###### 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. Most banks are considered systemically risky under the 2010 Dodd Frank bill.

(F) 7. Sales finance companies specialize in mortgage lending.

(F) 8. Finance companies take small consumer deposits and make large consumer loans.

(T) 9. Liabilities of financial intermediaries often include commercial paper.

(T) 10. Direct finance requires a more or less exact match of preferences between DSUs and SSUs

(F) 11. In the modern financial system, 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 unit (SSU) must hold a claim until its scheduled maturity.

(T) 17. Pension funds transfer spending power from the work period to the retirement period.

(T) 18. SSUs may prefer intermediated financing to direct financing if they are seeking liquidity and safety for their investments.

(T) 19. Commercial banks often lend to businesses in direct financial markets.

(F) 20. “Futures contract” and “forward contract” are identical 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 were created to 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 borrowing 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. Money market instruments are a form of short-term debt.

(T) 33. The money market is a dealer market, not an exchange, and has no specific location.

(T) 34. Most Federal agency financial activity is designed to increase funding and reduce the cost of borrowing for certain targeted sectors of the economy.

(T) 35. The money market is a market where liquidity is bought and sold.

(T) 36. Life insurance liabilities are generally more predictable than property and casualty insurer claims.

(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

a. income and expenditures for the period are equal.

b. income for the period exceeds expenditures.

c. expenditures for the period exceed receipts.

d. spending is entirely financed by credit cards

(c) 2. Which of the following is an example of indirect financing?

a. a surplus spending unit (SSU) purchasing a financial claim from a deficit spending unit (DSU)

b. a surplus spending unit (SSU) purchasing a preexisting financial claim from a dealer

c. a surplus spending unit (SSU) purchasing a financial claim from a commercial bank

d. a surplus spending unit (SSU) purchasing a financial claim from an underwriter

(d) 3. Which of the following does not take deposits?

a. commercial banks.

b. savings and loan associations.

c. credit unions.

d. finance companies.

(c) 4. When the financial system has achieved a high degree of efficiency,

a. Borrowers are able to finance at the highest possible cost.

b. Surplus spending units are able to receive the lowest return on their savings.

c. Transaction and intermediation costs are low.

d. Lenders will have a limited choice of financial investments.

(c) 5. An efficient financial system

a. eliminates search and transactions costs

b. is one that is tightly regulated to eliminate risk

c. promotes economic growth and social progress

d. depends on high volumes of “direct” transactions

(a) 6. Pension funds tend to invest in

a. higher-yielding long-term securities

b. money market securities exclusively

c. government securities exclusively

d. debt securities only

 (d) 7. Financial institutions facilitate the flow of investment funds

a. from savers to borrowers

b. from Surplus spending units (SSUs) to deficit spending units (DSUs)

c. from the household sector to the business sector

d. all of the above

(d) 8. Which sector has been most consistently in a surplus budget position?

a. Business

b. Federal Government

c. Banks

d. Household

(d) 9. Which of the following are “economic units”?

a. households

b. businesses

c. governments

d. all of the above

(b) 10. Which of the following best describes the "two faces of debt" concept?

a. Deficit spending units (DSUs) are sometimes Surplus spending units (SSUs).

b. Every financial asset is someone else’s liability.

c. Intermediaries may own both direct and indirect financial assets.

d. The government is unable to control its federal spending.

(a) 11. A customer wishes to sell stock they own and comes to a dealer. Which of the following would a securities dealer engage in?

a. buying the securities and adding them to their own inventory

b. locating a buyer for their client

c. issuing the stock to the public

d. loaning money to the client

(d) 12. Most financial intermediaries:

a. issue direct claims and purchase direct financial assets.

b. issue indirect claims and purchase indirect financial assets.

c. purchase large amounts of real, tangible assets.

d. purchase direct financial claims and issue indirect securities.

(a) 13. Profitability of financial intermediaries derives from all of the following except

 a. government regulation

b. economies of scale

 c. ability to manage credit risk

 d. control of transactions costs

 (c) 14. Denomination intermediation is best exemplified by

a. issuing insured deposits and making risky business loans.

b. bringing together investors of different religions

c. issuing five $3,000 CDs and making one $15,000 loan.

d. promising liquidity to surplus spending units (SSUs) while investing the funds long-term

(a) 15. All but one of the following is a comparative advantage of financial intermediaries:

a. exploit moral hazard in lending relationships.

b. ability to achieve economies of scale.

c. ability to reduce transaction costs.

d. ability to reduce information asymmetry.

