Financial Markets and Institutions GLOBAL EDITION (7E)
Chapter 2 Overview of the Financial System

2.1 Multiple Choice

1) Every financial market performs the following function:
A) It determines the level of interest rates.
B) It allows common stock to be traded.
C) It allows loans to be made.
D) It channels funds from lenders-savers to borrowers-spenders.
Answer: D
Question Status: Previous Edition

2) Financial markets have the basic function of
A) bringing together people with funds to lend and people who want to borrow funds.
B) assuring that the swings in the business cycle are less pronounced.
C) assuring that governments need never resort to printing money.
D) both A and B of the above.
E) both B and C of the above.
Answer: A
Question Status: Previous Edition

3) Which of the following can be described as involving direct finance?
A) A corporation's stock is traded in an over-the-counter market.
B) People buy shares in a mutual fund.
C) A pension fund manager buys commercial paper in the secondary market.
D) An insurance company buys shares of common stock in the over-the-counter markets.
E) None of the above.
Answer: E
Question Status: Previous Edition

4) Which of the following can be described as involving direct finance?
A) A corporation's stock is traded in an over-the-counter market.
B) A corporation buys commercial paper issued by another corporation.
C) A pension fund manager buys commercial paper from the issuing corporation.
D) Both A and B of the above.
E) Both B and C of the above.
Answer: B
Question Status: Previous Edition

5) Which of the following can be described as involving indirect finance?
A) A corporation takes out loans from a bank.
B) People buy shares in a mutual fund.
C) A corporation buys commercial paper in a secondary market.
D) All of the above.
E) Only A and B of the above.
Answer: E
Question Status: Previous Edition

6) Which of the following can be described as involving indirect finance?
A) A bank buys a U.S. Treasury bill from one of its depositors.
B) A corporation buys commercial paper issued by another corporation.
C) A pension fund manager buys commercial paper in the primary market.
D) Both A and C of the above.
Answer: D
Question Status: Previous Edition

7) Financial markets improve economic welfare because
A) they allow funds to move from those without productive investment opportunities to those who have such opportunities.
B) they allow consumers to time their purchases better.
C) they weed out inefficient firms.
D) they do all of the above.
E) they do A and B of the above.
Answer: E
Question Status: Previous Edition

8) A country whose financial markets function poorly is likely to
A) efficiently allocate its capital resources.
B) enjoy high productivity.
C) experience economic hardship and financial crises.
D) increase its standard of living.
Answer: C
Question Status: Previous Edition

9) Which of the following are securities?
A) A certificate of deposit
B) A share of Texaco common stock
C) A Treasury bill
D) All of the above
E) Only A and B of the above
Answer: D
Question Status: Previous Edition

10) Which of the following statements about the characteristics of debt and equity are true?
A) They both can be long-term financial instruments.
B) They both involve a claim on the issuer's income.
C) They both enable a corporation to raise funds.
D) All of the above.
E) Only A and B of the above.
Answer: D
Question Status: Previous Edition

11) The money market is the market in which ________ are traded.
A) new issues of securities
B) previously issued securities
C) short-term debt instruments
D) long-term debt and equity instruments
Answer: C
Question Status: Previous Edition

12) Long-term debt and equity instruments are traded in the ________ market.
A) primary
B) secondary
C) capital
D) money
Answer: C
Question Status: Previous Edition

13) Which of the following are primary markets?
A) The New York Stock Exchange
B) The U.S. government bond market
C) The over-the-counter stock market
D) The options markets
E) None of the above
Answer: E
Question Status: Previous Edition

14) Which of the following are secondary markets?
A) The New York Stock Exchange
B) The U.S. government bond market
C) The over-the-counter stock market
D) The options markets
E) All of the above
Answer: E
Question Status: Previous Edition

15) A corporation acquires new funds only when its securities are sold in the
A) secondary market by an investment bank.
B) primary market by an investment bank.
C) secondary market by a stock exchange broker.
D) secondary market by a commercial bank.
Answer: B
Question Status: Previous Edition

16) Intermediaries who are agents of investors and match buyers with sellers of securities are called
A) investment bankers.
B) traders.
C) brokers.
D) dealers.
E) none of the above.
Answer: C
Question Status: Previous Edition

