial paper
  - b. locally; their credit union
  - c. indirectly; negotiable CDs
  - d. indirectly; money market mutual funds
- (a) 64. Which of the following statements about the money market is true?
- a. The money market is a dealer market linked by efficient communications systems.
  - b. Money market transactions are seldom over \$1 million.
  - c. Market transactions include more primary than secondary market trades.
  - d. Most money market transactions are conducted by mail.
- (a) 65. Which of the following may be a liability of a nonfinancial business?
- a. commercial paper
  - b. Federal Funds
  - c. Treasury securities
  - d. agency securities
- (d) 66. Federal Funds are typically
- a. Treasury deposits.
  - b. Federal Reserve assets.
  - c. commercial bank deposits at the Federal Reserve.
  - d. overnight loans settled in immediately available funds.
- (d) 67. The money market is important because
- a. it is the world's liquidity market.
  - b. it is the market in which the Fed conducts monetary policy.
  - c. the federal government finances most of its credit needs in the money market.
  - d. all of the above

- (d) 68. The money market security represented by the largest dollar amount outstanding is
- commercial paper.
  - federal agency issues.
  - negotiable CDs.
  - Treasury bills.
- (c) 69. Which of the following bank money market securities is backed by specified collateral?
- negotiable CDs
  - banker's acceptances
  - repurchase agreements
  - commercial paper(d)
- (d) 71. Large industrial U.S. corporations are involved in the money market by
- investing excess cash balances.
  - buying and selling goods on credit in international trade.
  - issuing commercial papers and short-term corporate notes.
  - all of the above
- (d) 72. Financial markets provide financial institutions:
- a place to securitize assets.
  - a source of generating fee income from trading.
  - a source of funding.
  - all of the above.
- (b) 73. Corporations list their securities on exchanges in order to
- pay an annual listing fee and disclose important information.
  - enhance the liquidity of their securities for investors.
  - sell more securities.
  - increase the size of the firm.
- (b) 74. The diagram below is a diagram of the



- secondary markets
  - primary markets
  - money markets
  - derivatives markets
  - commodities markets
- (c) 75. Match the financial institutions with the characteristic that best describes its function.
- Pool funds of small savers and invest in either money or capital markets
  - Provide economic protection from adverse events
  - Provide consumer loans and real estate loans funded by deposits
  - Underwrite and trade securities and provide brokerage services
  - Accumulate and transfer wealth from work period to retirement period
- Credit unions
  - Insurance companies

3. Pension funds
  4. Securities firms and investment banks
  5. Mutual funds
- a. 1, 3, 2, 5, 4
  - b. 4, 2, 3, 5, 1
  - c. 5, 2, 1, 4, 3
  - d. 2, 4, 5, 3, 1
  - e. 5, 1, 3, 2, 4
- (e) 76. Secondary markets help support primary markets because secondary markets
- a. offer primary market purchasers liquidity for their holdings
  - b. reduce the cost of trading the primary market claims
  - c. help investors diversify portfolios
  - d. update the price or value of the primary market claims
  - e. all above

## ESSAY QUESTIONS

1. Explain financial intermediation and its benefits.

Answer: Financial institutions mediate unmatched preferences of deficit spending units (DSUs) and surplus spending units (SSUs) as to amount, maturity, and risk. Financial intermediaries buy financial claims with one set of characteristics from Deficit spending units (DSUs), then issue their own liabilities with different characteristics to Surplus spending units (SSUs). Thus, financial intermediaries “transform” claims to make them more attractive to both Deficit spending units (DSUs) and Surplus spending units (SSUs). This transformation is the basis for 5 services provided by financial intermediaries:

Denomination Divisibility. Deficit spending units (DSUs) prefer to borrow the full funding need all at once. Surplus spending units (SSUs) tend to save small amounts periodically. Intermediaries pool small savings into large investments.

Currency Transformation. Intermediaries can buy claims denominated in one currency while issuing claims denominated in another. This is difficult for an ordinary SSU.

Maturity Flexibility. Deficit spending units (DSUs) generally prefer longer-term financing. Surplus spending units (SSUs) generally prefer shorter-term investments. Intermediaries can offer different ranges of maturities to both.

Credit Risk Diversification. Intermediaries manage risk by evaluating and holding many different securities. Surplus spending units (SSUs) on their own would have to leave “more eggs in one basket.”

Liquidity. Many claims issued by intermediaries are highly liquid because intermediaries substitute their own liquidity for that of Deficit spending units (DSUs).

Without financial intermediation, funds would flow only when preferences of Surplus spending units (SSUs) and Deficit spending units (DSUs) match closely. Deficit spending units (DSUs) would not always obtain timely financing for attractive projects; Surplus spending units (SSUs) would under-utilize savings. Society’s “production possibilities frontier” would be smaller.

2. Explain how and why the secondary capital markets play an important role in our economy. How do secondary markets assist the primary market?

Answer: Secondary markets provide investors with liquidity and the ability to re-balance their portfolios at any time. Constant trading provides a base for selling additional securities (primary issue) into the market and constant price discovery promotes continuing evaluation and feedback. Secondary markets also enable investors to choose their own holding periods

3. List and briefly describe the main risks managed by financial intermediaries.

Answer:

Credit Risk (or default risk) is the possibility that a borrower may not pay as agreed.

Interest Rate Risk is the likelihood that interest rate fluctuations will change a security's price and reinvestment income.

Liquidity Risk is the possibility that a financial institution may be unable to pay required cash outflows.

Foreign Exchange Risk is the possibility of loss on fluctuations in exchange rates.

Political Risk is the possibility that government action will harm an institution's interests.

4. Discuss the major functions provided by investment banks and security firms.

Answer:

- a. Investing: Investing is managing pools of assets such as mutual funds and trusts.
- b. Investment Banking: Investment banking is underwriting and distributing new issues of debt and equity.
- c. Market Making: Market making is creating a secondary market for securities or contracts.
- d. Trading securities for itself and clients.