(a) 16. Which of the following would tend to hold the most corporate bonds as a percent of investments?

a. life insurance company

b. credit union

c. mutual savings bank

d. commercial bank

(d) 17. All but one of the following is a standard characteristic of financial claims:

a. They are recognized on two balance sheets.

b. They are intangible assets.

c. 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

a. depository institutions.

b. the stock market.

c. finance companies.

d. the real estate market.

(d) 19. All of the following are terms for or examples of financial claims except

a. bonds.

b. money.

c. loans.

d. commodities.

(c) 20. Of the following, direct finance is best exemplified by

a. the purchase of mutual fund shares.

b. depositing in a credit union.

c. borrowing from a friend or relative.

d. employee contributions to a pension fund.

(a) 21. Surplus spending units (SSUs) are also called

a. lenders.

b. borrowers.

c. sellers of securities.

d. 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)

 a. deficit spending unit (DSU)

 b. business entity

 c. surplus spending unit (SSU)

 d. government entity

(c) 23. The ease with which a financial claim can be resold is its

a. quality.

b. risk.

c. marketability.

d. perpetuity.

(c) 24. The flow of funds from saving to investment through direct financing involves

a. the saver holding the lender's IOU.

b. two separate contracts.

c. the lender holding the borrower's IOU.

d. several different financial institutions.

(a) 25. Intermediation, or \_\_\_\_ financing, involves \_\_\_ financial claim(s) linking surplus spending unit (SSU) and deficit spending unit (DSU) .

a. indirect; two

b. direct; two

c. indirect; one

d. direct; one

(d) 26. A market failure in banking occurs if

a. information asymmetry exists between the borrower and the lender.

b. there is the possibility of moral hazard once the loan is made..

c. there is there is the possibility of adverse selection .

d. one of the above problems prevents the bank from making loans in a given market.

(b) 27. The adverse selection problem in lending occurs

a. when information costs are low.

b. when more risky borrowers than safe borrowers seek a loan.

c. when a borrower engages in riskier activity after a loan is made.

d. bankers refuse to make a loan to a lender.

(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. The moral hazard problem in lending occurs

a. when information costs are low.

b. when more risky borrowers than safe borrowers seek a loan.

c. when a borrower engages in riskier activity after a loan is made.

d. bankers refuse to make a loan to a lender.

.

(d) 30. \_\_\_\_\_\_ execute buy or sell orders for their clients by matching orders with other investors; \_\_\_\_\_\_\_ “make markets”.

a. dealers; brokers

b. brokers; mutual funds

c. dealers; financial institutions

d. brokers; dealers

(b) 31. Second Security Bank accepts ten 6 month deposits of $5,000 each and uses the money to make a 6 month $50,000 loan to a business. This is an example of

a. maturity intermediation

b. denomination intermediation

c. currency transformation

d. credit risk diversification

(a) 32. Third National Bank accepts a 1 month deposits of $5,000 and uses the money to make a 6 month $5,000 loan to a business. This is an example of

a. maturity intermediation

b. denomination intermediation

c. currency transformation

d. credit risk diversification

(c) 33. Acting as matchmaker and earning a commission, the \_\_\_\_\_\_ is an important component in supporting 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 securities holdings

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 providing consulting services.

(d) 36. Which of the following are typical transaction costs in making a loan?

a. Credit evaluation of the lender

b. Cost of monitoring the loan

c. Cost of creating the loan document

d. All of the 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. securities trading

d. currency transformation

(c) 40. Bank credit risk diversification occurs when

a. adding loans to the portfolio increases the liquidity of the loan portfolio.

b. loans are sold to other banks

c. adding loans to the portfolio decreases the variability of the loan portfolio.

d. bank loans are repaid by the borrowers.

(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, but many DSUs need foreign currency claims

 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

a. pays the check written by a deposit customer.

b. redeems a savings deposit upon demand.

c. makes a loan fulfilling a loan commitment.

d. All of the above.

(c) 43. Disintermediation is best exemplified by

a. purchase of securities.

b. sale of securities.

c. taking funds from a bank and buying stock through your broker.

d. depositing an insurance settlement with a credit union.