17) Intermediaries who link buyers and sellers by buying and selling securities at stated prices are called
A) investment bankers.
B) traders.
C) brokers.
D) dealers.
E) none of the above.
Answer: D
Question Status: Previous Edition

18) An important financial institution that assists in the initial sale of securities in the primary market is the
A) investment bank.
B) commercial bank.
C) stock exchange.
D) brokerage house.
Answer: A
Question Status: Previous Edition

19) Which of the following statements about financial markets and securities are true?
A) Most common stocks are traded over-the-counter, although the largest corporations have their shares traded at organized stock exchanges such as the New York Stock Exchange.
B) A corporation acquires new funds only when its securities are sold in the primary market.
C) Money market securities are usually more widely traded than longer-term securities and so tend to be more liquid.
D) All of the above are true.
E) Only A and B of the above are true.
Answer: D
Question Status: Previous Edition

20) Which of the following statements about financial markets and securities are true?
A) A bond is a long-term security that promises to make periodic payments called dividends to the firm's residual claimants.
B) A debt instrument is intermediate term if its maturity is less than one year.
C) A debt instrument is long term if its maturity is ten years or longer.
D) The maturity of a debt instrument is the time (term) that has elapsed since it was issued.
Answer: C
Question Status: Previous Edition

21) Which of the following statements about financial markets and securities are true?
A) Few common stocks are traded over-the-counter, although the over-the-counter markets have grown in recent years.
B) A corporation acquires new funds only when its securities are sold in the primary market.
C) Capital market securities are usually more widely traded than longer-term securities and so tend to be more liquid.
D) All of the above are true.
E) Only A and B of the above are true.
Answer: B
Question Status: Previous Edition

22) Which of the following markets is sometimes organized as an over-the-counter market?
A) The stock market
B) The bond market
C) The foreign exchange market
D) The federal funds market
E) all of the above
Answer: E
Question Status: Previous Edition

23) Bonds that are sold in a foreign country and are denominated in that country's currency are known as
A) foreign bonds.
B) Eurobonds.
C) Eurocurrencies.
D) Eurodollars.
Answer: A
Question Status: Previous Edition

24) Bonds that are sold in a foreign country and are denominated in a currency other than that of the country in which they are sold are known as
A) foreign bonds.
B) Eurobonds.
C) Eurocurrencies.
D) Eurodollars.
Answer: B
Question Status: Previous Edition

25) Financial intermediaries
A) exist because there are substantial information and transaction costs in the economy.
B) improve the lot of the small saver.
C) are involved in the process of indirect finance.
D) do all of the above.
E) do only A and B of the above.
Answer: D
Question Status: Previous Edition

26) The main sources of financing for businesses, in order of importance, are
A) financial intermediaries, issuing bonds, issuing stocks.
B) issuing bonds, issuing stocks, financial intermediaries.
C) issuing stocks, issuing bonds, financial intermediaries.
D) issuing stocks, financial intermediaries, issuing bonds.
Answer: A
Question Status: Previous Edition

27) The presence of transaction costs in financial markets explains, in part, why
A) financial intermediaries and indirect finance play such an important role in financial markets.
B) equity and bond financing play such an important role in financial markets.
C) corporations get more funds through equity financing than they get from financial intermediaries.
D) direct financing is more important than indirect financing as a source of funds.
Answer: A
Question Status: Previous Edition

28) Financial intermediaries can substantially reduce transaction costs per dollar of transactions because their large size allows them to take advantage of
A) poorly informed consumers.
B) standardization.
C) economies of scale.
D) their market power.
Answer: C
Question Status: Previous Edition

29) The purpose of diversification is to
A) reduce the volatility of a portfolio's return.
B) raise the volatility of a portfolio's return.
C) reduce the average return on a portfolio.
D) raise the average return on a portfolio.
Answer: A
Question Status: Previous Edition

30) An investor who puts all her funds into one asset ________ her portfolio's ________.
A) increases; diversification
B) decreases; diversification
C) increases; average return
D) decreases; average return
Answer: B
Question Status: Previous Edition

31) Through risk-sharing activities, a financial intermediary ________ its own risk and ________ the risks of its customers.
A) reduces; increases
B) increases; reduces
C) reduces; reduces
D) increases; increases
Answer: B
Question Status: Previous Edition

32) The presence of ________ in financial markets leads to adverse selection and moral hazard problems that interfere with the efficient functioning of financial markets.
A) noncollateralized risk
B) free-riding
C) asymmetric information
D) costly state verification
Answer: C
Question Status: Previous Edition

33) When the lender and the borrower have different amounts of information regarding a transaction, ________ is said to exist.
A) asymmetric information
B) adverse selection
C) moral hazard
D) fraud
Answer: A
Question Status: Previous Edition

34) When the potential borrowers who are the most likely to default are the ones most actively seeking a loan, ________ is said to exist.
A) asymmetric information
B) adverse selection
C) moral hazard
D) fraud
Answer: B
Question Status: Previous Edition

35) When the borrower engages in activities that make it less likely that the loan will be repaid, ________ is said to exist.
A) asymmetric information
B) adverse selection
C) moral hazard
D) fraud
Answer: C
Question Status: Previous Edition

36) The concept of adverse selection helps to explain
A) which firms are more likely to obtain funds from banks and other financial intermediaries, rather than from the securities markets.
B) why indirect finance is more important than direct finance as a source of business finance.
C) why direct finance is more important than indirect finance as a source of business finance.
D) only A and B of the above.
E) only A and C of the above.
Answer: D
Question Status: Previous Edition

37) Adverse selection is a problem associated with equity and debt contracts arising from
A) the lender's relative lack of information about the borrower's potential returns and risks of his investment activities.
B) the lender's inability to legally require sufficient collateral to cover a 100 percent loss if the borrower defaults.
C) the borrower's lack of incentive to seek a loan for highly risky investments.
D) none of the above.
Answer: A
Question Status: Previous Edition

38) When the least desirable credit risks are the ones most likely to seek loans, lenders are subject to the
A) moral hazard problem.
B) adverse selection problem.
C) shirking problem.
D) free-rider problem.
E) principal-agent problem.
Answer: B
Question Status: Previous Edition

39) Successful financial intermediaries have higher earnings on their investments because they are better equipped than individuals to screen out good from bad risks, thereby reducing losses due to
A) moral hazard.
B) adverse selection.
C) bad luck.
D) financial panics.
Answer: B
Question Status: Previous Edition

40) In financial markets, lenders typically have inferior information about potential returns and risks associated with any investment project. This difference in information is called
A) comparative informational disadvantage.
B) asymmetric information.
C) variant information.
D) *caveat venditor*.
Answer: B
Question Status: Previous Edition

41) Which of the following financial intermediaries are depository institutions?
A) A savings and loan association
B) A commercial bank
C) A credit union
D) All of the above
E) Only A and C of the above
Answer: D
Question Status: Previous Edition

42) Which of the following is a contractual savings institution?
A) A life insurance company
B) A credit union
C) A savings and loan association
D) A mutual fund
Answer: A
Question Status: Previous Edition

43) Which of the following are not investment intermediaries?
A) A life insurance company
B) A pension fund
C) A mutual fund
D) Only A and B of the above
Answer: D
Question Status: Previous Edition

44) Which of the following are investment intermediaries?
A) Finance companies
B) Mutual funds
C) Pension funds
D) All of the above
E) Only A and B of the above
Answer: E
Question Status: Previous Edition

45) The government regulates financial markets for two main reasons:
A) to ensure soundness of the financial system and to increase the information available to investors.
B) to improve control of monetary policy and to increase the information available to investors.
C) to ensure that financial intermediaries do not earn more than the normal rate of return and to improve control of monetary policy.
D) to ensure soundness of financial intermediaries and to prevent financial intermediaries from earning less than the normal rate of return.
Answer: A
Question Status: Previous Edition

46) Asymmetric information can lead to widespread collapse of financial intermediaries, referred to as a
A) bank holiday.
B) financial panic.
C) financial disintermediation.
D) financial collapse.
Answer: B
Question Status: Previous Edition

47) Foreign currencies that are deposited in banks outside the home country are known as
A) foreign bonds.
B) Eurobond.
C) Eurocurrencies.
D) Eurodollars.
Answer: C
Question Status: Previous Edition

48) U.S. dollars deposited in foreign banks outside the United States or in foreign branches of U.S. are referred to as
A) Eurodollars.
B) Eurocurrencies.
C) Eurobonds.
D) foreign bonds.
Answer: A
Question Status: Previous Edition