(b) 44. The only “deposit-type” institutions that do not operate for profit are

 a. thrift institutions

 b. credit unions

 c. pension funds

 d. commercial banks

(a) 45. Credit unions are \_\_\_\_\_ institutions; pension funds are \_\_\_\_\_\_\_ institutions.

a. depository; contractual

b. contractual; depository

c. federal ; money market

d. depository; depository

(b) 46. The financial institution that is the largest issuer of commercial paper is

a. commercial banks.

b. finance companies.

c. property-casualty insurance companies.

d. pension funds.

(d) 47. Which of the following is not a debt security?

a. corporate bonds.

b. U.S. Government securities.

c. federal agency securities.

d. common stock.

 (c) 48. Federal agencies issue high quality securities and invest primarily in claims issued by

a. businesses that are “too big to fail”.

b. the U.S. Treasury to finance government deficits.

c. agricultural or housing-related sectors which have limited access to private credit.

d. foreign governments

(a) 49. Money market instruments and capital market instruments differ appreciably in

 a. maturity

 b. liquidity

 c. safety of principal

 d. all of the above

(d) 50. Potential effects of yield fluctuations on security prices and reinvestment income represent

a. credit risk.

b. liquidity risk.

c. 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. help banks raise funds

b. increase the marketability of securities.

c. provide a legal way to gamble.

d. supply money to deficit spending units.

(c) 54. Elm Street Bank accepts US dollar deposits and uses the money to make loan in euros to one of its corporate customers. This is an example of

a. maturity intermediation

b. denomination intermediation

c. currency transformation

d. credit risk diversification

(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. Thrift institutions include

 a. commercial banks.

 b. pension funds.

 c. federal agencies.

 d. savings associations.

(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. The simultaneous failure of many banks during a financial crisis is called a

a. nonsystemic event.

b. bank run.

c. bank panic.

d. deposit crisis.

(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. directly; 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 still 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. Credit union checking accounts are called

a. commercial paper.

b. share accounts.

c. certificates of deposit.

d. share drafts.

(c) 69. Which of the following bank money market securities is backed by marketable securities as collateral?

a. negotiable CDs

b. banker's acceptances

c. repurchase agreements

d. commercial paper(d)

(d) 71. Large industrial U.S. corporations are involved in the money market by

a. investing excess cash balances.

b. buying and selling goods on credit in international trade.

c. issuing commercial papers and short-term corporate notes.

d. all of the above

(d) 72. Which one of the following is a contractual institution?

a. credit union

b. finance company

c. thrift institution

d. life insurance company

(b) 73. Which of the following institutions provides risk protection from events such as automobile accidents?

a. finance company

b. property and casualty insurer

c. pension fund

d. mutual fund

(b) 74. The diagram below is a diagram of the

Users of Funds (DSU)

Underwriter

Suppliers of Funds (SSU)

 a. secondary markets

 b. primary markets

 c. money markets

 d. derivatives markets

 e. commodities markets

(c) 75. Match the financial institutions with the characteristic that best describes its function.

 I. Pool funds of small savers and invest in either money or capital markets

 II. Provide economic protection from adverse events

 III. Provide consumer loans and real estate loans funded by deposits

 IV. Underwrite and trade securities and provide brokerage services

 V. Accumulate and transfer wealth from work period to retirement period

 1. Credit unions

 2. 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 a. pension funds, b. mutual funds, c. life insurers, d. property and casualty insurers.

 **Answer:**

 a. Transfer purchasing power from an individual’s working years to their retirement years.

 b. Pool investors’ funds and invest in money or capital market instruments, exploiting economies of scale in investing.

 c. Provide income protection to heirs in the event of death of the insured may also provide investing for retirement.

 d. Provide protection from specific insured events such as property damage and liability.

5. Discuss the problem of systemically risky banks. What is a systemically risky bank and what is the government doing to limit the risk from these institutions? Is it likely to work and prevent another financial crisis?

**Answer:** A systemically risky bank is one the federal government has designated as so large and/or interconnected with other institutions that the bank’s failure could imperial the financial system. They are perceived as too big to fail. This creates a moral hazard problem. Investors in these banks may not price the institutions’ risk properly, believing the government would bail them out if necessary. This could encourage these banks to engage in riskier activities than otherwise. The government has increased regulations on risky activities and required these banks to hold more capital as a safeguard. It is also more difficult to bail out banks since the passage of the Dodd-Frank Act. It is not clear whether these actions will be sufficient to prevent another financial crisis.