49) Banks providing depositors with checking accounts that enable them to pay their bills easily is known as
A) liquidity services.
B) asset transformation.
C) risk sharing.
D) transaction costs.
Answer: A
Question Status: Previous Edition

50) A ________ is when one party in a financial contract has incentives to act in its own interest rather than in the interests of the other party.
A) moral hazard
B) risk
C) conflict of interest
D) financial panic
Answer: C
Question Status: Previous Edition

51) Fire and casualty insurance companies are what type of intermediary?
A) Contractual savings institution
B) Depository institutions
C) Investment intermediaries
D) None of the above
Answer: A
Question Status: Previous Edition

52) The country whose banks are the most restricted in the range of assets they may hold is
A) Japan.
B) Canada.
C) Germany.
D) the United States.
Answer: D
Question Status: Previous Edition

53) The largest depository institution (value of assets) at the end of 2009 was
A) commercial banks.
B) pension funds.
C) credit unions.
D) mutual funds.
Answer: A
Question Status: New Question

2.2 True/False

1) Every financial market allows loans to be made.
Answer: FALSE
Question Status: Previous Edition

2) An example of direct financing is if you were to lend money to your neighbor.
Answer: TRUE
Question Status: Previous Edition

3) The New York Stock Exchange is an example of a primary market.
Answer: FALSE
Question Status: Previous Edition

4) A bond denominated in euros and issued in a country that uses the euro as its currency is an example of a Eurobond.
Answer: FALSE
Question Status: Previous Edition

5) Most people's involvement with the financial system is through financial intermediaries rather than financial markets.
Answer: TRUE
Question Status: Previous Edition

6) A financial intermediary's risk-sharing activities are also referred to as asset transformation.
Answer: TRUE
Question Status: Previous Edition

7) The process of financial intermediation is also known as direct finance.
Answer: FALSE
Question Status: Previous Edition

8) A mutual fund is not a depository institution.
Answer: TRUE
Question Status: Previous Edition

9) A pension fund is not a contractual savings institution.
Answer: FALSE
Question Status: Previous Edition

10) Equity represents an ownership interest in a firm and entitles the holder to the residual cash flows.
Answer: TRUE
Question Status: Previous Edition

11) Adverse selection refers to those with high credit risks, being most aggressive in their search for funds.
Answer: TRUE
Question Status: Previous Edition

12) The capital market is a financial market in which only short-term debt instruments (generally those with an original maturity of less than one year) are traded.
Answer: FALSE
Question Status: Previous Edition

13) American investors pay attention to only the Dow Jones Industrial Average.
Answer: FALSE
Question Status: Previous Edition

14) The government agency that insures each depositor at a commercial bank, savings and loan association, or mutual savings bank up to a loss of $100,000 per account ($250,000 for individual retirement accounts) is the Securities and Exchange Commission (SEC).
Answer: FALSE
Question Status: Previous Edition

15) Many common stocks are traded over the counter, although a majority of the largest corporations have their shares traded at organized stock exchanges.
Answer: TRUE
Question Status: New Question

16) Many common stocks are traded at organized exchanges, although a majority of the largest corporations have their shares traded over the counter.
Answer: FALSE
Question Status: New Question

17) Corporations that issue new securities to raise capital now conduct more of this business in financial markets in Europe and Asia than in the U.S.
Answer: TRUE
Question Status: New Question

2.3 Essay

1) Distinguish between direct financing and indirect financing.
Question Status: Previous Edition

2) Distinguish between primary markets and secondary markets.
Question Status: Previous Edition

3) Distinguish between money markets and capital markets.
Question Status: Previous Edition

4) Why is it so important for an economy to have fully developed financial markets?
Question Status: Previous Edition

5) Why are financial intermediaries so important to an economy?
Question Status: Previous Edition

6) Describe how over-the-counter markets work.
Question Status: Previous Edition

7) What are adverse selection and moral hazard?
Question Status: Previous Edition

8) Why can a financial intermediary's risk-sharing activities be described as asset transformation?
Question Status: Previous Edition

9) Discuss the differences between depository institutions, contractual savings institutions, and investment intermediaries.
Question Status: Previous Edition

10) What are some of the differences between an organized exchange and an over-the-counter market?
Question Status: New Question